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Taxing times – getting the most out of disability super benefit payments

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In times of personal crisis involving a client becoming permanently incapacitated and unable to work, their super can provide a critical financial lifeline – especially where insurance is also held through super.

However, the taxation of disability-related super payments is complicated. It's important to understand the tax implications as well as the strategies available to reduce tax and ease financial stress for a client and their family during this most difficult of times.

Tax treatment of lump sum invalidity benefit payments

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Where a member has become permanently disabled and can no longer work, they can generally access their super under the permanent incapacity condition of release. However, where they withdraw a lump sum from a taxed fund, such as an SMSF, tax will apply to the payment depending on the member's age at the time of receiving the benefit payment and the tax components of the payment.

This is summarised in the following table:

Age	**Under 60**		**60 and over**	
Tax component	Tax free	Taxable	Tax free	Taxable
Max tax rate	Tax free	22%[1]	Tax free	

[1] Including Medicare Levy

Insurance proceeds

Where a fund held a total and permanent disability (TPD) insurance policy for a member and the fund received an insurance payout for the member, the trustee will be required to allocate those proceeds to the member's account (from which the premiums were deducted). From a tax component perspective, the insurance proceeds are then treated in the same way as investment returns, with the proceeds generally adding to the member's taxable component. Those insurance proceeds are then taxed in the same way as the member's accumulated benefits when paid out as a lump sum (i.e. as per the above table).

Modification of tax components for lump sum disability benefit payments

However, where a member's lump sum withdrawal also satisfies the definition of a disability superannuation benefit under the Income Tax Assessment Act 1997 (Tax Act), a special formula can apply to uplift the amount of tax-free component included in the lump sum benefit payment.

A disability superannuation benefit payment is defined in section 995-1 of the Tax Act as:

- a benefit payment paid to a person because they suffer from ill health (whether physical or mental), and
- two legally qualified medical practitioners have certified that, because of the ill health, it is unlikely that the person can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.

While this definition is very similar to the super permanent incapacity condition of release, a key difference is that for a benefit to qualify as a disability super benefit the trustee must be provided with two medical certificates confirming the member satisfies the above definition. In comparison, the super permanent incapacity condition of release only requires the trustee to be reasonably satisfied the member satisfies the above definition.

Therefore, while most trustees will generally require medical certificates to satisfy themselves the member has met the permanent incapacity condition of release, where the trustee considers they are not required, maybe due to the severity of the member's disability, a member may wish to consider providing two medical certificates anyway to ensure any lump sum payment will qualify as a disability super benefit payment and that the tax-free uplift will apply.

Calculating the tax-free component of a disability lump sum

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The formula to calculate the tax-free component of a disability lump sum is:

$$Tax\ free = Existing\ tax\ free + \left[Amount\ of\ benefit\ x\ \frac{Days\ to\ retirement}{Service\ days + Days\ to\ retirement}\right]$$

where:

Existing tax-free component is the sum of the tax-free component included in the lump sum worked out apart from using the disability formula.

Amount of benefit is the amount of the lump sum disability benefit being paid, including any insurance proceeds.

Days to retirement is the number of days from the day on which the person stopped being capable of being gainfully employed to their last retirement day (generally age 65).

Service days is the number of days in the service period for the lump sum

After calculating the tax-free component of the payment, the taxable component is simply the balance of the payment.

Case study

Bob is a member of an SMSF and was a qualified carpenter but after a workplace accident he has become permanently incapacitated. His details are the following:

- Age 53
- Date of birth: 01/06/1971 (Date will turn 65: 01/06/2036)
- Date of permanent incapacity: 06/07/2024

  - Days to retirement: 4349
  - Service days: 12819
- Accumulated super: $450,000 (100% taxable/fully preserved)
- Insurance proceeds: $1,100,000

Bob needs to withdraw $200,000 from his fund to extinguish debt and pay for some expenses. Assuming the above details, the tax components of the $200,000 payment would be calculated as follows:

$$Tax\ free = \$0 + \left[\$200{,}000\ x\ \frac{4{,}349}{12{,}819 + 4{,}349}\right]$$

Tax components and tax payable:

Tax component	Amount	Tax @22% (max.)
Tax free	$50,664	$0
Taxable	$149,336	$32,854

In relation to the formula, there are several important things to note. These include:

- The larger the ‘amount of benefit’ and the larger the existing tax-free component, the larger the tax-free uplift.
- The earlier the service date of the fund, the bigger the denominator and the smaller tax-free uplift. In this case, service date relates to the date the member first joined the fund or the date the member first commenced employment with an employer who has contributed to their superannuation fund. In addition, where a member rolls over a benefit from a different fund that had an earlier service date, the receiving fund adopts that earlier service date. Therefore, a fund could have a service date that predates the member’s membership in that fund.

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Understanding these issues can then allow an adviser to implement a range of strategies to try and maximise the tax-free component and therefore reduce the amount of tax the member may be required to pay on withdrawal of any disability super benefits.

Making large non-concessional contributions (NCCs) prior to taking any lump sum benefits

Under the above formula, the tax-free component of the withdrawal is calculated by adding together the existing tax-free component included in the benefit payment plus the relevant proportion of total amount of the payment – which also includes the tax-free component. Therefore, making an NCC prior to withdrawing a lump sum will increase the amount of tax-free component by more than may otherwise be expected.

