QUESTION WE'VE BEEN ASKED QB 15/09

INCOME TAX – INSURANCE – PERSONAL SICKNESS AND ACCIDENT INSURANCE TAKEN OUT BY EMPLOYEE WITH EMPLOYER PAYING THE PREMIUMS ON EMPLOYEE'S BEHALF

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

This Question We've Been Asked is about ss CA 1, CA 2(2), CE 1(1), CE 5, CE 11, CW 34, CX 4, DA 1, DA 2, RD 2, RD 3, RD 5(2) and the definition of "salary or wages" in s YA 1.

1. This Question We've Been Asked (QWBA) considers the income tax treatment of personal sickness or accident insurance policies. Some personal sickness or accident insurance policies include elements of income protection insurance. There are specific provisions in the Act that apply only to income protection insurance, so income protection insurance may have a different tax treatment to other personal sickness or accident insurance.
2. This QWBA does not consider the treatment of payments to or from sickness, accident, or death benefits funds.
3. This QWBA also does not consider the treatment of weekly compensation purchased under s 223 of the Accident Compensation Act 2001.

Question

4. What is the income tax treatment of a personal sickness or accident insurance policy that is:
   - taken out by an employee (the employee is the policy holder), and
   - the premiums are paid by the employer on the employee's behalf?

Answer

5. The employer will generally be entitled to a deduction for the premiums paid.
6. The amount of the premiums paid for income protection insurance will not be subject to PAYE. The amount of premiums paid for other personal sickness or accident insurance policies will be treated as salary or wages and, therefore, subject to PAYE. Fringe Benefit Tax will not apply because the policy belongs to the employee.
7. Amounts paid out (or that an employee is otherwise entitled to) under income protection insurance policies will be income under s CE 11. Amounts paid out (or that an employee is otherwise entitled to) under other personal sickness or accident policies will be income only if they are income under ordinary concepts (s CA 1(2)). Amounts that are not income under ordinary concepts will not be subject to tax.
8. Amounts that are income under s CE 11 or s CA 1(2) will be exempt income if they are payments:
   - made to a person because they (or another person) are incapacitated for work; and either
     - o paid by a friendly society (s CW 34(2)(a)); or
     - o <u>not</u> calculated according to a loss of earnings (s CW 34(2)(c)).
9. If the payment does not meet these criteria, it will be assessable income.

Explanation

10. 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 QWBAs covering common scenarios.

11. This QWBA considers the situation where an employee takes out a personal sickness or accident insurance policy and the employer pays the premiums. It does not cover the situation where an employer takes out a sickness or accident insurance policy for the employee's benefit (see QB 15/10 for discussion of that situation).

12. There are many different types of insurance policies that could be sickness or accident insurance (or could include an element of personal sickness or accident insurance). These include medical insurance, income protection insurance, accident insurance, and trauma or critical illness policies. Pay-outs under these insurance policies can be periodic or lump sum and can be calculated in a variety of ways.

13. Where only part of a policy comes within a particular definition, it may be necessary to apportion premiums between different types of insurance. Similarly where a pay-out under a policy is made for more than one thing, apportionment of the receipt may be required.

Deductibility of premiums for employer

14. 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 (and/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)).

15. 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 sickness or accident insurance premium for an employee that is paid in connection with the employee's employment is a business cost just like 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.

Whether amount of premium paid is taxable in the hands of the employee

16. An employee's income includes "expenditure on account" of that employee (s CE 1(1)(b)). Expenditure on account of an employee means a payment <u>made by an employer</u> relating to expenditure <u>incurred by an employee</u> (or to be incurred by an employee) (s CE 5(1)). This is subject to certain exceptions (in s CE 5(3)).

17. The only potentially relevant exclusion in this context is s CE 5(3)(j). Section CE 5(3)(j) applies to premiums for income protection insurance that an employer is liable to make a contribution towards for the benefit of an employee. Where a personal sickness or accident policy is also (or also includes) income protection insurance, s CE 5(3)(j) may be relevant.

18. In the situation covered by this QWBA, the <u>employee</u> has a legal obligation to the insurance company to pay the insurance premiums. Therefore, the amount of the insurance premiums is incurred by the employee. The <u>employer</u> is paying the premiums to the insurance company. Therefore, the payment of the insurance

premiums meets the definition of expenditure on account of the employee under s CE 5(1).

19. To the extent that the premium paid is:

- for "income protection insurance"; and
- the employer has a liability to pay (or make a contribution towards) that premium,

then the payment of the premium will not be expenditure on account of the employee. Premiums paid for income protection insurance are not subject to PAYE (ss CE 5(3)(j)).

