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THE TAXATION OF LIFE INSURERS IN SOUTH AFRICA

Mini dissertation by

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SUMMARY

THE TAXATION OF LIFE INSURERS IN SOUTH AFRICA

By

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The objective of this study was to compare the taxation of life insurers with the taxation of other corporate taxpayers in South Africa, in order to test the validity of a perception that may exist surrounding the preferential tax treatment of life insurers.

In this study, the tax regime of life insurers is summarised and critically analysed in order to identify deviation from general income tax principles. In some instances generic test data was used to make the analysis practical and meaningful. The outcome of this analysis is then used to determine whether the deviations identified created a preferential tax regime for life insurers, resulting in having a smaller income tax liability than other corporate taxpayers.

The main findings can be summarised as follows:

- The taxation of the life insurance industry is based on the 'trustee principle'. This principle entails that life insurers receive and administer funds on behalf of policyholders.
- In consequence of the 'trustee principle' a life insurer is divided into four separate taxpayers ("the four funds approach"): a policyholder fund for each of the various categories of owners of policies (being individuals, companies and retirement and benefit funds) as well as a corporate fund. The corporate fund represents the excess of an insurer's assets after all the policyholder liabilities have been met.
- Neither the 'trustee principle' nor the 'four funds approach' holds any preferential tax treatment for a life insurer.
- Resulting from the different rules that govern the taxation of each of the four funds deviations from general income tax principles are found in the taxation of a life insurer. None of these deviations has the result of creating a preferential tax regime for life insurers.

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- Part of a life insurer's underwriting results, must be disregarded for purposes of determining taxable income. This provision, however, does not bring about preferential tax treatment of life insurers when compared to other corporate taxpayers.
- The investment income of a life insurer is not taxed differently from any other corporate taxpayer, except for the fact that the deductible expenditure of a life insurer is determined in terms of a fixed formula. The fixed formula adversely affects the deductibility of expenditure of a life insurer, when compared to the deductibility of expenditure of other corporate taxpayers.
- Life insurers do not have a preferential CGT regime, but rather stand the chance of being taxed twice on transfers of assets between funds.

One cannot conclude on whether a specific life insurer enjoys preferential tax treatment over other corporate taxpayers without evaluating the circumstances relevant to that specific life insurer. It would be unfounded to generalise and categorically state that life insurers enjoy a preferential tax regime in comparison to other corporate taxpayers.

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OPSOMMING

DIE BELASTING VAN LEWENSVERSEKERAARS
IN SUID-AFRIKA
deur

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Die doel van hierdie studie was om die inkomstebelastingbestel van lewensversekeraars in Suid-Afrika te vergelyk met die van ander korporatiewe belastingpligtiges. Die vergelyking is gedoen om die geldigheid van die opvatting dat langtermynversekeraars 'n meer voordelige belastingposisie geniet, te toets.

In hierdie studie is die inkomstebelastingbestel van lewensversekeraars opgesom en krities ontleed, ten einde afwykings van algemene inkomstebelastingbeginsels te identifiseer. In sommige gevalle is daar van generiese toetsdata gebruik gemaak om die ontleding prakties en meer bruikbaar te maak. Die resultaat van die ontleding dien as basis om die geldigheid van die opvatting dat lewensversekeraars 'n gunstiger belastingbestel geniet as ander korporatiewe belastingpligtiges, te beoordeel.

Die bevindinge kan soos volg opgesom word:

- Die belastingbestel van lewensversekeraars is gebaseer op die 'trusteebeginsel'. Hierdie beginsel beteken kortliks dat langtermynversekeraars fondse van polishouers ten behoewe van daardie polishouers bestuur.
- As gevolg van die 'trusteebeginsel' word 'n lewensversekeraar opgedeel in vier afsonderlike belastingpligtiges ("die vier-fondsbenadering"): 'n polishouersfonds vir elke kategorie polishouer (individue, maatskappye en aftreefondse) asook 'n korporatiewe fonds. Die korporatiewe fonds verteenwoordig die oorskot bates van 'n lewensversekeraar nadat alle polishouersverpligtinge gedek is.
- Die belastingreëls van toepassing op die verskillende fondse van 'n lewensversekeraar het tot gevolg dat daar afgewyk word van normale beginsels in die berekening van 'n lewensversekeraar se inkomstebelastingaanspreeklikheid. Nie een

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van hierdie afwykings het tot gevolg dat 'n lewensversekeraar 'n meer voordelige belastingbestel het as 'n ander korporatiewe belastingpligtige nie.

- 'n Gedeelte van 'n lewensversekeraar se onderskrywingsinkomste word geignoreer in die berekening van belasbare inkomste. Hierdie bepaling het egter nie 'n gunstiger belastingposisie vir lewensversekeraars tot gevolg nie.
- 'n Lewensversekeraar word op dieselfde basis aangeslaan as enige ander korporatiewe belastingpligtige in sover dit beleggingsinkomste aangaan. Die aftrekbaarheid van lewensversekeraars se uitgawes vir belastingdoeleindes word beperk deurdat 'n vaste formule gebruik word om aftrekbare uitgawes te bepaal. Die vaste formule het tot gevolg dat lewensversekeraars 'n kleiner gedeelte van uitgawes kan aftrek as ander korporatiewe belastingpligtiges.
- Lewensversekeraars is nie onderhewig aan gunstiger kapitaalwinsbelastingwetgewing ("KWB") as ander korporatiewe belastingpligtiges nie, maar mag moontlik aan beide KWB en inkomstebelasting blootgestel wees ten opsigte van oordragte wat tussen fondse plaasvind.

Dit is nie moontlik om tot 'n gevolgtrekking te kom aangaande die voordeligheid van die inkomstebelastingbestel van lewensversekeraars sonder om die omstandighede spesifiek tot 'n individuele lewensversekeraar te beoordeel nie. Dit sou ongegrond wees om te veralgemeen en kategories die stelling te maak dat lewensversekeraars blootgestel is aan 'n meer voordelige inkomstebelastingbestel as ander korporatiewe belastingpligtiges.

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CHAPTER 1
INTRODUCTION AND PROBLEM STATEMENT

1.1 INTRODUCTION

Long-term insurance companies – hereafter referred to as 'life insurers' – play a very important part in the South African economy. This is apparent from the fact that life insurers administer millions of South Africans' savings and investments (Jacobs committee report 1992: § 4.2).

Moreover, the listing of Sanlam in 1998 soon followed by Old Mutual's de-mutualisation, also made policyholders shareholders in life insurers. From this point on it became apparent that life insurers also had to protect their shareholders' interests. Maximising return on investments and optimising bottom line figures feature high on the list of priorities. Since the listing of Sanlam and Old Mutual, the life insurance industry has become increasingly competitive. Finding the right balance between ensuring policyholders' returns and an investment strategy that focuses on optimising shareholders' return is clearly vital in managing a life insurer. Volatile equity markets and downward pressure on investment returns require insurers to adopt innovative yet sound investment strategies. Innovation in the industry is evident in the growing number of insurers providing alternative insurance options. (SARS 2002: 3.)

It follows from the above that it is crucial for life insurers to manage the income tax charge within the limitations of the Income Tax Act (1962)(hereafter referred to as "the Act") in this competitive environment.

The taxation of life insurers is seen as one of the most complex topics in public finance. This complexity arises because:

- tax legislation in respect of life companies introduced certain principles that almost seem to be in conflict with normal tax principles; and
- a wide range of financial and risk services are provided to policyholders and at the same time a return on savings and investments is offered. This creates some difficulties for the tax authorities because these same activities are taxed in different ways when separate companies carry them out. (SARS 2002: 8.)

The preceding statement is confirmed by the fact that the life insurance industry has been the subject of a number of commissions of investigation in the past. These commissions include

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the Steyn committee (1951), the Diedericks commission (1953), the Franzen commission (1970) and the Jacobs committee (1993). (SARS 2002: 8.)

The "four fund approach" was incorporated into the Act by the insertion of section 29. This section fundamentally changed the way in which life insurers were taxed. This is because this approach recognises the 'trustee principle'. In other words, it functions on the basis that life insurers hold and administer certain assets on behalf of various categories of policyholders. The balance of the assets represents shareholders' equity. (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 2.)

Ever increasing complexity seemed to be the greatest flaw in an otherwise theoretically sound system. The deficiencies included:

- different bases of valuation for accounting and tax purposes;
- diminishing margin provisions in respect of assets;
- favourable expense ratios; and
- favourable provisions regarding transfers.(SARS 2002: 8.)

This led the legislature to address deficiencies in section 29 of the Act by introducing section 29A with effect from years of assessment commencing on or after 1 January 2000. Section 29A is also based on the 'trustee principle'. (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 3)

Foreign tax jurisdictions such as Australia, Canada, New Zealand and the United Kingdom each have their own tax system to tax the life insurance industry (SARS 2002: 8). The following questions come to mind: Do South African life insurers contribute fairly to the fiscus? Who pays for the taxation charge eventually – policyholders? shareholders? both?

This dissertation has the objective of comparing life insurance taxation principles with those applicable to other corporate taxpayers in South Africa. Its purpose is to reach a conclusion as to whether life insurers contribute fairly to the fiscus or not, when compared to other industries.

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1.2 PROBLEM STATEMENT

The income tax legislation governing life insurers in South Africa is complex. The perception may exist that because it is complex, life insurers are benefiting from preferential tax treatment. Understanding the differences between the taxation of a life insurer and a corporate taxpayer and the reasons behind these differences are of vital importance in determining whether the perception that may exist is valid or not.

1.3 RESEARCH OBJECTIVE

The objective of this study is to deal with the principles and complexities associated with the taxation of life insurers and then comparing it to the principles applicable to the taxation of other corporate taxpayers. The principles will be dealt with separately and one at a time. This comparison needs to be done in order to test the validity of the possible perception surrounding the preferential tax treatment of life insurers.

In order to achieve the above-mentioned objective, the following principles will have to be considered:

- The trustee principle

Other corporate taxpayers are liable for the income tax charge on their taxable income and no conduit or trustee principle applies. Life insurers, on the other hand, receive or accrue investment returns on behalf of policyholders – only to on-distribute it to the policyholders at a much later date (SARS 2002: 8). However, the life company has access to policyholder funds in the meantime and may invest in a wide variety of assets without consulting the policyholder – as long as its guarantees (if any) to the policyholders are met.

- The four funds approach

This approach was introduced by insertion of the old section 29 of the Act (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 2). In terms of this principle, a life insurer is broken down into four funds, which are taxed as though each one is a separate taxpayer (Huxham & Haupt 2005: 626). Not all of the funds are taxed at the same tax rates (Huxham & Haupt 2005: 627).

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- Taxation of the life insurance ("underwriting") business

Section 29A(11)(g) of the Act provides that premium income received, claims paid as well as reinsurance claims received and reinsurance premiums paid, are to be disregarded in the determination of the taxable income of a life insurer. What this actually means is that life insurers are taxed on their investment income and not on the profits derived from conducting life assurance business (Huxham & Haupt 2005: 626). This seems to be contradicting to ordinary South African income tax principles (when the definition of 'gross income' in section 1 of the Act is read).

- Taxation of a life insurer's investment income

Normal South African income tax principles are applied (Huxham & Haupt 2005: 626). However, the nature and classification of investment income has a material impact on the deductibility of expenses on some of the policyholders funds due to the expense relief ratio contained in section 29A(11)(a)(ii) of the Act (SARS 2002: 10).

