



Institute of Actuaries of Australia

28 July 2006

Mr J Lonsdale  
Superannuation Retirement and Savings Division  
The Treasury  
Langton Crescent  
**PARKES ACT 2600**

Dear John

**A Plan to Simplify and Streamline Superannuation -  
Our fifth submission: Death and Disablement Benefits**

The attachment to this letter is the fifth of a number of submissions that the Institute will be writing in response to the invitation to comment on the Plan.

This submission has six components –

- 5A. Taxation and preservation requirements for Lump Sum Total and Permanent Disablement Benefits
- 5B. Taxation of Lump Sum Death Benefits
- 5C. Anti Detriment Provisions for Death Benefits
- 5D. Salary Continuance or Total but Temporary Disability Income Benefits
- 5E. Distribution of Lump Sum Death Benefits
- 5F. Adequacy of Lump Sum Death and Total and Permanent Disablement Benefits

Whilst we acknowledge that no changes are proposed to these aspects in the Treasurer's Plan, the Plan will change the environment in which they operate, leading to anomalies. We believe these "knock-on" effects should be dealt with, and this submission makes a series of recommendations accordingly.

We note that in addressing the issues under 5E on the distribution of death benefits, we are conscious that while affecting a minority of people, death benefit distribution is a major issue for those involved; it is usually sensitive and sometimes traumatic. Furthermore, the outcome can be affected by a wide range of circumstances and issues that make establishing simple rules difficult. In this context, our Task Force that prepared this submission have offered some conclusions based on their consideration of the issues.

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However, before pursuing any change we advocate undertaking broader community consultation. We would be please to provide further input to such consultation.

Our proposals are summarised on the first page of the attached submission. They focus on ways in which the system can be amended to achieve, in relation to death and disablement benefits:

- Simplified administration;
- Fairer outcomes for members; and
- Improved access to insurance coverage.

We urge the Treasury to consider carefully these proposals and, as far as possible, either to implement them concurrently with the other parts of the Treasurer's Plan or, if that is not practicable, to put them on the agenda for the next phase of superannuation reforms.

I would be happy to arrange for a member of our Task Force to discuss this submission with you at your convenience.

Yours sincerely

A handwritten signature in black ink, appearing to read 'M A Stevenson', with a stylized flourish at the end.

M A Stevenson  
President

## **The Treasurer's Superannuation Plan – IA Aust Submission**

### **Topic 5 – Taxation, Distribution, Preservation and Adequacy of Death and Disablement Benefits**

This submission comprises six sections. Each is listed below and together with a summary of our proposals put forward in this submission. The details of our proposals are explained and argued in the remainder of the submission.

#### **5A. Taxation and preservation requirements for Lump Sum Total and Permanent Disablement Benefits**

Total and Permanent Disablement Benefits be made on a tax free basis at all ages.

If the Total and Permanent Disablement Benefit is made on a tax free basis, we would also advocate that the ATO adopt a more rigorous process to assess total and permanent disability.

#### **5B. Taxation of Lump Sum Death Benefits**

Align the definitions of Dependant in SIS and the Tax Act. In particular, allow adult children to be considered as dependants.

If no changes are made then grandfathering of some existing pension arrangements with attached reversionary pensions will be necessary.

In cases where a member dies after age 60, either:

(i) Remove the tax differentiation between dependants and non-dependants by making these death benefits tax free.

or

(ii) Tax only the insured component of a death benefit paid to a non-dependant when death occurs after age 60.

If (i) above is adopted, make all death benefits tax free, in order to achieve administrative simplification from the removal of tax differentiation between dependants and non-dependants at all ages.

Reversionary pensions payable to dependants should also be tax free.

#### **5C. Anti Detriment Provisions for Death Benefits**

Remove anti-detriment provisions.

#### **5D. Salary Continuance or Total but Temporary Disability Income Benefits**

We believe clarification of the position is required regarding whether the benefit is a pension or ordinary income, and taxed accordingly.

If it is a pension, its taxation basis will also need to be specified. If the view is taken that the benefit is a pension, then under the Treasurer's Plan there would now be no measurement against RBL. We would expect that the income benefit could be paid tax free to any member over 60 with some tax paid at younger ages. If this is the case then the treatment may be more generous than current practice.

