

WELCOME to the first edition of **LEVERAGE**, the monthly Fulcrum financial planning journal.

The Fulcrum team (Business & Personal Solutions) has always been committed to providing solutions-driven financial planners with the support that they need to make a real difference in their clients' lives.

LEVERAGE is the next evolution in our strategy to put our supporting brokers at the cutting edge of the financial planning profession. The aim of

Fulcrum [fuul-kruhm] (noun): the point on which a lever turns or is supported.*

Leverage [lee-ver-ij] (noun): 1. the exertion of force by means of a lever. 2. the power to influence.*

*definitions from Oxford Dictionary

this publication is simple: to equip you with the knowledge and insight that you need to maximise your influence and value proposition to your client.

Through our relationship with a large number of top-flight financial planners all over the country, we are in the fortunate position to deal with a variety of challenging legal and technical issues on a daily basis, and

LEVERAGE is the ideal platform to share our experience with you. Thus, expect more than just legislative and regulatory updates; we want to expose you to the practical and conceptual issues faced by your fellow professionals on a daily basis.

Enjoy it!
Bertie Nel, CFP®
Head: Business and Personal solutions

FROM CONFORMING TO CONFUSING

The proceeds from a non-conforming policy are always tax-free, right? Think again...

Danie Rossouw, CFP®

The premiums on a policy owned by a company or an employer on the life of a director or employee may be tax-deductible if the policy complies with the requirements of section 11(w) of the Income Tax Act.

The following policies meet the requirements of section 11(w):

1. A policy issued before 1 June 1982.
2. A term policy or "disability" policy as defined in the Long Term Insurance Act.
3. A policy that conforms to certain requirements prescribed by the Minister of Finance - a so-called "conforming" policy.

As you can see, not only a "conforming" policy is tax-deductible. It is entirely possible that the company could own a term policy or a disability policy that does not comply with the Minister of Finance's regulations. And there you have it: a non-conforming policy with tax-deductible premiums and taxable proceeds (in terms of paragraph m of the definition of "gross income" in the Act). Clearly, you cannot use "non-conforming" as a synonym for "non-deductible", can you?

But it gets worse: a policy can also be "conforming", yet non-deductible.



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A “conforming” policy must simply have certain features, as per the Minister’s regulations, such as:

- One life assured only and no substitution of lives.
- A minimum amount of life cover.
- Limitations with regards to the premium increase rate.

However remember that section 11(w) demands that the policy must be on the life of an employee or director (or member in the case of a CC). If the policy is taken out by, say, a company on the life of a shareholder who is not an employee or director, the premiums will not be deductible, even though the features of the policy make it a “conforming” policy.

The moral of the story is this: we should stop referring to a policy as “conforming” or “non-conforming” when we’re talking about the tax implications. Rather, we should be asking: “are the premiums deductible in terms of section 11(w)?”

Most bad habits are difficult to break, but this is certainly one that has the potential to wreak havoc with your professional relationships!

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New: buy-back and multiple lives option on Fulcrum BNA

You asked for it, you got it. Danie Rossouw, CFP®

The Fulcrum team is pleased to announce that the latest release of the Fulcrum BNA (business needs analysis system) provides the option of a share buy-back, as well as a “single owner - multiple lives” option as an alternative to the traditional buy & sell structure.

Buy-backs

Since the changes to the Companies Act made it possible for companies to acquire their own shares, we have had numerous requests for buy-back agreements. These contracts (between company and shareholder) could not be generated by the Fulcrum BNA and had to be custom-drafted upon application.

The system has now been expanded to include full buy-back functionality and users will henceforth be able to generate both reports as well as agreements to support their buy-back proposals to their clients.

What is a buy-back?

The traditional buy and sell structure involves a contractual arrangement in terms of which the remaining shareholders will purchase the shares of a deceased or disabled shareholder. The parties will usually effect insurance policies on each other’s lives in order to provide the funds required to meet their contractual obligations in terms of the buy and sell agreement.

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In terms of a buy-back agreement, the company itself will buy a deceased or disabled shareholder's shares. The shares that are bought back must then be cancelled in the company's share register and their status restored to authorised (and unissued) shares. This will achieve a similar result for the remaining shareholders as would be the case with the "traditional" structure: they will now own a larger percentage of the issued share capital due to the cancellation of the departing shareholder's shares.

Section 85 of the Companies Act lists a number of requirements that must be met in order for the buy-back to be valid. Some of these are:

- The buy-back must be authorised by the articles of the company and approved by way of a special resolution of the company.
- There must not be reasonable grounds to believe that the company would, subsequent to acquiring the shares, be unable to pay its debts as they become due, or that its consolidated liabilities would then exceed its consolidated assets.
- The transaction may not result in only convertible or redeemable shares remaining as issued share capital.

Advantages and Disadvantages

The major benefit of a buy-back structure is ease of administration. Since the company would be the only policy owner, premiums do not have to be split and allocated to multiple owners in relation to their holdings in the company. Also, dealing with the policy (amendments, cessions, etc.) becomes much easier when the signatures of multiple owners are not required. Some shareholders may also prefer the fact that the cost of the insurance on each life is effectively shared by all the parties in the case of a buy-back; this avoids the resentment that often arises where the premiums on certain lives are significantly higher than on others.

