Inland Revenue
Te Tari Taake

QUESTION WE'VE BEEN ASKED QB 17/06

INCOME TAX: INSURANCE – KEY-PERSON INSURANCE POLICIES

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

This Question We've Been Asked is about ss CA 2, CB 1, CG 5B, DA 1, DA 2(1) and DA 2(3).

Question

1. What is the income tax treatment of payments made or received under a term life or an illness/disability insurance policy where:

   - the policy holder and recipient of any claim amount received under the policy is a business that employs staff;
   - the premium amounts are paid by the business;
   - the insured person is an employee of the business ("the key-person");
   - the employee has no enforceable or implied right against the employer to receive the claim or part thereof; and
   - the policy is taken out to compensate for a loss of business profits that would result from the death or incapacitation of the key person, whether or not the loss is accurately estimated?

   This type of insurance policy is commonly referred to as a "key-person insurance" policy and includes policies that cover total permanent disability, personal sickness and accident ("disablement policies").

Answer

2. A lump sum or a periodic sum paid under the policy is taxable income of the employer under s CB 1 (business income).

3. Premium amounts paid are deductible under s DA 1.

4. This QWBA covers key-person insurance policies to the extent that the policy is taken out to compensate for a loss of business profits that would result from the death or incapacitation of the key person. Insurance policies can be taken out for reasons other than, or in addition to, this loss of business profits purpose (eg, mortgage repayment protection, and collateral for capital funding). To the extent the insured amount is for replacement of capital, the claim amount portion that relates to the replacement of capital will not be taxable income. Where a policy is not solely to replace a loss of profits, apportionment of the premiums and/or claim amount may be required.

5. Fringe benefit tax (FBT) does not apply.

Explanation

6. Inland Revenue has reviewed all *Public Information Bulletins* (see http://www.ird.govt.nz/technical-tax/pib-review/). During this review, two items on the income tax treatment of insurance in an employment context were identified as being out of date.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). These PIBs covered a number of different scenarios. We are replacing the PIBs with a series of Questions We've Been Asked (QWBAs) covering common scenarios.

7. PIB 106 dealt with policies where the premiums were paid by the employer and proceeds were payable to the employer. Key-person insurance has these features. The PIB item noted that the tax treatment depended on what the insurance was for. This QWBA is considering the tax treatment of payments made or received under a key-person insurance policy for the replacement of loss of business profits.

8. Many businesses (including sole traders or partnerships) have a key employee who has a unique set of skills and/or knowledge, and is vital to the business's continued success. Should something happen to that employee, the loss of that employee will have a detrimental impact on the profitability of the business or generate financial strain. The employer may choose to protect the business from this risk by taking out a key-person insurance policy on the life and/or disablement of that key employee. This item covers policies where the purpose of the employer in taking out the policy is to obtain cover that provides revenue replacement to that employer in the event of a key person's death or disablement due to illness or accident. The disablement could be either temporary or permanent. The claim amount can be received as a lump sum (as in the case of death or permanent disablement) or as periodic payments where the incapacity is temporary. This item does not apply to business owners such as a sole trader who takes key person insurance out on themselves (see paragraph 11 below) .

9. The features of a key-person insurance policy covered by this QWBA are:

- the business (the employer) is the policy owner and the recipient of any amounts received under the policy (ie, the beneficiary);
- the employer pays the premiums;
- the employer is the only party eligible to make a claim under the policy;
- the policy is either a term life or a disablement insurance policy or a combination of both;
- the insured person is an employee;
- the policy is taken out to compensate for a loss of business profits (either due to a reduction in turnover or an increase in costs) that would result from the death or extended incapacity (due to illness or accident) of the key employee, whether or not the loss is accurately estimated;
- the employee has no enforceable or implied right against the employer to receive the claim or part thereof; and
- the claim amount is an agreed amount that may be paid as a lump sum or by periodic payments to the employer.

