THE IMPACT OF SOLVENCY ASSESSMENT AND MANAGEMENT ON THE TAXATION OF LONG-TERM INSURERS IN SOUTH AFRICA – A COMPARATIVE STUDY

by

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Submitted in partial fulfilment of the requirements for the degree

Magister Commercii in Taxation

in the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES

at the

UNIVERSITY OF PRETORIA

STUDY LEADER: Mr Jan Nell

Date of submission:
2013-09-16

ACKNOWLEDGEMENTS

This task and specifically this topic, was a tough challenge to master. But as I look up, I'm sincerely thankful "For I can do all things through Christ who gives me strength" (Philippians 4:13)

I am privileged to have had tremendous support and encouragement from my family, friends and colleagues. I woud specifically like to thank my parents, for their endless support and encouragement. Also my partners Jeanette Coetzee and Bernard Eloff, and the staff at PCE Accountants, thank you for your support, encouragement, and taking care of my duties at times when I was absent. Renier Maartens, today I can say thank you for that very persuasive conversation we once had.

I am sincerely thankful to Tiennie Hamman, Johan De La Rey, Neill Bester and Kari Lagler for their time and assistance. Without their help and valuable inputs, this study would not have been possible.

Finally, I would like to extend my gratitude to my study leader Jan Nell, for his guidance and effort in assisting me with this task.

ABSTRACT

THE IMPACT OF SOLVENCY ASSESSMENT AND MANAGEMENT ON THE TAXATION OF LONG-TERM INSURERS IN SOUTH AFRICA – A COMPARATIVE STUDY

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A new revised prudential regulatory regime for insurers will be introduced in order to align the South African insurance industry with international standards. This regime, called Solvency Assessment and Management, is based on its European counterpart, which is known as Solvency II.

This study starts off by investigating and comparing Solvency II, to be implemented in the United Kingdom, with Solvency Assessment and Management, to be implemented in South Africa, identifying a number of similarities between the regimes. The taxation of long-term insurers in both jurisdictions is then investigated, but no similarities are identified.

The above prepares the ground for the main purpose of the study, which is to identify the impact of Solvency Assessment and Management on the taxation of long-term insurers in South Africa. This study identified the impact as effecting a change in the current basis used for the valuation of policyholder liabilities, which will cause a decrease in the value of liabilities, and consequently an increase in underwriting profit. The impact of this change is illustrated, and there are clear indications that there is a need to amend current income tax legislation or the directive used to determine the value of liabilities. Two options for amendments are identified but no changes to legislation are expected before 2015.

KEY WORDS:

Solvency Assessment and Management

Solvency II

Long-term insurance

Taxation

Value of liabilities

Underwriting profit

South Africa

United Kingdom

OPSOMMING

DIE IMPAK VAN SOLVENSIE BEPALING EN BESTUUR OP LANG-TERMYN VERSEKERAARS IN SUID AFRIKA – 'N VERGELYKENDE STUDIE

Deur
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'n Nuwe, hersiene omsigtige regulatoriese beleid vir versekeraars, gaan bekend gestel word, om die Suid Afrikaanse versekeringsbedryf in lyn te bring met internasionale standaarde. Hierdie beleid genaamd Solvensie Bepaling en Bestuur is gebaseer op die Europese eweknie, genaamd Solvensie II.

Hierdie studie begin deur Solvensie II, wat in die Verenigde Koningryk geïmplementeer gaan word, te vergelyk met Solvensie Bepaling en Bestuur, wat in Suid Afrika geïmplementeer gaan word, en sodoende word 'n aantal ooreenkomste tussen die twee beleide onderskei. Daarna word die belasting van lang-termyn versekeraars in beide jurisdiksies ondersoek, maar geen ooreenkomste word geïdentifiseer nie.

Die voorafgenoemde, lê die grondslag om die hoofdoel van die studie aan te spreek, naamlik, om die impak van Solvensie Bepaling en Bestuur op die belasting van lang-termyn versekeraars te identifiseer. Die studie identifiseer hierdie impak as 'n verandering in die huidige basis wat gebruik word vir die waardering van polishouer verpligtinge. Die verandering van die basis, verminder die waarde van polishouer verpligtinge en vermeerder gevolglik die onderskrywingswins.

Die impak word geïllustreer en dui aan dat verandering in huidige wetgewing of die betrokke direktief, beslis nodig is. Twee opsies vir moontlike veranderinge word geïdentifiseer, maar na verwagting sal geen wetgewing voor 2015 gewysig word nie.

SLEUTERWOORDE:

Solvensie bepaling en bestuur

Solvensie II

Langtermyn versekering

Belasting

Waarde van verpligtinge

Onderskrywingswins

Suid-Afrika

Verenigde Koninkryk

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

With the release of the 2010 Medium Term Budget Policy on 27 October 2010, Pravin Gordhan, the Minister of Finance, announced that a revised prudential regulatory regime for insurers will be introduced in order to align the South African insurance industry with international standards (Department of National Treasury, 2010:19).

The Financial Services Board (FSB), which is an independent South African institution overseeing the South African non-banking financial services industry (Financial Services Board, Not dated), began the process of developing a new revised prudential regulatory regime called “Solvency Assessment and Management” (SAM) and commonly referred to as “SAM” (Financial Services Board, 2010a:4).

The SAM regime is based on Europe’s risk-based solvency regime, known as Solvency II. SAM is primarily focused on the protection of policyholders and beneficiaries and in addition thereto, the regime also has capital requirements and risk management objectives (Financial Services Board, 2010b:1).

Long-term insurers are currently taxed according to section 29A of the Income Tax Act 58 of 1962 (Income Tax Act), which is generally referred to as the “four-funds” basis of taxation. According to Barlow and Donaldson (2011:9), SAM will change the current valuation of what is generally referred to as “policyholder liability”, and this change in valuation could have a major impact on the taxation of long-term insurers in the Republic of South Africa (RSA).

SAM, being unique to the RSA, is still in its developmental phase. The project was initially planned with an original implementation date of 1 January 2014 (Financial Services Board, 2010a:40), but the deadline has twice been extended and implementation is currently only expected on 1 January 2016 (Van Deventer, 2013). The FSB is conducting quantitative impact studies to evaluate both the insurers' progress, and readiness for implementation (Financial Services Board, 2013d:2), but much uncertainty exists around the impact of SAM on the taxation of long-term insurers in the RSA and more specifically around the question of the changes that can be expected to current legislation in order to prepare the industry for the implementation of the SAM framework.

A wide-ranging search was performed on leading electronic databases, including EBSCOHost, Emerald, Google Scholar, HeinOnline, JSTOR, Proquest and SpringerLink, but no academic research specifically directed at the taxation impact of the solvency regime SAM was retrieved.

Academic research into the taxation of long-term insurers in the RSA has resulted in investigations of the current four-funds method of taxation. Hartwig (1994:1) developed a theoretical framework and argued that the four-funds approach to the taxation of life insurers fits the framework developed. Clover (2008:1) evaluated the four-funds approach and suggested possible changes. In a recent study Donaldson (2011:iv) also analysed the appropriateness of the four-funds approach, and included a comparison to a newly enacted approach adopted in New Zealand.

The Solvency Assessment and Management Tax Working Group 2 conducted research, and produced a paper entitled: "Solvency Assessment and Management: The impact of the implementation of the Solvency II Directive principles on the taxation of insurers in jurisdictions comparable to South Africa" (Financial Services Board, 2012c:4). The research paper focuses on the taxation effects of the implementation of Solvency II in various countries of the world and does not identify any expected taxation changes as a result of the implementation of SAM.

Previous research has addressed the effect of SAM on the medical scheme environment (Ganz, 2012:65), and Kruger (2011:34) touches on some of the challenges and changes that SAM is expected to produce. Viljoen (2012:iv) focuses on solvency assessment and the role of the statutory actuary. Severinson and Yermo (2012:4), Sandström (2011:339) and Buckham, Wahl and Rose (2011:71) have all addressed the general aspects of Solvency II, which is the European equivalent of SAM, as previously mentioned.

It is clear from the above account of previous research that neither the SAM framework nor the impact of SAM on the taxation of long-term insurers in the RSA has been the subject of any previous academic study.

1.2 PROBLEM STATEMENT

With the implementation date for SAM set at the beginning of 2016 (Van Deventer, 2013), there is still much uncertainty surrounding the impact of its implementation, especially with regard to the effect on taxation of long-term insurers in the RSA. No previous academic studies have investigated the impact that SAM will have on the taxation of long-term insurers in the RSA. It is believed that further research, specifically related to the taxation aspect of SAM, is essential in order firstly to inform stakeholders of the impact of SAM and secondly to identify and investigate possible solutions which could be implemented in order to resolve the tax problem the industry will face as a result of the implementation of SAM.

According to statistics provided by the Association for Savings and Investment South Africa (ASISA), the assets of the South African insurance industry totalled R1,738 trillion at the end of 2012 (Association for Savings and Investment South Africa, 2012). An examination of the size of the industry makes it clear that any changes impacting the tax treatment applicable to long-term insurers could possibly have far-reaching consequences.

1.3 PURPOSE STATEMENT

The main purpose of this study is to identify the impact of SAM on the taxation of long-term insurers in the RSA, by investigating the proposed solvency regimes, the taxation of long-

term insurers in the UK and the RSA, as well as the anticipated impact of SAM on the taxation of long-term insurers in the RSA. Possible solutions to the tax problem awaiting the South African long-term insurance industry will also be identified and investigated.

1.4 RESEARCH OBJECTIVES

The research objectives of this study are:

- to investigate the two selected solvency regimes, namely SAM, to be implemented in the RSA, and Solvency II, to be implemented in the UK;
- to draw a comparison between the two selected solvency regimes;
- to investigate the methods of taxation applicable to long-term insurers in the RSA and the UK prior to the implementation of the solvency regimes;
- to draw a comparison between the taxation of long-term insurers in the RSA and the UK;
- to identify the impact of SAM on the taxation of long-term insurers in SA; and
- to identify the income tax legislation or income tax policy changes expected to result from the anticipated implementation of the SAM regime in the RSA.

1.5 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

This proposed study will make a valuable contribution in providing theoretical projections of the expected tax impact of the implementation of SAM on the long-term insurance industry. The investigation into the solvency regimes and taxation of long-term insurers will include comparisons, where possible, and provide a valuable background as an aid to understanding the impact of SAM on the taxation of long-term insurers in South Africa.

By resolving unanswered questions, and informing stakeholders and interested parties of the impact that the implementation of SAM will have on the long-term insurance industry, this study will contribute to a smoother implementation of SAM and South Africa will be well on its way to aligning itself with the international regulatory standards governing its insurance industry.

1.6 DELIMITATIONS

The proposed study has a number of delimitations:

- The study will be limited to the South African solvency regime SAM, and its European equivalent Solvency II. The study will seek to draw a comparison between SAM and Solvency II, but the comparison will be limited to Solvency II applicable to the United Kingdom (UK).
- The study will be limited to the long-term insurance industry, also referred to as the life insurance industry, and more specifically long-term insurers registered or deemed to be registered in the RSA in terms of the Long-term Insurance Act 52 of 1998, and operating on a commercial basis. The South African long-term insurers will be compared only to the UK long-term insurance industry, with specific reference to long-term insurance firms that will fall within the parameters of Solvency II and have a gross premium income that exceeds €5 million.
- The study will be limited to the income tax aspect of SAM and Solvency II and will by no means seek to investigate other taxes, such as capital gains tax, VAT or any other type of tax.
- The review of the entire four-funds approach and current concerns regarding the approach to taxing long-term insurers in the RSA is not within the scope of this research.
- The study will not focus on the accounting treatment and financial reporting of long-term insurers, but where this is necessary to explain certain concepts, reference will be made to these matters.
- Because of the actuarial and highly technical nature of insurance, the study will not provide a complete and in-depth account of technical concepts. Concepts will be explained to the extent required in order to execute research objectives.

1.7 ASSUMPTION

Although neither Solvency II nor SAM has yet been implemented, it is assumed that the regimes will be implemented on the proposed dates as set at the time of completion of this research.

