Inland Revenue
Te Tari Taake

DISCOUNTS ENJOYED BY LIFE AGENTS AND THEIR FAMILIES ON LIFE POLICY PREMIUMS – FRINGE BENEFIT TAX IMPLICATIONS

PUBLIC RULING - BR Pub 00/02

Note (not part of ruling): The issue dealt with by this ruling was covered in public ruling BR Pub 96/9A, published in TIB Volume Eight, No.8, (November 1996). BR Pub 96/9A also dealt with the taxation of commissions received by life agent on their own policies and on family policies. These arrangements are now the subject of two separate rulings, with the taxation of commissions issue being covered in BR Pub 00/01. A single commentary accompanies both rulings. In addition to the separation of the arrangements into two rulings, some formatting changes have also been made. The period of application of the rulings is from 1 January 2000 to 31 December 2004. BR Pub 96/9A applied up until 31 December 1999.

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Law

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of section CI 1(h).

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- The enjoyment of discounted premiums by a life agent on a policy on the life agent's own life or that of a family member or the enjoyment of discounted premiums by members of the life agent's family on a family life policy.

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- When a life agent enjoys discounted premiums on a policy on the life agent's own life or that of a family member, or persons associated with the life agent receive discounted premiums on family life policies, the discounted premium will be a fringe benefit under section CI 1(h). The life insurer will be liable for fringe benefit tax (FBT) on the taxable value of the benefit.

The period for which this Ruling applies

This Ruling will apply for the period from 1 January 2000 to 31 December 2004 to the enjoyment of discounts by a life agent or by members of the life agent's family, occurring within that period.

This Ruling is signed by me on the 29th day of March 2000.

Inland Revenue
Te Tari Taake

Martin Smith
General Manager (Adjudication & Rulings)

Inland Revenue
Te Tari Taake

COMMENTARY ON PUBLIC RULINGS BR Pub 00/01 and BR Pub 00/02

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Rulings BR Pub 00/01 and BR Pub 00/02.

The subject matter covered in these Rulings was previously dealt with by BR Pub 96/9A and in TIB Volume Eight, No.8, (November 1996), at page 6. These Rulings apply for the period from 1 January 2000 to 31 December 2004.

Background

Public Ruling BR Pub 96/9A dealt with the income tax and fringe benefit consequences of life agents who take out life policies on their own lives and on the lives of their families. The period of application for that Ruling expired on 31 December 1999.

In short the Ruling concluded that:

1. Cash commissions received by a life agent on the life agent's own life policy or on a family life policy are gross income;

2. Discounted premiums enjoyed by a life agent or by family members on policies on their respective lives are fringe benefits.

The Commissioner has reconsidered his conclusions reached in BR Pub 96/9A and is satisfied that these conclusions are correct. However, instead of reissuing the ruling, he has decided that it is legally appropriate to issue two rulings to cover the two arrangements, i.e. the receipt of commissions and the enjoyment of discounted premiums. These rulings will apply for the period from 1 January 2000 to 31 December 2004.

Legislation

Section CD 3 states:

The gross income of any person includes any amount derived from any business.

Section CH 3 states:

All monetary remuneration derived by a person is gross income.

Section OB 1 defines "employer" and "employee" for the purposes of the FBT rules.

"Employee" means:

...a person who will receive, receives, or has at any time received, or who will be, is, or has at any time been entitled to receive, a source deduction payment...

"Employer" means:

...a person who will pay, pays, or has at any time paid, or who will be, is, or has at any time been liable to pay, a source deduction payment...

"Source deduction payment" is defined in section OB 2(1) as:

...a payment by way of salary or wages, an extra emolument,... or a withholding payment.

Section CI 1 defines "fringe benefit". Under section CI 1(h), a fringe benefit includes any benefit that consists of:

Any benefit of any other kind whatever, received or enjoyed by the employee in the quarter or...income year,-

being, as the case may be...a benefit that is used, enjoyed, or received, whether directly or indirectly, in relation to, in the course of, or by virtue of the employment of the employee (whether that employment will occur, is occurring, or has occurred) and which is provided or granted by the employer of the employee;...

