Contingent liability protection

A business often requires financing, whether it is to start a new venture, expand on existing business opportunities or to acquire new business assets. When negotiating with a financial institution for financing, it is often required that the shareholders provide personal surety for the loan. This can pose a potential risk to the personal estate of that shareholder.

The risk – upon the death or disability of the shareholder

The shareholder can be held personally liable for the debt during his/her life and upon death, if:

- The business has a liquidity problem and cannot service or settle the debt, resulting in the personal estate of the shareholder being targeted.
- There is no suitable candidate to replace the guarantor upon his/her death.
- Alternative security is not available.

If the estate of the shareholder is targeted after death, it can have the following effects:

- The winding up of the estate can be delayed unnecessarily.
- The estate can be depleted of all liquid funds available and be left insolvent.
- The lifestyle of the dependants will be affected.

Death of a shareholder can also have a detrimental impact on the business. Should the personal estate of the deceased shareholder settle the debt, the estate can claim it back from the business or its surviving owners. This may result in the unnecessary sale of business assets.

The solution

The business insures the life of the shareholder who has signed surety with a contingent liability insurance policy. The policy should ideally include a disability benefit and the amount of cover should be equal to the total outstanding debts (plus provisions for estate duty).

Policy premiums are paid by the business and an agreement is entered into whereby the business undertakes to utilise the proceeds to settle the outstanding liabilities, thereby relinquishing the guarantor's personal estate of any liability. An agreement between the business and the shareholder formalises this arrangement.

Benefits to the shareholder/ guarantor

- The personal estate of the shareholder is released from any liability.
- The winding up of the estate is not unnecessarily delayed.
- The lifestyle of the dependants will be unaffected.

Benefits to the business

- Liability is settled in full without impacting on the business's financial position.
- The proceeds will pay out tax free as the premiums are not tax deductible.

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Technical information

Income tax implications on premiums paid

If all the requirements of section 11(w)(ii) of the Income Tax Act are met, the premiums paid on this policy will be tax deductible. The requirements are as follows:

- The taxpayer (policyholder) is insured against any loss by reason of death, disablement or severe illness of an employee or director; and
- The policy is a risk policy without a cash value; and
- The policy is owned by the taxpayer at the time of paying the premiums; and
- The policy agreement states that section 11(w)(ii) applies to the premiums payable under the policy.

Note – a contingent liability policy cannot meet the abovementioned requirements as it is intended to protect the taxpayer against a capital loss and not an income loss. Therefore the premiums will not be tax deductible.

Income tax implications on the proceeds paid

If the requirements of section 11(w)(ii) are not met, the proceeds will pay out tax-free (an exemption in terms of section 10(1)(gH) will apply).

Estate duty implications in respect of the policy proceeds

In terms of section 3(3)(a) of the Estate Duty Act, policies on the life of the deceased owned by a third party will be a deemed asset in the estate of the deceased, for estate duty purposes. However, section 3(3)(a)(ii) provides for an exemption if the following requirements are met:

- The policy was not effected at the instance of the deceased;
- No premium was paid by the deceased in respect of the policy;
- No amount due under the policy will be payable to the estate of the deceased;
- No amount will be paid or utilised for the benefit of:
  - any relative of the deceased;
  - any person who is dependent on the deceased;
  - any company that is a family company in relation to the deceased.

Should the proceeds be subject to estate duty, a deduction against the proceeds will be allowed equal to all premiums plus 6% interest, if paid by a third party that is entitled to the proceeds.

Note – SARS publishes a guide in respect of the estate duty implications on key-person policies in 2008 and this guide stated that policies taken out as contingent liability insurance will not meet the requirements of section 3(3)(a)(ii) and the policy proceeds will be a deemed asset in the estate of the deceased.