AUTO-CONSOLIDATION, ROLLOVERS AND THE IMPACT ON MEMBERS' DISABILITY AND DEATH BENEFITS

Firstech Strategic Update – Linda Bruce, Senior Technical Manager

The Protecting your super package implemented in 2019, includes measures to protect member's super accounts from fee erosion by auto-consolidating members' inactive low-balance super accounts. Super funds are required to report and pay a member's inactive low-balance accounts to the ATO. The ATO then, where possible, transfers the ATO-held super to an eligible active super account on the member's behalf.

If during the process, an older super account is consolidated into a newer active super account, the eligible service period can be reset with an earlier start date. This is also the case where a member actively rolls over one of their older super accounts with an earlier eligible service date to a newer one.

Resetting the start date can have important tax implications. In the event of permanent incapacity, a higher amount of tax may be payable due to the calculation of the tax free uplift. On the other hand, in the event of a member's death where the member is aged under 65, it may result in a reduced tax liability where the beneficiary(ies) is a non-tax dependent and an untaxed element is calculated.

This article looks at how a member's eligible service date can be reset by the ATO's auto-consolidation process or a member initiated super rollover, and its potential impact on the member's TPD and death benefit.

Eligible service period

A member's eligible service period start date is generally the day the member joined the fund (or the day the member commenced employment with an employer who has contributed to the fund, if earlier). However, the start date can be reset with an earlier date where the fund receives a super rollover that has an earlier service period start date.

Similarly, when the super fund is required to transfer a member's inactive low balance account to the ATO, the eligible service period start date will be maintained and transferred to the member's active account identified by the ATO. If the eligible service period start date of the consolidated amount is earlier than the member's active super account, the member's active super account's service period will be altered with the earlier start date.

An earlier eligible service period start date means a longer service period, which can result in:

- A negative tax impact in the event of a member's permanent incapacity, that is, a lower tax-free uplift of a disability lump sum benefit payment and potentially higher amount of tax payable by the member when the member is aged under 60.
- A positive tax impact for a non-tax dependent beneficiary(ies) in the event of the member's death, where the death benefit contains a life insurance payout and the member was under age 65 at the time of death, that is, a lower amount of untaxed element and potentially lower amount of tax payable by a non-tax dependant beneficiary.

Permanent incapacity and the tax-free uplift

If the trustee of a super fund is satisfied that the member is unlikely, because of ill health, to engage in gainful employment that they are reasonably qualified for by education, training or experience, the member meets the permanent incapacity condition of release. In this case, the member's benefits in super can be cashed without any cashing restrictions. This can include:

- the member's accumulated member benefit, and
- any TPD insurance proceeds paid to the fund upon a successful claim.

Upon meeting such a condition of release, the member is able to take their member benefit as a lump sum or commence an income stream, and depending on the member's age, the tax components of the benefit paid are treated as follows for tax purposes (assuming they are a member of a taxed super fund):

Age	Component	Maximum tax on lump sum	Tax on income stream
Age 60 or over	Total benefit	0%	0%
Under preservation age	Tax-free	0%	0%
	Taxable – taxed	20%[1]	Marginal tax rate less 15% tax offset[2]
Between preservation age and age 60	Tax-free	0%	0%
	Taxable – taxed	First $210,000[3] at 0% excess at 15%[1]	Marginal tax rate less 15% tax offset

1 Plus 2% Medicare levy where applicable.

2 The tax offset is only available for a member under preservation age if the income stream is a disability super benefit, meaning the income stream is commenced because the member suffers from ill-health (whether physical or mental) and 2 legally qualified medical practitioners have certificated that, because of the ill-health, it is unlikely that the member can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.

3 This is a lifetime limit and indexed to AWOTE on 1 July each year.

Disability lump sum benefit and the tax-free uplift

If the member with an accumulation interest receives any TPD insurance payout within their fund, the insurance proceeds will initially form part of the taxable component in the fund.

In addition to any existing tax-free component in the fund, an increased tax-free component (ie the tax-free uplift) due to permanent incapacity can be calculated upon:

- taking the benefit as a lump sum, or
- rolling over the benefit to another superannuation fund; and
- the lump sum withdrawal or rollover is classified as a disability lump sum benefit by satisfying the criteria below:
  - The benefit is paid because the member suffers from ill health (whether physical or mental); and
  - two legally qualified medical practitioners have certified that, because of 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.

It is important to note that as long as the above conditions are satisfied, the increase in the tax-free component can apply regardless of whether the member's fund received a TPD insurance payout.

