The sections of the Income Tax Act that applies when it comes to the taxation of company/employer owned policies have been amended more than once in the last two years. It was first amended and thereafter the previous position was reinstated followed by an amendment which forms the basis of the current position. The position as it applies from 1 March 2012 is discussed below. Amendments contained in The Taxation Laws Amendment Act of 2012 has been taken into account.

A general rule one can say that historically the position has been that if an employer or company took out a policy on the life of an employee or director, the premium paid by the company/employer was tax deductible if the requirements of section 11(w) were met. On maturity of the policy the proceeds was only included in the gross income of the company/employer if the premiums were tax deductible.

The new rules that are introduced as from 1 March 2012 are not based on the same principles. The new system includes amounts paid in respect of certain policies into the gross income of the employer/company (paragraph (m)), or the gross income of the employee (paragraph (d)) and then exempts the proceeds, provided the requirements are met, from income tax under sections 10(1)(gG) and 10(1)(gH).

A new section 11(w) is introduced with effect from 1 March 2012. The section allows for deduction of the premiums paid by the employer/company under two subparagraphs, namely section 11(w)(i) and section 11(w)(ii). These two paragraphs are discussed separately.

As from 1 March 2012, any premium paid by an employer to an insurer directly or indirectly for the benefit of the employee or his or her spouse, child, dependant or nominee, is included in the gross income of the company/employer if the premiums were tax deductible.

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A new section 11(w) is introduced with effect from 1 March 2012. The section allows for deduction of the premiums paid by the employer/company under two subparagraphs, namely section 11(w)(i) and section 11(w)(ii). These two paragraphs are discussed separately.

As from 1 March 2012, any premium paid by an employer to an insurer directly or indirectly for the benefit of the employee or his or her spouse, child, dependant or nominee, is included in the gross income of the employee under paragraph (i) of the Seventh Schedule (paragraph 2(k)).

Section 11(w)(i) provides that expenditure incurred by a taxpayer (employer/company) in respect of premiums paid by the taxpayer under a policy of which the taxpayer is the policyholder is deductible from the taxpayer’s income if the policy relates to the death, disablement or severe
illness of an employee or director of the taxpayer and if the premiums so paid is deemed to be a taxable benefit under paragraph 2(\(k\)) of the Seventh Schedule. The section does not provide a choice as to whether to deduct or not to deduct such premium. If the premium is included in the taxable income of the employee, the taxpayer (employer/company) must claim the deduction or else it will be lost.

In this regard, it is important to distinguish between “approved” and “unapproved” group life plans. In the case of an “approved” group life policy, the policy is not owned by the employer/company but by a retirement fund. The retirement fund pays the premiums and as policyholder receives the proceeds. The proceeds are then paid to the dependants or nominees of the deceased member of the fund. The amount so paid is done in terms of the rules of the retirement fund. It is thus a retirement fund benefit and is taxed as such.

In the case of an “unapproved” group life fund, the employer is the policyholder, the employer pays the premium and the proceeds are paid directly or indirectly to the employee or his or her dependants or nominees. The premium paid by the employer is, in the latter case, deductible from income by the employer under section 11(\(w\))(\(i\)).

An income replacement policy also falls within the ambit of section 11(\(w\))(\(i\)). An income replacement policy must be distinguished from a capital disability policy. The former replaces the insured person’s income and any amount received in the event of a claim is also regarded as income. In the case of capital disability insurance the insured person has lost his capital ability to earn income. Any amount paid to him replaces the “capital” that he has lost and therefore is also regarded as capital. Any premium in respect of any of these policies that are paid by the company/employer for the benefit of the employee is included in the gross income of the employee as a fringe benefit and consequently tax deductible for the company/employer under section 11(\(w\))(\(i\)).

A premium paid by an employer for the benefit of an employee in respect of an income replacement policy that is included in the taxable income of the employee is deemed to have been paid by the employee. The employee can thus deduct the premium in terms of section 11(\(a\)). Any benefit paid to the employee in respect of such an income replacement policy does not qualify for the exemption under section 10(1)(\(g\)G).

