

Unpacking tax changes to income protection policies rules

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Income protection policies provide cover against the death, disablement (temporary and permanent), illness or unemployment of an individual. This individual could be the direct policyholder or employed by a company that holds the policy on his or her behalf.



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As of the latest tax year (starting 1 March 2015), companies are still struggling to come to grips with the consequences of the changes to the rules in respect of premiums paid to income protection policies for their payroll administration and payroll systems.

Old rules

Up until 28 February 2015, premiums that employers paid into employer-owned income protection policies were regarded as a fringe benefit of the same value as the premium. This fringe benefit was deemed to be a premium paid by the employee and the total premium paid by the employee (including any employee-paid premiums) was allowed as a tax deduction. Annuity or lump sum payouts from income protection policies were fully taxable.

Reversal of old order

As of 1 March 2015, new rules that are essentially the opposite of the old ones came into effect. Now, an employer's payment into an income protection policy is treated as a fully taxable fringe benefit, while any payments the employee makes into an income protection policy of his or her own is not tax deductible.

Should the employee need to claim from the policy - perhaps due to illness, disability or unemployment, the payout (irrespective of whether it is a lump sum or a monthly annuity income) is not taxable.

Administration challenges

Here is where some confusion comes in: monthly annuity income from an income protection policy has changed from being taxable (i.e. remuneration) to being not taxable (i.e. not remuneration) from 1 March 2015.

This creates some unexpected difficulties in the administration of temporary disability since most of the employment Acts rely on the payment of remuneration to define an employee. If no remuneration is paid, the individual is no longer an employee.

If an employee is booked off from work for the reason of temporary disability, and the annuity payout from an income protection policy is the only income he or she receives during this time, the annuity income is no longer remuneration. However, not being defined as an employee must not be confused with the individual's employment status.

Prior to the temporary disability period, the individual was an employee, and the employer or employee can only terminate employment for reasons specified in labour law and after following proper procedures. The individual remains employed, even though he or she is no longer an employee by definition.

What does the rather contradictory situation of a person not being an employee but still being employed mean in practice?

Example

Let us consider this by means of an example.

Temporary disability scenario:

1. An employee is booked off from work for six months from 1 June 2015 until 30 November 2015.
2. During this period, the employee does not work and no remuneration is paid or payable to him or her by the employer.
3. The insurance company pays monthly annuity income to the employer under the terms of an income protection policy.
4. The employer essentially acts as an administrative agent for the insurance company by paying the monthly annuity to the individual.

In this scenario, the company should treat the temporary disability lay-off period as a form of unpaid leave.

Applying employment laws

Employers should apply the various employment laws as follows:

Basic Conditions of Employment Act (BCEA)

1. BCEA Annual leave
Section 20(2) states that an employer must grant an employee at least one day of annual leave for every 17 days "... on which the employee worked or was entitled to be paid;". This individual is not entitled to annual leave accumulation because he or she did not work and was not entitled to be paid.

2. BCEA Sick leave

The individual is entitled to sick leave in terms of section 22(1) that refers to the sick leave cycle of "... 36 months' employment with the same employer ...". Employment did not come to an end; therefore the entitlement over the 36 month period remains valid. However, sick leave cannot be taken concurrently with the temporary disability layoff period.

3. BCEA Family Responsibility Leave

The individual retains his entitlement to family responsibility leave under conditions specified by the BCEA. Again, it cannot be taken concurrently with the temporary disability layoff period.

Income Tax Act (Fourth Schedule)

1. The person is not an employee as defined by the Fourth Schedule for the temporary disability period.
2. The person remains in employment for the temporary disability period.
3. The employee will be taxed on the six months of remuneration paid during the three months of work before and after the temporary disability period. This income will be reported on the tax certificate in the normal way, and on assessment will be spread over the 12 months of the tax year.
4. The six months of non-taxable annuity income from the income protection policy must be reported as code 3602 on the tax certificate.

In other words, the individual must be kept on the payroll during the six-month temporary disability period because there is still an employment relationship and because the annuity income must be reported on the tax certificate.

If the six-month temporary disability period had started on 1 December 2014, then the annuity income for the last three months of the 2014/15 tax year would have been taxable (code 3601), and the annuity income for the first three months of the 2015/16 tax year would have been not taxable (code 3602).

Unemployment Insurance Contributions Act (UICA)

1. The person is not an employee as defined by the UICA for the temporary disability period.
2. The person remains in employment for the temporary disability period.
3. No contributions are paid because the individual is not an employee, and there is no remuneration on which to calculate the contribution.

Unemployment Insurance Act (UIA)

1. In terms of section 56(4) of the UIA, the employer must declare the individual to the Unemployment Insurance Commissioner on a monthly basis during the six month temporary disability period.
2. The following code values must be used while declaring an employee who is on temporary disability:
 - Code 8280 (Employment Status code) = 10 (Illness leave)
 - Code 8290 (Reason Code for Non-Contribution) = 06 (No income paid for the period)

ABOUT ROB COOPER

Rob Cooper is a tax expert and director of legislation updates and proposed legislation of Sage VIP.
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