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OPINION

DATE: 16 March 2014

SUBJECT: **EMPLOYEES TAX: TAXATION OF EMPLOYER OWNED RISK BENEFITS**

Introduction:

1. Numerous concerns have been raised by Employers surrounding the taxability of risk benefits with effect from the 1st March 2015, although minimal adjustments were made to the Income Tax Act No.58 of 1962, as amended ("the Act") for the years of assessment ending 2016, the significant amendments were made in the prior years.

2. In order to provide an opinion on the adjustment made to the Act during the periods 1st March 2012 to 1st March 2015 we firstly need to emphasis that the Act does not provide for specific categorization of policies found in the market place but instead provides a set of rules that need to be applied against the actual policy documentation, therefore no product can be mentioned by name to fall with any category specifically.

3. This document is intended to elucidate the reader on the interpretation of the Act in order to apply the amendments to their own set of circumstances and therefore cannot be viewed as a final opinion on any specific product.

Background:

4. The Taxation Laws Amendment Bill of 2011 introduced the taxable fringe benefit of employer owned insurance policies. In the explanatory memorandum dated 27th January 2012, four types of policies for the benefit of employees or directors or their dependents or nominees was identified:

    a. "*Employer-funded death or permanent disability risk polices conducted through a 'approved' plan (i.e. group long term insurance with a pension or provident fund being the policyholder);*

    b. *`Employer-owned death or permanent disability risk policies through an 'unapproved' plan (i.e. an insurance policy where the employer is the policyholder);*

    c. *Employer-owned income protection risk policies; and*

    d. *Employer-owned compensation policies."*

5. For 'approved' policies no adjustments where made to the treatment of contributions, the only amendment was to 'un-approved' policies.

6. The Taxation Amendment Bill of 2012 provided further adjustments to employer-owned rules for deduction and exemption in terms of employee-related insurance policies. In the explanatory memorandum dated 10th December 2012 clarity for purposes of section 11(w) and paragraph 2(k) of the Seventh Schedule was provided on the treatment of policies "death, disability, or injury of an employee arising out of and in the course of employment", these determined to be by example work-related accident plans and travel insurance.

7. The Taxation Amendment Bill of 2013 provided alignment for the tax treatment of individual-based insurance policies. In the explanatory memorandum dated 24th October 2013, the aspect of the current two forms of disability insurance plans that are offered to individuals, namely capital protection and income protection was

discussed. Capital protection policies offered no deduction against income and income protection allowed for a deduction against income irrespective if the individual or the employer paid such policy. The resultant was that no deduction from income would be allowed for income protection.

General Terms used for Insurance:

8. Wikipedia provides certain definitions of labels used in the market place and the Act. Application of these definitions will assist in comparing the products and the relevant taxation provisions:

9. **"Insurance** is the equitable transfer of the risk of a loss, from one entity to another in exchange for payment. It is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss. An insurer, or insurance carrier, is a company selling the insurance; the insured, or policyholder, is the person or entity buying the insurance policy. The amount of money to be charged for a certain amount of insurance coverage is called the premium."

10. **Disability** is the consequence of an impairment that may be physical, cognitive, mental, sensory, emotional, developmental, or some combination of these. A disability may be present from birth, or occur during a person's lifetime.

11. A **severe illness** is an illness requiring prolonged hospitalization or recovery. Examples would include coma, [1] cancer, leukemia, heart attack or stroke. These illnesses usually involve high costs for hospitals, doctors and medicines and may incapacitate the person from working, creating a financial hardship.

Summary of policies:

12. <u>Approved Risk Benefits:</u> The Pension Fund Act No. 24 of 1956, as amended governs Fund owned policies. Retirement funds can offer their members risk cover in the form of funeral, death or disability benefits. The fund rules stipulate whether and what types of cover should be offered to members. These rules are designed to provide the

member with a benefit upon exiting the fund, and so can only cover death or disability events, which result in the member no longer being employed, and hence having to leave the fund. Benefits which will continue to be paid after the member has left the fund, or that cover dependents who are not members of the fund may not be offered through the fund.

13. Un-approved Risk Benefits: The Long Term Insurance Act No. 52 of 1998 governs Employer owned policies. If a retirement fund does not offer risk benefits to its members, an employer may decide to provide risk benefits to its employees through a separate group scheme. This has the advantage of allowing benefits such as permanent income disability and cover for spouses to be offered.

14. **"Income Protection Insurance** (IPI) is an insurance policy, available principally in Australia, Ireland, New Zealand, South Africa, and the United Kingdom, paying benefits to policyholders who are incapacitated and hence unable to work due to illness or accident. IPI policies were formerly called Permanent Health Insurance (PHI)."

Analysis of the tax treatment of the polices:

15. Following the distinction drawn between the three types of policies relating to risk benefits we apply the provisions of the Act in relation to the types of policies.

Taxation Laws Amendment Bill 2011:

16. With effect from the 1st March 2012 paragraph 2(k) of the Seventh Schedule was introduced to include as a benefit any payment to any insurer under a policy directly or indirectly for the benefit of the employee or his spouse, child, dependent or nominee.

17. Paragraph 12(C) of the Seventh Schedule to the Act in sub-paragraph (2) confirmed that in terms of a policy contemplated in section 23(m)(iii) the amount, to the extent

that is has deemed to be a benefit in terms of paragraph 2(k) is deemed to have been paid by that employee.

18. Section 23(m)(iii) allowed the premium paid against loss of income as a result of illness, injury, disability or unemployment to be deducted for purposes of determining taxable income on condition that any amounts payable in terms of the policy would constitute income as defined.

