

**THE TAXATION OF SHORT-TERM INSURERS: AN IMPACT  
ASSESSMENT AND ANALYSIS OF THE NEWLY PROPOSED  
CHANGES IN INSURANCE REGULATION WITH AN AIM TO PUT  
FORWARD OR RECOMMEND AN APPROPRIATE FISCAL  
RESPONSE**

By

Enock Rutendo Chivaura

Student Number: CHVENO001

SUBMITTED TO THE UNIVERSITY OF CAPE TOWN

In partial fulfilment of the requirements for the degree MCom (Taxation)

Faculty of Commerce

University of Cape Town

Date of Submission: 21 August 2012

Supervisor: Darron West, Department of Finance and Tax, University of Cape Town

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

## **DECLARATION**

I, Enock Rutendo Chivaura, hereby declare that the work on which this research paper is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole nor any part of it has been, is being, or is to be submitted for another degree in this or any other university.

I authorise the University to reproduce for the purpose of research either the whole or any portion of the contents in any manner whatsoever.

Signature:

Date: 21 August 2012

## TABLE OF CONTENTS

<b>Chapter One: Introduction.....</b>	<b>1</b>
Background.....	1
General Concept & History of Insurance.....	1
Evolution of the insurance industry (tax and regulation).....	2
Insurance legislation in South Africa.....	3
An overview of the short term insurance industry in South Africa.....	4
Problem Statement and Research Objectives.....	7
Significance of study.....	8
Methodology and Chapter Outline.....	9

## **CHAPTER TWO: TAX REGIME CURRENTLY APPLICABLE TO SHORT-TERM INSURERS.....11**

Introduction.....	11
Analysis of Section 28 of the Income Tax Act No. of 1962.....	13
Deductions applicable to the carrying on of short-term insurance business.....	17
The current valuation methods.....	21
The Interim Measures.....	23
Other provisions in s 28 (ITA).....	26

## **CHAPTER THREE: THEORETICAL VIEW ON TECHNICAL RESERVES.....27**

Introduction.....	27
Revenue authorities and Insurance Regulatory Bodies.....	28
Role of Technical Provisions in an Insurance Business AND how they operate.....	30
Characterisation of Technical Provisions Allowed for Tax Purposes.....	34
Unearned Premium Reserves.....	35
Unexpired Risks Reserves (URR).....	37
Outstanding Losses Reserve.....	39

Claims Incurred and Reported.....	39
Claims Incurred But Not Reported (IBNR).....	41
Catastrophe OR Contingency reserves.....	43

## **CHAPTER FOUR: REGULATORY CHANGES IN SOUTH AFRICA...47**

Introduction.....	47
Solvency Assessment and Management - Broad overview.....	47
Purpose/Objective of the SAM regime.....	48
The Three Pillars.....	49
Pillar 1 and the Valuation of Technical Provisions.....	51
Conclusion.....	56
Internal Model (SAM Framework) - Research & Development Expenditures.....	56
Current Tax Position.....	58
Conclusion.....	64

## **CHAPTER FIVE: TAX IMPACT AND RECOMMENDATIONS**

### **MOVING FORWARD.....65**

Introduction.....	65
The differences between SAM and the current regulatory rules.....	66
Question 1.....	68
Question 2.....	71
Conclusion.....	76
Tax-Deductions for Internal Model „Research and Development’ costs.....	77
Conclusion.....	85

### **CHAPTER SIX: MAIN CONCLUSION.....85**

### **BIBLIOGRAPHY.....90**

## **CHAPTER 1: INTRODUCTION**

### **Background**

The insurance business has always played a critical role in the trade and commerce industries, ultimately as a major tool in the management of risk. Even though this research paper is primarily focused on taxation issues affecting the South African short-term insurance industry<sup>1</sup>, it is firstly important and vital to briefly discuss the general concept of insurance, how it has evolved and more specifically it's role, relevance and impact on the South African economy, society and business community at large. For by having this preliminary discussion can one fully appreciate the important tax issues that will be discussed and explored in the proceeding chapters and furthermore provide a clear understanding of the rationale used to reach the various conclusions sought by this research paper.

