Adviser Information

MAKE A DIFFERENCE insurance

Technical Update

Best Interest Duties - Life Insurance In Super

The "best interest duty" required under FoFA became applicable on 1 July 2013. This will add a new level of complexity to the normal fiduciary duties currently required of financial advisers.

Although ASIC has confirmed best interest duty does not imply a need for perfect advice, proper execution will set new parameters for advice industry best practice.

When advisers begin working with best interest duty, and apply the safe harbour rule, they will also need to ask themselves the question "Is this in the best interest of my client?"

This ultimate question may lead some advisers to change the way they deliver advice, and to recommend different strategies for their clients.

Most importantly, this change may cause a shift away from looking just at the immediate funding efficiency need, to consider a wider and more complex range of issues.

Why Recommend Placing Life Insurance In Super?

The reasons for placing life insurance cover within super are well understood. It is convenient, and premiums can be paid either by regular contributions or debiting a member's super account. Where cover is through group life there is auto-acceptance and lower cost premiums. Retail cover provides a more tailored solution, generally more comprehensive benefit definitions and a superior claims processing philosophy.

Yet the main driver to choosing life cover through super is cost - the funding efficiency of pre-tax dollars, and when money is tight, the ability to debit a superannuation accumulation account for the cost of premiums.

The case study on the following page illustrates the pricing advantage.

Case Study – Bill

Bill, age 40, earns $100,000 net of super. He is married with two children under 18.

He is a non-smoker, and has placed all of his life insurance into his retail superannuation account, where his SG contributions are also directed. Bill's life cover consists of:

- death cover $1,000,000
- TPD cover $1,000,000
- income protection (indemnity) in super - benefits to age 65 with a 28 day waiting period

His annual life cover premium is $3,510, made up as follows:

- death = $660
- total and permanent disability = $1,350
- income protection (Indemnity) = $1,500

Currently, Bill's account receives only the 9 per cent compulsory SG contributions as he cannot afford to make additional super contributions. He is aware that he needs to maximise his retirement savings, but balances this against his current cost of living and the understanding that his life insurance cover provides the necessary financial security for him and his family.

Although Bill would have preferred 'own occupation' TPD cover, he is uncomfortable with the 'any occupation' TPD cover, and had also initially preferred 'agreed value' income protection. He considered these trade-offs acceptable considering the funding efficiencies of including life cover within his super.

Bill's marginal tax rate (MTR) (plus Medicare levy) is 38.5 per cent, so the 15 per cent maximum contributions tax rate provides a significant tax saving. With an annual insurance premium of $3,510, the pre-tax cost outside of super is:

Cost of premium ÷ (1 – (MTR + Medicare)) =

$3,510 ÷ 0.615 = $5,707

If Bill wished to maximise his retirement savings by conserving the value of his SG contributions, he could make additional contributions of $3,510 each year to cover the cost of his insurance premiums.

For anyone with an MTR more than 19 per cent, life cover through super is quite compelling on a premium cost basis. Using Bill's $3,510 premium as an example, the value is quite straightforward as the following table shows:

	In Super	Outside of Super			
Marginal tax rate + Medicare levy	N/A	20.5%	34%	38.5%	46.5%
Gross amount required	$3,510	$4,415	$5,318	$5,705	$6,650
Tax levied	N/A	$905	$1,808	$2,197	$3,050
Cost of Life Insurance	$3,510	$3,510	$3,510	$3,510	$3,510

Best interest duty – The challenge:

With the introduction of best interest duty, a recommendation solely based on funding efficiency may not be sufficient. There are a number of questions to be considered:

- How to handle super funds that only offer one insurer's product, or a dealership with a limited approved product list (APL)?
- Will advisers also have to make recommendations based on the core purpose of the cover, product features, benefit definitions and research house ratings?
- Will advisers also need to consider the insurer's underwriting and claims payment philosophy?

Obtaining life cover through super has a key implication when a claim is paid. For a benefit to be paid out from superannuation, it must meet a condition of release. Also, as it becomes a superannuation benefit, tax may be payable subject to a number of variables such as, to whom the benefit is paid, beneficiary age, type of benefit and the proportion of tax free to taxable components.

The ASIC test for the application of the best interest duty is whether 'it is reasonable to believe that the advice would leave the client in a better position'.

'In a better position' may not always be monetary improvement, but may include protection from risks, preparedness for the future, or access to product features. However, 'improvements that are trivial or have no value to the client' will not meet the test. Further a 'one size fits all' advice model would be unlikely to meet the best interest duty, as it does not take into account the client's relevant circumstances.