**5E. Distribution of Lump Sum Death Benefits**

We recommend that industry consultation be undertaken to find the most efficient process for the distribution of superannuation death benefits, and to recommend any required amendments to current legislation to accommodate changes.

**5F. Adequacy of Lump Sum Death and Total and Permanent Disablement Benefits**

FBT relief is currently given to employers on insurance premiums for employee temporary disability income benefits. We recommend that this relief be extended to cover premiums for lump sum death and total & permanent disablement.

This approach would 'free up' Member Choice for investments while assisting employers to make coherent arrangements for death and disability benefits for their employees.

## 5A. Taxation and preservation requirements for Lump Sum Total and Permanent Disablement Benefits

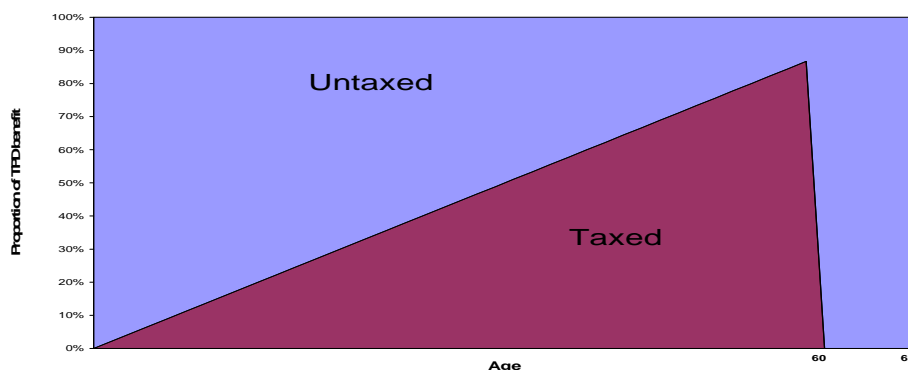
### Background

The Treasurer's Plan proposes continuation of the tax free post June 1994 invalidity component but no further detail is specified. We make the following observations.

*The dovetailing of the invalidity component gives less tax advantage to older members who leave due to total and permanent disablement.*

The invalidity component was designed to give advantage to those who left early due to total and permanent disablement. Its operation allows the part of the member's benefit notionally attributable to future service to be tax free whilst the benefit notionally attributable to past service is taxable. The effect of the invalidity component is therefore to give a tax free benefit to a person disabled at the start of his or her career, dovetailing into the fully taxed benefit at retirement that applied under the old system.

Under the new system benefits are tax free at the start of a member's career and tax free at the end (from age 60). Hence tax on the invalidity component in the interim years increases progressively to age 60, then falls abruptly to zero, as shown in the following illustration.



As can be seen from this illustration, the operation of the invalidity component will therefore disadvantage older disabled workers who under the new tax system may be very close to the point where they could receive tax free benefits.

**Conclusion:** The tax on invalidity benefits has become anomalous under the Treasurer's Plan and should be removed.

***Those taking total and permanent disablement benefits pay more tax than those retiring at age 60. However the disabled may have greater need than other retirees due to increased living costs and a longer retirement phase.***

Analysis of total and permanent disablement statistics from an insurer indicates that two-thirds of those claiming total and permanent disablement benefits do not have a substantially reduced life expectancy. This means that:

- they still require their superannuation benefits to fund what might be a long retirement period;
- they may incur additional living expenses as a consequence of their disablement; and/or
- they may have dependants for whom they are responsible and have no possibility for future employment.

It appears inequitable for this benefit not to be treated on the same basis that would have applied had the member been able to work gainfully up to age 60 and then take a similar benefit on a tax free basis.

**Conclusion:** The case for correcting the anomaly described above is, in our opinion, a very strong one.

***The tax rules treat differently members and their dependants who are in very similar circumstances.***

Death benefits paid to dependants are tax free whilst total and permanent disablement benefits are taxable. In addition, 'anti detriment' payments (see section 5C) are not available on disablement.

