CHAPTER 10

THE USE OF INSURANCE IN A BUSINESS ENVIRONMENT

Learning Outcomes

When you have completed this chapter you will be able to

- define a key-person in an organisation;
- explain what a deferred compensation plan is;
- explain the benefits of structuring an employer owned policy in accordance with the concessions provided by the Income Tax Act;
- explain the estate duty implications of a key-person policy;
- explain what a preferred compensation plan is and why they are sometimes used in place of deferred compensation plans;
- briefly describe what is meant by a sinking fund;
- explain the importance of a buy-and-sell agreement in a business environment and briefly describe how they work;
- describe the operation of a preference share capital redemption plan;
- explain what is meant by contingent liability insurance and how the plan works.

10.1 KEY-PERSON INSURANCE

The term **key-person** is one that is often heard in a business environment, but what makes a person in an organisation a key-person? If we were to ask the employers of these type of people to define their reasons for elevating a particular employee to the status of a key-person, we would end up with a number of different answers.

One usually finds that key-people in any organisation are those who, should they die or leave, will:

- be difficult to replace;
- effect the profits of the enterprise;
- result in a reduction of sales;
- result in costly training of a replacement; or
- require a possible change in management.

Once the role of a key-person in an organisation has been established, it becomes possible to decide on the value of the person. It is often difficult to do this in Rands and Cents and so the following may assist as a guide.

10.1.1 ESTABLISHING THE VALUE OF THE KEY-PERSON

Where it is not possible to accurately assess the loss that a key-person will mean to an employer, it is normal to use a multiple of his basic salary to determine the sum insured, for example, either 5 or 7 times his gross annual salary.

Should this method not be used, it is vital to ensure that, not only the actual loss, but also the costs that will be incurred in the recruitment and training of a replacement are taken into consideration.

10.1.2 KEY-PERSON AND DEFERRED COMPENSATION

Premiums payable on the life of an employee by an employer are an allowable deduction if certain rules and conditions are met. This deduction is then made in terms of **Section 11(w) of the Income Tax Act.** What is often forgotten, is that both a key-person and a deferred compensation policy are employer owned policies. Both these policy provisions, therefore, need to be considered when deciding on the benefits to be added to a policy. The employer, who owns the policy and pays the premiums, must be made aware of the implications of using one policy for both of the above provisions.

Assume the employer has undertaken, in terms of a service agreement, to pay the proceeds of the policy to the employee's beneficiaries on death. The employer could then find that the money that had been earmarked for use in replacing the employee is no longer available.

10.1.3 THE INCOME TAX ACT

Section 11(w)(ee)(B) of the Income Tax Act, restricts the size of the premium that the employer may deduct if the policy has a maturity benefit. A deferred compensation policy needs a maturity value, and so utilising one policy for both purposes will limit the size of the life cover and benefits available.

In terms of Section 11(w) of the Income Tax Act, there will be allowed as a deduction *"an allowance in respect of any premium which was actually paid by the taxpayer under any policy of insurance taken out upon the life of a employee of the taxpayer"*. In the case of a company, the deduction will also apply if the policy is on the life of a director.

A point which is often not appreciated by intermediaries and their clients is the fact that, where a policy premium is allowed as a deduction in terms of Section 11(w), the proceeds of the policy are fully taxable, on receipt, in the hands of the employer.

Only those portions of premiums that may have been disallowed (or not have been claimed) at any stage, will be allowed as a deduction (without interest) against the proceeds of the policy at maturity, when they must be included in the gross income of the employer.

Please note that this will apply whether the employer chooses to claim the tax deduction under Section 11(w), or not. The only way that an employer can avoid the payment of tax on the proceeds of a policy, owned by the employer, on the life of an employee, is to contract for what is commonly known as a "non-conforming" policy.

Where there is an estate duty liability on the proceeds of the policy (for example, in a family company), it is the practise of the revenue authorities to tax only the net proceeds of the policy i.e. after any estate duty payable has been deducted.