What are my best interest duty obligations from 1 July 2013?

The *Corporations Act* Section 961B(1) states that advisers must act in the best interests of the client and s.961B(2) sets out a compliance 'safe harbour'. It was intended that advisers can show they have met the best interest duty by meeting all of the elements of s. 961B(2), these are specific steps required to prove that best interests obligations have been satisfied.

An adviser must:

1. identify the objectives, financial situation and needs of the client that were disclosed by the client through instructions
2. identify the subject matter of the advice sought by the client (whether explicitly or implicitly)
3. identify the objectives, financial situation and needs of the client that would reasonably be considered relevant to the advice sought on that subject matter (client's relevant circumstances)
4. if it is reasonably apparent that information relating to the client's relevant circumstances is incomplete or inaccurate, make reasonable inquiries to obtain complete and accurate information.
5. assess whether the advice provider has the expertise required to provide the client with advice on the subject matter sought and, if not, decline to provide the advice
6. if it would be reasonable to consider recommending a financial product:
    - conduct a reasonable investigation into the financial products that might achieve the objectives and meet the needs of the client that would reasonably be considered relevant to advice on that subject matter
    - assess the information gathered in the investigation
7. base all judgments in advising the client on the client's relevant circumstances.
8. take any other step that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances.

ASIC has stated that 'in a better position' may not always be monetary improvement, so therefore a recommendation based solely on pricing may be inadequate.

SIC has further clarified a one size fits all advice model would be unlikely to meet the best interest duty as it does not take into account the client's relevant circumstance.

For example, if a client needs $800,000 after tax to repay debt, $800,000 in life cover within super may not meet this need if lump sum tax is deducted.

This means that advisers will need to consider a higher sum insured in super versus outside, to compensate for the tax.

Without a specific defined need such as in this example, is it then sufficient to make a recommendation disclosing all of the requirements of superannuation dependency, tax dependency and subsequent benefit tax? These can be complex and confusing even disregarding the ongoing risk of further regulatory change. Also, can an ordinary client with a reasonable level of knowledge, understand all of the nuances and potential pitfalls, even when disclosed?

ASIC stresses the importance of strategic advice – and the need to formulate the strategy the advice is based on before recommending a financial product. According to ASIC advice providers are expected to make their own inquiries and research into the products they give advice on and not just rely on service providers such as research houses.

So in the spirit of the legislation and of providing best practice advice, advisers need to understand the client's concerns, objectives and constraints and then recommend a strategy to satisfy the requirements of the best interest duty, and t hen deliver an outcome at a cost the client can afford.

We will now consider this further with reference to the different types of life cover and the circumstances of Bill's case study covered earlier.

Death cover

Any death benefit paid from a super fund must be paid either to a superannuation dependent or the deceased's legal personal representative. To who this payment is directed can be assured by the use of a binding nomination.

A 'superannuation dependent' may either be a tax dependent or a 'non tax dependent', which will define the potential benefit tax liability.

Some of the factors to consider here are:

- the differences between superannuation and tax dependents
- taxable and tax free components of a superannuation death benefit
- non tax dependents and the possibility of an untaxed element occurring in the taxable component
- the different treatment of adult children and minor children eligibility for death benefit pensions and tax
- anti-detriment benefits, what they are, who is eligible and tax treatment.

Case study – Bill – death cover

In Bill's circumstances, maintaining his death cover within superannuation can be justified. Also, certainty of payment to his spouse can be assured with a valid binding death benefit nomination.

The nomination determines to whom the benefit is paid, but not how it is paid for example, as either a pension, lump sum or combination of both. It is important to regularly review Bill's circumstances, and amend the strategy if necessary as his circumstances change. For example, if Bill's spouse were to pre-decease him, to consider the implications of a death benefit possibly paid to adult children.

Total and permanent disability

Total and permanent disability (TPD) insurance is usually sold as an additional benefit in addition to term death cover either inside or outside of superannuation. Outside of superannuation the benefit is usually tax free as long as it is paid to the life insured or a defined relative. Within superannuation, any TPD benefit paid will be taxed as part of the member's total superannuation benefit.

Despite the possibility of benefit tax, TPD cover within super has advantages. However, where super fund membership is linked to an employment arrangement, it is important to check whether continuation options are available to allow cover to continue on termination of employment.

A further consideration is that, while a person may be eligible to receive a TPD benefit under the terms of their insurance cover, for that benefit to be paid from a super fund, the member must also meet the definition of 'permanent incapacity' under SIS.

