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LEVERAGE

the fulcrum legal & technical update

COMPLICATION WITHOUT COMPENSATION?

The latest round of legislative proposals will not only sound the death knell for deferred compensation schemes, but will do away with the concept of "conforming" and "non-conforming" policies as well.

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The draft Taxation Laws Amendment Bill 2010 has been published for comment. The bill, if enacted, will introduce a number of far-reaching changes applicable to company-owned policies in general, and will effectively kill off deferred compensation by nullifying the tax benefits traditionally associated with these schemes.

Please note that this is a discussion of proposed changes – the legislative changes have not been enacted yet!

The key to these changes is to be found in a completely revised section 11(w) of the Income Tax Act. This section determines the deductibility of premiums in respect of policies owned on the lives of employees / directors.

In its current format, the section allows for a deduction if the policy is one of the following:

(A) *such policy was effected in terms of a written proposal accepted by the insurer before 1 June 1982 or the proposal for such policy was made before 25 May 1982 and accepted by the insurer not later than 21 June 1982; or*

A completely revised section 11(w) of the Income Tax Act.

(B) *the only benefit payable under the policy is a benefit payable within a period fixed in such policy upon or by reason of the death or disablement of the employee or director whose life is insured under the policy or the policy is a disability policy as defined in section 1 of the Long-term Insurance Act, 1998 (Act No. 52 of 1998); or*

(C) *the Minister of Finance has by regulation prescribed requirements in regard to terms and conditions with which insurance policies shall conform for the purposes of this subparagraph and the policy conforms with such requirements*

In short, the premiums in respect of a company-owned policy on the life of a director / employee are deductible if it is a term policy, a disability policy or a conforming policy. A "conforming" policy has to have certain features, such as a minimum amount of life cover, no substitution of lives and restrictions pertaining to the premium increase rate.

If a client uses a whole life policy, he has the choice of implementing a "conforming policy", where premiums are deductible and proceeds taxable, or a "non-conforming policy" with non-deductible premiums but a tax-free payout. If the policy is a disability policy or a term policy, the premiums will always be deductible and the proceeds will form part of gross income for tax purposes.

This is all about to change.

In terms of the draft legislation, the current wording of section 11(w) will be replaced in its entirety and the revised section will provide that a company / employer may claim the following as a income tax deduction:

"expenditure actually incurred by the taxpayer in respect of any premium under any policy of insurance in respect of an employee or director of the taxpayer, if –

(i) the benefit payable under the policy is payable ***solely upon or by reason of the death, disablement or severe illness of the employee or director;***

(ii) the policy ***exclusively*** *makes provision for a benefit for the purposes of indemnifying the taxpayer for any loss or diminution of profits by reason of the death or disablement of the employee or director;*

(iii) the policy is not the property of any person other than the taxpayer at the time of the payment of the premium in respect of any year of assessment:

Provided that any premium paid shall not be disallowed as a deduction by reason of –

(aa) the policy or the right to receive the proceeds thereof being ceded or otherwise made over to or in favour of a creditor of the taxpayer as security for any debt; or

(bb) the policy being pledged as security for any loan at the time that the policy is concluded,

(iv) the policy or the right to receive the proceeds of the policy or any portion thereof is ***not ceded or otherwise made over to or in favour of –***

(aa) ***the employee or director; or***

(bb) ***any relative of such employee or director,***

under any transaction, operation or scheme."

A policy with a savings/ investment component will not qualify for deduction.

As you can see from subsections (i) and (ii), a deductible policy may only provide death, disability or critical illness benefits. A policy with a savings / investment component will not qualify for deduction.

Secondly, subsection (iv) makes it clear that a policy which is directly or indirectly used for the benefit of the life insured will also not qualify.

Notable by its absence is any reference to a "conforming" policy.

What does all of this mean?

The cover will likely have to be increased to compensate for the unforeseen tax burden.

Say goodbye to your "non-conforming" keyman policy

If your company's risk-only policy provides only life, disability or critical illness benefits, and it was taken out as a "non-conforming" policy, you will now in all likelihood (once the bill has been enacted) find that the premiums have become deductible and the proceeds taxable – exactly as if it was a "conforming" policy!