The impact of taxation on the proceeds of a key-person policy can be severe. A company or close corporation, for instance, currently (2010) pays tax at a flat rate of 28%. It is advisable to take this cost into account when determining the level of life cover required on the life of the key-person.

Taxation Laws Amendment Act, 7 of 2010: Employer-owned policies

Premiums on employer-owned life insurance policies such as key person or deferred compensation policies will be tax deductible as from 1 January 2011, only if one of the two following conditions are met.

Condition 1

- The premiums are included in the taxable income of the employee or director as a fringe benefit.

OR

Condition 2

- The policy is owned by the employer, paid for by the employer and the employer is to receive the benefit. If there is a collateral or security cession on the policy then the premiums may still be claimed as a deduction, unless the cession is in favour of the life insured, his relatives or dependents.

- The policy is taken out on the life of the employee or director to insure the employer against any loss arising as a consequence of the death, disability or severe illness of the employee or director.
- The policy is a pure risk policy which means there must be no cash value to the policy.
- There must be no transaction, operation or scheme in existence in terms of which the benefits will be paid directly or indirectly to the life assured employee or director, his relatives, his estate or his dependents.

Practical implications - Existing key-person or personal liability policies

If either of the two conditions are met, then irrespective if the policy was originally set up as conforming or non-conforming, and irrespective of whether the deductions are factually claimed, as from 1 January 2011 the premiums will be fully deductible. The proceeds of policies that meet the conditions will be taxable to the extent that the premiums were deductible.

If neither of the conditions are met, then irrespective if the policy was originally set up as conforming or non-conforming, as from 1 January 2011, no premiums will be deductible. The proceeds of certain of the policies may still be taxable to the extent that the premiums were deductible under the old regime.

10.1.4 THE ESTATE DUTY ACT

In terms of Section 3(3) of the Estate Duty Act property which is deemed to be property of a deceased, in this case the key-person, includes-

(a) the proceeds of any domestic policy of insurance upon the life of the insured. This will not be the case in respect of any policy where-

  (ii) the Commissioner is satisfied that:
  - the policy was not taken out by, or at the insistence of the deceased;
  - no premium of the policy was at any time paid by the deceased;
  - none of the proceeds of the policy will be paid to the estate;
  - none of the proceeds of the policy will be paid to, or used for, the benefit of any relative or dependant of the deceased; and
  - none of the proceeds of the policy will be paid to any company which at any time was a family company in relation to the deceased.

A family company is defined as a company, not listed on the stock exchange which at any relevant time was controlled, or capable of being controlled, by the deceased or the deceased and one or more family members.

It is the duty and obligation of the intermediary to ensure the client is provided with the best possible advice in order to receive tax relief on the premiums.

It is also important to ensure that the estate of the deceased is not burdened with an additional estate duty liability. In practise the employer would settle any estate duty liability reflected against the policy. This will however, only aggravate the burden imposed by the tax due on the policy proceeds. Care must be taken to include this factor where a family company is involved when establishing the life cover requirement.

10.2 DEFERRED COMPENSATION

There are two ways in which services can be unexpectedly terminated.

The one is untimely death, the reason for key-person insurance, and the other is the employee's resignation. No employer can retain the services of an employee who wishes to leave. What the employer can do, however, is to provide the employee with incentives to stay.

These incentives can come in a number of guises:

- a company car;
- staff mortgage bond subsidies;
- attractive holiday incentives, for example, overseas trips;
- high salaries;
- good bonuses; and
- free meals and entertainment allowances.

While the above incentives are attractive, and have become fairly common, they leave the employer with two basic concerns:

- an employee can negotiate a similar or better package with his new employer; and
- every one of the benefits listed above increases the tax liability of the employee.

With the high rate of tax in this country, top earners are paying tax at a marginal rate in excess of 40%. Adding more incentives to a package therefore will essentially, reduce the real earnings of the key-person. It is also possible that the key employee has reached an age where the incentives listed above may no longer be necessary or attractive. It is imperative that the employer find some way in which:

- the employee can be rewarded without any additional tax liability being created;
- the reward is of such a nature that the employee can see some real actual, or future benefit; and
- the reward becomes an incentive for the employee to remain in the services of the employer.

