Vian Strydom

Partner
Head of Tax Management Services
Tel: +27 82 564 9118
Email: vian.strydom@kpmg.co.za

Haroon Jogee

Associate Director
Tax Management Services
Tel: +27 66 010 7812
Email: haroon.jogee@kpmg.co.za

Deepti Darji

Senior Manager
Tax Management Services
Tel: 27 82 718 9054
Email: deepti.darji@kpmg.co.za

Recent tax law cases and their impact on insurers

As the world becomes more sophisticated and industries look for ways to increase revenues and decrease expenses, we will see the Commissioner challenge the tax treatment of new and untested contractual arrangements between businesses and their customers and the insurance industry is right in the way. Insurers are responding to the challenge of differentiating themselves through innovative solutions and the more innovative they get the more they and SARS will need to work together to reach consensus on what these changes mean to both parties.

With this new business reality, we have noticed stricter revenue collection methods and more queries being raised by SARS. Put the above into a melting pot with far-reaching proposed tax amendments and stir in some interesting new tax case law and suddenly your tax environment becomes more complex and unpredictable.

In this article we highlight certain proposed tax amendments and recent court cases relevant to the insurance industry, which may lead to SARS audits and queries on these matters:

- proposed lowering of the corporate income tax rate;
- prepayments (Telkom court case); and
- loyalty programmes (Clicks court case).

Key highlights from the 2021 Budget Speech announcement and lowering of the corporate income tax rate

The Minister of Finance, in his 2021 Budget Speech, proposed to broaden the tax base through changes to the interest limitation provisions in respect of cross border debt, whereby interest deductions will be limited to 30% of Earnings Before Interest, Taxes, Depreciation and Amortisation ("EBITDA"). Another proposal is to limit the utilisation of assessed losses carried forward to taxable income. These measures were proposed to be introduced in 2022.

The Minister of Finance also announced the lowering of the corporate income tax rate from 28% to 27% with effect from years of assessment commencing on or after 1 April 2022. It is intended that the introduction of the lower rate will be implemented in a revenue neutral manner. In other words, the rate may be lower, but more taxes will be collected in other areas, for instance the limitation of interest deductions and limited utilisation of assessed losses.

The lowering of the corporate income tax rate will impact the accounting for and determination of deferred tax for year ends prior to years of assessment commencing on or after 1 April 2022. IAS 12: Income Taxes, paragraph 47 refers:

*Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the **asset is realised or the liability is settled**, based on tax rates (and tax laws) that have been **enacted or substantively enacted** by the end of the reporting period.*

There is currently uncertainty on the interpretation of 'enacted or substantively enacted'. From an accounting perspective there are arguments to support the view that the change in the corporate income tax rate has been substantively enacted.

On the other hand, section 5(2)(b) of the Income Tax Act states that where such an announcement is made, the rate change will be effective from the date given in the budget speech announcement and will be valid for a period of twelve months from the date of the budget speech announcement. This section, however, contains a proviso that the new rate will apply "subject to Parliament passing legislation giving effect to that announcement within that period of twelve months".

The deferred taxes raised prior to the rate change will need to be assessed and may also result in deferred tax being raised at blended rates i.e. short-term vs long-term realisation of deferred tax balances.

Finally, there may be disclosures which should be considered in terms of *IAS 10: Events After The Reporting Period*, in terms of:

- the nature of the event; and
- an estimate of its financial effect, or a statement that such an estimate cannot be made.

It is evident that each insurer would need to assess the impact on the annual financial statements and should consult both from a tax and accounting perspective to obtain clarity on when and how the change in the corporate income tax rate should be reflected.

Prepayments (Telkom court case)

In the Supreme Court of Appeal judgement between Telkom SA SOC Limited, ("Telkom"),and the Commissioner for the South African Revenue Services ("the Commissioner") (case no. 239/19 dated on 25 March 2020), the Supreme Court of Appeal had to decide, amongst other matters, on the tax treatment of prepayments in terms of the limitations of section 23H.

The case concerned the tax treatment of once-off cash incentive bonuses paid to "dealers" e.g. in the case of insurers these would be commission earners and agents on the sale of initial policyholder contracts. These bonuses were deducted for tax purposes by Telkom on the basis that the once-off incentive bonus was paid for a new connection with a customer, and the benefit attached to the payment related to the new contracts that were concluded.

The court found in favour of the Commissioner, stating that the period over which the expenditure may be claimed must be the period over which the true benefit is actually enjoyed as referenced in the below extract from the judgement:

"Telkom does not incur the incentive bonus expenditure solely to establish a new connection with a customer. The benefit lies in having a customer who pays subscription fees over the fixed term of the contract. Telkom does not enjoy any benefit immediately upon the conclusion of a new contract. It has nothing to show for it until such time as the connection turns into fee income. That is when Telkom begins to enjoy the true benefits of the cash incentive payments".

The submission by the Commissioner in the case focused on the term "any other benefit" as contained in section 23H and contended that the payment should be spread over the term of the subscriber contract. The court found that the expenditure may only be claimed as a deduction over the period during which the benefit is enjoyed, which in Telkom's case was over 24 months.

How does this affect insurers?

Applying the principle established in the Telkom court case, the key issue for consideration when claiming prepaid expenditure as a deduction is whether the benefit is enjoyed over a period of time in excess of six months after year-end and extends beyond the receipt or accrual of goods and services.

