Preferred compensation

One of the most valuable assets of any business is its employees, especially those with the relevant knowledge, skills and experience.

The Risk

A high staff turnover is a costly business risk as it results in loss of productivity, intellectual property, employment costs and training costs. Therefore it is important for a business to retain and motivate its employees.

The solution

The business can implement a preferred compensation scheme. This is an incentive scheme for valuable employees. The purpose of the scheme is to motivate and retain good employees. It rewards key employees with tax-free bonuses every five years and eliminates the cost of staff turnover and reduced productivity.

How the plan works?

The employee effects an endowment policy on his/her own life. The employer increases the employee's remuneration to allow for the payment of the full premium, with after-tax funds.

The employer enters into a service agreement with the employee whereby the employee undertakes to remain in the employer's service for a minimum period of five years. The policy, which is owned by the employee, is ceded to the employer as security for his/her undertaking. The employer is contractually bound to cancel this cession either prior to maturity or after five years or upon the death of the employee. Upon the cancellation of the cession the employee has the unconditional ownership of the policy. The employee can then make a withdrawal from the policy, which will be tax-free. Where the policy matures the proceeds will also be payable to the employee tax-free.

If the employee does not fulfill the contractual obligation, the employer will be entitled to retain the policy in terms of the security cession. The employer will be entitled to the proceeds in the policy and the proceeds will be payable to the employer tax-free.

Benefits to the employer

1. This is a unique way to retain employees securing the service of key employees for at least 5 years;
2. The total amount paid by the employer is tax deductible, as it is part of the remuneration of the employee; and
3. Should the employee not remain in the service of the employer for the specific time, the employer is assured of a cash benefit as compensation.

Benefits to the employee

1. The employee receives a tax-free benefit for long service;
2. The security of the benefit is provided by the service agreement;
3. This is a forced saving, making provision for future needs easier to the employee; and
4. This does not affect any tax benefit due to any other retirement funds or deferred compensation scheme.

Preferred compensation scheme

Technical information

Calculating the salary increase to the employee

It is important to remember that the increase in salary will increase the taxable income of the employee. Therefore, the tax implication on this increase should be taken into account to ensure that the net increase is sufficient to cover the contribution to the endowment.

The following example will illustrate the point:

Status Quo:

Assume the employee earns a current gross income of R12 000. The tax payable will be R3 000 per month resulting in a net salary of R9 000 per month (marginal tax rate of 25%, ignoring rebates).

Negative scenario:

If it is assumed that the premium on the policy is R1 000 per month and the employer only increases the salary by this amount, the tax payable will be R3 250 per month, resulting in a net salary of R9 750 per month. After paying the premium on the policy the actual net income will amount to R8 750, which is R250 worse off than the employee is used to.

It is important to keep the employee in the same position as what he/she was prior to the implementation of the scheme. To achieve this, the tax on the increase, has to be taken into account.

Positive scenario:

Therefore, as the marginal tax rate of the employee is 25%, the increase has to be R1 334 (premium required divided by (100% less marginal tax rate). The total gross income is R13 334 and the tax amounts to R3 334. The net salary is R10 000, less the premium of R1 000, the employees after tax income is R9 000, equal to the income that the employee is used to.

Income tax implications on the premium

The salary increase paid by the employer will be tax deductible under section 11(a) of the Income Tax Act for the employer.

The salary increase will be included in the gross income of the employee and will be taxable. The premium paid into the endowment policy will not be tax deductible.

Income tax implications on the proceeds

As the policy is funded with after tax funds the proceeds will always pay out tax-free.

There is also no capital gains tax payable. The Eight Schedule to the Income Tax Act provides for an exclusion of long term insurance policies payable to the original beneficial owner (including to his/her nominee/spouse and will also apply if payable to a cessionary in the case of a security cession).