Analysis of total and permanent disablement statistics from an insurer suggests that around a third of claims made are from causes that might be expected to result in significant lowering of life expectancy, such as cancer, heart disease and so on. Because these members can be expected to die in the short term, it is reasonable that they be treated in a similar way to those who claim death benefits. However, these members are required to pay tax on their benefits whilst death benefits are tax free.

A disabled person may require funds to set family financial affairs in order before he or she dies. However, if the member dies shortly after the benefit has been paid, the family has suffered additional tax which would not have been payable had the benefit payment been deferred and paid instead as a death benefit.

This is particularly relevant given the recent trend of insurers paying out benefits on the diagnosis of terminal illness. These benefits allow early payout of death benefits as total and permanent disablement benefits on terminal illness. This will result in higher numbers of disablement payments in lieu of death benefits.

**Conclusion:** The anomaly of taxing invalidity benefits is emphasised when considered against the tax arrangements for death benefits.

***The ATO process to establish total and permanent disablement is less rigorous than the processes that Trustees adopt under SIS to pay insured benefits.***

Under the current ATO process, fund members provide sign off from two doctors to the Trustee in order for them to be considered permanently disabled for tax purposes. This allows their benefit to be released before age 55 under SIS and allows a tax benefit from the invalidity component. For a total and permanent disablement benefit to be paid the member must also comply with the fund's definition of Total and Permanent Disablement. For this Trustees generally adopt a more rigorous process typically involving reports from doctors, specialists, and occupational experts. As we are recommending a tax free benefit on Total and Permanent Disablement it is reasonable for the ATO to seek a higher level of proof that the fund member is in fact totally and permanently disabled.

**Conclusion:** There is a case for the ATO to introduce a more rigorous process for establishing total and permanent disability.

***Total and permanent disablement benefits normally represents quite a small proportion of total benefits paid from a superannuation fund.***

**Conclusion:** removing tax on total and permanent disablement benefits should have a negligible effect on revenue.

## **Recommendations**

- 1. Permanent disablement benefits be made on a tax free basis at all ages.**
- 2. The ATO to adopt a more rigorous process to assess permanent disablement.**

These measures would provide equity between those who need to take a permanent disablement benefit, those who die leaving dependants and those who retire after age 60. It is more generous than at present but, in the context of the Treasurer's Plan where retirement benefits may be taken tax free to age 60, it is more logical and equitable than the status quo (which is proposed to continue and which favours younger members over older members).

## **5B. Taxation of Lump Sum Death Benefits and Reversionary Pensions**

### **Background**

*There are differences in the definitions of Dependant under SIS and under the Tax Act.*

The main points of difference are that adult children are considered as Dependants under SIS but are not considered as Dependants under the Tax Act. Conversely, an ex-spouse is not automatically considered a Dependant under SIS whereas an ex-spouse is considered a Dependant under the Tax Act.

A further difference exists in relation to anti-detriment provisions as the definition of Dependant for the operation of anti-detriment does not include Interdependency relationships (whereas the tax definition does include interdependency in relation to death benefit taxes).

This means that an interdependent may receive a tax free death benefit but is not eligible for an anti-detriment payment.

Conversely, an adult child, who must generally pay tax on the death benefit, is eligible to receive an anti-detriment payment. Please note it could be argued that anti-detriment should not have applied in cases where tax was not previously paid on death benefits.

Currently on the death a member a reversionary pension can be paid to a dependant in which the SIS Act definition of dependant applies.

The new proposals indicate that the Tax Act definition of dependant will apply in future and that a pension would not be able to revert to a non-dependant on death.

This will be inconsistent with some arrangements already in place and in the absence of any other changes we suggest grandfathering the existing pension contracts.

**Conclusion:** Differences in the definitions of dependant are problematical and should be rationalised.

*Large tax differentials based on unclear definitions lead to avoidance strategies and additional work for Trustees who need to adjudicate on the conditions.*

Where there are large differentials in taxation based on unclear definitions, there may be tax planning strategies to avoid payment. This position favours those who can afford advice.

Where there is a tax differential for a benefit, Trustees need to assess the circumstances. If rules are clear this is relatively straightforward. In some instances, however, Trustees need to adjudicate on some difficult circumstances as to whether or not a person is to be considered a Dependant under the ATO definitions. This takes a disproportionate amount of Trustee time and cost.

