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The (un)expected observations - tax experiences in a pandemic

While this is the second year that the majority of the world has had to deal with the impact of the COVID-19 pandemic, we not too long ago completed the first round of audits of insurance companies.

The COVID-19 pandemic has affected insurance companies in many ways. In addition to customer, people and operational considerations, volatile markets have affected investment portfolios on balance sheets, all of which unsurprisingly has had a tax impact.

The pandemic has resulted in the loss of lives globally over the past eighteen months. Many individuals lost their jobs and many businesses have suffered losses, with some even closing down. As a result, many insurance companies throughout South Africa had to settle claims ranging from death and disability to business interruption. The impact of this can be seen in the financial results released by many insurance companies.

In general, policyholder behaviour has arguably also changed as a result of COVID-19. For instance, cash flow or financial constraints may force the early surrender of policies or even increase the probability of insurance fraud being committed. Furthermore, lockdown regulations would have stifled new business sales thereby affecting the premium income of insurance companies.

At the start of the pandemic we speculated what themes and trends would emerge for the insurance industry. We set out below highlights of our key observations for life insurance companies.

Underwriting profits

Simply put, ‘transfer tax’ is the result of the excess of policyholder assets over liabilities at the financial year-end, and can also loosely be described as the underwriting profits earned by an insurance company. We have observed a general trend with the increase of policyholder liabilities – as a result of an increase in anticipated future claims – along with a corresponding decreasing trend in the financial markets and its related impact on the assets held by policyholders. Consequently, insurance companies have as a result generated reduced surpluses, and deficits in some instances, when comparing the market value of policyholder assets to the policyholder liabilities at year-end. This has the effect of reducing the tax liability of insurance companies. In addition, there are deferred tax consequences which are set out further in the article.

Consideration has to be given to whether to impair any policyholder assets due to the impact of COVID-19. To the extent that these assets are allocated to policyholder funds, any impairment will reduce the profit transfer in the year that it is raised, and will similarly have a consequential impact of a reduction in tax.

Less to share with SARS

Losses suffered by businesses over the past year and a half have negatively affected the declaration of dividends with many listed companies declaring lower dividends, and in some instances, not declaring any dividends at all. This has an impact on the dividends tax paid to SARS. Rental income of property-owning companies has decreased due to business interruption, with some businesses not able to continue operating after the initial hard lockdown was relaxed. To the extent that policyholder assets include investments in listed companies and property-owning companies, returns on these investments would be lower due to the aforementioned reasons. In addition to lower (or no) transfer tax being payable as described above, insurance companies are withholding less tax from policyholder funds as a result of lower profits being derived from the net of investment returns (on assets) and expenses allocated to that policyholder fund.

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As investment values reduce, lower realised capital gains (or even realised capital losses) generated from the disposal of underlying policyholder assets also leave less for SARS.

Deferred tax

The lower market value of assets, and as a result the reduced unrealised capital gain on those policyholder assets, and other assets held by insurance companies, will result in a decrease in the deferred tax liability that would generally be recognised on the unrealised gain attributable to those assets.

In other instances where there is a deficit (in other words the value of the policyholder assets is less than the policyholder liabilities at year-end), no profit transfer arises to the corporate fund. This deficit results in a reverse interfund transfer (the corporate fund makes good the aforementioned shortfall where the policyholder assets are less than the policyholder fund liabilities.) These reverse interfund transfers raise the question whether the insurance company should recognise a deferred tax asset in its corporate fund.

The recognition of deferred tax assets requires consideration of the future movement of the market value of assets held by policyholders in addition to the future actuarial valuation of liabilities of the policyholders.

(Imminent) limitation of use of assessed loss

During the 2020 Budget Speech it was announced that National Treasury intended to restrict the offset of assessed losses carried forward. It was proposed that the offset of an assessed loss brought forward would be restricted to 80% of taxable income. At face value, the impact would be that taxpayers would be subject to tax on a minimum of 20% of their taxable income calculated for that year, irrespective of the quantum of any assessed loss brought forward. While not clearly stated, it is assumed that the balance of any unutilised assessed loss will remain available to be carried forward to the next year, subject to the same restriction in the following year. This proposed change – which has been placed on hold as a result of COVID-19 – is likely to affect company cash flows as it would have to pay tax on profits earned in a financial year even where it has a significant assessed loss to offset the profits. This will also affect the recognition of deferred tax assets on assessed losses as the full value of the tax loss is deferred to future years. The proposed limitation of assessed losses, once promulgated, will similarly affect insurance companies (including their policyholder funds) and may create cash flow constraints.