Life insurance has for many years been used by companies/employees to fund gratuity payments to an employee/director at retirement. These plans were referred to as “deferred compensation plans”. These plans were structured in such a way that the premiums paid by the employer/company were tax deductible under section 11(\(w\)) (as it then was). The proceeds of the policy were included into the company/employer’s gross income, but deductible under section 11(\(a\)) when paid over to the employee on retirement, subject to the condition that the requirements under section 11(\(a\)) were met. The employee in turn qualified for a partial exemption and a concessionary rate when taxed on the gratuity. In the last ten years or more there has effectively been no real tax benefit in entering into such a deferred compensation. The income tax that was saved as a result of the tax deduction to the company/employer was according to the marginal tax rate of the employee/director. This is the rate at which the amount of the premium would have been taxed as if it were to be paid to the employee/director as part of his or her salary. It is possible that the employee/director could have been taxed at a higher rate of tax on the gratuity. This was in the case in which the rate of tax at which the gratuity were to be taxed exceeded the employee/director’s average marginal rate of tax over the period that the employer/company was allowed to deduct the premium under section 11(\(w\)). In spite of this, the Government has decided to amend section 11(\(w\)) in such a way so that a premium paid by the company/employer is only deductible under section 11(\(w\)) if the policy insures the employer/company against a loss by way of a pure risk policy with no cash or surrender value. This deduction is under section 11(\(w\))(\(ii\)) that came into operation as on 1 March 2012 and applies in respect of premiums paid on or after that date.
3.4.1 *Premiums taxed as “fringe benefits”*

Employers/companies often pay life insurance premiums in respect of insurance policies on the lives of employees or directors. It is often in respect of a group life policy for the benefit of an employee/director. In the case of group life policies one must distinguish between premiums paid in respect of “approved plans”, and “unapproved plans”.

In the case of an “approved plan”, the policy is owned by a pension or provident fund. With an approved plan the policy proceeds received by the fund are, on death of the member, paid out as part of the fund benefits. The premiums in respect of such a policy are paid by the retirement fund and not by the employer. In the hands of the member or beneficiary the amount is regarded as a retirement fund lump sum benefit and is taxed as such.

Paragraph (i) of the definition of gross income” in section 1 of the Income Tax Act includes the cash equivalent of certain fringe benefits into gross income. This cash equivalent is determined under the Seventh Schedule of the Income Tax Act. With effect from 1 March 2012 a new paragraph (k) was inserted in paragraph 2 of the Seventh Schedule. It provides that if the employer has during any period made any payment to any insurer under an insurance policy which is directly or indirectly for the benefit of the employee or his or her spouse, child, dependant or nominee, the premium paid is included in the gross income of the employee. Paragraph 12C(1) provides that the cash equivalent is the expenditure incurred by the employer during the year of assessment in respect of premiums payable under a policy of insurance for the benefit of the employee, his or her spouse, child, dependant or nominee. Paragraph 12C(2) deems the premium paid by the employer, to extent that it has been included in the taxable income of the employee, to have been paid by the employee. This ensures that the employee can deduct the premium so included in his gross income under section 11(a). Where an appropriate portion of the total premium paid by the employer cannot be attributed to an employee for whose benefit the premium is paid, an amount equal to total the expenditure (premium) incurred during the year for benefit of all employees, divided by the number of employees in respect of whom the expenditure is incurred, will be included in the gross income of that employee (see paragraph 12C(3)).

Section 23 provides that a taxpayer who derives any remuneration (as defined in the Fourth Schedule) may not deduct certain expenditure. Certain exceptions apply. In other words, the deduction of certain expenditure is not prohibited. Paragraph 23(m)(iii) provides that the following is not prohibited:

“any deduction which is allowable under section 11(a) in respect of any premium paid by that person in terms of an of an insurance policy, to the extent that—

(aa) it covers that person against the loss of income as a result of illness, injury, disability or unemployment, and

(bb) the amounts payable in terms of that policy contemplated in item (aa) constitutes or will constitute income as defined.”