The development of deferred compensation packages, funded by life insurance, has evolved as a result of certain tax concessions available to the employer and the employee. It is possible to fund a deferred compensation fund from other sources, such as profits in the year of retirement or share investments, but these other avenues would not be able to compete with life insurance because of the Section 11(w) deductions available. Employees are also happier knowing that their benefits are based on the returns of a life office, and not on the fluctuations of the business market.

There are two sides to any deferred compensation fund: the employers and the employees. Let us therefore deal, firstly, with the implications and advantages to the employer and then, the employee's situation.

10.2.1 THE EMPLOYER'S POSITION

As was mentioned when we looked at key-man insurance, the Income Tax Act (Section 11(w)) will allow as a deduction "*an allowance in respect of any premium which was actually paid by the taxpayer under any policy of insurance taken out upon the life of an employee of the taxpayer".* In the case of a company the deduction will also apply if the policy is on the life of a director.

This allowance is restricted in that any policy used must abide by the terms of a government notice (GN R 2408) to be a conforming policy. The deduction of the premiums of a conforming policy are further restricted to an amount equal to 10% of the remuneration of the employee or director.

A further point, which is often not appreciated by intermediaries and their clients, is the fact that where a policy premium is allowed as a deduction in terms of Section 11(w), the terms and conditions set out in Part 4 of the Regulations to the Long Term Insurance Act do not apply. The proceeds of a conforming policy will therefore be fully taxable in the hands of the employer.

On the retirement of the employee, the conditions of a Service Agreement, entered into between the employer and the employee, will require that the employer pays an amount equal to the proceeds of the policy to the employee. This being a condition of service, the employer will be permitted a deduction of the gratuity paid under Section 11(a) - expenditure incurred in the production of income, not of a capital nature. One, therefore, finds that the proceeds of the policy, which were included in the gross income of the employer, are now allowed as a deduction against that same gross income, effectively creating a tax neutral position for the employer.

10.2.2 THE EMPLOYEE'S POSITION

In order to ensure that the employee is **not taxed** on the value of the premiums paid on the policy by the employer, as if they were income accruing to him, certain rules have to be obeyed:

- the employee must not be entitled to any benefit under the policy other than those benefits as set out in the Service Agreement. These benefits must only be due to the employee as a result of the termination of his services; and

- no salary sacrifice will be possible by the employee. Section 7(1) of the Income Tax Act incorporates into the income of a taxpayer any income which is due and payable to a taxpayer, even though such income has been invested or otherwise dealt with on his behalf. It will be argued that any salary sacrifice made by an employee to fund a deferred compensation scheme, would be construed as an investment made on the employee's behalf.

Provided that these rules are complied with, the position of the employee will be the same as it was prior to the institution of the fund.

It must be noted that at retirement the employee will **not** be receiving the proceeds of an insurance policy. The money received by the employee from his employer at retirement is in the form of **a gratuity** which can be funded from any source. The gratuity is, therefore, included in the gross income of the employee.

Any employee that receives a gratuity from his employer will, however, be entitled to claim an amount as does not exceed R30 000 as being exempt from tax. Any other amounts previously excluded from tax for the same reason (in the current or any previous year of assessment) will reduce the amount of the exemption now allowed.

The exemption will only apply in respect of the amount received if it is in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of office or employment and the following conditions apply:

(i) the person receiving the amount has attained the age of fifty-five years; or

(ii) the employee is relinquishing, terminating, losing, repudiating, cancelling, or varying his office or employment as a result of superannuation, ill health or other infirmity; or

(iii) the termination of the employee’s services are as a result of the employer ceasing to carry on business, or reducing the workforce, as a result of which the employee is retrenched. Where, however, the employer is a company and the employee is, or was at any time, a director and at some stage owned at least 5% of the shareholding this particular point will not be applicable.

