Personal injury superannuation contributions

Introduction

Ordinarily, when a person makes a non-concessional contribution (NCC) to superannuation, it counts towards their NCC cap. Broadly speaking, this cap is limited to $100,000 per financial year or, where eligible, up to $300,000 using the 'bring-forward' rules. Furthermore, NCCs cannot effectively be made where a person's total super balance (TSB) exceeds $1.6 million as at 30 June of the immediately preceding year.

But what happens when a person receives a payment, often substantial in size, resulting from a personal injury and wants to contribute to super?

Fortunately, the Government has addressed these issues upon both the introduction of the NCC caps in 2007 and subsequent super reforms in 2017. Consequently:

- Eligible personal injury contributions are excluded from the NCC cap and can be made regardless of the contributor's TSB;
- Once within the super environment, the entire contribution can be used to commence a retirement phase income stream (i.e. an income stream where earnings on assets supporting the income stream are tax-free). A retirement phase income stream commenced with a personal injury contribution does not count towards the contributor's pension transfer balance cap.

Why contribute to super?

Before discussing the technical rules around contributing personal injury payments to super, we first need to establish why this might be beneficial for the client.

The main benefit is the ability to use all or part of the personal injury payment to establish an income stream (usually in the form of an account based pension), where both earnings on assets supporting the account based pension (ABP) and income payments from the ABP are tax-free, regardless of the client's age.

Let's take the hypothetical case of a person who receives a $3 million personal injury payment.

If the proceeds are invested outside of super, the earnings are taxed at the person's MTR, which could be as high as 47%. Some or all the proceeds could be used to establish an insurance bond where earnings are taxed at a maximum of 30% and paid tax-free to a beneficiary or their estate upon death. Other potentially tax-effective strategies may include investing in the name of a lower income earning spouse or a discretionary trust.

Alternatively, the person could:

- contribute the $3 million as an after-tax NCC to a superannuation fund, regardless of their TSB,
- use the personal injury contribution (and any other accumulated super) to commence an ABP where a minimum income payment must be drawn, the earnings on assets supporting the pension are tax-free and, if contributed to a fund **solely containing the personal injury payment** (i.e. no other 'taxable' accumulated super money)**,** the entire income payment is tax- free regardless of age, and
- potentially contribute additional NCCs from non-personal injury money using their 'standard' NCC cap.

Rather than being wholly converted to an ABP, all or part of the personal injury contribution can remain in accumulation phase in which case the contributed amount and any earnings will be exempt from the social security means test (while the person is below their Age Pension qualifying age).

Given most payments of this nature are substantial in value, it is unusual for proceeds to be retained in accumulation phase where the earnings are taxed at a maximum of 15%. Further, a compensation preclusion period may apply meaning that social security payments cannot be made immediately.

Despite this, some clients might benefit from this strategy where a smaller personal injury payment is received. Further information on the social security treatment of super in accumulation phase is available in *TapIn Social security fact sheet: Superannuation.*

Considerations

When determining whether the personal injury rules apply and how they can be used to maximum effect, the following issues need to be considered:

- Can the contribution be made to super in the first instance?
- Is the contribution eligible to be disregarded for NCC cap rules?
- How much of the personal injury payment can and should be contributed to super?
- What timeframes apply and what paperwork must be completed to ensure the contribution is disregarded for NCC cap rules?
- Once contributed, will the client be able to access the contribution?
- How will the contribution be used once made? Will it be retained in accumulation phase, used to commence an ABP or a combination of both?
- Should the contribution be made into an existing fund or a new fund?
- Who will receive the remaining proceeds upon death?
- Where social security entitlements are a possibility, how much should be contributed to super vs remain outside and the implications of any preclusion period.

For ease of reading, we refer to eligible contributions disregarded from the NCC cap rules as 'personal injury contributions' in the remainder of this article.

Making the contribution

The first step in the process is determining whether the client can contribute to super in the first instance. Commonly, this will not be an issue as the client is under age 65 and there are no restrictions. However:

- if age 65 to 74, the 40/30 work-test must be met, or
- if age 75+, the latest the super fund can accept the contribution is 28 days following the end of the month the person turns 75 (and the person has already met the 40-30 work test for the relevant financial year).

Despite the above contribution restrictions, a super fund trustee has discretion to accept contributions in respect of a previous period where the person would have been able to contribute.

