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The Endowment Policy – Technical Details

The endowment policy is governed by the Long Term Insurance Act and the Income Tax Act. The Long Term Insurance Act governs all insurance policies and places some restrictions on the policies and also provides for some form of protection.

An endowment policy has four parties that are relevant. It is the policyholder, the life insured, the beneficiary and the insurance company. In terms of the Act and the policy contract, the insurance company will pay out the insured amount in the event of the insured event taking place in respect of the life insured.

The Act also provides for a sinking fund policy, which in essence is the same as an endowment policy, however it does not have a life insured attached to it (therefore no beneficiary is nominated and the proceeds pay out to the policyholder upon maturity). A sinking fund was introduced to allow business entities to invest via a long term insurance policy.

Income tax consequences

A payment from an endowment policy to the policyholder does not result in gross income and is not subject to income tax in the hands of the investor. It is deemed a capital amount. This does not mean that the endowment is tax-free – it is subject to income tax and capital gains tax during the investment term in the hands of the insurance company. Section 29A of the Income Tax Act provides for the five fund approach, which is the tax regime applicable to insurance companies. The five funds and its tax consequences are as follows:

Individual Policyholder Fund – investment policies			
Policyholder	Individuals Trusts (with individual beneficiaries)		
Income Tax	30%	Effective CGT	12%
Risk Policy Fund – risk policies			
Policyholder	All risk policies as defined		
Income Tax	28%	Effective CGT	22.4%
Company Policyholder Fund			
Policyholder	Company or CC		
Income Tax	28%	Effective CGT	22.4%
Untaxed Policyholder Fund			
Policyholder	Tax exempt entities and all retirement funds		
Income Tax	Nil	Effective CGT	Nil
Corporate Fund (insurance company's funds)			
Income Tax	28%	Effective CGT	22.4%

Capital gains tax consequences

An endowment policy's payout to the policyholder is a capital amount which is potentially subject to capital gains tax. Paragraph 55 of the Eight Schedule to the Income Tax Act provides for an exclusion in respect of the proceeds from long term insurance policies in particular circumstances.

In the case of an endowment policy, the proceeds will be excluded for CGT purposes if payable to the original beneficial owner, his/her spouse, beneficiaries, nominees, deceased estate or to a former spouse of that original beneficial owner. Where the endowment policy is payable to a subsequent policyholder – in the case of a second hand policy – the proceeds may be subject to CGT insofar a gain is realised. (See ASAP on the Traded Endowment Option)

Estate duty and endowment policies

Policyholder and life insured is the same person – upon the death of the life insured, the policy will be included as a deemed asset in the estate of the deceased.

Policyholder and life insured is not the same person – upon the death of the policyholder, the policy's value will be included in the estate of that policyholder as property.

Policyholder and life insured is not the same person – upon the death of the life insured, the policy will pay out to the policyholder or beneficiary and it will be a deemed asset in the estate of the life insured. If there are multiple lives insured – therefore the policy does not pay out on death of the specific life insured – the policy will not be included in the estate of the deceased life insured and it will continue until the death of the last surviving life insured. Additional lives insured can be added during the course of the policy's lifetime to ensure continuity until the maturity date is reached.

Where the policyholder is a trust and there are constantly multiple lives insured on the policy, the endowment policy will only cease when the contractual maturity date is reached and the policyholder opts for maturity, or the policyholder surrenders the policy. Therefore no estate duty consequence will be experienced in this instance – as long as there is a surviving life insured on the policy. If the last surviving life insured dies, the policy will become due and payable to the trust, in which case the proceeds will be a deemed asset in the estate of the life insured. In this instance where the trust was the premium payer, the estate will enjoy a deduction equal to all premiums paid by the trust plus 6% per annum, in determining the dutiable estate.

Estate duty and sinking fund policies

In general, sinking fund policies are owned by legal persons and as there is no life insured, the policy will continue to exist until maturity or surrender.

Where a natural person is the policyholder of a sinking fund policy, the policy's fund value will be included as property in the deceased policyholder's estate – even though the policy continues to exist. The policy will be part of the assets of the deceased and will be dealt with in accordance with his/her will.

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Section 63 of the Long Term Insurance Act – Policy Protection

This section provides protection for long term insurance policies in the event of the insolvency of the policyholder's estate. This section was amended by the Financial Services General Laws Amendment Act 15 of 2013. For the protection to apply, the following requirements must be met:

- The policy benefits must be payable to a person that is also the life insured under the policy or the spouse of that life insured (unless stipulated otherwise in the Act), and
- The policy must have been in force for at least 3 years.

Where these initial requirements are met, the policy benefits or any assets acquired exclusively with those policy benefits shall be protected against creditors of that person's insolvent estate:

- during his/her lifetime, or
- upon his/her death, if survived by a spouse, child, stepchild or parent and the policy benefits are paid to the spouse, child, stepchild or parent upon that person's death.