10. A number of other insurance policies also address types of financial loss suffered by a business (eg, business interruption). The type of key-person policy covered by this QWBA insures against an event involving the personal health (or death) of a key employee. Whereas a business interruption policy insures against financial loss triggered by physical damage to the business's operations caused by an event such as fire, earthquake or cyclone. Business interruption policies do not have a life insurance component to them.

11. The type of key-person policy covered by this QWBA is also distinguishable from an income protection policy because it protects the income of the business

(employer), whereas income protection policies provide protection for the income of the insured person (eg, income of the employee or sole trader). Business interruption and income protection policies are not covered in this QWBA. Also this item does not cover whole of life or endowment policies as we understand that these types of policies are no longer commonly used in this context.

Income tax treatment of the claim amount

12. An employer can receive an amount of money from an insurer on the occurrence of the insured event, referred to as the claim amount.

13. An amount derived from a business is income (s CB 1(1)). Capital amounts are excluded from taxable income (s CB 1(2)). Whether a claim amount received is income or capital depends on whether it is compensating for a loss of a capital or revenue nature (*Egmont Co-operative Dairies Ltd (in liq) v CIR* [1996] 2 NZLR 419 (1996) 17 NZTC 12,536, *Carapark Holdings Ltd v FCT* (1967) 115 CLR 653).

14. Insurance claim amounts that are received to "fill the hole of" or replace lost business profits are generally considered to be business income in nature. Richardson P in *Egmont* (quoting Kitto, Taylor and Owen JJ in *Carapark*) stated:

> In general, insurance moneys are to be considered as received on revenue account where the purpose of the insurance was to fill the place of a revenue receipt which the event insured against has prevented from arising, or any outgoing which has been incurred on revenue account in consequence of the event insured against, whether as a legal liability or as a gratuitous payment actuated only by considerations of morality or expediency.

15. Similarly, in *CIR v Soma President Textiles Ltd; CIR v New Zealand Knitting Mills Ltd* (1994) 16 NZTC 11,313, McGechan J stated (at 11,321):

> ... It is well recognised that the character of a compensation receipt-as capital or income-is coloured by the character of the item it compensates. Compensation for capital assets is capital: for income items, is income....

See also *Burmah Steam Ship Co Ltd v IRC* (1931) 16 TC 67 and *London & Thames Haven Oil Wharves Ltd v Attwooll* [1967] 2 All ER 124,134.

16. The Courts have confirmed that income derived under a policy insuring a key-person will generally be revenue in nature (see *Gray & Co Ltd v Murphy* (1940) 23 TC 225 (KB), *Executors of Williams v IR Commissioners* (1924) 26 TC 23 (HL), *Keir & Cawder v Commissioners of Inland Revenue* (1958) 38 TC 23 (Court of Session), and *Carapark*). In *Keir & Cawder*, Lord President Clyde summarised this principle as follows:

> In the ordinary case where a company insures the life of an employee whose services are valuable to them, the sum received by the company on his death is a revenue reciept: see *Commissioners of Inland Revenue v Williams's Executors*, 26 T.C. 23; for the expenditure incurred by the company in securing and retaining his services is a proper revenue charge, and the benefits derived from these services, being reflected in the profits of the company, are also of a revenue character. In the ordinary case, therefore, if the company insures the life of that person and on his death receives a payment from the insurance company, that payment represents compensation to the company for the loss of his services in helping them to earn profits and is a receipt on revenue account.

17. As key-person insurance amounts replace taxable business profits they will also be taxable income under the Act. However, if the claim amount replaces a capital component, that component of the claim amount would be capital for tax purposes.

18. If the income that is being replaced by the claim amount is exempt or excluded income (s CA 2) then the claim amount will also be exempt or excluded income in the same manner as the income it replaces.

