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Superannuation administration made simple!

Insurance Premiums – to claim or not to claim a tax deduction?

There are strategic reasons why you might not claim a tax deduction on life or Total and Permanent Disability (TPD) insurance premiums within an SMSF, particularly related to how it impacts the tax components of a superannuation death benefit — specifically the untaxed element.

We will look at the basic concepts and then look at an example.

Concepts

1. Tax Deduction for Premiums

SMSFs can claim tax deductions for premiums paid on life and TPD insurance if the policy is held for the purpose of providing a death or disability benefit.

2. Taxable vs Untaxed Elements (Death Benefit)

When a death benefit is paid from a super fund:

- The **taxable component** may have a **"taxed"** and an **"untaxed"** element.
- The **"untaxed element"** arises when:
    - The SMSF claimed deductions for insurance premiums and
    - The benefit is paid to a non-tax dependant (e.g. an adult child).

Untaxed elements are taxed at a higher rate when paid to non-dependants:

- 15% (taxed element)) + Medicare levy * (total 17%)
- 30% (untaxed element) + Medicare levy (total 32%)

* Medicare Levy is 2.0% currently as per the ATO.

Why Not Claim the Deduction?

Choosing **not to claim the tax deduction** for life or TPD premiums can:

- **Eliminate the untaxed element** in the death benefit.
- **Lower the tax payable** by non-dependant beneficiaries (like adult children).
- Be beneficial when **death benefits are likely to be paid to non-dependants**.

In short: you give up a small annual deduction now to minimise a large tax bill later where there is an insurance benefit paid and a death benefit to non-dependants.

Example

Assumptions:

- Life insurance policy in SMSF: $1,000,000
- Annual premium: $5,000
- SMSF earns enough income to claim full deductions.
- Death benefit paid to adult child (non-tax dependant).
- Member passes after 10 years of premiums paid.
- Fund has consistently claimed tax deductions for insurance premiums.

Member Balance at death		$500,000.00
Death Benefit Lump Sum inc Insurance		$1,500,000.00
Member Components at Death		
Taxable	80%	$1,200,000.00
Tax Free	20%	$300,000.00
Total	100%	$1,500,000.00

Key Dates:

Date of Birth	10/08/1975
Start of Service Period	5/08/1996
Date of Death	1/07/2024
Date of Turning 65	10/08/2040
Service Days	10,192
Days to Retirement	5,884

Option 1: Deduction Claimed Each Year

- $5,000 deduction/year × 10 years = $50,000 of deductions
- Death benefit to adult child:
    - Portion becomes **untaxed element**: $549,017.17*
    - Tax payable on $549,017.17: **32% = $175,685.49**
    - Remainder ($650,982.83) taxed at **17% = $110,667.08**
- Total tax on death benefit:

  = $175,685.49 (untaxed) + $110,667.08 (taxed)

  = **$286,352.58**

Option 2: No Deduction Claimed

- No untaxed element created.
- $1,200,000 considered "taxed element" and $300,000 “tax free”.
- Tax at 17% on full taxed element = **$204,000**

Outcome:

Option	Tax Payable on Death Benefit
Deduction Claimed	$286,352.58
No Deduction Claimed	$204,000
Difference	**$82,352.58**

In this case, **not claiming the deduction could have saved $82,352.58 in tax** on the death benefit.

To summarise:

- **Claiming deductions increases short-term tax efficiency** for the SMSF.
- **Not claiming** may be better long-term **estate planning** if non-dependant beneficiaries are expected.
- This is a strategic decision — best made with a financial adviser who understands your fund’s likely beneficiary structure.

* Detailed calculation of components where untaxed element arises:

Step 1

Calculate the tax free and taxable proportions of the interest before the benefit is paid:

Member Components at Death		
Taxable	80%	$1,200,000.00
Tax Free	20%	$300,000.00
Total	100%	$1,500,000.00

Step 2

Apply proportions to work out components of death benefit (example is payout of full balance but could be interim and final lump sum death benefit).

Taxable	80%	$1,200,000.00
Tax Free	20%	$300,000.00
Total	100%	$1,500,000.00

Step 3

Calculate taxed element using formula

Lump sum amount x service days / (service days + days to retirement)

1500000 x 10192	$950,982.83
10,192 + 5,884	

Reduce the amount by the tax free component of the lump sum

Taxed	
$950,982.83 – $300,000	$650,982.83

Step 4

Calculate untaxed element by subtracting taxed element from taxable component

Untaxed element	
$120,0000 – $650,982.83	$549,017.17

Result:

Tax Free	$300,000.00
Taxable	
- Taxed	$650,982.83
- Untaxed	$549,017.17
Total	**$1,500,000.00**