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National Treasury
Private Bag X115
Pretoria
0001

For attention: nombasa nkumanda@treasury.gov.za;
acollins@sars.gov.za

Dear Nombasa and Adele,

DRAFT TAXATION LAWS AMENDMENT BILL, 2014: CHANGES TO SECTION 29A

We refer to the call for comments on the above-mentioned document. Set out below please find the SAICA National Tax Committee’s submission relating to the proposed changes to Section 29A of the Income Tax Act, 1962, as outlined in the First Draft of the Tax Laws Amendment Bill, 2014 (“2014 Draft TLAB”).

Unless indicated otherwise, all references to sections are to sections of the Income Tax Act, No 58 of 1962 (“the Act”) and references to clauses are to clauses of the 2014 Draft TLAB.
Clause (a) of the 2014 Draft TLAB: Definition of ‘Risk Policy’

The proposed definition of ‘risk policy’ in clause (a) is extremely wide. In SAICA’s opinion the proposed definition of a “risk policy” will include policies that contain a substantial investment element. In its proposed form it include typical “investment policies” with an appropriate level of risk cover, which will lead to unintended tax and financial consequences. Furthermore, the proposed definition will provide life companies with the opportunity to design long-term policies in a manner that ensures a particular tax status and tax fund allocation. This is not in line with National Treasury’s intention as set out in the Media statement, dated 10 June 2014, where it is stated that a clear distinction will be drawn in the taxation of investment and risk business conducted by long-term insurers.

The proposed definition of a “risk policy” and the consequent taxation of the business will thus have significant financial implications for long-term insurers if enacted in the current proposed form. The consequence is that new business underwritten with effect from 1 January 2016, which qualifies as a “risk policy”, will gain access to gross tax roll-up (acquisition and other expenses will be off-set against any investment return, with little or no tax emerging). This may also have the unintended consequence of exposing existing Individual Policyholder Fund (‘IPF’) policies to a lapse and re-entry risk as these policies are moved to the corporate fund to gain access to the gross roll-up. Such large scale churn will not be in the interest of either long-term insurers or National Treasury/SARS and could lead to significant financial losses being incurred by both long-term insurers and the fiscus.
SAICA recommends that the definition of a “risk policy” be reworded by referencing it to the UK Finance Act definition for risk policies, and should read as follows:

“Risk policy means-

(a) any contract of long-term insurance under which the benefits payable cannot exceed the amount of premiums paid, except on death or in respect of a life event such as incapacity due to disability, injury, illness or other infirmity”;
(b) Any reinsurance contract in respect of a policy as contemplated in paragraph (a); and
(c) The contract is entered into on or after 1 January 2016.

The definition must further exclude annual premium increases and/or enhancements in respect of existing policies in force at the effective date to ensure that in-force business is not reclassified and subject to taxation in respect of the new proposals.

Furthermore, consideration must be given to allow for circumstances where the surrender value of the “risk policy” exceeds the premium paid during the life of the policy.

Clause (b) and (c) of the 2014 Draft TLAB: Exclusion of a “Risk Policy” from the Untaxed Policyholder Fund

SAICA recommends that risk business attributable to retirement fund benefits and other exempt institutions, allocated to the Untaxed Policyholder Fund
be excluded from this new dispensation. The UPF is not taxable and therefore the expenses relating to UPF risk policies do not shield investment returns relating to investment policies.

The reference to “other than a risk policy” should therefore be removed from clause (b)(i) and (c).

The proposed amendment to subsection 4(a) and (a)(ii), if retained, will significantly impact a long-term insurer’s ability to compete for business as it will serve as a disincentive for an exempt institution to enter into a policy which will attract normal tax.

**Clause (e) of the 2014 Draft TLAB: Excess asset transfer**

In clause (e) the reference to the four month period within which a long-term insurer should re-determine its value of liabilities as at the last day of the year of assessment and transfers such excess/shortfall in assets to/from the CF, has been taken out.

SAICA requests clarification whether, by removing the four month period as envisaged in section 29A(7) of the Act, a long-term insurer has to transfer the assets at its year-end or whether it has the discretion to transfer assets during the following year of assessment.

It is operationally impossible to calculate and transfer assets as at the last day of the year of assessment given the complexity and quantum of the assets involved. For the reasons stated above, SAICA recommends that the four month period be retained.
Clause (f) of the 2014 Draft TLAB: Proposed formula in the Corporate Fund (‘CF’)

The proposed formula in clause (f) goes against basic tax principles and cannot be supported by SAICA.