*Example 1 – Group income replacement policies*

Sparkles (Pty) Ltd affected a group income replacement policy its employees. The premium that the company paid in respect of its employee Bruce is R1 0000 per month (R12 000 per annum). A total of R12 000 is included in Bruce’s gross income as a fringe benefit. Bruce may deduct the amount of R12 000 under section 11(a) of the Income Tax Act. Bruce is thus not effectively taxed on the benefit. He will, however, be taxed on any benefit that he receives under the policy.
3.4.1.1 Employer/company deductions under section 11(w)

The “new” section 11(w) that comes into operation on 1 March 2012 provides for a deduction in respect of expenditure incurred by a taxpayer in respect of premiums payable under an insurance policy (but not a policy solely against an accident as defined in section 1 of the Compensation for Occupational Injuries and Diseases Act) of which the taxpayer is the policyholder. It allows for deductions in respect of two categories of policies [section 11(w)(i) and section 11(w)(ii)]. For ease of reference these are referred to as (i) “fringe benefit” policies and (ii) key person policies. The preamble to section 11(w) provides that the deduction allowed under that section does not apply in respect of a policy that relates to the death, disablement or severe illness of an employee or director arising solely out of and in the course of employment of the employee or director. It follows that if an employer insures the life of an employee in terms of a policy, the benefits of which will only be paid if the employee should die in a work related accident (employment event policy), the premiums cannot be deducted under section 11(w). This will be the case even if all of the other requirements of the section are met. Such a premium can, however, be deductible under section 11(a) if the requirements of that section are met. Section 23B, does not prohibit a deduction under section 11(a) where the policy is an employment event policy.

3.4.1.2 Deduction in respect of premium “fringe benefit” policies – section 11(w)(i)

In terms of section 11(w)(i) a premium paid by a company/employer in respect of an insurance policy (other than a policy solely against an accident defined in section 1 of the Compensation for Occupational Injuries and Diseases Act 130 of 1993) of which the company/employer is the policyholder is tax deductible in the hands of the company/employer of the following requirements are met—

(a) the policy relates to the death, disablement or severe illness of an employee or director of the taxpayer; and

(b) the premium paid by the employer/company is deemed to be a taxable benefit granted to the employee/director (paragraph 2(k)).

Example 2 – Section 11(w)(i) deduction

Big Fish (Pty) Ltd is the policyholder of an unapproved group life plan for employees. It provides life cover the amount of which is to be paid to employee’s nominated beneficiary on the death of the employee. The portion of the premium paid for the benefit of employee John is R3 000 the 2012/13 year of assessment.

It is not required that the policy must be a pure risk policy in order for the premium to be deductible under section 11(w)(i). It can be a pure risk policy, an endowment policy with a surrender or a cash value, or a combination of the two.

Big Fish can deduct the premium (R3 000) under section 11(w)(i) and an amount of R3 000 is included in John’s gross income. He may not deduct the premium so that he is effectively taxed on the R3 000. The proceeds when paid to the beneficiary will be tax free.

3.4.2 Deduction in respect of premium “key person policies” – section 11(w)(ii)

The deduction allowed under section 11(w)(ii) is applicable where the premium is not included in the gross income of the employee/director and if a number of requirements under the section are met. The requirements that must be met are—

(a) the taxpayer is insured against any loss by reason of the death, disablement or severe illness of an employee or director of the taxpayer;

(b) the policy is a risk policy with no cash or surrender value;
(c) the policy is not owned by a person other than the taxpayer at the time of payment of the premium (deduction will not be disallowed if ceded as security);

(d) In respect of a policy entered into—

(A) on or after 1 March 2012 the policy agreement states that this paragraph applies in respect of premiums payable under that policy; or

(B) before 1 March 2012, it is stated in an addendum to the policy agreement by no later than 31 August 2012 that this paragraph applies in respect of premiums payable under the policy.