***For those with no dependants (including adult children), death benefits are taxed but retirement benefits from age 60 are tax-free.***

Under the Treasurer's Plan, at age 60 a member may fully withdraw a benefit and pay no tax. However, if the member dies after age 60, either before having taken a benefit because the member chose to remain in the workforce, or after having chosen to take a pension in preference to a lump sum, tax will be payable on the remaining benefit if paid to a non-dependant (including adult children).

After age 60 any insured component of a death benefit is likely to be very small. The death benefit paid is therefore in most cases the same amount as the member's retirement benefit which could be taken tax free.

Consider the case of a couple who choose to keep their savings within the superannuation environment, for example as an allocated pension. On the death of the first partner there can be a seamless transition with the pension transferring to the surviving spouse. However, on the death of the surviving spouse now, if the benefit is then paid to an adult child, there will be tax payable. On the other hand, if the surviving spouse had cashed out the superannuation just before death then the benefit could have transferred to the adult child tax free via the estate.

**Conclusion:** Consistency would require taxes on death benefits payable to non-dependants to be eliminated if death occurs after age 60. If any tax is to be payable it should be limited to the insured component for those over 60.

***Discontinuity in tax rules can influence behaviour when applied to elective benefits but exerts no influence in the case of death benefits.***

Under the Treasurer's Plan tax is payable on benefits paid to those who choose to take their benefits at ages between 55 and 60 and this should encourage members to continue in the workplace at least to age 60. In the case of death benefits, there being no choice involved, any tax incentive or discouragement is of course ineffective and so there would appear no reason for the tax payment to discriminate on the basis of age. In particular it could produce inequity for those close to 60.

**Conclusion:** Consistency would require taxes on death benefits payable to non-dependants to be eliminated if death occurs before age 60.

***Inconsistency in the tax treatment of reversionary pensions***

The proposals suggest that from 1 July 2007 the Tax Act definition of dependant, as opposed to the SIS Act definition, will apply for reversionary pensions. This means that in future all reversionary pensioners will be dependants as assessed against the Tax Act.

The proposals suggest that when a pensioner dies, the tax treatment of the reversionary (ongoing) pension will depend on the age of both the original

pensioner and the reversionary pensioner. In brief, when the original pensioner dies:

- the pension will automatically continue to be tax free regardless of the age of the reversionary pensioner if the original pensioner was already over 60; but
- if the original pensioner was not over 60 at death, the pension will only be tax free once the *reversionary* pensioner is over 60.

As in future all reversionary pensioners will be dependants under the Tax Act, we suggest that the reversionary pension should be taxed as if it was a death benefit.

**Conclusion:** The reversionary pension payable to dependants should therefore be tax free irrespective of the age of the original pensioner or the reversionary pensioner.

### Recommendations

- 1. Align the definitions of Dependant in SIS and the Tax Act. In particular, allow adult children to be considered as dependants.**
- 2. If no changes under (1) are made then grandfathering of existing pension arrangements with attaching reversionary pensions will be necessary.**
- 3. In cases where a member dies after age 60, either:**
  - a) Remove the tax differentiation between dependants and non-dependants by making these death benefits tax free.**

**or**

  - b) Tax only the insured component of a death benefit paid to a non-dependant when death occurs after age 60.**

This approach would be justifiable on grounds of equity, recognising that the taxation of death benefits will not cause a modification in behaviour (whereas encouraging a deferred retirement age for retirement benefits can cause behaviour change).

- 4. If 3(a) is adopted extend the removal of the tax differentiation between dependants and non-dependants to all ages by making all death benefits tax free.**

This approach would also have the very real and important advantage of reducing the disproportionate amount of Trustee time taken to establish dependency for tax purposes. It would incidentally resolve any current concerns of uneven treatment for same sex relationships.

- 5. Make reversionary pensions payable to dependants tax free.**

## 5C. Anti-Detriment Provisions for Death Benefits

### Background

These provisions were introduced in 1988 with introduction of the contributions tax. Previously, retirement benefits were taxed but death benefits were tax free.