The person claiming the protection will always have the burden of proof to prove that the protection applies in his/her specific circumstances. The protection shall apply for a period of 5 years from the date on which the policy benefits were provided. The protection does not apply if the policy was ceded as security for a specific debt or where it can be shown that the policy was taken out with the intention to defraud creditors.

It is important to note, that where a policy is payable to a nominated beneficiary of a policy – so the insurance company is contractually bound to make payment to that party - reliance on case law (like the Pieterse vs Schrosbee case) can result in the policy benefits being excluded from an insolvent estate upon the death of the policyholder that is also the life insured.

Section 54 of the Long Term Insurance Act

This section refers to the Regulations to the Act that imposes certain restrictions on certain long term insurance policies. This is a complex piece of legislation which is often misinterpreted.

The purpose of the restrictions imposed on endowment/sinking fund policies are to ensure that long term insurance companies do not compete with banking products and that they remain true to their long term insurance license conditions. The restrictions can be summarised as follows:

Restriction on investment term

Endowment/sinking fund policies have a minimum term of 5 years. This is referred to as the restriction period and it commences on the inception date of the policy.

Restriction on fund accessibility

During the restriction period the policyholder can only access the funds in the policy by way of one withdrawal AND one loan.

A loan can either be interest bearing or interest free and it can be repaid by the policyholder at a later stage without impacting the restriction period of the policy. A withdrawal cannot be repaid – where a withdrawal was made and funds are paid into the policy at a later stage, in excess of the restricted amount, the restriction period can be extended.

The amount available as a loan or withdrawal will always be restricted to premiums received plus 5% per annum. This is referred to as the restricted amount.

The practical implications are as follows:

- Where the surrender value is less than the restricted amount, the full surrender value can be accessed. Therefore, the policy can be surrendered in totality.

  Example – the policy's restricted value (premiums plus 5% per annum) is equal to R100 000 and the fund value available in the policy is R78 000. The policyholder will be able to access the full R78 000 as it is less than the restricted amount. The policy will cease to exist.

- Where the fund value exceeds the restricted amount, the withdrawal or loan will be limited to the restricted amount. Therefore, the surplus funds will only be accessible upon maturity.

  Example – the policy's restricted value is R100 000 and the fund value is R134 000. The policyholder will be able to access a maximum of R100 000 as a loan and/or a withdrawal or a combination of both. Assuming R100 000 is withdrawn, the remaining R34 000 will have to remain in the policy until the contractual maturity date. The amount will remain fully invested during that time.

Restriction on premium increases

The increase in premium is restricted and if this restriction is exceeded, a new restriction period will commence (extended restriction period) – the 5 year restriction period will start from the date the excess premium is paid into the policy.

To prevent a new restriction period, the total premium received during a premium period (a 12 month period starting on the day that the first premium was received) may not exceed the higher of the total value of the premiums received by the long-term insurer during any one of the two premium periods immediately preceding that premium period by more than 20%. The following example will illustrate the point:

A policy commenced on 1 January 2015 with a monthly premium of R10 000 without escalation. The contractual maturity date is 1 January 2020. During the term of the policy, the policyholder wishes to inject ad hoc single premium payments into the policy. This table will illustrate the impact thereof on the restriction period.

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Legal and Technical Update

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Premium period (12 months from date of first premium)	Period 1	Period 2	Period 3
Year	Jan2015 - Jan2016	Jan 2016 – Jan 2017	Jan 2017 – Jan 2018
Contractual premium **Total annual premium**	R10,000 pm R120 000 pa	R10,000 pm R120 000 pa	R10,000 pm R120 000 pa
Ad hoc premium **Date** **Total annual premium paid**	R50,000 1 June 2015 Total of R170 000 pa	R100,000 1 May 2016 Total of R220 000 pa	R100,000 1 April 2017 Total of R220 000 pa
Impact of the 20% Rule The total premium received during a premium period may not exceed the higher of the total value of the premiums received by the long-term insurer during any one of the two premium periods immediately preceding that premium period, by more than 20%.	No impact as there is no previous premium period against which to measure the restriction.	The higher of the previous 2 years' premium + 20% (in this case only year 1): R170,000 + 20% = R204,000 max. premiums permitted in year 2	The higher of the previous 2 years' premiums+20% (in this case year 2): R220,000 (actual premium paid) + 20% = R264,000 max. premiums permitted in year 3
Maximum ad hoc allowed	Unlimited	R204 000 – R120 000 = R84 000 < R100 000 Therefore restricted amount is exceeded	R264 000 – R120 000 = R144 000 > R100 000 Therefore restricted amount is not exceeded
Result	Ad hoc will have no impact on the restriction period. Maturity date remains at 1 January 2020.	Ad hoc will result in an extended restriction period from 1 May 2016. Maturity date is extended to 1 May 2021.	Ad hoc will have no impact on the existing restriction period. Maturity date remains at 1 May 2021.