### **General concept & history of Insurance**

Modern general insurance as we know it today began in several Italian city states in the fourteenth century. It was used by Italian merchants who were involved in international trade by sea, and in their line of business they faced enormous financial risks, and insurance enabled these risks to be shared, either through an agreement with other merchants to provide cover if one member of the group suffered a loss or through an insurer, who, in exchange for the payment of a premium, agreed to cover specified losses and would then seek to spread that risk among other insured persons or parties (John Lowry *et al.*, (2011)).

It is this voluntary (or mandatory in some instances) provision or safeguard against risks which falls at the heart of every insurance agreement – in essence it affords individuals and corporate entities a sense of security as they engage in risky personal and financial transactions. This security is primarily achieved by transferring or shifting a risk (or risks) from one party to another, which in turn ensures that the undesirable consequences of that risk (or risks) are wholly or partially neutralized (MFB Reinecke *et al.*, (1989)).

This provision against risks by means of insurance as described above, invariably takes the form of a binding contract or agreement between an insurer and an insured person or persons. A general definition of what encapsulates a modern day insurance agreement/contract (i.e. the proposal form and policy) has been formulated and can be summarily be stated as an agreement in which for some consideration, usually but not necessarily in periodical

---

<sup>1</sup> Short-term insurance is also known as general, non-life or property & casualty insurance.

payments called premiums<sup>2</sup>, you secure yourself to some benefit, usually but not necessarily the payment of a sum of money, upon the happening of some event. Then the next thing that is necessary is that the event should be one which involves some amount of uncertainty. There must be either uncertainty whether the event will ever happen or not, or if the event is one which must happen at some time there must be uncertainty as to the time at which it will happen. Furthermore, the insurance agreement must be against something and the insured must have an interest in the subject matter, that is to say, the uncertain event which is necessary to make the contract amount to an insurance agreement must be an event which is prima facie adverse to the interest of the insured. Subsequent to the uncertain event taking place the insurer is obligated to provide for the payment of a sum of money or provide its equivalent to meet the loss or detriment which will or may be suffered by the insured upon the happening of the event (John Lowry *et al.*, (2011)).

### **Evolution of the insurance industry (tax and regulation)**

As with any business concept, insurance has evolved and changed over many decades because of the increased complexity and greater scope of personal and commercial transactions, and it is because of this evolution that one can safely conclude that in the 21<sup>st</sup> century it is possible to insure almost every conceivable event or thing against the risk of loss or damage (John Birds *et al.*, (2004)).

Notwithstanding the increased scope in risks covered by insurance contracts, another factor which has constantly changed and shaped the face of the insurance industry over time is the increased amount of statutory regulation and restrictions imposed on insurance providers. Governments and financial services regulators have always kept a close eye on institutions that receive and handle funds from the public, and the regulatory controls they put in place are extremely vital. If anything, the 2008 global financial crisis was a stark reminder of the importance of tight regulatory controls and oversight for financial systems and intermediaries.

The main reason behind the imposition of tight controls is to maintain the probity and integrity of the various insurance and financial institutions, which in turn will ensure that consumers are financially protected from any unfair practices, abuse and mischief perpetrated by institutions and insurers for their own benefit. Furthermore, strict financial regulation,

---

<sup>2</sup> The insurer will 'price or set' premiums in accordance with the level of risks covered i.e. a higher level of risks means a higher premium and the converse is also true.

although onerous is important as it affords the public to have confidence in the insurers and financial institutions that receive and handle their funds; the loss of such confidence by the public in the financial system is simply catastrophic at every level of the economy, business and society.

From a tax perspective, it is trite that financial regulators and revenue collectors are completely independent and autonomous in their objectives, functions and processes - which is perfectly normal but in reality insurance regulation will in most cases have an impact and effect on the tax provisions applicable to insurers. As such any changes in insurance regulation automatically calls upon government and treasury to reassess the tax position, to ensure that taxes are still being collected in line with the basic tenets of any tax system, which include *inter-alia* - equity, certainty, convenience, efficiency and neutrality. Hence, it is imperative for revenue collectors and treasury to accurately assess and predict the impact and effect of insurance regulatory reform before a decision to amend or not to amend tax legislation is reached.

This discussion surrounding an appropriate fiscal response to regulatory changes is a central and important part of this research study because of the monumental regulatory reform currently taking place in the South African insurance industry. This aspect will be revisited and further discussed as the research problem and question is outlined below.