Further details on the contribution eligibility rules is available in *TapIn Guide: Superannuation contributions: An overview.*

Example 1: Contribution requirements

Jean (age 66) was injured in an accident 3 years ago, has not worked since and recently received a personal injury payment of $1 million. She meets all the criteria for this amount to be contributed to super using the personal injury provisions and therefore disregarded under the NCC cap rules.

Despite this, Jean cannot contribute any amount to super as she hasn't met the 40/30 work test.

However, Jean could consider requesting the fund trustee explore the possibility of applying the discretion contained in SISR 7.04 which allows the fund trustee to accept contributions in respect of a previous period where the person was eligible to contribute. This could extend to seeking a ruling from the relevant regulator (e.g. APRA or ATO).

Disregarding contribution from the NCC cap: eligibility conditions

Broadly speaking, a personal injury contribution must meet the criteria contained in ITAA 1997 sec 295.95 to be disregarded under the NCC cap rules. These criteria are outlined below:

i. the payment must arise from a structured settlement, workers compensation payment or personal injury order [292.95(1a)],

ii. the contribution must be made to superannuation within certain timeframes [292.95(1b)],

iii. the contributor must be permanently incapacitated [292.95(1c)], and

iv. before or at the time the contribution is made, an ATO *Contributions for personal injury election form* [292.95(1d)] must be supplied to the fund.

We discuss each of these requirements in the following sections.

1. Qualifying personal injury payment

A qualifying personal injury payment must arise from a;

- structured settlement,
- lump sum workers compensation payment, or
- court order for a personal injury payment.

The exact criteria are shown in Table 1 below:

Table 1: Qualifying personal injury payment

Structured settlement a) the claim: i. is for compensation or damages for, or in respect of, personal injury suffered by the person; ii. is made by the person or their legal personal representative (LPR); b) the claim is based on the commission of a wrong, or on a right created by statute; c) the settlement takes the form of a written agreement between the parties to the claim.
Workers compensation The settlement of a claim in relation to a personal injury suffered by the person under a law of the Commonwealth or of a State or Territory relating to workers compensation.
Court order for personal injury payment a) The order is made in respect of a claim that: i. is for compensation or damages for, or in respect of, personal injury suffered by the person; ii. is made by the person or their LPR; b) the claim is based on the commission of a wrong, or on a right created by statute;

NOTE: The client or their LPR must seek legal advice as to whether the payment received meets the above criteria.

2. Timeframe for contribution

A personal injury contribution must be made to the superannuation fund within 90 days of the latest of:

- the day on which personal injury payment is received,
- the day an agreement for settlement of a personal injury payment was entered, or
- the day on which a court order for the personal injury payment was made.

The ATO Commissioner has discretion to allow a longer period.

3. Permanent incapacity

The client (or their LPR) must declare in the personal injury cap election form (see Point 4 below) that because of the personal injury, it is unlikely that the person can ever be gainfully employed in a capacity for which they are reasonably qualified because of education, experience, or training.

Further, two legally qualified medical practitioners must certify that this is the case.

Gainfully employed means employed or self-employed in any business, trade, profession, vocation, calling, occupation or employment.

4. Personal injury election

The contributor or their LPR must notify the fund of the personal injury contribution to be made. This is done via submitting an ATO Contributions for personal injury election form (NAT 71162) to the superannuation fund no later than the day the contribution is made.

This form requires declarations from the contributor or their LPR that the requirements of ITAA 292.95 have been met. In practice, the super fund trustee usually requires medical certificates as well. These will be required in any case to establish that the client meets the permanent incapacity condition of release to be able to access the contributed amount (discussed later).

The form does not need to be sent to the ATO. The super fund will report the contribution made as a personal injury amount to the ATO. This will ensure that the contribution is disregarded from the members NCC cap.

If any of the four requirements above is not met and the contribution is made, it will not be exempted from the person's NCC cap which could result in excess NCCs.

How much can be contributed?

The exemption from the NCC cap rules only applies to the amount of the personal injury payment that relates to personal injury.

Where a claim relates to both compensation or damages for personal injury suffered by the person and to some other remedy (e.g. compensation or damages for loss of, or damage to, property), the exemption from the NCC cap rules only apply to the personal injury compensation or damages amounts.

It is also worthwhile noting that a person may choose to use some of the personal injury payment to make a deductible superannuation contribution. In this case, the amount contributed counts towards their concessional contributions cap (For FY 2017-2018, $25,000 p.a). There is no special dispensation under the concessional cap for personal injury payments. The standard concessional cap applies.

Total superannuation balance (TSB)

A person's TSB effectively limits the amount of NCCs that can be contributed to super for people whose TSB are $1.4 million or more.