19. Section CG 5B is a specific provision that taxes certain receipts for interruption or impairment of business activities. In an insurance context it taxes insurance payments received **for** an interruption or impairment of business activities resulting from an event. If the key-person insurance policy includes payments that are contingent on the taxpayer proving an actual loss of income, these payments are likely to be taxable under s CG 5B and subject to the timing provision in s CG 5B(3).

Deductibility of premiums for employer

20. 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 taxable (and/or excluded) income (s DA 1). It is also necessary that the deduction is not denied by the general limitations contained in s DA 2.

21. As set out above, insurance recovery amounts under key-person insurance policies will generally be revenue in nature (see *Egmont; Carapark*). Where that is the case, the payment of a premium intended to insure against the lost taxable income will satisfy the nexus test in s DA 1. The capital limitation in s DA 2(1) will not apply because the premiums are a regular expense outlaid as part of the regular demands on the income of the business.

22. There will, however, be situations where premiums will not be deductible, either because the expenditure will not satisfy the general permission in s DA 1, or because one or more of the general limitations in s DA 2 will apply. For example, the Commissioner considers that premiums will not be deductible in the following situations:

- Where the employer takes out a policy for the purpose of securing the ability to repay a loan. In this situation, the capital limitation will apply.[1]
- Where the employer takes out a policy on behalf of its shareholders in order to buy out a shareholder's estate in the event one of them dies. In this situation, the benefit accrues to the shareholders, rather than to the company itself. Therefore, the general permission will not be satisfied.

23. Where a policy is not solely to replace a loss of profits, apportionment of the premiums and/or claim amount may be required.

24. The taxpayer has the onus of proving that an insurance premium is deductible. Therefore, it will be necessary to regularly review the purpose of a policy to determine deductibility of the premium, consistent with the principles of self-assessment.

Fringe Benefit Tax

25. For the avoidance of doubt, there is no benefit provided to an employee in connection with the key person insurance policies covered in this QWBA. This means no fringe benefit tax applies.

Examples

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

[1] The Commissioner has also confirmed that a deduction will not be allowed under s DB 5 where the insurance has a primary purpose of ensuring repayment obligations can be met (see "Deductibility of expenditure incurred in borrowing money – section DB 5" Interpretation statement IS 13/03 (Tax Information Bulletin Vol 26, No 1 (February 2014):3)).

Example 1 – Purpose is only for loss of profits

27. ABC Ltd relies heavily on its top salesperson, Bob Adams. ABC Ltd is concerned that if something happened to Bob, the company would suffer a significant loss of profits. It estimates its potential loss of profits would be at least $400,000. To help manage this risk, ABC Ltd takes out a key-person insurance policy. Features of the policy are:

- Bob Adams is the life insured;
- the policy document describes the policy benefits as a "term life insurance policy" and names ABC Ltd as the policy owner;
- ABC Ltd is contractually bound to pay the monthly premiums;
- the insurer will pay out to ABC Ltd on death, or on total permanent disablement of Bob, or pay a monthly benefit based on expected losses suffered if Bob is temporarily unable to work.

28. A claim amount of $400,000 is payable as a lump sum on death or total permanent disablement. A lesser amount is payable for partial disablement. Alternatively for temporary incapacity, a monthly benefit ($12,500 per month payable in monthly instalments for a maximum of 24 months) will be paid to ABC Ltd until either Bob can return to work or is no longer employed by ABC Ltd.

29. The value of the claim amount and the value of the monthly benefit amounts have been determined with reference to ABC Ltd's historical financial results.

30. ABC Ltd wants to know whether it can deduct the premiums that it pays on the policy. ABC Ltd is allowed a deduction for the premiums paid as they are a cost incurred by them in deriving taxable income (s DA 1).

31. Unfortunately the following year, Bob is killed in a car accident and ABC Ltd receives the $400,000 claim amount shortly after this event.

