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Holding income protection via super

This article discusses the benefits and implications of holding income protection insurance inside super

Summary

Insurance companies offer income protection (IP) policies that replace part of a person's lost income when the person cannot work because of illness or injury.

Super fund trustees can own IP policies with members being the life insured.

Member balances and employer and/or personal contributions can fund premium payments.

Where an insurer is satisfied that a person meets the disability definition to claim IP, insurance proceeds are paid into the member's super account.

The super trustee must then be satisfied that the member meets the temporary incapacity condition of release to pay the proceeds to the member in the form of a non-commutable income stream.

IP in super is generally suitable for clients who are cashflow constrained or do not require extensive product features.

Structural changes to IP policies

Since 1 July 2014, a super fund trustee can only provide members with IP benefits that align to the temporary incapacity condition of release. This means all new policies must align to the any occupation definition.

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IP policies with an own occupation definition purchased in a super fund before 1 July 2014 can continue after 1 July 2014 and the cover may be increased or decreased. However, policies with a disability definition not aligning with the temporary incapacity condition of release may not be 100% tax deductible.

Since 1 April 2020, insurers can only offer an indemnity value policy to new customers, both inside and outside of super, which is based on earnings in the 12 months prior to claim.

They cannot offer a guaranteed value policy, which is based on an agreed value of earnings just prior to the application for cover.

With guaranteed policies purchased prior to 1 April 2020, access problems may arise where the IP policy has a guaranteed insured amount and the insured has a substantial drop in income prior to becoming disabled, as the insurance proceeds can only replace a part of lost income.

Since 1 October 2021, the income replacement ratio for new IP policies purchased, both inside and outside of super, dropped from a standard of 75% to 70% of pre-disability income (with an allowance of up to 90% of pre-disability income in the first six months of claim). Policies purchased before 1 October 2021 can continue to provide cover at the higher level.

As a result of the structural changes made over the previous decade, new superannuation owned IP policies will include an any occupation definition, pre-disability income determined via an indemnity value and an income replacement ratio of 70% (or less) of pre-disability earnings.

Advice tip

A super-linked policy that combines super and non-super IP policies can provide more comprehensive cover as it allows for an own occupation definition in the non-super policy. Generally, under super-linked policies any claim is assessed against the super owned policy first. Benefits could be paid from either or both policies.

Funding premiums for IP insurance in super

Insurance premiums may be funded from a member's super account balance. Contributions may be made to the member's account to top up the balance, ensuring that premiums can be paid. Generally, contributions made for this purpose are employer contributions (superannuation guarantee and salary sacrifice) and personal tax-deductible super contributions. These contributions are included in the client's concessional contributions cap, which may include carry forward concessional contributions.

Other types of super contributions used to fund premiums can include:

- Voluntary member contributions (non-concessional). If eligible, the member may benefit from the Government superannuation co-contribution (up to \$500). The co-contribution cannot be paid into an insurance only super fund.
- Spouse contributions which may qualify the contributing spouse for a tax offset of up to \$540 per annum, if eligible.

For members of a couple, outflows for premiums may also be offset by contribution splitting (if eligible).

Deduction for IP premiums

The merits of purchasing IP cover via super should be compared to owning the cover personally. Generally, premiums for IP cover outside super are tax deductible. Where a successful claim is made, policy proceeds are paid to the policy owner as assessable income, both inside and outside of super.

Generally, a super fund can claim a deduction for IP premiums it pays for its members. Employer contributions and personal deductible contributions are assessable income for the super fund and generally taxed at 15%. Where a super fund pays IP insurance premiums, its taxable income may be reduced by these deductions and result in a partial or full reduction of tax on the member's taxable contributions, depending on whether the super fund accounts for the deduction at a fund level or individual member level.

Advice tip

An additional 15% tax may apply to higher income earners from Div 293 tax. Div 293 tax will be payable despite the super fund being able to claim a deduction for IP premiums. Therefore, those impacted by Div 293 and making contributions to fund IP premiums may consider holding IP insurance under a non-super policy instead, as premiums are also fully deductible and no Div 293 tax is payable.

Accessing IP benefits within super

IP proceeds received by the super fund can generally be released to the life insured (a member of the super fund) under the temporary incapacity condition of release. A member is temporarily incapacitated where they cease to be gainfully employed because of physical or mental ill-health which does not constitute permanent incapacity. Ceased to be gainfully employed includes where a member has ceased temporarily to receive a gain or reward under a continuing arrangement for the member to be gainfully employed.

If the temporary incapacity condition of release is met, payments are made as a non-commutable income stream to replace in part or full, the reduced gain or reward the member received just before their incapacity. The payments cannot exceed the individual's pre-disability income. Payments cannot be made for longer than the period of temporary incapacity.

Advice tip

Where the member is not gainfully employed or on unpaid leave when they became disabled, they may not be able to receive their salary continuance, as they did not have any pre-disability employment income.

Additionally, payments made under temporary incapacity must not be paid from the member's 'minimum benefits,' meaning the released funds must generally be sourced from an IP insurance policy.

Taxation of IP proceeds

Insurance proceeds paid to the super fund are not assessable to the fund. When the fund pays benefits to the member, the amounts are not deductible to the fund. Benefits paid under the temporary incapacity condition of release are assessable to the member (even if the member is at least age 60). The super fund must withhold PAYG tax from the payments using the PAYG withholding tables.

Reasons to hold IP outside of super

Clients who have adequate cashflow may prefer to fund premiums with an individually owned IP policy because the premiums are generally deductible against their assessable income and reduce their personal taxable income.

Clients applying for a new IP policy will be limited to what IP coverage they can get within super. Non-super owned policies can offer more extensive features, such as the ability to cover specific costs which are not associated with lost employment income (eg rehabilitation costs) and an own occupation definition which may be important for some clients.

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