national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

**MEDIA STATEMENT**

# Effective date of increased capital gains tax rates for long-term insurers and related matters

As part of the tax proposals announced by the Minister of Finance in the 2012 Budget review, capital gains tax rates will be increased. National Treasury hereby releases for public comment proposals relating to how these increased capital gains tax rates will be applied to long-term insurers in 2012. National Treasury also requests comment relating to the longer-term proposal of mark-to-market taxation of long-term insurer policyholder funds as well as longer-term proposed revisions that will simplify the four funds tax calculation.

## 2012 EFFECTIVE DATE CONSIDERATIONS

### I. Corporate (shareholder) fund

Implementation of the increased capital gains inclusion rate from 50 per cent to 66.6 per cent will apply to the corporate (shareholder) fund for capital gains arising during years of assessment commencing on or after 1 March 2012. This effective date matches the effective date for all other companies.

### II. Policyholder funds

#### A. Change in inclusion rates

Long-term insurers have three sets of policyholder funds for tax purposes – the individual policyholder fund, the company policyholder fund and the untaxed policyholder fund. The effective capital gains tax rate for individual policyholder funds will increase from 7.5 per cent (i.e. the pre-existing 25 per cent inclusion rate as applied to a tax rate of 30 per cent) to 10 per cent (the new 33.3 per cent inclusion rate as applied to a tax rate of 30 per cent). The effective capital gains tax rate for company policyholder funds will increase from 14 per cent (the pre-existing 50 per cent inclusion rate as applied to a tax rate of 28 per cent) to 18.6 per cent (the new 66.6 per cent inclusion rate as applied to a tax rate of 28 per cent). Untaxed policyholder funds remain fully exempt from the payment of income and capital gains tax.

## B. Timing

The proposed changes in capital gains tax inclusion rates will take effect for all disposals of assets from 1 March 2012 without regard to the years of assessment at issue.

## C. Deemed disposal and reacquisition

*1. Need for special rules*

Any change in effective capital gains tax rates for policyholder funds creates complications for insurers as trustees regardless of whether the change is triggered by disposals from a specified date or in respect of disposals occurring from a specified year of assessment. In particular, if the higher rates apply only from a later date, the policyholders notionally affected by the asset disposal bears the rate of increase not only for the period of that policyholder's notional ownership but also in respect of all prior periods of notional ownership by other policyholders.

EXAMPLE

*Facts:* Long-term Insurer purchases Share X for the benefit of Individual Policyholder A on 15 June 2011 at the price of R100. On 20 February 2012, notional ownership of Share X switches from Individual policyholder A to individual Policyholder B when the value of share X is R200. Long-term insurer sells Share X for the benefit of Individual Policyholder B on 10 August 2012 when the value of Share X is R250.

*Result:* Long-term insurer allocates R92.50 of post-tax gain to Individual Policyholder A on 20 February 2012. This gain is based on the R100 unrealised gain in respect of Share X less the reserve of R7.50 for the capital gains tax (i.e. effective rate of 7,5 per cent on the notional gain of R100). Long-term insurer allocates R45 of post-tax gain to Policyholder B on 10 August 2012 (R50 realised gain less the capital gains tax of R5), less a further capital gains tax charge of R2.50 (2.5 per cent on the initial R100 gain which is realised on 10 August 2012).

Because the effective capital gains tax rate increased from 7.5 per cent to 10 per cent by the date of disposal, an additional 2,5 per cent charge is due in respect of the R100 prior notional capital gain allocated to Individual Policyholder A. However, this amount cannot be properly charged against individual Policyholder A as the actual disposal of Share X occurred after that individual ceased to be a policyholder. Therefore, the additional 2.5 per cent charge will ultimately have to be borne by Individual Policyholder B because Individual Policyholder B is the only remaining policyholder that is notionally connected to Share X at the time of disposal.

*2. Deemed disposal / re-acquisition*

In order to remedy this misallocation of additional capital gains tax among policyholders in an administratively viable manner (and without causing undue distortionary benefits vis-à-vis other classes of taxpayers), it is proposed that a deemed disposal and re-acquisition be applied to all policyholder fund assets. Under this approach, Long-term insurers would recognise all unrealised gains and losses arising before the 1 March 2012 effective date of the increased capital gains inclusion rates for policyholder funds (i.e. on the close of 29 February 2012). The new higher inclusion rates will then apply only from 1 March 2012 onward.

In essence, the higher inclusion rate will apply only in respect of post-effective date value changes at the cost of deemed taxable gain or loss in respect of unrealised gains and losses arising before the close of February 2012. The net result would be to trigger gain or loss for policyholders, but the practical tax impact would not undermine their savings because long-term insurers already charge policyholders with capital gains tax on a regular (i.e. daily, monthly or annual) mark-to-market basis due to the trustee nature of these holdings. Policyholders would then be freed from higher capital gains tax inclusion rates in respect of unrealised capital gains on assets acquired before 1 March 2012, even if the actual disposal of those assets occurs after the 1 March 2012 effective date.

