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Expense allocation – changes to LIFE INSURANCE TAX

The allocation of expenses between the Individual Policyholder Fund ("IPF"), Company Policyholder Fund ("CPF"), Untaxed Policyholder Fund ("UPF"), the Corporate Fund ("CF") and the newly introduced Risk Policy Fund ("RPF"), has always been a contentious issue for long-term insurance companies.

The South African Revenue Service ("SARS") issued Binding General Ruling 30 ("BGR 30") on 7 January 2016 with the purpose to determine the allocation of direct and indirect operating expenses within and between the funds that are required to be established by insurers under section 29A and the subsequent deductibility of such operating expenses, and the deductibility of expenses against transfers under section 29A(7).

It follows that the allocation of expenses are crucially important as it impacts the following:

- Direct result on the tax charge or tax loss owing to each fund. The Income Tax Act requires a long-term insurance company to treat each fund as a separate taxpayer. A long-term insurance company may also not offset the tax loss within one fund against the taxable income of another fund.
- Direct result on the transfers from one fund to another fund as required per the Income Tax Act which may result in an impact on the tax charge or tax loss owing to a specific fund.
- The tax deductibility of an expense within a fund.

It follows that a specific expense may be tax deductible in one fund, but deemed non-deductible within another fund.

- Section 29A(11) requires a company to allocate a deductibility ratio per fund to indirect expenses. Therefore, the misallocation of indirect expenses from one fund to another fund or from direct expenses to indirect expenses can have an impact on the tax charge or tax loss.

Past treatment

Discrepancies identified in the expense allocation method applied – not only ranged from one entity to another – but also within the same entity's application from one year to another year and in some instance, within the same year. SARS also created doubt owing to revised assessments issued to companies attacking the tax deductibility of expenses allocated to the CF. Below is a list of, among others, the most common discrepancies identified.

Inconsistent methodology applied

Companies have allocated expenditure to the various funds by applying the following methodologies:

- Detailed allocation of direct expenditure
- No allocation of expenses as direct expenditure
- Allocation of indirect expenses based on the opening actuarial value of fund liabilities

- Allocation of indirect expenses based on the closing actuarial value of fund liabilities
- Allocation of indirect expenses based on the average actuarial value of fund liabilities
- Allocation of indirect expenses based on the current year premium income of each fund
- Allocation of indirect expenses based on the financial controller's understanding of the business

As mentioned, the above methodologies were not applied consistently. In certain instances, one company, within the same year of assessment, would for instance allocate employee salaries to only the policyholder funds (IPF, CPF and UPF), however, the provision for leave pay was allocated equally between all funds, including the CF.

SARS limitation of tax deductible expenditure

As indicated above, additional assessments received from SARS, denying the tax deductibility of certain expenses within the CF also created doubt and resulted in most long-term insurance companies adopting a conservative approach to allocating expenditure to the CF. As most policyholder funds are in a tax loss position and generally, the CF is tax paying, this resulted in an increase in the tax charge of a company.

The rationale for SARS denying the tax deduction of the expenditure within the CF was owing to the strict application of Section 11(a) and Section 23(g). Among others, Section 11(a) requires an expense to be incurred in the production of income and Section 23(g) indicates an expense is not allowed as a tax deduction from taxable income to the extent that the expense was not laid out for the purpose of trade. Considering that, in terms of the Income Tax Act, all premium income should be allocated to the policyholder funds and each fund is treated as a separate taxpayer, in most cases only investment and rental income are allocated to the CF. It follows that the nature of investment and rental income are more passive in nature. It is SARS' argument that the expenses were neither incurred in the "production" of income, nor was it laid out for the purpose of "trade" as

the income accrued to the CF is passive in nature and would have accrued to the CF without the incurrance of most allocated expenses.

Binding General Ruling 30

In order to address the above mentioned discrepancies and inconsistencies, SARS issued BGR 30.