1.8 DEFINITIONS OF KEY TERMS

The study involves a number of key terms. For the purposes of this study, the terms are defined as follows:

The term **best estimate** is defined as "… equal to the probability-weighted average of future cash flows, taking into account the time value of money" (Financial Services Board: 2010a:18). The term is further described in chapter 4.2, where the taxation impact of SAM is investigated.

Oliver (2004:16) describes **life insurance** as insurance which is contingent upon human life. Under a standard life insurance policy, the policy would provide payment to the insured's beneficiaries on the death of the insured policyholder. Oliver also refers to two other types of life insurance that include annuities and income maintenance insurance.

Life insurers are defined as institutions that "accept premiums from policyholders for the insurance of risks related to loss of health or life or long term disability; as risks may not be realised until far in the future, funds may be invested to fund future risks" (Organisation for Economic Co-operation and Development, 2001:12). Life insurers do not only offer risk policies, but also investment or savings products, as well as mixed products (Donaldson, 2011:5). The term **"long-term insurer"** is also used to refer to a **"life insurer"** or **"life company"** (Donaldson, 2011:2)

Solvency II is Europe's new solvency regime. It is characterised by the fact that it looks at the balance sheet of an insurance company from the perspective of market value. On this basis, a market value is determined for every balance sheet item. The market value of the assets minus the market value of the liabilities would indicate the available capital portion,

which is then compared with the risks on the balance sheet (De Weert, 2011:95). Solvency II is investigated and further described in chapter 2.2.1.

South Africa's solvency regime, which is known as **Solvency Assessment and Management (SAM),** is based on Europe's Solvency II regime. SAM is primarily concerned with the protection of policyholders and beneficiaries and in addition thereto, the regime also has capital requirements and risk management objectives (Financial Services Board, 2010a:1). Chapter 2.2.2 investigates the South African solvency regime SAM in greater detail.

The word **solvent** as an adjective is defined as "having assets in excess of liabilities; able to pay one's debts" (AskOxford.com, Not dated.)

The **trustee principle** is a principle whereby the insurer holds and administers assets on behalf of policyholders. The report of the committee of investigation into the promotion of equal competition for funds in financial markets in the RSA, chaired by Dr A.S. Jacobs (referred to as the Jacobs Committee), describes the principle as follows: "This principle, in short, entails that life insurers are deemed to be holding and investing funds on behalf of their policy holders, and that they should pay income tax on the income derived therefrom on a similar basis" (Jacobs Committee, 1992:89). In chapter 3.3.2, the taxation of long-term insurers in the RSA is investigated and the trustee principle is further described.

Donaldson (2011:100) describes **underwriting profits**, in the context of the four-funds tax calculation, as "… the market value of assets in the policyholder fund less the value of policyholder liabilities". This calculation is done at the end of each tax year for each of the policyholder funds of the RSA four-funds approach. The term "underwriting profits" is further described in chapter 3.3.2.

1.9 ABBREVIATIONS USED

For the purposes of this study, table 1 tabulates the meanings of the abbreviations used:

Table 1: Abbreviations used in this document

Abbreviation	Meaning
£	Pound currency symbol
€	Euro currency symbol
ASISA	Association for Savings and Investment South Africa
BLAGAB	Basic Life Assurance and General Annuity Business
CEIOPS	European Insurance and Occupational Pensions Supervisors
CF	Corporate Fund
CPF	Company Policyholder Fund
DAC	Deferred Acquisition Cost
EU	European Union
FSA	Financial Services Authority (United Kingdom)
FSB	Financial Service Board (South African)
GAAP	General Accepted Accounting Practice
GRB	Gross Roll-up Business
IAIS	International Association of Insurance Supervisors
I-E	I minus E
IFRS	International Financial Reporting Standards
PBT	Profit before tax
PHI	Permanent Health Insurance
R	South African Rand currency symbol
RSA	Republic of South Africa
SAQIS	South African Quantitative Impact Study
SAM	Solvency Assessment and Management
SAP	Standard of Actuarial Practice
SARS	South African Revenue Services
SVM	Statutory Valuation Method
TWG	Tax Working Group
UK	United Kingdom
UPF	Untaxed Policyholder Fund
www	World wide web

1.10 RESEARCH DESIGN

The research for this study will be conducted using a qualitative case study research design. The case study will comprise empirical and non-empirical components. The

method used in conducting a case study is described as follows: "… the researcher collects extensive data on the individual(s), program(s), or event(s) on which the investigation is focused" (Leedy & Ormrod, 2010:137).

In order to lay the foundation for determining the impact of SAM on the taxation of long-term insurers in South Africa, both the solvency regimes, namely Solvency II and SAM, will be investigated, and attention will be given to the taxation of long-term insurers in the UK and the RSA. This will be done by means of a literature review, which comprises the non-empirical component. Leedy and Ormrod (2010:66) describe a literature review as follows: "The review describes theoretical perspectives and previous research findings regarding the problem at hand."

A literature review is an essential part of this study. It will, however, be limited in the sense that it will do no more than summarise the existing available information. In view of the extremely dynamic nature of this study, and a lack of available literature on the taxation aspects of SAM, the literature review will be supplemented with information gathered from unstructured interviews, also referred to as informant interviews. Saunders, Lewis and Thornhill (2009:603) define the term "unstructured interview" as follows: "loosely structured and informally conducted interview that may commence with one or more themes to explore with participants, but without a predetermined list of questions to work through". Saunders *et al*. (2009:593) describe "informant interviews" as follows: "interview guided by the perceptions of the interviewee". A few selected specialists from different organisations involved in the SAM project, and more specifically the taxation aspect of SAM, will be interviewed in one-on-one, face-to-face interviews, in order to gather sufficient information. These interviews will comprise the empirical component of the study.

1.11 BRIEF OVERVIEW OF CHAPTERS

Chapter 1 provides the background, problem and purpose statements. The importance and benefits of the study are pointed out, illustrating the rationale for the study. The research objectives are listed, and delimitations and assumptions are given to indicate the scope of the research. The chapter provides definitions of key terms, and lists abbreviations used throughout the study. The selected research design is also described.

Chapter 2 investigates the solvency regimes, namely Solvency II, to be implemented in the UK, and SAM, to be implemented in the RSA. The two solvency regimes are then compared and points of concurrence and difference are identified.

Chapter 3 investigates the taxation of long-term insurers in the UK and the RSA. Following the investigation, the taxation methods applicable to long-term insurers in the UK and the RSA are compared.

Chapter 4 is focused on the RSA only and investigates the taxation impact of SAM while identifying the options for resolving the SAM tax challenge. Possible approaches to the amendment of current legislation are also identified.

Chapter 5 concludes the study by providing a summary of findings in relation to the research objectives listed in chapter 1. The chapter concludes with recommendations for future research.

CHAPTER 2

THE SOLVENCY REGIMES

2 THE SOLVENCY REGIMES

2.1 INTRODUCTION

The main purpose of this study is to identify the impact of SAM on the taxation of long-term insurers in the RSA, by investigating the proposed solvency regimes, the taxation of long-term insurers in the UK and the RSA, as well as the anticipated impact that SAM will have on the taxation of long-term insurers in the RSA. Possible solutions to the tax problem awaiting the RSA long-term insurance industry will also be identified and investigated. The research objectives will be aligned with the main purpose and discussed in the remaining chapters.

This chapter will address the first and second of the objectives listed in chapter 1.4 by means of a literature review. To meet the first objective, Solvency II, which will be implemented in the UK, will be investigated, and this will be followed by an investigation of SAM, which will be implemented in the RSA. The second listed objective of this study will then be achieved by drawing a comparison between Solvency II and SAM.

2.2 A BASIC OVERVIEW OF THE SOLVENCY REGIMES

Financial soundness is not only a matter of being solvent (Buckham *et al.*, 2011:73). The term solvent is defined as: “having assets in excess of liabilities” (AskOxford.com, Not dated.). In its most basic form, the European Solvency II directive and the South African SAM directive can be described as risk management frameworks to ensure financial soundness of insurance firms (Buckham *et al.*, 2011:73).

2.2.2 The European Solvency II regime

In July 2007, even before the global financial crisis of 2008, the Solvency II draft directive framework was launched, after it became clear to industry observers that insurers and re-insurers needed to reassess their risk and management practices (Buckham *et al.*, 2011:71).

When the financial crisis hit the world, it merely confirmed that a more elaborate risk management system was desperately needed to replace Solvency I, the predecessor to Solvency II.

Solvency I is inadequate in the sense that it is not a risk-based system, and it did not take the risk on the asset side of the balance sheet into account. It merely focused on the insurance risk on the liability side. (De Weert, 2011:95).

Solvency II is characterised by the fact that it looks at the balance sheet of an insurance company on a market value basis. On this basis, a market value is determined for every balance sheet item. The market value of the assets minus the market value of the liabilities indicates the available capital portion, which is then compared with the risks on the balance sheet (De Weert, 2011:95). The capital requirements of the directive provide an early warning system for any decline in solvency levels (Buckham *et al.*, 2011:72).

Although the directive is named “Solvency II”, the regulation of capital requirements for insurance undertakings is not the only way to prevent failures. The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) conducted studies and found that the main cause of failure was surprisingly not the lack of capital, but rather poor management decisions and inappropriate risk decisions (Buckham *et al.*, 2011:73).

The managing director for European Insurance at Moody’s Corporation, Simon Harris, said: “The purpose of Solvency II is not necessarily to strengthen the industry’s capital base, but more to ensure that sufficient regulatory and internal risk management controls are in place to enable management and regulators to more fully understand and control the dynamics of the industry’s risk profile” (Buckham *et al.*, 2011:73).

The primary objective of the Solvency II directive is the protection of policyholders and beneficiaries through a consistent European standard (Financial Services Authority, 2008:3), aiming to establish a revised set of European Union (EU) wide capital requirements, valuation techniques and risk management standards. It should provide supervisors with the appropriate tools and powers to assess the overall solvency of all insurance and reinsurance companies based on a prospective and risk-oriented approach. Secondary objectives are to (Buckham *et al.*, 2011:72):

- "Deepen integration of the European insurance market."
- "Improve the international competitiveness of EU insurers."
- "Promote better regulation through a principle-based and risk sensitive solvency regime."
- "Align capital requirements to a company's risk profile."
- "Instil risk awareness into governance, operations, and decision making."

There are three pillars that support the quantitative elements and the qualitative aspects that influence an insurer's risk standing (Buckham *et al.*, 2011:77):

- pillar 1: the quantitative requirements;
- pillar 2: the supervisory activities; and
- pillar 3: the reporting and public disclosure requirement.

Solvency II is expected to apply to all insurance and reinsurance firms with a gross premium income exceeding €5 million that conduct business in the European Economic Area, which covers all 27 EU countries, together with Norway, Liechtenstein, and Iceland. Insurance companies with a gross premium income of less than €5 million may choose to apply the Solvency II directive voluntarily (Buckham *et al.*, 2011:72).

With its wide application, Solvency II will level the playing field, but simultaneously provide a competitive advantage in the global insurance market by allowing insurance firms the freedom to choose their own risk profile, as long as they hold adequate capital (Buckham *et al.*, 2011:85).

According to Buckham *et al*. (2011:72), the planned implementation date was 1 January 2013. The implementation date has, however, been extended to 1 January 2014, and it has recently been suggested that implementation could possibly be further delayed to 2016 (O'Brien, 2013).

2.2.3 The South African SAM regime

As already stated, the South African solvency regime SAM that is being developed will share the same broad features as Solvency II. SAM will also be a principle-based regulation, based on an economic balance sheet, and this innovative solvency regime is steered by a South African authority, the Financial Services Board (FSB) (Financial Services Board, 2010a:4).

There are a few factors that influenced the decision to base SAM on Solvency II. They can be summarised as follows (Financial Services Board, 2010a:9):

- There are strong economic ties between the RSA and Europe.
- The Solvency II regime as a principle-based, three pillar framework denotes international regulatory best practice.
- The RSA will be aligned to international standards being developed by the International Association of Insurance Supervisors (IAIS).
- Should the RSA be able to achieve Solvency II third country equivalence status, it would help to ensure that South African insurers will be able to continue doing business in the European Union (EU) and other international jurisdictions, while a trusted level of regulation is maintained.