The increase in the tax-free portion of the disability super benefit is calculated as:

$$\textbf{Amount of benefit} \times \frac{\textbf{Days to retirement}}{\textbf{Service days} + \textbf{Days to retirement}}$$

Where:

Days to retirement = Number of days from when the person stopped being capable of being gainfully employed, to their last retirement date (usually age 65).

Service days = Number of days from the start of the eligible service period in the fund to the date the disability super lump sum benefit is paid to the member.

The Australian Taxation Office (ATO) advised that any days that are included in both 'service days' and 'days to retirement' are to be counted only once in the formula's denominator. Therefore, the denominator will always have the number of days in the period from the service period start date to the last retirement date (usually age 65). This means regardless of when the disability benefit is paid, the uplift of the tax-free component of the disability lump sum remains the same. Otherwise any delay in paying the disability benefit could result in a lower tax-free component.

Product providers using the ATO's approach could result in a higher tax-free component.

Impact of longer service period due to rollover or auto-consolidation

The formula above results in a smaller tax-free uplift where the member has a longer service period. Accordingly, where the member's eligible service period start date is reset to an earlier day due to a rollover or the ATO's auto-consolidation process, the tax-free uplift amount will be reduced when a disability lump sum benefit is paid (ie lump sum withdrawal or rollover).

Example 1 – auto consolidation and TPD tax-free uplift

Luca, age 40 (born on 1 January 1980), has accumulated super benefits of $20,000 (with a 90% taxable component and a 10% tax-free component) in ABC super fund that she joined two years ago. ABC super fund shows 1 January 2018 as the eligible service period start date.

Luca also has $4,000 (100% taxable component) with XYZ super fund which was contributed by an employer she worked for years ago before she took a career break. The fund has no insurance. The eligible service period start date in this fund is 1 January 2000. Luca has not made any contributions or rolled any amounts to XYZ super fund for a number of years.

Luca's super account with XYZ was identified as an inactive low-balance account and the balance was transferred to the ATO. The ATO then paid this amount that carries an earlier eligible service period start date to Luca's active super account with ABC super fund. ABC super fund must alter Luca's eligible service period start date from 1 January 2018 to 1 January 2000.

Luca became permanently incapacitated on 1 January 2020. The fund received a $500,000 TPD insurance pay-out.

Luca provided the required medical certificates to the fund resulting in either a lump sum withdrawal or rollover meeting the definition of a disability lump sum benefit.

The table below compares the tax-free uplift amounts that Luca receives, with and without the ATO's auto-consolidation of her inactive low-balance super account:

	No auto-consolidation	With auto-consolidation
Eligible service period start date	1 Jan 2018	1 Jan 2000
Date of permanent incapacity	1 Jan 2020	1 Jan 2020
65th birthday	1 Jan 2045	1 Jan 2045
Days to retirement	9,133	9,133
Service days	**730**	**7,305**
Lump sum withdrawal or rollover	$520,000	$524,000
Existing tax-free	$2,000	$2,000
Tax-free uplift	**$481,513**	**$291,136**
Disability lump sum withdrawal or rollover tax components		
Tax-free component	**$483,513**	**$293,136**
Taxable component	**$36,487**	**$230,864**

Due to the reset of the eligible service period start date as part of the ATO's auto-consolidation process, Luca's tax-free component contained in a disability lump sum withdrawal or rollover is significantly reduced. This means Luca potentially needs to pay a higher amount of tax on the increased taxable component if taking a lump sum withdrawal or commencing an income stream post rolling over her super benefit to a new fund.

Option 1: Luca takes the entire benefit as a lump sum withdrawal

- Without ATO's auto-consolidation of her inactive low-balance super account, she only needs to pay up to 22% tax (including Medicare levy) on the taxable component of $36,487;
- With the ATO's auto-consolidation of her inactive low-balance super account, she needs to pay up to 22% tax on taxable component of $230,864.

Where Luca takes a partial lump sum withdrawal, the tax-free uplift will be based on the partial lump sum Luca takes from her fund.

Option 2: Luca commences disability income stream with ABC super fund

An increase in the tax-free component (ie the tax-free uplift) due to permanent disability can only be calculated when a lump sum benefit is paid. This means the payment must be taken as a cash lump sum or rolled over to a different fund to trigger the calculation.

Unfortunately, commencing a disability income stream within the same fund cannot increase the tax-free component. This is because the ATO consider this to be the commencement of an income stream from an existing superannuation interest rather than a rollover or transfer in ATO ID 2009/125.

