Inland Revenue
Te Tari Taake

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QUESTION WE'VE BEEN ASKED

QB 18/02
Income Tax – insurance – term life insurance policy taken out by employee with employer paying the premiums on employee's behalf

This Question We've Been Asked (QWBA) considers the income tax treatment of term life insurance policies where an employee takes out the policy and their employer pays the premiums for them.

This QWBA replaces QB 15/05: "Income Tax – Insurance – Term life insurance policy taken out by employee with employer paying the premiums on employee's behalf" Tax Information Bulletin *Volume Twenty Seven, No 6 (July 2015).*

Key provisions

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

Question

What is the income tax treatment of a term life 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

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

The amount of the premiums will be treated as salary or wages and, therefore, subject to PAYE. Fringe Benefit Tax will not apply.

Lump sum claims paid under a term life insurance policy will not be taxable income of the employee (or the employee's estate).

Explanation

1. Inland Revenue 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During that review two items on the income tax treatment of insurance in an employment context were identified as being out of date.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. Those items were replaced with a series of Questions We've Been Asked (QWBAs) covering common scenarios.

2. Since those QWBAs were published changes have been made to the Income Tax Act to simplify the treatment of employer provided insurance. Those changes came into effect on 30 March 2017. It has, therefore, been decided to update and replace the affected QWBAs.

3. This QWBA considers the situation where an employee takes out a term life insurance policy and the employer pays the premiums. The previous version of this QWBA was QB 15/05: "Income Tax – Insurance – Term life insurance policy taken out by employee with employer paying the premiums on employee's behalf" *Tax Information Bulletin* Volume Twenty Seven, No 6 (July 2015). This QWBA does not cover the situation where an employer takes out a life insurance policy for the employee's benefit. For discussion of that situation, see QB 18/03.

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

Deductibility of premiums

5. 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)).

6. 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 an employee 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.

Amount of premium paid taxable in the hands of the employee

7. 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)), none of which are relevant here. In particular, the exclusion in s CE 5(3)(a) will not apply as the expenditure would not be deductible to the employee in the absence of the employment limitation (being a payment made to secure a capital benefit).

8. In the situation covered by this QWBA, the employee has a legal obligation to the insurance company to pay the insurance premiums. Therefore, the amount of the insurance premiums has been incurred by the employee. The employer is paying the premiums to the insurance company. Therefore, the payment of the insurance premiums is expenditure on account of the employee and is the employee's income.

9. 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.

10. As the payment of the premium is assessable income to the employee, the fringe benefit tax rules will not apply (s CX 4).

11. 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 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).

Income tax treatment of claims paid

12. The claim 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 claim payments under term life insurance policies.

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

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

Example

Sally takes out a term life insurance policy with XYZ Insurance Ltd (XYZ). The sum insured is payable to Sally's family in the event of her death. Sally's employer, Flamingo Plumbing Ltd (FPL), pays the premiums to XYZ on Sally's behalf. FPL and Sally want to know the income tax implications of this.

FPL is allowed a deduction for the amounts of premium paid to XYZ. The amounts of premium paid will be treated as part of Sally's salary or wages. These amounts are, therefore, subject to PAYE. Any lump sum claim paid under the policy to Sally (or her estate) will not be subject to income tax.

References

Subject references

Expenditure on account of an employee
Life insurance

Legislative references

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

Other references

"Staff insurance schemes" *Public Information Bulletin* No 70 (December 1972): 11
"Life and accident insurance policies" *Public Information Bulletin* No 106 (July 1980): 2
QB 15/05: "Income Tax – Insurance – Term life insurance policy taken out by employee with employer paying the premiums on employee's behalf" *Tax Information Bulletin* Volume Twenty Seven, No 6 (July 2015)