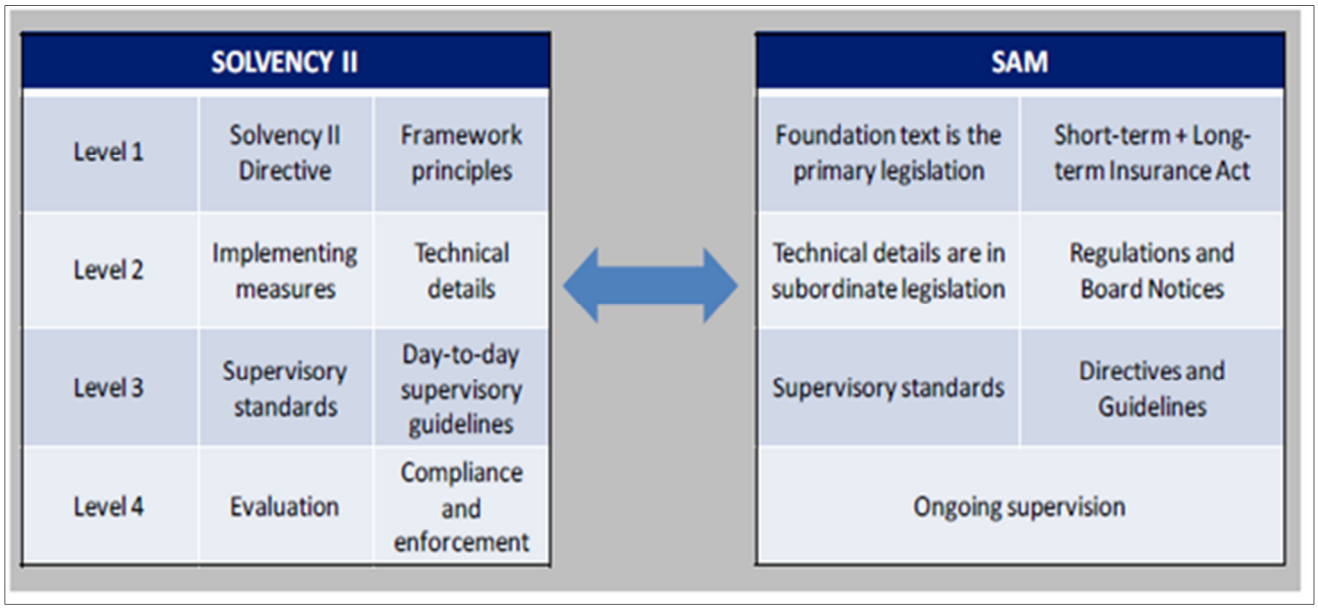
Third country equivalence is a principle recognised by the EU in respect of regulatory insurance standards for countries outside the EU. The SAM project is aimed at reaching the requirements for third country equivalence status, and therefore it is being based on Solvency II, but the framework will simultaneously be adjusted for South African circumstances (Financial Services Board, 2010a:9). One of the criteria for reaching third country equivalence status is that the regulatory framework will be completely risk-based (Financial Services Board, 2010a 10). The SAM project will be assessed to determine

whether it can be accorded third country equivalence status (Financial Services Board, 2010a:9).

In terms of the legislation governing the SAM regime, the FSB made the following statement in its SAM Roadmap document: "The foundation text of the SAM regime will be the primary legislation which will draw extensively on the principles enshrined in the level 1 Solvency II text" (Financial Services Board, 2010a:12). It was also stated that subordinate legislation (i.e. regulations and board notices) would contain all technical details related to the implementation of SAM and directives and guidance notes would be used to convey supervisory standards (Financial Services Board, 2010a:12).

On a level-to-level basis, the above points of concurrence can be illustrated in the following figure:

Figure 1: Solvency II – SAM Points of Concurrence



Source: Financial Services Board (2010a:12)

The three pillar structure which is synonymous with Solvency II was also used for the SAM structure. The three pillars on which SAM will rest are indicated as follows (Financial Services Board, 2010a:4):

- pillar 1: capital adequacy
- pillar 2: systems of governance

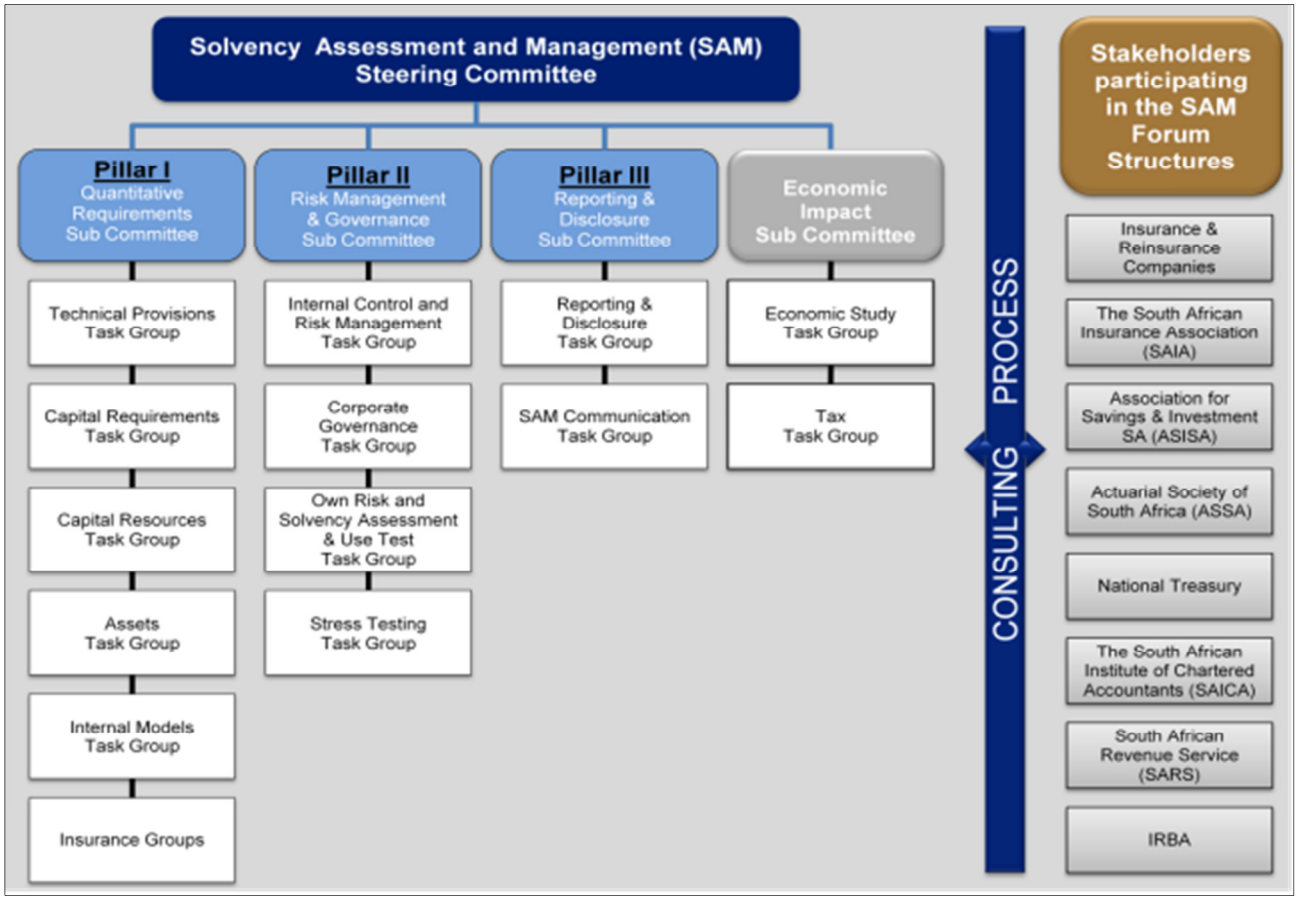
- pillar 3: reporting requirements

Another matching point between the two ground-breaking solvency regimes is that for both Solvency II and SAM, the primary focus is on the protection of policyholders and beneficiaries. Secondary objectives of SAM are (Financial Services Board, 2010a:4):

- To align capital requirements with the underlying risks of an insurer.
- To develop a proportionate, risk-based approach to supervision with appropriate treatment both for small insurers and large, cross border groups.
- To provide incentives to insurers to adopt more sophisticated risk monitoring and risk management tools – this would include developing full and partial internal capital models and increased use of risk mitigation and risk transfer tools.
- To maintain financial stability.

The governance structure of SAM is depicted by the following figure. The figure also indicates the three pillar structure, the various task groups that have been set up and the participating stakeholders involved.

Figure 2: Solvency Assessment and Management (SAM) Governance Structure



Source: Financial Services Board (2010a:6)

Whereas the application of Solvency II will only be compulsory for insurers with a gross premium income of more than €5 million (Buckham *et al*., 2011:72), SAM will be applied to all insurance firms operating on a commercial basis, including government-owned insurers (Financial Services Board, 2010:4), and will replace the current regulatory framework as required under the Long-term Insurance Act 52 of 1998 (Viljoen, 2012:12).

To date, two quantitative impact studies have been conducted by the FSB (Van Deventer, 2013), and the draft technical specifications for the third quantitative impact study were released in August 2013 (Financial Services Board, 2013d:2). The studies are intended to assist in the development of the proposed SAM regime by providing technical specifications, and to determine insurance firms' readiness to implement the SAM regime and the progress they are making in their preparation to do so. The studies included calibration of parameters for the standard formula for calculating the solvency capital requirement (Financial Services Board, 2012a: 7).

Before the SAM project is finally implemented on 1 January 2016, the FSB has suggested a two-stage parallel run. This parallel run will be a trial implementation of the SAM regime, and will run parallel to the current solvency regime. The two stages of the parallel run are expected to take place in the following periods (Van Deventer, 2013):

- light parallel run, from 1 July 2014 to 31 December 2014; and
- comprehensive parallel run, from 1 January 2015 to 31 December 2015.

2.3 A COMPARISON BETWEEN THE SOLVENCY FRAMEWORKS

Having investigated the two solvency regimes, namely Solvency II and SAM, respectively in chapters 2.2.1 and 2.2.2 above, a comparison will be drawn between the two regimes in this chapter, with reference to both points of concurrence and differences between the two solvency regimes.

The following points of concurrence between the two solvency regimes were identified:

- SAM was developed on the basis of the European Solvency II (Financial Services Board, 2010a:4).
- SAM shares the same broad features as Solvency II (Financial Services Board, 2010a:4).
- The primary focus of SAM, like Solvency II, is the protection of policyholders and beneficiaries (Financial Services Board, 2010a:4).
- The foundation text of SAM will draw heavily on the principles of level 1 Solvency II text (Financial Services Board, 2010a:12). Figure 1 above clearly indicates the points of concurrence between the Solvency II text and the SAM process.
- SAM is built upon the same three pillar structure that is synonymous with Solvency II (Financial Services Board, 2010a:4).

The main differences identified between Solvency II and SAM are as follows:

- Although SAM is based on the Solvency II framework, it will be adjusted for South African circumstances. The aim is, however, for SAM to obtain third country equivalence status (Financial Services Board, 2010a:9).

- Whereas the application of Solvency II will only be compulsory for insurers with a gross premium income of more than €5 million (Buckham *et al.*, 2011:72), SAM will be applied to all insurance firms operated on a commercial basis, including government-owned insurers (Financial Services Board, 2010a:4).

If one looks at the many points of concurrence between the two solvency regimes in comparison with the few differences, it is clear that Solvency II is close to being a blueprint for the development of the SAM framework.

Having determined the points of concurrence, the taxation methods applied to long-term insurers in the UK and the RSA will now be investigated in order to determine whether SAM and Solvency II could possibly have the same effect on the taxation of long-term insurers.

2.4 CONCLUSION

The two solvency regimes, namely Solvency II and SAM, were investigated in this chapter. Following the investigation, a comparison was drawn between the two regimes in order to determine points of concurrence and differences between the two regimes.