- Taxation of capital gains

Life insurers are also subject to the provisions contained in section 26A and the Eighth schedule to the Act regarding capital gains tax (hereafter referred to as 'CGT') (Clegg 2003: 42). Paragraph 12(2)(f) of the Eighth schedule determines that any transfer to or from the corporate fund as well as transfers between policyholder funds constitute a disposal for CGT purposes and is therefore also subject to CGT.

- Different tax rates applied to the various policyholder funds and the corporate fund

In his budget speech for the 2006 fiscal year, Finance Minister Trevor Manuel introduced a decrease in the corporate income tax rate from 30% to 29. This decrease in the corporate tax rate also applies to life insurers, with the exception of the individual policyholder's fund ("IPF") (SARS 2005: 10.) This dissertation also intends to deal with reasons behind having different tax rates for the various funds within a life insurer and whether these reasons coincide with normal tax principles or not.

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1.4 HYPOTHESIS

The income tax liability of a life insurer is determined by the application of principles that seem to deviate from normal income tax principles in respect of other corporate taxpayers. It is hypothesised that the different principles applied to life insurers do not benefit the life insurance industry by creating preferential tax treatment, but rather represents a sound approach to the taxation of a life insurer's business.

1.5 DEFINING THE SCOPE OF THE STUDY

This study will focus on a practical and comparative study of the taxation of life insurers as opposed to other corporate taxpayers and will deal mainly with the provisions of section 29A of the Act in comparison to other sections of the Act affecting other industries.

However, due to the extensive scope of this undertaking, the limits of the study need to be defined. Tax on retirement funds ("RFT"), detailed CGT implications for life insurers, the transitional arrangements on the change from section 29 to section 29A of the Act as well as the phasing out of the 'old expense ratio' (as described in section 29A(11B) & (11C) of the Act) will not be addressed. Furthermore, this study will not compare the taxation of life insurers to the taxation of natural persons, trusts or entities that are exempt from income tax in terms of section 10 of the Act.

1.6 IMPORTANCE OF THIS STUDY

The following parties will benefit from this study:

Beneficiaries	Criteria for success
University of Pretoria	The final document must conform to the guidelines as laid out in the postgraduate information brochure.
SARS	The output must be in the frame of section 29A as well as the remainder of the Act applicable to corporate taxpayers.
Tax practitioners and taxpayers	The final document's conclusion must be informative and persuasive of the merits of section 29A of the Act.
The researcher	The final document must address the issue raised in the problem statement and be accepted by the University of Pretoria.

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Beneficiaries	How will the product or output resulting from this research be used?
University of Pretoria	The research product will form part of the University's database for future reference and use by the department of taxation if required
SARS	The study will either confirm the effectiveness of South African income tax legislation on life insurers or will indicate areas of potential improvement in securing reasonable and sound yet effective rules for optimising revenue collection from the life insurance industry.
Tax practitioners and taxpayers	Giving a clear background as to how life insurers are taxed and why those approaches and rules are applied in South African income tax will hopefully assist both tax practitioners and taxpayers in having a better understanding of life insurance taxation and the rationale behind the principles applied in South African tax legislation.
The researcher	Having clients that are life insurers, the research will definitely benefit the researcher.

1.7 RESEARCH STRATEGY

To ensure that the study is as complete as possible in order to compile a sound conclusion, an analysis was based on:

- a study of tax legislation and literature applying the principles of interpretation;
- information gathered from websites of the tax authorities and opinions from the websites and publications of the Big 4 audit firms (being PricewaterhouseCoopers, Deloitte & Touche, KPMG and Ernst & Young), tax attorney's firms as well as from local and foreign insurance surveys will form an integral part of the research.
- investigation of the reports and findings of committees such as the Jacobs committee that have done extensive work and research on the taxation of life insurers;
- tables and summaries drawn up from data collected;
- further research conducted as a result of initial findings; and
- interviews and correspondence with regulatory bodies, that, *inter alia*, include the following bodies:

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- ✓ The Financial Services Board (FSB);
- ✓ The Life Offices Association (LOA);
- ✓ The Actuarial Society of South Africa (ASSA); and
- ✓ The South African Institute of Chartered Accountants (SAICA)

1.8 RELEVANT DEFINITIONS

Section 29A(1) of the Act defines the following:
"... *For the purposes of this section-*
"business" *means any long-term insurance business as defined in section I of the Long-term Insurance Act;*
"insurer" *means any long-term insurer as defined in section I of the Long-term Insurance Act;*
"Long-term Insurance Act" *means the Long-term Insurance Act, 1998 (Act No. 52 of 1998);*
"market value"*, in relation to any asset, means the sum which a person having the right freely to dispose of such asset might reasonably expect to obtain from a sale of such asset in the open market;*
"owner"*, in relation to a policy, means the person who is entitled to enforce any benefit provided for in the policy...*
"policy" *means a long-term policy as defined in section I of the Long-term Insurance Act;*
"policyholder fund" *means any fund contemplated in subsection (4) (a), (b) or (c)..."* (being the individual policyholder fund ("IPF"), untaxed policyholder fund ("UPF") and the company policyholder fund ("CPF"), and lastly
"...***"value of liabilities"****, means an amount equal to the value of the liabilities of the insurer in respect of the business conducted by it in the fund concerned calculated on the basis as shall be determined by the Chief Actuary of the Financial Services Board in consultation with the Commissioner."* [the 'Commissioner' being the Commissioner for the South African Revenue Service ("SARS")].

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CHAPTER 2

SUMMARY OF THE PRINCIPLES APPLIED IN THE TAXATION OF THE LIFE INSURANCE INDUSTRY IN SOUTH AFRICA

2.1 INTRODUCTION

Numerous principles, adopted from various foreign jurisdictions and established over time, form the basis of the South African income tax system and dictate the manner in which tax legislation is drafted and administered (Emslie, Hutton, Davis & Olivier 2001: 1).

Are these principles applied consistently across all industries and to all taxpayers? The income tax legislation affecting the life insurance industry is widely regarded as complex (Jacobs committee report 1992: Chapter 5 paragraph 3.1). The intention is to provide a brief summary in this chapter of the principles applied in the taxation of life insurers.

2.2 NATURE OF A LIFE INSURER'S BUSINESS

It is imperative to understand the nature of a life insurer's business, in order to have a better understanding of the applicable income tax legislation. Some facts and characteristics of the business are:

- it is regulated by the Long-Term Insurance Act, No. 58 of 1998;
- amongst others, The Long-Term Insurance Act provides that:
  - ✓ the business may only be conducted by a person registered as a long-term (life) insurer (The Long-Term Insurance Act 1998: section 7(1));
  - ✓ long-term insurance business means the business of providing policy benefits under long-term policies (The Long-term Insurance Act 1998: section 1),
  - ✓ a long-term policy means an assistance policy, a disability policy, fund policy, health policy, life policy or sinking fund policy, or a contract comprising a combination of any of those policies (The Long-term Insurance Act 1998: section 1);
  - ✓ pension funds do not fall under this Act (The Long-Term Insurance Act 1998: section 7(2)(a));
  - ✓ a life insurer is obliged to maintain its business in a financially sound condition and to, at all times, have sufficient assets to meet its liabilities to policyholders and maintain the required capital adequacy requirement (The Long-Term Insurance Act 1998: section 29(1));

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- ✓ a life insurer's assets at any point in time have to exceed its policyholder liabilities (The Long-Term Insurance Act 1998: section 30(1)); and
- ✓ a life insurer may not have any external borrowings (The Long-Term Insurance Act 1998: section 34(1)).

- new products are often developed and marketed by life insurers (Jacobs committee report 1992: 86); and
- demarcation between the life insurance industry and that of deposit-taking institutions is based on (Jacobs committee report 1992: 87):
  - ✓ the term of the liability assumed with regard to products offered by the different industries. Life insurers may not offer deposit-related products of which the term does not exceed five years;
  - ✓ the nature of the liabilities assumed by the different industries; and
  - ✓ the fact that life insurers underwrite risks whereas deposit-taking institutions do not.

2.3 NEED FOR INDUSTRY SPECIFIC INCOME TAX LEGISLATION FOR LIFE INSURERS

The Jacobs committee report (1992: 86) gives a short history of the development of the need for industry specific tax legislation for the life insurance industry:
"The 6th Schedule to the Income Tax Act, No. 58 of 1962, was originally introduced to serve as a demarcation between the business areas of deposit-taking institutions and life insurers, respectively, when insurers started intruding into the markets traditionally serviced by deposit-taking institutions, primarily with regard to single-premium policies... This method of demarcation was not very successful and has progressively been circumvented by an astute life insurance industry, which increasingly applied tax-based product development and marketing strategies. In turn, this caused progressive amendments to the 6th Schedule to curtail these activities, finally resulting in a most complex and difficult piece of legislation developing on the statute-book."

From this extract it appears that:

- a demarcation between the life insurance industry and deposit-taking institutions was necessary and inevitable. This was mainly because life insurers and deposit-taking institutions began competing for the same pool of investment funds; and
- life insurers circumvented the limitations placed on them by income tax legislation contained in the Sixth schedule to the Act and in this way continued to compete with deposit-taking institutions.

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The Jacobs committee's report (1992: Chapter 5 paragraph 3.2) further explains that various developments in the financial services sector necessitated an investigation of the Sixth schedule to the Act. These developments were:

- placing the supervisory and regulatory function of deposit-taking institutions under the jurisdiction of the Reserve Bank and that of other financial services industries (such as the life insurance industry) under the Financial Services Board ("FSB");
- re-introducing "sinking fund policies" as a class of insurance business. These policies enabled life insurers to compete with deposit-taking institutions for investment funds;
- demarcation between the life insurance industry and that of deposit-taking institutions by the proposed introduction of a new Long-Term Insurance Act; and
- the proposed development of a new tax system for life insurers.

Following the Jacobs committee's report, the Sixth schedule to the Act was repealed and section 29 introduced to the Act (Explanatory Memorandum Revenue Laws Amendment Bill: 1999).

Section 29 of the Act was replaced by section 29A. Section 29A(2) determines that section 29A was introduced for years of assessment commencing on or after 1 January 2000. Also, Section 29A of the Act still governs the taxation of life insurers (Huxham & Haupt 2005: 626).

2.4 PRINCIPLES APPLIED IN THE TAXATION OF LIFE INSURERS

The following principles are applied in the taxation of life insurers:

2.4.1 The 'trustee principle'

Life insurers fulfil a significant role as mobilisers of national long-term savings and the application thereof in the economy (Jacobs committee report 1992: 89). Assets that are not policyholder assets in that they do not back any liability the life insurer might have towards policyholders, represent shareholders' equity and are therefore treated and administered as shareholder's assets (Huxham & Haupt 2005: 627).

The 'trustee principle' entails that a life insurer is a representative of the constituent body of its policyholders and also represents that body of constituent policyholders in respect of its taxation (Jacobs committee report 1992: 89).

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The effect of the 'trustee principle' is that the taxable income generated by assets administered in the policyholder funds is taxed in the hands of the insurer and not in the hands of policyholders (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 2).

2.4.2 The 'four funds approach'

The four funds approach was introduced by the introduction of section 29 and was maintained in section 29A of the Act (Huxham & Haupt 2005: 626).

