Legal and Technical Update

The Traded Endowment Policy

A traded endowment policy allows an investor the benefits of being invested in an endowment policy without the original investment term restriction period of 5 years.

Ownership

This is a second-hand endowment policy that is ceded by the original policyholder to the new investor. This is done by way of an outright cession. The new investor can be a natural person, company, close corporation or a trust.

The life insured

As this is a long term insurance policy (which is not a sinking fund), it will have a life insured on the policy. The original life insured cannot be removed from the policy, however, traded endowment policies allow for the addition of alternative lives insured. This will prevent the policy from paying out on the death of any one of the lives insured and will ensure the continuity of the investment. Traded endowment policies allow for the nomination of a beneficiary for ownership to further ensure the continuity of the investment.

Example:

Alex is the policyholder of a traded endowment policy and Alex and Ben are the lives insured. Upon the death of Alex the policy will not pay out as Ben still remains the life insured on the policy. Alex can nominate a beneficiary for ownership. That new policyholder can add another alternative life insured to the policy to ensure continuity.

Access to funds

Funds in the traded endowment policy can either be accessed as a part-withdrawal or as an interest-free loan.

Where a loan is used, the investor can always reinvest funds back into the investment by repaying that loan.

No ad hoc investments are allowed as it will result in a new restriction period (which is 5 years from). This will defeat the object of the investment and eliminate the benefits thereof.

Income tax implications within the fund

The underlying funds in the policy will be subject to tax according to the five fund approach. The insurer is the taxpayer at this level.

Income earned will be subject to income tax and capital gains tax will be payable on all capital gains realised. Capital gains are generated by the sale of units either to facilitate an investment switch or to fund a loan or withdrawal.

The rates in the two most common policyholder funds are as follows:

Individual policyholder fund	Corporate policyholder fund:
Type of Policyholder:	
Natural persons	Company or close corporation
Trust with natural persons as beneficiaries	Income tax rate:
Income tax rate:	
30%	28%
Capital gains tax rate:	
Inclusion rate 40%	Inclusion rate 80%
Effective rate is 12%	Effective rate is 22.4%

Important note when taking a loan or a withdrawal:

As mentioned above, a loan or withdrawal will result in the sale of units in the underlying funds in the policy which can result in a capital gain being realised.

In that case CGT will be payable by the insurer. Different insurers account for this tax liability differently.

- Momentum will deduct the CGT payable from the loan or withdrawal amount.
- Other insurers/administrators may deduct it from the remaining fund value in the policy.

In the case of a Momentum traded endowment, it is important to consider this when determining the gross loan or withdrawal amount to ensure the client receives the correct net amount.

In the case of other companies, it is important to explain the impact on the underlying investment value where it is deducted against the fund value.

Second capital gains tax layer

There is a second layer of capital gains tax (CGT) that applies to the investor/policyholder when investing in a traded endowment policy.
All proceeds from long term insurance policies are seen as capital gains.

The Income Tax Act contains certain exclusions where capital gains tax will not apply to policy proceeds.

The specific exclusion relevant to endowment policies applies if the policy proceeds pay to the original beneficial owner of the policy or his/her nominees, beneficiaries or spouse/ex-spouse in terms of a divorce order. Where the policy pays out to any other person or entity, as is the case with a traded endowment policy, the capital gains tax exclusion shall not apply.

A disposal for capital gains tax purposes, in the hands of the investor/policyholder, will occur in the event of a surrender (in part or full) and in the event of the death of the policyholder (as death is a deemed disposal for CGT purposes).

If there is a part withdrawal, the proportionate base cost will be calculated using the following formula (SARS Comprehensive Guide on CGT):

$$\frac{\text{Amount withdrawn}}{\text{Market value before withdrawal}} \times \text{Original base cost}$$

This base cost is then deducted from the withdrawal amount to determine the capital gain or loss. This calculation can become complex where multiple withdrawals are made.

Example – Part-disposal of second-hand policy (Extract from SARS Guide)

In 1996 Brenda took out a 5-year endowment policy as the original beneficial owner. Keith purchased the policy from Brenda in 2000 for R100 000. The market value of the policy on 1 October 2001 was R90 000.

Keith made the following withdrawals:

Date	Amount	MV before Withdrawal
1 July 2002	R5 000	R100 000
1 July 2003	R6 000	R108 000
1 July 2006	R120 000	R120 000

Keith adopts the market value method for determining the valuation date value of the policy.

Keith's capital gain or loss is determined as follows:

<u>2003 year of assessment</u>

Proceeds	R5 000
Less: Base cost	(R4 500)
(R5 000/R100 000 x R90 000)	
Capital gain	R 500

Base cost after part-disposal:
R90 000 – R4 500 = R85 500

<u>2004 year of assessment:</u>

Proceeds	R6 000
Less: Base cost	(R4 750)
(R6 000/R108 000 x R85 500)	
Capital gain	R1 250

Base cost after part-disposal:
R85 500 – R4 750 = R80 750

<u>2006 year of assessment (final withdrawal</u>)

Proceeds	R120 000
Less: Base cost	(R80 750)
(R120 000/R120 000 x R80 750)	
Capital gain	R 39 250

If the investor is an individual, the annual exclusion (currently R40 000 in life and R300 000 upon death) will apply to determine the net capital gain.

Thereafter the inclusion rate will be applied to the net capital gain. This will determine the taxable capital gain to be included in the taxable income of the individual taxpayer.

If the investor is a trust/company/close corporation, no annual exclusion will apply.

When loans are made against the policy, CGT is not payable as a loan is not treated as a disposal for CGT purposes (remember that there will be a disposal of units in the endowment policy to fund the loan and CGT can still be payable inside the policy in terms of the five fund approach).

The CGT will be calculated upon the investment being liquidated or upon the death of the policyholder.

Estate duty implications

Upon the death of the policyholder, where there are other surviving lives insured, the market value of the policy will be an asset in the estate of the policyholder and may be subject to estate duty (the policy will not pay out in this instance).

If the policyholder is also the life insured and the policy pays out upon his/her death, the proceeds will be a deemed asset in the estate of the policyholder/life insured and can be subject to estate duty.

Where the policy is owned by a trust and there are multiple lives insured nominated on the policy, the policy will not pay out on the death of one of them and therefore there will not be any estate duty inclusion in that instance.

However, where the last life insured on the policy dies, the policy will pay out to the trust and the proceeds will be a deemed asset in the estate of the life insured for estate duty purposes.

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