DEATH BENEFITS AND TAXES
SAVE MORE THE *APPROVED* WAY

There are two ways to provide lump sum death benefit insurance for employees. One leads to benefits that are "free" of tax and the other to benefits that are taxed.

Which way is better?

> *Perhaps surprisingly, benefits that are taxed give more cover or are cheaper.*
>
> *This seems hard to believe. Below we go into necessary detail to demonstrate why it is so.*

INTRODUCTION

Death benefits for employees are commonly provided through a 'group life' insurance policy. Such policies can be structured on what is known as an 'approved' or an 'unapproved' basis. These labels refer to the tax treatment of the premiums and the claim proceeds.

With an *approved policy*, normally where the benefit is promised in the rules of a tax-approved pension or provident fund, the policy is owned and the premiums are paid by the fund, and there are no fringe benefit tax consequences for the employee.

On death, R500,000 of the benefit (reduced by any retirement fund tax-free benefit allowances previously received) is free of tax and the balance is taxed as follows:

- any amount from R500,001 to R700,000 is taxed at 18%
- any amount from R700,001 to R1,050,000 is taxed at 27%
- any amount from R1,050,001 upwards is taxed at 36%

With an *unapproved policy*, typically a separate insurance policy issued to the employer and not associated with a pension or provident fund, the payment of premiums is normally arranged in one of two ways:

- the employee pays the premium, in which case it comes out of after-tax income; or
- the employer pays the premium, in which case it must be added to the employee's income as a fringe benefit and is subject to tax at the employee's marginal rate.

On death, the unapproved policy benefit is paid in full with no tax deduction.

Robson Savage is a licensed Financial Services Provider, license number 16359

THE ISSUE

When advocating the merits of an *unapproved* policy 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 (probably unexpected by the family) tax deduction.

It's argued that the dependants would have been much better off had the same benefit been arranged in terms of an unapproved scheme because then the benefits would be free of tax. This appears to be obvious but the argument is flawed in that it **ignores the difference in purchasing power between a given amount of money pre- and post-tax**. A different picture emerges when one allows for this in the analysis.

The correct, if not immediately obvious, approach is to start from the amount of gross income that is given up in order to provide the benefit.

WORKED EXAMPLE 1

Let's get our hands (or calculators) dirty with some actual figures.

As an example, consider spending 1.5% of gross salary on the insurance premium. We will assume that the cost for life cover of one times annual salary is 0.3% of salary *(this assumption does not affect the principle nor the conclusion)*.

Consider the case of an employee with taxable income of R360,000 per annum and the applicable marginal rate of tax (2021/2022 tax year) of 31%. The example is done on the basis that the same amount of gross (pre-tax) pay is spent on the benefit, thereby leaving take-home pay the same in both cases.

- ***APPROVED POLICY:***
  - ***PREMIUM AND COVER***

    The retirement fund pays a premium of 1.5% of salary.

    This is fully deductible in the employee's hands as part of the retirement fund contribution.

    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.

    Life cover effected: R1,800,000 (which is 5 times salary).

  - ***BENEFIT ON DEATH***

    Out of the R1,800,000 gross benefit, R500,000 is paid free of tax.

    The balance of R1,300,000 is taxed in accordance with the rates set out in the introduction above, with resulting tax of R400,500. The net benefit after tax is thus ***R1,399,500***.

- ***UNAPPROVED POLICY:***
  - ***PREMIUM AND COVER***

    The employer/employee applies 1.5% of gross salary in the provision of an unapproved group life benefit (i.e. the same as for the approved arrangement above).

    The employer's outlay is added to the employee's remuneration and the employee is taxed thereon at her marginal rate. Therefore, in order that the

employee's take-home pay is the same as it would have been had an approved policy been used, the outlay on premium equals 1.035% of salary, the other 0.465% being paid as income tax (at the 31% marginal rate on 1.5% of salary).

Alternatively the employee simply spends 1.035% of salary out of after tax money to pay the premium.

Life cover effected: R1,242,000 (which is 3.45 times salary).

