Yacoob Jaffar

Partner
Corporate Tax
Tel: +27 78 786 2277
Email: yacoob.jaffar@kpmg.co.za

Shaficque Narker

Associate Director
Corporate Tax
Tel: +27 66 101 6774
Email: shaficque.narker@kpmg.co.za

Erina Cooper

Partner
Indirect Tax
Tel: +27 82 719 5758
Email: erina.cooper@kpmg.co.za

How will IFRS 17 impact the tax profile of insurance companies?

Introduction

***International Financial Reporting Standard 17: Insurance Contracts* (IFRS 17) is the new accounting standard that changes the way insurance contracts are accounted for. This new standard replaces *IFRS 4 Insurance Contracts* (IFRS 4).**

IFRS 17 will be effective for reporting periods commencing on or after 1 January 2023. The standard specifically sets out the principles of recognition, measurement, presentation and disclosure of insurance contracts. IFRS 17 aims to improve the consistent application of these principles, enabling users of financial statements to meaningfully compare financial results of insurers.

Implementation of the new standard

Insurers are currently busy with their IFRS 17 implementation projects. The new standard requires a fully retrospective transition as the default transition approach (i.e. IFRS 17 needs to be adopted "as though it was always in place" as a default principle, although there are some exemptions/practical expedients if one of the other transition approaches is followed). This will result in an opening balance adjustment on 1 January 2022 (for insurers with a 31 December year-end, or later for those with non-December year-ends) on adoption of the standard, as well as restated comparatives for the 2022 (or 2023 for non-December year-ends) financial year.

What are the conceptual tax challenges?

The opening balance adjustment referred to above, and the subsequent measurement of insurance contracts under IFRS 17 will change the timing of the emergence of profits and will therefore have income tax consequences. The introduction of IFRS 17 is expected to have a material impact on both the life and non-life insurance industry. National Treasury released the Draft Taxation Laws Amendment Bill, 2022 (2022 TLAB) on 29 July 2022, which proposes amendments to the income tax legislation aimed at managing (minimising) the consequent cash flow disruptions as a result of the new standard.

For life insurers

Life insurers are expected to experience accelerated profit emergence when compared to current patterns under IFRS 4. In addition, any additional prudence, (currently included in the technical provisions under IFRS 4) will need to be released which will result in an overall increase in accounting profit. These accounting changes are expected to result in significant tax cash flow consequences and we discuss below the measures proposed by National Treasury in the 2022 TLAB to mitigate the impact by introducing phasing-in measures.

For non-life insurers

Due to the shorter-term duration of contracts issued by non-life insurers, the anticipated potential tax cash flow impact as a result of the implementation of IFRS 17 is expected to be less severe.

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A summary of the proposed tax amendments set out in the 2022 TLAB

Terminology changes

A few years back, amendments were made to section 29A of the Income Tax Act (the Act) to account for changes introduced by the Financial Services Board (now referred to as the Prudential Authority). The changes were aimed at addressing the Solvency Assessment and Management (SAM) regulatory regime applicable to insurers and the IFRS 4 standard for insurance.

This SAM framework prompted the introduction of certain definitions and terminologies which included the definition of "adjusted IFRS value" and "negative liability".

"Adjusted IFRS value" was broadly defined to include liabilities in respect of policies of the insurer adjusted for reinsurance assets, negative liabilities, deferred tax liabilities, deferred acquisition costs and deferred revenue determined in accordance with IFRS.

In order to facilitate an easier transition to IFRS 17, National Treasury has proposed changes to the tax legislation in order to align terminology in section 29A of the Act with that set out in IFRS 17. The main terminology changes proposed are as follows:

- *Definition of "value of liabilities"*

  The definition of "value of liabilities" will be amended to refer to all other liabilities that fall outside of the "adjusted IFRS value" definition (see revisions to this definition below), but which are allocated to policyholder business.