Section CI 3 provides the methods for calculating the value of a fringe benefit. When services are provided to an employee, and the services are provided as part of the employer's business, the fringe benefit is valued in accordance with section CI 3(10)(a):

Where the services were provided by the employer of the employee where the employer of the employee, as part of that employer's business, normally provides such services for payment, the price for which, at the time when the services were so provided to the employee, services identical or similar to those services were customarily provided by the employer of the employee to a member of the general public in the open market in New Zealand on ordinary trade terms between buyers and sellers independent of each other:

Section GC 15(1) states:

For the purposes of the FBT rules, where any benefit which, if it were provided for or granted to an employee would be a fringe benefit, is provided or granted by the employer of the employee,...for or to a person other than the employee of the employer, the employee of the employer and the other person being associated persons, that benefit shall be deemed to be a benefit provided for or granted to the employee by the employer of the employee.

For the purposes of section GC 15 "associated person" is defined in section OD 7(1). That section states:

For the purposes of this Act, unless the context otherwise requires, at any time associated persons or persons associated with each other are-
...
(c) Two persons who are at the time relatives;...

"Relative" is defined in section OB 1:

(a) Except in the international tax rules, in relation to any person, means any other person connected with the first-mentioned person by blood relationship, marriage, or adoption; and

includes a trustee of a trust under which a relative has benefited or is eligible to benefit; and for the purposes of this paragraph-

(i) Persons are connected by blood relationship if within the fourth degree of relationship:

(ii) Persons are connected by marriage if one is married to the other or to a person who is connected by blood relationship to the other:

(iii) Persons are connected by adoption if one has been adopted as the child of the other or as a child of a person who is within the third degree of relationship to the other:

Application of the Legislation

1. Cash commissions received by life agents on their own policies or family policies

"Income" is not a term of art and has to be examined in accordance with ordinary concepts and usages (*Scott v C of T* (1935) 35 SRNSW 215 at page 219). The courts have identified several criteria that are considered to be the hallmarks of receipts of an income nature. The High Court in *Reid v CIR* (1983) 6 NZTC 61,624 at page 61,629 described the criteria as follows:

- Income is something which comes in; and
- Income imports the notion of periodicity, re-occurrence and regularity; and
- Whether a particular receipt is income depends upon its quality in the hands of the recipient.

An important feature of income is that it is something that comes in. This was emphasised in *Lambe v IR Commrs* (1933) 18 T.C. 212 where Finlay J said at page 217:

> Of course income may be of various sorts,...but none the less the [income] tax is a tax on income. It is a tax on what in one form or another goes into a man's pocket. That is the general principle.

Cash commissions received by life agents on own policies or family policies come in, in the same way that commissions from the sale of policies to unrelated third parties come in.

The major determinant in many cases is the periodic nature of the payment. Generally, commission income is periodic in nature. However, this in itself is not enough. It is necessary to consider the relationship between the life insurer and the life agent to determine the quality of the commission in the hands of the life agent.

Alternative arguments

One possible argument is that commissions received by life agents on their own policies are not income but are the proceeds from mutual transactions.

Mutual transactions

The general principle of income tax known as mutuality starts from the premise that a person cannot make a profit from trading with himself or herself, or with a body or association of persons of which the person is a member. In *Sydney Water Board Employees' Credit Union Ltd v FC of T* (1973) ATC 4,129 Barwick J said:

> The description "mutuality principle" is used, unfortunately as I think, to express the reason for the conclusion that the return to a taxpayer of a share of the surplus of a fund to which he has contributed in common with others after its use for a purpose agreed between them is not income...**What distinguishes the amount refunded in such circumstances from profit or income is that the payment is made out of moneys which are in substance the moneys of the contributors**. (At page 4,131.)(emphasis added)

Prima facie the profits from mutual transactions are not gross income.

There are numerous cases discussing the mutuality principle. Most discuss the situation where a person trades with a body or association of persons of which he or she is a member. There was some discussion of the principle that a person cannot trade with himself or herself in *Dublin Corporation v M'Adam* 2 T.C. 387 at page 397. The Court stated that:

> There must be, at least, two parties...If these two parties are identical, in my opinion there can be no trading. No man, in my opinion, can trade with himself; he cannot, in my opinion, make, in what is its true sense or meaning, taxable profit by dealing with himself; and in every case of this description it appears to be a question on the construction of the Act whether the two bodies - the body that supplies and the body or class that has to pay - were either identical, or, upon the true construction of the Act, must be admitted to have been held by the Legislature to be identical...

Does the mutuality principle apply?

Although the life agent is the person who *causes* the commission to be paid by taking up the policy on that person's life or the lives of the person's family, the commission is not a return of the life agent's own money. The commission comes from a source outside of the life agent, i.e. from the funds of the life insurer. The life agent is paid the commission for introducing business to the life insurer, not for taking out the policy and paying the premiums.