The effect of this approach can be summarised as follows:

- the application of the four-fund approach requires that insurers allocate their assets and liabilities to separate funds representative of the various policyholder or corporate (shareholders) interests (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 3);
- each fund is taxed as a separate taxpayer (Income Tax Act 1962: section 29A(10));
- as the various tax funds are seen as separate taxpayers, an assessed loss arising in one fund may not be set off against taxable income in another (Income Tax Act 1962: section 20);
- the four funds consist of a corporate (shareholders) fund and three policyholder funds (please refer to chapter 4 of this study for a detailed discussion on the policyholder funds) (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 3);
- each of the policyholder funds is permitted to hold assets with a market value equal to the insurer's liabilities to those policyholders (Income Tax Act 1962: section 29A(4)), and
- the surplus of the insurer's assets must be transferred to the corporate fund (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 3).

2.4.3 Taxability of the life insurance business ("underwriting business")

Section 29A(11)(g) of the Act states that premium income received, claims paid as well as reinsurance claims received and reinsurance premiums paid are to be disregarded in the determination of the taxable income of a life insurer.

What this seems to mean is that life insurers are not taxed on their underwriting business profits, but effectively only on investment income accrued net of expenditure incurred in the production of that investment income, and net of running costs (Huxham & Haupt 2005: 626).

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Section 29A(7) of the Act provides for the annual determination of an excess or a deficit of assets held in each policyholder fund in comparison to the liabilities of that fund towards its policyholders ("liabilities").

The definition of the "value of liabilities" in section 29A(1) of the Act determines that the liabilities in each of the policyholder funds are actuarially determined in accordance with the guidelines and rules set out from time to time by the FSB. Excess assets over liabilities are transferred to the corporate fund and shortfalls or deficits in assets over liabilities are transferred from the corporate fund (Income Tax Act 1962: section 29A(7)). These transfers to and from the corporate fund are taxed in the corporate fund (Income Tax Act 1962: section 29A(11)(d) & (e)). Transfers are taxed at the corporate tax rate (currently 29%) (Huxham & Haupt 2005: §28.5.1).

2.4.4 Taxation of investment income

Section 29A(2) of the Act determines that ordinary South African income tax principles apply to life insurers. Thus:

- dividends from a South African source are exempt from tax (Income Tax Act 1962: section 10(1)(k));
- foreign dividends are taxable (Income Tax Act 1962: section 10(1)(k));
- rental income is taxable (Income Tax Act 1962: section 1 'gross income' definition);
- interest income is fully taxable (Income Tax Act 1962: section 1 'gross income' definition);
- interest income accrues and is incurred in terms of the provisions of section 24J of the Act; and
- realised capital gains are subject to CGT legislation as effected by section 26A and the Eighth schedule of the Act. (Huxham & Haupt 2005: 626.)

Moreover, the provisions of section 29A(11) of the Act limit the deductibility of expenses Fixed formulae for two of the three policyholder funds (the IPF and the CPF) regulate this (Income Tax Act 1962: section 29A(11)(a)). The deductibility of expenses in both other corporate taxpayers' and insurers' hands will be determined in terms of section 11(a) read together with section 23(g) of the Act (**Port Elizabeth Electric Tramway Co Ltd v CIR,** 1936 CPD (8 SATC 13)). Section 23(f) of the Act limits the deduction of expenses that were incurred in the production of amounts that do not constitute 'income' as defined (Silke 2005: §7.5.6).

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2.4.5 Taxation of capital gains

Similar to any other South African resident, a life insurer is subject to CGT on the disposal of assets held on capital account (Income Tax Act 1962: section 26A). Paragraph 12(2)(f) of the Eighth schedule to the Act determines that any transfer between the corporate fund and any of the policyholder funds constitute a deemed disposal for CGT purposes and is therefore also subject to CGT.

2.5 SUMMARY

Life insurers are subject to the provisions of the Long-Term Insurance Act (1998). In terms of this Act, strict rules are imposed on life insurers to regulate how their capital is to be raised and maintained, what liabilities they may incur and what business they may conduct.

Having been described as "mobilisers of national long-term savings" (Jacobs committee report 1992: 89), life insurers find themselves in a very competitive market – competing for investment funds with deposit-taking institutions.

A life insurer's business is twofold: the one involves managing a profitable 'life office' (being the business of underwriting risks) and the other is that of investing funds in order to meet policyholder liabilities, to maximise policyholder returns and to optimise shareholders' wealth.

Because a life insurer's business demands these two separate businesses to be run within the same legal entity, the taxation of life insurers is complex. The 'trustee principle', the 'four funds approach' as well as the taxing of excess assets in shareholders' hands are evidence of this complexity.

The next chapter of this study deals with the 'trustee principle' in more detail.

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CHAPTER 3
THE 'TRUSTEE PRINCIPLE'

3.1 INTRODUCTION

The outcome of the Jacobs committee report (1992) was an overhaul of the way in which life insurers were taxed (Explanatory Memorandum Revenue Laws Amendment Bill 1999:2). Act no.113 of 1993 introduced section 29 to the Act. In terms of section 29 of the Act, life insurers were subjected to the 'trustee principle' with effect from years of assessment commencing on or after 1 July 1996 (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 2).

3.2 BACKGROUND TO THE DEVELOPMENT OF THE 'TRUSTEE PRINCIPLE'

In 1970, the second report of the commission of enquiry into fiscal and monetary policy in South Africa (the Franzsen commission 1970: paragraph 435) held that *"an appreciable proportion, if not the whole, of the net premium receipts of long-term insurers does not constitute "income". Furthermore only that portion of the investment income in excess of the valuation rate represents profit, and even then a portion of it may have been earmarked in advance "for provision of" bonuses to be added to participating policies in the future..."*

Following this statement in the Franzsen committee's report, The Jacobs committee report (1992: 88), held that *"the income-tax system for life insurers is guided by the "trustee principle". This principle, in short, entails that life insurers are deemed to be "holding" and investing funds on behalf of their policyholders, and that they should pay income tax on the income derived there from on a similar basis. The principle has subsequently been accepted by the fiscal authorities as being appropriate and correct, and also enjoys unanimous support in the industry."*

The Jacobs committee report (1992: 89) further held that *"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."*

Following the Jacobs committee report, the sixth schedule to the Act was repealed in 1993 and replaced by section 29 (Act no.113 of 1993: section 25(1)). Section 29 was replaced by section 29A of the Act in order to raise more tax from life insurers as it was felt that despite

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substantial profits, section 29 had the effect that tax paid by the life insurance industry was decreasing (Huxham & Haupt 2005: §28.5). The Explanatory Memorandum to the Revenue Laws Amendment Bill (1999: 2) held that prior to 1993, a long-term insurer's taxable income was determined in accordance with a formula. In essence, it represented the gross amount of investment income less 55 per cent of expenses. Certain fees for managerial or secretarial services were also included. Investment income included interest, rental income from the letting of property and one-third of dividends received. In 1993, section 29 was inserted in the Act. This introduced a new method of taxation of life insurers and their policyholders: the four-fund approach.

3.3 EFFECT OF THE 'TRUSTEE PRINCIPLE' IN THE TAXATION OF LIFE INSURERS

3.3.1 Authority for the trustee principle

The income tax system for life insurers is guided by the 'trustee principle' (Jacobs committee report 1992: 88). This statement suggests that the 'trustee principle' forms the basis for the taxation of life insurers.

3.3.2 Practical effects of the 'trustee principle'

Life insurers receive premiums from policyholders and then administer and manage assets acquired with these premium funds on behalf of various categories of policyholders (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 2). Following the preceding statement it can be said that life insurers hold funds in trust for the benefit of policyholders

The Jacobs committee's report (1992: chapter 5 §4.1) further states that *"...this principle (the 'trustee principle'), in short, entails that life insurers are deemed to be "holding" and investing funds on behalf of their policyholders, and that they should pay income tax on the income derived there from on a similar basis..."*. It is clear from the above quotation that

- funds received by life insurers from policyholders (to be administered and managed on their behalf) are held on behalf of policyholders or 'in trust' by the insurers; and
- that life insurers pay income tax from the income derived from these funds held in trust.

The question comes to mind: Is the income tax payable on the income derived from the funds held on behalf of policyholders an expense of the life insurer, or does the insurer recover any taxes paid from policyholders? This question is answered in Professional Guidance Note

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(PGN) 104 (2005: §3.2.4.3) issued by the Actuarial Society of South Africa (ASSA) where it states that in determining the actuary's best estimate of policyholder liabilities "allowance" has to be made for tax. Following this explanation it is concluded that although a life insurer has to pay the income tax on income derived from funds held on behalf of policyholders the expense is not for the life insurer's own pocket, but for that of the policyholder. It follows from the preceding discussion and authority that the life insurer acts as a representative taxpayer in respect of taxes payable on policyholder funds.

Other practical implications of the trustee principle are:

- a distinction between policyholder assets and liabilities and that of shareholders (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 2);
- policyholder funds being taxed on its investment income net of costs producing that income and net of running costs (Huxham & Haupt 2005: §28.5);
- the Corporate fund representing shareholder's equity (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 2);
- the Corporate fund being taxed on its own investment income and transfers from the policyholder funds (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 4); and
- in terms of the trustee principle, income would retain its nature (**Armstrong v CIR**, 1938 AD (10 SATC 1). For example: interest received or accrued by a life insurer on behalf of the insured, would be interest in the hands of the insured. The same would apply to any other income derived from funds held on policyholders' behalf (Silke 2005: §28.4).

3.4 RELEVANCE OF THE 'TRUSTEE PRINCIPLE' IN THE TAXATION OF TAXPAYERS OTHER THAN LIFE INSURERS

In the taxation of other taxpayers, it is a well-established income tax principle that "*...a person could not be subjected to tax on amounts received by him for the benefit of another.*" (Silke 2005: §2.3.1). In **Geldenhuys v CIR**, 1947 CPD (14 SATC 419) the court held that, in the definition of 'gross income', "*...in favour of any person...*" means that a taxpayer must have received or accrued an amount "*...on his own behalf or for his own benefit...*" This principle is confirmed in the taxation of trusts. Income received by a trust which vests in a beneficiary, is taxed in the hands of the beneficiary and not the trust. (Income Tax Act 1962: section 25B.)

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A trust is seen to be a conduit pipe by means of which income is conveyed to a beneficiary who is legally entitled to it (Silke 2005: 552). In terms of the 'conduit principle', income would retain its nature in the hands of a beneficiary (**ITC 1450** 1988 (51 SATC 70).

A trustee of a trust is deemed to be the 'representative taxpayer' of a trust (Income Tax Act 1962: section 1 paragraph (c) of the definition of 'representative taxpayer').

3.5 SUMMARY

Following from the 'trustee principle', insurers are taxed in two tiers:

- in a representative capacity on behalf of policyholders, and
- in respect of an insurer's own income.

(Explanatory Memorandum Revenue Laws Amendment Bill 1999: 4)

The fundamental provisions of the 'trustee principle' are also applicable to other corporate taxpayers. These fundamental provisions include:

- income derived from funds held for the benefit of another, accrues to that other person and not to the person acting as custodian over the funds;
- income received by a trust which vests in a beneficiary, is taxed in the hands of the beneficiary and not the trust;
- a trust is seen to be a conduit pipe by means of which income is conveyed to a beneficiary who is legally entitled to it;
- in terms of the 'conduit principle' income received by a trust would retain its nature in the hands of a beneficiary; and
- a trustee of a trust is deemed to be the 'representative taxpayer' of that trust.

