

REFERENCE GUIDE

ESTATE DUTY IMPLICATIONS ON KEY MAN POLICIES

1 PURPOSE

- Currently, no case law exists with regard to the application of section 3(3)(a)(ii) of the Estate Duty Act, 1955. This guide expresses the views of SARS in this regard; and any letter previously issued by a SARS office differing from the views expressed in this document, is hereby withdrawn. This guide explains what is meant by the concept “Key Man” policy.

2 SCOPE

- This basic guide explains the applicable legislative requirements for the deduction and the payment of estate duty in Key Man policies.

3 REFERENCES

3.1 LEGISLATION

TYPE OF REFERENCE	REFERENCE
Legislation and Rules administered by SARS:	Estate Duty Act, 45 of 1955
Other Legislation:	Trust Property Control Act, 57 of 1988
International Instruments:	None.

3.2 CROSS REFERENCES

DOCUMENT #	DOCUMENT TITLE	APPLICABILITY
QMS-01	Quality Management System Manual	ISO 9001:2000

4 DEFINITIONS AND ACRONYMS

SARS	South African Revenue Service
PBO	Public Benefit Organisation
L&D Account	Liquidation and Distribution Account

5 BACKGROUND

- Currently no case law exists with regard to the application of section 3(3)(a)(ii) of the Estate Duty Act, 1955. This document expresses the views of SARS in this regard; and any letter previously issued by a SARS office differing from the views expressed in this document, is hereby withdrawn.
- In terms of section 3(3)(a) of the Act, any amount due and recoverable under any policy of insurance which is a “domestic policy” (as defined in section 1 of the Act) upon the life of the deceased, is regarded as “deemed property” of the deceased. The requirement for inclusion in the estate of the deceased as deemed property, for estate duty purposes, is not based on whether the deceased was the owner of the policy or not, but whether it was his / her life which was insured.
- Regardless of whether the proceeds of a policy are payable to the deceased's estate or to a nominated beneficiary or were ceded to a beneficiary during his lifetime, if such proceeds flow from a “domestic policy on the life of the deceased” they fall within the ambit of section 3(3)(a) of the Act. It may, however, be mentioned that in cases where a Public Benefit Organisation or the surviving spouse is the beneficiary of the policy, the proceeds of the policy will qualify as a deduction in terms of section 4(h) or 4(q) of the Act, respectively. Except for the deductions as mentioned above, the only other exclusions available in terms of the Act are those listed in section 3(3)(a)(i), (iA) and (ii) of the Act. If one of the said exclusions or deductions does not apply, the proceeds of the “domestic policy upon the life of the deceased” are subject to estate duty.

- The relevant part of section 3(3) of the Estate Duty Act reads as follows:
 - “(3) Property which is deemed to be property of the deceased includes-
 - (a) so much of any amount due and recoverable under any policy which is a ‘domestic policy’ upon the life of the deceased as exceeds the aggregate amount of any premiums or consideration proved to the satisfaction of the Commissioner to have been paid by any person who is entitled to the amount due under the policy, together with interest at six per cent per annum calculated upon such premiums or consideration from the date of payment to the date of death: Provided that the foregoing provisions of this paragraph shall not apply in respect of any amount due and recoverable under a policy of insurance, if -
 - (i) ...; or
 - (iA)...; or
 - (ii) except where the provisions of paragraph (i) or (iA) of this proviso apply, the Commissioner is satisfied and remains satisfied that such policy was not effected by or at the instance of the deceased, that no premium on such policy has been or will be paid by the deceased, that no amount due or recoverable under such policy has been or will be paid into the estate of the deceased and that no such amount has been or will be paid to, or utilized for the benefit of, any relative of the deceased or any person who was wholly or partly dependent for his maintenance upon the deceased or any company which was at any time a family company in relation to the deceased;”
- Policies which fall within the ambit of section 3(3)(a)(ii) are commonly referred to as “key-man” policies. Liability for income tax with regard to these types of policies is provided for in the definition of “gross income” (section 1) and section 11(w) of the Income Tax Act No 58 of 1962. However, for estate duty purposes it does not matter whether the premiums payable in respect of the policy were claimed as a deduction for income tax purposes or not.