The long-term insurance industry in both the UK and the RSA is on the verge of entering a new era with the anticipated implementation of the new solvency regimes. From the comparison drawn, it can be concluded that Solvency II served, and will continue to serve, as a blueprint for the development of the SAM framework. With that said, and with the anticipated implementation date for SAM currently running a mere two years behind that for Solvency II, the RSA should keep a close eye on the progress and developments of Solvency II for it is believed that much can be learned and resolved by observing how Solvency II fares.

It is precisely for this reason that the following chapter will investigate the taxation aspect of long-term insurers in the UK and the RSA, and will again draw a comparison between the two jurisdictions. Should further points of concurrence be found between the taxation of long-term insurers in the UK and the RSA, it would mean that the impact that Solvency

II will have on the taxation of long-term insurers in the UK could possibly be used as a model to demonstrate the impact that SAM will have on the taxation of long-term insurers in the RSA.

CHAPTER 3

THE TAXATION OF LONG-TERM INSURERS

3 THE TAXATION OF LONG-TERM INSURERS

3.1 INTRODUCTION

Chapter 2 investigated the solvency regimes and determined that there are many points of concurrence between the two frameworks, since SAM was developed to share the same broad features as Solvency II (Financial Services Board, 2010a:4). By means of a literature review, this chapter will address the third and fourth objectives of this study, namely the investigation of the methods of taxation applicable to long-term insurers in the RSA and the UK, followed by a comparison of those methods. The object of this is to identify any points of concurrence or dissimilarities in the tax regime applicable to long-term insurers in the RSA as opposed to those in the UK.

The investigation into the taxation of long-term insurers, which is regarded as a fairly complex subject, will provide a broad overview of the operation of the systems and the information provided will be confined to information required in order to understand the changes that will be brought about by the implementation of the solvency frameworks.

3.2 CHALLENGES TO TAXING LONG-TERM INSURERS

Owing to the long-term nature of life policies, which can extend over the indefinite lifetime of individuals, long-term insurers in the RSA and many other jurisdictions across the world are in a league of their own when it comes to taxation.

It is deemed necessary to point out some of the difficulties associated with the taxation of long-term insurers in order to explain why a totally different approach has to be followed when it comes to the taxation of long-term insurers.

Klumpes and Morgan (2008:2) refer to two factors which complicate the determination of profits stemming from the insurance business:

- The first is "… uncertainty as to future cash flows emanating from an insurance contract at the point of sale and subsequently".
- Secondly, there are "… different approaches as to how those cash flows should be incorporated into the entity's financial statements".

Clover (2008:3) indicates that the difficulty of taxing the life insurance industry lies in separately identifying and appropriately taxing each of the following components:

- "the mix of savings return"
- "savings and risk intermediation"
- "risk pooling"

The seminal work of Hartwig (1994:5) also refers to the difficulties in taxing long-term insurers and alludes to eight complicating factors.

3.3 A BASIC OVERVIEW OF THE METHODS OF TAXING LONG-TERM INSURERS IN THE UK AND THE RSA

The taxation of long-term insurers in both the UK and the RSA will now be investigated. More emphasis will, however, be placed on the taxation of long-term insurers in the RSA since the main purpose of this study is to identify the impact of SAM on the taxation of long-term insurers in the RSA.

3.3.1 Current taxation of long-term insurers in the UK

3.3.1.1 *Legislation and overview*

The following acts currently legislate the taxation treatment of long-term insurers in the UK (Financial Services Board, 2012c:23):

- Income and Corporation Taxes Act 1988 (UK legislation)
- Finance Act 1989 (UK legislation)
- Corporation Tax Act 2009 (UK legislation)

On 1 January 2013, the tax landscape of long-term insurers in the UK changed significantly, in an attempt to simplify the extremely complex taxing system, in conjunction with preparations for the implementation of Solvency II (Deloitte, 2012b:9). Chapters 3.3.1.2 and 3.3.1.3 hereafter will briefly describe the taxation of long-term insurers in the UK prior to 1 January 2013, and also the changes that were implemented with effect from 1 January 2013.

3.3.1.2 *Taxation prior to 1 January 2013*

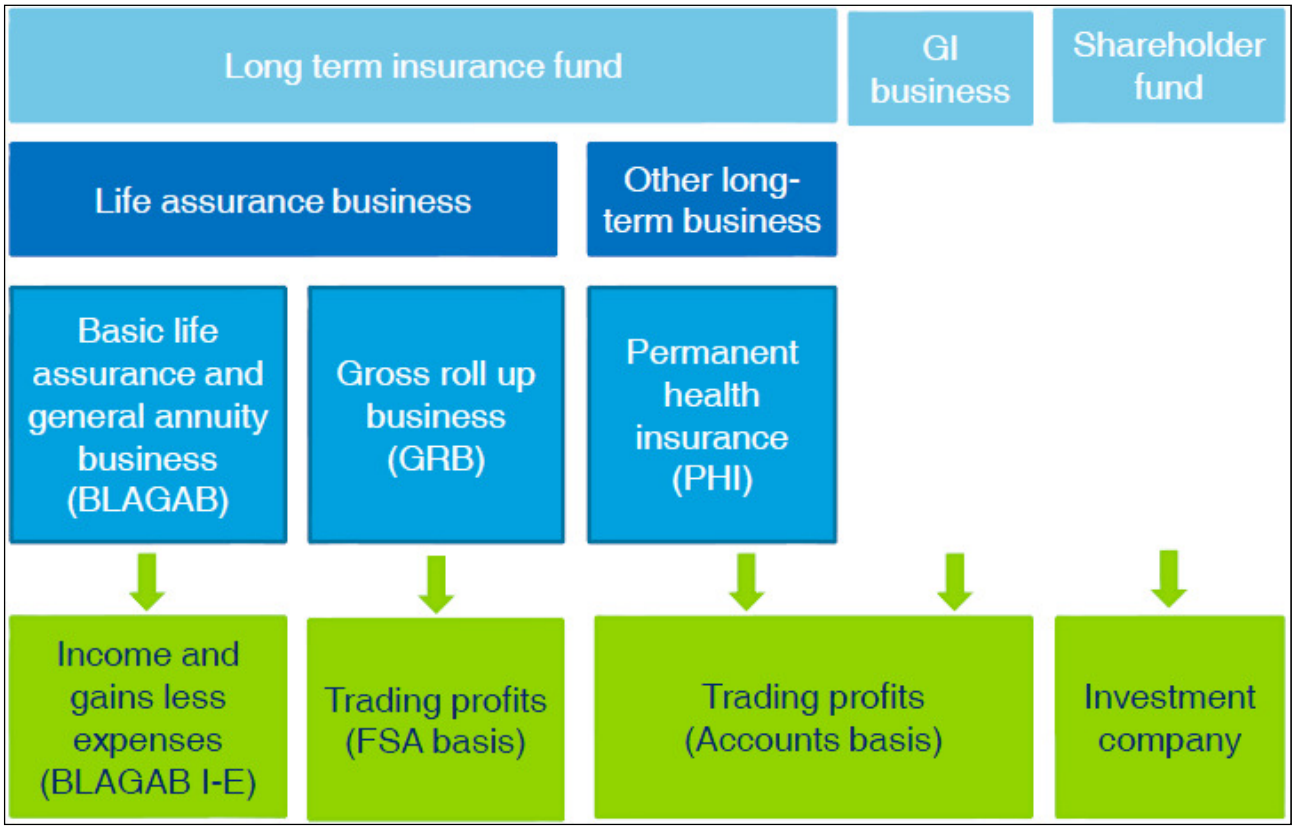
For tax purposes, prior to 1 January 2013, business generated by the long-term insurance industry in the UK was divided into three main categories. The categories were as follows (Her Majesty's Revenue & Customs, 2011:7):

- Basic Life Assurance and General Annuity business (BLAGAB)
- Gross Roll Up business (GRB), incorporating the pension business
- Permanent Health Insurance business (PHI)

As illustrated in figure 3, all business falling within the BLAGAB category was taxed on the basis of the regulatory return required by the Financial Services Authority (FSA), whereas the GRB and PHI were taxed on trade profits. Using the regulatory return, BLAGAB was taxed using what is commonly referred to as the "Income minus Expenses" (I-E) basis of taxation (Her Majesty's Revenue & Customs, 2011:7).

Figure 3 below clearly sets out how a life-insurance company was previously taxed:

Figure 3: The life company – previous regime



Source: Deloitte (2012b:5)

Life insurance companies are viewed as investment vehicles and are therefore taxed on their investment income (Financial Services Board, 2012c:23). The objective of the I-E basis of taxation is to do the following all at once (Deloitte, 2012b:7):

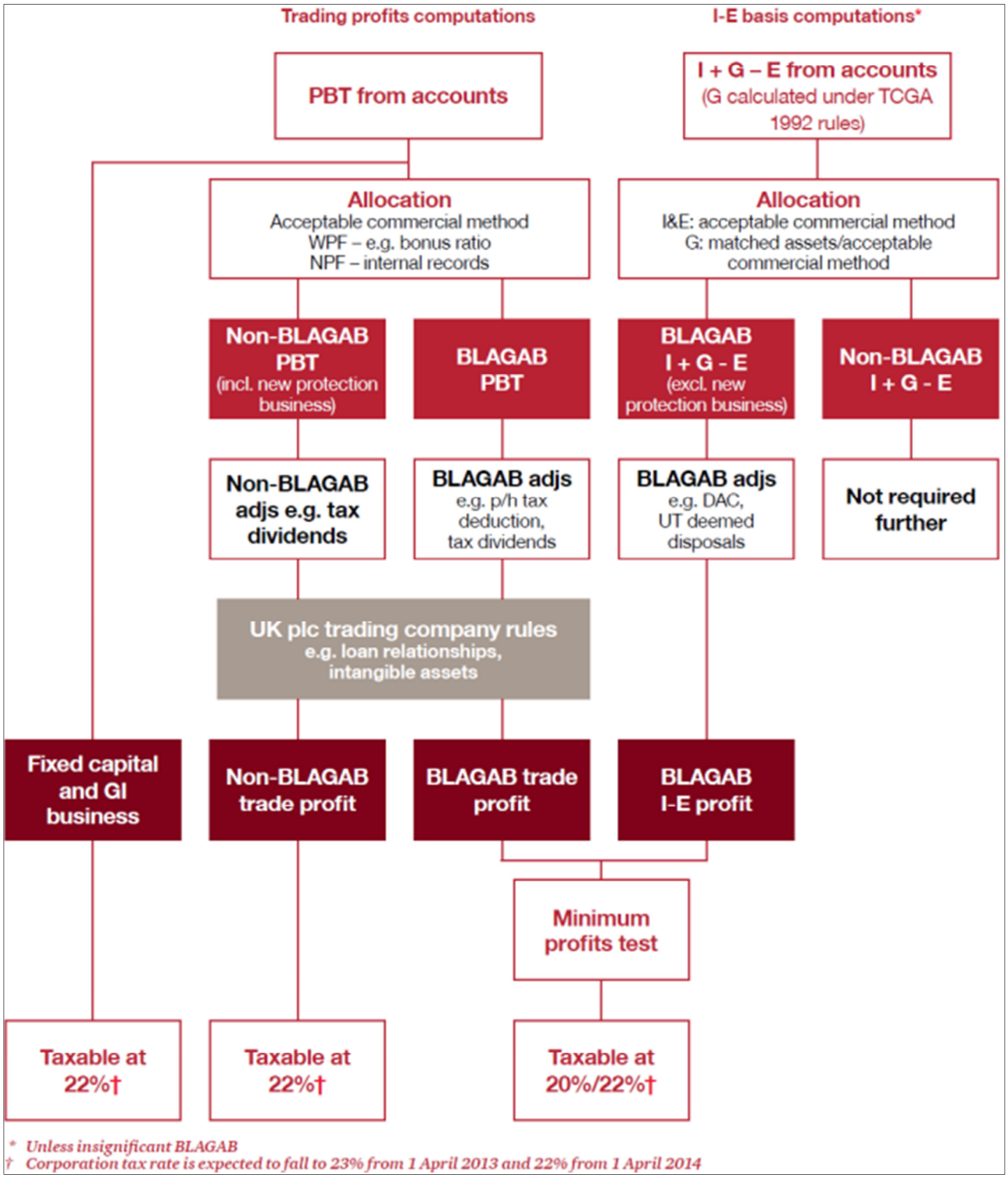
- Tax policyholders on the gains of the policy using the calculation: Claims minus (-) premiums
- Tax companies on the profits they made from selling insurance using the calculation: Premiums plus (+) investment return minus (-) expenses minus (-) claims
- Therefore: Policyholder gains plus (+) company profits equals = Investment return minus (-) expenses

3.3.1.3 *Taxation post 1 January 2013*

In preparation for the implementation of Solvency II, and with the simultaneous object of simplifying the taxation rules applicable to UK long-term insurers, a new tax system was introduced for long-term insurers on 1 January 2013 (Deloitte, 2012b:9).