It follows from the comparison above that life insurers are subject to the same rules and principles as other taxpayers with respect to the funds accrued on behalf of someone else. Life insurers would therefore not be benefiting from preferential income tax legislation as a result of the 'trustee principle' as it also applies to any other taxpayer who receives or accrues income on behalf of or for the benefit of someone else.

The next comparison in this study, the 'four funds approach' will be dealt with in the next chapter.

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CHAPTER 4
THE 'FOUR FUNDS APPROACH'

4.1 INTRODUCTION

As a result of the Jacobs committee's report (1992), the 'trustee principle' was established in the taxation of life insurers (refer to chapter 3 of this study). Following the 'trustee principle', the 'four fund approach' was introduced to the Act (Explanatory Memorandum Revenue Laws Amendments Bill 1999: 2). This chapter intends to provide some insight into the mechanics of the 'four funds approach' and compare the income tax effect thereof with other taxpayers

4.2 BACKGROUND TO THE 'FOUR FUNDS APPROACH'

The application of the 'four fund approach' requires that insurers allocate their assets and liabilities to separate funds. These funds are representative of the various policyholder or corporate interests. (Explanatory Memorandum Revenue Laws Amendments Bill 1999: 3.) Each fund is taxed as a separate entity in accordance with the applicable taxation principles (Huxham & Haupt 2005: 626).
(The different funds are generally referred to in the abbreviated form. For ease of reference these funds will be referred to in the abbreviated form (when discussed individually) and as 'tax funds' when hereafter referred to collectively for the rest of this document.)
Section 29A(4) of the Act describes the four tax funds as

- the untaxed policyholders fund ("UPF");
- the individual policyholders fund ("IPF");
- the company policyholders fund ("CPF"); and
- the corporate fund ("CF"). This is the fund for non-insurance business, shareholders and corporate reserves (Jacobs committee report 1992: §4.6.2).

Authority for the 'four funds approach' is found in section 29A(3) of the Act. It provides that:
"… [e]very insurer shall establish four separate funds as contemplated in subsection (4), and shall thereafter maintain such funds in accordance with the provisions of this section…"

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4.3 MEANING OF THE 'FOUR FUNDS APPROACH'

The Jacobs committee report (1992: 90) stated that *"...[t]he approach involves the maintenance of four funds for tax purposes to which, save as may be qualified, the general principles of taxation will apply..."*

The question comes to mind: what does 'establish' and 'maintain' mean? The Jacobs committee report (1992: §4.6.2) states that *"... [i]t should be stressed that the four funds exist only for income tax purposes. From a legal point of view, for solvency purposes and for the purpose of determining earnings and dividends, the insurer is indivisible."*

It also states that '**establish**' means that the following be kept for each of the tax funds:

- separate accounting records (Jacobs committee report 1992: §4.6.2);
- segregated assets (it is envisaged that segregated assets should be held for the four funds, allowing income and capital appreciation to follow automatically) (Jacobs committee report 1992: §4.6.4); and
- separate revenue accounts (Jacobs committee report 1992: §4.6.5).
  This envisages that it will be necessary to draw up separate revenue accounts for each fund at the end of the tax year, for tax purposes; premiums and claims will flow directly to the different revenue accounts, as will investment income where segregated assets are held; expenses associated with the issue and maintenance of policies are allocated to the respective policyholders' funds, and other expenses are allocated between the tax funds on a basis *"...consistent with and appropriate to the manner in which its business is conducted."*. (Income Tax Act 1962: section 29A(12).)

The report went further by setting out the rules (Jacobs committee report 1992: §4.6.6) in terms of how these funds are to be established and maintained:

- the policyholders' funds must be equal to the actuarial liabilities, unless the CF is zero;
- the CF will be equal to the market value of the assets, less the amount of the policyholders' funds;
- transfers from the CF will be needed to cover shortfalls in the IPF, the CPF or the UPF when flows of new business are strong. These funds, together with surpluses not earmarked for policyholders on a long-term basis and profits or losses attributable to shareholders, will be returned to the CF as new business slows down; and
- transfers between the policyholders' funds will be required as and when there is a change in the tax status of a particular policy, for example, when a company-owned

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policy is ceded to an individual.

As far as '**maintenance**' of the various funds is concerned, the rules are that at the end of each tax year:

- the policyholders' funds may not exceed the actuarial value of the liabilities;
- any excess must be transferred to the CF;
- deficits in the policyholder funds must be made good by the CF;
- the CF may not be negative;
- the policyholders' funds may not be less than their respective actuarial liabilities; and
- direct transfers between the IFF, the CPF and the UPF are not allowed, unless necessitated by changes in the tax status of policies. (Jacobs committee report 1992 §4.6.7.)

The four funds consist of a corporate fund and three policyholder funds (Explanatory Memorandum Revenue Laws Amendments Bill: 1999). Section 29A(4) of the Act describes the mentioned funds in detail:

"...the funds referred to in subsection (3) shall be-

(a) a fund, to be known as the *untaxed policyholder fund*, *in which shall be placed ...*

(i) business carried on by the insurer with, and any policy of which the owner is, any pension fund, provident fund, retirement annuity fund or benefit fund;

(ii) any policy of which the owner is a person where any amount constituting gross income of whatever nature would be exempt from tax in terms of section 10...;

(iii) any annuity contracts entered into by it in respect of which annuities are being paid;

(b) a fund, to be known as the *individual policyholder fund*, *in which shall be placed assets...in relation to any policy...of which the owner is any person other than a company;*

(c) a fund, to be known as the *company policyholder fund*, *in which shall be placed assets...in relation to any policy...of which the owner is a company; and*

(d) a fund, to be known as the *corporate fund*, *in which shall be placed all the assets (if any) held by the insurer, and all liabilities owed by it, other than those contemplated in paragraphs (a), (b) and (c)..."* (my underlining).

The Jacobs committee report (1992: §4.6.2) explained that *"[a]ll life insurers, including mutual insurers, will be required to set up a CF. In essence, the IPF, the CPF and the UPF represent funds held to cover policyholders' liabilities, whereas the CF represents the balance of the*

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assets... In the longer term, all benefits paid to policyholders that are individuals will have been subject to tax at the trustee rate (unless the business is untaxed). On the other hand, all benefits paid to policyholders that are companies will have been subject to tax at the corporate tax rate (unless the business is untaxed)..."

4.4 MECHANICS OF THE 'FOUR FUNDS APPROACH'

A very important component of the 'four funds approach' is dealt with in section 29A(10) of the Act. It prescribes that the taxable income of the IPF, CPF and CF *"...shall be determined separately in accordance with the provisions of this Act as if each such fund had been a separate taxpayer..."* It further states that the IPF, CPF, UPF and CF *"... shall be deemed to be separate companies which are connected persons in relation to each other for the purposes of subsections (6), (7) and (8) and sections 9B, 20, 24I, 24J, 24K, 24L and 26A and the Eighth Schedule to this Act."* (my emphasis).

The following is notable from the above extract:

- the UPF is specifically excluded from the provisions of section 29A(10) because of the provisions of section 29A(9) that will be discussed later in this chapter;
- the taxable income of the IPF, CPF and CF is to be 'determined separately' as if these funds are 'separate taxpayers'. Knowing that these funds are separate taxpayers, it follows logically that tax losses in one fund will not be allowed to be offset against profits in another fund, but instead may be carried forward (Income Tax Act 1962: section 20); and
- the various funds are also treated as 'separate companies' for certain sections of the Act and are also treated as connected persons in relation to each other for purposes of those other sections.

4.5 THE UPF

Section 29A(9) of the Act prescribes that *"...[s]ubject to the provisions of subsection (11)(d), there shall be exempt from tax any income received by or accrued to an insurer from assets held by it in, and business conducted by it in relation to, its untaxed policyholder fund."* (Subsection (11)(d) deals with transfers to and from the corporate fund resulting from the provisions of section 29A(7)).

The UPF is not subject to income tax in terms of section 29A(9) of the Act. Also, its inclusion rate in respect of CGT is 0% in terms of paragraph 10(b)(ii) of the Eighth schedule to the Act.

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However, it is subject to tax on retirement funds ("RFT"). (Tax on Retirement Funds Act 1996: section (2)(a).)

RFT is levied in terms of the Tax on Retirement Funds Act (1996), and is currently calculated at 18% (PWC Tax Information 2005/2006) of the sum of gross interest and net rental income (Tax on Retirement Funds Act 1996: section 3). A detailed review of RFT however is beyond the scope of this document.

4.6 THE IPF

The owners of policies allocated to the IPF are individuals (natural persons) as they would not be companies or owners for purposes of the UPF (Income Tax Act 1962: section 29A(4)(b)).

The IPF is taxed on investment income, less expenditure related to the production of that investment income and less running costs (Huxham & Haupt 2005: 626). (Refer to chapter 5 & 6 for a detailed discussion on the portion of expenses that may be deducted for tax purposes).

Net investment return is currently taxed at a rate of 30 percent (Huxham & Haupt 2005: 627).

Premium income, reinsurance claims received, claims paid and reinsurance premiums paid is to be *'disregarded'* for purposes of determining the IPF's taxable income (Income Tax Act 1962: section 29A(11)(g)).

In terms of paragraph 10(b)(ii) of the Eighth schedule to the Act the IPF must include 25% of its net capital gains as taxable capital gains for CGT purposes.

4.7 THE CPF

The owners of policies allocated to the CPF are companies (Income Tax Act 1962: section 29A(4)(c)).

The CPF is, like the IPF, taxed on investment income less expenditure related to the production of that investment income (Huxham & Haupt 2005: 626).

Net investment return is taxed at the corporate tax rate (Huxham & Haupt 2005: 627). This rate is currently 29 percent (SARS 2005/2006 Budget Tax Proposals: 10)

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As is the case with the IPF and the UPF, premium income, reinsurance claims received, claims paid and reinsurance premiums paid are to be *'disregarded'* for purposes of determining the CPF's taxable income (Income Tax Act 1962: section 29A (11)(g)).

In terms of paragraph 10(c) of the Eighth schedule to the Act the CPF has to include 50% of its net capital gains as taxable capital gains for CGT purposes.

4.8 THE CF

The balance of all the remaining assets held by the insurer and that is not allocated to the other three funds, is placed in the CF (Explanatory Memorandum Revenue Laws Amendments Bill: 1999).

This fund is taxed at the company rate (Huxham & Haupt 2005: 627) (currently 29%) on:

- its own investment return from "shareholders funds" or assets (Huxham & Haupt 2005: 626);
- the excess of policyholder assets over what is required to meet policy benefits or liabilities (Income Tax Act 1962: section 29A(11)(d)); and
- 50% of the net capital gains are included as taxable capital gains for CGT purposes (Income Tax Act 1962: paragraph 10(c) of the Eighth schedule).

4.9 REASONS WHY DIFFERENT TAX RATES ARE APPLIED TO THE VARIOUS TAX FUNDS

The Jacobs committee report (1992: §4.3) was clear in its proposals to parliament that *"[t]ax neutrality must prevail, as far as possible, between different classes of policy holders. In particular, there should be no tax advantages for corporate policyholders. (It is accepted that this principle cannot be fully served so as to allow for the various individual tax rates of the individual constituent policy holders of an insurer, and that an average rate must be used in this case.)"*.

Different tax rates are therefore used for the various funds in order to recognise the owner of the policy's effective tax rate (in the case of policyholders) and the corporate tax rate for shareholders (SARS 2005: 3).

The UPF is not subject to income tax in terms of the Income Tax Act (1962: section 29A(9)).