When contributions tax was introduced ‘anti-detriment’ arrangements were put in place covering death benefits to ensure that members were not disadvantaged by the “bringing forward” of tax from benefits to the contribution payment stage. The provisions aim to return the contributions tax paid to those who claim a death benefit. This was deemed necessary as death benefits were not previously taxed. The new contributions tax arrangement would have otherwise resulted in an additional tax on death benefits.

*These anti-detriment provisions are complex to apply and yet yield only small benefits to recipients. They are often unclaimed as they are largely unknown to members. In the context of the Treasurer’s Plan the provisions may even be viewed as inequitable as they are not available to those claiming total and permanent disablement benefits. These members and their dependants may be in very similar circumstances to the dependants of members who die but under the current tax arrangements are not only required to pay benefits tax, but also are unable to claim anti detriment payments. The effect of these transitional provisions is increasing and there is no sunset clause.*

- **Complex to administer** – Under the Treasurer’s Plan, the anti-detriment provisions remain. The individual calculations required can be complicated and each individual payment must be accounted for by the Trustee in order to reclaim tax. This adds complexity for the administrator of a fund and the gain for members is offset by the cost to the Trustee of recalculating the benefit and reclaiming tax.

Where benefits are paid via an estate, it is possible that the administrator is not aware that the anti-detriment benefit can be claimed. If a claim is made then the costs and complication involved are significant.

- **Members generally unaware of the provisions** – Members are generally unaware of the existence of the anti-detriment provisions.

In view of the complexity involved, it is possible, particularly where benefits are paid to the member’s estate, that many providers do not pay or reclaim anti detriment payments. This is indicated by the fact that one provider has recently introduced anti detriment payments as a new feature of their arrangements and is using this fact as a marketing tool.

- **No “sunset ‘arrangements** – The effects of transitional arrangements are generally designed to reduce over time. In contrast, the impact of anti-detriment is increasing as time progresses and there are no “sunset” arrangements to stop this.

As noted above, these provisions were introduced in 1988 with introduction of the contributions tax. Many new members have joined the superannuation system since then. It could be argued that those who join the superannuation system after 1988

should always have been excluded from the provisions – this essentially means those currently aged under around 40. This avenue could be pursued if Treasury wished to curtail this provision.

- **Anti detriment could be viewed as inequitable** – Very few people would now be aware of the anti detriment provision and its history. In the context of the Treasurer’s Plan the provisions may even be viewed as inequitable as they are not available to those claiming total and permanent disablement benefits. These members and their dependants may be in very similar circumstances to the dependants of members who die but under the current tax arrangements are not only required to pay benefits tax, but also are unable to claim anti detriment payments.
- **Differences in definitions for Dependant that apply for anti-detriment and under SIS result in anomalies** - Interdependency relationships are not included for the purpose of anti-detriment by the ATO (whereas the tax definition does include interdependency in relation to death benefit taxes).

This means that a dependant may receive a tax free death benefit but is not eligible for an anti-detriment payment.

Conversely, an adult child, who must generally pay tax on the death benefit, is eligible to receive an anti-detriment payment. Please note it could be argued that anti-detriment should not have applied in cases where tax was previously paid on death benefits.

**Conclusion:** Removal of anti-detriment provisions is well justified in the context of the proposed major changes and the simplifications that will result.

### **Recommendation**

- **Remove anti-detriment provisions**

We believe that this measure is well justified in the context of the proposed current wide ranging changes..

## **5D. Salary Continuance or Total but Temporary Disability Income Benefits**

### **Background**

There is currently some confusion relating to the taxation of these income benefits within superannuation funds. Some tax advice suggests that the income benefit is a pension and under the current system should be taxed as a pension with a 15% tax rebate with the benefit payments counting towards the member's RBL.

In practice, to our knowledge, this is not the approach taken by superannuation funds. Currently these payments are taxed as member's income and are not counted towards the member's RBL.

### **Clarification Requested**

We believe clarification of the position is required regarding whether the benefit is a pension or ordinary income, and taxed accordingly.

If it is a pension, its taxation basis will also need to be specified.

If the view is taken that the benefit is a pension, then under the Treasurer's Plan there would now be no measurement against RBL. We would expect that the income benefit could be paid tax free to any member over 60 with some tax paid at younger ages. If this is the case then the treatment may be more generous than current practice.