As a result, with or without the ATO's auto-consolidation, Luca's disability income stream commenced with the ABC super fund would only contain a $2,000 tax-free component at commencement.

Option 3: Luca rolls over her super benefit to a new fund before commencing a disability income stream

A member may want to rollover their super disability benefit to a different fund before commencing the income stream. This may be because the current fund does not offer an income stream, or the new fund is more appropriate for the member's needs.

If Luca rolls over her super disability benefit, including the insurance proceeds and the accumulation amount, from ABC super fund to a different fund, the tax-free uplift can be calculated by ABC super fund and included in the rollover statement.

After the new fund receives the rollover, Luca can then commence an income stream. In order to have the income stream classified as disability benefit so that Luca can get the 15% pension tax offset, she must provide two recent medical certificates to the new fund before commencing the income stream.

- Without the ATO's auto-consolidation, Luca's income stream commenced with the new fund would have a **7% taxable component**. This means only 7% of the income stream payments will be taxed at Luca's marginal tax rate, with a 15% tax offset. It is likely that the tax payable is minimal.
- With the ATO's auto-consolidation, Luca's income stream commenced with the new fund would have a **44% taxable component**. This means 44% of the income stream payments will be taxed at Luca's marginal tax rate with 15% tax offset. The tax liability will most likely be increased due to the ATO's auto-consolidation process.

Strategies and considerations

Inactive low balance account

In order to reduce the unintended impact of resetting the eligible service period start date with an earlier date due to the ATO's auto-consolidation process, a member in Luca's situation may want to make an election to ensure their inactive low balance super account is not transferred to the ATO.

Alternatively, where possible the member should initiate rolling over the inactive low balance super account to an eligible active super account that has earlier eligible service date to consolidate their super accounts without resetting an earlier eligible service date.

Super rollover

It's a common strategy to rollover an amount from one super fund to another, typically a super account only held for insurance purposes, to pay for the insurance premiums held in the second fund.

If the first fund has an earlier service period start date, this date will be carried over with the rollover to the second fund and will become the service period start date of the second fund. Similar to Luca's example, a super rollover can result in a longer service period and a lower tax-free uplift of a disability lump sum benefit payment in the event of permanent incapacity (ie a higher amount of tax may be payable by the member).

Advisers should exercise caution when recommending rolling over from one fund to another to pay for insurance premiums, or recommending consolidating member's super accounts to avoid resetting the eligible service period start date.

Lump sum death benefit and untaxed element

A lump sum death benefit can contain an untaxed element even if it is paid from a taxed fund (eg a retail fund or an industry fund), if the following conditions are met:

- the death benefit contains life insurance proceeds and the super fund claims a tax deduction for life insurance premiums; and
- the death benefit is paid as a lump sum[1]

Where a lump sum death benefit is paid to a non-tax dependant, the lump sum is subject to tax shown in the table below:

Component	Maximum tax rate
Taxable (taxed element)	15%[2]
Taxable (untaxed element)	30%[2]
Tax free	0%

2 Plus Medicare Levy where applicable.

Interestingly, a longer service period can provide a better tax outcome for a non-tax dependant of the deceased where the untaxed element needs to be calculated by the fund. This is because a longer service period can result in a lower amount of untaxed element based on the legislative formula (please refer to the Service period and untaxed element section in this article for further details) and therefore the tax payable on the untaxed element can be reduced.

On the other hand, where the beneficiary is a tax dependant, a lump sum death benefit can be paid tax free, regardless of whether the death benefit has any taxable taxed or untaxed element. Therefore, the increased service period has no impact where the death benefit is paid as a lump sum to a tax dependant.

Service period and untaxed element

The untaxed element is calculated using the below formula taking into consideration the amount of the death benefit (including insurance), eligible service period within the fund and age of the member.

Calculating untaxed element of the lump sum death benefit

Step 1

$$\text{Amount of entire superannuation lump sum} \times \frac{\text{Service days}}{\text{Service days} + \text{Days to retirement}}$$

Where:

Days to retirement = Number of days from date of death to the deceased's last retirement day (usually age 65).

Service days = Number of days from the start of the eligible service period in the fund to date of death.

Step 2

Taxable taxed element = result from Step 1 – any existing tax-free component

This amount cannot be below $0

Step 3

Taxable untaxed element = Lump sum death benefit – tax free amount – taxed element (result from step 2)

Observations

The calculation of the untaxed element based on the formula above means:

1. A lump sum death benefit can only contain an untaxed element if the deceased is under age 65 at the time of death.

   If the deceased has turned age 65 at the time of death, the future services days will be 0. This means the entire taxable component can only contain a taxed element. The untaxed element would not be applicable.
2. Longer service days in the fund results in a larger taxable taxed element and a lower untaxed element. This means when the lump sum death benefit is paid to a non-tax dependant, it is potentially subject to a lower amount of tax payable.