Normal tax principles in respect of the disallowance of expenses should apply to the extent that a taxpayer cannot demonstrate or calculate expenses attributable to exempt income, especially when it is the stated intention of National Treasury to subject risk business to normal tax principles as generally applied to short-term insurers. The envisaged “tainting” of dividend income and capital gains in respect of shareholder specific assets, which is necessary to provide capital to a long-term insurer is not applied to other categories of taxpayers or industry at large.

If the formula is introduced in its current format it will influence the way long-term insurers invest and hold their surplus assets. More likely than not, long-term insurers will be inclined to hold the bare minimum of capital required by statute and surplus assets will be likely to be held outside the long-term insurance entities. The formula is thus likely to drive undesirable outcomes and cause capital allocation distortions.

According to the formula, the ratio of risk premiums to total CF assets must be applied to “amounts allocated to the corporate fund”. It is unclear what is meant by “amounts allocated to the CF” and clarification is required.
SAICA recommends that the assets backing “Risk Policies” be ring-fenced and separately identified from the assets backing a long-term insurer’s capital, through the establishment of a fifth fund to which the risk business must be allocated and which would be taxed according to normal tax principles applicable to, for example, a short-term insurer. This would allow the underwriting profits to emerge in the CF, without distortion. These profits will be fully taxed as envisaged in section 29A(7) of the Act, which will have a much more equitable effect than allocating the business to the CF.

**Clause (h) of the 2014 Draft TLAB: Deduction of insurance liabilities in accordance with IFRS**

Subject to the recommendations below, SAICA is of the view that IFRS is an acceptable basis to use in the determination of a long-term insurer’s liabilities in respect of risk business and is also in line with international principles.

However, SAICA cautions against a pure IFRS valuation basis without regard to negative Rand reserves. In our view, negative Rand reserves should be eliminated and limited to nil on a per policy basis to ensure that the long-term insurer not be taxed on the negative Rand reserves in the initial period of the policy contract term.

Further consideration must be given to align the determination of the insurance liabilities in respect of risk policies with the determination of the “value of liabilities”, as contemplated by section 29A(1) of the Act. The “value of liabilities”, as envisaged, is currently determined by the Chief Actuary of the Financial Services Board, in consultation with the Commissioner. This will, in
SAICA’s view, eliminate any inconsistencies and avoid inequitable results in the profit emerging from risk business.

General

The proposed changes in the manner in which risk business will be subject to tax will have significant and far reaching implications for the long-term insurance industry. The following are the issues that must be considered by National Treasury:

- The lapse risk in churning existing IPF policies into the new tax regime. It is anticipated that it could cost long-term insurers between R200m and R600m depending on whether the policy is placed with the same insurer or not.

- The effect on the pricing of risk business upon implementation of the new tax basis. It is anticipated that premiums of new risk policies will increase by between 5% and 15% for the same insurance cover.

- The impact on current in-force investment business as well as future new business. Although the Retail Distribution Regulations were implemented during the same time, Investment business underwritten by UK life companies declined significantly after the move to the new risk business taxation regime and the investment industry is now completely unattractive from a policyholder perspective and as a consequence has contracted completely. This will have a significant implication on the current savings culture in South Africa, as well as long-term insurers and intermediaries.

- The taxation regime applicable to the IPF will essentially become an investment business fund. The boundaries between a long-term insurer’s
IPF and a collective investment scheme (“CIS”) are now more closely aligned. SAICA recommends that further consideration be given to align the tax treatment of the IPF to that of a CIS in order to avoid any tax arbitrage between long-term insurers and CISs and to ensure a level playing field.

- The operational complexities to implement the new tax regime and required changes to systems in order to administer the new tax regime. The conversion and change in the taxation of risk business in the UK took three years to implement.
- The future additional changes required in the taxation of long-term insurers upon implementation of Solvency II on 1 January 2016.

SAICA is concerned that insufficient time and consultation was allowed to fully comprehend and evaluate the implications of this important change to the Act, the changes in the UK were only implemented after significant iterations and consultations with the industry. Furthermore, the proposed changes must be aligned with the investigation of the taxation of financial institutions currently undertaken by the Davis Tax Committee,

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

Piet Nel CA(SA)

**PROJECT DIRECTOR: TAX**

*The South African Institute of Chartered Accountants*