

# Non-conforming policies vs conforming policies

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## Abstract

The restriction on the deductibility of insurance premiums in terms of section 11(w) of the Income Tax Act ("the Act") has created constraints regarding the implementation of deferred compensation schemes. However, for insurance premiums that are not deductible in terms of the Act, there seem to be additional opportunities for the introduction of a deferred compensation plan that could result in tax savings.

In this article the relevant Income Tax legislation and principles, as established by the courts, are analyzed in order to determine the tax implications and benefits of a traditional deferred compensation plan. The tax and cash flow savings were furthermore, compared for deferred compensation plans utilising policies of which the premiums are deductible in terms of the Act as well as policies of which the premiums are not deductible.

## Key words

*Deferred compensation schemes*

*Insurance policies*

*General deduction formula*

*Non-conforming policies*

*Annuity*

*Timing of accrual*

*Conforming policies*

## 1 Introduction

A deferred compensation scheme is a common arrangement between an employer and a highly taxed executive. However, nowhere in the Income Tax Act, No. 58 of 1962 (hereafter referred to as "the Act"), is this term defined.

According to Broomberg and Kruger (1998:219) deferred compensation is

"The postponement of an immediate increment in salary in favor of a lump sum payment, on or near a retirement date . . ."

Meyerowitz, Meyerowitz & Davis (1993:204) compares the mechanics of a deferred compensation scheme to that of contributions by an employer to a pension or provident fund. The similarity lies in the objective, which is to provide a sum of money at a lower tax rate at the end of the employee's service than would have been the case had there been no deferment in the payment of the compensation. However, it operates differently because it takes the form of an individual service contract between an employer and an employee and, as a result of this individuality, the contract can be more flexible than a pension or provident fund, whose rules have to conform to the Act.

Deferred compensation is provided mostly to employees for one of the following reasons (Meyerowitz *et al.* 1993:205):

- i) the employee prefers that additional remuneration which his employer is willing to pay, should be deferred until such time as the tax payable on such an amount is reduced; or
- ii) the employer extends this incentive to the employee in order to retain his services.

If the former motive is the objective, the employee will be out of pocket by the net amount (after tax) that he would have received if he had not taken the option. The employer on the other hand is in pocket by the net saving in salary until the time of payment of compensation comes. The employee will therefore expect as deferred compensation something more than the amount of salary previously foregone. This "something more" is usually achieved through the funding of an insurance policy. This gives meaning to the statement by Dickman (1991:132) who defines "deferred compensation" as:

"A marketing term coined by the insurance industry primarily to promote the use of insurance policies as a means of funding the employer's obligations."

There are two insurance-based methods of funding a deferred compensation scheme. Firstly by funding it via insurance policies of which the premiums payable are deductible by the employer in terms of the Act ("conforming policies") and secondly by utilizing "non-conforming policies", of which the premiums payable by the employer are not deductible in terms of the Act (Goudge 1995:74).

## 2 Definitions

### 2.1 Conforming policies

An insurance policy taken out by an employer or company over the life of an employee or director of which the employer or company may deduct premiums in terms of section 11(w), 11(a) or 11(b) of the Act.

### 2.2 Non-conforming policies

An insurance policy taken out by an employer or company over the life of an employee or director of which the employer or company is not allowed to deduct premiums in terms of section 11(w), 11(a) or 11(b) of the Act.

## 3 The problem and objective of the investigation

As no immediate tax relief is available for premiums payable by the employer where deferred compensation schemes are funded by non-conforming policies, concerning parties tend to oversee the positive tax consequences of this method.

The objective of this article is to determine from –

- i) the employer's viewpoint whether a deferred compensation scheme funded by non-conforming policies will put him in a better/neutral tax position should the employee prefer to defer remuneration that he is willing to pay to a later point in time;
- ii) the employee's viewpoint whether non-conforming policies contains equal or better opportunities than conforming policies for the introduction of a deferred compensation plan that could result in tax savings and consequently a better net cash inflow.

## 4 Research design

In this article relevant legislation of the Act and principles, as established by the courts, are analyzed. The tax and cash flow implications of deferred compensation schemes were furthermore compared to conclude which is the better option for both the employer and the employee.

As the aim of the research was not to compare various investment products provided by alternative insurance companies, information on the policy proceeds was gathered from only one insurance company, namely Sanlam. (Liza Langer, manager in actuarial development at Sanlam's head office in Cape Town). Old Mutual and Liberty Life insurance companies were also approached to provide similar information but did not respond to the request.