Where the taxable income of the taxpayer, after having received the exemption mentioned above still includes an amount received by way of a gratuity the normal tax payable on that amount is then determined in accordance with the provisions of Section 5(10). This is the rating formula whereby the taxpayer pays tax at the average and not the marginal rate of tax. The same conditions as applicable for the exemption of the first R30 000 apply

It can be seen that a deferred compensation fund has many advantages for both the employer and the employee. Setting up a scheme for the mutual benefit of both parties requires that the terms and conditions are in writing. Where the employer is a company it will be necessary to have a board resolution for the records.

Note

The R30 000 exemption **was** withdrawn in March 2011. All lump sums received on retirement will be taxed according to the current tax tables.

10.3 PREFERRED COMPENSATION (RESTRAINT OF TRADE)

A key-person in any organisation can cause a major disruption if he should leave unexpectedly. The key employee's vacant position might be difficult to fill. In addition, the knowledge and expertise that he may be able to impart to a competitor, could also seriously damage the market share that the employer had, prior to the termination of the employee's services.

Deferred compensation funds have been set up at a number of different employers, specifically to encourage the employees to stay until normal retirement age.

Whilst this fund has proven to be very attractive, both to the employer and the employee, **there are certain circumstances in which a deferred compensation fund is not the best solution to the problem.**

Let us look at a few of these instances:

- in some industries, such as the advertising industry, it is normal for employees to move from one employer to another. Much as any agency may wish to retain the services of a particularly talented employee, the retention period would seldom stretch to normal retirement age. This is because the nature of the enterprise requires a constant flow of new ideas, and therefore new talent;

- the employer may be a tax-exempt institution such as a Section 21 company, and so will not be able to reap any benefit in terms of the tax relief applicable. It would, therefore, be more appropriate to concentrate on the tax position of the employee;

- the age of the employee may be such that the period to normal retirement age may be considered too long, and so the plan would not be an incentive for the employee to remain in the service of the employer.

The solution to any one of the above concerns is to adapt the employer owned fund in such a way that the employee will feel that a real benefit can be reaped for remaining in the service of the employer. At the same time the employer must be able to see a real benefit for himself as well.

The design of **a preferred compensation scheme** is such that both the employer and the employee will be aware of the benefits. Whilst the scheme is marketed as a unique package, it is important to bear in mind that the policy used **can be any ordinary life insurance policy**. It is also possible to add any of the many supplementary benefits available to the policy for the benefit of the life insured and, where applicable, his family.

The employer and the employee further agree, in writing, to the following:

(a) the employer shall pay the employee a special, non-retirement funding, salary increment;

(b) the employee shall, after having paid the tax due on the special increment received, purchase a policy of life insurance; and

(c) the employee is required to cede the policy to the employer as security for the special increment received.

10.3.1 THE EMPLOYER'S POSITION

The employer will pay to the employee a special increment in lieu of the premium that he would have invested into a deferred compensation fund. By making the increment non-retirement funding, the employer will avoid the additional costs that are incurred with a normal increment, for example, the employer's contribution to the pension fund.

An employer is permitted to claim salary expenses as a general tax deduction in terms of Section 11(a), being expenses incurred in the production of income. The employer will, where applicable, therefore claim the additional salary expense.

10.3.2 THE EMPLOYEE'S POSITION

The employee receives a special increment from his employer. This increase is only granted by the employer because he expects the employee to remain in his service for a minimum period of 10 years for example. To ensure that this is in fact the case the employer will require that the employee uses the special increase to purchase a life insurance policy.

The policy must then be ceded to the employer as security for the employee's undertaking to remain in service with the employer.

The cession must be a security cession and not an outright cession. The importance of this is that ownership will not be transferred with a security cession and the policy will remain the property of the employee. As the employee is a natural person the investment account of the policy will be placed in the individual policyholder’s fund which is taxed at a lower rate than the company owned policyholder’s fund.

