Understanding insurance

Version 5.2

This document provides some additional information to help you understand the financial planning concepts discussed in the SOA in relation to **insurance**.

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HOW TO READ THIS DOCUMENT

Managing your finances to meet your day to day requirements as well as your long-term goals can be a complex task. There are all sorts of issues you need to consider such as taxation, legislation, protecting your wealth and assets, associated costs and the inherent risks of investment. When undertaking a financial plan it is important you understand how these issues will impact you and what you should expect over time.

Your financial adviser will provide you with a Statement of Advice (SOA) which sets out the details of the advice and how it will meet your goals and objectives.

This document provides some additional information to help you understand the financial planning concepts discussed in the SOA in relation to **insurance**.

It is very important you read this document to help you understand the benefits of the strategies recommended to you and the associated costs and risks.

Please contact your adviser if you do not understand anything, or need further information or clarification.

Insurance

Below is an overview of the common types of personal and general insurance cover available.

Personal insurance

The common belief "it won't happen to me" often results in many people having a sound plan for wealth creation but not an adequate plan to protect the very thing that generates the wealth – themselves!

How death, disability or illness affects your ability (or your family's ability) to realise your lifestyle goals and objectives depends on the wealth protection strategy you have in place.

By taking out insurance, you can provide some financial protection for your family's personal needs. Insurance can be structured to provide for such things as the repayment of your debts upon death or disability, financial assistance for dependants and protection against the loss of income.

Income Protection insurance

Income protection insurance (also known as salary continuance) is designed to provide a regular income in the event you are unable to work due to sickness or injury. Generally, income protection insurance provides a regular income during a period of disablement for up to a pre-determined and agreed benefit period. Generally, the benefit amount payable is up to 75% of your income.

Statistics show in 2014-15, more than 11 million Australians had at least one of eight selected chronic diseases, and 25% of the population had two or more.[1]

The fact it's more likely for you to be away from your work for an extended period than to die before retirement means insuring your income-earning ability is a must.

[1] Australian Institute of Health and Welfare – Australia's Health 2016.

Be aware

- Most income protection policies offer a range of waiting periods before you start receiving your insurance benefit (with options normally between 14 days and two years). The shorter the waiting period, the more the insurance will cost.
- You can choose from a range of benefit payment periods, with maximum cover generally available up to age 65. The longer the benefit period, the more the insurance will cost.
- Income protection insurance is increasingly important when borrowing as it can help meet loan repayments if you are unable to work due to illness or injury.

You should ensure your insurance cover is adequate for your needs. Under-insurance could result in serious financial difficulty.

Life insurance

Life insurance can be critical for a secure financial future. In simple terms, you insure yourself for a particular amount and in the unfortunate event you die, the insurer pays that amount.

The lump sum payment can be used to help with the repayment of debts, the covering of future needs (for example, the cost of children's education or long-term care) and providing funds for investment to generate an income or to keep your business afloat.

Be aware

- You should ensure your insurance cover is adequate for your needs. Under-insurance could result in serious financial difficulty.
- Changes in your personal circumstances (ie taking on additional debt, birth of a child) often necessitate higher insurance levels.
- Death benefits received via a superannuation policy may be taxed.

Total and Permanent Disability insurance

Total and Permanent Disability (TPD) insurance provides a lump sum payment should you suffer an illness or injury which totally and permanently prevents you from working again.

There are broadly two main definitions of Total and Permanent Disability:

Own occupation

The insured must show they have a total and permanent disability that prevents them from working in their own occupation which they disclosed when applying for this cover.

"Own occupation" is a more liberal definition of disability, because even if you can work in another occupation, you may still be eligible to receive disability benefits. Because it is relatively easy to qualify for benefits under this definition of disability, insurance companies are limiting the availability of this type of cover. Own occupation cover is often more expensive, and may only be available to individuals who have a clean medical history and work in a relatively risk-free occupation, and

Any occupation

The insured must show they are totally and permanently disabled and unable to work in their usual, or any other occupation for which they are reasonably suited by their education, training or experience.