## 5 From the employer's viewpoint

To achieve the first-mentioned objective of this article the tax effects for the employer of two types of deferred compensation schemes were compared in table 5. One scheme is funded by a conformed policy and the other by a non-conforming policy. The negative amounts represent amounts that are deductible for tax purposes, while positive amounts represent taxable amounts. For each scheme the following assumptions were made –

- i) an employer takes out an insurance policy on the life of an employee/director and the premiums payable amount to R1 000 per month for 10 years;
- ii) the insurance policy matures on the date on which the employee retires at his anticipated retirement age;
- iii) having received the proceeds of the policy on maturity date, the employer would then pay out the sum to the employee or director (deducting the payment in terms of section 11(a) of the Act);
- iv) the time value of money was not taken into account for purposes of this comparison.

**Table 5**

|   | Conforming policy | Non-conforming policy |
|---|-------------------|-----------------------|
|   | Traditional plan  | Traditional plan      |
| Premiums payable for 10 years until retirement date | (120 000)         | -                     |
| Proceeds payable to the employer on retirement date | 218 379           | -                     |
| Payment made to employee                            | (218 379)         | (218 379)             |
| Net tax deduction by the employer                   | (120 000)         | (218 379)             |

### 5.1 Results of the comparison

#### 5.1.1 Premiums payable for 10 years

In the case of a conforming policy the premiums are deductible in terms of either section 11(w), 11(a) or 11(b) of the Act. Section 11(w) will only apply in respect of the following types of policies (Arendse, Jordaan, Kolitz & Stein 2000:128):

- i) Policies accepted by the insurer before 1 June 1982;
- ii) Policies which have a fixed term and which pay out as a result of death or disablement by the insured (a term policy);
- iii) Personal accident policies;
- iv) Any policies approved by the State President

If the above-mentioned types of policies meet certain additional requirements as set out in section 11(w)(i), the employer will be entitled to a deduction for the premiums but limited to an amount equal to 10% of the remuneration derived by the employee whose life is ensured during that year of assessment (section 11(w)(ee)(B) of the Act). If the employer is not entitled to a deduction in terms 11(w), he could pose to deduct the premiums either in terms of section 11(a) or section 11(b). Such a deduction will usually be allowed for premiums of:

- a) a policy of which the employer is not the owner; or
- b) a policy that is not a life policy nor a personal accident policy as defined in section 1 of the Insurance Act.

In the case of a non-conforming policy, the premiums of R120 000 are not deductible by the employer. According to Goudge (1995:76) an easy way for the employer to ensure that a policy is non-conforming, is to take out a pure endowment policy or to contract for irregular-type premiums.

### 5.1.2 Proceeds of the policy payable to the employer

If any premium in respect of a policy is or was deductible from the employer's income, the proceeds of the policy will be included in the taxable income of such a person (paragraph (m) of the definition of "gross income").

The proceeds will therefore be taxable in the hands of the employer where a conforming policy was used to fund the scheme. The proceeds of the non-conforming policy will not be taxable in the hands of the employer on maturity date.

### 5.1.3 Payment made to the employee

The employer would seek to deduct the amount it is paying over to the employee. The employer's permissible deduction in this regard is governed by section 11(a) read with section 23(g) of the Act.

If the requirements are met the employer would be entitled to a deduction if he used either the conforming or non-conforming policies to fund the scheme. However, kindly note that there is a tax risk in this regard (see paragraph 5.2.2).

#### **5.1.4 Net tax deduction and conclusion**

The net tax deductions as set out in table 5 indicates the following -

5.1.4.1 The conforming policy put the employer in a tax neutral position where the employee preferred to defer R1 000 per month for 10 years that the employer was willing to pay until his retirement date. The employer was only entitled to a R120 000 deduction over a period of 10 years. Further note that the limitations of section 11(w) could possibly reduce this deduction if the employee's remuneration did not exceed R120 000 for the year of assessment.

5.1.4.2 The non-conforming policy provided the employer with a greater tax deduction. Although the premiums were not deductible over the period of 10 years, the proceeds of the policy on maturity date were also not taxable although the employer deducted the amount paid to the employee.

### **5.2 Tax risks to be considered by the employer**

#### **5.2.1 Inclusion of policy proceeds on maturity date**

Whenever a policy premium is legally deductible, regardless of whether the employer has actually deducted the premiums, the proceeds will be included in gross income under paragraph (m).

