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Income tax challenges expected from the implementation of *IFRS 17 Insurance Contracts*

Introduction and background

IFRS 17 Insurance Contracts **(IFRS 17) has been waiting in the wings for several years, with the standard becoming effective for annual reporting periods commencing on or after 1 January 2023. A number of industry bodies were formed to understand what the implementation of IFRS 17 would mean from various perspectives, ranging from accounting and tax to actuarial modelling and regulatory reporting.**

Insurers have been working on determining the impact that the standard would have on taxable income and, ultimately, their tax liability for the 2023 and subsequent financial years. With the Taxation Laws Amendment Act 20 of 2022 (TLAB) having been issued and signed by the President at the end of 2022, the TLAB was regarded as substantively enacted in December 2022.

In the period leading up to the implementation of IFRS 17, various industry groups lobbied to provide commentary that could guide the legislators in their efforts to draw up relevant tax regulations. Despite best efforts to consider all eventualities and permutations (with specific reference to sections 28 and 29A of the Income Tax Act), as one would expect, certain nuances were only identified post implementation date.

We unpack some of our observations of the practical implementation challenges that we have recently encountered.

Life insurance

IFRS 17 impacts the manner in which policyholder assets and liabilities are recognised and measured. This creates nuances that require careful consideration when calculating both current and deferred tax assets and liabilities.

Value of liabilities

Insurers are required to calculate a phasing-in amount for income tax purposes. This phasing-in amount is based on the difference between the "value of liabilities" determined under the previously applied accounting standard *IFRS 4 Insurance Contracts* (IFRS 4), and the "value of liabilities" determined under IFRS 17[1]. The TLAB specifies the formula and the periods that should be used to calculate the phasing-in amount for non-life (section 14(1)(3C)(e)) and life insurers (section 15(1)(d)(15)).

The difference between the "value of liabilities" under the two accounting standards results in either a surplus or deficit that the life insurer has to phase-in to its tax calculation over a period of six years resulting in both current and deferred tax consequences. For example, a deferred tax liability is raised on a phase-in surplus and released to current tax over the phasing-in period.

[1] Section 29A(15) of the Income Tax Act sets out the manner in which the phasing-in amount has to be calculated.

The constituent components that need to be considered in determining the "value of liabilities" under IFRS 4, are different to those under IFRS 17. For example, premium debtors are not explicitly included in the "value of liabilities" under IFRS 17. For life insurers applying the general measurement model (GMM), this is because all expected fulfilment cash flows relating to future coverage will be included in the liability for remaining coverage.

Thus, the impact of these deductions when determining the "value of liabilities" under IFRS 4 compared to "value of liabilities" under IFRS 17 could result in a material surplus or deficit. This would then lead to a material impact on the phasing-in amount, and the consequent tax liability.

In determining the phasing-in amount, it is important for life insurers to carefully consider that premium debtors have been appropriately allocated to insurance (or reinsurance) contract liabilities.

One of the objectives of IFRS 17 is for the consistent application of the standard by all insurers in order for users of financial statements to be able to better compare the performance of different insurers. Equally, it is important that the reasons for adjustments to "value of liabilities" are understood and applied consistently by insurers (and accord with the principles prescribed in section 29A of the Income Tax Act).

Contractual service margin

IFRS 17 requires insurers to account for a contractual service margin; this represents the unearned profit of a group of contracts issued. This contractual service margin is released to profit or loss as the insurer provides insurance and/or investment services, over the coverage period of the contract. If contracts are onerous, no contractual service margin is recognised and instead the expected loss is recognised immediately in profit or loss.

As the measurement principles in IFRS 17 are not applied to a single contract but rather to a group of contracts, life insurers need to assess whether the contractual service margin is taken into account in the correct policyholder fund for purposes of determining the respective tax liability at the end of the financial year. For example, one accounting group of insurance contracts may need to be allocated into more than one policyholder tax fund which brings an additional layer of complexity.

Solvency Assessment and Management (SAM)

With the adoption of the SAM solvency capital regime effective 1 July 2018, life insurers were afforded a six-year phasing-in period for tax purposes. As it related to negative liabilities, additional tax was due by those insurers that adopted the phasing-in approach at the time. Not all life insurers adopted the phasing-in of negative liabilities under this dispensation.

Under IFRS 17, insurers that had not adopted the phasing-in approach under the SAM regime are now forced to zeroise their negative liabilities which were calculated in terms of IFRS 4. Negative liabilities are disclosed as insurance assets, which has a direct impact on the phasing-in calculation. Therefore, life insurers that had adopted the phasing-in methodology under the SAM regime are likely to have a lower phasing-in balance under IFRS 17. The result is therefore that the tax impact on these life insurers is reduced.

Application of assessed loss limitation

Section 20(1) of the Income Tax Act was amended by the TLAB. The impact of the amendment is that companies that would be in a positive taxable income position for the year of assessment ending on or after 31 March 2023, would be restricted from utilising any carried forward assessed loss in excess of 80% of taxable income, subject to certain limitations. Consequently, companies would be required to pay income tax on 20% of their taxable income (despite having an assessed loss that potentially exceeds that taxable income).