### **Insurance legislation in South Africa**

From a legislative perspective, South Africa has two distinct classes of insurance, namely short-term insurance and long-term insurance<sup>3</sup>. Broadly speaking, the difference between the two classes of insurance lies in the fact that long-term insurance agreements are regarded as contracts for contingency insurance i.e. contracts to pay an agreed sum of money when the event insured against occurs, whereas short-term insurance agreements are regarded as contracts to indemnify the insured only in respect of the loss suffered if it is actually suffered and only to the extent of the loss suffered (John Birds *et al.*, (2004)).

Long-term insurance is governed by the Long-term Insurance Act (No. 52 of 1998). This research does not include any elements pertaining to long-term insurance, and as such no further comment or discussion will be made in connection with long-term insurance.

---

<sup>3</sup> Long-term insurance is also referred to as life insurance.

Reference will only be made if there is a direct bearing and correlation to the main focus and subject of this research.

Short-term insurance is governed by the Short-term Insurance Act (No. 53 of 1998), and the regulations and amendments gazetted and published by the Financial Services Board (FSB)<sup>4</sup>. An overview of the current trends and analysis of the South African short-term insurance industry is outlined in the following sub-section.

### **An overview of the short term insurance industry in South Africa**

The short-term insurance industry is one of the most vibrant, rapidly changing and increasingly complex industries in South Africa. Tighter regulatory controls, new market entrants, changing customer preferences, different and evolving marketing strategies affected by changes in technology and market erosion across product lines are some of the few factors that have constantly been affecting and altering the way in which business is conducted in this industry. The industry is on a growth path because of the increased capacity/demand for insurance as well as competition amongst short-term insurers<sup>5</sup> (PWC, 2011).

#### Capacity/demand

In terms of personal lines insurance, some of the noticeable factors contributing to the increase in capacity include –

- (a) Sustained effort and hard work by insurers to diversify and increase their product range, and in so doing they have created more distinct product lines covering a wider range and assortment of risks.
- (b) Changing demographics in the South African market and customer base caused by a new and rising middle class with buying power. This has created an opportunity for insurers to sell insurance to a market that did not exist before.
- (c) Reduced levels of household debt, which enables individuals to devote more of their disposable income towards purchasing insurance and securing their assets

---

<sup>4</sup> The Financial Services Board (FSB) is a South African government agency or organ responsible for the non-banking financial services industry in South Africa. It is an independent body that supervises and regulates the financial services industry in the public's interest (Wikipedia, 2012).

<sup>5</sup> The top four insurers in South Africa based on gross premiums include Santam Ltd, Mutual & Federal Ltd, Outsurance Holdings Ltd and Zurich Insurance Company South Africa Ltd (PWC, 2011).

(d) Technological advances (i.e. mobile and internet technology) which have expanded access to previously excluded communities, particularly in rural South Africa and across the African continent (PWC, 2012).

The increase in capacity is not only limited to personal lines insurance but is across the board. The latter has been confirmed by the growing number of reinsurers as well as niche or specialised insurers<sup>6</sup>. The South African Insurance Association (SAIA) 2011 Annual Review reported that the overall position and business for reinsurers and niche insurers was extremely positive with strong premium growth and profits for several consecutive years.

More specifically for niche insurers, their numbers have grown because of a common trend developing in South Africa where leading insurers (e.g. Santam, Mutual and Federal) and many others are creating or acquiring smaller companies that are mandated and solely responsible to underwrite risks arising in specific and particular industry sectors; all of this done as a way of remaining competitive, growing their business volumes and ultimately enhancing shareholder value (Richard Masson - Marsh Insurance Brokers, 22 May 2012).

In addition to the above, capacity levels have increased because of a general push and consensus amongst all stakeholders (government and private sector) in the industry to ensure that insurance services are accessible to the poorer communities and people in the low-income bracket. Part of this initiative has seen a rapid expansion of micro-insurance schemes such as cell captives<sup>7</sup>, which ultimately enable access of insurance services and products to the poorer South African community.

### Competition and Product offering

Moving in tandem with increased capacity is the fierce competition that has emerged amongst insurers in the industry. This stiff competition has primarily been caused by new entrants (including banks<sup>8</sup>) into the market as well as the different and alternative distribution channels offered by insurers.

More specifically in terms of new entrants and distribution channels is the significant and combined effect of direct underwriters (e.g. OutSurance, Miway, Hippo, iWyse etc), and the use of mobile and internet technology. The latter has enabled insurers to sell insurance

---

<sup>6</sup> Niche insurers - insurers covering a unique set of risks in which cover is difficult to obtain from ordinary insurers.