- *Definition of "adjusted IFRS value"*

  The implementation of IFRS 17 introduces a distinction in the accounting recognition and disclosure between insurance contract liabilities in terms of IFRS 17 and investment contract liabilities in terms of IFRS 9. It is proposed that changes are made to refer to "investment contract liabilities" instead of the current general reference to liabilities.

"Adjusted IFRS value" under section 29A of the Act is calculated in accordance with a specific formula. This formula includes different components which ultimately make up the "adjusted IFRS value" which is to be used as part of the income tax calculation.

In terms of the proposed tax amendments "L"[1] in the definition of "adjusted IFRS value" will be amended and comprises of the following:

- insurance contract liabilities;
- investment contract liabilities; and
- reinsurance contract liabilities;

reduced by:

- insurance contract assets;
- reinsurance contract assets; and
- liability for incurred claims; provided that this amount is not less than zero.

The "adjusted IFRS value" formula now also provides for the separate addition of the liability for incurred claims as the liability of a group of insurance contracts comprises the liability for remaining coverage and the liability for incurred claims in terms of IFRS 17.

[1] In the 2022 TLAB, the proposed formula for the amount to be determined is I = (L + LIC + DL + PF) – PT – DC + DR, as set out in section 15 of the 2022 TLAB (http://www.treasury.gov.za/comm_media/press/2022/2022%2DraftTax/2022%20DRAFT%20TLAB%20-29%20July%202022.pdf). The change is thus the addition of "LIC" (liability for incurred claims) to the formula.

Phasing-in measures for life insurers

The 2022 TLAB proposes the following phasing-in measures for life insurers:

- A phasing-in period of six years that will provide for the "phasing in amount" to be deducted from (or included in) the income of the corporate fund;
- The "phasing-in amount" will be the difference between:
  - The "adjusted IFRS value" amount determined with reference to IFRS 4 (at the end of the year of assessment commencing on or after 1 January 2022 but before 1 January 2023); and
  - The "adjusted IFRS value" determined with reference to IFRS 17 (as amended by the 2022 TLAB, and applied to the year of assessment as referred to above);
- The amount that has been deducted as a "phasing-in amount" will be included in the income of the corporate fund in the following year of assessment (or vice versa).

We understand that these proposed tax amendments are not aligned to what some of the larger life insurers were expecting and concerns have been raised by the insurance industry on the first draft of the proposed amendments. We set out some of the industry concerns later in this article.

Proposed amendments applicable to non-life insurers

Under SAM, non-life insurers may claim deductions for amounts recognised as liabilities in accordance with IFRS. In determining the taxable income of a non-life insurer, IFRS insurance liabilities, adjusted for reinsurance assets, deferred acquisition costs and deferred revenue relating to premiums and claims, may be claimed as a tax deduction. This deduction must be added back to taxable income of the non-life insurer in the following year of assessment.

IFRS 17 requires that:

- Estimates of future cash flows included in the determination of insurance contract liabilities are to be discounted to a present value;
- Salvages and third-party recoveries are to be included in the determination of the total insurance contract liabilities; and
- Premium debtor amounts are to be included in the determination of the total insurance contract liabilities.

The requirements noted above are anticipated to result in an increase in the taxable income of non-life insurers due to a reduction in the amount that is deductible after the implementation of IFRS 17. In order to mitigate the tax and cash flow impact for non-life insurers, the following transitional measures have been proposed:

- Due to the shorter-term duration of contracts issued by non-life insurers, a "phasing-in" period of three years is provided to non-life insurers to account for the possible reduction in the deduction which the non-life insurer may claim in determining its taxable income;
- The "phasing-in amount" will be the difference between:
  - The amount that is deductible from the income of a non-life insurer in terms of the current provisions of the Act (at the end of the year of assessment commencing on or after 1 January 2022 but before 1 January 2023 determined under the current rules of the Act); and
  - The amount of the deduction applying the revised provisions of the Act due to the implementation of IFRS 17 for the period referred to above.

