Group life benefits: approved or unapproved?

1. Introduction

1.1. Staff lump sum death benefits are most commonly provided through a group life insurance policy. Such policies can be arranged on what is known as an ‘approved’ or an ‘unapproved’ basis. These labels refer to the tax treatment of the insurance policy premiums and the claim proceeds, as explained in detail below.

1.2. With an approved scheme, normally where the benefit is promised in the rules of a tax-approved pension or provident fund, the policy is owned and premiums are paid by the fund and this creates no fringe benefit tax consequences for the employee. On death, R500,000 (less any previously-taken applicable tax-free allowances from retirement funds) is free of tax and the balance taxed as follows:

1.2.1. Any amount from R500,001 to R700,000 is taxed at 18%;

1.2.2. Any amount from R700,001 to R1,050,000 is taxed at 27%;

1.2.3. Any amount from R1,050,001 upwards is taxed at 36%.

(This tax structure was introduced in the February 2014 budget and applies for the tax year 2014/2015.)

1.3. With an unapproved scheme, typically a separate insurance policy issued to the employer and not associated with a pension or provident fund, it is common for the employee to pay all or part of the premium in which case it comes out of after-tax pay.

If the employer pays all or part of the premium, this is tax deductable as an expense for the employer’s tax purposes but the amount must be added to the employee’s income and taxed accordingly as a fringe benefit.

On death, the total benefit is paid free from any tax liability.

1.4. The purpose of this note is to demonstrate that, except where the death benefit is exceptionally large relative to income, **approved arrangements are more cost-efficient than unapproved**.

2. The issue

2.1. When advocating the merits of an *unapproved* scheme the example is always given of a staff member dying under an approved scheme and the emerging benefit being less than anticipated due to the

(possibly unexpected to the family) tax deduction.

2.2. It is argued that the dependants would have been much better off had the same benefit been arranged in terms of an unapproved scheme due to the benefits being paid tax-free. This appears to be obvious but the simplistic and misleading in that it **completely ignores the difference in purchasing power between a given amount of money pre- and post-tax, and the impact of the tax structure shown above**. A different picture emerges when one allows for this in the calculations.

2.3. The correct, if perhaps counter-intuitive, approach is to consider the level of expenditure for which the employer/employee is prepared to budget in the provision of life assurance benefits.

3. Worked example

Take as a simplified example a budget of 2% of salary roll and further assume that the premium for life cover of one times annual salary is 0.4% of salary for each employee irrespective of age *(the simplification does not affect the principle nor the conclusion)*.

Consider the case of an employee with taxable income of R240,000 per annum with a marginal rate of tax (2014/15 tax year) of 25%. The example is performed on the basis that take-home pay will be unaffected whichever route is adopted.

3.1. Approved cover: premium and cover

3.1.1. Fund pays premium of 2% of salary.

3.1.2. This cost is fully deductible in the employer's hands as part of the employer's fund contribution.

3.1.3. The premium is not a fringe benefit, hence is not added to the employee's remuneration and therefore not taxable in the hands of the employee.

3.1.4. Life cover effected: R1,200,000 (which is five times salary).

3.2. Approved cover: benefit on death

3.2.1. R500,000 is paid free of tax.

3.2.2. The balance of R700,000 is taxed in accordance with the rates set out in 1.2 above, with resulting tax of R184,500. The net benefit after tax would thus be ***R1,015,500***.

3.3. Unapproved cover: premium and cover

3.3.1. Employer/employee applies 2% of gross salary in the provision of unapproved group life benefit.

3.3.2. Employer's outlay is deductible as a cost of business.

3.3.3. Employer's outlay is added to employee's remuneration and employee is taxed thereon at his marginal rate. Therefore, in order that the employee's take-home pay is the same as it would have been had an approved fund been used, the outlay on premium equals 1.5% of salary, the other 0.5% being paid as income tax (at the 25% marginal rate).

3.3.4. Life cover effected: R900,000.

3.4. Unapproved cover: benefit on death

3.4.1. The total benefit of ***R900,000*** is paid free of income tax.

4. Discussion

4.1. The example illustrates that, assuming equality of outlay at gross salary level, and equality of take-home pay by the employee, the approved arrangement offers better value for money (i.e. higher net benefit for the same gross outlay). Confusion arises because the human brain instinctively makes the comparison without allowing for the loss of purchasing power that results from paying tax *before* spending what is left over (as is the case in an unapproved scheme).

4.2. The same conclusion is reached if instead we consider the provision of a specific targeted net death benefit.

4.3. Consider an example of an employee earning R480,000 per annum with a marginal tax rate of 35% and who wishes after-tax cover of three times salary, i.e. R1,440,000. She can either give up 1.8462% of pre-tax pay, which after 35% tax will leave the 1.2% of pay needed for the premium on a non-taxable benefit of R1,440,000. **OR** a premium of 1.5527% of salary (deductible) can be paid through a tax-approved retirement fund for a gross benefit of R1,863,281, providing the required after-tax amount of R1,440,000. Again the approved route uses up less pre-tax pay and is seen to be more advantageous. (Note: some figures in this paragraph have been slightly rounded off for convenience, but this doesn't affect the conclusion.)

4.4. By now it should start to become clear what is going on – if your marginal tax rate on income is higher than the average rate of tax that would be paid on an approved fund benefit, then you must be better off having an approved scheme. You save tax on the premiums at a higher rate than the rate of tax that would be paid on the benefit.

5. EXCEPTION

5.1. The only instance where the above analysis would lead to a different conclusion is where an employee's marginal tax rate is less than the average tax rate on the approved scheme benefit.

5.2. For example, someone earning R200,000 per annum would have a current marginal tax rate of 25%. A fund death benefit greater than R2,250,000 would lead to a tax liability in excess of 25% of the gross benefit. In such circumstances, the tax paid on the benefit would exceed the marginal tax saved on the premium, and unapproved cover would be more cost effective.

5.3. We point out however that in this example the fund death benefit has to be in excess of 11.3 times salary before the unapproved approach becomes cost effective. Testing the situation for a variety of taxpayers at different levels of income confirms the unfeasibly high benefits that would have to be in place for this exception to apply. Funds do not as a rule have death benefit multiples high enough to bring the exception into play.

6. Conclusion

6.1. Subject to the exception noted in section 5, the analysis shows the favourable position created by an approved scheme in circumstances where the employee dies and the policy benefits are paid out.

6.2. The conclusion is the same in the case of employees who do not die, where we simply see that the unapproved route leads to an unnecessarily higher tax bill for those employees.

Robson Savage (Pty) Ltd

April 2014