The policy, when taken out by the employee, must be taken out as a normal policy in accordance with the conditions contained in the Regulation to the Long Term Insurance Act. **This will ensure that the proceeds will then be fully redeemable and tax-free at maturity.**

The employee will not be able to claim any of the premiums as a tax deduction. It is necessary to first determine the tax due on the increment and then to ensure that balance is utilised for the premiums.

As the employee is the one taking out the policy, and as the ownership will remain with the employee, the employee is able to take out any normal policy that may fit his needs. Any supplementary benefits available can also be added. Naturally, no retirement annuity contract can be used for this purpose, as a retirement annuity cannot be ceded.

The arrangements of a preferred compensation are such that they often appeal to employers who have already discarded the idea of a deferred compensation fund. The most important factor that must, at all times, be remembered is the fact the there must be an agreement drafted and signed. Without an agreement both the employer and the employee could find themselves in a very awkward situation at the time that the employee’s services are terminated.

10.4 SINKING FUNDS (CAPITAL ASSET REPLACEMENT PLAN)

Unlike land and buildings, plant, machinery, motor vehicles, office equipment, are wasting assets with a limited time-span usage. Because of this, it is accounting policy to depreciate capital assets at a fixed amount each year for their expected life span.

The depreciation of these assets reflects the estimated annual cost of wear and tear, and is tax deductible in determining the company's taxable income which is gross income less deductions, upon which tax is assessed. In practice these assets may still be capable of functioning reasonably effectively. Although depreciation is a cost, the charging of it does not involve any cash outlay.

To ensure that enough funds are available to replace these assets, cash amounts equal to the depreciation charges must be invested in a sinking fund, such as, a pure endowment policy.

10.4.1 HOW IS THIS DONE?

The annual depreciation charge is matched with an annual payment into a pure endowment policy for a term of at least 5 years. Because there is no life cover on a pure endowment the company will not be able to deduct the premiums and therefore the proceeds will be tax free when received by the company at maturity.

In accordance with the conditions stipulated in Part 4 of the Regulations to the Long Term Insurance Act, there is also no longer a need for a policy to have a life insured if there is no life cover included in the policy. The company, therefore, owns the policy as an asset, and no outside influences, like the death of the nominated life insured under a historic policy, will affect the date of maturity.

Sinking funds, in addition to replacing capital assets, are the ideal way for a company to save for employee bonus schemes. Duly authorised body corporates can also make use of sinking funds to fund repair and maintenance costs.

10.5 BUY-AND-SELL AGREEMENTS

Unless adequate provisions are made within a business entity, the death of any one of the parties involved creates major areas of concern for the survivors. The primary concern is in the area of the control over the deceased's interest or share in the enterprise.

It would be far simpler for all concerned if the sole proprietor, partners, members in the close corporation, or shareholders in a private company arranged for the continuity of their business entity while they were still able to do so. The most effective way of doing this is through a buy-and-sell agreement. In the case of a sole proprietor, the agreement can be with a valued employee, or even a competitor, as is sometimes found amongst pharmacists.

The most efficient way of funding any agreement reached, is to use life insurance policies on the lives of the people who are party to the agreement.

10.5.1 THE SOLE PROPRIETOR

The sole proprietor is, by definition, a one-man operation and so on the death, or retirement, of the sole proprietor, the business will cease. The business may, at that stage, have established itself in the community, have a large asset base and employ a number of people. The sole proprietor would, therefore like to see the continuity of his work.

The only way that this can be done is to arrange for a purchaser of the enterprise while the sole proprietor is still active in his occupation. A forced sale on death, or a sale at retirement, will almost never realise the true value of the business.

The most likely purchaser of the business of the sole proprietor is a key employee who knows the customers, is familiar with the operation, and has established his credibility in the community.

The problem would be the raising of the finances for the purchase price. A purchasing, commonly known as a buy-and-sell agreement, funded by life insurance that matures at the retirement age of the sole proprietor and has sufficient life cover to cater for prior death, is the solution.