19. Section 11(w) allowed expenditure incurred by a taxpayer of any premiums under a policy of insurance of which the taxpayer is the policyholder, excluding a policy of insurance that relates to death, disablement or severe illness of an employee or director of that taxpayer arising solely out of and in the course of employment of such employee or director. The deduction allowable where the policy relates to death, disablement or severe illness of an employee or director and the amount incurred by the taxpayer is deemed to be a taxable benefit granted to the employee or director in terms of paragraph 2(k) of the Seventh Schedule to the Act.

Submission on Taxation Laws Amendment Bill 2011:

20. The concept of Approved Risk Benefits versus Un-Approved Risk benefits was created by the first amendment whereby a classification is required for payment of premiums by an employer for purposes of risk benefits.

21. If such premium were paid by the policy holder (the Employer) and the proceeds from a claim were payable to the Employer who in turn would make payment to the employee or the spouse or child of the employee then such premium would be considered a contribution to an un-approved risk benefit. The individual employee would be taxed on such premiums made by the employer.

22. Conversely if the premiums where paid by virtue of membership to a Pension or Provident Fund, which incorporated risk benefits in terms of the rules of the Fund, such contributions would be excluded for purposes of a taxable benefit in terms of paragraph 2(k) of the Seventh Schedule to the Act, based on the fact that such holder

of the policy is not the employer. In the event of a claim in terms of a Pension or Provident Fund, the Fund would make such payment directly to or on behalf of the employee (member), such payment would be deemed to be a lumpsum as contemplated in the Second Schedule to the Act read with sub-section (e) of the definition of 'gross income' in section 1 of the Act.

23. The amendment further included any amount payable by the employer to a policy in the name of the employee for purposes of income protection, where such contribution would be deemed to be a benefit for purposes of paragraph 2(k) of the Seventh Schedule and deductible by the employee in terms of paragraph 2(4)(c)(i) and (ii) of the Fourth Schedule, read with section 23(m)(iii).

In Summary:

24. The first amendment categorized risk benefit into two distinctive categories based on the following criteria:

    a. If the holder of the policy is the employer and such policy extended or could extend coverage to persons other than employees, such policy would be deemed to be un-approved and the individual employee would have the premium included as a taxable benefit. Any proceeds made in respect of such policy to the policy holder would be included in taxable income of the Employer less any amounts that where paid to the employee or deemed to be paid to the employee and included as 'remuneration' in the hands of the employee.

    b. If the premiums where payable to a Pension or Provident Fund in the course of membership of the employee by the employer and such Fund made provisions for the payment of risk benefits to the employee (member), such premiums would be deemed approved, irrespective if the Fund took out a policy in order to make payment of such risk benefits. For purposes of the Pension Fund Act a

Fund is defined as a 'juristic person' meaning that any policy owned by the Fund cannot be purported to be owned by the employer.

Taxation Laws Amendment Bill 2012:

25. With effect from 1st March 2013 clarity was provided for the exclusion of certain types of employer-owned risk benefit policies that arise solely out of and in the course of employment of such employee or director for purposes of deductibility in terms section 11(w) versus section 11(a).

26. Work accident or travel insurance is excluded from section 11(w) and does not constitute a taxable benefit for purposes of paragraph 2(k), read with paragraph 12(C) of the Seventh Schedule to the Act.

In Summary:

27. Policies in relation to employer-owned risks that are directly attributed to the course and scope of the employee are excluded for purposes of determination of a taxable benefit.

Taxation Laws Amendment Bill 2013:

28. With effect from the 1st March 2015 proceeds from an un-approved policy will be viewed as exempt income by virtue of the provisions of section 10(1)(g)(G) of the Act read in conjunction with sub-section (d)(ii) of the definition of 'gross income' in section (1) of the Act. Subsection (d)(ii) deals with an amount received or accrued to a person, or dependent or nominee of the person, directly or indirectly in respect of proceeds from a policy of insurance where the person is or was an employee or director of the policyholder. The proviso to sub-section (d), specifically excludes any lump sum award from any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity.

29. Section 10(1)(g)(G) further requires that for the amount of the proceeds to be viewed as exempt, the premiums paid with effect from the 1st March 2012 has been deemed to be a taxable benefit in terms of the Seventh Schedule to the Act.

30. Paragraph 12(C) (2) was deleted with effect from the 1st March 2015 in relation to individual owned income protection contributions made by the employer been deemed to be made by the employer, further paragraph 2(4)(c)(i) and (ii) of the Fourth Schedule has been deleted with effect from the 1st March 2015.

In Summary:

31. The third amendment effective from the 1st of March 2015 deals exclusively with the exemption of risk benefit proceeds when such policy was an un-approved policy for which the premiums were taxed as a fringe benefit in the hands of the employee.

In Conclusion:

32. Contributions made on behalf of the Employees by Employers to the Fund for purposes of risk benefits are excluded from the Seventh Schedule to the Act and in specific paragraph (2)(k).

33. All contributions of risk benefits to an approved fund remain deductible and are subject to taxation on any benefit payment as determined by the Second Schedule to the Act.

34. Specific attention to whether or not the contributions are in respect of approved or un-approved risk benefits is required when such contributions are made to an Insurer who also preforms the services of Administrator of the Pension or Provident Fund to which an element of the contributions relate.

35. All un-approved risk benefit contributions, excluding those directly in the course of employment owned by the employer, are deemed to be a taxable benefit.

36. All payments on behalf of employees in respect of income protection, owned by the individual are deemed to be a taxable benefit.

IRP5 Source Codes with effect 1st March 2015.

Income:

Source Code	**Name**
3602	Income (Excl)
3907	Other Lump sums from un-approved funds
3922	Compensation Lump Sum, i.r.o. Death in the course of employment

Fringe Benefit Codes:

3801	General Fringe Benefits, including para 2(k) read with para 12(C) of the Seventh Schedule.