How has the 2022 TLAB been received by the industry?

We understand that a number of concerns have been raised by the insurance industry in respect of the 2022 TLAB. Some of these relate to textual errors, and there are concerns that the wording used in the 2022 TLAB does not achieve its intended objective (and has some unintended consequences). We briefly discuss some of the concerns which no doubt will be escalated to National Treasury for further consideration.

Phasing-in period

We understand that the proposed phasing-in period of six years may be considered to be too short for life insurers. In the United Kingdom, a ten-year phasing-in period has recently been confirmed by Her Majesty's Revenue and Customs (in a consultation outcome document titled "Corporation tax: response to accounting changes for insurance contracts – summary of responses[2]") dated 20 July 2022. This, we understand, is partly motivated by the fact that life insurance contracts have a long duration which extends to ten years, and more. This duration provides for profits or losses that the insurer will be earning to be spread over the life of the contract. Similarly, a phasing-in period of three years for non-life insurers appears to be disproportionate given the shorter-term duration of those contracts.

The utilisation of losses and special transfer credits in policyholder funds

The phasing-in methodology in the 2022 TLAB proposes that a phasing-in amount needs to be determined in the policyholder funds and this phasing-in amount needs to be included in the income of the corporate fund. Based on this, there is uncertainty as to how a life insurer would be able to utilise tax losses or special transfer credits in its policyholder funds, if the phasing-in amount is included in the corporate fund on transition.

Phasing-in of capital gains

The manner in which the phasing-in mechanism has been proposed in the 2022 TLAB (realising all transitional transfers of assets to/from the corporate fund in the year of transition), may require that the asset portfolios in policyholder funds are rebalanced. In order to achieve this rebalancing, a transfer of assets will be required, which will trigger a 'disposal' for capital gains tax purposes. Currently, the 2022 TLAB does not provide for any relief of any resultant capital gains (similar to the phasing-in set out above).

Other aspects to consider

IFRS 17 introduces new terminology and will require a redesign of the annual financial statements from a presentation and disclosure perspective. These changes have currently not been accommodated for in the current ITR14. This may require SARS to reconsider the format of the ITR14 after the implementation of IFRS 17 to maintain alignment with the revised presentation and disclosure requirements in the financial statements prepared by applying IFRS 17.

Value-Added Tax (VAT)

Lastly, the adoption of IFRS 17 may also have indirect VAT impacts. Although the determination of VAT is not expected to be impacted by IFRS 17, insurers may need to consider whether any of the inputs used in the calculations required when the turnover-based method is used, are affected by the adoption of IFRS 17. Insurers may also need to consider whether their operational procedures for VAT are affected, specifically if the capturing of VAT is currently driven off the back of their current IFRS 4 financial reporting.

Conclusion

As the effective date of the standard draws closer, insurers are running out of time to work out what needs to be actioned based on the transitional arrangements provided by National Treasury. It is currently expected that a large number of insurers may need to pay additional tax on the IFRS 17 transitional opening balance adjustment based on preliminary transition impact analyses.

The insurance industry has been surveyed (both life and non-life) by various working groups co-ordinated by industry bodies, to understand the impacts the adoption of IFRS 17 will have on the income tax profile and cash flows. In addition, there were individual discussions between insurers and National Treasury prior to the release of the 2022 TLAB. It is our impression that this first round of proposed tax amendments has fallen short of the insurance industry's expectations. We acknowledge the complexity involved with drafting income tax legislation to incorporate IFRS 17; the facts and circumstances of insurers are different. National Treasury and insurers will have to find a balance between their respective objectives.

[2] https://www.gov.uk/government/consultations/corporation-tax-response-to-accounting-changes-for-insurance-contracts/outcome/corporation-tax-response-to-accounting-changes-for-insurance-contracts-summary-of-responses