The other option is a buy-and-sell agreement with a competitor in a similar line of business, who incidentally, possibly has a similar problem. Here the two parties can agree that the business of the first dying will be purchased by the survivor, who can then, when the time is right, sell the business at its true value. The survivor also could appoint a competent manager and retain the business.

10.5.2 PARTNERS, MEMBERS & SHAREHOLDERS

A partnership, close corporation or private company all have purchasers available to buy the interest in the enterprise from a deceased co-owner’s estate. The problem of having sufficient funds to purchase the interest may, however, be an issue at the time. The only way that this can be overcome, is by setting down all the conditions applicable to the sale of the interest of a partner, member or shareholder on his death, in a buy-and-sell agreement, and funding the agreement with life insurance.

The buy-and-sell agreement will ensure that the executor of the deceased’s estate is obliged to fulfil the conditions of the sale. No clause in any will set up by the deceased will be able to override the terms and conditions of the buy-and-sell agreement.

The buy-and-sell agreement is drafted after the value of each partner's interest has been calculated. The type of life policy used will often be dictated by the personal circumstances of the individual partners, as well as the value placed on the partnership.

Term insurance is advisable for affordability, especially when a new business is being started up, as expenses are usually higher at this stage. Being inexpensive, one can opt for a 5 or 10 years convertible term policy, that can be converted at a later stage when a higher premium can be afforded. A limitation of this type of cover is that should the term run out, the client has to convert the plan, or it will expire.

The timing may not be appropriate, therefore a renewable convertible term policy could be more appropriate, with the premium increasing at each renewal date.

Another type of cover is universal whole life insurance. The premium is (subject only to a negative review) constant throughout the duration of the policy. It also provides cash values after a number of years. The benefit of having cash values is that where the business is sold or ceases to operate, the cash payouts from the policies can be an added benefit to the partners. The policies of the last few years, offering whole of life cover without investment, or free-standing disability / debility or dread disease cover, are a cost effective way of funding the provisions of buy and sell agreements

Buy-and-sell agreements have become an accepted part of sound planning for most small businesses. The awareness of the need has resulted in many businessmen arranging their agreements through their attorneys which would be correct in all the legal implications. What has been found on occasion, though, is that there is an omission in arranging the needed life insurance to fund the provisions of the agreements.

10.6 PREFERENCE SHARE CAPITAL REDEMPTION PLANS

Preference shares are generally used by a company to raise money. Whilst a preference shareholder obtains certain rights against the assets of the company they usually have no voting rights with regards the running of the company. In other words, they cannot vote at the annual general meeting where the board of directors are elected.

Holders of preference shares are entitled to a participation in the profits of the company before the declaration of a dividend to ordinary shareholders.

Preference shares can be either cumulative or non-cumulative. Where they are cumulative, and a dividend is not declared during a financial year, the preference shareholders must be paid their arrear dividends in the next year, before a dividend can be declared. They, in effect, become creditors against the future profits of the company.

Preference shares usually bear a fixed minimum annual rate of dividend, and this rate cannot be changed unless the majority of the preference shareholders agree. One therefore finds that, while there is a higher level of security in preference shares, the return on the investment may not be as high as it would have been if the investment had been in ordinary shares. Preference shareholders have a prior claim to the repayment of capital upon the winding up of the company.

Preference shareholders will find that their shares either have a redemption date, at which stage the company will repay the capital at a specified redemption price, or a conversion clause allowing the conversion of all or a part of the holdings into ordinary shares, again at a specified price. This is usually also linked to a specified date.

Should the issued preference shares be redeemable, the company will redeem them, either out of the profits that are, at that stage, available for dividends, or out of the proceeds of a fresh issue of shares that are issued specifically for this purpose.

Another option that the directors could investigate, is the setting up of a sinking fund for the repayment of the capital required to redeem the preference shares. As the redemption is at a specific price on a pre-determined date, it is possible to plan ahead by investing in a sinking fund with a premium that will provide sufficient capital at the required maturity date.

10.6.1 HOW IS THIS DONE?

The annual premium is based on a quotation that will provide an illustrative maturity value at the selected maturity date.

