Lump sum disability insurance benefit: Approved vs unapproved

This Legal Update must be read together with Legal Updates 2 of 2014 and 3 of 2016. It sets out the differences between approved and unapproved lump sum disability insurance benefits. An approved benefit is one that is provided by the fund and is paid out together with the member's retirement savings in the fund. An unapproved or self-standing benefit is provided through an insurance policy issued to the employer and does not form part of the fund benefits.

A. Introduction

A lump sum disability insurance benefit is a benefit that is paid to the member if he is totally and permanently disabled in terms of the policy.

The features of the FundsAtWork lump sum disability insurance benefit are as follows:

- Matching lump sum death benefit at least equal to the lump sum disability benefit must be provided.
- The maximum benefit available is the lesser of R6 million, 8 times annual salary and the member's FlexiCovers lump sum death benefit.
- This maximum benefit will increase automatically from time to time unless the employer informs Momentum to the contrary.
- The waiting period is up to 6 months if the employer takes the lump sum disability benefit on its own. If combined with temporary income disability benefit then the waiting period can be 6 or 12 or 18 or 24 months, depending on the payment period of the temporary income disability benefit.
- The taper period can be 0 or 5 or 10 years.

B. Approved lump sum disability insurance benefit

If an employer chooses an approved lump sum disability insurance benefit, the premium for this benefit will form part of the total contributions to the fund. If the total fund contributions paid for this member fall under the allowable tax deductions (currently 27,5% of the higher of the member's remuneration and taxable income, subject to a maximum of R350 000 per year), then the premiums for this insurance benefit will not be taxable. If the member wants to optimise his retirement savings, the premiums payable in respect of approved insurance detracts from that objective. This means that a part of the contributions payable for the member goes towards insurance benefits instead of being allocated to his retirement savings. The member is then not using the maximum tax deductions for contributions towards savings for retirement.

If the member becomes totally and permanently disabled and qualifies for the lump sum disability benefit, the lump sum disability insurance benefit, together with the member's retirement savings account balance, will be paid to him. The member's membership of the fund will then be terminated.

The General Rules of the FundsAtWork Umbrella Funds allow a member to postpone the payment of his lump sum disability benefit. This means that the member does not have to take his benefit when he becomes disabled, but can postpone the date on which this benefit should be paid to him. It's all or nothing though – the member cannot decide to take the lump sum disability insurance benefit when the disability benefit becomes payable and leave his retirement savings in the fund until a later date; he has to either take everything when the benefit becomes payable or postpone payment of everything until a later date. Because the member's employment will be terminated due to his disability, it is highly unlikely that he would want to postpone taking his disability benefit when it becomes payable.

In the FundsAtWork Umbrella Pension Fund, the member can only take one third of his disability benefit in a lump sum, with the rest being used to buy a pension, unless the total benefit (the lump sum disability insurance benefit and the member's retirement savings) is less than R247 500. In both the pension fund and the provident fund, the portion of the benefit that is taken as a lump sum will be taxed on the retirement tax table.

Because a fund can only pay benefits in relation to a member and his beneficiaries, the salary payback option cannot be applied on an approved lump sum disability insurance benefit. The salary payback amount is paid to an employer to compensate them for the salary that they paid to the disabled member during the waiting period before the member's lump sum disability benefit is paid to him.

C. Unapproved lump sum disability insurance benefit

If an employer chooses an unapproved lump sum disability insurance benefit, the premium for this benefit will not form part of the total contributions to the fund. It will not impact on the allowable tax deductions for contributions, which means that the member can optimise his retirement savings by contributing the maximum amount that could qualify for a tax deduction towards his retirement benefit.

The premium will be taxed in the hands of the member. If the member never qualifies for the lump sum disability benefit, then he will never get the benefit of having paid these premiums.

If however the member does become totally and permanently disabled and qualifies for the lump sum disability benefit, the lump sum disability insurance benefit will be paid to him tax free. The tax free benefit far outweighs the taxable premiums paid towards this benefit.

If the member is also a member of a FundsAtWork Umbrella Fund, and his employment is terminated as a result of his disability, his fund membership will terminate and his fund benefit will also become payable to him. However, the member does not have to take this benefit immediately. The General Rules of the FundsAtWork Umbrella Funds allow a member to postpone the payment of his lump sum disability benefit. This means that the member does not have to take his benefit when he becomes disabled, but can postpone the date on which this benefit should be paid to him. He can decide to take the lump sum disability insurance benefit when the disability benefit becomes payable and leave his retirement savings in the fund until a later date. This ensures the longevity of the member's income and prevents him spending it all in the first few years of his disability.

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The salary payback option applies on an unapproved lump sum disability insurance benefit. The salary payback amount is paid to an employer to compensate him for the salary that he paid to the disabled member in the waiting period before the member's lump sum disability benefit is paid to him.

D. Comparison

Feature	Approved	Unapproved
Premium	Taxable as part of fund contributions	Taxable in member's hands
Deduction on contribution	Yes. Part of 27,5% / R350 000 limit	No
Impact on maximising retirement savings in the fund	Yes. Reduces amount that can be allocated towards savings	No
Benefit	Taxable on retirement tax table	No tax
Salary payback available	No	Yes
Ability to postpone payment of retirement benefit	No	Yes

E. Conclusion

An employer needs to consider all of these factors, and the specific needs of its employees, before making a choice between approved and unapproved lump sum disability insurance benefits. They should consult their financial adviser to discuss the pros and cons of the two options.

Hettie Joubert
Legal Adviser
MMI Investments and Savings: Retirement Solutions