

# Deferred tax and long-term insurers

With the issuing of AC 102 (revised) (the new AC 102) on Income Taxes in March 1999, several new issues regarding the provision of deferred tax arose for enterprises in general and for long-term insurers in particular.

This new statement on deferred tax is applicable to enterprises' financial statements that cover all periods commencing on or after 1 July 1999. Before this date, the management of long-term insurers could choose to adopt either the requirements of the original AC 102 (the former AC 102) or the exposure draft ED 111. In respect of the financial statements that commence after 1 July 1999, long-term insurers will have to comply with the new AC 102, if their financial statements are to be drafted in accordance with GAAP.

## TAXATION OF LONG-TERM INSURERS

Only the principles essential for understanding the implications of deferred tax for long-term insurers are addressed in this article.

Section 29 of the Income Tax Act, No. 58 of 1962 (the Act) concerns the calculation of taxable income derived by a long-term insurer in respect of any year of assessment that commences before 1 January 2000. It is therefore still applicable to the 1999 and the 2000 tax years. With effect from the 2001 tax year, section 29A should be applied in calculating the taxable income derived by a long-term insurer.

Sections 29 and 29A of the Act give effect to what is termed the four-fund approach to the taxation of long-term insurers as recommended by the Jacobs Committee. The essence of the four-fund approach is that every life insurer is to establish four separate funds and subsequently to maintain these funds. The Explanatory Memorandum (1993) states the philosophy of the four-fund approach as follows:

"This approach is based on the recognition that insurers hold and administer certain of their assets on behalf of various categories of policyholders, while the balance of their assets represents, in the case of proprietary insurers, shareholders' equity, and in the case of mutual insurers, funds to which current policyholders are not entitled and which should thus be treated as corporate funds."

The four funds are:

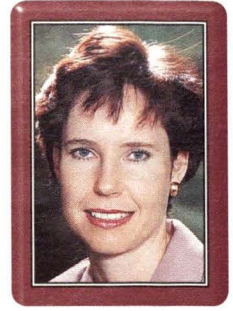
- The *untaxed policyholder* fund that represents the insurer's so-called exempt business. The exempt business envisaged, comprises business conducted by the insurer and includes:
  - Any policy of which the owner is a pension fund, provident fund, retirement annuity fund or benefit fund;
  - policies of which the owner is a person or body, the entire receipts and accruals of which are exempt from income tax; and
  - annuity contracts entered into by the insurer on which annuities are being paid (i.e. immediate annuity business).

Although this fund is exempt from tax in terms of the Act, the fund does pay tax in terms of the Tax on Retirement Funds Act, No. 38 of 1996. The taxable income of the fund (which is in essence gross interest and net rental) must be determined for every tax period and tax is paid at a rate of 25%.

- The taxable income of the *individual policyholder fund* is taxed at a rate of 30%. This is a fund in respect of policies of which the owners are persons other than companies. The 30% is the proxy for the average marginal rate of tax on individuals.

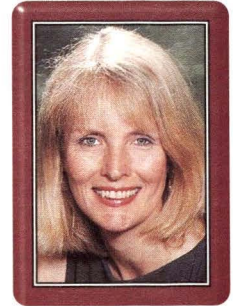
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- The *company policyholder fund* represents life insurance business conducted with companies or close corporations. This fund pays tax at the company's tax rate. For the tax year commencing on or after 1 April 1999, the tax rate for companies is 30%.
- The *corporate fund* reflects the insurer's "own" assets and is the only one of the four funds that is not a policyholder fund. All the remaining assets, if any, held by the insurer and all its remaining liabilities are placed in this fund.
- The Act stipulates that the taxable income derived by an insurer in respect of its untaxed policyholder fund, individual policyholder fund, company policyholder fund and corporate fund shall be determined separately in accordance with the provisions of this Act as if each such fund had been a separate taxpayer. It is therefore clear that each of the four funds is a separate tax entity and that the taxable income for each fund should be determined separately.

The insurer pays income tax on behalf of the various policyholders in accordance with the relevant average tax rates. Policyholders of the taxed policyholder funds receive after-tax money as proceeds of their policies and they usually do not again pay tax in their individual capacity.

## CHANGES INTRODUCED BY THE NEW AC 102

The main difference between the former AC 102 and the new AC 102 is that the former focused on timing differences that arise between the accounting profit and the taxable income in the income statement, while the latter focuses on temporary differences that arise between the accounting carrying value and the tax base of assets and liabilities in the balance sheet. One result of the balance sheet approach in the new AC 102 is that the partial basis used in providing for deferred tax is no longer an allowed accounting treatment. The new statement requires deferred tax to be raised on all temporary differences. In instances in which long-term insurers are still using the partial basis in providing for deferred tax, the accounting policy for deferred tax will have to be changed in accordance with the requirements of AC 103. The use of the partial basis in providing for deferred tax was an attractive alternative, especially where the deferred tax assets of certain funds could not be recognised and offset against the deferred tax liabilities of other funds.