The new section 11(w) does not provide for a pure risk policy to be structured as "non-conforming" as was the case up to now. Thus, the fact that your policy allows for substitution of lives or a particular premium increase rate will be irrelevant – if the policy meets the new criteria, the premiums will be deductible and the proceeds will be taxable. It is not inconceivable that a new policy could have additional features / benefits which may render it non-deductible, but the fact remains that most policyholders who took out "non-conforming" policies for "keyman"-type purposes will likely be oblivious to the fact that their premiums may have become deductible and that the eventual policy proceeds will be taxable.

The client will have to be made aware of this issue, so that he may start deducting the premiums as from the effective date (the 2011-2012 tax year, in all likelihood). Furthermore, the client will have to be made aware of the fact that the after-tax proceeds may be insufficient to achieve his original objectives; the cover will likely have to be increased to compensate for the unforeseen tax burden.

Fortunately, the bill will also introduce an amended paragraph (m) of the definition of "gross income", in terms of which the policy proceeds will be exempted on a pro-rata basis for insofar the premiums were not deductible in previous tax years.

"Conforming" policies for Buy-back transactions: no can do.

Subsection (ii) of the proposed new section 11(w) makes it clear that premiums can only rank for deduction if the policy was taken out to protect the company against losses or reduced profits flowing from the death / disability or critical illness of the director / employee. If it was taken out for any other purpose, such as funding a buy-back, the premiums will not qualify for deduction.

Clients (and their accountants, perhaps) will have to be informed that they should stop deducting the premium as from the effective date, and also that the insured amount may then be in excess of their requirements, since they would not have to allow for income tax anymore.

R.I.P. Deferred Compensation?

Once the bill has been enacted, a moment of silence for the venerable deferred compensation scheme would be in order.

A deferred compensation scheme involves a policy (usually an endowment policy with some life cover, in order to make it "conforming") taken out by the employer on the life of a valuable senior employee, in lieu of a salary increase. Instead of paying the employee an additional amount of salary, of which 40% may be lost in tax, the company invests the money in a endowment policy until the retirement of the employee. At that stage, the proceeds pay out to the company as taxable income, but the amount is then paid over to the employee in terms of a service agreement, making the proceeds tax-neutral in the hands of the company. The employee would then benefit from the concessions allowed in terms of section 10(1)(x) and 7(A)(4A) of the Income Tax Act, which provide for the amount to be tax-free up to R30 000 and the balance, within certain limits, to be taxed at average rates.

Deferred compensation premiums will not qualify for deduction.

The tax efficiency of a deferred compensation scheme hinges on the tax-deductibility of the proceeds (leaving the company in the same position as if it had paid the premium amounts to the employee as remuneration) and the tax concessions provided by section 10(1)(x) and 7(A)(4A) – if not for the average rate concession, the employee would probably pay tax on the full policy proceeds at the maximum marginal rate of 40%.

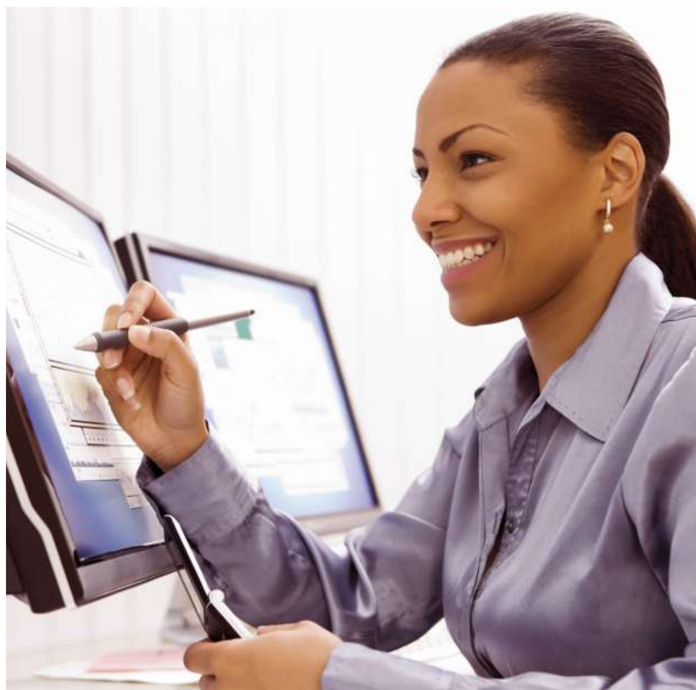
From the company's perspective, it is clear that deferred compensation premiums will not qualify for deduction in terms of the proposed new section 11(w) because:

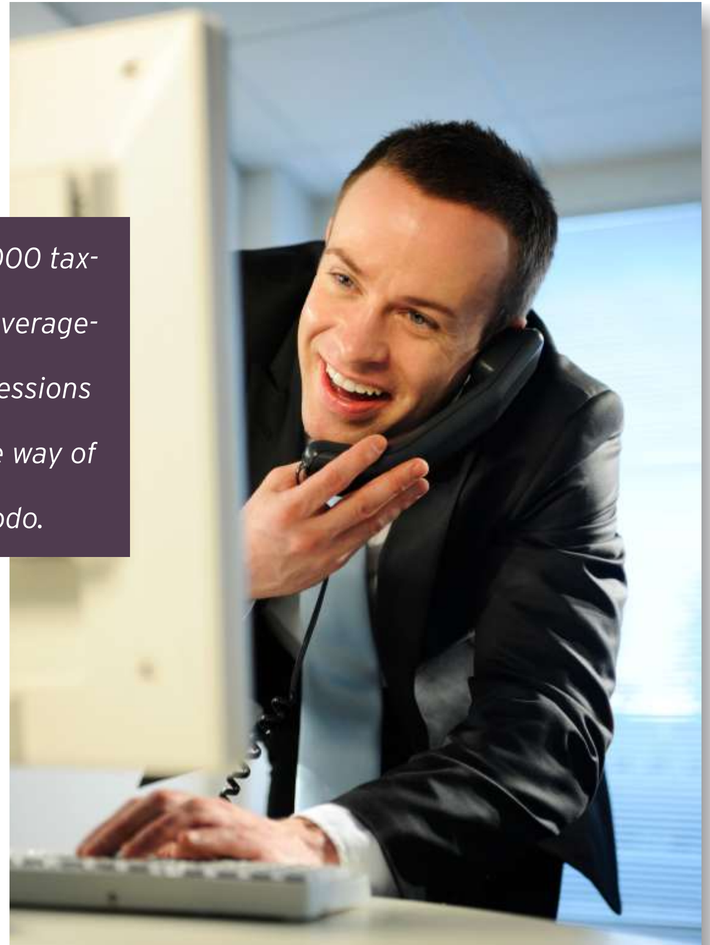
- as an investment policy, its benefits are not limited to amounts payable upon the death, disability or critical illness of the employee; and
- its sole purpose is not to indemnify the company for losses resulting from the death, disability or critical illness of the employee.

But it gets worse: the draft bill also provides that the policy may not be used, directly or indirectly, for the benefit of the employee / director. If that is the case, special anti-avoidance rules will result in the company forfeiting the tax deduction and the proceeds paid to the employee becoming fully taxable income in his hands.

The R30 000 tax-free and average-rate concessions will go the way of the dodo.

The R30 000 tax-free and average-rate concessions provided by sections 10(1)(x) and 7(A)(4A) will go the way of the dodo. All amounts received from the employer upon retirement or retrenchment will be taxed as if it was a retirement benefit, according to the retirement lump sum tax tables (where up to R300 000 may be tax-free), but not if the amount was funded by a policy in respect of which the premiums had ranked for deduction in terms of section 11(w). (We will discuss the issue of retrenchment payments in a future issue of Leverage.) It is not entirely clear from the draft bill and the explanatory memorandum whether deferred compensation policy proceeds will qualify for the R300 000 exemption on a pro-rata basis, for insofar the policy was in existence prior to the amendments.





So yes, once this bill becomes law, deferred compensation schemes will become extinct.

Conclusion

Please keep in mind that the legislative changes are still at proposal stage, and are subject to change and clarification. There are a number of inconsistencies and some problematic drafting which will have to be clarified over the next couple of weeks before the bill is presented to parliament. We will keep you informed of the progress in this regard.

However, the draft bill does give us a good idea of what to expect. Going forward, you would be well-advised to consider the issue of tax-deductibility of premiums very carefully when dealing with new company-owned policies.

Please contact your legal business development manager for further information on how to deal with new and existing company-owned policies in light of the expected changes.

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