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Navigating the current tax landscape for life insurance companies

Introduction and background

The introduction of *IFRS 17 Insurance Contracts* (IFRS 17) has marked a transformative period for the insurance industry, signalling significant change to how insurance contracts are accounted for globally.

The transition from *IFRS 4 Insurance Contracts* (IFRS 4) to IFRS 17 has not only altered the way in which technical insurance liabilities and profits are recognised and measured, it has also introduced new complexities in the calculation of taxable income.

Insurers with 31 December year-ends have reported 2023 year-end results under the new standard for the first time. This has been a period of intense adjustment as insurers endeavoured to understand the impacts of IFRS 17 on taxable income and overall tax liabilities for the 2023 and subsequent financial years.

The expectation of insurers of the impact of IFRS 17 on the related business-as-usual and transitional tax provisions was varied across the industry. The variation in expectations was largely dependent on the specific facts and circumstances of each insurance company, which highlighted the importance of a tailored approach to the implementation of IFRS 17 for tax purposes.

In the run-up to the implementation of IFRS 17, industry bodies and stakeholders engaged in extensive lobbying and discussions with tax legislators to obtain guidance to address anticipated implementation challenges. Despite these efforts, unanticipated tax impacts emerged post-implementation of the standard.

In this article we share with you our observations on the practical challenges life insurers are grappling with in determining taxable income, as a result of the implementation of IFRS 17, as well as other observations that have also had an impact on the determination of the tax position of life insurers.

IFRS 17 related observations

Premium debtors

Section 29A(15) of the Income Tax Act (the Act) sets out the manner in which the transition phasing-in amount is to be calculated and requires an adjustment for 'premium debtors' as reported in the annual financial statements. However, it is not explicit that this adjustment should apply only to premium debtors classified as part of the liability or asset for remaining coverage under IFRS 17. Under IFRS 17 the liability or asset for remaining coverage is adjusted for insurance and reinsurance receivables and payables, including premium debtors, but excludes premium debtors accounted for under *IFRS 9 Financial Instruments* (IFRS 9). This ambiguity in legislation may result in premium debtors accounted for under IFRS 9 being inappropriately included in determining the transition phasing-in amount.

In our view it is evident that the intention of the legislation is for this adjustment to specifically address premium debtors classified under IFRS 17. We recommend that insurers carefully understand the accounting classification of premium debtors as set out in the annual financial statements to ensure that the appropriate amounts are taken into account in determining the phasing-in amount.

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Unwind of deferred tax on the equity adjustment
At the date of implementation of IFRS 17, insurers were required to recognise an equity adjustment arising from the transition from IFRS 4 to IFRS 17. The equity adjustment results in a deferred tax asset or liability arising, as it reflects the amount that is expected to unwind over the next six years in terms of section 29A(15) of the Act.

Should an increase in equity arise on transition, a deferred tax liability would arise with the insurer being liable to pay one-sixth of the transition from phasing-in amount to SARS at the end of the first financial year post implementation. The realisation of the deferred tax balance arising on the equity adjustment results in a reduction in the deferred tax liability and increase in the deferred tax expense in profit or loss. Simultaneously, a current tax liability is raised, with a current tax expense recognised in profit or loss.

Consequently, this transaction results in a nil impact on the income tax expense.

In practice we have observed some insurers having only recognised the impact on current tax, without accounting for the impact on deferred tax, resulting in a higher income tax expense recognised.

We recommend that insurers assess all related tax impacts resulting from equity adjustment to ensure that the correct tax position is determined.

Contractual service margin
IFRS 17 introduces the concept of the contractual service margin (CSM), representing the unearned profit of a group of insurance contracts. The allocation of the CSM to the appropriate policyholder fund for tax purposes is a crucial step as this allocation directly influences the timing and determination of taxable income, in particular policyholder funds.

Insurers may face challenges with this allocation due to the complexity of IFRS 17 and specific tax reporting requirements. The difficulty is compounded by the need for detailed contract-level data, which many insurers' legacy systems may not be able to provide. Moreover, varying tax treatments across policyholder funds can lead to errors, resulting in under- or overpayment of taxes. If insurers had not previously maintained controls and appropriate historical information with regard to the allocation of policy information, these challenges are exacerbated under IFRS 17.