In accordance with the conditions in Part 4 of the Regulations to the Long Term Insurance Act, there is no longer a need for a policy to have a life insured if there is no life cover included in the policy. The company, therefore, owns the policy as an asset, and no outside influences, like the death of the nominated life insured under a policy, will affect the date of maturity.

At maturity, the proceeds of the policy will be tax free in the hands of the company, and will be used to redeem most or all of the preference shares. The advantage to the company of utilising a policy of insurance will be the fact that either:

(a) no new issue of shares will be required to raise the capital for redemption; or

(b) normal dividends can be issued as the profits will not be needed for redemption.

10.7 CONTINGENT LIABILITY INSURANCE

A private company, or close corporation (cc), will, on occasion, need to borrow money. The reason for the borrowing is not what is important in this scenario, but what is of vital importance to the directors, or members in the case of a CC, is the personal surety that he may be required to sign. It is not unusual that a bank will insist that the directors of a private company pledge their personal assets, where the bankers feel that the assets of the business provide insufficient security.

By signing a surety in his personal capacity, the director effectively binds his personal estate for the liabilities of the business. On the death of the director, the loan will be recalled and the business will need to repay the loan. Should this not be possible, the business will need to exercise one of the following options:

- find an alternate director who can replace the deceased as an alternate guarantor;
- find alternative collateral security acceptable to the creditor; or
- come to an alternative arrangement with the creditor for the repayment of the loan.

Should the business be unsuccessful in its attempts to make alternative arrangements, the creditors may claim the full outstanding debt directly from the personal estate of the deceased director.

In order to avoid the personal estate of a director being liquidated for the settlement of business debts, it is prudent that the business takes out policies of insurance of the lives of any directors that may have signed personal sureties.

10.7.1 HOW IS THIS DONE?

The director(s) agree that a policy of insurance is taken out by the business on his life, on the conditions that:

- premiums are paid by the business;
- the proceeds of the policy are used to settle any amounts outstanding to creditors who hold personal guarantees that the director may have signed;
- any surplus remaining after the settlement of the secured debts may be retained by the business;
- a written agreement is entered into between the business and the director, that compels the business to use the proceeds of the policy(ies) to settle the amount owing to the creditors; and
- creditors accept the plan, and provide a written undertaking to cancel the personal surety provided by the director on the repayment of the debt.

As the total and permanent disability of a director may result in the creditor lo~~o~~sing faith in the business's ability to repay the loan, it is perhaps also advisable that permanent disability insurance be included with the policy.

Setting up of a contingent liability plan can safeguard, not only the estate of a deceased director, or member of a close corporation, but also the business against financial hardship, should the personal guarantor pass away suddenly.

10.8 THE IMPACT OF CAPITAL GAINS TAX (CGT) ON BUSINESS INSURANCE SOLUTIONS

The introduction of Capital Gains Tax (CGT) has resulted in many people looking to their assets, and wondering what impact this tax has on the real value of these assets.

Certainly business persons, whether it be a partner who has funded a buy-and-sell agreement with insurance policies, or an employee who has elected to received some form of deferred or preferred compensation scheme in lieu of an annual salary increment, will be looking at the potential impact of CGT on their future lump sum receipts.

Fortunately, the fiscus chose, when it came to insurance policies, to address the portfolios in which the investments are held by the relevant insurer and subject them to CGT.

Persons, therefore, need not declare the proceeds of insurance policies for the purposes of the payment of any capital gains tax.

Note that this does not, however, apply in the case of a second-hand policy where the proceeds will have to be declared as a capital gain or a capital loss.