<sup>7</sup> Cell Captives - the provision of insurance in a typically low-income market by a non-registered insurer using the licence of a registered insurer.

<sup>8</sup> This is also referred to as Bancassurance, and the main business focus in this context is credit life insurance.

directly to the public at a much faster pace, with greater efficiency, simplicity and without any prior advice or consultation provided by an insurance intermediary. The PWC 2011 Survey concluded that these direct underwriters have saturated the insurance market, and their entry will continue to intensify the competition, reduce the stickiness of clients and could ultimately result in a continual underwriting margin squeeze for market participants.

At this point it's not very clear whether or not these direct underwriters are effecting a saving by negotiating directly with consumers and in the process eliminating insurance intermediaries, which in-effect reduces their acquisition cost but increases their administration cost. Suffice to say, this direct contact with clients and consumers has been derided and described as posing a serious conflict of interest, as the insurer is the client's advisor as well as insurance provider. The danger of concluding insurance contracts in this manner is that it might impinge and cloud the insurer's ability to provide impartial advice to the consumer (Richard Masson - Marsh Insurance Brokers, 22 May 2012).

In terms of actual business recorded by insurers, it is clear that motor insurance is the largest class of business in South Africa. For most insurers half of all claims paid out relate to motor claims (SAIA 2011 Annual Review). The main reason for such a large portion of business going to motor insurance has been attributed to the high number of road accidents in South Africa<sup>9</sup>, which in turn leads to a very high number of claims that insurers are continually called upon to settle. The other eminent categories of insurance policies written include property, transportation, accident and health, guarantee, liability, engineering and many more which cannot be characterized into one group (SAIA Annual Review, 2011).

#### New regulation for the industry

Notwithstanding the growth and expansion prospects of the Short-term Insurance Industry, as shown above, it is clear that the most pressing and pre-eminent issue affecting insurers and most stakeholders is regulatory reform. The industry is presently going through monumental and unprecedented regulatory reform as part of an alignment with international regulatory standards applicable to insurers. The main pieces of regulation that will have an impact on insurers one way or another include the Solvency Assessment and Management, Financial Condition Reporting, Treating Customers Fairly, Pension Fund Proposals, National Health Insurance Reforms and Binder Agreements (PWC, 2012).

---

<sup>9</sup> According to SAIA approximately 40 people are killed on the roads every day, which makes the annual figure 14 000, (SAIA 2011 Annual Review).

The pieces of regulation mentioned above are all important but for the purposes of this research paper most of the focus will be on the Solvency Assessment and Management. Further analysis and discussion on this framework will be done in later chapters but for now it is worth noting that all regulatory changes are important for insurers as they are mandatory and compliance by the insurer will ensure its continued existence and operation. In terms of other stakeholders, regulatory changes are important, especially if the stakeholder's objectives, functions and processes are inextricably linked with the operations of the insurer (for example the taxpayer and tax-collector relationship that exists between insurance providers and the South African Revenue Services).

### **Problem Statement and Research Objectives**

In the wake of the 2008 global financial crisis, regulators across the world have been making reforms to strengthen financial systems and intermediaries, with the sole purpose of ensuring that such calamities are prevented from happening and that „main street’ is adequately protected. This trend has also been true in South Africa as various measures have been taken legislatively to ensure that the entire South African financial services system operates in a transparent, disciplined and non-abusive manner.

More specifically for this research, the Short-term insurance industry has been the target and subject of regulatory reform for a-while. As early as 2005 - 2007, the Financial Services Board (FSB) was drafting amendments and regulatory proposals for short-term insurers in the form of the Financial\_Condition Reporting Regulation (FCR). This FCR Regulation was ostensibly comprehensive but after the financial crisis, the FSB doubled down and introduced the Solvency Assessment Management regime (SAM). In introducing the SAM regime in November 2010, the FSB stated that the FCR would be superseded and included in the new framework. The SAM regime is primarily based on the „Principles and Risk based’ Solvency II Directive Framework - the latter was adopted by the European Parliament in 2009 and will be implemented on 1 January 2014 by all European Union countries. Meanwhile, the SAM regime will be effective from 1 January 2015.