"Any occupation" is often the cheaper option however it can be more difficult to meet the requirements of this type of disability definition.

Some insurers have a third definition available to clients –a "homemaker" definition. Payment of benefits under this definition would be based on the proviso the insured, through sickness or injury, is unable to do any normal physical domestic duties and will never be able to do so again.

Be aware

- You should ensure your insurance cover is adequate for your needs. Under-insurance could result in serious financial difficulty.
- Changes in your personal circumstances (ie taking on additional debt, birth of a child) often necessitate higher insurance levels.
- There may be taxation consequences where a disability lump sum superannuation payout is made.
- Since 1 July 2014 'Own occupation' TPD cover cannot be purchased in superannuation. However this insurance type may be connected with other insurances that are held in superannuation, which can reduce the administration and costs of implementing the insurances via separate policies. See 'Insurance in superannuation' below for more information.

Critical Illness insurance

Critical illness insurance (also known as trauma insurance) provides a lump sum benefit in the event the life insured suffers a "critical condition" as defined by the insurance provider. Critical illness cover is designed to help you financially recover from a trauma or crisis, such as a heart attack, stroke, cancer or other life threatening conditions.

Be aware

- You should ensure your insurance cover is adequate for your needs. Under-insurance could result in serious financial difficulty.
- Critical illness cover cannot be purchased in superannuation since 1 July 2014. . However this insurance type may be connected with other insurances that are held in superannuation, which can reduce the administration and costs of implementing the insurances via separate policies. See 'Insurance in superannuation' below for more information.

Less-common types of personal insurance

Endowment policy

Endowment policies provide a specific amount of life insurance cover. They usually also have an investment component. The benefit payable from an Endowment policy is the sum insured plus any accumulated bonuses. The policy proceeds become payable on a specified maturity date or upon the death of the life insured prior to maturity.

Whole of Life

Whole of Life policies provide a specific amount of life cover plus an investment component. The benefit payable is the sum insured plus accumulated bonuses. The sum insured plus bonuses are payable at the earlier of:

- the death of the individual insured, or
- the individual insured attaining the age specified in the policy (being at least the age of 85).

Stepped vs level insurance premiums

When taking out insurance, there are generally two ways you can pay your premium.

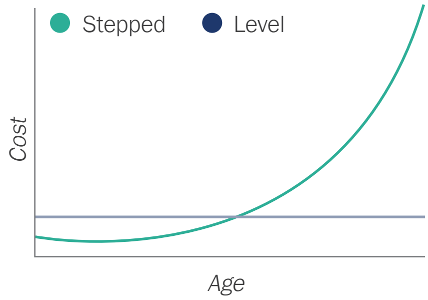
- **Stepped premium** – your premium increases every year with your age as well as annual inflationary and policy fee increases.
- **Level premium** – your premium generally does not change (with the exception of annual inflationary and policy fee increases) and is based on your age when the policy commences.

While stepped premiums are usually lower in the early years, level premiums can be a more cost-effective option if you retain the insurance over a longer period. If insurance cover is only required for a short timeframe, a stepped premium may be more appropriate and cost-effective.

Level premiums

Level premiums are higher than stepped premiums at the start (see graph below). However, as stepped premiums increase as you get older, level premiums are generally consistent over time and can end up cheaper – often at the stage in life when you need cover the most. The premium savings in later years can make up for the additional payments in earlier years – saving you money over the life of the policy.

Level versus stepped premiums



This graph is for illustrative purposes only and does not take into account inflation or general policy fee increases on premiums.

Combining stepped and level premiums

Just as you can opt for a combination of fixed and variable rate home loans, you may want to take out part of your insurance using stepped premiums and use level premiums for the rest. This way, the premium in the earlier years will be lower than if you opt entirely for level premiums.

