momentum

Business Assurance: Asset replacement

Many businesses use expensive machinery, equipment and motor vehicles in order to generate their income. The fixed cost of these assets is then either financed out of shareholder capital or through bank loans. Either way, the interest charge, if any, is not normally allowed as a deduction from tax because a special annual depreciation, or wear-and-tear allowance, is provided for in section 11(e) of the Income Tax Act.

The need

Most businesses use the depreciation deduction as a book entry in order to reduce their taxable income and therefore the amount of tax to be paid each year is reduced as well. While this makes accounting sense, what happens to the asset at the end of its useful life? In most cases, the business merely goes back to the shareholder or bank and refinances the purchase of a new asset. No planning or provision is made during the useful life of the asset to fund its replacement cost in the future. This should always form part of the business's holistic planning process.

The solution

The business takes out an investment policy (or an alternative investment vehicle) to accumulate capital to assist with the repurchasing of assets. The business may choose to invest sufficient amounts to cover all its assets in one investment or may prefer a combination of investments. Financing of the investments would be provided for by taking the tax savings generated by the depreciation allowance and investing this for the future.

The advantages

- Good corporate governance practices are instilled by making adequate provisions.
- Initiate the growth of alternative assets within the business, thus increasing its value to shareholders.
- Long-term liabilities are replaced on the balance sheet with fixed assets, thus improving the gearing ratios.
- The creditworthiness of the business is dramatically improved.
- Planning allows for systematic and structured investment for future expenses.
- An investment is created that can generate tax-free income after a five year period.

The implementation

- The business calculates the depreciation allowance and chooses either to invest the tax saving only, or the full allowance, depending on cash flow.
- The business chooses the most appropriate investment/s.
- When the asset is no longer productively utilised, the business can access the capital provision (by way of a loan or a withdrawal) and either purchase a replacement asset or pay a large deposit towards the purchase price.
- The investment continues to grow as a result of utilising the new depreciation allowance to fund future contributions.

Technical information

Income Tax

Contributions to the investment are not tax deductible.

The tax implications on the investment return will depend on the type of investment used.

Endowment policy	Flexible investment option
Income tax is payable in the endowment wrapper by the insurer based on the five fund approach.	Interest and dividends generated by the investment accrues to the investor and will be subject to tax in the hands of the investor.
No income tax is payable in the hands of the policyholder.	
Where units are sold in the endowment wrapper to fund withdrawals/loans/to switch from one fund to another, capital gains tax (CGT) can be triggered in the investment and payable in terms of the five fund approach.	Where units are sold to withdraw or to switch between funds, and a capital gain is realized, it will be taxable in the hands of the investor.
Where the policy matures, no CGT is payable by the policyholder (as the original beneficial owner).	

Estate duty

Where a business entity owns the endowment policy, estate duty will only be relevant if the last/only life insured on the policy dies and the policy pays out. It will be a deemed asset in the estate of that person, whilst qualifying for a deductions of premiums plus 6% (that was paid by the person that was entitled to the policy proceeds). If a sinking fund policy is used, it will not attract any estate duty implications (unless it is owned by a natural person).

In the case of the flexible investment option, if owned by a business entity, no estate duty will be payable. If owned by a natural person, it will be an asset in the estate of that person.