#### **5.2.2 Deductibility of payment made to the employee**

##### **5.2.2.1 In production of income**

There is a potential problem confronting the employer who seeks to deduct from his income a payment made to an employee upon the termination of employment, as the requirements of section 11(a) clearly state that an amount should be incurred in the production of income.

In *WF Johnstone & Co Ltd v CIR* it was held that certain payments paid to long-serving employees upon retirement were not permissible deductions in terms of the then equivalent of section 11(a) of the Act, as there did not exist any legal obligation on the paying company to pay these

or similar amounts. The court accepted that the payments “were made in recognition of past services rendered to the company”. Consequently the payments were not in production of income and therefore not deductible for income tax purposes. This principle was confirmed in the special court cases *ITC 1326* as well as *ITC 1506*).

However, in *Provider v COT* the employer succeeded in his claim for a deduction when he justified his payment of retirement lump sums as comprising a part of an employment practice aimed not at rewarding retiring employees for past services, but at creating a settled and supportive working environment to motivate his remaining employees (*Emslie et al.* 1995:1169).

In the view of the principles laid down in the above cases, the employer’s position as to the deduction of the amount would be strengthened if one or both of the following requirements were met:

- i) When the payment is made in terms of an absolute legal obligation, there is a general consensus that the amount is deductible. This will be the case where the payment is made in terms of the employee’s service contract. If the amount is agreed to at the inception of employment, it will strengthen the argument that the payment was not with regard to services rendered in the past.
- ii) The employer should have an established policy of making payments of this nature to his employees. According to Goudge (1995:75) all the employees of the organisation should be aware of such a policy and the employer should in fact implement such policy. The underlying logic is to secure the employees’ services. The employer should consciously and deliberately have bound himself, at least by implication, to making payments of such a nature, should the qualifying event take place.

#### 5.2.2.2 Laid out or expended for the purposes of trade

The South African Revenue Services (“SARS”) is entitled to disallow expenditure to the extent to which it is excessive, on the grounds that it does not conform to the requirements of section 11(a) read with section 23(g).

If a portion of the deduction is disallowed as being excessive and not incurred in the production of income, it appears that the recipient will nevertheless be taxed on the full amount received. This fact emerges from *ITC 792* and *WF Johnstone & Co Ltd v CIR* where it was stated in the latter case that it did not follow that because any particular amount was not allowed as a deduction in the hands of the employer, it was not taxable in the hands of the employee (Arendse *et al.* 2000:94).

## 6 From the employee's viewpoint

To achieve the second objective of this article the net cash inflow for the employee of the two types of deferred compensation schemes were compared in table 6. The negative amounts represent cash outflows while the positive amounts represent cash inflows. For each scheme the following assumptions were made –

- i) an employer takes out an insurance policy on the life of an employee/director when he is 45 years old and the premiums payable amount to R1 000 per month for 10 years;
- ii) the employee retires at the age of 55. The policy reaches maturity on the date the employee retires;
- iii) at the date of retirement the employer pays an amount equal to the value of the policy to the employee;
- iv) the employee is taxed on the award he receives from the employer at the marginal rate, but qualifies for the section 10(1)(x) exemption, as he is 55 years of age.

**Table 6**

|  | Conforming policy | Non-conforming policy |
|--|-------------------|-----------------------|
|  | Traditional plan  | Traditional plan      |
| Lump sum on retirement date  | 218 379           | 218 379               |
| Income tax liability with respect to the lump sum received on retirement | (84 771)          | (84 771)              |
| Net cash inflow  | 133 608           | 133 608               |

## **6.1 Results of the comparison**

### **6.2.1 Lump sum and income tax liability on retirement**

Any amount received as a gratuity may be included in gross income either in terms of paragraph (c), (d) or (f) of the gross income definition (Mitchell 1998:41).

However, employees should ensure that the lump sum received from the employer is included in their gross income under the provisions of either paragraph (c) or (d), as these paragraphs could lead to the section 10(1)(x) exemption. If the requirements of section 10(1)(x) are met, the lump sum included in the employee's gross income shall be exempt up to a maximum of R30 000 less any amounts which were previously exempt in the employee's hands in terms of such section.

When a lump-sum award is made under paragraph (c), (d) or (f) of the gross income, it is taxable in full in the year of receipt. However, if section 7A(4a) of the Act applies (which has similar requirements to section 10(1)(x)), the amount shall be taxed at the highest average rate of tax payable by the employee in respect of other income, i.e. excluding the lump sum, for the previous or current year of assessment (section 5(10) of the Act).