The way in which policy proceeds are to be dealt with for the purposes of CGT are stipulated in paragraph 55 of the Eighth Schedule:

> *A person must disregard any capital gain or capital loss determined in respect of a disposal that resulted in the receipt by or accrual to that person of an amount-*
>
> *(a) in respect of a policy as defined in Section 29A with an insurer as defined in that section, where that person-*
> *(i) is the original beneficial owner or one of the original beneficial owners of the policy;*
> *(ii) is the spouse, nominee, dependant as contemplated in the Pension Funds Act, 1956 (Act No. 24 of 1956), or deceased estate of the original beneficial owner of the relevant policy and no amount was paid or is payable or will become payable, whether directly or indirectly, in respect of the cession of that policy from the beneficial owner of that policy to that spouse, nominee or dependant; or*
> *(iii) is the former spouse of the original beneficial owner and that policy was ceded to that spouse in consequence of a divorce order or, in the case of a union contemplated in paragraph (b) or (c) of the definition of "spouse" in Section 1 of this Act, an agreement of division of assets which has been made an order of court;*
>
> *(b) in respect of any policy taken out on the life of an employee or director as contemplated in Section 11(w);*
>
> *(c) in respect of a policy that was originally taken out on the life of any other person who was a partner of that person, or held any share or similar interest in a company in which that person held any share or similar interest, for the purpose of enabling that person to acquire, upon the death of that other person, the whole or part of-*
> *(i) that other person's interest in the partnership concerned; or*
> *(ii) that other person's share or similar interest in that company and any claim by that other person against that company, and no premium on the policy was paid or borne by that other person or any connected person in relation to that other person;*
>
> *(d) in respect of a policy originally taken out on the life of a person, where that policy is provided to that person or dependant by or in consequence of that person's membership of a pension fund, provident fund or retirement annuity fund.*

Just as an aside, retirement funds are not subject to CGT. This is in accordance with paragraph 54 of the Eighth Schedule which states:

> *A person must disregard any capital gain or capital loss determined in respect of a disposal that resulted in that person receiving-*
>
> *(a) a lump sum benefit as defined in the Second Schedule; or*
>
> *(b) a lump sum benefit paid from a fund, arrangement or instrument situated outside the Republic which provides similar benefits under similar conditions to a pension, provident or retirement annuity fund approved in terms of this Act.*

10.9 RECOMMENDED ADDITIONAL READING

The student who wishes to know more about insurance for business will find that a number of books are available to assist with further reading. A few of these have been listed below.

“The Financial Advisers Development Series”
by M Botha, I du Preez, WD Geach, b Goodall and L Rossini
published by Butterworths

“Entrepreneurial Law”
by HS Cilliers, ML Benade, JJ Henning, JJ du Plessis, PA Delport, JSA Fourie & L de Koker
published by Butterworths

QUESTIONS ON CHAPTER 10

Mental revision questions

Work through these mental revision questions as a test of your understanding of this chapter. We suggest that you attempt these before tackling the written questions. Please note that suggested answers are not provided as the chapter's text contains the answers.

1. Define a key-person.

2. Explain why an employer would wish to institute a deferred compensation plan for certain members of his staff.

3. List and explain some of the reasons where a preferred compensation plan would be better than a deferred compensation plan.

4. Explain how a sole proprietor can enter into a buy-and-sell agreement.

5. What is a preference share?

6. Briefly explain how a contingent liability plan works.

Written questions

Attempt these questions after you have completed this chapter and its mental revision questions. Suggested answers to these questions are at the end of this book.

1. Mr. Big, the owner of a large company, wishes to retain the services of his key sales people. Explain to Mr. Big what a conforming policy is and what the tax advantages of such a policy are to both the company and the sales staff.

2. James Seller, a 24 year old sales "star" who works for Mr. Big, is not sure that a deferred compensation scheme is in his best interests. Explain the tax advantages, both before and after retirement, that Mr. Seller will enjoy if he partakes in the scheme.

3. Still not convinced, Mr. Seller asks that you explain a preferred compensation scheme to him. Mr. Big is also interested to know whether he will be better off with either a deferred or preferred compensation scheme. Prepare a report for:
   3.1 Mr. Seller; and
   3.2 Mr. Big.

4. Mr. Manufacturer knows that the new machinery that he has recently bought will need to be replaced in five years time. He has asked you for a solution in raising the required capital. Explain the option of a sinking fund, and how it works, to your client, giving an example.