When we look at the insurance industry, deferred acquisition costs may be impacted and should be considered. The impact for non-life insurance companies may be limited owing to a specific provision in section 28 of the Income Tax Act which states that the section 23H limitation does not apply, but an assessment is still necessary. This assessment may entail comparing the principles in the court case and assessing these against the current provisions in section 28 for non-life insurance companies.

However, section 29A of the Income Tax Act relevant to life insurers does not contain the same provision as non-life insurers and hence life insurers must consider the Telkom Court case with reference to the expense deduction in terms of section 29A(11) of the Income Tax Act.

Whilst performing the above assessment of the relevant impact, it is also important to consider how prior periods should be corrected, if necessary.

Loyalty programmes (Clicks court case)

In a recent Constitutional Court judgement in the dispute between Clicks Retailers Proprietary Limited ("Clicks") and the Commissioner (case CCT 07/20 dated on 21 May 2021), the Constitutional Court had to decide whether Clicks was entitled to claim a section 24C allowance in terms of the Income Tax Act in respect of future expenditure to be incurred under its Clicks ClubCard loyalty programme.

Section 24C of the Income Tax Act provides that a taxpayer may defer paying tax on income if that income accrues in terms of a contract and such income will be used to finance future expenditure, which the taxpayer is obliged to incur in terms of such contract (i.e. expenditure to be incurred in a subsequent tax year).

Where the income accrues and the obligation to incur the future expenditure are contained in a single contract, the scope of section 24C poses no problem. However, taxpayers have sought to extend the scope of section 24C to cover arrangements where the accrual of income and obligation in respect of the future expenditure are contained in separate but inextricably linked contracts.

Clicks claimed a section 24C allowance on its Clicks ClubCard loyalty programme. In terms of the loyalty programme, Clicks provides its customers with cash back vouchers in proportion to the value of purchases made at Clicks stores. Clicks argued that the income it earned from individual sale contracts with loyalty programme members will be used to fund future expenditure when the vouchers are redeemed. In addition, Clicks argued that they were entitled to claim a section 24C allowance as the income and obligation to incur the future expenditure arose from one contract.

The Constitutional Court confirmed that it was not sufficient for a taxpayer to show that the contract under which the income was earned and the Clicks ClubCard contract under which the future expenditure would be incurred, were inextricably linked. The taxpayer must show that the inextricable link between the contracts is such that the contracts meet the section 24C requirement for sameness. It is, however, unlikely that the sameness requirement would be met where the contracts are not inextricably linked.

An "inextricable link" will be established when an issue, claim, contract or conduct cannot be determined or assessed without another, or the legal consequence of the one cannot be understood or measured without reference to another. In contrast, the concept of "sameness" requires at a minimum that both the earning of income and the obligation to finance future expenditure must depend on the existence of both contracts. If either contract can be entered into and exist without the other, the requirement would not be met.

The Constitutional Court concluded that the income earned on the sales contract with the customers was not the same as the contract which customers entered into regarding the ClubCard contract. The Constitutional Court found that Clicks had not established the contractual sameness that is required by section 24C and hence disallowed the section 24C allowance.

Conclusion for insurers

Based on the principles established in the Clicks case, a section 24C allowance will only be available where a single contract exists or the accrual of income and obligation to incur future expenditure are contained in inextricably linked contracts that are not capable of being applied independently of one another.

Many insurance companies have loyalty programmes for their policyholders. It is necessary that the income tax implications of these loyalty programmes are considered, taking into account the principles established in the Clicks court case together with the Big G Restaurants[1] court case in order to assess whether a section 24C allowance may find application.

For non-life insurance companies, the IFRS disclosure of the future costs could be very relevant and will impact the tax treatment, following the application of section 28(3).

For life insurance companies, the deduction as part of the so-called I-E methodology will largely depend on the application of section 29A(11) and whether the future cost liability will be considered a claim as envisaged in the Income Tax Act.

Looking forward

The journey ahead would not be complete without considering the tax implications of IFRS 17: Insurance Contract (IFRS 17) impacts. There are potential challenges that non-life and life insurers may face with the introduction of IFRS 17. Distinct cash flow mismatches may arise which can result in tax being paid upfront, rather than smoothed over a period of time. Another area of consideration would be over the transitional provisions or day 1 IFRS 17 adjustments to determine whether the taxing event is on transition date of IFRS 17 or over a period of time.

The tax working groups of the Actuarial Society of South Africa for life insurers and the South African Insurance Association for non-life insurers are in the process of collating information from insurers to determine the tax-related challenges of implementing IFRS 17. The objective of this exercise is to gather information to consult with National Treasury to facilitate draft changes to relevant provisions of the Income Tax Act to minimise and/or mitigate areas of challenge identified by the industry.

We remain positive that the consultation process between industry representatives and National Treasury will result in tax legislation with minimal and refined outcomes for insurers once promulgated.

[1] 'In the matter of Big G Restaurants (Pty) Ltd v CSARS 2020 (6) SA 1 (CC), the Constitutional Court accepted that section 24C required the contract in terms of which which the income accrued to be the same contract under which the obligation to incur the future expenditure arises. However, the court held that two or more contracts contracts may be so inextricably linked that they may satisfy this requirement of "sameness".