20. In all other cases the payment of the premium will be expenditure on account of the employee. A payment of expenditure on account of an employee is part of the employee's "salary or wages" (s RD 5(2)). A payment of salary or wages is a "PAYE income payment" (s RD 3). Therefore, the PAYE rules apply and the amounts are subject to PAYE. The amount of the premiums needs to be grossed up before PAYE is calculated. That is, the amount of the premium paid is the amount net of tax.

21. As the payment of the premium is assessable income to the employee, the FBT rules will not apply (s CX 4).

22. There are also other potential implications of having the gross amounts of the premiums included in an employee's salary or wages. For example, there are various other circumstances where obligations, eligibility, or entitlements may be calculated based on an employee's salary or wages (for example KiwiSaver and Working for Families Tax Credits).

Treatment of proceeds to the employee

23. Whether a payment made under an insurance policy is taxable will depend on what it is paid for. Some payments will not be income (under a specific provision or ordinary concepts) and, therefore, will not be taxable. Payments that are "income" may be either taxable or exempt income depending on the circumstances. The following discussion is intended to assist with determining how a payment under an insurance policy should be treated.

Is the payment to the employee income?

24. If a personal sickness or accident insurance policy is (or includes) income protection insurance, s CE 11 may apply. Payments made under a policy of income protection insurance where an employer is liable to pay or contribute to the premiums are income to the employee under s CE 11.

25. There are no specific provisions that apply to make payments under other personal sickness or accident insurance policies income. Therefore, payments under these insurance policies will be income only if they are income under ordinary concepts (s CA 1(2)).

26. Whether a payment under an insurance policy is income or not will depend on the relationship between the payer and the recipient and the purpose of the payment (*Reid v CIR* (1985) 7 NZTC 5,176). Where a payment is made to replace income which the recipient would otherwise have earned or where the purpose of the payments is to provide the recipient with amounts to meet their living expenses, the payments are likely to be income. Payments that are regular or recurring are much more likely to be income (*Reid*). However, a one-off payment may still be income (*FCT v Hyteco Hiring Pty Ltd* 92 ATC 4,694).

27. Therefore, the payments that are most likely to be income are payments that are intended to compensate an insured person for lost income (whether periodic, or lump

sum) and other regular or periodic payments intended to help the insured person meet their living expenses. Other lump sum and reimbursing payments are unlikely to be income (for example, a lump sum payment made to compensate a person for the loss of a limb, or a payment reimbursing medical expenses).

28. Payments that are not "income" (either under s CE 11 or s CA 1(2)) will not be taxable. If a payment is "income", it is necessary to consider whether it is assessable income or exempt income.

Is the payment exempt income of the employee?

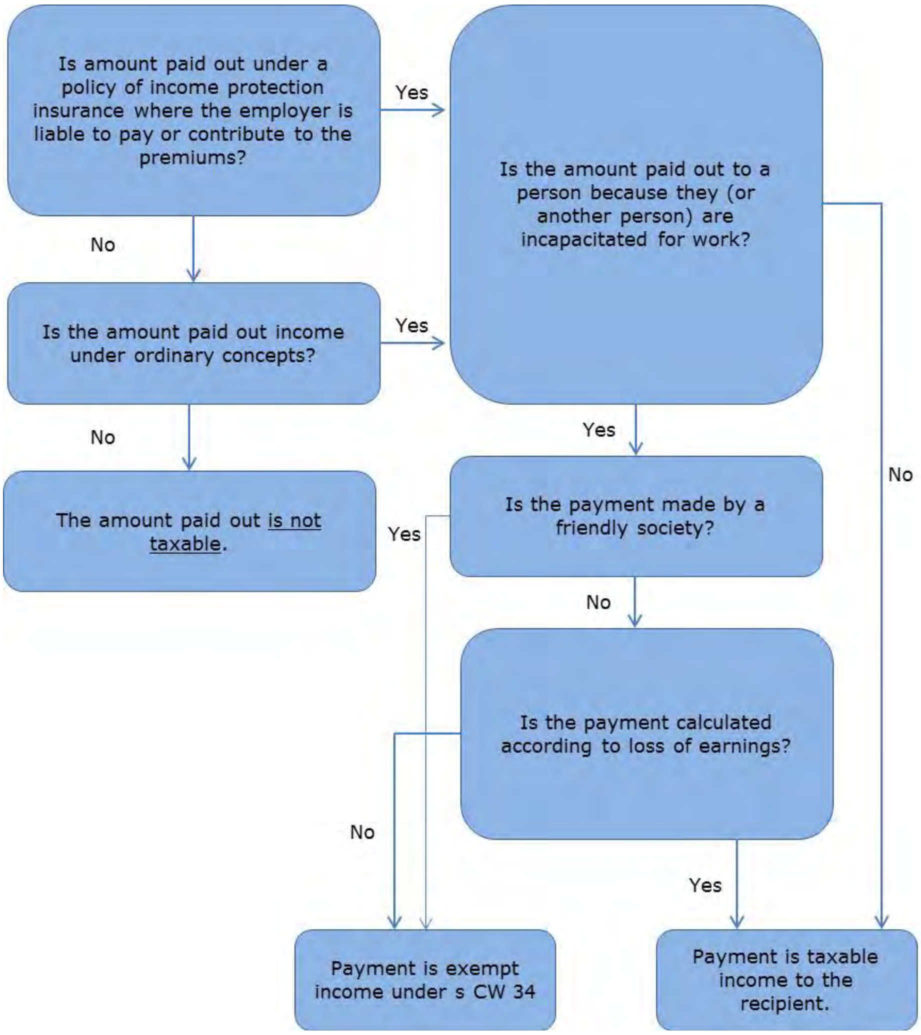
29. The relevant exemption provision is s CW 34. A payment of income made under a policy of personal sickness or accident insurance will be exempt under s CW 34 if:

- it is made to a person because they (or another person) are incapacitated for work; and either
  - the payment is made by a friendly society; or
  - the payment is <u>not</u> calculated according to loss of earnings.

30. If the payment does not meet these criteria, it will be assessable income.

31. The following diagram sets out the process for determining how an amount paid out under a policy should be treated. Each payment needs to be considered separately. As noted above, where a single payment is made for more than one thing, apportionment may be required:

Treatment of payment made to a person under a policy of personal sickness or accident insurance



Examples

32. The following examples are included to assist in explaining the application of the law.

Example 1 – Income Protection Insurance

33. Joan takes out an income protection insurance policy for herself. Joan's employment contract contains a clause that, if Joan takes out an income protection insurance policy, her employer will pay the premiums. Joan's policy provides that, if Joan is unable to work due to sickness or accident, she will be paid 75% of her lost earnings. Joan and her employer want to know the income tax implications of this.

34. Joan's employer is allowed a deduction for the amounts of premium paid to the insurer. There is no PAYE payable on the amount of premiums as they are excluded from being "expenditure on account" under s CE 5(3)(j). If Joan becomes unable to work and her policy pays out, these amounts will be Joan's assessable income. The payments will not be exempt under s CW 34 as they will be calculated according to the earnings that Joan has lost.

Example 2 – Accident Insurance

35. Dennis takes out an accident insurance policy and, as part of his remuneration package, his employer agrees to pay the premiums. Under the policy Dennis will receive a fixed lump sum payment on the occurrence of certain specified events if caused by an accident. Dennis' accident insurance policy will also reimburse medical expenses incurred as a result of an accident up to a maximum of $50,000. Dennis' employer is allowed a deduction for the premiums and Dennis is subject to PAYE on the amounts of the premiums paid.

36. The following year Dennis has an accident while using his axe at home and loses a toe. His policy pays out a fixed amount of $1,000 for the loss of his toe and also reimburses Dennis $10,000 for his medical expenses. Dennis wants to know whether to include these amounts in his income.

37. The sum for the loss of his toe and the reimbursements of Dennis' medical expenses are not income. The amounts are not income under ordinary concepts. They are not periodic or regular payments. Also, they are not paid to compensate Dennis for lost income nor are they payments on which Dennis can rely for his living expenses.

References

Related rulings/statements

"Staff insurance schemes" *Public Information Bulletin* No 70 (December 1972): 11

"Life and accident insurance policies" *Public Information Bulletin* No 106 (July 1980): 2

Subject references

Expenditure on account of an employee

Income protection insurance

Personal sickness or accident insurance

Legislative references

Income Tax Act 2007, ss CA 1, CA 2(2), CE 1(1), CE 5, CE 11, CW 34, CX 4, DA 1, DA 2, RD 2, RD 3, RD 5(2) and the definition of "salary or wages" in s YA 1

Case references

FCT v Hyteco Hiring Pty Ltd 92 ATC 4,694

Reid v CIR (1985) 7 NZTC 5,176