Whereas the previous tax system made use of the regulatory return as a starting point, the new tax system uses the statutory financial statements, prepared according to UK Generally Accepted Accounting Practice (GAAP), or International Financial Reporting Standards (IFRS), to determine the profit before tax (PBT). This statutory PBT value is then used as the take-off point in calculating the tax (PWC, 2012:2). The operation of the new tax system is illustrated in figure 4 below.

Figure 4: Life tax reform – the new regime



Source: PWC (2012:6)

In an article entitled "The new UK life tax regime – A summary of the corporation tax rules applying from 1 January 2013", reference is made to six main differences in the new tax system as compared with the previous more complex system (Deloitte, 2012a:1):

- Instead of the previous three categories used for tax purposes, there are now only two categories for long-term business – BLAGAB and non-BLAGAB.
- BLAGAB is taxed using the I-E rules, whereas non-BLAGAB is taxed on actual trade profits.
- As a result of the above, a BLAGAB trade profits measure is used for the calculation of policyholder profits and the minimum profits charge.
- "Trade profits measures are based on the financial statements, and all the usual trade profit rules apply to them. However, dividends (including PHI dividends) are taxable, and indexation on index-linked gilts is only available to the extent they back index-linked PHI liabilities. Policyholders' bonuses and movements in FFA/UDS are tax effective. The policyholder tax deduction is now expressly defined in the legislation."
- Acceptable commercial methods can be used to apportion investment return, expenses and trade profits between BLAGAB and non-BLAGAB;
- "There is no longer any separately taxed 'shareholder fund'. Instead there is a new concept of 'long-term business fixed capital'. Grandfathered shareholder fund assets, and share and loans to insurance dependants held otherwise than in a with profit fund form part of long-term business fixed capital. The status of other items is determined on a factual basis."

It is also expected (with much certainty) that the industry will change from using the current IFRS to adopting IFRS4 phase II as soon as it has been endorsed by the EU (Lloyd's, 2012:29).

3.3.2 Current taxation approach applicable to long-term insurers in South Africa

3.3.2.1 *Legislation and overview*

The following acts and directives currently legislate the taxation treatment applicable to long-term insurers in the RSA (Financial Services Board, 2012c:23):

- section 29A of the Income Tax Act;
- the Third Schedule to the Long-term Insurance Act 52 of 1998; and
- various directives and tax directives issued by the FSB

Chapters 3.3.2.2 and 3.3.2.3 below describe the history and method of operation of the South African approach to taxing long-term insurers, commonly known as the four-fund approach. The four-fund approach to taxation is currently being reviewed, and it is anticipated that the entire section 29A of the Income Tax Act may be adjusted simultaneously with the amendment required for the implementation of the SAM framework (South African Revenue Services, 2013). Changes other than that required by the implementation of SAM will, however, not fall within the scope of this study, as stated in chapter 1.5, which listed the limitations of the study.

3.3.2.2 *History of the taxation of long-term insurers in the RSA*

The original legislation enacted for the taxation of long-term insurers in the RSA was the previous section 28 of and Sixth Schedule to the Income Tax Act. In terms of the previous section 28, a formula was used to determine the taxable income of long-term insurers, and this system was based on the trustee principle (Donaldson, 2011:15). The principle was described by the Jacobs Committee as follows: “This principle, in short, entails that life insurers are deemed to be holding and investing funds on behalf of their policy holders, and that they should pay income tax on the income derived therefrom on a similar basis” (Jacobs Committee, 1992:89). The previous Sixth Schedule served to delimit the business areas of deposit-taking institutions and long-terms insurers (Donaldson, 2011:15).

What is commonly known today as the “four-funds approach” came about in consequence of recommendations made by the Jacobs Committee in 1992. The Jacobs Committee was

set up to make recommendations to promote equal competition between funds operating within the South African financial markets. Because of various factors and developments affecting the financial sector, the Jacobs Committee recommended that the previous Sixth Schedule be revoked and that a replacement provision be included in the Income Tax Act (Donaldson, 2011:15).

The majority of recommendations proposed by this committee were enacted and section 29 of the Income Tax Act was promulgated in 1993 to replace the previous section 28 (Clover, 2008:17). The principles which were recommended by the committee are as follows (Jacobs Committee, 1992:89-90):

- "The 'trustee principle' should be adhered to in respect of all income representative of the insurer's constituent body of policyholders and should reflect all relevant aspects of their taxation, including the effective tax rate."
- "All income that an insurer receives and that is not representative of the policyholders (and hence not subject to the 'trustee principle') should be subject to normal corporate tax."
- "Tax neutrality and competitive neutrality between life insurers inter se and between the life-insurance industry and other financial industries must result, as far as possible, from the new system."
- "Tax neutrality must prevail, as far as possible, between different classes of policyholders. In particular, there should be no tax advantages for corporate policyholders. (It is accepted that this principle cannot be fully served as to allow for the various individual tax rates of the individual constituent policyholders of an insurer, and that an average rate must be used in this case.)"

It was further recommended that four separate funds, namely: the untaxed policyholder fund (UPF), the individual policyholder fund (IPF), the company policyholder fund (CPF) and the corporate fund (CF), be established for income tax purposes (Jacobs Committee, 1992:91). The four-funds approach therefore became the mechanism through which the recommended principles were applied, and because of the four required funds, the taxing system became commonly known as the four-funds approach (Donaldson, 2011:17).

In 1999 section 29 was replaced by section 29A after a number of deficiencies in section 29 had been discovered. The four-fund method was, however, retained and continued under section 29A (Donaldson, 2011:25).

With the move towards the residence basis of taxation and the introduction of capital gains tax in 2001, further amendments to section 29A were required (Donaldson, 2011:29). Since 2001, a few insignificant textual changes have been made, but in essence what we know today as the four-funds approach to the taxation of long-term insurers has been in effect since 2001 (Donaldson, 2011:31).

3.3.2.3 *The current four-funds approach explained*

Donaldson (2011:9) describes the trustee principle on which the four-funds approach is based and the result thereof as "… the life insurer holds and administers assets on behalf of its policyholders with excess assets representing the shareholder's interest. The result of the trustee principle is that the income derived on policyholder assets is taxed in the life company rather than in the hands of all the policyholders."

Therefore, since the insurer acts as trustee over the policyholders' assets, the policyholders' income is taxed in the hands of the insurer, and any benefits paid to the policyholders are paid out after tax, with no tax consequences in the hands of the policyholder. In other words the long-term insurer is taxed as a proxy for the policyholders, and this casts light on the rationale behind the establishment of the four different funds, which was done in order to distinguish between profits of the shareholders of the insurer on one hand, and the three different classes of policyholders, namely: individuals, companies and tax-exempt persons on the other (Donaldson, 2011:9). It should be noted that investment and savings policies are treated in the same way as risk policies (Financial Services Board, 2012c:23). Each of the four funds is then taxed at what is considered to be the appropriate tax rate for that specific class of taxpayers (Donaldson, 2011:10).

The operation and method of taxation of the each of the three policyholder funds, which are established solely for tax purposes, will now be investigated in further detail.

The untaxed policyholder fund (UPF)

Section 29A(4)(a) of the Income Tax Act (58/1962) governs this fund and, *inter alia,* states that:

- The fund should contain assets with a market value equal to the value of liabilities.
- The above should be calculated relative to: policies owned by pension funds, pension preservation funds, provident funds, provident preservation funds, retirement annuity funds or benefit funds, as well as policies owned by persons who are exempt from tax.

The fund is exempt from tax (Donaldson, 2011:103).

The individual policyholder fund (IPF)

Section 29A(4)(b) of the Income Tax Act (58/1962) governs this fund and states, *inter alia,* that:

- The fund should contain assets with a market value equal to the value of its liabilities.
- The above should be calculated relative to policies owned by individuals or any person who is not a company.

The fund is taxed at a rate of 30%, which is considered to be the average tax rate applicable to individuals (Donaldson, 2011:10). The tax rate of 30% is applied consistently to all life insurance products with the exception of annuities, which are taxed in the hands of the individual taxpayer (Donaldson, 2011:99).

The company policyholder fund (CPF)

- Section 29A(4)(c) of the Income Tax Act (58/1962) governs this fund and states, *inter alia,* that:
- The fund should contain assets with a market value equal to the value of its liabilities.
- The above should be calculated relative to policies owned by companies.

The fund is taxed at a rate of 28%, which is the current tax rate applicable to companies (Donaldson, 2011:103).

Section 29A(7) of the Income Tax Act (58/1962) requires that long-term insurers recalculate the value of liabilities applicable to all three of the policyholder funds within a

period of four months after the end of their year of assessment. The value of liabilities should be calculated to ensure that each fund contains assets equal to the value of liabilities. It is therefore also important to note how the market value of assets should be determined.

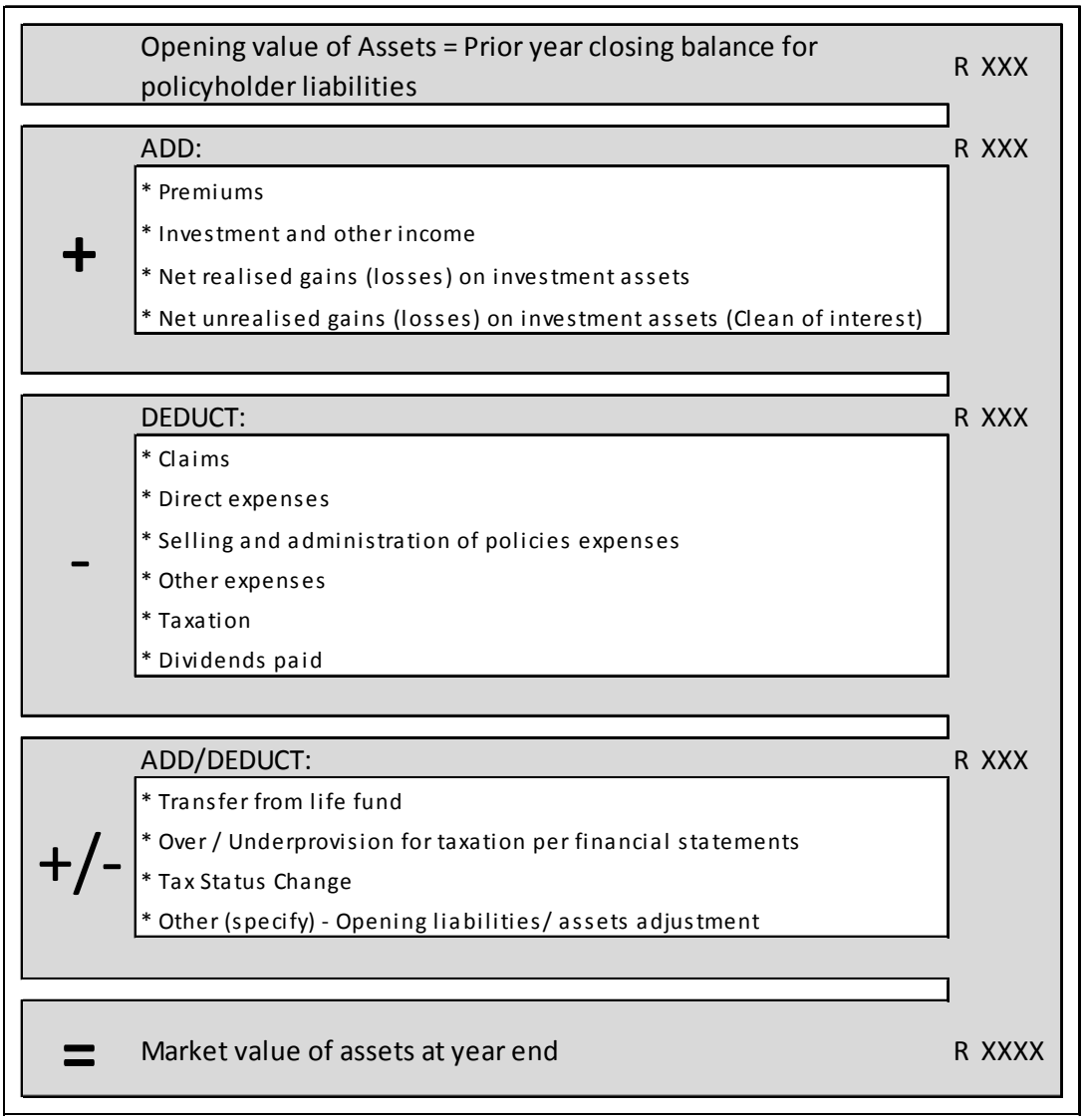
Determining the market value of assets

The Standard of Actuarial Practice (SAP) 104 states: "The valuation of assets for tax purposes must correspond to the valuation of assets in the annual published financial statements" (Actuarial Society of South Africa, 2012:30).