The tax treatment of a lump sum payment will be as a disability superannuation benefit. Outside of superannuation individuals generally cannot obtain a personal tax deduction for TPD insurance premiums.

However, a key advantage is that the benefit is tax free unless paid to someone other the life insured or a defined relative.

The TPD challenge

Should you recommend TPD cover inside or out of superannuation. This will depend on criteria relevant to your client's circumstances and objectives:

The purpose of the cover:

- Is the funding sensitive to timing for example for business succession or key person purposes?
- Is it solely a pricing decision and to what degree is the premium deductible?
- What is tax payable on the payment proceeds, and is there a need to gross up the sum insured? Does the client need the policy to be portable?
- Is own occupation cover preferred to any occupation requirements?

Case study – Bill – TPD

As Bill would have preferred an own occupation TPD definition, in light of best interest duty, it may be worth considering this further.

Should a client want to maximise the tax deduction on their TPD premium as well having the comfort of an own occupation definition, there are solutions to address this.

A client may have the same sum insured owned by the super fund (any occupation) and self-owned (own occupation).

The benefits of splitting TPD ownership are:

- potential superannuation definition complications are avoided
- full tax deductibility for the portion of the premium paying for any occupation cover
- only a portion of the premium (the cost difference between the any occupation definition and own occupation definition is non -deductible.

This presents a suitable tailored for the client solution, which goes beyond cost alone.

Income protection

Within superannuation, payments made by an insurer with respect to income protection cover must be kept separate from your client's other benefits and can only be paid as an income stream subject to the member's marginal tax rate. No tax offsets are available.

When income protection cover is held within superannuation, although premiums can be deducted from your client's account, the payment of temporary incapacity benefits must be paid directly to the member, rather than credited to their superannuation account.

Premiums are tax deductible for cover held both inside and outside of super. Your client can package non-superannuation income protection premiums paid by their employer as a fringe benefit, but this packaged benefit is made exempt from fringe benefit tax by the otherwise deductible rule in *Commonwealth Fringe Benefits Tax Assessment Act 1986* section 24.

There are Centrelink issues to be considered when long term income protection benefits or a negotiated lump sum is received. However, benefits originating from a superannuation fund receive more favourable treatment.

Bringing It All Together

With the introduction of best interest duty, what should we do with a client who currently has adequate cover within super? How do we proactively ensure we comply with our best interest duty obligations and retain the client in the new regime?

Case study – Bill

Bill's adviser reviews his circumstances, objectives and constraints, and recommends a strategy involving improved product features to reduce risk and to enhance his savings potential.

Cover	Inside Super	Outside Super
Death $1,000,000	$660	
TPD $1,000,000 (any occupation)	$1,120	
TPD $1,000,000 (own occupation)		$230
Income Protection Premier 28 day waiting period 2 years benefits (indemnity)		$950*
Income Protection Standard 2 year waiting period benefits to age 65 (indemnity)	$630	
Total premium	$2,410	$1,180

*100% deductible

Bill's adviser has proactively complied with his best interest duty, and through innovative use of professional knowledge recommended a solution of improved features which:

- Increases the superannuation contributions towards Bill's retirement savings by $1,100 each year by reducing the amount deducted for life cover premiums from his super account.
- Ensures who will receive any death benefit by using a binding nomination directed to Bill's wife as a tax free benefit.
- Restructures Bill's TPD cover for the same cost Bill has both $1,000,000 inside super as any occupation and $1,000,000 outside of super under an own occupation definition. The fund gets 100% deductibility for the any occupation premium, and more importantly for Bill he now has 'own occupation' cover
- Restructures Bill's income protection cover to provide:
  - comprehensive short term (2 year) cover outside of super – a period which will cover most claims occur, and
  - long term cover within super to provide cover for periods longer than 2 years.

  This solution costs an extra $80 a year ($1.50 per week), but he retains 100 per cent deductibility.
- Appropriate ownership is strategically ensured to maximise the probability of Centrelink concessions in the event of permanent or temporary incapacity.

Summary

Enshrining adviser best interest duties into legislation may at first glance appear to have added a level of complexity.

However, what this really does is to codify what has already been embraced in day to day best practice principles across the advice industry.

With a positive mindset change creates opportunities. Although placing life cover into super has many obvious advantages, we need to think beyond only a funding efficiency consideration to deliver the best outcome for the client and to genuinely answer that ultimate question – “Is this in the best interest of my client?”

Tel: 1300 799 839

www.madinsurance.com.au

Make A Difference Insurance Pty Ltd ABN 67 120 665 750
Hallmark Business Park, Unit 18, 328 Reserve Road
Cheltenham Vic 3192