Importantly, personal injury contributions are excluded from a person's TSB meaning that eligible amounts can be contributed regardless of the person's existing super balance.

Example 2: Total superannuation balance

Julia, age 45, has $300,000 accumulated in superannuation. She has never made any NCCs.

On 1 June 2018, Julia receives an eligible personal injury payment of $2 million and contributes this to super on 30 June 2018. It is exempt from her NCC cap.

Julia receives an additional $200,000 as compensation from damages to property on 1 August 2018 which cannot be contributed under the personal injury provisions. She would also like to contribute this amount to super.

Despite her accumulated super being $2.3 million on 30 June 2018, her TSB is only $300,000 as the personal injury contribution does not count.

Therefore, Julia could also contribute her additional $200,000 to super using the 3-year NCC bring forward provisions.

Pre-1 July 2017 personal injury contributions

Where a person made a personal injury contribution before 1 July 2017, the contributed amount is also exempt from the person's TSB.

Which fund should the contribution be made into?

Consideration is also required as to where the personal injury contribution is to be made. The client may have existing super benefits containing taxable component.

If the personal injury contribution is made to such a fund, the resulting tax-free component will be mixed with the existing taxable component. This means that any lump sum withdrawal and/or income payment (where an income stream has been commenced) will contain taxable component, which may have tax consequences, both personally and when received as a death benefit by certain beneficiaries.

By contributing to a different fund and then immediately commencing an ABP, both the income payments and the earnings on assets supporting the ABP will be tax-free, regardless of the client's age. This is because the personal injury contribution will be recorded as tax-free component. This tax-free component will be 'locked' in as 100% upon commencement of the ABP. Because any amount paid from an ABP is in proportion to the underlying tax components, both income payments and lump sum withdrawals will be tax-free. See *TapIn Guide: Retirement income streams* for further information.

Furthermore, any death benefit will consist entirely of tax-free component and thus paid tax-free to any person who receives it.

Release of personal injury contributions

Personal injury contributions are preserved when made to the superannuation fund. The member must then meet a superannuation condition of release to have these released as either a lump sum or income stream.

Despite a person needing to be permanently incapacitated to qualify for a personal injury contribution to be disregarded from the NCC cap rules in the first instance, and this definition of permanent incapacity being the same as that under the SIS regulations, we recommend having the relevant trustee pre-approve the release of benefits. This is because the requirements under ITAA 295.95 are declared to be met by the contributor or their LPR whereas the release under the permanent incapacity condition of release requires the trustee to be satisfied that this is the case.

There are situations where the contribution could be accessed through another condition of release. For example, retirement on or after preservation age, terminal illness or being age 65 or over.

Retain in accumulation phase

There are several reasons that the amount contributed might be retained in accumulation phase. Firstly, where the client is under their Age Pension age and wishes to have the amount exempt from social security means testing. See *TapIn Social security strategy: Sheltering money in superannuation* for more information. Importantly, a compensation preclusion period might need to be served upon receipt of a personal injury payment, thus precluding the person from receiving social security benefits for a calculated number of weeks. The [Centrelink Compensation Recovery team] can assist with queries of this nature.

Secondly, the contribution may be so large that the minimum to be drawn down from any ABP (see next section) may exceed the client's income needs and the unspent amount will build up outside of super and the earnings taxed at marginal tax rates which may be higher than 15%. In such a situation though, other tax-effective strategies could be considered such as recontributing any excess proceeds to super as a NCC, making a personal deductible contribution, investing in the name of a lower income earning spouse or via a discretionary trust.

Commence account based pension

The contribution can be accessed (in either full or part) as an ABP. An ABP commenced using the permanent incapacity, retirement, or age 65 condition of release will be a 'retirement phase' income stream (i.e. an income stream where earnings on assets supporting the pension are tax-free).

From 1 July 2017, amounts transferred into retirement phase are generally limited to the transfer balance cap (for FY 2017-2018, $1.6 million).

Despite this, there is a carve out for personal injury payments. That is, personal injury contributions are excluded from the member's transfer balance cap when commencing 'retirement phase' pensions These contribution amounts will create a 'debit' in the member's pension transfer cap account. This debit will offset the corresponding credit which is raised on commencement of a retirement phase pension account.

Example 3: Personal injury payment used to commence ABP post 1 July 2017

Brenda is seriously injured in a car accident. She undertakes legal proceedings against the driver and is awarded a court ordered personal injury payment of $2 million on 1 February 2018.

