QUESTION WE'VE BEEN ASKED QB 15/06

INCOME TAX – INSURANCE – TERM LIFE INSURANCE POLICY TAKEN OUT BY EMPLOYER FOR THE BENEFIT OF AN EMPLOYEE

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Question We've Been Asked is about ss CA 1, CE 1(1), CE 5, CX 2, CX 4, CX 16, CX 37, DA 1, DA 2, GB 32, RD 3, RD 5(2) and the definitions of "expenditure on account of an employee" and "salary or wages" in s YA 1.

Question

1. What is the income tax treatment of a term life insurance policy that is taken out by an employer and where an employee (or their spouse, civil union partner, de facto partner or child) is the beneficiary?

2. This item applies to both individual term life policies and group life policies where the employees (or associates) are the beneficiaries of the policy.

Answer

3. The employer will generally be entitled to a deduction for the premiums paid.

4. The premiums paid will be subject to fringe benefit tax (FBT).

5. Lump sums paid out on death under a term life insurance policy will not be taxable income of the employee (or the employee's estate).

Explanation

6. Inland Revenue recently undertook a review of all Public Information Bulletins (see http://www.ird.govt.nz/technical-tax/pib-review/). During that review, two items on the income tax treatment of insurance in an employment context were identified as being out of date. The two items are "Staff insurance schemes" (*Public Information Bulletin* No 70 (December 1972): 11) and "Life and accident insurance policies" (*Public Information Bulletin* No 106 (July 1980): 2). Those PIBs covered a number of different scenarios. We intend to replace the PIBs with a series of Questions We've Been Asked (QWBAs) covering common scenarios.

7. This QWBA considers the situation where a term life insurance policy is taken out by an employer for the benefit of an employee (or their spouse, civil union partner, de facto partner or child).

8. Term (or temporary) life insurance pays out the sum insured (as a lump sum) if the life insured dies during the term of the policy.

Deductibility of premiums

9. A person is allowed a deduction for an amount of expenditure or loss to the extent that it is incurred by them in the course of carrying on a business for the purpose of deriving assessable (or excluded) income (s DA 1). Section DA 2 sets out some limitations on deductibility. For example, expenditure that is capital in nature, or expenditure incurred in deriving exempt income, is not deductible (s DA 2(1) and (3)).

10. In most cases, salary and wage costs will be deductible because they will satisfy the nexus test in s DA 1 and none of the general limitations will apply. The payment of a life insurance premium for the benefit of an employee (or their

family) is a business cost just like the employee's salary or wages. Therefore, provided the costs of an employee's salary or wages are deductible, the costs of paying the insurance premiums will be too.

When amount of premium subject to PAYE

11. An employee's income includes "expenditure on account" of that employee (s CE 1(1)(b)), as defined in s CE 5. Section CE 5(2) expressly includes premiums paid by an employer who takes out certain life insurance policies for the benefit of an employee of their family members:

> **CE 5 Meaning of expenditure on account of an employee**
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> …
>
> *Inclusion*
>
> (2) **Expenditure on account of an employee** includes a premium that an employer pays on a life insurance policy taken out for the benefit of the employee, or their spouse, civil union partner, de facto partner, or their child. This subsection is overridden by subsection (3)(f) to (i).

12. Section CE 5(3)(f)–(i) exclude premiums under certain policies from being expenditure on account of an employee under s CE 5(2). The potentially relevant exclusions are:

> **CE 5 Meaning of expenditure on account of an employee**
>
> …
>
> *Exclusions*
>
> (3) **Expenditure on account of an employee** does not include—
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> …
>
> (f) a premium that an employer pays on a life insurance policy taken out for the benefit of the employee, or their spouse, civil union partner, de facto partner, or their child, if—
>
> (i) the premium cannot be refunded to, or converted to cash by, the employee or an associated person; and
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> (ii) the only benefits that are payable under the policy are those payable on the death of the employee, or their spouse, civil union partner, de facto partner, or their child, or those payable because of accident, disease, or sickness of the employee, or their spouse, civil union partner, de facto partner, or their child:
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> (g) a premium that an employer that is a close company pays on a life insurance policy taken out for the benefit of the employee, or their spouse, civil union partner, de facto partner, or their child, to the extent to which the expenditure is treated as a dividend under subpart CD (Income from equity):
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> (h) a premium that an employer pays on a life insurance policy taken out for the benefit of the employee, or their spouse, civil union partner, de facto partner, or their child, if the policy is, or is included in, a superannuation category 1 scheme, a superannuation category 2 scheme, or a superannuation category 3 scheme:
>
> (i) a premium that an employer pays on a life insurance policy taken out for the benefit of the employee, or their spouse, civil union partner, de facto partner, or their child, if the policy is held by or for the trustees of a superannuation category 3 scheme:
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> …

13. Paragraph (g) applies where a close company (being the employer) pays a premium on a life insurance policy to the extent that it is treated as a dividend under subpart CD. The treatment of these policies is not considered in this item. Similarly, paragraphs (h) and (i) apply to life insurances policies that are, or are included in, or are held by or for the trustees in, certain superannuation schemes. This item does not consider the treatment of these policies.

14. Paragraph (f) excludes from "expenditure on account of an employee" premiums on life insurance policies where:

- the premium cannot be refunded to, or converted to cash by, the employee or an associated person; and
- the only benefits payable are those payable on the death of the employee (or relevant family member), or those payable because of accident, disease, or sickness of the employee (or relevant family member).

15. In the case of a term life policy taken out by an employer, an employee (or associate) will have no ability to have the premium refunded or converted to cash. Further, the only insurance benefit payable under this term life policy is a benefit payable on death. Consequently, para (f) will apply to exclude the premiums from being "expenditure on account of an employee".

16. As the payment of the premium by the employer is not expenditure on account of an employee and is not assessable income of the employee, it is necessary to consider whether FBT applies (s CX 4).

When amount of premium subject to FBT

17. Under s CX 2, a "fringe benefit" is a benefit that is provided by an employer to an employee in connection with their employment and comes within one of ss CX 6, CX 9, CX 10, or CX 12–CX 16, or is an unclassified benefit under s CX 37. Some benefits are also excluded from being fringe benefits by specific provisions in subpart CX. None of those exclusions are relevant here.

18. It is the provision of the policy rather than any payment under the policy that is the relevant "benefit" for FBT purposes. The provision of a life insurance policy is an economic benefit to an employee as they received cover under the policy without the need to pay for it themselves.

19. Section CX 16 specifically includes certain life insurance policies as fringe benefits. It applies when an employer pays a "specified insurance premium". The potentially relevant definition of "specified insurance premium" is set out in s CX 16(4):

> **CX 16 Contributions to life or health insurance**
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> …
>
> *Life insurance*
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> (4) The first kind of policy referred to in subsection (3) is a policy of insurance on the life of the employee or their spouse, civil union partner or de facto partner, or on their joint lives, or on the life of their child, to which all the following apply:
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> (a) for policies other than whole of life policies, the minimum term is—
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> (i) 10 years; or
>
> (ii) 5 years, for a policy whose maturity date is no earlier than the date on which a life assured reaches 60 years of age; and
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> (b) the only benefits payable earlier than 10 years from the start of the policy or its maturity date, whichever is earlier, are—
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> (i) benefits payable for the death of a life assured; or
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> (ii) additional benefits payable for an accident to a life assured or disease or sickness of a life assured; and
>
> (c) the policy—
>
> (i) provides for a payment on the death of a life assured of a benefit that is not a return of premiums, is substantially capital, and is not materially less than the total benefit payable under the policy otherwise than for death; or

(ii) is a policy on the life of a person who, because of ill health or physical disability, is unable to effect a policy of the kind described in subparagraph (i) at ordinary rates; or

(iii) is a deferred life assurance policy on the life of a child.