It is essential that the finance and tax departments work hand in hand to determine the correct allocation of policies and CSM to the respective policyholder funds. Insurers would also be encouraged to establish clear internal processes to clarify best practices for the CSM allocation.

Other observations

While significant attention has been given to IFRS 17, life insurers continue to face a barrage of other critical tax-related challenges. Included below are our observations in respect of these matters.

Assessed losses
Section 20(1) of the Act, dealing with the treatment of assessed losses, was amended by the Taxation Laws Amendment Act of 2022. The impact of the amendment is that companies in a positive taxable income position for a year of assessment ending on or after 31 March 2023, would be restricted from utilising any assessed losses carried forward 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 taxable income.

The application of this amendment created uncertainty for life insurers with an assessed loss in a tax-paying policyholder fund. This uncertainty arises from how the assessed loss limitation impacts the determination of taxable income in the policyholder fund, which also has a taxable transfer deduction available in a particular year of assessment.

The taxable income of a life insurer should first be calculated in terms of section 29A of the Act before applying the assessed loss limitation. This view is confirmed (albeit in part) in the newly published Binding General Ruling 73 (dated 30 July 2024). To address any ambiguities, SARS has suggested that the Act may need to be amended to clarify the sequence of adjustments for life insurers.

The incorrect application of the assessed loss limitation and the resultant impact on the taxable transfer deduction may result in an inaccurate assessed loss carried forward and taxable income determined in respect of the policyholder fund.

The impact of the aforementioned assessed loss limitation means potentially higher taxable income and consequently, an increased tax liability, especially where significant taxable interfund transfers are involved.

We understand that SARS aims to align the disclosure on form 7 (of the IT14L tax return) with the final assessment it issues, ensuring that both the set-off of assessed losses and the taxable amount due to the assessed loss limitation are clearly reflected.

Differences in asset balances for accounting and tax reporting

Life insurers often face discrepancies between asset balances reported for accounting and tax purposes. Accounting standards aim to provide a true and fair view of a company's financial position, often requiring fair value measurement and recognition of unrealised gains and losses. In contrast, tax reporting focuses on historical cost and realised gains, resulting in different asset values across the two bases. Common contributors to the difference in accounting and tax bases include divergent valuation methods, timing of income and expense recognition, differing depreciation, amortisation and wear and tear rates, impairments and write-downs and revaluation reserves.

We have observed that understanding the reconciling items between these two bases is an area of common challenge experienced by the industry. Insurers often struggle with the implementation of effective systems and processes to track these differences accurately, leading to potential errors in the determination of taxable income and capital gains tax. The key challenge is that legacy systems may not fully integrate the fair value accounting standards with tax reporting requirements, making it difficult to reconcile values consistently and accurately.

If tax implications are not appropriately considered, this may also affect the pricing of insurance products. Inaccurate tax assumptions may lead to mispricing, which could impact profitability and competitiveness of impacted insurance products. To mitigate these risks, we recommend that life insurers conduct regular reconciliations between accounting and tax bases, maintain a comprehensive audit trail, enable team-wide awareness and understanding of reconciling differences and utilise integrated software for tracking the differences between accounting and tax amounts.

Income tax reporting errors

Life insurers occasionally encounter challenges in respect of the reporting of investment income due to inaccuracies emanating from underlying asset administration systems. For example, interest income may be incorrectly reported as dividend income. This increases the tax compliance risk as the tax treatment of interest income is vastly different to dividend income.

This challenge often arises as a result of the use of multiple legacy systems that do not integrate seamlessly, or where information is housed with third-party asset administrators. This challenge is exacerbated by the complexity of modern investment portfolios, where numerous income types need to be tracked and classified accurately.

The root cause often stems from ineffective communication between insurers and asset administrators, as well as unclear or inconsistent instructions. This misalignment increases the risk of errors and can lead to the overpayment or underpayment of tax.

Ensuring accurate and consistent investment income reporting necessitates clear communication and robust oversight over the asset administration processes. We recommend that insurers implement stringent checks and controls to verify the accuracy of income classification and ensure that asset administrators are effectively upskilled to understand the importance of accurate investment income reporting.

Conclusion

The implementation of IFRS 17 has brought about significant change and uncertainties for life insurers, exacerbated by day-to-day business-as-usual challenges. Continuous collaboration between industry bodies and National Treasury is essential to ensure that industry challenges, concerns and observations are comprehensively and robustly addressed.

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