



national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

DRAFT EXPLANATORY MEMORANDUM

ON THE

FIRST BATCH OF THE DRAFT TAXATION LAWS AMENDMENT BILL, 2014

10 JUNE 2014

LONG-TERM INSURER'S RISK INSURANCE BUSINESS TO BE TAXED IN CORPORATE FUND

[Applicable provision: section 29A]

I. Background

Currently, South Africa taxes long term insurance business in accordance with the four funds approach. In terms of the four funds approach, all long-term insurance business written by a long-term insurer must be separated into three policyholder funds and a corporate fund. These are as follows:

- The Individual Policyholder Fund (IPF) for policies owned by individuals.
- The Company Policyholder Fund (CPF) for policies owned by corporate entities.
- The Untaxed Policyholder Fund (UPF) for policies owned by untaxed entities and annuity contracts. It consists of policies owned by retirement funds and other tax exempt entities and annuity contracts currently paying annuities.
- Corporate Fund. It consists of all the assets held by the insurer and all the liabilities owed by the insurer not falling in the above-mentioned policyholder funds.

With regard to the three policyholders funds ((i.e. IPF, CPF and UPF), the insurer is required to allocate assets, income, expenditure and liabilities relating to each fund and the taxable income of each fund is determined separately in accordance with the applicable taxation principles. With regard to the policyholder funds, the insurer acts as a “trustee” to collect tax from the pool of policyholders and to pay it to SARS “on behalf” of the policyholders.

With regard to the corporate fund, the intention of the legislature is to tax the insurer (corporate fund) in respect of “profits earned” from running the insurance business. The liabilities of each policyholder fund are required to be actuarially valued at the end of each year of assessment and to the extent that assets in a policyholder fund exceed the liabilities the surplus must be transferred to the corporate fund where it is taxed at the corporate income tax rate. The surpluses transferred represent part of the profit earned by the “shareholder” fund of the long-term insurer.

II. Reasons for change

There are concerns that the current taxation of long term insurers does not distinguish between investment and risk business. In practice, a risk policy will pay out a specified cash amount on the happening of an event regardless of the amount of investment income earned during the term of the policy. As such, this could result in a loss in respect of a specific policy.

Example:

Facts

A disability policy is issued for R500 000 in year 1.

The policyholder becomes disabled in year 4.

During the duration of the policy, the policyholder paid premiums of R36 000.

The policyholder received a cash payment of R500 000 when he became disabled.

Results

Ignoring other expenses such as sales commission and the cost of administering the policy, the disability policy will result in a loss of R464 000 for the insurer.

Profit or loss arising in respect of risk business should therefore not form part of the tax calculation of a policyholder fund since it is not part of the investment business that should be taxed on the trustee basis. It should be taxed in the corporate fund.

III. Proposal

A. Overview

It is proposed that business in respect of risk policies be taxed in the corporate fund.

B. Risk policy

A risk policy is defined as:

- a policy issued by an insurer during the insurer's year of assessment commencing on or after 1 January 2016 in terms of which any benefits payable under a policy is dependent on any future event the happening of which is uncertain or in terms of which any amount payable under the policy is only payable by reason of death; or
- any reinsurance policy in respect of a policy described under the bullet above.

A policy with both investment and risk elements will be a risk policy if any of the policy benefits under the policy are risk benefits, even if it represents only a small portion of the total policy benefits.

Currently disability policies, health policies, term life insurance and credit life insurance are all policies where the benefits under the policy depend on any future event the happening of which is uncertain. Funeral cover and life cover are policies under which an amount is payable by reason of death.

Assets to cover liabilities of policies where any of the total policy benefits are risk benefits are to be allocated to the corporate fund. Only assets having a market value equal to the value of liabilities determined in relation to policies that are not risk policies shall be placed in policyholder funds.

C. Deduction for risk insurance liabilities

The corporate fund shall be allowed to annually claim a deduction equal to the amount of the insurance liabilities reduced by reinsurance assets in respect of risk policies determined at the end of the year in accordance with IFRS as applied for purposes of financial reporting by the insurer in respect of that year of assessment. The amount of insurance liabilities reduced by reinsurance assets in respect of risk policies claimed in the preceding year of assessment must be added back.

D. Avoiding loss for the fiscus

The corporate fund will be a mixed fund in which both surplus assets of the insurer and the risk business of the insurer (which relates to policies issued during the insurer's years of assessment commencing on or after 1 January 2016) is allocated.