## 5E. Distribution of Lump Sum Death Benefits

### Background

*In the current environment, most members cannot be absolutely sure in advance as to how their death benefits will be distributed.*

Trustees distribute death benefits in line with their Trust Deeds, which commonly require the Trustee to distribute to a member's dependants and, if there are no dependants, then to the member's estate.

There are essentially three methods adopted in distributing benefits: non-binding nominations, binding nominations and payments direct to the estate. We consider each in turn:

- ***Non Binding Nominations – not secure and payments can take a long time to resolve.***

Members may make non-binding nominations setting out their preferred beneficiaries but the Trustee must distribute in line with the Trust Deed. Whilst the member's nomination may be taken into account, the Trustee is not bound by the nomination.

An example where a death benefit was not distributed in line with a member's nomination to his spouse was recently outlined in an article in ***Risk in Practice***. The member had nominated his wife as sole beneficiary but the Trustee ultimately resolved to divide the benefit between the widow and adult children from a previous marriage. The process took almost a year to resolve and in this case there was no SCT involvement.

The Trustee process outlined in the article was in line with the process adopted by many if not all Trustees. This is not therefore an isolated case and there was no inference that the Trustee should have been able to resolve the issue sooner.

By way of illustration, a typical process on receiving notice of the death of a member would be:

- (i) Write to the next of kin and employer requesting a listing and contact details of all those who could be considered dependants under the definitions of the Trust Deed.
- (ii) Request from the relevant contacts documents as appropriate, including a certified copy of the will, birth certificates, death certificates, marriage certificates, divorce documentation and where necessary documentation showing full or partial financial dependence, and where necessary declarations and/or documentation relating to interdependency.
- (iii) Send all dependants Statutory Declarations for completion, setting out the benefit that is to be distributed and whether or not the dependant wishes to be considered for receipt of a payment.

- (iv) Having collected all relevant information on potential dependants, the Trustee considers the information including the non-binding nomination and makes its decision regarding the distribution.
- (v) The Trustee may then make a determination, giving all potential dependants 28 days in which to dispute the determination.
- (vi) If all dependants are in agreement then the payment is made.
- (vii) If dependant(s) disagree then the Trustee has 90 days to respond to complaints and there may be iterations of dispute.
- (viii) If a resolution is not possible then the claim will be heard by the SCT.

Because the Trustee must seek to establish all the dependants a member may have, and because it may take some time to receive responses under (i), (ii) and (iii) above, the process can be quite lengthy. It would be considered a good result if a distribution is made in 3 months. A longer period of around 6 months is more common. A more extended timeframe results if there is dispute.

Whilst members within families commonly have wills in place, young unmarried members typically have not made wills.

The research required to establish dependence can appear invasive and insensitive. In addition, contact is made with a number of dependants and information revealed, such as the amount of the benefit, that some may prefer to keep private.

- ***Binding Nominations – not always secure and a lengthy time is often needed for the Trustee to establish the position.***

Some funds allow Binding Nominations but these may not ultimately be valid as they must be witnessed and updated every three years to be valid. Binding as well as non-binding nominations may be invalid if the member nominates a person who cannot be considered a dependant under SIS. The status of a person's dependency may change over time and if the Binding Nomination has not been revoked the Trustee may be bound to make a payment to an inappropriate beneficiary. Binding nominations can therefore be even more problematic as members may incorrectly believe that their nominations are secure.

- ***Payment direct to the estate – need to wait for probate.***

Where Trust Deeds are set up to pay benefits direct to the estate, payments can be decided and made quickly by the Trustee. However, there can be delays before probate is obtained and there are some costs for the dependants in applying for probate. This would not be required if superannuation was the only member asset and it was paid direct to a beneficiary.

One point to note in relation to the payment of any benefit direct to an estate is that if the member had creditors then the payment would become available to

pay creditors before both dependants and non-dependants.

If all benefits were required to be paid to the member's estate then the member could consider superannuation assets along with all other assets. In addition a superannuation fund would not be required to consider issues of dependency. This would be resolved by the executor of the estate who would ultimately distribute the benefit.

If the member died without making a will then the benefit proceeds would be distributed in line with the relevant state law.