Over time, you can reduce your stepped premium cover as you build up more assets and potentially need less insurance. As a result, you could end up paying level premiums on most (if not all) of your insurance in the later years and benefit from the lower premium costs associated with level premiums at that time.

Be aware

- The earlier you 'lock-in' the level premium the greater the potential long-term savings. This is because level premiums are generally lower if you take out the insurance at a younger age. However, as you approach age 65, the difference between the two premium structures diminishes for new policies.
- Level premiums are generally not guaranteed to remain the same. Level premium rates may increase over time due to annual inflationary and policy fee increases. However, unlike stepped premiums, level premiums are not subject to age-related increases.
- Level premiums can make budgeting easier because you know with greater certainty what your insurance is going to cost.
- The maximum age you can start a policy with level premiums is generally lower than for stepped premiums.

Tax deductibility of insurance premiums

The premiums payable on income protection policies are generally tax deductible however, the income payments received are considered assessable income and are taxed at your marginal tax rate.

Generally, when insurance is held for the purpose of family and personal protection, life, critical illness and TPD insurance premiums paid are not tax deductible but when a claim is paid, the benefits are not subject to tax.

Insurance in superannuation

It can also be beneficial to hold insurance via superannuation.

Insurance held via superannuation is owned by the trustee of the superannuation fund for the benefit of the insured member. The trustee deducts the insurance premiums from either ongoing contributions or the member's account balance.

Generally, life and TPD and some income protection policies can be held in the superannuation environment. Since 1 July 2014, income protection policies that provide 'extra benefits' cannot be taken out within superannuation however, policies in force prior to this date can be retained.

The premiums for life and income protection insurances purchased through a superannuation fund are completely tax deductible to the fund. The premiums for TPD cover may be either fully or partially deductible to the fund depending on the characteristics of the policy as follows:

TPD policy type	Deductible portion
Any occupation	100%
Own occupation	67%
Own occupation bundled with life cover	80%

Since 1 July 2014, 'own occupation' TPD cover is unavailable within superannuation, however policies already in force prior to this date can be retained. This is because insurance benefits must be consistent with the definition of 'permanent in capacity' under superannuation legislation.

You may be able to fund the insurance premiums via employer or salary sacrifice contributions made to your superannuation fund or a tax-deductible superannuation contribution if you are self-employed. Note the tax treatment of insurance premiums should never be the primary reason for holding an insurance policy under a particular structure.

Insurance benefits can be paid out as either lump sums or pensions (or a combination of both) based on your (or your beneficiary's) circumstances at the time. Insuring via superannuation can also assist with personal cash flow as the premiums are paid by the fund.

Preservation of superannuation

Generally, money in a superannuation fund is 'preserved' until you meet a condition of release (such as retiring from the workforce after your preservation age).

Conditions of release that may apply prior to preservation age include permanent incapacity, terminal illness and death. Other conditions of release that may apply prior to preservation age including temporary incapacity, compassionate grounds and severe financial hardship have "cashing restrictions" attached to them which either limits the amount that can be paid to you or compels the fund to release benefits in the form of a pension rather than lump sum.

Death benefits – tax dependent beneficiaries

In the event of your death, the policy proceeds are paid into your superannuation account. The proceeds together with your accumulated superannuation balance may be paid tax-free lump sum to your nominated beneficiary(ies) either directly or via the estate.

Alternatively your beneficiary(ies) could choose to have some or all of your benefits paid as a tax-effective pension if they are eligible to do so at that time.

Death benefits – non-dependent beneficiaries

In the event of your death, the policy proceeds are paid into your superannuation account. The proceeds together with your accumulated superannuation balance are paid to your nominated beneficiary(ies) and/or your estate.

If your superannuation is paid to a non-dependent beneficiary on your death, it is anticipated tax will apply. The amount of tax payable will depend on the components of the superannuation benefit and whether the trustee has claimed the premium as a tax deduction.

Death benefit nominations

If you do not make a valid nomination, the rules of the superannuation fund determine how your death benefit is paid. The superannuation fund can use its discretion to determine who will receive the benefit which may be your estate.