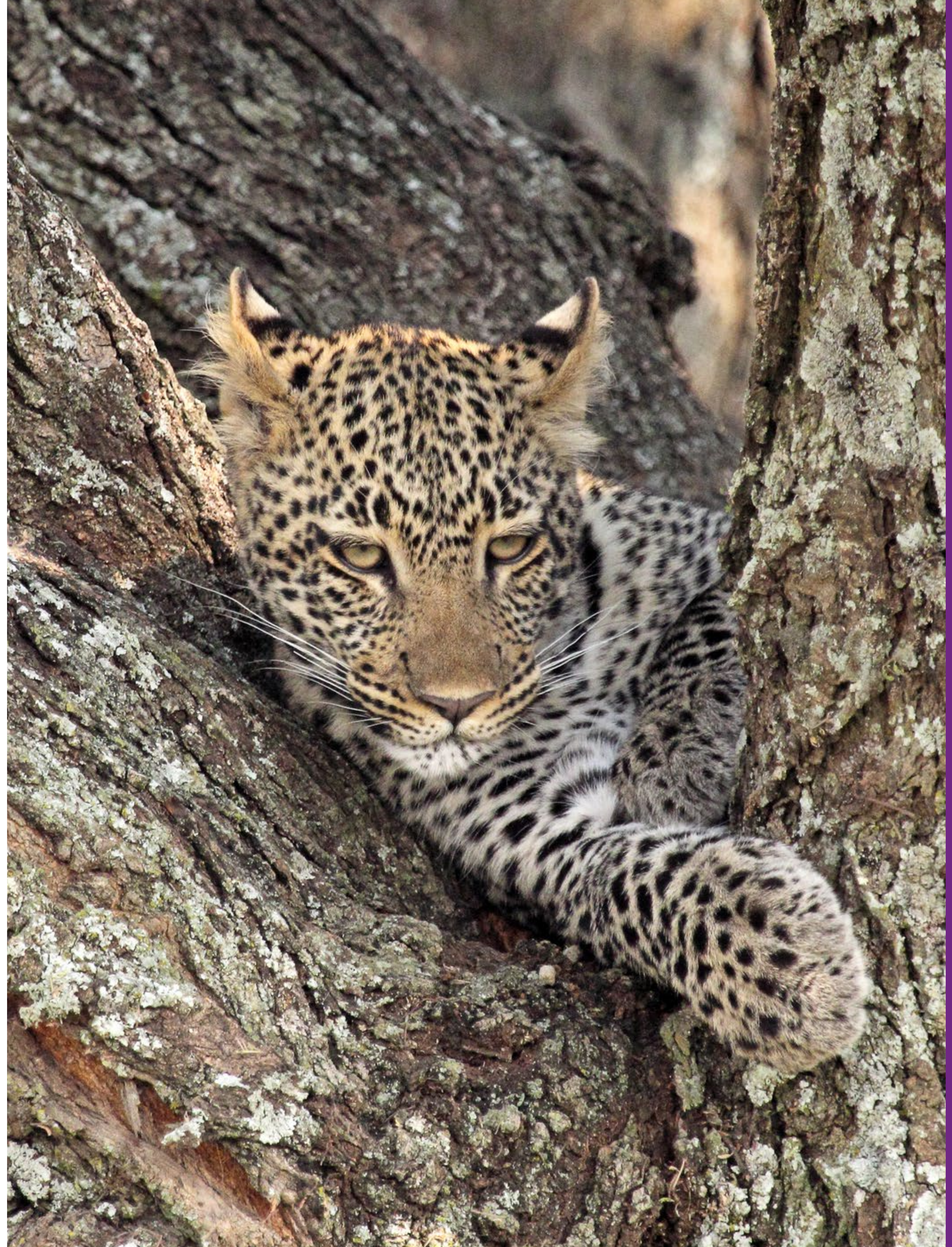
Changing costs

The introduction of the first hard lockdown presented an immediate challenge for businesses as they had to rapidly enable a mass transition to remote working in order to maintain operations. In the insurance sector, the degree of challenge this presented varied widely; some were in a better position than others to effect the change. It is essential to establish a true picture of the costs of running the remote workforce, and cost savings like the reduced need for office space, compared to normal baseline costs. The changing cost of running a remote workforce will result in a change in the cost allocation applied by insurance companies, which will ultimately affect the determination of taxable income for both the insurer and its policyholder funds.

From an employees' perspective, SARS recently released a revised draft Interpretation Note 28, to provide clarity on the deductibility of home office expenses incurred by persons in employment or persons holding an office. The revision provides for a strict application of when a taxpayer can claim home office expenditure. The home office must be regularly and exclusively used for trade purposes. Anecdotally, taxpayers who claim the deduction, and especially those who claim it for the first time, are likely to be subjected to an audit by SARS.

Concluding comments

This uncertainty associated with the pandemic does not bode well for insurance companies as the severity of the "third wave" will determine the extent to which these companies are impacted financially. If the trends that we described above continues, there is a knock-on impact from a tax revenue perspective which would place the spotlight firmly on SARS. If SARS continues to face pressure on the collection of tax revenues – not only from insurance companies – but from all businesses, it will be interesting to see what tax reforms and legislative changes are tabled in the coming cycle. In addition, with the implementation of IFRS 17 looming for insurance companies, there certainly are a number of significant changes to contend with in a very uncertain environment.



Insurance industry training

Our tailor-made training courses are designed to meet the specific needs of your organisation – whether it's education on insurance regulations, market conduct, solvency reporting, financial reporting and IFRS 17, to taxation changes, the latest in technology or recent insurance industry developments.

Our training courses can be conducted either at our premises or yours. In addition, our training offering has now been extended to include the option of delivering training in a virtual and no-contact format.

We also offer annual training packages covering our entire suite of training courses, to which your staff are always welcome.

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