With reference to "Form 1" of the IT14L income tax return spreadsheet, the market value of assets is determined by a calculation illustrated in figure 5, where income statement amounts are adjusted, and selected balance sheet items taken into account in order to determine the growth. The adjusted total is then split between the four funds, in other words, each fund then has its own calculation of the value of assets and the total for the four funds adds up to the income statement total (South African Revenue Services, Not dated.).

The calculation of the market value of assets applies to each of the four tax funds and is depicted in figure 5 below:

Figure 5: Calculation of market value of assets



Source: Adapted from IT14L (South African Revenue Services, Not dated.)

Determining the value of liabilities

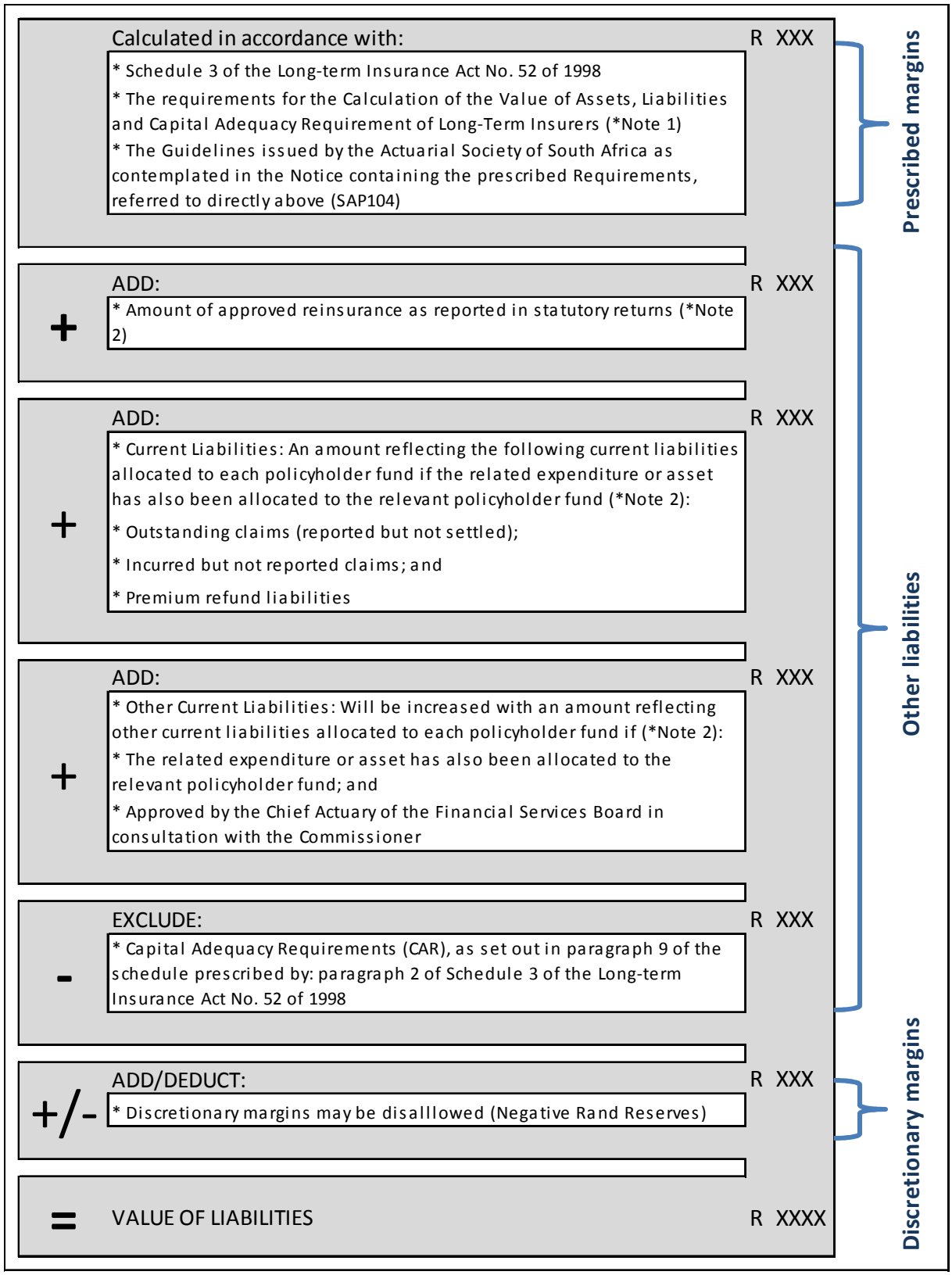
The value of liabilities, which is an actuarial calculation, is described by Barlow and Donaldson (2011:9) as being "… a reserve for future claims and profits to be recognised by the life insurer over the remaining term of the policies it has written to date".

Particulars of how the value of liabilities should be calculated are not provided in section 29A of the Income Tax Act (58/1962), but the act states, *inter alia,* that the value of liabilities should be calculated "… on the basis as shall be determined by the Chief Actuary of the Financial Services Board in consultation with the Commissioner". The basis, also

referred to as a set of assumptions, that should currently be used in calculating the value of liabilities is a regulatory basis referred to as the statutory valuation method (SVM), prescribed by the FSB tax directive referenced “LT Tax”, effective from 9 December 2011 (Financial Services Board, 2011:1). Figure 6 illustrates the calculation of the value of liabilities. Mainly because of the different treatment of discretionary margins, the SVM basis is not equal to the IFRS basis for all insurers (Financial Services Board, 2013d:95).

The calculation of the value of liabilities, which is also applied to each of the four tax funds, is depicted in figure 6 below:

Figure 6: Calculation of the value of liabilities for tax purposes



Note 1	As perscribed by the Registrar of Long-term insurance under paragraph 2 of Schedule 3 of the Long-term Insurance Act No. 52 of 1998 (the "Requirements"). The applicable schedule was announced by board notice 14 of 2010 and published in the Government Gazette on 5 February 2010
Note 2	The current liabilities referred to above can only be included to the extent that they are not already included in the value of policyholder liabilities

Source: Adapted from FSB LTax Directive (Financial Services Board, 2011b:1)

Once the market value of the policyholder assets and the value of policyholder liabilities have been calculated as at year end, for each of the policyholder funds, the amount equalling assets minus liabilities is identified as the underwriting profits. The underwriting profits represent profits generated by the shareholders in conducting the insurance business. The underwriting profits calculated for each of the shareholder funds should then be transferred to the corporate fund in terms of section 29A(7)(a) of the Income Tax Act (58/1962). A hypothetical calculation of underwriting profits is illustrated in figure 7.

If there is no excess of assets but a shortfall instead, then the required amount of assets should be transferred from the corporate fund to the policyholder fund in terms of section 29A(7)(b) of the Income Tax Act (58/1962).

The corporate fund (CF)

Section 29A(4)(d) of the Income Tax Act (58/1962) governs this fund and states, *inter alia,* that the fund should contain all other assets and liabilities of the insurer excluding those held by the policyholder funds

The above should be calculated relative to profits of the shareholders and profits in this fund are not subject to the trustee principle (Donaldson, 2011:100). The fund is subsequently taxed at a rate of 28%, which is the current tax rate applicable to companies (Donaldson, 2011:103). This calculation of taxable income and the taxation thereof, which takes place in the shareholder fund, is illustrated by figure 7 using hypothetical amounts.

From the above paragraphs, which describe the fund build-up mechanism, the calculation of profits in the policyholder funds, and the calculation of shareholder profits, it is clear that both policyholders and shareholders are taxed in the respective funds.

Barlow and Donaldson (2011:9) confirm the above explanations by stating that there are two sources from which tax is generated in the funds:

- "The Excess of investment income (and non-insurance income allocated to the corporate fund) over qualifying expenditure."
- "Profit transfers generated from the policyholder funds and taxed in the corporate fund."

Figure 7 below depicts the taxing of long-term insurers in a simplified manner using hypothetical amounts. The figure depicts the calculation of underwriting profits and the calculation of income tax payable in the policyholder funds as well as the corporate fund:

Figure 7: Taxation of long-term insurers

	Policyholder funds (IPF, CPF)	
Calculation of fund build-up:		**Current**
	Marke value of assets	20,000.00
-	Value of liabilities	- 15,000.00
=	Underwriting profit/loss	5,000.00

	Policyholder funds (IPF, CPF)	
Calculation of tax payable:		**Current**
	Income	17,000.00
-	Expenses	- 4,000.00
-	Allowable transfer amount (30% *)	- 1,500.00
=	Taxable income	11,500.00
x	Tax rate (IPF @ 30%) (CPF @ 28%)	28%
=	Tax payable	3,220.00

	Corporate fund (CF)	
Calculation of tax payable:		**Current**
+	Income	7,000.00
-	Expenses	- 3,000.00
+	Transfers from policyholder funds	5,000.00
=	Taxable income	9,000.00
x	Tax rate (CF @ 28%)	28%
=	Tax payable	2,520.00

* 30% of total transfer with an apportionment ratio of 100% used for this example

Capital gains or losses are not take into account for purposes of this example

Source: Adapted from IT14L (South African Revenue Services, Not dated.)

3.3.3 Comparison between the taxation of long-term insurers in the United Kingdom and South Africa

The taxation of long-term insurers in the UK and the RSA was investigated in chapters 3.3.1 and 3.3.2 above. This chapter seeks to draw a comparison between the taxation of long-term insurers in the UK and those in the RSA, but if the taxation of long-term insurers in both jurisdictions is examined in conjunction, it is clear that the method of taxing long-term insurers in the UK is totally different from the four-funds approach followed in the RSA. Two main differences, which make it inappropriate to compare the taxation of long-term insurers in the UK and the RSA, are described below:

- Prior to 2013, the business of a UK long-term insurer was divided into three main categories (BLAGAB, GRB, and PHI), and from 1 January 2013, it was divided into two categories (Non-BLAGAB and BLAGAB) (Deloitte, 2012a:1). The business of RSA long-term insurers is divided on a totally different basis into four tax funds, namely UPF, IPF CPF and CF (section 29A(4) of the 1962 Income Tax Act).
- In the UK, prior to 2013, all business falling within the BLAGAB category was taxed on the basis of the regulatory return required by the FSA, whereas the GRB and PHI were taxed on trade profits (Her Majesty's Revenue & Customs, 2011:7). Since 1 January 2013, the UK no longer makes use of the regulatory return, but instead uses the statutory financial statements prepared according to UK GAAP or IFRS in order to determine the PBT (PWC, 2012:2). In the RSA, the value of liabilities is currently determined by making use of a regulatory basis, whereas the market value of assets is calculated using the statutory income statement or IFRS accounts as a starting point (Financial Services Board, 2011b:1). To a limited extent the outdated UK approach in which the statutory return was used as the starting point for tax calculations can be compared to the current value of liabilities calculation applied in SA. However, the basis for these calculations was never the same, and thus they cannot be compared.