You should ensure your Will is up to date to address the payment of superannuation death benefits if paid to your estate.

Insurance within a Self Managed Super Fund (SMSF)

Insuring via superannuation can also be done within a SMSF. The insurance held via a SMSF is not owned personally by you but is owned by the trustees of your superannuation fund. You may fund the insurance premiums by contributing to superannuation or by paying the premiums from the balance of your SMSF. In most cases, tax deductions for insurance premiums paid by your SMSF are the same as other superannuation funds as detailed above.

Trustees of a SMSF must act in accordance with the fund's trust deed and investment strategy. Some SMSF trust deeds may not allow insurances to be held and so require amendments to implement the recommended insurance. It is also important to maintain minutes detailing decisions made that affect the fund's operations. Trust deed amendments and the preparation of minutes may include:

- ensuring the purpose of the insurance policies is documented
- establishing a process for payments
- ensuring the required payment options are allowed (such as a Pension), and
- binding nominations are made (where appropriate).

Critical Illness insurance within superannuation

Critical illness insurance cannot be purchased by any superannuation fund, including SMSFs. However, policies in force prior to 1 July 2014 via a SMSF can be retained. As there is no specific condition of release for critical illness trigger events, when a benefit is paid to the fund, it will remain to be the case that you **may not be able to access the proceeds** of the payment.

If you do not meet a condition of release, you may have to wait until you reach preservation age and retire (or meet another condition of release) to receive the benefit.

Only people in a financially comfortable position and/or those who are close to reaching (or have reached) preservation age should consider this option.

There are ***additional risks*** associated with holding critical illness within a SMSF if the purpose of the policy does not comply with the superannuation 'sole purpose test'. This could lead to your SMSF becoming non-complying. However the superannuation regulatory authorities have indicated provision of critical illness benefits is permissible if you (in your role as trustees) duly consider certain issues.

Important matters to be considered and documented include but are not limited to:

- the design and purpose of the insurance
- the manner and time in which the trustee intends to distribute any proceeds of the policy
- the ratio of the premium to contributions being made
- issues of ownership of the policy
- the superannuation benefit payment rules, and
- taxation issues.

Any premiums paid for Critical Illness cannot be claimed as a tax deduction by the fund.

General insurance

Health insurance

All Australian citizens currently have a level of medical cover through the Medicare system. Under Medicare, the Commonwealth Government covers your accommodation and medical expenses in a public hospital. However, you do not have your choice of doctors and where your condition is not life threatening, you may experience lengthy waiting periods.

Private health insurance gives you the opportunity to choose your doctor and hospital, and can ensure you avoid waiting periods for elective surgery. Depending on the policy, private health insurance may also cover expenses relating to dental, physiotherapy, pharmacy and optical needs. To encourage the adoption of private health insurance, the Federal Government provides a health insurance rebate. The extent of this rebate is means tested based on income. This rebate may be claimed in your taxation return or via a reduced health insurance premium. If you are a high income earner and you do not have adequate private health cover, your income may also be subject to the Medicare surcharge in addition to the general Medicare levy payable with your annual tax assessment.

Home and contents insurance

With burglaries and natural disasters a regular occurrence, home and contents insurance is important. Home insurance alone covers your home from damage. You can also structure this type of insurance to protect the contents within and around your home. Considerable discounts may be gained by combining home and contents cover in this way.

Car insurance

Each day, cars are involved in accidents or stolen. You can minimise the impact of such events by putting in place car insurance. Car insurance is generally offered at a number of different levels of cover. These include comprehensive, third party property damage, fire and theft. Comprehensive cover is preferred as this insures you for a wide range of events or occurrences. Third party insurance only insures you for damage caused to someone else's car or property.

Residential investor insurance

Investing in a property can provide substantial rewards through rental income and capital gains. This type of insurance protects both the property's income as well as the property itself.

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