Credit loan account protection

When any business starts out, it requires financing to enable it to purchase any essential equipment for example stationery or other items, and to pay the regular expenses like salaries, telecoms, rental, etc. When a business has no assets, there are only two ways to raise the necessary funds, either by issuing shares or borrowing money. Business owners do not necessarily want other people involved in their business therefore they normally rely on the loan method to fund their ventures

The risk

While the normal route would be to approach a bank or other lending institution, it is important to remember that they all ask for security and charge interest on any loan. However, generally the preferred method for the owners and/or directors remains to make a personal loan to the business.

The terms of such personal loans are normally done informally with no written contract, with no fixed term and the payment of any interest is not reflected. This is displayed on the balance sheet of the business as a long-term liability that only needs to be repaid in an indeterminable future time.

A risk emerges if the business owner dies, becomes disabled or even critically ill, and the business cannot repay the loan. This can result in the business being declared insolvent thus negatively affecting all parties concerned.

The solutions

The need of the business is to be able to repay the loan on demand if called upon to do so by the owner/director, or any other person like an executor who may be authorised to act on behalf of such owner/director.

There are two possible solutions that may be implemented either alternatively, or in conjunction with each other depending on the particular circumstances:

1. Protection

The business would apply for a life policy on the life of the owner/director, pay the premium and receive any proceeds upon death. The parties should enter into an agreement that will ensure that the proceeds are used in the settlement of any debt.

Advantages of protection:

- The loan will be settled in full on the death or permanent disability of the owner/director;
- There will be sufficient capital available immediately if it is required in the near future; and
- The business pays very little in the way of premiums relative to the possible insured value.

Disadvantages of protection:

- The business has to pay for the life cover which is an on-going expense,

- The policy may not pay out for many years if the owner/director is healthy,
- This cannot be used if the owner/director is uninsurable.

2. Redemption

A structured repayment of the loan also permits two further options, the gearing route or regular payments.

2.1 Gearing option

The business borrows an amount equal to the owner/director's loan from a bank and then uses it to settle the unsecured loan. Upon receipt, the owner/director then invests this lump sum into a tax efficient investment vehicle in order to achieve growth and then cedes this to the bank as security for the bank loan.

Advantages of gearing:

- The loan is converted from a stagnant asset into a growth asset;
- It provides investment diversification outside of the business;
- After 5 years, it is fully accessible and is able to provide tax-free capital to the director/shareholder. The loan can be structured to be repaid by the time the director/shareholder wishes to retire; and
- The capital can be used as security for other enterprises in the future.

Disadvantages of gearing:

- It requires a fixed level of cash flow from the business;
- The owner's equity reduces which affects business ratios; and
- Banks regard the size of the credit loan accounts as a measurement of the financial involvement of the owner in the future success of the business.

2.2 The recurring option

The business elects to finance the repayments out of profit. This is done on a regular basis rather than a lump sum, but the amounts are still paid into an investment in the name of the owner/director. The investment does not need to be ceded to anyone as security and can be aimed at maximum growth in the hands of the owner/director.

Credit loan account

Technical information

Income tax implications on premiums paid on a life policy for protection

The premiums paid will not be tax deductible as it is not an expense in the production of income and rather an expense to provide capital protection. The requirements of section 11(w)(ii) of the Income Tax Act will not be met.

Income tax implications on the proceeds paid from a life policy

As the premiums are not tax deductible the proceeds will be exempt from taxation in terms of section 10(1)(gH) of the Income Tax Act.

Income tax implications in respect of the gearing option

The loan from the bank will result in an interest expense. It is questionable if the interest will be tax deductible as it is not an expense in the production of income but rather the realisation of a capital asset. The only time the interest on the bank loan will be tax deductible is if the business owner's loan had an interest rate attached to it. This is not the case in most instances.

Income tax implications on premiums paid on an investment policy

The contributions made to the investment policies, either as a lump sum or a recurring premium will not be tax deductible.

Income tax implications on proceeds paid from an investment policy

As the policies are funded with "after tax" funds, the proceeds will pay out tax-free.

Capital gains tax on all policy proceeds

While a death claim on the life insurance policy is deemed to be a disposal thereof, the proceeds enjoy an exemption in terms of paragraph 55 of the Eighth Schedule to the Income Tax Act in the hands of the business as the original beneficial owner.

The capital gains tax status of the investment will depend on which vehicle is chosen by the client. Endowments and sinking funds both enjoy exemptions in terms of paragraph 55 when the original beneficial owner thereof makes withdrawals. If unit trust investments are used the disposal of units can result in capital gains tax.

Estate duty implications of life policies

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. Where the premium is funded by a third party that is entitled to the proceeds, the premiums paid, plus 6%, will be deducted from the amount included in the dutiable estate.

Estate duty implications of investment policies

The business owner is the owner of the policies and therefore the fund value will be included in his/her estate as property.