Although two totally different methods are applied to the taxation of long-term insurers in the UK and the RSA, the RSA could possibly benefit from taking note of the following actions taken by the UK, as identified in paragraph 3.3.1 above:

- Where changes to tax legislation were required in order to prepare the long-term insurers for the implementation of Solvency II, legislators took this opportunity to simplify the UK tax legislation (Deloitte, 2012b:9). The RSA, currently reviewing the four-funds method of taxation, could similarly amend tax legislation concurrently with introducing the changes required for the implementation of SAM.
- Changes to the UK tax legislation were implemented well in advance of the implementation of the Solvency II regime (Deloitte, 2012b:9). Solvency II is expected to be implemented with effect from 1 January 2014, whereas the tax legislation applicable to long-term insurers in the UK was amended with effect from 1 January 2013 (Deloitte, 2012b:9). If the RSA follows the same proactive approach, tax legislation should be amended with effect from 1 January 2015 with a view to the current expected implementation date for SAM.
- The UK moved away from the regulatory FSA return as starting point, towards the use of UK GAAP or the current IFRS, to prepare the industry for the implementation of IFRS4 phase II, which will, once implemented, also be suitable for use as a tax basis (PWC, 2012:2). The change-over from a regulatory return to local GAAP or current IFRS could also help to prepare the South African long-term insurance industry for the implementation of IFRS4 phase II.

3.4 CONCLUSION

The taxation of long-term insurers in the UK and the RSA was investigated in this chapter. An attempt was made to draw a comparison between the taxation of long-term insurers in the respective jurisdictions in paragraph 3.3.3. Although no comparison could be drawn, certain actions taken by the UK in preparing the industry for the implementation of Solvency II were pointed out. These actions set an example which the RSA could apply in a similar way to its own circumstances, in order to prepare the industry for the implementation of SAM.

This investigation of the current taxation of long-term insurers in the RSA has prepared the ground for understanding the taxation impact of SAM on the taxation of long-term insurers in the RSA, a topic which will be covered in the next chapter.

CHAPTER 4

THE TAXATION IMPACT OF SAM

4 THE TAXATION IMPACT OF SAM

4.1 INTRODUCTION

Having investigated and compared the two solvency regimes and the taxation of long-term insurers in the UK and the RSA in chapter 2 and 3, this chapter will address the two remaining research objectives. Focusing on the RSA only, this chapter will firstly investigate the impact of SAM on the taxation of long-term insurers in the RSA. The options for resolving the SAM tax challenge will then be identified.

In view of the extremely dynamic nature of this study, and a lack of available literature specifically related to the taxation aspect of SAM and the options for addressing the SAM tax problem, the literature review for this chapter is supplemented with information obtained directly from three unstructured interviews (also referred to as informant interviews) conducted by the researcher. On 16 May 2013 the researcher interviewed Mr Marthinus Hamman, Head of Department: Actuarial Insurance and Chairman of the Tax Task Committee at the FSB (Hamman, 2013). Mr Johan de la Rey, Specialist: Corporate Income Tax, Department: Legislative Research and Development at the South African Revenue Services (SARS) was interviewed on 8 August 2013 (De la Rey, 2013) and Mr Neill Bester, an independent consultant was interviewed on 20 August 2013 (Bester, 2013).

4.2 AN INVESTIGATION INTO THE TAXATION IMPACT OF SAM

Since SAM is only expected to be implemented on 1 January 2016, there is much uncertainty as to what the tax landscape of long-term insurers will look like by the time the implementation date is reached. This uncertainty is partly due to the fact that the appropriateness of the four-funds approach to taxing long-term insurers is in the process of being investigated. The Minister of Finance has recently appointed a Tax Review Committee, chaired by Judge Dennis Davis, to specifically investigate (amongst other

things) the four-funds approach applicable to long-term insurers (South African Revenue Services, 2013).

During the 2013 Budget Review it was mentioned that risk policies should be taxed in the corporate fund instead of being taxed in the three policyholder funds (Department of National Treasury, 2013:55). It is therefore expected that a number of changes to the tax legislation applicable to long-term insurers could arise simultaneously with the implementation of SAM.

According to Barlow and Donaldson (2011:9), SAM will change the current valuation of what is generally referred to as “policyholder liability”. This change in valuation could have a major impact on the taxation of long-term insurers in the RSA, since it is the valuation basis that determines the emergence of profit. Barlow and Donaldson’s view was confirmed by Hamman (2013) and De La Rey (2013), as well as by the technical specifications provided in the second South African quantitative impact study, (SAQIS) (Financial Services Board, 2012a:95), and third SAQIS (Financial Services Board, 2013d,95) conducted by the FSB.

The FSB’s Draft Technical Specifications document for the second SAQIS states: “The ‘value of liabilities’ as defined in section 29A was identified as the critical item that needs clarification for the implementation of SAM. Currently, the value of liabilities is calculated on the regulatory basis (Statutory Valuation Method), which for a number of insurers is equal to the International Financial Reporting Standards (IFRS) basis (if gross policy liabilities are reduced by Deferred Acquisition Cost (DAC) and the reinsurance asset)” (Financial Services Board, 2012a:95).

As explained in paragraph 2.4.2 of this document, a policyholder fund should contain assets equal to policyholder liabilities and any surplus of assets is then transferred from the policyholder funds to the corporate fund and then taxed as profit in the corporate fund.

Should the four-funds method of taxation as per the current section 29A remain unaltered, the market value of assets will continue to be determined using the annual financial statements as a starting point. In valuing the policyholder liabilities, section 29A of the

Income Tax Act (58/1962) states that the regulatory basis should be used to determine the value of liabilities. With the implementation of SAM, the current SVM basis will then be replaced by the SAM basis of valuing liabilities, which is a “best estimate” basis (Hamman, 2013).

The term “best estimate” is defined as: “… equal to the probability-weighted average of future cash flows, taking into account the time value of money” (Financial Services Board, 2010a:18).

With the current practice of using the SVM to value the liabilities, the best estimate basis is adjusted by adding margins. The long-term insurers are required to add prescribed margins and according to the discretion of the actuary, discretionary margins may also be added to the best estimate basis (Actuarial Society of South Africa, 2012:6). Any margins added to the best estimate basis increase the value of liabilities. The margins also help to spread the profit over the lifetime of the policy (Financial Services Board, 2013d:96).

For certain policies, the value of policyholder liabilities may be determined as a negative liability. De la Rey (2013) explained that for each policy the insurer has a liability to pay the insured policyholder if a certain event, such as sickness or death, were to happen in the future. When the present, discounted value of all expected future cash flows is taken into account, for certain policies, it may possibly not equate to a liability for the insurer, but a negative liability, which is the equivalent of an intangible asset. The insurer would then recognise future profits of a policy at the first financial year-end following the inception of the policy. Current SVM practice allows insurers the option of zeroising the negative liabilities, which they refer to as negative Rand reserves (NRRs). In the event of the NRRs being zeroised, this creates a discretionary margin (Barlow & Donaldson, 2011:10).

The SAM framework will move towards a best estimate basis of valuation with added risk margins (Financial Services Board, 2010a:16). The use of discretionary margins is expected to fall away under SAM and as a result, the zeroisation of NRRs will no longer take place (Barlow & Donaldson, 2011:10). By no longer zeroising the NRRs, these NRRs equating intangible assets will then decrease the value of liabilities significantly, and result

in a large amount of assets being transferred as underwriting profit. The increased underwriting profit will increase the taxable income of the corporate fund, resulting in an increase in the tax payable (Hamman, 2013). This increase in underwriting profit will take place at the point of transitioning from the current SVM to the SAM framework. Profit which would otherwise have been recognised in future years will then be released in year one of implementing SAM as illustrated in figure 8.

The chain reaction explained above is illustrated in the following figure, using hypothetical amounts.

Figure 8: Tax effect of SAM at the point of transition

Policyholder funds (IPF, CPF)				
Calculation of fund build-up:	**Current**	**SAM**		**Difference**
Marke value of assets	20,000	20,000		-
- Value of liabilities	- 16,000	- 8,000	↓	8,000
Best estimate	- 13,000	- 13,000		-
Prescribed margins (Current)	- 2,000			-
Risk margins (SAM)		- 2,000		
Discretionary margin: (Optional) Zeroisation of negative rand reserves (Current)	-		↓	8,000
Negative rand reserves (SAM)		8,000		
Other non-technical liabilities	- 1,000	- 1,000		-
= Underwriting profit/loss	4,000	12,000	↑	8,000

Technical provisions

Policyholder funds (IPF, CPF)				
Calculation of tax payable:	**Current**	**SAM**		**Difference**
Income	17,000	17,000		-
- Expenses	- 4,000	- 4,000		-
- Allowable transfer amount (30% *)	- 1,200	- 3,600	↑	- 2,400
= Taxable income	11,800	9,400	↑	- 2,400
x Tax rate (IPF - 30%) (CPF -28%)	28%	28%		28%
= Tax payable	3,304	2,632	↓	- 672

Corporate fund (CF)				
Calculation of tax payable:	**Current**	**SAM**		**Difference**
+ Income	7,000	7,000		-
- Expenses	- 3,000	- 3,000		-
+ Transfers from policyholder funds	4,000	12,000	↑	8,000
= Taxable income	8,000	16,000	↑	8,000
x Tax rate (CF -28%)	28%	28%		28%
= Tax payable	2,240	4,480	↑	2,240

* 30% of total transfer with an apportionment ratio of 100% used for this example
Capital gains or losses are not taken into account for purposes of this example

It is clear from the above explanation that the SAM framework will provide a completely inappropriate answer for tax purposes. Hamman (2013) stated that SAM was never intended for use as a tax base, or for profit recognition.

This view is evident from the results of the first SAQIS, which report that when the statutory basis was used for tax purposes, there was an increase in deferred tax liability to the value of approximately R20 billion. The increase was a result of the removal of margins, causing a big release in technical provisions (Financial Services Board, 2011a:11).

Oliver (2004:19) states the following: “Regulatory rules are concerned with the overall solvency of financial entities and the financial sector. In contrast, the objective of income tax rules is to measure the annual income of financial entities accurately.” This statement by Oliver (2004:19) bears out the opinion expressed by Hamman (2013), namely that SAM was never intended to be used as a tax base, which explains the alarming increase in deferred tax liability as reported in the results of the first SAQIS (Financial Services Board, 2011a:26).

If there are no changes to current directives or legislation, the implementation of SAM could possibly have far-reaching consequences for long-term insurers’ cash flow, solvency and possibly even on the cost of premiums of policyholders.

4.3 OPTIONS FOR RESOLVING THE SAM TAX CHALLENGE

Various committees have been formed in order to address the different aspects of the SAM project. To investigate the taxation aspect of SAM, a SAM Tax Task Group was formed. Regular meetings are held and the FSB, National Treasury, SARS and other industry stakeholders are involved (Financial Services Board, 2010a:12).

Facing much uncertainty with regard to the four-funds approach and the findings of the Davis committee, the FSB’s SAM tax task group will be moving ahead with preparations for the implementation of SAM based on the premise that the current four-funds approach will continue under SAM (Financial Services Board, 2013d:95).

At the end of July 2013 the Economic Impact Study Task Group, which was established by the FSB SAM Steering Committee, released an economic impact study in which all

insurers (other than those who are not taking on new insurance business) are obliged to participate (Financial Services Board, 2013a:1). One of the questions listed in the chapter on taxation requests insurers to indicate which basis they believe to be appropriate for corporate income tax. Participants can indicate this as one of the following (Financial Services Board, 2013b:O_Tax):

- SAM;
- adjusted IFRS;
- current basis; or
- other (If they select this option, insurers are requested to provide further details).

According to De la Rey (2013), the options which are being investigated for possible use as an appropriate basis for the valuation of liabilities have not been finalised. As part of the SAM project, possibilities and options will be investigated in an attempt to arrive at a more reasonable answer that will fit in with the current tax system, irrespective of the findings of the Davis committee.