The deduction applies in respect of premiums paid by the company/employer on or after 1 March 2012. All the above requirements must be met. The policyholder must be insured against a loss. A distinction must be made between a policy that is taken out to cover the company/employer against business operating loss and a policy where proceeds are intended to be used to repay capital. In the latter case, the expenditure is not in respect of an operational loss and therefore not tax deductible.

Example 3 – Policy to cover redemption of a loan.

On 1 March 2012, Windsor (Pty) Ltd insured Brian’s life for an amount of R2 000 000. Brian provided security in his personal capacity in respect of a loan that the company obtained from the bank. The purpose of the policy is to redeem the outstanding bank loan on Brian’s death. The company owns the policy and pays the premium of R1 000 per month. It is a pure risk policy with no cash or surrender value. It does not matter whether or not the policyholder stated in the policy agreement whether the provisions of section 11(w)(ii) are to apply. It will not make any difference.

All the requirements must be met before the premium is tax deductible. In this case the company is not insured against a loss but merely to repay a loan (capital). Consequently, the premium does not qualify for tax deduction.

Example 4 – Pre-1 March 2012 policy

On 1 March 2008, ABC (Pty) Ltd took out a pure risk policy on the life of employee Eric. It has no cash or surrender value. The policy was a non-conforming policy prior to 1 March 2012 as the policy document states that lives insured may be substituted. No premiums paid before 1 March 2012 qualified for deduction under section 11(w) as it was before 1 March 2012. It is a key person policy. It is to insure the company against an operating loss in the event of the Eric’s death.

The company (Pty) Ltd is concerned that after 1 March 2012 the premiums will rank for tax deduction under the new amended section 11(w)(ii). They want to know what is to be done to ensure that the premium will not rank for tax deduction. The answer is simply that the company’s mere inaction (not stating in an addendum to the agreement that the provisions of section 11(w)(ii) is to apply) will suffice. If they failed to make this statement in an addendum to the agreement before 31 August 2012, the last requirement is not met and consequently the premiums payable on or after 1 March 2012 are not deductible. On Eric’s death the amount paid to the company under the policy will be included in the company’s gross income in terms of paragraph (m) of the definition of gross income. If none of the premiums paid on or after 1 March 2012 qualified for tax deduction, as is the case here, the amount so included is exempt under section 10(1)(gH). See paragraph 3.4.5 for a discussion of section 10(1)(gH).

3.4.3 Taxation of the proceeds of company/employer-owned policies after 1 March 2012

As from 1 March 2012 there are two provisions in terms of which “company-owned” policies are taxed. They are paragraphs (d) and (m) of the definition of “gross income”.

These two provisions include the “policy proceeds” in gross income irrespective of whether the premiums ranked for tax deduction or not. It is no longer required that the policy proceeds are only included in gross income if the premium ranked for tax deduction. The fact that the proceeds are included in gross income does, however, not mean that it will in fact be subject to income tax. Section 10(1)(gH) can exempt the policy proceeds from tax if the requirements of the section are met.
3.4.3.1 Paragraph (d) of the definition of “gross income”

Paragraph (d) of the definition of gross income applies where the policy benefits is received by or accrues to the employee/director or a dependant or nominee of that employee/director. It reads as follows:

“Any amount including a voluntary award received or accrued—

(i) in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of any office or employment (or right to be appointed) to any office or employment;

(ii) by or to a person, or dependant or nominee of the person, directly or indirectly, in respect of proceeds from a policy of insurance where the person is or was an employee or director of the policyholder;

(iii) by or to a person, or dependant or nominee of the person, in respect of any policy of insurance (other than a risk policy with no cash value or surrender value) that has been ceded to

(aa) the person (employee/director); or

(bb) a dependant; or

Paragraphs (d)(i) and (d)(ii) do not apply to a lump sum award from a retirement fund. A amount which becomes payable in consequence of the death of the person is deemed to have accrued to the person immediately prior to his or her death. Any amount that is received by or accrues to a dependant or nominee of the employee/director of a person is deemed to be received by or accrued to that person.