Case law indicates that the mutuality principle only applies when a person trades with himself or herself, i.e. there is only one party to the transaction giving rise to the income. Here there are two parties to the transaction. The commission arises from the sale of a life insurance product by one party (the life insurer) to another party (the life agent). It does not matter that the life insurance product is sold by the life insurer through the life agent. There are still two parties to the transaction.

Mutuality principle - conclusion

The mutuality principle does not apply to commissions received by life agents on their own policies.

Discount on premiums

It may also be argued that cash commissions received by life agents on own policies should be regarded as discounts from the premiums payable under the policy and not as gross income. For example, a life agent takes out a policy on her life. The premium is $1,000. The life agent receives a cash commission of $200. The $200 can be seen as a discount, i.e. the 'real' cost of the policy is $800.

As discussed in the background to the Rulings, this was the view taken in *Commissions on Life Insurance sold to Agent's Family* in TIB Volume Four, No.10 (May 1993).

The treatment of cash commissions as reductions or discounts from the premiums payable under the policies is not supported by the legislation.

The commission payment arises from an arrangement between the life agent and the life insurer. The life agent receives the commission for introducing business to the life insurer, not for taking out the policy and paying the premiums.

Conclusion

Cash commissions received by life agents on own policies or family policies are gross income under section CD 3 or CH 3.

2. Life agents' commission is set off

Life agents may set off commissions on own policies or family policies against the premiums payable on their own policies.

Under section EB 1(1), an amount is deemed to have been derived by a person although it has not actually been paid, or received by the person, or already become due or receivable, if that amount:

> ...has been credited in account, or reinvested, or accumulated, or capitalised, or carried to any reserve, sinking, or insurance fund, or otherwise dealt with in the person's interest or on the person's behalf.

Case law has established that income is derived under section EB 1 when the taxpayer does not receive a payment of that income, but some other monetary benefit moves to the taxpayer. This has been found to occur when income that would otherwise have been paid to the taxpayer is diverted for uses that are of benefit to the taxpayer (*Dunn v C of IR* (1974) 1 NZTC 61,245).

When life agents set off the commission, the amount of commission is gross income under section CD 3 or CH 3. The commission (which would otherwise have been paid to the agent) is diverted for uses that produce other financial benefit to the life agent, i.e. payment of the premiums on own policies.

The practice of setting off commissions on policies may also occur in respect of policies sold to third parties. For example, a life agent sells a policy to an unrelated third party and becomes entitled to a commission. Instead of being paid the

commission, the life agent sets the commission off against premiums payable on own policies. Here, the commission, although not paid to the life agent, is derived by the life agent and is therefore gross income.

3. Charging of discounted premiums to life agents on own policies or to members of life agents' families on family policies

It is common for life insurers to allow life agents to receive lower commissions in order to discount premiums to prospective clients. The Commissioner understands that if a life agent agrees that no commission entitlement will arise on the sale of a policy, there is a corresponding reduction in the premiums payable under that policy.

The Commissioner also understands that when life agents agree that no commission entitlement will arise on their own policies or on family policies, the premiums payable under those policies are reduced.

Life agents who agree that no commission entitlement will arise on policies sold to third parties are not assessable on any notional commission, i.e. the amount of commission that would have been received. As discussed, an important feature of income is that it is something that comes in. When a life agent agrees that no commission entitlement will arise no income comes in.

This must also be the case when life agents agree that no commission entitlement arises on their own policies or family policies. As the life agent receives no commission, no income arises.

Alternative arguments

An important feature of income is that it is something that comes in. When life agents agree that no commission entitlement will arise on their own policies no money comes in. They do not receive a cash commission. However, if a life agent decides to either take the commission, or agree that no entitlement will arise and receive a discounted premium on a policy on the agent's own life or that of his or her family, the issue of convertibility arises. In particular, does the fact that the life agent can receive the commission in lieu of the discounted premium mean that the discounted premium is convertible into money, and therefore assessable?

Case law

The principle of convertibility was initially laid down in *Tennant v Smith* [1892] 3 T.C. 158. *Tennant* involved a bank employee who received a benefit in the form of rent-free accommodation. The issue was whether the accommodation was assessable under Schedule E of the UK legislation (by virtue of the words "salaries, fees, wages, perquisites or profits payable"). The Court held that the taxpayer would only be taxable if what he received was convertible into money, i.e. was money or money's worth. Because the taxpayer could not sublet the accommodation or turn it to pecuniary account in any other way, he was not taxed.