The insurer will have to include all premiums received or accrued in respect of risk policies in the income of the corporate fund and will *inter alia* be allowed to deduct all claims actually incurred in respect of risk policies from its income. In terms of subsection 12 the insurer allocates amounts in respect of dividends received, foreign dividends received and proceeds and expenditure in respect of capital assets to the four funds. To the extent that those amounts are allocated to the corporate fund they could be utilised by the corporate fund to pay claims on risk policies. This can lead to an inconsistency in that an amount of say dividends, which is exempt from tax, could be used to pay a claim in respect of a risk policy which will further entitle the insurer to claim a tax deduction in respect of the amount in the corporate fund.

To avoid this subsection 11(b) has been inserted. This subsection provides that the following percentage of dividends or foreign dividends received will not be exempt from income tax:

$$\left\{ \frac{\text{premiums in respect of risk policies received by the corporate fund during the year of assessment}}{\text{total value of assets in the corporate fund at the end of the year of assessment}} \right\} \times 100$$

In the case of capital gains, the above percentage of capital gains will be subject to normal tax at a rate of 28%.

E. Reinsurance premiums and reinsurance claims

The corporate fund will have to include reinsurance claims received in and deduct reinsurance premiums paid from its income. Therefore, subsection 11(g) will not apply to risk policies.

IV Effective date

The proposed amendments apply to years of assessment commencing on or after 1 January 2016.

VALUATION OF FRINGE BENEFIT FOR DEFINED BENEFIT CONTRIBUTIONS

[Applicable provision: Paragraph 1 and 12D of the Seventh Schedule and the introduction of specific regulations]

I. Background

In 2013 changes were made in the Taxation Laws Amendment Act of 2013 regarding the valuation of defined benefit contributions by an employer as a fringe benefit in the hands of the employee.

Defined benefit funds have retirement benefits that are calculated according to the rules of the pension fund where the value of the contributions to the fund may not be an accurate reflection of the benefits that may be received by the retirement fund member. For example, if the pension fund is in financial difficulty and the employer needs to make additional contributions to meet the expected liabilities, it may be unfair to tax the individual on those contributions as if they were a fringe benefit if there is no associated increase in benefits.

In order to avoid these discrepancies, align the tax treatment of contributions to defined contributions pension funds and defined benefit pension funds and to improve fairness in relation to the receipt of retirement benefits within defined benefit funds, a formula was introduced to approximate the increase in retirement benefits within a defined benefit fund.

The formula calculates a notional employer contribution to the defined benefit fund based on the estimated increase in retirement benefits. The notional amount is deemed a fringe benefit to the employee.

II. Reasons for change

The formula that was included in the Taxation Laws Amendment Act of 2013 requires the use of a factor to determine the value of the notional employer contribution. The amendments provide the methodology that should be used by the pension fund actuaries to calculate the factor that is used by the employer as an input in the final formula. The amendments also describe the processes required to ensure that the factor and additional relevant information is provided on a timely basis to employers and has been verified by the appropriate personnel.

With regard to hybrid pension funds which have an ‘underpin’ component, the amendments also provide additional details on the calculation of the notional employer contributions. These funds have retirement benefits which consist of both a defined contribution element and a defined benefit element, but where the retirement benefit is based on whichever element is greater.

III. Proposal

A. *Fund member category*

The amended proposal relies on the concept of a ‘fund member category’. A ‘fund member category’ is a group of members of a fund whose entitlement to receive benefits and the value of those benefits when they are received are determined by the same rules, and in respect of whom the same contributions are paid as a proportion of pensionable salary by them and by

their employer. The notional employer contribution should be calculated separately for each fund member category of a fund.

This refinement is introduced to ensure that the notional employer contributions are calculated across groups of members in the same way as the fund pools contributions and the costs of paying benefits across members. The calculation of notional employer contribution, which is used to calculate the total pension contributions and is assessed as a percentage of taxable income to determine deductibility, thus introduces no additional unfairness between different individual members beyond that which is already captured in the fund rules.

Example A:

A retirement fund has an accrual rate of 1/55 for all members in respect of service less than ten years, rising to 1/40 in respect of service greater than ten years. The employer pays a contribution rate of 16% of pensionable salary in respect of all members of the fund, and all members pay contributions at a rate of 7.5% of pensionable salary.

Although the fund has two accrual rates, all members are eligible to receive the additional accrual under the same circumstances, and the employer and employee contribution rates are the same for all members. The fund therefore pools costs across members with less than ten years' service and members with more than ten years' service. There is thus only one fund member category.