It appears that the application of this amendment has created uncertainty in the scenario where a life insurer has an assessed loss in a tax paying policyholder fund. The uncertainty emanates from the application of the assessed loss limitation when determining the taxable income of a policyholder fund that also has a taxable transfer deduction available in a year of assessment. The Income Tax Act provides for the deduction of a transfer of surpluses calculated in the policyholder fund, limited to the taxable income of the policyholder fund, before this deduction.

To the extent that the limitation of an assessed loss and its impact on a taxable transfer deduction are not correctly applied, the assessed loss carried forward in that policyholder fund may be misstated. We illustrate this in a simplified example below for the individual policyholder fund, where the assessed loss is R500,000, taxable income is R224,000 and 20% of taxable income is R48,000:

	Historic position	Alternative 1	Alternative 2
Income	300 000	300 000	300 000
Deduct: Other expenses	80 000	80 000	80 000
Sub Total	**220 000**	**220 000**	**220 000**
Add:			
Taxable capital gain on disposal of assets	4 000	4 000	4 000
Taxable income	224 000	224 000	224 000
Loss limitation before transfer deduction		44 800	
Deduct: (enter as positive amounts)			
Allowable deduction in respect of taxable transfers	14 000	14 000	14 000
Taxable income	210 000	30 800	210 000
Loss limitation after transfer deduction			42 000
Assessed loss brought forward - policyholders' funds	500 000	500 000	500 000
Assessed loss carried forward	**-290 000**	**-320 800**	**-332 000**
Tax rate	30%	30%	30%
NORMAL TAX	**0**	**9 240**	**12 600**

Under Alternative 1, the loss limitation is applied on the taxable income before determining the allowable deduction in respect of taxable transfers. As the example illustrates, the correct application (Alternative 1) results in a larger portion of the assessed loss brought forward being utilised in that particular tax year, resulting in reduced taxable income. While we acknowledge that the example above does not consider all facts and circumstances that may exist, what is important to note is that the correct application of the revised assessed loss limitation has a direct impact on the tax due by a life insurer.

Non-life insurance

Common challenges that non-life insurers have experienced to date include the treatment of the liability for remaining coverage and deferred acquisition costs when determining the phasing-in amount for tax purposes. Again, the challenges stem from the difference in measurement between IFRS 4 and IFRS 17.

Unearned premium provision and premium debtors

The liability for remaining coverage under IFRS 17 may be largely equivalent to the unearned premium provision previously held under IFRS 4, less insurance and reinsurance receivables (including premium debtors) and payables.

Section 28(3)(a) of the Income Tax Act previously provided for the deduction of the unearned premium provision in determining the taxable income of a non-life insurer. The amendments to section 28(3)(a) of the Income Tax Act require careful consideration by insurers as the amended section now merely refers to a deduction "*… equal to the sum of liabilities for incurred claims relating to short-term insurance business in respect of the policies of the insurer, net of amounts recognised in respect of reinsurance contracts for liabilities for incurred claims, which are determined in accordance with IFRS as reported by the insurer to shareholders in the audited annual financial statements ..*".

The challenge arises due to the differences in recognition requirements between the two accounting standards and the changes introduced in section 28 of the Income Tax Act (due to the implementation of IFRS 17). Under IFRS 4, the components that made up the value of liabilities were more easily identifiable on the face of the balance sheet. Under IFRS 17, insurers will need to be more careful to ensure that the various components of the liabilities to be included in taxable income are appropriately identified.

For non-life insurers applying the premium allocation approach (PAA), an asset for remaining coverage will exist where cash has not been received but insurance revenue has been recognised (effectively premium debtors under IFRS 4). In order for the correct adjustment or deduction to be taken into account when determining taxable income, the non-life insurer should be cognisant that an adjustment for insurance and reinsurance receivables and payables, including premium debtors, is required in terms of the amendments to section 28(3C)(c) of the Income Tax Act. The purpose of the amendment is to ensure that tax is being paid on premiums earned.

General observations

Income tax return preparation and submission

The insurance industry had requested in its submissions to National Treasury, that the income tax return (IT14L and ITR14) be amended to allow for additional disclosure that would facilitate sharing of information likely to result in either additional tax or possibly lower tax (in instances where the insurer calculates a deficit as opposed to a surplus on transitioning to IFRS 17) amounts being declared.

A draft IT14L tax return has been released which now appears to provide life insurers with an opportunity to illustrate the impact of the phasing-in calculation as part of its income tax return. Additional disclosures also allow insurers to capture how the limitation of assessed losses is being applied. An updated tax return has not been released for non-life insurers yet.

Conclusion

The implementation of IFRS 17 has introduced areas of uncertainty and complexity, which is to be expected given the significance of this new accounting standard. We recommend that insurers carefully assess how changes in respect of all key components that contribute to the taxable income calculation are taken into account.

At this stage, it is not clear whether further amendments to sections 28 and 29A of the Income Tax Act would be required to comprehensively deal with any unforeseen challenges that have been or are yet to be encountered. Given that various industry bodies have been (successfully) rallying to drive collaboration with National Treasury, we anticipate further discussion and potential changes to remedy these uncertainties.