The new AC 102 contains more detailed requirements regarding the recognition, measurement and disclosure of current tax and deferred tax in the financial statements. In particular, the new statement allows deferred tax assets to be created from deductible temporary differences as well as from unutilised tax losses and unutilised tax credits. It appears therefore that this statement is accommodating in respect of the creation of deferred tax assets, which is an important deferred tax issue for most long-term insurers. This perception is, however, not entirely correct as the new statement contains a comprehensive set of guidelines on when deferred tax assets may be recognised. In addition, it contains specific criteria for the offsetting of deferred tax assets and deferred tax liabilities.

In calculating deferred tax, long-term insurers will have to calculate the

temporary differences for each of the four funds by comparing the accounting carrying values of the assets and liabilities in the balance sheet to their tax bases. Within each of the funds, the recognised taxable temporary differences may be offset against the deductible temporary differences to produce either a net taxable temporary difference or a net deductible temporary difference, which results in respectively a deferred tax liability or a deferred tax asset.

Temporary differences may arise even though no asset or liability appears in the balance sheet of the enterprise. An example of such a temporary difference for long-term insurers is the treatment of selling expenses. Section 29 (14)(a) of the Act determines that an insurer is allowed to deduct the annual average of selling expenses incurred during the current year and the immediately preceding four years. For accounting purposes, selling expenses are written off in the income statement as they are incurred. In this example there is no carrying value for selling expenses, but there is, however, a tax base and the difference between the two gives rise to a temporary difference (see AC 102.13). This application will, however, only apply to the 1999 tax year.

**IMPACT OF DEFERRED TAX ON SURPLUSES AND DEFICITS IN FUNDS**

Each of the policyholder funds is permitted to hold only assets that have a mar-

ket value equal to the insurer's liabilities to policyholders. The balances of the insurer's assets are to be placed in the corporate fund, because it is the repository of the balances of the insurer's funds.

Section 29 provides for the balance to be transferred progressively over a period of four years. A portion of the surplus remains in the policyholder fund, and unless a deficit arises in future years, this surplus will be transferred to the corporate fund in future years. Any amount transferred shall be a tax deduction in the fund from which it is transferred and be included in the gross income of the fund to which it is transferred, unless it qualifies as a "special transfer".

A brief overview of the position of the funds regarding the transfer of surpluses appears to suggest that the fund in which the surpluses are deductible against future taxable income should have a deferred tax asset. In contrast, the corporate fund in which the surpluses are taxable in the future should have a deferred tax liability. The application of the definitions of tax bases for assets and liabilities and the exemption clauses contained in AC 102.19 and

29 do not necessarily provide this answer. As section 29A does not provide for a progressive transfer of any surpluses (surpluses and short-falls are immediately transferred in the year in which they arise), the above-mentioned should not create any additional problems in respect of deferred tax with effect from the 2001 tax year.

**REVALUATION OF ASSETS**

Long-term insurers usually mark-

to-market their assets in their financial statements. In terms of AC 102, deferred tax should be provided on the revaluation of assets, irrespective of whether the intention is to use or sell the asset. If the exemption clauses contained in AC 102.19 are used in particular circumstances to obviate the provision for temporary differences that arise from differences between the carrying values and tax bases of assets, it should be borne in mind that the exemption falls away once the assets are revalued. It is submitted, however, that the temporary differences that arise between the carrying values and the tax bases of the revalued assets in these funds may be provided for at a nil tax rate in terms of AC 102.55, because the profits on the sale of certain assets (e.g. stocks, shares, etc.) are usually treated as capital profits and taxed at a nil tax rate in South Africa. The draft interpretation D21 of the IASC clarifies the position further by concluding that deferred tax need not be provided on non-depreciable assets (assets which will be realised through sale) if the realised profit will not be taxed. Most of the assets in the funds of long term insurers should fall into this category.

The issue is however more complex for long-term insurers due to the requirements of the Act. Section 29 determines that, for long-term insurers, the increase in the valuation of assets resulting in a surplus is allowed as a tax deduction in one fund over four years, while the benefit of the revaluation is actually taxed in another fund over the same period. Section 29A provides for the transfer of the surplus to be taxable in the corporate fund, but that does not provide for the full amount to be deductible in the respective policyholder funds from which the transfer is to be made. As the surplus on revaluation is deductible/taxable for tax purposes in long term insurers and D21 suggests that the deferred tax liability/asset that arises from the revaluation of a non-depreciable asset is measured based on the tax consequences that follow from recovery through sale, it seems to suggest that deferred tax may have to be provided on the revaluation of assets in individual funds, if the transfer of assets between funds is viewed as sales.

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As remarked by Arthur Levitt, US SEC Chairman to the American Council on Germany in October 1999:

"If anyone doubts the disparate effects that different accounting practices can have, consider again the case of Daimler-Benz. Under German accounting standards, Daimler reported a profit of 168 million Deutschmarks in 1993. Under U.S. GAAP standards, the company reported a loss of almost a billion Deutschmarks for the exact same period."