Example B:

A retirement fund has an accrual rate of 1/55 for staff and 1/30 for executives. The employer pays contributions of 20% of pensionable salary for staff and 30% of pensionable salary for executives. Since a different contribution rate is paid by the employer, there are two fund member categories and separate notional employer contribution amounts should be calculated for each.

B. Contribution certificate

It is proposed that a separate 'contribution certificate' be provided by the Fund for each fund member category, to the employer and SARS. The 'contribution certificate' must contain various pieces of information, including:

- Details of the pension fund and year of assessment to which the certificate applies;
- Details of the employer; the different components of the fund – whether they be defined benefit components, defined contribution components; risk benefit components or hybrid elements; and
- The fund member category factor for the applicable fund member category.

Requirements for the contribution certificate are laid out in a regulation.

C. Calculation of the value of the fringe benefit

To calculate the notional employer contribution to a defined benefit fund, the employer would need to multiply the pensionable salary by the 'fund member category factor' that is provided in the 'contribution certificate' and subtract the value of any contributions made by the employee.

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The pension fund would be required to calculate the 'fund member category factor' by following the calculation method specified in the regulation. This requires the fund to separate benefits for which members of the fund are eligible into defined benefit, defined contribution, underpin and risk benefit components. A separate calculation method is specified for each type of component. If the fund offers more than one benefit component of a particular type, a calculation would need to be performed for each benefit component separately, and the results aggregated.

D. Defined benefit component factor

A formula is prescribed for the calculation of this factor. The formula assumes that the defined benefit on retirement is a combination of an annuity and a lump sum.

The value of the annuity accrual is determined by multiplying the annuity accrual rate by a number intended to reflect the value of the benefits, which depends on the pension increase policy of the pension fund in terms of section 14B(3) of the Pension Funds Act and the average age at which members of that fund member category retire from the fund with benefits that are unreduced or un-augmented in terms of the fund rules as a consequence of the age at which they retire. The number is read off a table provided in the regulation.

This table has been calculated taking the following factors into consideration:

- Average expected levels of post-retirement mortality
- Average expected levels of pre-retirement mortality
- Expected investment returns pre- and post-retirement on a portfolio of assets whose term, nature and security broadly matches the lump-sum and annuity liabilities promised by defined benefit pension funds
- The average level of spousal benefits provided by pension funds
- The prices of annuities available in the private market.

Consistent with the overall methodology, the intention of the factors is to approximately reflect some estimate of the long-run cost of providing a benefit to a particular group of members, rather than the pace at which particular employers may choose to fund for those benefits.

The annuity accrual rate is defined as the average increase (over all members of the fund member category) in the annuity benefit expressed as a proportion of final salary occurring as a result of membership of the fund over the year of assessment, assuming that individual members remain in the fund until retirement. Valuers should first calculate the improvement in annuity benefits expressed as a proportion of final salary for each individual member over the year of assessment, and then take the average across all members of the fund member category. For funds without split accrual this should be a simple exercise.

If the fund pays a lump sum benefit on retirement, the lump sum accrual rate would be multiplied by 0.9 to estimate the increase in the lump sum retirement benefit. These amounts are added together to obtain the defined benefit component factor.

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Lump sum and annuity accrual rates should be calculated after any commutation to which members may be entitled, based on the average rate at which members have exercised this option in the recent past, and the terms upon which that commutation is exercised.

E. Underpin component factor

Retirement funds that have an 'underpin' would use a revised formula which takes the maximum of either the defined benefit sub-component factor calculated using the method specified above or the defined contribution sub-component factor and adds 10 per cent of whichever component factor is smaller. Adding the 10 per cent is intended to represent the additional benefit to the member of having the protection offered by the underpin.

F. Risk benefit component factor

The risk benefit component factor is calculated by multiplying the average risk benefit that members of the fund member category are entitled to should they die in the year of assessment, expressed as a proportion of pensionable salary, by 0.01. (Disability benefits are not valued by the formula, but are expected to be broadly proportional to the value of the death benefits). As before, the valuator should first calculate the risk benefits payable to each individual member or their dependents as a proportion of pensionable salary, and then take an average of members of the fund member category. Any defined contribution account values paid to the member's dependents on their deaths should be excluded from this calculation.

The 'fund member category factor' (that the employer will use to value the notional employer contribution) is the sum of the defined benefit component factor and the risk benefit component factor.

G. Defined contribution component factor

The defined contribution component factor is equal to the contribution rate in respect of the defined contribution benefit component.