The principle of convertibility has been discussed and applied by the New Zealand courts on a number of occasions. See *C of IR v Parson (No. 2)* (1968) NZLR 574, *Stagg v Inland Revenue Commissioner* (1959) NZLR 1,252, and *Dawson v Commissioner of Inland Revenue* (1978) 3 NZTC 61,252.

The convertibility test is normally satisfied by demonstrating that the benefit may be sold or exchanged for money. (In *Stagg* the value of holiday airfares given to an employee was held not to be assessable income of the employee. The employee could not sell the fares or require the company to give him the equivalent cash value.)

However, it is clear from case law that there are other ways in which convertibility can be satisfied. See *Abbott v Philbin* [1961] 2 All E.R. 763 and *Heaton (Inspector of Taxes) v Bell* [1969] 2 All E.R. 70.

The principle of convertibility was considered by the New Zealand Supreme Court in *Dawson*. The taxpayer subscribed for debenture stock under a debenture holders' colour television plan. Under that plan a person could subscribe for debenture stock and would receive in return a TV free of hire for five years. No interest was payable on the debentures.

The Commissioner argued that the use of the TV set was the substitution of one form of a benefit for another, i.e. interest, and that in taking the hire of the set rather than the payment of interest, the taxpayer received a benefit which could be valued in terms of money.

McMullin J said at page 61,258:

> In the view which I take of this matter, it is of some importance to note that Objector did not apply for a television set as an alternative to an interest-bearing investment. It is true that it was open to him initially to choose to invest in interest-bearing stock as, I have no doubt, many other investors did, but he completed his application for a television set and a television set only.

The Court held that the benefit that the taxpayer received was that he did not have to pay rental for the TV. That benefit did not constitute income in the ordinary sense because the benefit received by the taxpayer was not in monetary form, nor was it capable of being sold, surrendered, assigned, or mortgaged for money or money's worth.

Arguably *Dawson* provides some support for the view that the receipt of a discounted premium is convertible into money or money's worth, the discounted premium being a substitution for the commission. It may be implied from the Court's comments in *Dawson* that if the taxpayer had the option of investing and receiving either a TV set or an interest-bearing investment, and in fact received a TV set, the benefit would be convertible into money.

However, the better view is that discounted premiums are not convertible into money or money's worth.

The fact that a life agent initially has the choice of receiving a commission, or not receiving a commission and enjoying a discounted premium, is not relevant. The issue of convertibility is considered at the time the taxpayer receives the benefit.

If a life agent chooses to receive a commission, no question of convertibility arises as the commission is money.

However, when a life agent chooses to receive a discounted premium, it is the discounted premium itself that must be convertible into money or money's worth. At the time the discounted premium is received it cannot be converted into money. Therefore, the convertibility principle does not apply.

Conclusion

When life agents receive discounted premiums on own policies or members of their families receive discounted premiums on family policies, the amount of the discount is not gross income of the life agent.

4. FBT and discounted policies

A life insurer who provides discounted premiums to life agents on policies on their own lives or on the lives of their families or to members of their families on family policies may be liable to FBT.

For the purposes of FBT a life agent is an "employee", regardless of whether the life agent is an employee or an independent contractor at common law.

Employee vs independent contractor

The terms "employee", "employer" and "employment" are defined for FBT purposes by reference to the PAYE system.

Section OB 1 defines "employee" for the purposes of the FBT rules as:

> ...a person who will receive, receives, or has at any time received, or who will be, is, or has at any time been entitled to receive, a source deduction payment...

Section OB 2(1) defines "source deduction payment" as:

> ...a payment by way of salary or wages, an extra emolument,... or a withholding payment.

"Withholding payment" is defined in section OB 1 as:

> ...a payment which is declared by regulations under this Act to be a withholding payment for the purposes of the PAYE rules:

Under section 4 of the Income Tax (Withholding Payments) Regulations 1979, all payments of the classes specified in the Schedule to the regulations are withholding payments for the purposes of the PAYE rules. Included in Part A of the Schedule are commissions or other remuneration to insurance agents or sub-agents, or to salesmen.

A life agent who is an employee at common law is an "employee" for the purposes of FBT because of receiving a source deduction payment, namely salary and wages. A life agent who is an independent contractor at common law is also an "employee" for the purposes of FBT because of receiving a source deduction payment, namely withholding payments.

Discounts on family policies

If an employer provides a benefit to an associated person of any of the employer's employees, i.e. a member of the life agent's immediate family (and the benefit would have been a fringe benefit if provided to an employee), section GC 15(1) deems the benefit to be a benefit provided to the employee.

For the purposes of section GC 15, "associated person" is defined in section OD 7(1). An "associated person" includes two persons who are at the time relatives.