- ***BENEFIT ON DEATH***

  The total benefit of ***R1,242,000*** is paid free of income tax.

DISCUSSION

The example illustrates that with equality of outlay at gross salary level, and equality of after-tax take-home pay by the employee, the approved arrangement offers much better value for money (net benefit of R1,399,500 compared to R1,242,000, in this case giving nearly 13% more net benefit for the same outlay).

How can this be so? Confusion arises because our attention is drawn to the outcome: "tax-free benefits" just sounds so good compared to "benefits will be taxed". We don't think to allow for the loss of purchasing power that has resulted from paying tax before spending what remains on insurance (which is what is actually happening in the case of an unapproved policy) as opposed to spending the full amount, pre-tax, on cover then paying tax later (which is what is actually happening in the case of an approved policy).

WORKED EXAMPLE 2

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

Consider an employee earning R480,000 per annum with a marginal tax rate of 36% and target after-tax cover of R1,440,000 (three times salary). He can either give up 1.4063% of pre-tax pay, which after 36% tax will leave the 0.9% of pay needed for the premium on a non-taxable benefit of R1,440,000. **OR** a premium of 1.16% of salary (tax-deductible) can be paid through a tax-approved retirement fund for a gross benefit of R1,863,281, which after paying tax of R423,281 on death will provide the required after-tax benefit of R1,440,000.

It will be seen that the approved route uses up less pre-tax pay and is again the more advantageous choice.

> *By now it may be becoming clear what's going on:*
>
> - *if your marginal tax rate is higher than the average rate of tax that would be paid on an approved fund benefit, you must be better off using an approved policy*
> - *this is the case because you are saving tax on the premiums at a higher rate than the rate of tax that would be paid on the benefit*

EXCEPTION

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

For example, someone earning R250,000 per annum has a marginal tax rate of 26%. An approved policy death benefit greater than R2,475,000 would lead to a tax liability on death that is in excess of 26% of the gross benefit. In such circumstances, the rate of tax paid on the benefit would exceed the marginal tax rate saved on the premium, and unapproved cover would be more cost-effective.

It will be seen however that in this example the approved policy gross death benefit has to be in excess of 9.9 times salary before the unapproved policy becomes the preferred route. Testing the situation for a variety of taxpayers at different levels of income confirms the uncommonly high benefits that would have to be in place for this exception to apply – few if any employers provide death benefit multiples high enough to bring it into play.

CONCLUSION

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

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.

And therein lies the rub: by allowing our attention to be drawn to the fact that there's no tax payable on the benefits, we forget to consider the fact that in unapproved arrangements ***you have already paid the tax!*** And worse, the loss of purchasing power through having paid tax at marginal rates on the money that is used to pay the premiums exceeds the "gain" of the benefits being free from further tax.

Building on the above, for a given target net benefit, a member of an approved arrangement could save the difference in their retirement fund: in the case of the earlier example an extra 0.2463% of salary (the difference between 1.4063% and 1.16%). Over a working lifetime, this will add up to a lot of money.

This further highlights the unintended effect of the flawed reasoning behind the 'tax-free must be better' argument – the dependants of a fund member will be better off to the tune of the additional fund credit if the member dies; the member will be better off to the tune of the same additional amount if she doesn't die – the fund credit on retirement will just be higher than the member of the unapproved arrangement, even though they have spent the same.

WHAT DOES THIS MEAN FOR YOU?

The myth that tax-free benefits are more beneficial continues to be peddled by many advisers.

Buying benefits with pre-tax money and then paying tax if death occurs is, however, the most cost- and tax-effective way to buy lump sum death insurance. This is because you can buy additional cover with the money that would otherwise have been paid in tax.

If an employee wishes, as he or she might reasonably do, to adjust the amount of cover to compensate for the tax that would be payable on death, this is best done by adjusting the amount of benefit in a tax approved retirement fund.

Your Robson Savage consultant will be glad to provide any further input you might require.

Visit us at www.robsav.com