



Income Disability insurance: 75% Tax Modified benefit scale



Suitable for employers that require affordable, yet comprehensive, monthly disability income benefits for their employees, the benefit scale is more closely aligned with employees' after tax salaries, immediately before they became disabled.

The Taxation Laws Amendment Act 31 of 2013 resulted in Income Disability policies being taxed differently from 1 March 2015.

The impact of the difference in the tax treatment of disability income benefits, relative to income derived from employment, depends largely on the employee's level of pre-tax income earned immediately before and after becoming disabled.

A tax-modified scale benefit ensures claimants' tax-free disability income benefit does not exceed their after tax income immediately before disability. In other words the replacement ratio is based on net income or "take home pay".

Since claimants do not pay tax on their disability income, any employee earning an income above the minimum tax threshold would be affected:

- ⌚ Employees with income *below* the tax threshold are not affected, because their before- and after-tax incomes are identical;
- ⌚ For employees with income *above* the tax threshold, the after-tax disability income benefits will increase and can potentially exceed 100% of the employee's after-tax income (take-home pay) received while working, depending on the employee's actual average tax rate.

This would contradict the original intention of the Income Disability insurance, which is to replace the claimant's after-tax income while working, subject to the applicable replacement ratio, and leads to **over-insurance**.

Taxation rules affecting Income Disability insurance policies

What was the impact of this change in taxation?

Prior to 1 March 2015

After 1 March 2015

Employee was entitled to a **tax deduction on the monthly premiums** paid towards an Income Disability policy.

Employee **NOT** entitled to a **tax deduction on the monthly premiums** paid towards an Income Disability policy.

Employee **paid tax** on the **monthly income** received from an Income Disability policy.

Employee does **NOT pay tax** on the **monthly income** received from an Income Disability policy.



How did this affect employees?

Employees' take-home pay (after tax) could have reduced due to additional tax on their monthly premiums, but they could now receive a higher after-tax disability income, as benefits became tax-free.

This increase in disability income benefits affects the higher earners the most, as it is dependent on the employee's average tax rate.



From 1 March 2015 Sanlam Group Risk (SGR) is limiting claimants' Net monthly disability benefit to 100% of the employee's total Net Average Income before disability, derived from engaging in his/her current occupation with the relevant employer, i.e. the take-home pay.

The need for a Tax Modified benefit scale

Benefit scales are typically based on a percentage of the employee's monthly **pre-tax** salary (gross salary) before disablement, e.g. 75% of salary. This percentage is referred to as the replacement ratio.

An alternative approach is to compensate for the difference in the tax treatment of the employee's income before and after becoming disabled, by creating a benefit scale that takes the notional tax payable on the disability income into account, based on a specified replacement ratio, e.g. 75% of salary.

SGR has therefore introduced a 75% Tax modified benefit scale that scales the employee's flat 75% disability income benefit down, depending on the level of the employee's before-tax salary, to align closely with the after-tax disability income the claimant would have received, if it had been taxable.

75% Tax modified benefit scale:

The insured monthly income is equal to:

- ① **75%** of the first **R10,000** of monthly salary, plus
- ② **60%** of the next **R30,000** of monthly salary, plus
- ③ **50%** of the monthly salary in excess of **R40,000**

The insured monthly income is limited to the lesser of a maximum amount as specified in the quotation and the monthly net average income that the employee received immediately before disability.

When comparing the claimant's income before and after the changes in the tax legislation, the disabled employee is therefore placed in a similar position to that he/she would have been if the monthly disability income was taxable, after employee and employer contributions have been deducted.

What is the Net Average Income?

The employee's Net Average Income is defined as:

Gross salary

- ① **LESS** employer's fund contribution
- ② **LESS** Income Disability insurance premium
- ③ **LESS** income tax

(i.e. this approximates the employee's take-home pay.)

The average monthly earnings of the employee before disability is taken as the average per month of all income and remuneration accrued to the employee from him/her engaging in his/her occupation with the relevant employer during the three (3) years before the start of the waiting period.

Any forms of benefits of a non-recurrent nature are excluded; however, discretionary bonus payments or commission will be taken into account if these are of a recurrent nature. Furthermore, all expenditure and costs incurred directly with a view to earning such income and remuneration are deducted from the afore-mentioned income and remuneration.

call us 

For full particulars on the 75% Tax Modified benefit please contact your Client Solutions representative or Client Relationship Manager at Sanlam Group Risk.