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In the CPF's and CF's instances the tax rate is that of other companies (currently 29%) (SARS 2005/2006 Budget Tax Proposals: 10).

It follows from the quotation above that in consequence of the Jacobs committee report (1992: §4.3), the IPF's current tax rate is 30% and not the sliding scale rates for individuals. The average tax rate for individuals has been decided to be 30% and therefore the IPF is taxed at a rate of 30% (SARS 2005: 3). Since there was no adjustment to the marginal tax rate of individuals in the 2005/2006 budget, it was decided by the legislature not to amend the IPF's tax rate either (SARS 2005: 3).

4.10 COMPARISON BETWEEN THE 'FOUR FUNDS APPROACH' AND THE TAXATION OF OTHER CORPORATE TAXPAYERS

The 'four funds approach' is unique to the life insurance industry in that no other corporate taxpayer:

- has more than one taxpayer within a single legal entity (Income Tax Act: 1962). A life insurer potentially has four different taxpayers within one legal entity (Income tax Act 1962: section 29A(4));
- is taxed at more than one income tax rate. A life insurer is potentially taxed at three different tax rates (see discussion in paragraph 4.9 above);
- 'disregards' its business from a particular line of business for income tax purposes (Income Tax Act: 1962). A life insurer 'disregards' part of its underwriting results for income tax purposes (Income Tax Act 1962: section 29A(11)(g));
- has a fixed formula for determining the deductible portion of expenditure incurred in the production of income (Income Tax Act 1962: section 23(f)). The deductible expenditure of a life insurer's IPF and CPF is prescribed by a fixed formula (Income Tax Act 1962: section 29A(11)(a)(ii)); and
- is prohibited from offsetting an assessed loss from one line of business against taxable income from another line of business (Income Tax Act 1962: section 20(1)(b)). A life insurer may not offset the assessed loss in one of its four funds against taxable income in another one of its four funds (Income Tax Act 1962: section 29A(10))

However concerning the following items, the 'four funds approach' is not unique:

- the application of normal income tax principles in respect of the taxation of investment income (Huxham & Haupt 2005: 626); and
- the deductibility of expenses incurred in the production of income of a life insurer's CF and any other corporate taxpayer (Income Tax Act 1962: section 23(f)).

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4.11 SUMMARY

The 'four funds approach' has its roots in the application of the 'trustee principle' (SARS 2005: 3). It was concluded in chapter 3 of this study that the 'trustee principle' does not result in any direct tax-beneficial treatment of life insurers. One would therefore expect not to find any tax-beneficial treatment of life insurers following the application of the 'four funds approach'.

It is concluded from the research findings in this chapter that:

- the 'four funds approach' has developed over time as a result of the need for an income tax regime that distinguishes life insurers from deposit-taking institutions;
- unlike other corporate taxpayers, life insurers potentially have four separate taxpayers within one legal entity. It can therefore be stated that the concept of having more than one taxpayer within one legal entity is unique to the life insurance industry; and
- it follows from the conclusion that the 'four funds approach' is unique to the life insurance industry that it brought about income tax legislation that is specific to the life insurance industry. Having part of its underwriting results ignored for purposes of determining taxable income (Income Tax Act 1962: section 29A(11)(g)) and having its UPF's investment income taxed at 18% and not 29% are examples to substantiate this conclusion.

Whether or not the uniqueness of the 'four funds approach' to the life insurance industry results in a tax preferential regime for life insurers cannot be concluded upon without investigating the effect of the specific income tax legislation it brought about. This investigation will be undertaken in chapter 5 to 7 of this study.

In the next chapter of this study the taxation of a life insurer's underwriting business will be discussed in order to conclude whether or not beneficial tax treatment for life insurers results from current income tax legislation.

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CHAPTER 5
TAXATION OF THE UNDERWRITING BUSINESS OF A LIFE INSURER

5.1 INTRODUCTION

In chapter 2 of this study it was concluded that a life insurer's business is twofold: one involves managing a profitable 'life office' (being the business of underwriting risks) and the other is that of investing funds in order to meet policyholder liabilities and to optimise shareholders' wealth. This chapter deals with the taxation of the first part of a life insurer's business: that of its underwriting business.

5.2 TAXATION OF THE UNDERWRITING BUSINESS OF A LIFE INSURER

5.2.1 Certain items pertaining to a life insurer's business disregarded for income tax purposes

Section 29A(11) of the Act prescribes that *"[i]n the determination of the taxable income derived by an insurer in respect of its individual policyholder fund, its company policyholder fund and its corporate fund in respect of any year of assessment...premiums and reinsurance claims received and claims and reinsurance premiums paid shall be disregarded."* (my underlining).

A summary of the taxability of a life insurer's underwriting results would thus be:

Income statement item	Income tax treatment	Authority
Premium income earned	Disregard	Section 29A(11)(g)
Claims incurred	Disregard	Section 29A(11)(g)
Net commissions paid	Apply normal income tax rules (subject to expense relief ratio)	Section 29A(2) & 29A(11)(a)(ii)
Management expenses	Apply normal income tax rules (subject to expense relief ratio)	Section 29A(2) & 29A(11)(a)(ii)

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It is notable from the above extract that:

- only the IPF, CPF and CF are affected by section 29A(11)(g) of the Act. The reason for this is that the UPF is not subject to income tax (Income Tax Act 1962: section 29A(9)); and
- only a portion of a life insurer's income and expenditure is disregarded in the IPF, CPF and CF in determining the taxable income relating to those policyholders and not the total.

A few questions may arise in this context:

- What does 'disregard' mean?

  The explanatory memorandum to Act no. 30 of 1999 states that to 'disregard' these items from determining taxable income mean that *"...premiums and claims, as well as reinsurance premiums and claims, are excluded from the tax computation..."* (my underlining).

  In the absence of case law defining the meaning of 'disregard', the ordinary meaning was established with reference to the Concise Oxford Dictionary (1992: 338): *"...pay no attention to...ignore... treat as of no importance..."*

- Why does a life insurer have to disregard its premium income, claims and reinsurance premiums and reinsurance claims in the IPF, CPF and CF when determining the taxable income relating to those policyholders? In chapter 3 of this study it was established that a life insurer is taxed in two tiers:

  ✓ in a representative capacity (my underlining) on behalf of policyholders; and

  ✓ in respect of its own income.

  (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 4)

  It follows from this authority that a life insurer is for its own account liable for tax only on its own income, and merely acts in a representative capacity in respect of the tax payable by policyholders.

  Furthermore, the exclusion of these items from the calculation of the taxable income of the IPF, CPF and CF indicates that the life insurer does not have a representative taxpaying capacity in respect of these items. This is because, to the body of policyholders as a whole, premiums are an investment of capital (Income Tax Practice Manual 2005: 533). The Jacobs committee report (1992: chapter 5 §4.1) confirms that *"...this principle (the 'trustee principle'), in short, entails that life insurers are deemed to be "holding" and investing funds on behalf of their policyholders, and that they*

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should pay income tax on the income derived there from on a similar basis…". It therefore follows that a life insurer's representative taxpaying capacity is on the investment income derived by policyholders and not in respect of their capital invested.

However, the surpluses and deficits that arise in policyholder funds represent the underwriting results of a life insurer. These surpluses and deficits are transferred to and from the CF in terms of section 29A(7) of the Act on an annual basis. The inclusion of the transfer of surpluses in the CF's taxable income in terms of section 29A(11)(d)(i) indicates that a life insurer is taxed on its underwriting profit. This is in line with the taxation of all other corporate taxpayers on their trading results. (Le Grange: 2005.)

5.2.2 Excess assets of policyholder funds to be transferred to the CF

Section 29A(7) of the Act states that a life insurer shall determine the value of liabilities in relation to each of its policyholder funds as at the last day of each financial year. It further determines that, should the market value of assets held in such a policyholder fund (to back the liabilities of that fund), be different from the value of the liabilities, the difference needs to be transferred to or from the CF. Excess assets are to be transferred from the policyholder fund to the CF (Income Tax Act 1962: section 29A(7)(a)). The exact opposite is applicable where the assets held by a policyholder fund is inadequate to meet its liabilities (a so-called "deficit" or "shortfall") – then the CF would transfer assets to such a policyholder fund (Income Tax Act 1962: section 29A(7)(b)).

In the calculation of a life insurer's tax liability on the transfers from policyholder funds to the CF, the following methodology is followed:

- the sum of all income items of such a fund is added (i.e. premium income, reinsurance claims received, investment & other income, realised and unrealised accounting gains on the disposal of investment assets) to the opening value of the policyholder fund's assets; and
- the value of policyholder liabilities of the particular fund as well as expense items of the policyholder fund are then deducted (i.e. claims (policyholder benefits), reinsurance premiums paid, selling & administration expenses, realised and unrealised accounting losses, other expenses and taxation attributable to such fund) from the sum of the policyholder assets. (IT14L return, part 10, form 1.)

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A practical example of how the transfer to or from the CF is calculated is:

Income statement item	IPF R	UPF R
Premium income	1,000,000	1,000,000
Reinsurance claims	50,000	50,000
Investment income	100,000	100,000
Accounting gains	120,000	120,000
Claims	(650,000)	(650,000)
Reinsurance premiums	(40,000)	(40,000)
Selling & admin expenses	(350,000)	(350,000)
Accounting losses	(10,000)	(10,000)
Total movement for the year	220,000	220,000
Plus: Opening value of policy holder assets	280,000	280,000
Closing value of assets	500,000	500,000
Less: Value of liabilities	(450,000)	(520,000)
Excess/ (deficit) transfer	50,000	(20,000)

(IT14L return, part 10, form 1)

In the preceding example, the R50,000 excess of assets over liabilities in the IPF would be transferred to the CF and would be taxable in the CF's hands (Income Tax Act 1962: section 29A(7)(a) & section 29A(11)(d)(i)). In the same example the R20.000 deficit in the UPF would have to be made good by the CF, resulting in a transfer from the CF to the UPF (Income Tax Act 1962: section 29A(7)(b)). In terms of section 29A(11)(d)(ii) of the Act the transfer from the CF to the UPF is not deductible in the CF's hands, nor is it taxable in the UPF's hands but instead creates a balance of deficits that may be offset against future transfers to the CF.

Following from the preceding explanation, in determining the tax liability arising on the transfer, it seems as if premiums, claims, reinsurance claims received and premiums paid are effectively included in the CF's income, by taking these items into account in calculating the value of assets. It is important to note however that one can only conclude on the inclusion of these items in the transfer from the relevant policyholder fund to the CF after considering the treatment thereof in calculating the value of liabilities (see discussion in 5.2.2 below).

Moreover, excess assets of a policyholder fund transferred in terms of section 29A(7)(a) of the Act are included in the CF's income (Income Tax Act 1962: section 29A(11)(d)(i)).

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5.2.3 Actuarial principles

Professional Guidance Note 104 (2005: §5.3) issued by the Actuarial Society of South Africa (ASSA) determines that a life insurer's policyholder liabilities are to be determined in terms of Board Notice 72 (2005) issued by the FSB. Board Notice 72 (2005) provides for the inclusion in a policyholder fund's underwriting liabilities the following items:

- premium income;
- claims incurred;
- expenses incurred;
- guarantees that have been given under the policy; and
- future fees and charges that may be deducted in terms of the policy. (FSB Notice 72 2005: §2.3 & 6.2.)