Example 5 – Unapproved group life proceeds

Sea View (Pty) Ltd is the policyholder of an unapproved group life policy (a pure life policy with no cash or surrender value) taken out for the benefit of its employees. On the death of employee Robert an amount of R1 000 000 is paid to his wife and is included in his gross income. The policy proceeds will be exempt from tax provided that that the premiums paid by the employer on or after 1 March 2012 were included in Robert’s taxable income as a fringe benefit.

Example 6 – Deferred compensation policy

Noordhoek (Pty) Ltd started a deferred compensation scheme for employees in 2001. It is funded by “con- forming policies” which were “deductible” under the pre 1 March 2012 section 11(w). Employee Stuart retires on 31 November 2012. On that date the policy that funds the agreement matures and an amount of R500 000 is paid to Noordhoek (Pty) Ltd. It is then paid to Stuart in terms of a service agreement. The amount received by the company is included in its gross income under paragraph (m) of the definition of gross income and the company will be eligible for a deduction when paying over the proceeds to an employee. The amount received by Stuart will be included in his gross income under paragraph (d)(ii) and will consequently be taxed in his hands.

If the policy were to be ceded to Eric on 31 March 2012, the value of the policy (R500 000) would be included in his gross income in terms of paragraph (d)(iii). The employer cannot claim a deduction in respect of the cession value (see section 23 (p)). If the employer should cede the policy to any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund for the benefit of the employee, the value of the policy is not included in the gross income of the employee/director. The company, in the latter case, will once again not qualify for a deduction in respect of the value of the policy so ceded.

3.4.3.2 Paragraph (m) of the definition of “gross income”

Paragraph (m) of the definition of gross income includes amounts that are received by or that accrues to a company/employer into the gross income of the company/employer. As from 1 March 2012 the following is included in gross income:

“(m) any amount received or accrued in respect of a policy of insurance of which the taxpayer is the policyholder, where the policy relates to the death, disablement or severe illness of an employee or
director (or former employee or director) of the taxpayer, including by way of any loan or advance;
Provided that any amount so received or accrued shall be reduced by the amount of any such loan or
advance which is or has been included in the taxpayer’s gross income.”

**Example 7 – Proceeds of key person policy**

On 1 June 2011, Jupiter (Pty) Ltd took out a pure risk policy with no cash or surrender value on the life of
employee Greg. The premium did not qualify for deduction before 1 March 2012 and it was not stated in an
addendum to the policy agreement (before 31 August 2012) that the provisions of section 11(w)(ii) were to
apply to the policy. The premiums paid on or after 1 March 2012 are therefore not deductible under sec-
tion 11(w)(ii).

Greg dies on 1 October 2012 and an amount of R800 000 is paid to Jupiter (Pty) Ltd.

For the purposes of inclusion of the amount into the gross income of the company, it does not matter
whether any of the premiums qualified for tax deduction or not. Paragraph (m) does not require that the
premiums must be tax deductible (or ranked for deduction) in order for the amount received or accrued in the
compny/employer’s gross income. The amount of R800 000 is included in Jupiter’s gross income under
paragraph (m). The proceeds so included in gross income are exempt from tax as none of the premiums paid
on or after 1 March 2012 qualified for tax deduction (section 10(10(gH)).

3.4.3.3 Section 23(p) of the Income Tax Act

If a company/employer cedes a policy to a director/employee, the company/employer cannot
deduct the value of the policy so ceded. On cession of the policy no amount is included in the
employer’s gross income. Section 23 (p) prohibits the deduction. It comes in to operation on
1 March 2012 and states that the following may not be deducted:

“(p) the value in respect of any cession of a policy of insurance ceded by a taxpayer to—
(i) any—
(aa) employee (or former employee);
(bb) director (or former director); or
(cc) dependant or nominee of the employee (or former employee) or director (or former
director),
of the taxpayer; or
(ii) any pension fund, pension preservation fund, provident fund, provident preservation fund or
retirement annuity fund for the benefit of any—
(aa) employee (or former employee);
(bb) director (or former director); or
(cc) dependant or nominee of the employee (or former employee) or director (or former
director),
of the taxpayer;”