The fund member category factor is the aggregate of all the factors calculated in respect of the benefit components of the fund.

The contribution certificate must be compiled by the board of the pension fund in consultation with the valuator of the fund and must be provided to the employer at least a month before the year of assessment.

Example A:

An employer offers a defined benefit pension to their employees, which has an annuity accrual rate of 1/55 for those who have less than ten years' service and 1/40 for those who have more than ten years' service. The fund also pays a lump sum at retirement of 0.067 of final salary per year of service. The fund reports that the average increase in pension benefits over the previous five years has been 100% of CPI. Members of this fund are able to retire from age 60 with unreduced benefits in terms of the rules, but their actual average retirement age is 63.

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There are no differences in contribution rates or rules determining the eligibility for and value of the benefits paid to members of the fund so there is only one fund member category. The pension fund is required to complete a 'contribution certificate' for that fund member category that needs to be passed on to the employer one month before the start of the individuals' tax year.

The pension fund would need to calculate the expected actual accrual rate for members. This value is calculated by averaging the increase in the annuity accrual across all members during the year of assessment. Since the fund has increased benefits for those who have served longer than ten years, the average annuity accrual rate is 1/50. The pension fund then needs to read off the value in the table of numbers provided in the annexure that is associated with the average retirement age of fund members – 63 – and the actual average pension increases granted over the last five years – 100% of CPI. The number to be used in the defined benefit component factor calculation is therefore 9.9.

The defined benefit component factor is calculated according to the formula in the regulations and equals $(1/50 * 9.9) + (0.067 * 0.9)$ which is 0.2583.

The pension fund would also calculate the average risk benefit that members (or their dependents or nominees) would be entitled to upon death should they die during the year of assessment, expressed as a proportion of their pensionable salary. If this amount is two times pensionable salary the risk benefit component factor would equal $(2 * 0.01)$ which is 0.02.

Since there are no other benefit components for which calculation methodologies are supplied, the defined benefit component factor and the risk benefit component factor are added together in the 'contribution certificate' to get a fund member category factor of 0.2783.

The employer, or the payroll company, would receive this number from the pension fund in the 'contribution certificate' and use it in the formula provided in the legislation to calculate the value of the notional employer contribution (which would be a fringe benefit). An employee who had a gross annual salary of R500 000 and a pensionable salary of R350 000, with employee contributions of 7.5% of pensionable salary, would have a notional employer contribution of $(0.2783 * 350\ 000) - (0.075 * 350\ 000) = 97\ 405 - 26\ 250 = R71\ 115$ for the year of assessment.

To check whether the employee is within the allowable deductible limits of either 27.5% of total remuneration or the R350 000 deductibility cap, the employer would need to add the notional employer contribution onto gross salary to obtain total remuneration. In this example total remuneration would be $(500\ 000 + 71\ 115) = R571\ 115$ and the total contributions to a retirement fund would be $(71\ 115 + 26\ 250) = R97\ 405$. The percentage contribution to the retirement fund is thus $(97\ 405 / 571\ 115)$ which is 17.06%. The individual could make further retirement contributions (say to a retirement annuity) of up to $(0.275 - 0.1706) * 571\ 115 = R59\ 629$ while still receiving a tax deduction.

Example B:

An employer offers a hybrid pension scheme to their employees. On retirement, the employees get a benefit which is the greater of 1/40 of their final salary per year of service and an annuity which can be purchased by a contribution rate of 15% of pensionable salary to a defined contribution account. The fund allows retirement from age 63 and the pension benefits granted over the previous five years has averaged 100% of CPI. Death benefits are 3 times pensionable salary plus the value of the defined contribution account on death.

The fund therefore has one fund member category, who are eligible for two benefit components – a risk benefit and an underpin benefit.

The value of the underpin benefit is the greater of the factor in respect of the defined benefit sub-component and the factor in respect of the defined contribution sub-component plus 10% of the lesser of the two.

Following the method described above, the value of the defined benefit sub-component factor is $9.9 / 40 = 0.2475$. The defined contribution sub-component factor has a value of 0.15. The underpin component factor is therefore equal to $0.2475 + 0.1 \times 0.15 = 0.2625$.

The risk benefit component is valued at $0.01 \times 3 = 0.03$ (the value of any defined contribution account paid out on death is excluded from the calculation of risk benefit factors).

The fund member category factor is therefore $0.2625 + 0.03 = 0.2925$.

IV. Effective date

The proposed amendments are effective as from 01 March 2015 and will be applicable in respect of years of assessment commencing on or after that date.