6 THE SUBSECTION CAN BE ANALYSED AS FOLLOWS:

- As mentioned above no case law is available to rely upon and in view thereof the guidelines as set out below entail a summary based upon Meyerowitz on Administration of Estates and Estate Duty, 2007 Edition (paragraphs 27.39 to 27.42) and the Estate Duty Handbook published on 1 December 1971 (for official use only), by the Secretary for Inland Revenue.
- For the exclusion in terms of section 3(3)(a)(ii) of the Act to be applicable the following circumstances must be considered:
 - The Commissioner must be ‘satisfied’ that all the requirements of the section are met before the exclusion will be allowed. To enable SARS (on behalf of the Commissioner) to consider whether the proceeds of a policy fall within the ambit of the exclusion, all the relevant documentation pertaining to the case:
 - copies of the resolution taken by company to take out such policy,
 - application made for the policy and any other documentation to prove that the proceeds of the policy were not applied to benefit either the estate, any relative of the deceased or any person who was dependent upon the deceased for his/her maintenance or a family company of the deceased as envisaged in the relevant section of the Act.
 - These must be submitted together with the Liquidation and Distribution Account to the Master’s Office where the SARS estate auditor will verify the documentation.
 - A policy will have been ‘effected by the deceased’ if he was the person who contracted with the insurer for the issue of the policy, whether or not he was the beneficiary under the policy.
 - ‘At the instance’ of a person is defined in the dictionaries as ‘at the request or suggestion’ of a person. A policy will be effected at the instance of the deceased if the proposer would not have effected the policy had he not been requested by the deceased to do so.
 - Premiums will have been ‘paid or borne’ by the deceased where it has been paid by him directly, or indirectly by someone else on his behalf out of funds provided by the deceased. If a company paid the premiums of a policy on the life of A and debited A with the amount thereof on loan account, it is submitted that A bore the premiums.

- The words ‘no amount has been’ or ‘will be paid to the estate,’ are capable of meaning that the condition is not fulfilled if there is an actual or future payment of any portion of the proceeds into the estate. The absence of some obligation linking the proceeds with the payment to the estate largely removes the basis for connecting any payment to the estate with the proceeds of the policy, a connection which must be present before it can be said that the condition has not been fulfilled.
 - The connection or link between the proceeds and their payment to the estate applies equally to the payment or utilisation for the benefit of relatives, dependants or family companies. This condition also includes the use of any of the proceeds not merely paid to the persons falling into the above-mentioned categories, but also includes the utilisation of funds for their benefit flowing from such a policy. If any person in the above-mentioned categories was released from his/her liability or his/her liability was reduced by the whole or part of the proceeds of such policy, the condition would not be fulfilled and the proceeds of the policy would form part of the dutiable estate of the insured.
 - If the company was ‘at any time’ a family company in relation to the deceased, the condition is not fulfilled and the proceeds will be dutiable even though at the time the policy was effected and, continuously thereafter, the company was not a family company in relation to the deceased.
- Some authors of textbooks are of the opinion that if part of the proceeds is utilised for the benefit of relatives (dependants, estate or family company) of the deceased, and the balance used as set out in the section, a *pro rata* exclusion would be allowed, provided that all the other requirements are met. In other words, the Commissioner accepts an apportionment of the amount due under the policy. However, the relevant exclusion does not provide for a *pro-rata* share either to be included or excluded for estate duty purposes. The proceeds of the policy, therefore, either qualify for the exclusion or are subject to estate duty. No *pro rata* share of the proceeds is envisaged by the Act.
- Where the exclusion in terms of section 3(3)(a)(iA) of the Act deals with a partner/co-shareholder or co-member without referring to the blood relationship between the partners, co-shareholders or co-members, section 3(3)(A)(ii) specifically excludes scenarios where the funds have been paid to relatives of the deceased and any company which was at any time a family company in relation to the deceased. “Relative” and “family company” are defined in section 1 of the Act.