In light of the proposed regulatory framework, the main purpose and objective of this dissertation is to assess and analyse the impact that the proposed changes in regulation will have on the taxation of short-term insurers. The main focus of the impact assessment will be on the principal provision that is applicable to the taxation of short-term insurers - s 28 of the Income Tax Act (No. 58 of 1962) (Tax Act).

As will be seen in later Chapters, the central issue that is heavily impacted by the proposed regulatory changes revolves around technical provisions. Technical provisions are an important and integral part of an insurer's business model but they are often a source of contention between regulators and tax-administrators. Therefore as part of the SAM framework analysis, the following issues related to technical provisions will be addressed:

- 1) Establishing the connection that technical reserves create between insurance regulation and tax legislation,
- 2) Highlighting the role and importance of technical provisions,
- 3) Understanding and explaining the impact that the regulatory reform will have on technical provisions and the ensuing tax-consequences, and
- 4) Once the impact in Question (3) is fully understood then it is important to ascertain if any changes in tax-legislation are necessary in response to the regulatory changes.

In addition to technical reserves, another crucial issue to be investigated in this dissertation revolves around the tax-deductibility of expenditures incurred to implement the SAM framework. More specifically in this regard are the expenditures incurred by insurers in „Researching and Developing Internal Models’. As will be seen most of these expenditures are not deductible under the current tax-provisions. As such the real question/inquiry becomes whether or not a special concession should be enacted for such expenditures?? All the relevant issues will be considered before reaching a conclusion on the matter.

Lastly, it is important to note that the SAM framework is pervasive, and will no doubt have an effect on other tax issues above and beyond the issues raised in the above objectives. Those other issues, though important, have not been considered in this dissertation because the immediate focus has been to investigate the potential tax issues & problems coming out of the principal provision applicable to short-term insurers in South Africa.

### **Significance of study**

It is my opinion that the findings of this study will be useful to all stakeholders in the short-term insurance industry. Generally speaking, whenever regulatory reform of this magnitude is proposed and eventually promulgated, it will have an impact on many other sectors of the economy – and that impact and knock-on effect must be determined.

In-fact at the outset of the SAM regime in November 2010, the FSB formed an Economic Impact\_Sub-Committee, which comprised of an economic study task group and a tax task

group. The latter task force was mandated by the FSB in the following statement – *„it is recognised that the outcome of the SAM project, specifically with respect to reserving issues, may also require amendments to the tax-legislation pertaining to long-term and short-term insurers. A tax task group, which will include representatives of National Treasury, SARS, industry, and the FSB, to be housed under the Economic Impact Sub-committee of SAM, has been formed to investigate tax issues’* (FSB - SAM Roadmap, 2010).

Although this dissertation is not part of that tax task group, it is however my hope that the analyses and perspectives given in this study will dovetail the conclusions reached by members of the aforementioned task force.

### **Methodology and Chapter Outline**

In order to address the issues laid out in the „Research Objectives’ above, it will be crucial to clearly show what the current regulatory regime is and what the proposed rules under the SAM framework entail. This is an important comparison as it will show the regime that short-term insurers are transitioning to. To that end, Chapter Two will assess the current tax-position of a „typical short-term insurer’ in South Africa – all the provisions of s 28 of the Tax Act will be discussed. For the purposes of this dissertation a „typical short-term insurer’ refers to an insurance provider resident in South Africa, and carrying on insurance business only in South Africa. On the other hand, Chapter Four will discuss the proposed SAM framework in the context of technical provisions, as well as other tax-issues that are connected with implementing the SAM framework.

Chapter Three is meant to bridge the gap between Chapters Two and Four by giving a theoretical perspective on the technical provisions that short-term insurers maintain statutorily and in some cases voluntarily. More specifically, the purpose of this theoretical perspective is, firstly to highlight the important role played by technical provisions in an insurance business, secondly, to give a better understanding of technical provisions, and thirdly, to perform a thorough analysis of the tax-issues that are commonly associated with technical provisions.

Chapter Five will continue the discussion from Chapter Four and Two by carrying out an analysis of the impact caused by the regulatory reform. The aim of the impact assessment is to reach conclusions and make recommendations for the future. Chapter Six will provide the

main conclusion by giving a Chapter summary and putting all the issues discussed into perspective.

Lastly, in order to get a practical perspective and opinion on some of the regulatory issues discussed in the chapters above, independent opinions from the FSB and other insurance associations were solicited. Opinions from the FSB are particularly important and significant because the FSB is at the epicentre of this regulatory reform, and in most cases they have first-hand information on recent developments and progress made with respect to the SAM framework.