It therefore follows from the application of FSB Notice 72 (2005) and PGN 104 (2005) that premium income and claims incurred are to be included in the value of liabilities.

As explained earlier in this chapter, the excess or deficit of a policyholder fund's assets over its liabilities is determined by deducting the liabilities of such policyholder fund from the market value of assets (Income Tax Act 1962: section 29(A)(7)).

It logically follows from the discussion above that premium income received, claims paid, reinsurance premiums paid and reinsurance claims received are included in both the market value of assets as well as in the value of liabilities. Notwithstanding the preceding conclusion, a life insurer is taxed on its underwriting result by way of the inclusion of surpluses in the CF's taxable income in terms of section 29A(11)(d)(i). (Bester: 2005.)

5.3 SUMMARY

Section 29A(11)(g) of the Act determines that part of the underwriting results of a life insurer is disregarded for purposes of determining its taxable income. This is because a life insurer does not have a representative taxpaying capacity in respect of the capital (premiums) invested by policyholders.

Furthermore, section 29A(11)(d) of the Act determines that the surplus of assets over liabilities in a particular policyholder fund have to be transferred to and taxed in the CF. It was found that both the market value of assets, as well as the value of liabilities include the underwriting results of a particular policyholder fund. A life insurer is however taxed on its

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underwriting results by way of the annual transfer of surpluses from policyholder funds to the CF.

Life insurers are therefore taxed on their underwriting business. All other corporate taxpayers are subject to tax on their trading or business profits. It is therefore concluded that the income tax regime in respect of a life insurer's underwriting business does not create a preferential tax position for life insurers in comparison to other corporate taxpayers.

In the following chapter of this study the taxation of the other part of a life insurer's business. its investment activities and the return derived there from, will be discussed and compared with that of other corporate taxpayers.

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CHAPTER 6
TAXATION OF INVESTMENT INCOME ACCRUED BY LIFE INSURERS

6.1 INTRODUCTION

The Explanatory Memorandum Revenue Laws Amendment Bill (1999:3) held that a life insurer is taxed on two tiers: one in its representative capacity of policyholder funds and the other on its own income. This chapter examines and concludes on the taxation of a life insurer's investment income.

6.2 TAX PRINCIPLES APPLIED IN THE TAXATION OF INVESTMENT INCOME

Section 29A(2) of the Act determines that *"[t]he taxable income derived by any insurer in respect of any year of assessment commencing on or after 1 January 2000, shall be determined in accordance with the provisions of this Act, but subject to the provisions of this section"*. It therefore follows that the investment income of a life insurer is taxed in terms of the same principles and provisions as any other taxpayer, except in cases where section 29A of the Act determines otherwise.

Huxham & Haupt (2005: 625) states that *"[e]ffectively, therefore, the insurer is taxed on investment income net of costs of producing that income and net of running costs. Basically, any expenses incurred specifically in the production of exempt income are disallowed."*

In view of the above, a life insurer's taxable income derived from investments is subject to the gross income definition (Income Tax Act 1962: section 1) and the general deduction formula (Income Tax Act 1962: section 11(a)) read together with section 23(g) of the Act (**Port Elizabeth Electric Tramway Co Ltd v CIR**,1936 CPD (8 SATC 13)).

Other provisions of the Act that would be applicable include:

- section 24J in respect of the accrual and incurral of interest;
- section 10(1)(k) in respect of exempt dividend income;
- section 10(1)(k) in respect non-exempt foreign dividend income;
- section 23(f) in respect of expenditure incurred in the production of an amount that does not constitute income as defined; and
- section 11 in respect of various deductions and allowances. (Income Tax Act 1962: section 29A(2).)

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In terms of the trustee principle a life insurer pays income tax on the investment income derived by policyholder funds as a result of its representative taxpaying capacity (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 4). The cost of the tax on the investment income however is borne by the relevant policyholders within the specific fund (FSB Notice 72 2005: §2.3 & 6.2)

6.3 SPECIFIC PROVISIONS IN RESPECT OF THE DEDUCTIBILITY OF EXPENDITURE INCURRED BY A LIFE INSURER

Section 29A(11)(a) of the Act contains a formula in order to specifically determine the deductible expenditure in the IPF and the CPF (Huxham & Haupt 2005: 628). It provides that a life insurer should determine the deductible portion of the IPF's selling, administration and other expenses according to the following formula:

$$Y = \frac{(I+R+F)}{(I + 2{,}5R + 4{,}75F + 4{,}75L)} \times \frac{100}{1}$$

It further prescribes that the deductible portion of the CPF's selling, administration and other expenses should be determined according to the following formula:

$$Y = \frac{(I+R+F)}{(I + 2R + 3{,}5F + 3{,}5L)} \times \frac{100}{1}$$

In both formulas the symbols represent the following:

- "Y" represents the percentage to be applied to such amount;
- "I" represents the gross amount of any interest as defined in section 24J of the Act, received by or accrued to such fund;
- "R" represents the rental income of such fund after deduction of expenses directly attributable to such income;
- "L" represents the dividend income (other than taxable foreign dividends) of such fund; and
- "F" represents the taxable foreign dividends of such fund. (Income Tax Act 1962: section 29A(11)(a).)

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It follows clearly from the extract above that:

- exempt dividend income is excluded from the denominator but included in the numerator. It thus effectively reduces the deductible portion of expenditure. This conclusion is confirmed in the Explanatory Memorandum Revenue Laws Amendment Bill (1999: 4) which states that *"the underlying principle of apportionment is to exclude that portion of expenses attributable to non-taxable income, such as dividend income…"*;
- the factor applied to net rental income is 2.5 and 2.0 for the IPF and CPF respectively,
- the factor applied to foreign dividends is 4.75 and 3.5 for the IPF and CPF respectively; and
- the factor applied to local dividend income is 4.75 and 3.5 for the IPF and CPF respectively.

The reason for reducing the deductible portion of expenditure is that only expenditure incurred in the production of amounts that constitute "income" as defined in section 1 of the Act may be deducted for purposes of determining taxable income (Income Tax Act 1962: section 23(f)). Income is defined in section 1 of the Act as *"…the amount remaining of the gross income of any person for any year or period of assessment after deducting there from any amounts exempt from normal tax…"* In terms of section 10(1)(k) of the Act, dividend income from a South African source (in short referred to as 'local dividend income') is exempt from tax (Silke 2005: 73). Local dividend income would, in general, therefore not be included in income as defined.

It therefore follows that in terms of section 23(f) of the Act any expenditure incurred in the production of exempt local dividend income would not be deductible for purposes of determining taxable income. It is also important to note that the above-mentioned formulae are only applied to expenditure of the IPF and the CPF, but not to the CF.

6.4 EFFECT OF THE 'EXPENSE RELIEF RATIO'

The effect of the expense relief ratio discussed in 6.3 above and contained in section 29A(11)(a)(ii) of the Act is evaluated in the example below.

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Assume a taxpayer accrues the following income during a year of assessment:

Interest income	R1,000,000
Local dividend income	R500,000
Foreign dividend income	R300,000
Net rental income	R200,000

Further assume that expenses incurred in the production of the above-mentioned income amounted to R1,200,000 and that the portion of these expenses that relates exclusively to the production of local dividend income is not known.

The effect on the deductibility of these expenses is summarised in the table below, assuming that the identity of the taxpayer is that of the column headings:

Item	**IPF**		**CPF**		**Other corporate taxpayer**	
	Factor	**Total R**	**Factor**	**Total R**	**Factor**	**Total R**
Numerator		*1,500,000*		*1,500,00*		*1,500,000*
Interest	1	1,000,000	1	1,000,000	1	1,000,000
Foreign dividends	1	300,000	1	300,000	1	300,000
Net rental	1	200,000	1	200,000	1	200,000
Denominator		*5,300,000*		*4,200,000*		*2,000,000*
Interest	1	1,000,000	1	1,000,000	1	1,000,000
Foreign dividends	4.75	1,425,000	3.5	1,050,000	1	300,000
Net rental	2.5	500,000	2	400,000	1	200,000
Local dividends	4.75	2,375,000	3.5	1,750,000	1	500,000
Answer to formula		28.3%		35.7%		75%
Deductible portion		R339,623		R428,571		R900,000

It is clear from this example that the formulae contained in section 29A(11)(a)(ii) of the Act adversely effects the deductibility of expenses incurred by a life insurer when compared to other corporate taxpayers.

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In evaluating the effect of the formulae on the deductibility of expenditure in a scenario where no exempt income is accrued, the outcome was as follows (all details are the same as in the preceding example except for the local dividend income being R nil):

Item	IPF		CPF		Other corporate taxpayer	
	Factor	Total R	Factor	Total R	Factor	Total R
Numerator		*1,500,000*		*1,500,00*		*1,500,000*
Interest	1	1,000,000	1	1,000,000	1	1,000,000
Foreign dividends	1	300,000	1	300,000	1	300,000
Net rental	1	200,000	1	200,000	1	200,000
Denominator		*2,925,000*		*2,450,000*		*1,500,000*
Interest	1	1,000,000	1	1,000,000	1	1,000,000
Foreign dividends	4.75	1,425,000	3.5	1,050,000	1	300,000
Net rental	2.5	500,000	2	400,000	1	200,000
Local dividends	4.75	Nil	3.5	Nil	1	Nil
Answer to formula		51.3%		61.2%		100%
Deductible portion of R1,200,000 expenses		R615,385		R734,694		R1,200,000

As was the case in the first example, the formulae contained in section 29A(11)(a)(ii) of the Act produce results that serve as proof that life insurers are effected adversely by present income tax legislation in respect of the deductibility of expenditure subject to section 29A(11)(a)(ii).

The reason for weighing the rental income, local dividends and foreign dividends in the denominator of the formulae contained in section 29A(11)(a)(ii) of the Act is to bring it in line with the yield on an interest bearing investment. At the time that section 29A of the Act was drafted, a reasonable yield on an interest bearing investment was 15%, on a rental bearing investment 5% and on a dividend bearing investment 2.5%. The weights allocated to rental income, local dividend income and foreign dividend income are therefore intended to make these items comparable with the pre-tax status of interest income and to ensure the tax treatment thereof is in line with general income tax principles. (Landman: 2005.)

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6.5 ALLOCATION OF ITEMS BETWEEN THE FOUR TAX FUNDS

The allocation of expenses between the various tax funds is critical as a result of the effect that the formulae contained in section 29A(11)(a) of the Act has on the deductibility of a life insurer's expenditure (as explained in 6.4 above).

Section 29A(12) of the Act provides that *"[i]n the allocation of any asset, expenditure or liability to any fund contemplated in subsection (4), an insurer shall, when establishing such fund and at all times thereafter-*

(a) to the extent to which such asset, expenditure or liability relates exclusively to business conducted by it in anyone fund, allocate such asset, expenditure or liability to that fund; and

(b) to the extent to which such asset, expenditure or liability does not relate exclusively to business conducted by it in any one fund, allocate such asset, expenditure or liability in a manner which is consistent with and appropriate to the manner in which its business is conducted."

It is notable from the above extract: that section 29A(12) of the Act only deals with the allocation of assets, liabilities and expenditure between the tax funds. It is silent about the allocation of income between the four tax funds. However it follows logically that income derived from a specific asset would follow that asset, i.e. an interest-bearing investment would produce interest income, a dividend-yielding investment would produce dividend income, etc. The fund to which the asset has been allocated would therefore also be the fund to which the income from that asset be allocated.
However, in terms of section 31(2) of the Long-Term Insurance Act (1998) a life insurer may only invest in those types of assets that match the life insurer's liabilities towards policyholders. It logically follows that the liabilities of a policyholder fund would determine the types of assets that the life insurer may invest in. Since income follows assets (as explained above) it therefore logically follows that the liabilities of a policyholder fund would determine the types of income derived from investments by that policyholder fund.