32. ABC Ltd wants to know whether the claim amount is taxable.

33. The claim amount is taxable under s CB 1. The purpose of the policy is *to ensure ABC Ltd does not suffer a loss of business profits* due to Bob being unable to contribute to the business's profitability. As the amount of $400,000 received from the insurer is intended to replace business profits, it will be taxable income under s CB 1(1).

34. If Bob had been only injured in the car accident, ABC Ltd would suffer a temporary loss of business profits. In that case, ABC Ltd would receive a monthly benefit. The monthly benefit amounts would also be taxable income under s CB 1.

Example 2 – Multiple purpose key-person policy

35. Quick Growth Ltd relies heavily on its chief programmer, John Jones. Five years ago when the company began Quick Growth Ltd was concerned that if something happened to John, the company would suffer a significant loss of profits. To help manage this risk Quick Growth Ltd took out a key-person insurance policy for $500,000. The features of the policy were identical to ABC Ltd's policy (above).

36. Because Quick Growth Ltd has expanded rapidly they are reassessing their insurance requirements. In addition, Quick Growth has applied for a loan from the bank. The bank has indicated they will accept the key-person insurance policy will meet their requirement for mortgage repayment insurance. Quick

Growth Ltd decides they now require $600,000 to cover the loss of profits risk but also require an additional $400,000 cover to satisfy the bank's requirements.

37. Quick Growth Ltd wants to know if it can claim the premiums it pays on the policy. Quick Growth Ltd is allowed a proportional deduction for the premiums paid based on the ratio of the insured amount relating to the loss of profits/total insured amount (eg, $600,000/$1,000,000 = 60%). The remaining 40% of the premium is subject to the capital limitation in s DA 2.

38. Six months later John has a heart attack and dies. Quick Growth Ltd receives the $1,000,000 claim amount shortly after this event.

39. Quick Growth Ltd wants to know whether the claim amount is taxable.

40. The claim amount of $600,000 for loss of profits is taxable (s CB 1). The purpose of this amount was to replace business profits due to John being unable to contribute to the business's profitability. The balance is not taxable. As the amount of $400,000 is intended to replace capital repayments it will not be taxable under s CB 1(1).

References

Related rulings/statements

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

"Deductibility of expenditure incurred in borrowing money – section DB 5" *Interpretation Statement* IS 13/03 (2013) *Tax Information Bulletin* Vol 26 No 1 (February 2014)

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

QB 15/05 Term life insurance taken out by employee with employer paying the premiums on employee's behalf (TIB Vol 27, No 6 (July 2015))

QB 15/06 Term life insurance policy taken out by employer for the benefit of an employee (TIB Vol 27, No 6 (July 2015))

QB 15/09 Personal sickness and accident insurance taken out by employee with employer paying the premiums on employee's behalf (TIB Vol 27, No 10 (November 2015))

QB 15/10 Personal sickness and accident insurance taken out by employer for the benefit of an employee (TIB Vol 27, No 10 (November 2015))

Subject references

Income protection insurance
Life insurance
Personal Illness or Disability insurance

Legislative references

Income Tax Act 2007 – ss CA 2, CB 1, CG 5B, DA 1, DA 2(1) and DA 2(3)

Case references

Burmah Steam Ship Co Ltd v IRC (1931) 16 TC 67
Carapark Holdings Ltd v FCT (1967) 115 CLR 653
CIR v Soma President Textiles Ltd; CIR v New Zealand Knitting Mills Ltd (1994) 16 NZTC 11,313
Gray & Co Ltd v Murphy (1940) 23 TC 225 (KB)
Egmont Co-operative Dairies Limited (in liq) v CIR (1996) 17 NZTC 12,536
Executors of Williams v IR Commissioners (1924) 26 TC 23 (HL)
Keir & Cawder v Commissioners of Inland Revenue (1958) 38 TC 23 (Court of Session)
London & Thames Haven Oil Wharves Ltd v Attwooll [1967] 2 All ER 124,134

Other references

http://www.ird.govt.nz/technical-tax/pib-review/