20. If a term life insurance policy meets the requirements of s CX 16(4) it will be subject to FBT under s CX 16(1). However, many term life policies will not meet the requirements of s CX 16. Group insurance policies, for example, will often not meet the minimum term requirements set out in s CX 16(4)(a).

21. If a term life policy does not meet the requirements of s CX 16, it will be an unclassified benefit under s CX 37. Section CX 37 applies to benefits that an employer provides to an employee in connection with their employment that are not covered or excluded by a more specific provision. Section CX 16 applies to "specified insurance premiums". When the predecessor to s CX 16 was enacted, there were different rates of FBT for different types of benefits. Relevantly, specified insurance premiums were subject to FBT at a lower rate than other benefits. Therefore, historically, specified insurance premiums were subject to FBT under a predecessor to s CX 16 while other insurance premiums were subject to FBT under a predecessor to s CX 37. The FBT rules have maintained this distinction, although, there are now few differences between applying s CX 16 and s CX 37.

22. There are no provisions in subpart CX that would exclude a term life insurance policy from being subject to FBT. Therefore, a term life insurance policy will be subject to FBT either under s CX 16 or CX 37.

23. Where an employer provides a fringe benefit to a person associated with an employee, s GB 32 treats the benefit as if it were provided by the employer to the employee. This is subject to the shareholder-employee exemption in s GB 32(2) and the look-through company exemption in s GB 32(2B). Therefore, premiums paid on term life insurance policies taken out by an employer for the benefit of an employee's spouse, civil union partner, de facto partner or child will also be subject to FBT.

Operational matters

24. It is possible that some employers may have been incorrectly applying s CX 16 rather than s CX 37 to term life insurance policies that they have provided for employees.

25. If employers have previously returned FBT on term life insurance policies under s CX 16 rather than s CX 37, the Commissioner will not be seeking to amend those previous FBT returns. However, employers must use the correct provision for any FBT returns filed for the period beginning 1 April 2015 onwards.

26. Any applications by taxpayers to have their FBT returns amended under s 113 will be considered by the Commissioner on a case by case basis.

Income tax treatment of proceeds

27. The proceeds received by an employee (or their estate) under a term life insurance policy are not income. An amount is income if it comes within a provision of Part C of the Act (s CA 1(1)). There are no specific provisions that tax payments under term life insurance policies.

28. An amount is also income if it is income under ordinary concepts (s CA 1(2)). A lump sum payment under a life insurance policy is not income under ordinary concepts.

Example

29. The following example is included to assist in explaining the application of the law.

30. Red Herring Fishing Ltd (RHF) takes out a term life insurance policy for one of its employees, Jared Stone. The policy is for a term of two years. The only benefit payable under the policy is if death occurs during the policy term. In such a case, the sum insured is paid to the employee's estate. RHF pays the premiums, which are non-refundable. RHF and Jared want to know the income tax implications of this arrangement.

31. RHF is allowed a deduction for the amounts of premium paid. The amounts of premium paid are not subject to PAYE. Also, they are not subject to s CX 16(4). However, they are "unclassified benefits" and, therefore, subject to FBT under s CX 37. Any lump sum paid out under the policy will not be subject to income tax.

References

"Part I - The Income Tax Amendment Act (No 2) 1988" *Public Information Bulletin* No 174 (May 1988): 35
"Life and accident insurance policies" *Public Information Bulletin* No 106 (July 1980): 2
"Staff insurance schemes" *Public Information Bulletin* No 70 (December 1972): 11

Subject references

Expenditure on account of an employee
FBT
Fringe benefit
Life insurance

Legislative references

Income Tax Act 2007, ss CA 1, CE 1(1), CE 5, CX 2, CX 4, CX 16, CX 37, DA 1, DA 2, GB 32, RD 3, RD 5(2), and the definitions of "expenditure on account of an employee" and "salary or wages" in s YA 1