

Legal update

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Taxation of group insurance premiums and benefits

Summary

The Taxation Laws Amendment Act No. 31 of 2013 that was published in Government Gazette No. 37158 on 12 December 2013 brings a change to the taxation of employer-provided disability income benefits. From 1 March 2015, a member will no longer be able to claim a tax deduction on the premium paid for a disability income benefit and the benefit will be paid out tax-free.

Current position for the employer-provided (unapproved) insurance benefits that have been set up for the benefit of the employee or their spouse, child, dependant or nominee

	Death, disability, severe illness lump sum	Disability income
Employer	Deduction for premiums paid on behalf of the employee.	Deduction for premiums paid on behalf of the employee.
Member	Premiums taxed as fringe benefit. No deduction for premiums paid.	Premiums taxed as fringe benefit. Deduction for premiums paid.
Benefit	Tax-free – exemption will apply.	Taxed – included in gross income, no exemption.

Currently, the premiums paid by an employer on self-standing insurance benefits such as death and disability for the benefit of the employee or their spouse, child, dependant or nominee, are deemed to be a taxable benefit granted by the employer to the employee. This means that these premiums have to be taxed as fringe benefits in the hands of the employee.

A lump sum benefit is paid out tax-free to the employee or their dependants or nominees in terms of section 10(1)(gG) of the Income Tax Act. When the benefit is paid to the employer, it is included in the employer's gross income. If the employer then on-pays this amount to the employee or their dependants or nominees, the employer must ask for a section 11(a) deduction for this payment. The employer's tax position is ultimately neutral, but they first need to account for the accrual and subsequent deduction in their own records.

Employer-provided disability income benefits on the other hand are treated differently. The employee is entitled to claim a tax deduction for the premium on which they paid fringe benefit tax. The employee's tax position for the premium is neutral – they pay fringe benefit tax, but get a deduction for that. If the employee receives a benefit, it is taxed.

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Position from 1 March 2015 for the employer-provided (unapproved) insurance benefits that are set up for the benefit of the employee or their spouse, child, dependant or nominee

	Death, disability, severe illness (whether the benefit is paid as a lump sum or annuity)
Employer	Deduction for premiums paid on behalf of the employee.
Member	Premiums taxed as fringe benefit. No tax deduction.
Benefit	Tax-free – exemption will apply.

National Treasury has set out to align the tax position of lump sum disability and income disability insurance benefits. From 1 March 2015, an employee will no longer be able to claim a deduction on the premiums paid for disability income insurance benefits. These benefits will be treated the same as employer-provided lump sum insurance benefits – the premiums will be taxed as fringe benefits in the hands of the employee and the benefit will be paid out to the employee tax-free. The premiums will still be deductible for the employer as long as the premiums have been taxed in the hands of the employee as a fringe benefit. The employer deduction will fall under section 11(w)(i) of the Income Tax Act. Section 11(w)(i) only relates to cover for employees or directors of the employer. If any other person is covered, the employer should ask for a deduction under the general deduction formula.

Impact on FundsAtWork members

These changes will have an effect on the take-home pay of members who are covered for disability income insurance benefits provided by their employers, as they will no longer be able to claim a tax deduction on the premiums. On the other hand, the benefit will no longer be taxed.

The following simplified example, which does not take any probabilities or interest into account, illustrates the difference between having to pay tax on the premium and paying tax on the benefit.

Mark is 25 years old. His disability income benefit is equal to 100% of his annual insurance salary of R165 000. The premium for this benefit is R1 732.50 per year. The termination date for the benefit is when Mark turns 65. His tax rate is 18%. We assume that neither his insurance salary nor his premiums change. He becomes disabled when he is 50. By that time he paid R43 312.50 (R1 732.50 per year X 25 years) in premiums. His total benefit at age 65 would be R2 475 000 (R165 000 per year X 15 years).

If the benefit is taxed, Mark would pay tax of R445 500 in total during the 15 years. If the premiums are taxed, Mark would pay tax of R7 796.25 over the period of 25 years. In this example, the tax on the benefit is much higher than the tax on the premium and therefore Mark will be better off under the new dispensation.

However, if Mark did not become disabled, he would have paid tax on the premiums without ever receiving the tax-free benefit. Most members do not become disabled before retirement. Most members would therefore not be subject to the benefits of the tax saving on the benefit payments.

From 1 March 2015 all employer-provided insurance benefits will be tax-free, even if the premiums were previously deductible. Members who were claiming a tax deduction on disability income premiums will be in the fortunate position of having had a tax neutral position for the premiums up to 1 March 2015 and getting their benefit paid out to them tax-free if they claim after this date.

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