However, the requirements of section 85 mean that a buy-back structure is not as secure as the traditional structure, because a lot will depend on the prevailing circumstances at the time of death. There are also tax implications which should be carefully considered before implementing a buy-back structure and we will discuss some of these issues in this piece.

Estate Duty, CGT and Dividends Tax

The most obvious disadvantage of a buy-back structure is the negative estate duty implications. Since this would be a company-owned policy, it



would have to meet the requirements of section 3(3)(a)(ii) of the Estate Duty Act in order to qualify for the "deemed asset" exemption. These requirements are:

- The policy must not have been effected by or at the instance of the deceased;
- No premiums must have been paid or borne by the deceased;
- No amount due under the policy will be paid to the deceased's estate or paid to or utilized for the benefit of his relatives or dependants or any company that is a family company in relation to the deceased.

Recently published reference guides from SARS have made it clear that the Receiver will interpret section 3(3) quite aggressively where policy proceeds end up in the deceased's estate and have left us in no doubt that the proceeds from a policy funding a buy-back will **not** qualify for the "deemed" asset exemption. Accordingly, the insurance cover should always be increased to make provision for estate duty when a buy-back structure is used.

A further complication is that the purchase price will be deemed to be a dividend paid to the departing shareholder, for insofar the purchase price exceeds the nominal value of the shares (the value shown on the share certificate). Thus, if shares with a par value of R10 000 is bought back by the company for R100 000, R90 000 would be deemed to be a dividend paid to the shareholder and taxed at 10% (current rates). This should of course have the effect of cancelling out any capital gain in respect of the disposal of the shares to the company: using the same example, the deceased estate will have disposed (for CGT purposes) of the shares at

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R10 000 and not at R100 000. If the particular shareholder had acquired the shares for more than R10 000, he would, in fact, be able to show a capital loss. Whether or not this interplay between dividends tax and CGT will be to the detriment of a shareholder will depend on the particular taxpayer's circumstances, but there's no doubt that it should be taken into account when a buy-back structure is being considered.

There may also be CGT implications for the remaining shareholders, because the value of their shareholding in the company will increase subsequent to the buy-back. After all, they will now effectively own a larger percentage of the business. However, they did not purchase the seller's shares - their existing number of shares would simply have increased in value - and they could thus be faced with a huge CGT bill when they eventually dispose of their shares. If they had acquired their deceased partners' shares via a traditional buy & sell arrangement, they would have been able to use the policy proceeds as the base cost of the shares that they had acquired. Using the buy-back structure however, means that they would not have paid anything towards the increase in the value of their shares, so selling their shareholding at a later stage could have significant tax implications, even if such a sale is not a buy-back.

Income Tax

Like most company-owned policies, a buy-back policy can be structured to meet the requirements of section 11(w) of the Income Tax Act, which means that the premiums will be tax-deductible and that the proceeds must be included in the company's taxable income.

As you can see from the above, buy-backs are rather complex arrangements and it is far from certain that a particular client will benefit from using such a structure. Our advice is to proceed with great caution and to contact the legal Business Development Manager (BDM) in your area for guidance in this regard.

Alternative option: single owner - multiple lives policy

The latest release of the Fulcrum BNA also supports a "single-owner - multiple lives"-structure, which we will call the "alternative structure" to distinguish it from the "traditional" and "buy-back" structures.

Some clients prefer this type of structure because the administration thereof is less complex than that of the traditional structure. In order to comply with section 3(3)(a)(iA) of the Estate Duty Act, it is of critical



importance that the insured shareholders do not inadvertently pay or bear the cost of any premiums on their own lives. Furthermore, each shareholder should only have to bear the cost of the policy of which he is a co-owner in proportion to his percentage ownership in the policy, which is only fair. Where multiple owners share ownership of one policy, the allocation of part of the premium to each shareholder's loan account can be an admin-intensive exercise and this is made worse by the fact that the premium usually changes at least once a year.

The alternative structure will allow one policy owner to insure the lives of all of his partners in one policy whereas the traditional approach would have multiple owners and one insured life. This makes it much simpler to account for in the books of the company, because the premium doesn't

have to be divided between multiple shareholders; the entire premium is simply allocated to its single owner.

A drawback of the alternative structure is that a departing shareholder will not be able to take cession of a policy on his life, because the policy owner would want to keep the policy in place for insofar it insures the lives of the other remaining shareholders. The policy cannot be split into two policies for this purpose. There may also be negative CGT implications if the departing shareholder cedes the policy that he owns on the lives of the others to them, to enable them to carry on with the cover for buy & sell purposes. The traditional structure would allow this, because the departing shareholder would cede his co-ownership in a policy to the other co-owners of the policy; the proceeds would not be subject to CGT in their (the remaining co-owners') hands because each of them would be one of the original beneficial owners as contemplated by paragraph 55(1)(a) of the Eighth Schedule of the Income Tax Act.

It is far from certain that a particular client will benefit from using such a structure.

THE FULCRUM TEAM



The Fulcrum Team (Business & Personal Solutions) is a select group of financial planning specialists in the Momentum Risk & Savings Division. Every member of the team is a qualified legal adviser and most have been admitted as Certified Financial Planner® professionals. They offer expert financial planning advice and support services to users of the Fulcrum BNA and Fulcrum for Individuals software packages.

If you are not a Fulcrum user and would like more information about our products and services, please contact your marketing adviser.

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