### **6.2.2 Net cash inflow and conclusion**

According to the table, the conforming policy and the non-conforming policy provides the employee with the same net cash inflow.

## **6.2 Tax risk to be considered by the employee**

As mentioned in paragraph 5.2.2, a contract should be entered into, between the employer and employee, as a voluntary payment by the employer could have an unfavourable impact upon the employer's ability to deduct the payment for tax purposes.

Care should be taken, however, that the wording of the contract does not imply that a benefit accrues to the employee when the agreement is entered into, as the benefit of a deferred compensation plan is the deferment of the accrual of income until an employee's date of retirement.

In *WH Lategan v CIR* it was held that the meaning of the words "accrued to" meant, "entitled to" (upheld by the decision in *CIR v People's Stores*). Accrual can only take place after the obligations have

been met or conditions fulfilled, since until these requirements have taken place the taxpayer is not entitled to claim payment (*Ochberg v CIR, Mooi v SIR*).

An entitlement, which is contingent on a future event, does not result in an accrual until the event has occurred. Therefore, premiums paid, by the employer (in accordance with the contract of the policy) for the benefit of the employee, are tax free, as benefits which may result therefrom do not accrue upon payment thereof by the employer, but only on account of specific future events, such as retirement, death, etc.

However, on change of employer deferred compensation policies are often ceded to an employee's new employer, presumably under an arrangement in terms of which the new employer will continue the deferred compensation scheme. This may result in the application of section 7(1), which reads as follows:

"Income shall be deemed to have accrued to a person notwithstanding that such income has ... not been actually paid over to him but ... has been ... dealt with in his name or on his behalf ..."

In *CIR v Polonsky* the equivalent of section 7(1) was invoked to hold that there was an accrual to beneficiaries of income accumulated by administrators under a will which directed them to accumulate such income as was not paid out, the beneficiaries being entitled to the capital and accumulated income on reaching the age of 30 years. It is considered that section 7(1) does not widen the meaning of the word "accrue" despite the words "income shall be deemed to accrue". It merely ensures that a pre-existing accrual will not be disturbed even if the income is dealt with in the manner it envisaged. As *Arendse et al.* (2000:6-9) puts it - "it does not say that there shall be deemed to be an accrual in the circumstances set out but that there shall be an accrual **notwithstanding** these circumstances." The purpose of this provision is therefore to include income that vests in a person (*De Koker* 1997, pp.2-33).

Considering the above, the mere fact that a deferred compensation policy may be ceded to a new employer may imply that the employee will be entitled to the compensation, notwithstanding the fact that he only receives it on retirement date. Just as the beneficiary in *CIR v Polonsky* was sure of income at the age of 30, so the cession of a policy may imply that the employee will be entitled to the policy proceeds on the date of retirement irrespective of whom services are rendered to. However, *Broomberg and Kruger* (1998:227) are of the opinion that the act of cession to the new

employer does not provide the employee with any better rights than he previously had. They further argue that there will be no accrual as long as the employee's entitlement remains conditional upon his serving out the prescribed remaining term of employment.

## **7 Conclusion**

The significant advantage of a deferred compensation scheme (utilising conforming or non-conforming policies) to the employee is most probably that it offers the employee an opportunity to earn R30 000 free from taxation, and to be taxed on the remaining portion of the lump sum at the average rate of tax payable by the employee in respect of other income, that is excluding the taxable portion of the lump sum.

Although a deferred compensation scheme may have various tax benefits, factors such as the condition in the agreement with the employer in order to avoid early accrual, the possible tax dangers of ceding the policy to a future employer, the risk of the employer's insolvency and other investment opportunities for the pre-tax income should be considered by the employee beforehand.

However, if the employee has considered all the above and decides to take part in a deferred compensation scheme, the fact that the employer is not entitled to deduct monthly premiums of a policy forming part of a deferred compensation scheme could hold just as much, if not more, advantage for the employer as well as the employee.

Comparisons between the various alternatives are becoming more complex and flexibility is limited. From the comparison made in this article it is clear that a deferred compensation plan utilising non-conforming policies provided the employer with greater tax savings.

The calculations determining the net cash inflow for the employee, indicates that the deferred compensation schemes utilising both the conforming and non-conforming policies provides the employee with an equal, significant cash inflow of R133 608.

Considering the above it is concluded that it is not necessary for an insurance policy to be tax deductible for an employer in order to provide the employee with a tax effective method of structuring income.

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