For example, where Bob made a $360,000 NCC prior to withdrawing the $200,000 lump sum, his tax-free component would be calculated as 19% x 200,000 + 25% x $200,000 = $88,360 (44%). Therefore, by making a $360,000 NCC prior to withdrawing the $200,000 lump sum, Bob increased the tax-free component included in the lump sum from $50,664 to $88,360, and therefore reduce the maximum tax on his withdrawal from $32,854 to $24,560.

Note – while making a large NCC would generally be considered a valid strategy where the member made an NCC for reasons other than obtaining a tax benefit, such as to reduce their assessable assets for Centrelink purposes (see below), where the strategy involved making a large NCC and then immediately withdrawing the member’s

entire balance, this may be deemed Part IVA[1] tax avoidance if the sole or dominant reason the member made the contribution was to obtain a tax benefit.

Arranging for insurance to be held in a separate newly established fund

Arranging for insurance to be held separately in a newly established fund or account, such as within an insurance only super fund, can also assist to maximise the tax-free uplift as it minimises the days in the service period. However, this will only be effective where the member funds the insurance with contributions to that fund rather than with rollovers, as otherwise the fund holding the insurance will adopt the same service date as the rollover fund.

For example, if Bob changed his insurance arrangements by taking out a new Life and TPD policy via an insurance only super fund two years ago and then funded the premiums with concessional contributions instead of rollovers, his service period in the new fund would only be 730 days, instead of 12,819 days. As a result, if he took the $200,000 lump sum benefit from that fund and rolled over the remainder, the tax components of the $200,000 payment would as follows:

$$Tax\ free = \$0 + \left[\$200{,}000\ x\ \frac{4{,}349}{730 +\ 4{,}349}\right]$$

Tax components and tax payable:

Tax component	Amount	Tax @22% (max.)
Tax free	$171,254	$0
Taxable	$28,746 PUBLIC	$6,324

This would result in a tax saving of $26,530.

Note – this strategy could result in a higher untaxed element calculation which could result in a larger proportion of any death benefit (that includes insurance proceeds) paid to a non-tax dependant being taxed at rates of up to 32%.

Withdrawing lump sums over time

Where a member becomes permanently incapacitated, any benefits they hold within the accumulation phase are exempt for Centrelink means testing purposes. Therefore, it is a common strategy for these members to retain benefits within the accumulation phase to maximise any means tested benefits, such as the disability support pension, and only withdraw lump sums as required.

However, in this situation it's important to note that the trustee cannot continue to rely on the original medical certificates to apply the tax-free uplift to all future lump sum payments.

For example, in ATO ID 2015/19 the ATO confirmed that a trustee could rely on the original medical certificates to apply the tax-free uplift to a number of different lump sums payments as they were paid over a 'short period of time' (in this case November 2007 for the first and April 2008 for the last) and there was nothing to suggest the individual's circumstances had changed in some relevant way.

[1] Part IVA, Income Tax Assessment Act 1936

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Therefore, where a member retains their benefits in super, they need to be aware that they may be required to obtain updated medical certificates to enable the tax-free uplift to be applied to future lump sum payments – which may not always be possible, especially where the member has re-trained and returned to work.

To avoid this situation, a member could consider rolling over their entire benefit to a different fund within a reasonable period, as this would also constitute the payment of a lump sum for tax purposes. In this case, the trustee could then apply the tax-free uplift to the member's entire benefit on rollover.

For example, if Bob made a $360,000 NCC to his SMSF prior to rolling over his entire balance, the tax components included in his rollover would be as follows:

Benefit amount	**Tax-free component**	**Taxable component**
$1.91m	$843,841 (44%)	$1,066,159 (56%)

This would then effectively ensure Bob would get the benefit of the tax-free uplift applying to any future lump sums without needing to provide updated medical certificates at that time. This also shows the benefit of making a large NCC prior to rolling over, instead of making the NCC to the new fund. For example, in this situation Bob's tax-free component in the new fund would only have been $752,646, approximately $91,000 less.

Tax treatment of disability benefit income streams

Where a member instead decides to commence an account-based pension (ABP) for example within the same fund due to becoming permanently incapacitated, their pension payments will be taxed as follows:

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Age	**Under 60**		**60 and over**	
Tax component	Tax free	Taxable	Tax free	Taxable
Max tax rate	Tax free	Included in assessable income and taxed at marginal rate	Tax free	

However, where the pension payments qualify as disability super benefit payments (see above), a member under age 60 will be entitled to a 15% tax offset on the amount of taxable component included in the pension payments.

In this case, it's important to note that the ATO has confirmed the tax-free uplift will not apply where a member uses their benefits to commence an ABP in the same fund, even where the pension payments would qualify as disability benefit payments. This is because the tax-free uplift only applies on the payment of a lump sum and commencing a pension within the same fund does not qualify as a lump sum payment.

However, as above, where a member under age 60 rolled over their benefits to a different fund, the rollover would qualify as a lump sum benefit payment for tax purposes and the tax-free uplift could apply. Where the member then provided the required medical certificates to the receiving fund for their pension payments to qualify as disability super benefit payments, the member would get the benefit of both the tax-free uplift applying to increase the tax-free component of the pension payments, as well as a 15% tax offset applying to reduce the tax on the taxable component included in the pension payments.

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