6.6 TAX ON THE UPF'S INVESTMENT INCOME

In terms of section 29A(9) of the Act the UPF is exempt from income tax. It is, however, taxed on its interest income and net rental income (Tax on Retirement Funds Act 1996: section 3). The sum of the UPF's interest and net rental income is currently taxed at a rate of 18% (PwC Tax Information 2005/2006).

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6.7 SUMMARY

It is clear from the above discussion that life insurers are not taxed differently from other corporate taxpayers in respect of investment income accrued. This conclusion, however, is not true in respect of the deductibility of expenditure incurred by both the IPF and CPF of a life insurer in producing investment income. The examples discussed in 6.4 above proved that a smaller portion of both the IPF's and CPF's expenditure would be deductible for purposes of determining taxable income when compared to other corporate taxpayers

The deductibility of expenditure incurred in the production of investment income adversely affects a life insurer. Also, the composition of a life insurer's investment income would have a significant impact on its income tax position.

It is concluded that the composition of a life insurer's policyholder liabilities would directly impact on its composition of assets backing those liabilities and therefore also on the composition of investment income. The composition and allocation of investment income between the various tax funds would directly effect the life insurer's income tax position (see 6.5 above).

Whether current income tax legislation in respect of investment income is more or less favourable to the life insurance industry, cannot be concluded on. The conclusion can only be made on a case-by-case basis after consideration was given to the specific facts and circumstances at hand.

The next chapter of this study will deal with the taxation of capital gains and losses in a life insurer.

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CHAPTER 7
TAXATION OF CAPITAL GAINS IN LIFE INSURERS

7.1 INTRODUCTION

Any resident person is subject to CGT with effect from 1 October 2001 (Income Tax Act 1962: section 26A). Considering the fact that a resident life insurer is a person (Income Tax Act 1962: section 1), the provisions of section 26A also apply to a life insurer. It would therefore have to include the taxable capital gain accrued in any year of assessment in the calculation of its taxable income (Income Tax Act 1962: section 26A). The taxable capital gain is calculated in terms of the provisions of the Eighth Schedule to the Act (Clegg 2003: 7).

Although not intended to be a detailed discussion on CGT, this chapter will deal with the more important CGT provisions affecting life insurers in comparison to other corporate taxpayers.

7.2 CGT AND ALL CORPORATE TAXPAYERS (INCLUDING A LIFE INSURER)

Although not a complete list, the following provisions of the Eighth Schedule to the Act affect all corporate taxpayers, including life insurers:

- CGT is triggered by the disposal of an asset (Clegg 2003: § 3.1);
- a disposal is defined as "*...any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset...)*
  (Clegg 2003: § 3.1). Note that a disposal is not necessarily a bilateral transaction but can also result from the failure to do something ("forbearance") or from the action of a third party ("operation of law")(Clegg 2003: 12);
- an asset is defined as –
  "(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
  (b) a right or interest of whatever nature to or in such property..."
  (Income Tax Act 1962: paragraph 1 of the Eighth Schedule);
- in principle, capital gains and losses are determined by deducting from the proceeds (determined in terms of part VI) of a disposal (defined in paragraph 11) or a deemed disposal (defined in paragraph 12), the base cost (determined in terms of part V) of an asset (Silke 2005: 563);

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- proceeds is defined as *"...the amount received by or accrued to, or which is treated as having been received by, or accrued to or in favour of, that person in respect of that disposal..."* (Income Tax Act 1962: paragraph 35(1) of the Eighth Schedule). Proceeds must be reduced by any amount of the proceeds included in gross income or taken into account in determining the taxable income of that person before inclusion of taxable capital gains (Income Tax Act 1962: paragraph 35(3)(a) of the Eighth Schedule);
- in simple terms the base cost of an asset is the cost of acquiring it, plus costs of improving or adding to it (Huxham & Haupt 2005: 674);
- CGT is payable in respect of every year of assessment's taxable capital gains (Income Tax Act 1962: section 26A). In order to calculate taxable capital gains, the following sequence is followed:
  - ✓ current year capital gains and losses are added together and result in an aggregate capital gain or aggregate capital loss (Income Tax Act 1962: paragraph 6(a) and 7(a) of Eighth Schedule);
  - ✓ the net capital gain of a taxpayer is determined by deducting from its aggregate capital gains any assessed capital losses brought forward from earlier years of assessment (Income Tax Act 1962: paragraph 8 of Eighth Schedule); and
  - ✓ an inclusion rate is then applied to the net capital gain to arrive at a taxable capital gain (Income Tax Act 1962: paragraph 10 of Eighth Schedule);
- both the CPF and CF have an inclusion rate of 50% of net capital gains as taxable capital gains (Income Tax Act 1962: paragraph 10(c) of the Eighth Schedule). All other corporate taxpayers (except entities that are exempt from income tax in terms of section 10 of the Act also have to include 50% of their net capital gains as taxable capital gains in terms of the same paragraph of the Eighth Schedule (Clegg 2003: § 2.1);
- aggregate capital losses are ring-fenced and the taxable income in a specific year of assessment cannot be reduced by the amount of capital losses generated during the year (Clegg 2003: 8); and
- an income tax loss can, however, be offset against a taxable capital gain (Clegg 2003: § 2.1).

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7.3 CGT PROVISIONS ONLY APPLICABLE TO LIFE INSURERS

The following provisions of the Eighth Schedule to the Act represent some of the CGT provisions that are only applicable to life insurers in comparison to other corporate taxpayers:

- transfers between policyholder funds and the CF in terms of section 29A(7) of the Act are deemed to be disposals for CGT purposes (Income Tax Act 1962: paragraph 12(2)(f) of the Eighth Schedule); and
- for CGT purposes the various tax funds of a life insurer are "*...deemed to be separate companies which are connected persons in relation to each other...*" (Income Tax Act 1962: section 29A(10)). It follows from the quotation that a life insurer's tax funds are deemed to be companies for CGT purposes.

Having established that one can therefore compare the various tax funds of a life insurer with other corporate taxpayers for purposes of this study, it is important to note that in terms of paragraph 10(b)(i) of the Eighth Schedule, the IPF has an inclusion rate of 25% of net capital gains in taxable income. Considering that all other corporate taxpayers have to include 50% of their net capital gains in taxable income (Income Tax Act 1962: paragraph 10(c) of the Eighth Schedule), it appears on face value that life insurers do have preferential tax treatment in respect of the IPF's lower inclusion rate than that of other companies. One should however not lose sight of the fact that:

- a life insurer has a representative taxpaying capacity in respect of income derived by policyholder funds (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 4); and
- the inclusion rates of net capital gains applicable to policyholder funds are in sink with the inclusion rates of the underlying policyholders (SARS 2005: 3).

It follows from the above that a life insurer includes 25% of the net capital gains accrued by the IPF in its taxable income, as a result of the representative taxpaying capacity imposed by the 'trustee principle'. A life insurer therefore merely acts as the representative taxpayer on behalf of the individual policyholders. One can therefore not conclude that a life insurer has a preferential CGT regime because of the IPF's lower inclusion rate of net capital gains.

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7.4 POTENTIAL DOUBLE TAX ON YEAR-END TRANSFERS

In terms of section 29A(7) of the Act a life insurer has to determine its policyholder liabilities on an annual basis within four months after its year-end.

Moreover, a life insurer is allowed to place assets in each of its policyholder funds, having a market value equal to the liabilities of that fund (Income Tax Act 1962: section 29A(4)(a), (b) & (c)).

On an annual basis, the excess of the market value of these assets over the value of policyholder liabilities needs to be transferred from the particular policyholder fund to the CF (Income Tax Act 1962: section 29A(7)(a)). Likewise, a deficit of the market value of these assets under the value of policyholder liabilities needs to be transferred from the CF to the particular policyholder fund (Income Tax Act 1962: section 29A(7)(b)).

Section 29A(8) of the Act provides that *"... [A]ny transfer of an asset effected by an insurer between one fund and another fund shall be effected by way of a disposal of such asset at the market value thereof and shall for the purposes of this Act be treated as an acquisition or disposal of such asset, as the case may be, in each such fund."*

Section 29A(11)(d), (e) & (f)) further provides that:

- any amount transferred to the CF in terms of the provisions of subsection (7)(a) shall be included in the income of the CF;
- any amount transferred from the CF shall not be deducted from the income of the CF, but is carried forward to be offset against future transfers to the CF; and
- any amount transferred from the CF to a policyholder fund will not be included in the income of such policyholder fund.

It is clear from the above that the transfer from a policyholder fund to the CF is taxable in the CF. This transfer is taxed in the CF at the normal income tax rate applicable to companies (currently 29%) (Huxham & Haupt 2005: 628). Furthermore, the CF cannot deduct from its taxable income any transfer made to a policyholder fund in order to make good a shortfall or deficit in that policyholder fund, but instead gets relief from income tax on future transfers of excesses from policyholder funds (Income Tax Act 1962: section 29A(11)(d)(ii)). Thus, in summary, the CF pays the normal income tax charge on transfers from policyholder funds (Explanatory Memorandum Revenue Laws Amendment Bill 1999: 4).

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However, paragraph 12(2)(f) of the Eighth Schedule to the Act deems the transfer of an asset resultant from the provisions of section 29A(7) to be a disposal for CGT purposes. Any tax fund of a life insurer would therefore have to include in its capital gains and losses an amount in respect of the gains or losses accrued or incurred on the deemed disposal of assets in order to facilitate the transfer contemplated in section 29A(7) of the Act.

It follows from the extracts above that the transfer contemplated in section 29A(7) might be taxed twice: it increases the CF's taxable income (as explained earlier in this chapter) and at the same time could give rise to a CGT liability in the policyholder fund from which the assets are transferred.

A practical example should explain this better:
Assume the information in the table below as the year end transfer to or from the CF in terms of section 29A(7) of the Act. Further assume that the assets transferred do not constitute currency for purposes of the definition of an asset in paragraph 1 of the Eighth schedule to the Act.

Income statement item	**IPF** **R**	**UPF** **R**
Premium income	1,000,000	1,000,000
Reinsurance claims	50,000	50,000
Investment income	100,000	100,000
Accounting gains	120,000	120,000
Claims	(650,000)	(650,000)
Reinsurance premiums	(40,000)	(40,000)
Selling & admin expenses	(350,000)	(350,000)
Accounting losses	(10,000)	(10,000)
Total movement for the year	220,000	220,000
Plus: Opening value of policy holder assets	280,000	280,000
Closing value of assets	500,000	500,000
Less: Value of liabilities	(450,000)	(520,000)
Excess/ (deficit) transfer	50,000	(20,000)

The effect of the transfers on taxable income is that:

- the CF includes the R50,000 transfer in its taxable income (Income Tax Act 1962: section 29A(11)(d)(i));

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- the IPF is deemed to have disposed of assets for proceeds equal to R50,000 to the CF (Income Tax Act 1962: paragraph 12(2)(f) of the Eighth Schedule). The IPF includes 25% of the net capital gain resulting from the deemed disposal in its taxable income as taxable capital gains (Income Tax Act 1962: paragraph 10(b)(i) of the Eighth Schedule);
- the CF is deemed to have disposed of assets for proceeds equal to R20,000 to the UPF (Income Tax Act 1962: paragraph 12(2)(f) of the Eighth Schedule). The CF includes 50% of the net capital gain resulting from the deemed disposal in its taxable income as taxable capital gains (Income Tax Act 1962: paragraph 10(c) of the Eighth Schedule); and
- thus, assuming that the base cost of the assets disposed of is R nil, the total income tax charge on the transfer is an amount of R21,150, which is made up as follows:
  IPF: R3,750 (25% x R50,000 x 30%)
  CF: R14,500 (R50,000 x 29%)
  CF: R2,900 (50% x R20,000 x 29%)

  The CGT on the year end transfers therefore increases the life insurer's total income tax charge with R6,650.