1 While death benefits paid in the form of an income stream within the same fund does not trigger the untaxed element calculation, rollover over a death benefit income to a different fund is consider a death benefit lump sum payment and the untaxed element may be calculated if all conditions are met. However, the Government introduced a Bill, currently in the Senate, which aims to fix the unintended tax consequences of rolling over by excluding the untaxed element contained in a death benefit rollover statement from being treated as assessable income in the receiving fund.

Example 2 – auto-consolidation and untaxed element

Continuing with example 1, Luca also has $500,000 of death insurance cover in her ABC super fund and the fund has been claiming a deduction for the insurance premiums.

Unfortunately Luca's health has deteriorated since she became permanently incapacitated and she dies on 1 January 2022. After the $500,000 death cover is paid to Luca's **ABC super fund**, Luca's death benefit totals $700,000. The death benefit contains $100,000 of tax-free component as a result of non-concessional contributions that Luca made after becoming permanently incapacitated.

The table below compares the untaxed element and tax consequences, with and without the ATO's auto-consolidation of her inactive low-balance super account from XYZ to ABC super fund, in the event that her death benefit is paid as a lump sum either directly to a SIS dependant or to her deceased estate.

	No auto-consolidation	With auto-consolidation
Eligible service period start date	**1 Jan 2018**	**1 Jan 2000**
Date of death	1 Jan 2022	1 Jan 2022
65th birthday	1 Jan 2045	1 Jan 2045
Service days	**1,461**	**8,036**
Days to retirement	8,402	8,402
Lump sum death benefit	$700,000	$700,000
Existing tax-free	$100,000	$100,000
Tax components of the lump sum death benefit		
Tax-free component	$100,000	$100,000
Taxable taxed element	$3,691	$242,207
Taxable untaxed element	$596,309	$357,793
Tax payable if death benefit lump sum paid to a non-tax dependant		
Tax on taxed element @ max 15%[1]	$554	$36,331
Tax on untaxed element @ max 30%[1]	$178,892	$107,338
Total tax payable if paid to a non-tax dependant	**$179,446**	**$143,669**
Net death benefit	**$520,554**	**$556,331**
Tax payable if death benefit lump sum paid to a tax dependant		
Tax on taxed element @ 0%	$0	$0
Tax on untaxed element @ 0%	$0	$0
Total tax payable if paid to a tax dependant	**$0**	**$0**
Net death benefit	**$700,000**	**$700,000**

1 Medicare levy also applies if death benefit is paid to a non-tax dependant directly from Luca's super fund. However, Medicare levy is not payable if the death benefit is paid to Luca's deceased estate first and then distributed to a non-tax dependant.

The ATO's auto consolidation of Luca's inactive low balance super fund with XYZ super fund to ABC super fund resulted in resetting Luca's eligible service period start date from 1 January 2018 to 1 January 2000. Luca's service period in the fund became 18 years longer.

The longer service period provided a larger taxable taxed element and smaller taxable untaxed element. As a result, where Luca's death benefit is paid to a non-tax dependant, the longer service period could potentially save a non-tax dependant approximately $36,000 in tax.

Where Luca's death benefit is paid to a tax dependant, such as a surviving spouse or minor child, the entire death benefit can be paid tax-free. The longer service period has no impact under such circumstances.

Strategies and considerations

A potential strategy to maximise the service days and reduce the untaxed element is to rollover at least a small amount from a super fund with an earlier eligible start date to the fund where the life insurance cover is held.

As the new fund is able to retain the earlier eligible service date from the rollover fund, the untaxed element could be minimised due to the longer service days, and hence less tax may be payable when the lump sum death benefit is paid to a non-tax dependant.

Service period dilemma

A longer service period can provide favourable tax results in the event of a member's death (when the member is aged under 65) and the lump sum death benefit is paid to a non-tax dependant and the death benefit contains untaxed element. However, a longer service period can cause a significant reduction in the member's tax-free component when the member becomes permanently incapacitated, which may result in a higher amount of tax payable by the member where under age 60.

Where a member's death benefit is intended to be paid to a tax-dependant, it can be paid tax-free if paid as a lump sum or the untaxed element is not relevant if paid as a death benefit income stream. Members in this situation may wish to minimise the service period so that the tax-free component of a disability benefit can be maximised should the member become permanently incapacitated.

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