**Conclusion:** On balance the Task Force believe that direct distribution via a member's estate gives the greatest level of certainty to the member.

***Trustees may be unable to change their Trust Deeds to pay benefits direct to the member's estate, without direction.***

It is possible to set up funds so that all death benefits are payable to a member's estate. However, if a current Trust Deed requires a Trustee to exercise a discretion to pay to dependants then, for legal reasons, some consider it unsafe to amend the Trust Deed to allow payment only to a member's estate. Trustees are not therefore in a position to resolve this issue without a requirement for them to pay death benefits to a member's estate.

**Conclusion:** Most trustees would need to amend their Trust Deed to effect a change in the way they distribute death benefits. In many instances this could only be legally achievable if it became a regulatory requirement to pay death benefit proceeds in a particular way, for example direct to a member's estate.

***Is the time and expense spent by Trustee's and the SCT on death benefit distributions adding value for members?***

A great deal of trustee time can be spent on deciding to whom a member's death benefit should be paid and, if to more than one person, then in what proportions.

A major part of the work of the Superannuation Complaints Tribunal (SCT) work relates to distribution of death benefits.

Trustees can be involved in costly and protracted disputes in relation to the distribution of death benefits. These family disputes need not be played out in a superannuation forum (where other members share the administration expense). They are likely to be duplicated in other legal forums along with other actions in relation to the member's estate.

We believe many members do not fully appreciate the processes that must be followed by Trustees to distribute death benefits and would be surprised to find that benefits are not in practice automatically paid to their nominated beneficiary. Further we believe that many members do not appreciate the time that it may take to finally resolve the distribution of a benefit.

In view of the processes that must be followed members are unable to rely upon their nomination of how they wish their death benefits to be distributed. This limits their ability to make fully secure financial arrangements for all their dependants.

If benefits were distributed to a member's estate then much of the Trustee process would disappear. Members could organise all their affairs via their estate that they control.

There are also impacts which some would consider negative such as:

- If a member is bankrupt then the benefit would be available for creditors whereas payment direct to a dependant may protect them.
- There may be greater ability to structure payments in a tax effective way when paid direct to dependants at the direction of a Trustee. This may be particularly relevant for small funds.
- There may be longer delays in payment to the final beneficiary via the estate in the more straightforward cases. Again this is likely to be of greater concern for small funds.
- Superannuation proceeds would become subject to the intestacy provisions under state law, which may not operate in as favourable a manner as a trust arrangement, from the beneficiaries' point of view.

**Conclusion:** The Task Force believe that the additional Trustee processes in distributing death benefits direct to dependants do not generally add value. In some respects they detract value for members as they are unsure of outcomes and this impedes their ability to plan their financial affairs. We believe the advantages that can be gained from requiring benefits to be paid to a member's estate are substantial and therefore worthwhile.

However there are some negative aspects to this approach that will need to be worked through, in particular an expected longer settlement period for the most straightforward cases. There is therefore a need for further debate and industry consultation to find the most efficient process for the distribution of superannuation death benefits.

## **Recommendations**

**We believe that if all death benefits were paid via the member's estate (and if the member died intestate, then distributed in line with the relevant State law) there would be several valuable benefits:–**

- If this measure was taken members would be able to make secure financial arrangements for all their dependants. They would be able to direct how their benefits were to be distributed within their estate. It would allow all assets to be considered together in the estate rather than as separate pieces.
- This measure would have a large impact in terms of reducing complexity, delays and costs for Trustee's resulting from disputed death benefit distributions. Any

dispute is likely to be duplicated in relation to other member assets in the estate and so should serve to reduce overall legal costs.

- Given the current processes required to ensure death benefits are distributed in members' best interests (some of which require resolution by the SCT) this change would not result in greatly extended delays in beneficiaries receiving benefits.
- Trustees would no longer need to assess dependency or decide to whom benefits should be paid. We believe that a great deal of time is spent by both Trustees and the SCT on distribution of benefits but we do not believe there is commensurate adding of value for members, and in some instances it could be considered unhelpful.