7 DIFFERENT SCENARIOS:

- **SCENARIO 1: A is a trustee of the A Family Trust. The other trustees are the trust’s lawyer and auditor. The capital beneficiaries of the trust are A’s family members. Payments to the income beneficiaries of the trust are, however, subject to the discretionary powers of the trustees. The trust took out a policy on A’s life. Will the proceeds of the policy (paid to the trust after A’s death) be subject to estate duty?**
 - The question is whether it can really be said that the “policy was not effected by or at the instance” of the trustee? In terms of the Trust Property Control Act, No 57 of 1988, the trust property is placed under the trustee’s control to be administered or disposed of in accordance with the provisions of the trust deed. It would be difficult to discharge the onus of proof to show that such policy was not effected by or at the instance of the deceased. When a policy is taken out on someone else’s life, the life insurers usually insist that the insured party agrees to and signs the proposal for insurance on his life. It is also required that the applicant must have an insurable interest in such a policy.
 - As the proceeds will be paid to the trust of which the family of the deceased are the trust beneficiaries, the requirement that “*no such amount has been or will be paid to, or utilised for the benefit of, any relative of the deceased*” is not met. In such a case the proceeds of the policy constitute “deemed property of the deceased” which is subject to estate duty. In terms of section 11(b)(i) of the Act, the trust would be liable for the *pro rata* estate duty levied on the proceeds of the policy less all the premiums paid by the trust (including interest thereon) in terms of section 3(3)(a) of the Act.

- If the argument is that it is a discretionary trust and the proceeds cannot be subject to estate duty as the family might never receive any benefit from the proceeds, one can easily argue that the class of beneficiaries is fixed (the family) although it depends on the discretion of the trustees to appoint from that class a beneficiary (or beneficiaries) who will become entitled to the proceeds.
- **SCENARIO 2: A is the Managing Director of a private company. The company borrows R1million from a financial institution. A, as MD of the company, stands surety for the company's debt. The company takes out a policy on the life of A, to meet their obligations to the financial institution at A's death.**
 - If A stands surety for the debt of the company, the financial institution will claim the value of the outstanding debt from A's estate as their surety is diminished due to A's death. The executor of A's estate has two options as to how to handle such a scenario:
 - If the claim is approved by the executor and paid by the estate, it must, on strength of the surety agreement, be paid by the estate, although it does not represent a liability of the deceased in terms of section 4(b) of the Act. As the debt of the company has been paid from A's estate it must be reflected as a counter-claim in the asset section of the Liquidation Account. See judgment delivered in ITC 1773 (66 SATC 251).
 - The executor can propose a new surety to the financial institution. If accepted by them, the estate will be released from the liability of payment as surety and the claim will not be reflected in the L&D Account of the deceased.
 - In cases where the company took out insurance cover on the life of A to enable them to pay the debt as set out in (1) above to his estate, the argument that the policy was not effected by or at the instance of A would be very difficult to prove as the deceased was directly involved in the negotiations regarding the whole transaction.
- **SCENARIO 3: A is the Production Manager of a private company, which is not a family company. As A is a highly qualified and skilled person, the company took out a policy on his life to replace him after his death. A died unexpectedly at the age of 52 and the company used the proceeds of the policy to provide for a replacement.**
 - As all the requirements of section 3(3)(a)(ii) of the Act are met in this scenario, the exclusion applies, subject to the condition that the relevant documentation to prove the facts must be submitted as vouchers upon submission of the L&D Account to the Master's Office.

8 QUALITY RECORDS

- None.

9 DOCUMENT MANAGEMENT

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