**Example 8**

Newlands (Pty) Ltd entered into a deferred compensation scheme with its employees in 2001. On 31 May
2012 employee Hilton retires. The “conforming policy” on his life has a cash value of R1 000 000. Newlands
(Pty) Ltd cedes the policy to Hilton on that date. The premiums on the policy that were paid before 1 March
2012 were tax deductible. No amount is included in the gross income of the company as there is no accrual.
The company cannot claim a deduction in respect of the value of the policy ceded (section 23(p)). In terms of
paragraph (d)(iii) of the definition of gross income the amount of R1 000 000 is included in Hilton’s gross
income. No exemption will apply so that Hilton will be taxed on the amount of R1 000 000.

3.4.4 Exemption – section 10(gG)

Two new exemptions (sections 10(1)(gG) and 10(1)(gH)) were inserted into the Income Tax Act
with effect from 1 March 2012. The new section 10(1)(gG) exempts an amount that is included in
the gross income of the employee/director under paragraphs (d)(ii) and (d)(iii) from tax in the following instances:

“(i) in the case of a policy that is a **risk policy with no cash value or surrender value**, if the amount of premiums paid in respect of that policy by the employer of the person has been deemed to be a taxable benefit of the person in terms of the Seventh Schedule since the later of—

(aa) the date on which the employer or company contemplated in those subparagraphs became the policyholder of that policy; or

(bb) 1 March 2012,

unless the amount of the premiums paid was deductible by the person in terms of section 11(a);

(ii) in the case of **any other policy**, if an amount equal to the aggregate of the amount of any premiums has been included in the income of the person as a taxable benefit in terms of the Seventh Schedule since the date on which the policy was entered into;”

In the case of paragraph (ii) above it clear that all the premiums since date of inception should have been included in gross income as a fringe benefit before the exemption applies.

### 3.4.5 Exemption – section 10(gH)

The new section 10(1)(gH) (as amended with effect from 1 March 2012) exempts the following amount from tax:

“(gH) any amount received or accrued in respect of a policy of insurance where—

(i) the policy relates to death, disablement or severe illness of an employee or director, or former employee or director, of the person that is the policyholder; and

(ii) no amount of premiums payable in respect of that policy on or after 1 March 2012 is deductible from the income of that person for the purposes of determining the taxable income derived by the person from carrying on any trade;”

It is clear that a “clean break” approach was taken by the legislator. Premiums paid before 1 March 2012 are not taken into account when determining whether or not the policy proceeds are exempt.

**Example 9**

A company took out a policy as a key person policy on 30 March 1995. All the premiums paid prior to 1 March 2012 were tax deductible under the previous (pre-1 March 2012) section 11(w). On 1 March 2012 and thereafter the policy meets all the requirements of section 11(w)(ii) for tax deduction except that no statement that section 11(w)(ii) is to apply was made in an addendum to the policy document. The policy proceeds are included in gross income but exempt under section 10(1)(gH).

Once a policy proceeds has been included in the gross income of a company/employee under paragraph (m) of the definition of gross income the only provision that can exempt it from tax is section 10(gH). For this exemption to apply no premiums paid under the policy on or after 1 March 2012 must have qualified for deduction against income.

### 3.5 Policy taken out by the employer on the life of the employee for the benefit of the employer

#### 3.5.1 Keyperson assurance

Almost every business has one or more persons on the staff members upon whom it depends heavily for its success. More often than not, it is the managing director or proprietor, but it may be a sales manager, an accountant or one of the technical staff – a chemist, engineer or scientist. These are often as vital to the success of the business as its physical and capital assets.

The premature death of a keyperson can result in a severe financial loss to a business. By virtue of his skill, experience and training an employee can often become very difficult to replace and to compensate the business for the loss it will sustain, it may become vital to take out a policy on his life. If he dies prematurely the plan guarantees that cash will be available to absorb the shock to...