A relative of a life agent is any person connected with the life agent:

- By blood relationship (if within the fourth degree of relationship); or

- By marriage (persons are connected by marriage if one is married to the other or to a person who is connected by blood relationship to the other); or

- By adoption (persons are connected by adoption if one has been adopted as the child of the other or as a child of a person who is within the third degree of relationship to the other).

Is there a fringe benefit?

As discussed above, when a life agent agrees that no commission entitlement will arise and enjoys a discounted premium, that discounted premium is not gross income of the life agent.

A discounted premium that represents a reduction in charges other than commission is also not gross income. A discount is not regarded as gross income. Income is something that comes in, not something that is saved from going out (see *Tennant* Lord Halsbury at page 165).

The issue then is whether discounted premiums received by life agents on own policies or discounted premiums received by members of their families on family policies constitute fringe benefits.

Analysis

Section CI 1 defines "fringe benefit" for the purposes of the FBT rules:

In the FBT rules, "fringe benefit", in relation to an employee and to any quarter...or income year, means any benefit that consists of-
...

Any benefit of any other kind whatever, received or enjoyed by the employee in the quarter or...income year,-

being, as the case may be...a benefit that is used, enjoyed, or received, whether directly or indirectly, in relation to, in the course of, or by virtue of the employment of the employee (whether that employment will occur, is occurring, or has occurred) and which is provided or granted by the employer of the employee;...

It is clear from these opening words that in order to be a fringe benefit there must be some *benefit* to the employee, provided or granted by the employee's employer.

A life agent may have a discretion to reduce his or her commission in order to reduce premiums on policies sold to members of the public. In this case it may be argued that when life agents do not charge a commission on their own policies and receive discounted premiums, no benefit arises to the life agents because the benefit is also available to members of the public.

If a life agent purchases a life insurance policy at full value, i.e. the full amount of premiums are payable, there is no benefit to the life agent or his or her family. However, when a commission is not charged the full amount of premium is not paid. If a life agent agrees that no commission entitlement will arise, be it on an own policy or a policy sold to a member of the public, the amount of premium payable under the policy is reduced. This reduction in premium is clearly a benefit to the life agent and the public alike.

A life agent who enjoys a discounted premium, when the discount represents a reduction in charges other than commission, clearly receives a benefit. The benefit is the receipt of the services of the employer (the life insurance policy) for less than market value.

Therefore, discounted premiums received by life agents on own policies and discounted premiums received by members of their families on family policies are fringe benefits under section CI 1(h).

Note that sections CI 1(e) and CI 1(f) do not apply to discounts received by life agents (or associated persons) on own policies or family policies. The policies sold by the life agent are not "sick, accident, or death benefit funds" as defined in section CB 5(2) (see CI 1(e)), nor is the discount a "specified insurance premium" as defined in section OB 1. The life insurer does not pay the life insurance premiums of the life agent or the agent's family on the life agent's own policies or family policies (see section CI 1(f)).

Value of the benefit

The Act provides methods for valuing a fringe benefit.

Specific provisions exist for determining the value of services provided to an employee when they are provided as part of the employer's business.

Here the benefit is the provision of a life insurance policy at less than market value. The life insurer is in the business of selling such life insurance policies to the general public. Therefore, section CI 3(10)(a) applies to determine the value of the benefit.

The extent to which the benefit is subject to FBT will depend on the extent to which the discounts provided to life agents or members of life agents' family are greater than the discounts available to members of the general public.

It is a question of fact whether the price paid for the policy by the life agent is the same as is customarily paid by a member of the general public in the open market on ordinary trade terms between buyers and sellers independent of each other. There will be no taxable value if the amount paid by the employee is the same as, or exceeds, the price customarily paid by a member of the general public in the open market on ordinary trade terms between buyers and sellers independent of each other.

Expenditure on account of an employee

The Ruling covers the situation when an employer (the life insurer) provides a benefit to the employee or associated person (the life agent or relative) by discounting the premiums payable by the life agent on the insurance policy. It does not seek to address the situation when the life insurer *pays* the life insurance premium of a life agent.

When a life insurer pays a life agent's insurance premiums, that expenditure will be expenditure on account of an employee if the employee is liable to pay the insurance premiums. Expenditure on account of an employee is monetary remuneration and is assessable income to the employee.

When a life insurer pays a life agent's insurance premiums, and the life insurer is liable for those premiums, that expenditure is a fringe benefit (unless expressly excluded from the definition of fringe benefit in section CI 1).