3. *Technical issues*

The bulk of the assets within policyholder funds typically are held in the form of shares, bonds, derivatives and immovable property. Insurers also hold interests in collective investment schemes and similar investment schemes that invest in shares, bonds and immovable property for the benefit of policyholder funds. It is proposed that the deemed disposal / re-acquisition arising at the end of 29 February 2012 apply to all asset classes. However, collateral adjustments will be required to avoid distortions for these asset classes.

- *Shares:* The proceeds in respect of shares disposed of by taxpayers after being held for at least three years are automatically deemed to be of capital nature. It is proposed that the deemed disposal / re-acquisition be treated as having no bearing on this three year holding period (i.e. that the deemed disposal / re-acquisition be viewed as not triggering a new three-year start date for purposes of section 9C). In addition, it is proposed that losses in respect of these deemed disposals / re-acquisitions be fully recognised despite certain anti-avoidance rules to the contrary (e.g. paragraph 42 of the Eighth Schedule).

- *Bonds*: The tax yield to maturity calculation for bonds requires the holder to make a calculation of the yield based on the cost of acquisition as well as all future cash flows applying time-value of money principles. It is proposed that the deemed disposal / re-acquisition rule also triggers a new acquisition date for future bond yield to maturity calculations. In addition, it is proposed that these deemed disposals / re-acquisitions be fully recognised despite certain anti-avoidance rules to the contrary (e.g. 42 of the Eighth Schedule).

- *Derivatives:* Derivatives need to be taken into account on regular basis to avoid distortions (especially in the case of derivatives acting as hedges). A special rule will accordingly be provided that will tax annual changes in fair values relating to derivatives.

- *Real estate:* Some immovable property is depreciable. For instance, qualifying commercial buildings are depreciable at a 5 per cent rate over a 20-year period. Disposals and deemed disposals could potentially trigger recoupment of prior depreciation and distortions in depreciation calculations. It is accordingly proposed that the deemed disposal / re-acquisition rules should not trigger recoupment and the tax cost for future depreciation should remain without regard to deemed disposal / re-acquisitions.

### D. Timing of collections

It is recognised that the deemed disposal / re-acquisition rule will trigger substantial amounts of capital gains at the end of February (i.e. immediately before 1 March 2012). These gains relate to amounts that have appreciated over many years (e.g. typically between 3 and 15 years). Given this long period of appreciation, the payment of tax in respect of all the unrealised gains may create a strain on liquidity for certain long-term insurers. It is accordingly proposed that aggregate capital gains resulting from the deemed disposal rule be spread over a period of four years (the current year and following three years of assessment). Similarly, any aggregate capital losses stemming from this deemed disposal rule should also be spread over a period of four years.

Secondly, provisional tax payments for years of assessment ending on or before 30 June 2012 may exclude the increased taxable income as a result of deemed disposals occurring on 29 February 2012. Insurers cannot be immediately expected to make this adjustment given the short-notice. However, these gains must be included by the third top-up provisional payment in respect of those same years of assessment.

## III. Related matters for Long-term insurers

### A. Annual mark-to-market proposal

Application of the deemed disposal / re-acquisition approach for the capital gains inclusion rate change raises the question of whether capital gains and losses should simply be taxed annually. This annual taxation would be consistent with the approach already taken by long-term insurers, most or all of whom are annually setting aside capital gains tax potentially payable in respect of policyholder assets. This amount should accordingly be paid over on an annual basis as capital gains tax is effectively being withheld by the long-term insurer in its role as trustee. A mark-to-market approach would also be consistent with the growing trend to shift towards applying a mark-to-market system for treating financial products for financial reporting purposes.

Like the initial set of deemed gains and losses arising on 29 February 2012, future annual capital gains and losses will be spread over a four-year period. The purpose of this spreading rule is to effectively create an averaging mechanism so as to reduce excessive annual upswings and downswings. Without averaging, concerns exist that an extreme downswing could create liquidity problems if a long-term insurer must pay tax out of reduced assets existing in the downswing year when tax is owing in respect of prior-year gains.

### B. Policyholder deduction formula

The deduction limitation associated with indirect expenses allocated to policyholder funds is governed by a complex formula. The formula seeks to ensure that indirect policy administration and policy related expenses are deductible only to the extent that these expenses are incurred to earn ordinary revenue as opposed to exempt amounts or capital gains/losses. Much of the complication of the formula is associated with the fact that the current formula is not based on actual taxable amounts or realised/unrealised capital gains/losses arising during the year of assessment. The numerical formula is simply based on assumptions that may depart from economic reality.

However, if the taxation of capital gains/losses shifts to a mark-to-market approach, many of the reasons for the complexity relating to the deduction limitation formula are no longer required. It is accordingly proposed that the formula be adjusted to simply require a ratio of taxable income (before selling and indirect overhead expenses) over economic income (taxable income (before selling and indirect overhead expenses) plus dividend receipts and fully included capital gains)).

## IV. Public Comments

Members of the public are invited to send their comments to the National Treasury before 14 May 2012. Comments in this regard should be sent by email to nomfanelo.mpotulo@treasury.gov.za or by fax to 012 315 5516.

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