
Legal and Technical Update

# Buy and Sell Arrangement

## Accounting for premiums paid by the business

Most buy and sell arrangements are funded by life insurance policies on the lives of the selling parties, which is owned by the buying parties. The following example will illustrate how the policies are generally structured:

> Cool Eyes (Pty) Ltd manufactures and distributes sunglasses. The business is owned by Paula with 50%, Andrew with 35% and Kyle with 15%. The value of the business is R10 million. The following table will outline the policy structure:

| **Selling party/life insured** | Paula | Andrew | Kyle |
|---|---|---|---|
| **Value of shares** | R5 million | R3,5 million | R1,5 million |
| **Policyholders** | Andrew owns 70%<br>Kyle owns 30% | Paula owns 77%<br>Kyle owns 23% | Paula owns 59%<br>Andrew owns 41% |
| **Total premium** | R2 500<br>Andrew pays R1 750<br>Kyle pays R750 | R3 800<br>Paula pays R2 926<br>Kyle pays R874 | R900<br>Paula pays R531<br>Andrew pays R369 |

Even though the buy and sell agreement states that the premiums are payable by the policyholders, in practice, it is common for the business to pay the policy premiums on behalf of the shareholders/policyholders. Where this is done and the premiums are not accounted for correctly, it can have dire income tax consequences and can also result in the policy proceeds being subject to estate duty.

When the business pays the premiums, it is effectively paying it on behalf of the policyholders and not for the benefit of the business. There are various ways that this premium payment is accounted for, and each can have its own consequences:

## Accounted for as a business expense

It often happens that all insurance premiums (buy and sell policies, key-person policies, contingent liability policies, short term insurance policies, etc.) are added together on the income statement of the business and then claimed as a tax deduction. The outcome is that the buy and sell premiums that were paid on behalf of the policyholders are incorrectly claimed as an expense in the production of income. SARS may pick up on this when doing an audit which can result in a total audit of the company's financial and a recoupment of the tax benefit enjoyed, whilst adding penalties to that amount.

## Accounted for as a salary expense

Where the policyholders are all also employed by the business, the business may decide to add it to their salary expenses and deduct it for tax – as salary expenses are a tax deductible expense. This is not altogether wrong, but if this is done, one has to ensure that the proportionate premium paid on behalf of each policyholder is included in their salary as a taxable benefit. The conclusion being that the business will enjoy the tax deduction but the policyholder (who is also an employee) will be taxed on the total premiums paid on their behalf.

Note – if the policyholder is not an employee of the business, this option will not be available.

## Using loan accounts to account for the premium payment – credit loan account

One of the most effective accounting and allocation methods is to use the policyholder/shareholder's credit loan accounts, where applicable. Where the parties have credit loan accounts owed to them by the business, the business can write the premium off against that loan account as a part repayment of the loan. This will not result in a tax deductible expense, but it will improve the business' balance sheet each year, as the debt is being reduced, and it will not result in a taxable receipt for the policyholder/shareholder, as the repayment of a loan is a capital receipt which is not subject to income tax or capital gains tax.

## Using loan accounts to account for the premium payment – debit loan account

Where the shareholder/policyholder does not have a credit loan account, there is a practice to create a debit loan account – so the policyholder/shareholder owes the business an amount equal to the premiums paid on their behalf.

Reviewing this practice, the conclusion is obvious - the loan account is created with the sole purpose of avoiding the income tax that would be payable if the premium was added to the gross income of the policyholder/shareholder, and therefore it is safe to say that this practice can be treated as a tax avoidance scheme by SARS. The Income Tax Act contains anti-avoidance provisions and it provides SARS with the power to ignore any such tax avoidance scheme and to tax the taxpayer/s as if the scheme was never entered into.

Where the shareholder/policyholder is not an employee, the debit loan account can still be seen as a tax avoidance scheme. Where the company pays the premium on behalf of this shareholder it can either be treated as a dividend, which will attract DWT or if the company pays the premium on behalf of a policyholder that is not a shareholder, it can be treated as a deemed donation, which will be subject to donations tax. In both instance the debit loan account will be seen as a mechanism to avoid either of these tax consequences.

## Wrong allocation of premiums

In most of the above scenarios, the business has to allocate the correct portion of the premium to the right policyholder/shareholder/employee. If we use the example, the allocation of premiums to each policyholder should be as follows:

- Andrew's total premium payable is R1 750 plus R369 = R2 119
- Paula's total premium payable is R2 926 plus R531 = R3 457
- Kyle's total premium payable is R750 plus R874 = R1 624.

If this allocation is done incorrectly, it can result in the estate duty exemption being jeopardised. One of the requirements to qualify for the estate duty exclusion is that the life insured on the policy may not pay any of the premiums on the policy on their own life.

If we assume the business decides to allocate the premiums equally amongst the policyholders, the outcome will be as follows:

- Andrew's allocation is R2 400 compared to the R2 119 that he should be paying. The result is that he is overpaying and if one splits that overpayment between the three policies, the effect is that he is paying a portion of the premium on his own life, thereby jeopardising the estate duty exclusion.
- Paula's allocation will be R2 400 compared to the R3 457 that she should be paying – therefore the same outcome as with Andrew will apply and she will also potentially lose the estate duty exclusion.

- Kyle's allocation will be R2 400 compared to the R1 624 that he should be paying. He will probably have the best possible outcome, however, SARS can still argue that, as the premiums are being split equally amongst the parties, they are in fact all paying a portion of each of the three policies funding this buy and sell arrangement.
- The outcome can therefore be that the policies will not qualify for the estate duty exclusion.

## Corrective measures

If one of the above practices has been identified, the only corrective measure will be to consult with their tax practitioner and to correct the accounting of the premium and to inform SARS of such to come to an agreement to settle the matter. If the business comes forward and informs SARS of the error, SARS may be lenient and waive penalties and/or interest.

Please note that where the business pays a premium on behalf of a shareholder/employee/policyholder, one cannot make a conclusion that this payment is a payment made by the person on a policy on their own life. It is often encountered where the funds of the company are attributed to the shareholder – the funds of the business cannot automatically be attributed to a shareholder. It will only be the shareholder's funds if a dividend was declared and a resolution states that the dividend is being used to fund the premium. Each set of facts must be investigated and each individual's situation must be considered before a conclusion can be made.

It is important to note that the replacement of the policy with a new policy will not solve the problem in most instances. It is only an alternative to consider when the life insured is deemed to have paid a premium on their life. However one must consider all factors before advising on the replacement.

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