Two main options can, however, be identified at this stage, namely either an IFRS-adjusted basis or a SAM-adjusted basis (De la Rey, 2013). Each of the two main options will now be further discussed.

4.3.1 IFRS-adjusted basis

The majority of countries implementing Solvency II use their local GAAP as a starting point for tax calculations of long-term insurance profits, and are in the process of transitioning to IFRS (Financial Services Board, 2012c:5). The RSA's IFRS will also transition to IFRS 4 phase II, but the time frame for implementing IFRS 4 phase II is unclear and this phase is only expected to come into effect by 2017 or 2018 (De la Rey, 2013). According to De la Rey (2013), the IFRS-adjusted option is therefore to be approached with caution because a decision to make use of an IFRS-adjusted option for calculating the value of liabilities would mean that this entire approach would have to be amended in future, once IFRS 4 phase II comes into effect.

According to De la Rey (2013), another problem with the option of making use of an IFRS-adjusted basis is that there is currently no uniformity amongst insurers. The current IFRS does not require all insurers to disclose negative Rand reserves (NRR), because the current IFRS includes options and insurers may exercise discretion. Some insurers take negative Rand reserves into account, others do not. There are indications, however, that IFRS4 phase II will eliminate more or less all discretion (Financial Services Board, 2013d:96).

The technical specifications of SAQIS2 required participating insurers to use the current IFRS basis for tax purposes (Financial Services Board, 2012a:96). The results of SAQIS2 showed that the only problem identified by insurers in relation to assets and liabilities was the technical provisions (Financial Services Board, 2013c:26).

According to the draft technical specifications of SAQIS 3, members of the SAM tax working group 1 (TWG 1) indicated a preference for using an IFRS (probably an IFRS-adjusted) basis for taxation as opposed to a SAM basis. The reasons provided in support of the IFRS preference can be summarised as follows (Financial Services Board, 2013d:95-96):

- SAM's primary objective is that of policyholder protection and it is not intended to be a basis for profit recognition.
- SAM only applies to the balance sheet of the insurer.
- Using the SAM basis may result in substantial transitional transfer, having an impact on capital adequacy, cash flow, permanent tax differences and tax losses.
- The SAM basis will release the majority of margins up front and thereby recognise profits or losses on day one (the first year), instead of over the lifetime of the policy. The SAM basis is therefore more volatile than the IFRS basis. Both the current IFRS and the draft IFRS 4 phase II allow for certain margins, which has the effect of recognising profit more evenly over the life of the policy.
- There are indications that most of the discretion that can be exercised under the current IFRS will be removed with the implementation of IFRS 4 phase II.
- It would be more appropriate to use the IFRS profit, as reported to shareholders of the insurer, as a basis for tax.

- The SAM TWG 2 investigated the taxation of insurers in jurisdictions comparable to the RSA and found that the majority of the jurisdictions have an alignment between the taxation of shareholder profits and accounting profits. Also, all of these jurisdictions will probably implement IFRS 4 phase II and are currently running IFRS or they are in the process of transitioning from their local GAAP to the current IFRS.

According to Hamman (2013), the use of an IFRS-adjusted base could be favoured from a compliance point of view in the sense that the an audited figure would be used as a starting point for calculations, whereas the figures currently used for tax calculation purposes are not audited but merely signed off by the public officer.

4.3.2 SAM-adjusted basis

The use of the SAM basis without adjustments clearly provides an inappropriate answer for tax purposes, as proven by the R20 billion increase in deferred tax liability reported (Financial Services Board, 2011a:26). According to De la Rey (2013), a SAM-adjusted base could possibly provide a more reasonable and realistic answer. An option would be to use the SAM base as a starting point and, similar to what they did with the tax of short-term insurers, make adjustments in order to get to a tax figure for the value of liabilities.

De la Rey (2013) was asked whether temporary relief measures would be implemented if needed, in order to smooth out any substantial increase in underwriting profit recognised, but replied that the aim would rather be to find a basis that can be used for tax purposes, which will **not** yield a substantial increase in underwriting profit.

If one looks at the reasons listed in support of an IFRS-adjusted basis, as given in paragraph 4.3.3 above, as well as SAQIS 3, it may be expected that a slightly adjusted IFRS basis may apply in future (Financial Services Board, 2013d:95-96). It seems as if the SAM-adjusted option may not end up being the chosen option to resolve the SAM tax challenge. It remains to be seen, however, what the end result will be.

4.3.4 Options for the method of amendment

As stated in 2.4.2, the definition of “value of liabilities” as given in section 29A of the Income Tax Act (58/1962) refers to a basis determined by the Chief Actuary of the FSB in consultation with the Commissioner of SARS.

In order to change the base that should be used for calculating the value of liabilities, one of two processes can be followed, namely either to change the directive issued by the Chief Actuary of the FSB in consultation with the Commissioner of SARS, or alternatively to amend the definition of “value of liabilities” as found in section 29A of the Income Tax Act (De la Rey, 2013).

The process that would need to be followed to amend the definition of “value of liabilities” would involve a parliamentary process. The parliamentary process would be a more transparent way of making an amendment since the concept would first be open for comment by all stakeholders. The result of the amendment to the definition of “value of liabilities” will become legislation if the process is followed through (De la Rey, 2013).

On the other hand, the directive issued by the Chief Actuary of the FSB in consultation with the Commissioner of SARS could be amended. This process would not be as transparent since the matter would be dealt with by the two parties, namely the FSB and SARS, and other interested parties would not be involved (De la Rey, 2013).

There are not currently any certainties as to which route will be followed once a decision has been taken regarding the treatment of the value of liabilities and according to De la Rey (2013) no amendments are expected before 2015.

4.4 CONCLUSION

This chapter investigated the impact of SAM on the taxation of long-term insurers and speculatively identified the income tax changes that could be brought about by the anticipated implementation of the SAM regime.

A critical concern is the basis to be used in determining the “value of liabilities”, as SAM will change the current valuation of liabilities, and have a major impact on taxation (Financial Services Board, 2013d:95). With the implementation of SAM moving towards a best estimate basis, all discretionary margins are expected to fall away and NRRs will not be zeroised. This will cause the value of liabilities to decrease and the underwriting profit to increase at the point of transitioning from the current SVM to the SAM basis (Barlow & Donaldson, 2011:10). The underwriting profit transferred and partially deducted in the policyholder funds will slightly decrease the profit of the applicable policyholder fund. On the other hand, the underwriting profit transferred to the corporate fund will cause an enormous increase in taxable income and tax payable in the corporate fund (Hamman, 2013).

The two main options that have been identified to resolve the matter are to make use of a slightly adjusted IFRS basis or alternatively an adjusted SAM basis for calculating the value of liabilities (De la Rey, 2013). At this stage it seems as if the IFRS-adjusted basis is more likely to be used in future; it is favoured among members of the FSB tax working group 1 (Financial Services Board, 2013d:95). Options for a method of amending current legislation or directives to resolve the SAM tax challenge are also identified. There is, however, no certainty at this stage and no changes are expected before 2015 (De la Rey, 2013).

CHAPTER 5

CONCLUSION

5 CONCLUSION

5.1 INTRODUCTION

The main purpose of this study was to identify the impact of SAM on the taxation of long-term insurers in the RSA. In conclusion, this chapter will provide a summary of findings in relation to the six research objectives listed in paragraph 1.4. Recommendations for further research will also be provided.

5.2 SUMMARY OF FINDINGS AND ANSWER TO RESEARCH OBJECTIVES

The insurance industry in the UK and the RSA is readying itself for what could almost be described as a revolution heading its way. It is anticipated that the UK will be implementing its newly developed risk-based solvency regime called “Solvency II” on 1 January 2014 (O’Brien, 2013). The RSA is close behind and has apparently used Sovency II as a blueprint for the development of its own risk-based solvency regime known as “SAM”. SAM, while it has been adjusted for the RSA’s unique circumstances, shares the same broad features with the European Solvency II, and it is currently expected that SAM will be implemented on 1 January 2016 (Van Deventer, 2013).

A comparison between Solvency II and SAM reveals many points of concurrence. As mentioned above, SAM shares the same broad features, and was developed on the basis of Solvency II. In addition, both regimes are aimed at the protection of policyholders and beneficiaries (Financial Services Board, 2010a:4). SAM’s foundation text will also be closely based on the principles of the level 1 Solvency II text. The three pillar structure illustrated in figure 2 is also found in both regimes (Financial Services Board, 2010a:6).

In preparation for the implementation of Solvency II, the tax system applicable to long-term insurers in the UK has already been amended with effect from 1 January 2013. Six main differences distinguish the new tax system from the old one (Deloitte, 2012a:1). In

contrast, the RSA applies a four-fund approach to taxing long-term insurers. Whereas there are many similarities between the new solvency regimes to be implemented in the UK and the RSA, the opposite is true when it comes to the taxation of long-term insurers in the UK and the RSA. However, although the UK follows a completely different approach to taxing long-term insurers, the RSA can learn from certain actions taken by the UK in relation to the taxation of long-term insurers when preparing for the implementation of Solvency II.

The implementation of SAM will affect the current valuation of what is generally referred to as “policyholder liability” (Financial Services Board, 2013d:95). The current SVM basis will be replaced by a best estimate basis and all discretionary margins are expected to fall away. This will cause a major decrease in the value of liabilities and in effect a major increase in underwriting profits (Hamman, 2013). Should no amendments be made to the current definition of “value of liabilities” in section 29A of the Income Tax Act, or to the current directives guiding the SVM, used as the current basis to determine the value of liabilities, the implementation of SAM will have a major impact on the taxation of long-term insurers in the RSA.

In preparing for the implementation of SAM, quantitative impact studies are being conducted, and options for a new valuation basis to be used in determining the value of liabilities for tax purposes are being investigated and tested. At this stage, two main options are on the table, namely either an IFRS-adjusted basis or a SAM-adjusted basis. Once a suitable basis has been identified to replace the current SVM for valuing policyholder liabilities, either the change could be legislated through the parliamentary process of amending the current definition of “value of liabilities” as found in section 29A, or alternatively the tax directive could be amended (De la Rey, 2013).

5.4 CONCLUSIONS

Benjamin Franklin (1996:152) said: “In this world nothing is certain but death and taxes”. Especially with regard to SA’s long-term insurance industry, this familiar quotation has again proved to be true.

It is evident that there is much uncertainty as to what the tax landscape of long-term insurers will look like by the time SAM is implemented. Although all planning is being based on the premise that the current four-fund approach will continue under SAM, the eventual outcome of the Davis committee’s investigation could result in a totally different situation (Financial Services Board, 2013d:95).

This dynamic study was characterised by constant change. New information on the topic of Solvency II and SAM became available on an almost daily basis, and will continue to do so. Amidst the challenges and uncertainties, this study was, however, successful in achieving its main purpose of identifying the impact of SAM on the taxation of long-term insurers in the RSA.

5.5 RECOMMENDATIONS FOR FUTURE RESEARCH

This study identifies options for resolving the SAM tax challenge, as making use of an IFRS adjusted basis, or alternatively, a SAM adjusted basis for the valuation of policyholder liabilities. The profit emergence should be tested using an IFRS adjusted basis compared to a SAM adjusted basis. Future research could be valuable in attempting to determine the most appropriate basis to be used for profit recognition and tax purposes.

In a discussion with the researcher, Mr Neill Bester (2013) emphasised the fact that section 29A(7)(a) of the Income Tax Act (58/1962) uses two values in the determination of underwriting profit, namely the market value of assets and the value of policyholder liabilities. While preparing for the implementation of SAM, the focus has been solely on the value of liabilities since that would be the only value which will be directly affected by the implementation of SAM. According to Bester (2013), it could be asked whether the current basis for calculating the market value of assets is accurate. Since both the market value of

assets and the value of liabilities are used to determine the underwriting profit, this would mean that an accurately determined market value of assets together with an accurately determined value of policyholder liabilities would result in an accurately determined profit. It is believed that further research could therefore also be directed towards investigating the appropriateness of the basis used to determine the market value of assets.

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