However there are also impacts which some may consider negative. For instance, if a member dies and is bankrupt, this approach would result in assets being made available for creditors before both dependants and non-dependants. Also the settlement process may be longer for the most straightforward cases, and the provisions of state intestacy law may not act as well in the interests of the beneficiaries as they or the member may have wished.

On balance, we believe that such effects are likely to be outweighed by the advantages described above in many cases. However to achieve change and to create a new climate there would need to be industry consultation in order to –

- establish a wider common understanding of the issues,
- ascertain a more effective process for the distribution of superannuation death benefits, and
- determine any required amendments to current legislation to accommodate changes.

## **5F. Adequacy of Lump Sum Death and Total and Permanent Disablement Benefits**

### **Background**

*Members may choose from superannuation funds that offer varying levels of insurance cover.*

Some employers have expressed concern that they no longer have the ability within superannuation to ensure that their employees are consistently and adequately covered in the event of death and disablement.

Under the new Choice and Portability conditions employees can choose funds that offer widely differing insurance options. As a result employers cannot be assured that all their staff are consistently or adequately covered by insurance.

**Conclusion:** Under Choice and Portability employers can no longer ensure all employees are adequately covered by insurance.

*Over time some funds may be required to introduce individual underwriting for insurance that could deter members and hence further reduce insurance coverage.*

Over time, it is likely that the proportion of members who are members of a particular Company fund will fall. Insurers generally require that 75% to 85% of eligible employees join a given fund in order to provide a material level of automatic cover – i.e. provide an automatic acceptance limit (AAL). An unintended consequence of Choice is therefore that some superannuation funds may not meet the insurer's conditions to retain their right to operate an AAL. The AAL system allows all new members, irrespective of insurability issues that may otherwise apply to them individually, to take insurance cover up to the AAL without the need for medical underwriting.

**Conclusion:** If AALs are lost then members will require individual underwriting for their insurance and as a result some members will not be able to obtain cover and furthermore, over time, it can be expected that take-up of cover will fall.

*Employers are not in a position to offer new employees a promised level of insurance cover.*

There is anecdotal evidence that not being able to reproduce current insurance cover without underwriting can affect an individual's decision about taking new employment.

**Conclusion:** Lack of certainty surrounding insurance cover may impede workforce mobility.

***Investment returns are a member's main focus in assessing the performance of their superannuation arrangements.***

Members tend to choose and leave a superannuation fund based on the fund's investment performance. Insurance is a secondary issue and can muddy the water of decision making.

**Conclusion:** Choices would be clearer for some members if their superannuation and adequacy of insurance cover could be separately considered.

***It is more expensive from a tax perspective for an employer to provide employees insurance cover outside superannuation.***

FBT is payable on premiums for insurance of death and total and permanent disablement benefits designated for payment to the employees. In contrast no FBT is levied on premiums covering temporary disability income benefits for employees. Therefore, if as an alternative employers wish to set up additional insurance arrangements for their employees outside of superannuation, it is not tax effective for them.

The lifting of FBT on death and total and permanent disablement premiums could encourage more employers to consider insurance programmes for their employees outside superannuation. The employer would pay benefits direct to the member on disablement and as per the recommendation under 5E above on death. Benefits should be payable on a tax free basis. These policies could cover all staff and as a result insurers could continue providing AAL conditions and continuation options.

Employers would be in a position, if they wished, to be certain that their staff were consistently and adequately insured.

**Conclusion:** Lifting FBT from premiums would provide a level playing field from a tax perspective so employers could choose to provide insurance cover for their employees inside or outside superannuation in a cost effective manner. This could help increase the overall level of insurance in the community, including access to insurance by those otherwise not able to obtain cover.

## **Recommendations**

- 1. FBT relief is currently given to employers on insurance premiums for employee temporary disability income benefits. We recommend that this relief be extended to cover premiums for lump sum death and total and permanent disablement.**

This approach would provide a level playing field so that employers, if they wish, could provide lump sum death and total and permanent disablement insurance arrangements for their employees as a Company benefit outside of superannuation in a cost effective manner.

**We believe that the issues surrounding insurance resulting from the Treasurer's Plan**

together with recent Choice and Portability legislation will emerge slowly. Whilst they may not currently be deemed to be urgent the issues are very important and should be resolved as part of the implementation of the Treasurer's Plan.