However, section 29A(10) of the Act states that the various tax funds of a life insurer are treated as *"separate taxpayers"*. It follows therefore that transfers between the various policyholder funds of a life insurer and its CF in a particular year of assessment is taxed in different taxpayers (one being the CF and the other being the policyholder fund).

7.5 SUMMARY

CGT introduced the principle of tax on profits of a capital nature to the South African income tax system.

Capital profits are only taxed on realisation ('disposal') of assets in terms of CGT legislation. Life insurers like any other corporate taxpayer (other than an entity exempt from income tax in terms of section 10 of the Act are taxed on the realisation of the capital profit resulting from the disposal of assets held for non-speculative purposes.

It could have been argued that CGT legislation effecting life insurers is more beneficial than that of other corporate taxpayers considering that the IPF includes a smaller portion (25%) of its net capital gains in taxable income. All other companies (except for companies that are

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exempt from income tax in terms of section 10 of the Act have to include 50% of their net capital gains in taxable income. However, the IPF's inclusion rate results from the effect of the 'trustee principle' in that a life insurer has a representative taxpaying capacity in respect of the tax liability derived by a policyholder fund. It thus follows that the lower inclusion rate of the IPF is merely a reflection of the CGT charge of the natural persons that are policyholders of that fund and does not constitute a preferential CGT regime for a life insurer.

Moreover, the fact that a life insurer would incur both a CGT as well as a normal income tax liability in respect of year-end transfers between funds (refer to discussion and example in 7.4 above) effectively means that life insurers have a less beneficial CGT regime. The fact that an amount is taxed twice within a single legal entity (albeit in separate taxpayers) constitutes an additional tax charge for the life insurer.

It would therefore be incorrect to conclude on this matter that life insurers in general, have a more beneficial CGT regime than other corporate taxpayers. The conclusion can only be made with reference to the assets that a life insurer transfers at year-end, in terms of section 29A(7) of the Act. Also, with reference to the fund that has to include the taxable capital gains in its taxable income.

The next chapter of this study represents the research conclusion and recommendations

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CHAPTER 8
CONCLUSION AND RECOMMENDATIONS

8.1 INTRODUCTION

In chapters 3 to 7 the income tax regime of life insurers was compared to that of other taxpayers. In this chapter, which concludes the research, the study will be summarised and the conclusion will be tested against the objectives and hypothesis stated in chapter 1.

8.2 SUMMARY OF RESEARCH STRATEGY

The objective (as stated in chapter 1) of this study was to test the validity of the potential perception, surrounding the preferential tax treatment of life insurers, by comparing the principles associated with the taxation of a life insurer with that of other corporate taxpayers.

In order to achieve the primary objective, the following strategy was followed:

- an extensive literature study was conducted to ensure quality and practical information;
- the basic principles of the life insurance industry's income tax regime was discussed (chapter 2) to provide the necessary background information;
- the 'trustee principle' which is the foundation of the current tax regime of the life insurance industry, was discussed in detail (chapter 3);
- the 'four funds approach' that governs the taxation of life insurers, was discussed in detail (chapter 4);
- the taxation of a life insurer's business of underwriting risks was compared to that of other corporate taxpayers (chapter 5);
- principles applied in the taxation of a life insurer's investment income were compared to the principles governing the taxation of investment income in the hands of other corporate taxpayers (chapter 6); and
- the taxation of capital gains in the hands of a life insurer was compared to the taxation of capital gains in the hands of other corporate taxpayers (chapter 7).

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8.3 COMMENTS AND RECOMMENDATIONS

The table below summarises the findings of the study on the differences between the taxation of life insurers and other companies:

Criteria	Differences found	Favourable tax treatment
Application of the 'trustee principle' (chapter 3)	The 'trustee principle' applies automatically to life insurers because they are deemed to be holding and administering funds on behalf of policyholders. The principle that a person cannot be taxed on an amount accrued on behalf of someone else applies to all taxpayers.	No favouritism to any group of taxpayers *per se*. The principle of no taxation on an amount accrued on behalf of someone else or for the benefit of someone else applies to both life insurers as well as other corporate taxpayers.
Application of the 'four funds approach' (chapter 4).	The 'four funds approach' forms the basis for calculating a life insurer's income tax liability. Only life insurers have to establish and maintain four separate taxpayers within one legal entity.	The 'four funds approach' is unique to the life insurance industry and brought about income tax legislation that is specific to life insurers. Preferential tax treatment for life insurers can only result from the legislation that is specific to them. Preferential tax treatment can therefore only be concluded upon with reference to the effect on the taxation of underwriting results, investment income and capital gains.
Taxation of underwriting profits (chapter 5).	Life insurers must 'disregard' certain income statement items (that are included in their underwriting results) for purposes of determining taxable income. The disregarding of	The principle of a person not being taxed on income accrued on behalf of someone else, applies to both life insurers and other corporate taxpayers. Life

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Criteria	Differences found	Favourable tax treatment
	these income and expenditure items result from the representative taxpaying capacity imposed on a life insurer by the 'trustee principle'. A life insurer is however taxed on its underwriting results by way of the annual transfer of surpluses to the CF.	insurers are however taxed on their underwriting profits. This is no different than any other corporate taxpayer that is taxed on trading or business profits. No preferential tax treatment has thus been awarded to life insurers in respect of the taxation of their underwriting results.
Taxation of investment income (chapter 6).	Life insurers are taxed on their investment income on a basis consistent with the provisions of the Act. The same provisions apply to other taxpayers. The fixed formulae that determine the deductible portion of a life insurer's selling and other expenses have the effect that a life insurer cannot deduct the same portion of expenses in determining taxable income as other corporate taxpayers. A smaller portion of expenses is deductible for purposes of determining taxable income by a life insurer.	There is no beneficial income tax treatment for life insurers in respect of investment income. However deductible expenditure is not calculated with reference to a fixed formula by other corporate taxpayers. One cannot conclude on preferential tax treatment with regards to investment income without taking into account the investment income composition of a corporate taxpayer and that of a life insurer. Any evaluation of preferential tax treatment in respect of investment income therefore can only be based on the merits and facts of each individual case.
Taxation of capital gains (chapter 7).	The various tax funds of life insurers apply different inclusion	The preferential inclusion rates of the UPF and IPF of

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Criteria	Differences found	Favourable tax treatment
	rates to net capital gains, in order to determine taxable capital gains. The various inclusion rates are indicative of the nature of the policyholders and shareholders that ultimately bares the CGT cost. Other corporate taxpayers have to include 50% of their net capital gains in order to determine taxable capital gains. In addition, life insurers are subject to CGT on transfers between the four tax funds as well as income tax on transfers between policyholder funds and the CF. Other corporate taxpayers are not subject to any transfers of this kind as they would not have four separate taxpayers within one legal entity like a life insurer has.	a life insurer are in consequence of the representative tax paying capacity imposed on a life insurer by the 'trustee principle'. Other corporate taxpayers are taxed on exactly the same basis in respect of capital gains accrued on behalf of someone else. It can therefore not be concluded that life insurers have a more beneficial tax regime than other corporate taxpayers in respect of CGT. The fact that a life insurer might be subject to both income tax and CGT on transfers between tax funds, impacts negatively on a life insurer when compared to other corporate taxpayers. As is the case with investment income, a conclusion with respect to whether a life insurer has a preferential CGT position or not can only be made if one considers all relevant circumstances. These circumstances include the type of business the life

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Criteria	Differences found	Favourable tax treatment
		insurer underwrites, the identity of the fund in which the business is written, the nature of the assets that back policyholder liabilities, etc. To generalise on the matter would be an incorrect account of the real position.

It is recommended that the tax rate applicable to profits of the IPF be revisited by the legislature, as the composition of IPF business differs from life insurer to life insurer. Some life insurers focus on providing wealthy individuals with alternative investment options to those products offered by deposit-taking institutions while other life insurers focus on providing lower income earning individuals with risk benefits. Clearly the income earning capacity of the individuals mentioned in the preceding example is not the same. It is therefore not equitable to assume an average tax rate of 30% for individuals and apply that to all life insurers that write IPF business.

8.4 CONCLUSION

The research undertaken in this study revealed several differences between the taxation of life insurers and other corporate taxpayers. On face value, some of these differences seem to create preferential tax treatment of life insurers. These differences include:

- the UPF's profits are exempt from income tax.
  One can however therefore not compare the UPF with other corporate taxpayers that are not exempt from income tax. To conduct a meaningful comparison with the UPF one has to compare it to other entities that are also exempt from income tax. Such a study does not fall within the scope of this study and one therefore cannot conclude on preferential treatment of the UPF for purposes of this study; and
- the IPF has a lower inclusion rate (25%) in respect of its net capital gains
  Other corporate taxpayers have to include 50% of their net capital gains in the calculation of taxable income. The IPF's lower inclusion rate however results from its representative taxpaying capacity in consequence of the 'trustee principle'. The 'trustee principle' applies to other corporate taxpayers as well in respect of income derived on behalf of someone else. Thus no preferential tax treatment for life insurers

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resulting from CGT legislation.

It is therefore concluded that the differences identified that supposedly create tax preferential treatment of life insurers result from the application of the 'trustee principle'. The 'trustee principle' applies to both life insurers as well as other corporate taxpayers with respect to income that is derived on behalf of someone else. There were therefore no instances found that indicated preferential tax treatment for life insurers compared to other corporate taxpayers.

Moreover, on face value, life insurers have a less-favourable tax regime in respect of:

- expenditure that they may claim as a deduction for purposes of calculating taxable income. This is because of the fixed expense relief ratio that must be applied to a portion of its expenditure; and
- the income tax as well as CGT provisions governing the treatment of transfers between tax funds. A life insurer may incur both a CGT liability in the transferor fund as well as an income tax liability in the transferee fund, in respect of the same amount. Any other company will incur a tax liability (whether it's a CGT liability or an income tax liability) only once on a specific amount.

These differences however may only be applicable under certain circumstances and will not be applicable to all life insurers. To generalise on the matter would therefore be incorrect and ignorant of all relevant issues.

It is clear from the summary above that some provisions of the Act may be perceived to have the effect of creating a more favourable tax regime for life insurers, whereas some provisions have the exact opposite effect: creating a less favourable tax position for a life insurer

The research results have proven that one cannot generalise and conclude on the preferential tax treatment of life insurers under all circumstances. Variables such as the identity of a life insurer's policyholder funds, the nature of assets that back the policyholder liabilities as well as the types of business that a life insurer conducts will determine the tax-favouritism attached to a life insurer. These variables will differ from life insurer to life insurer and one can therefore only conclude on the issue of tax-favouritism after considering all circumstances relevant to a specific life insurer.

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