More pertinently recent South African legal opinion has highlighted the need to comply with all requirements of Statements of Generally Accepted Accounting Practice. The conclusion to the September 1999 legal opinion was that on the available evidence paragraph 5 of Schedule 4 required disclosure:

"whenever the financial statements of a company depart from any of the Accounting Practices Board (APB) Statements"

Since 1997, there have been a number of new International Accounting Standards issued by the International Accounting Standards Committee (IASC), an independent private-sector body of which South Africa, along with many other Southern African countries, is a member. The IASC is working to achieve uniformity in the accounting principles that are used by business and other organisations for financial reporting around the world. The South African Institute of Chartered Accountants (SAICA) has been driving the process to harmonise South African financial reporting with International Accounting Standards.

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**RECOGNITION OF DEFERRED TAX ASSETS**

A deferred tax asset represents the income tax amounts that are recoverable in future periods in respect of:

- deductible temporary differences;
- carry-forward of unused tax losses; and
- carry-forward of unused tax credits.

If, in calculating the deferred tax of a fund, there are insufficient taxable temporary differences in the fund to offset the deductible temporary differences, a deferred tax asset is only recognised to the extent that:

- it is probable that there will be sufficient taxable profits in the same periods as that in which the reversal of the deductible temporary differences occurs; or
- there are tax planning opportunities available to the enterprise that will create taxable profits. Tax-planning opportunities include the reduction of non-taxable income in applicable funds, for example reducing dividend income in favour of taxable income such as interest.

In terms of AC 102.38, a deferred tax asset is also recognised for unused tax losses and unused tax credits to the extent that there will in future be taxable profits against which the unused losses and credits can be utilised. In addition to the requirements for raising a deferred tax asset for net deductible temporary differences, additional criteria should be considered for unutilised tax losses and credits. For example, when unutilised tax losses arose as a result of recent operating losses, it may indicate that in the near future taxable profits may not be available to utilise tax losses. Other indications that future taxable profits may not be available are the insurer's history of unused or expired tax losses and tax credits as well as management's expectation of future losses (see AC 102.40). It is apparent from these additional criteria that the requirements for raising a deferred tax asset from unutilised tax losses and credits are more onerous than for net deductible temporary differences.

**OFFSETTING OF DEFERRED TAX ASSETS AND LIABILITIES**

If a long-term insurer recognises deferred tax assets on certain of the funds and deferred tax liabilities on others, the next question that arises, is whether the deferred tax asset recognised in respect of one fund can be offset against the deferred tax liability of another fund to reduce the overall provision for deferred tax in the financial statements of the long-term insurer. In this regard AC 102.78 states that an enterprise can offset deferred tax assets and deferred tax liabilities if, and only if, all of the following conditions are met:

- The enterprise has a legally enforceable right to offsetting current tax assets against current tax liabilities; *and*
- the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same tax authority on either:
- the same taxable entity; or
- different taxable entities that intend to either settle current tax liabilities and assets on a net basis or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

The first problem that long-term insurers will encounter with offsetting arises from the first requirement, namely "the legally enforceable right to offset current tax assets and liabilities". As each of the funds of insurers is ringfenced and current tax assets and liabilities of the four funds may not be offset, it is submitted that this requirement will not be met.

Consequently offsetting is not available to long-term insurers, because the statement requires both the requirements to be met before offsetting is effected.

The second requirement, introduced to accommodate the taxation of a group, also raises a number of questions. The requirement that income taxes be levied by the same tax authority should not pose a problem for

long-term insurers which are usually registered with one office of the South African Revenue Services. The term "taxable entity" is, however not defined in the statement, nor is it a recognised term in the Act. It can be argued that the term refers to a registered taxpayer, namely the long-term insurer, or that it refers to each taxpaying entity, which is each fund. These possible interpretations of the term will probably allow long-term insurers to meet the second requirement for offsetting.

It is submitted that the offsetting of deferred tax assets and deferred tax liabilities that arise in the four funds of long-term insurers are not allowed in terms of the new AC 102, because a legally enforceable right to the offsetting of current tax assets and current tax liabilities of individual funds is not permitted. This interpretation also impacts on other businesses to which ringfencing applies. It appears that the standard setters may not have considered the impact of the statement in the Act on enterprises that are ringfenced.

**SUMMARY**

The adoption of the new AC 102 on Income Taxes raises a number of issues in respect of calculating deferred tax. The implications of this approach may not be without problems for long-term insurers for inter alia the following reasons:

- The partial method of providing for deferred tax is no longer an acceptable accounting treatment;
- the treatment of surpluses and deficits between funds of insurers is not accommodated in the definitions and exemption clauses contained in the new AC 102;
- deferred tax assets that arise, especially from unutilised tax losses or credits, may not be readily recognised; and
- the deferred tax asset of one fund may probably not be offset against the deferred tax liability of another fund.

The purpose of the article is to provide a brief overview of the deferred tax implications for long-term insurers. However, the requirements of the new AC 102 are onerous and should be studied in detail before an attempt is made to calculate the provisions for deferred tax. **ASA**

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