Brenda contributes the $2 million into her superannuation fund as a personal injury contribution which meets the requirements of ITAA 1997 sec 292.95. Brenda also has $350,000 of accumulated benefits in the same fund.

On 15 July 2018, Brenda commences an ABP with her entire account balance of $2.35 million and a credit of this amount arises in her transfer balance account. A debit equal to $2 million (equal to the amount of the personal injury contribution) is also applied to her transfer balance on the same day.

Because a transfer balance account is measured at the end of the day, only an amount of $350,000 remains (i.e. credit of $2.35 million less debit of $2 million) in her transfer balance account. Therefore, Brenda has not breached her personal transfer balance cap of $1.6 million.

Pre- 1 July 2017 ABPs containing personal injury contributions

Clients who made personal injury contributions to super prior to 1 July 2017 should have received a debit equal to the value of all their pension accounts as at 30 June 2017 (i.e. even ABPs containing non-personal injury contributions).

This means they will effectively have an initial 1 July 2017 pension transfer balance account of nil for the purposes of the pension transfer balance cap. It can even result in a negative transfer balance account as shown in Example 4.

Example 4: Personal injury contribution used to commence ABP prior to 1 July 2017

Danielle is seriously injured in a car accident. She undertakes legal proceedings against the driver and is awarded a court ordered structured settlement of $4 million on 1 July 2016.

Danielle contributes the $4 million into her superannuation fund, notifies her superannuation fund that this contribution is a qualifying personal injury payment and commences an ABP with this amount.

Example 4: Personal injury contribution used to commence ABP prior to 1 July 2017 cont.

Immediately before 1 July 2017, the value of Danielle's ABP is now $3.5 million due to investment returns and income stream payments made to her. Danielle's transfer balance account commences on 1 July 2017 and a transfer balance credit of $3.5 million arises on this day in respect of her ABP.

On 1 July 2017, a transfer balance debit of $4 million also arises in Danielle's transfer balance account in respect of the personal injury payment. Therefore, Danielle's transfer balance is negative $500,000 at the end of 1 July 2017. Danielle is entitled to start another retirement phase income stream with a value up to $2.1 million without exceeding her transfer balance cap ($1.6 million).

Because her transfer balance is measured at the end of a day, Danielle has never had an excess transfer balance (because the relevant credit and debit both arose on the same day, 1 July 2017) and is eligible to increase her transfer balance cap by indexation in future years.

The following ATO Law Companion Rulings contain further information about personal injury contributions and the application of the TSB and transfer balance cap rules:

- LCR 2016/9: Superannuation Reform: Transfer balance cap
- LCR 2016/12: Superannuation Reform: Total Superannuation balance

Practical considerations for personal injury clients

At the beginning of this fact sheet, we considered the advantages of contributing personal injury payments to super. In this section, we highlight some further considerations.

Personal injury clients can be almost any age ranging from infants who have suffered medical negligence (maybe from birth) to adults.

The use of a tax-exempt ABP is usually the preferred strategy for personal injury clients whose care costs throughout their life may be quite high. The tax-exempt ABP will help prolong the life of their capital compared to investing outside super where income will be taxed at normal 'adult' marginal tax rates, including for disabled children.

In some cases, an appropriate family member may be appointed by the court as the disabled person's 'financial manager', in other cases the court may specify that the use of a professional trustee company or service is required.

The use of a 'Special Disability Trust' (SDT) for personal injury payments is not an option as the disabled person is ineligible to contribute to the SDT on their own behalf.

In some cases, major capital expenditure may be required from the personal injury payment. This could include to purchase or modify a dwelling for the disabled person, a modified motor vehicle and/or therapeutic equipment. In the interests of providing greatest flexibility for future super contributions and pension commencement, consideration should be given to contributing the maximum allowable personal injury amount in these cases and then making lump sum withdrawals to fund these needs. The lump sum withdrawals will create additional debits in the client's pension transfer balance account.

Estate planning considerations

Due to the significant assets and often, the reduced life expectancy and capacity, it is critical that clients in these situations seek specialist estate planning advice as soon as possible.

The estate planning specialist can assist with various issues including, establishing enduring powers of attorney and guardianships, drafting wills, and nominations for superannuation. Depending on the client's estate planning objectives, a testamentary trust may need be considered.

Further information about superannuation nomination options, eligible beneficiaries, death benefit options and directing superannuation to the estate is available in *TapIn Guide Superannuation Death Benefits*.

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