The proposed allocation of expenses per BGR 30 is as follows:

- Direct allocation of as much expenses as possible to the different funds, such as commissions paid per policy sold
- Expenses incurred directly for shareholding activities should be allocated to the CF
- The remaining expenses which is not deemed direct, is referred to as indirect expenses
- The indirect expenses is first split into two categories, one category for policyholders and one for the CF. The split is accomplished by using the average actuarial value of liabilities per the policyholder funds (opening vs closing balance) and the average market value of assets per the CF (opening vs closing).
- The indirect expenses allocated to the policyholder funds are then further allocated to the IPF, CPF, UPF and RPF by using the premium income for the year per fund.
- BGR 30 explicitly states the following:
 - Expenses that are directly attributable to assets which give rise to exempt income will not be deductible
 - No expenses relating to the CF activities are allowed to be deducted in the CF from the transfers contemplated in Section 29A(7) since no expense is viewed to be incurred in the CF to produce such transfer
 - The deduction of expenses allocated to the corporate fund and the risk policy fund is subject to the requirements of Section 11 read with Section 23
 - The apportioned indirect operating expenses allocated to the CF and the RPF should further be apportioned with reference to the ratio of income in the fund concerned plus the taxable capital gain applicable to the fund concerned over total amounts received or accrued



Example

	Total	Policyholder Funds	IPF	CFP	UPF	RPF	CF
Direct Expenses	115	100	20	20	30	30	15
Indirect Expenses	85						
Opening balance of liabilities		950	250	150	300	250	
Closing balance of liabilities		1150	300	200	350	300	
Opening market value of assets							400
Closing market value of assets							500
Premium income		4 800	1000	1250	1350	1200	
Allocation of Indirect Expenses		59.5	12.4	15.5	16.7	14.9	25.5

Therefore, based on the above example, 25.5 of the 85 should be allocated to the CF. This is a potential problem as management of the company would generally have allocated significantly less expenditure to the CF. Should SARS attack the 25.5 based on the principles of “production” and “trade” as discussed above, then the non-deductible portion would not only be lost for the CF, but also for the IPF, CFP, UPF and the RPF. This is a valid concern as BGR 30 states the expense should still be deductible in terms of Section 11 and Section 23.

By allocating more indirect expenses from the policyholder funds to the CF, the market values per Form 1 of the 7 Form tax calculation is also increased, owing to a reduced deduction of expenditure against income, which compared to the actuarial valuation of liabilities, could result in an increased taxable transfer from the policyholder funds to the CF.

Conclusion

While the introduction of BGR 30 is welcomed in order to establish consistency in the methodologies applied by companies to allocate expenditure between its different funds, it is clear that companies should do the following in order to get the most benefit from the ruling:

- Perform a detailed analysis in order to allocate as much expenses as possible to direct expenses. This would provide the following benefits:
 - The company would not have to use the indirect expense allocation methodologies as prescribed in BGR 30
 - The company would not have to apply the ratio as indicated per Section 29A(11) of the Income Tax Act to further reduce the deductibility of the expenditure and would therefore be able to claim 100% of the direct expenses
 - The company would not have to be concerned about the “production” and “trade” argument of SARS
- Document the reason why management is confident the indirect expenditure allocated as prescribed in terms of BGR 30, does meet the “production” and “trade” argument from SARS.

Based on the following wording used in BGR 30, “the treatment of expenses set out below is accepted for purposes of section 29A(11) and 29A(12)”, we are comfortable for companies to still apply their own methodology of allocating expenditure, if the following requirements are met:

- The methodology is consistently applied
- The methodology of allocating expenditure is a scientific exercise based on detailed current and historic knowledge of the business
- Management is comfortable that they would be able to withstand an attack by SARS on the methodology applied in the allocation of expenses between the different funds, as well as the “production” and “trade” arguments.

BGR 30 and the introduction of the RPF has certainly kept Life Insurance Tax very interesting and I am sure we will see further developments for long-term insurers from a tax perspective.