## **CHAPTER TWO: TAX REGIME CURRENTLY APPLICABLE TO SHORT-TERM INSURERS**

### **Introduction**

The first step in addressing the research objective above is to identify and outline the current tax position for short-term insurers in South Africa. This is an important step because an analysis of the current provisions will provide better understanding of the impact precipitated and caused by the regulatory reform.

It is trite that insurers operate in a very unique manner and environment. This uniqueness stems from a wide range of factors e.g. a separate regulatory regime which insurers fall under requiring a statutory return based on stringent rules and standards, special accounting systems which in most cases are different to the normal accounting rules, and a generally difficult business model in which amounts used to calculate income are based on complex actuarial computations and estimations.

It is because of these and other complexities associated with the insurance business that the ordinary tax rules generally fall short in their application to this special type of business. Hence, in most jurisdictions, insurance providers are classified as „special tax-payers’ because they have their own special income tax provisions. Even though these tax provisions are uniquely crafted to cater for insurers, they are still set in line with the well-known principal objective of any tax system, which is to collect and preserve revenue that is properly owed on current year’s profit.

South Africa is no exception to the aforementioned as tax-policy makers understand the practical and tricky issues that often arise in trying to tax insurers under the general income taxation principles. As such there are special provisions in the Income Tax Act available to entities carrying on short-term insurance business. The principal tax-provision applicable to short-term insurers is s 28 of the Income Tax Act (No. 58 of 1962) and its purpose is stated in the preamble, which is the “Determination of taxable income derived from insurance business”.

Summarily stated short-term insurers report two elements of income, namely underwriting and investment returns - both are fully taxable. Reported underwriting income or profits are computed by taking into account premiums received, actual policyholder claims and technical provisions. In practice and in general terms, underwriting profits can vary and fluctuate from

one year of assessment to the other because of a whole range of factors. Three eminent & easily identifiable factors causing such fluctuations would include –

- (a) A significant drop or rise in premium income, normally in response to consumer demand and competition e.g. a highly competitive environment will precipitate a widespread reduction and depression in the prices of insurance products, thereby lowering premium income.
- (b) Volatility of claims. In some cases an insurer will write new business/policies with ordinarily little historic claims, but suddenly due to a major, catastrophic and unexpected event (nuclear, natural or environmental) the insurer suffers an enormous amount of claims. The obvious result from this surge in claims is to reduce the underwriting profits recorded by the insurer or in the worst case scenario the insurer will suffer an underwriting net-loss. This spike in claims is generally known and referred to as „high-standard deviation’.
- (c) Lastly, underwriting income could fluctuate if there are significant changes in the level of insurance liabilities or technical provisions without a corresponding change in the level and volumes of the insurance business/policies written. Put differently, this refers to when an insurer maintains the same level and volume of insurance business but at the same time record an increase or decrease in the level of future insurance liabilities or cash-outflows. Such movements in technical provisions which are not related to the volumes of insurance business written might be caused by regulatory and legislative changes or a drastic change in the insurer’s reserving policy and philosophy.

NB. In the normal course of business insurance liabilities and technical provisions will increase or decrease depending on the amount of insurance business written and sold i.e. more insurance written and sold necessitates a higher level of technical provisions and future liabilities, and the opposite applies where if „negative insurance sales’ take place then future liabilities and provisions must also go down. In this case „negative insurance sales’ refers to a hypothetical situation where an insurer is not selling any new insurance policies and at the same time existing policyholders are cancelling their contracts and coverage (for a detailed discussion on technical reserves see Chapter Three & Four).

The provisions of s 28 of the Income Tax Act (No. 58 of 1962) mainly deal with the computation of underwriting income. They will be explored and discussed sequentially in the following sub-section. For the purposes of this research, matters related to an insurer’s

investment policy, returns and the appropriate tax-relief (deductions and exemptions) applicable to such investment returns fall outside the scope of this study, and as such no further comments will be made in this regard.

Two things must be noted about the following sub-section:

- i) Some of the tax provisions to be discussed in the following sub-section have not been directly impacted by the regulatory reform mentioned in Chapter One and discussed in Chapter Four, but they have been included as part of this Chapter and discussion for the sake of presenting and giving a complete assessment of the current tax position for a typical short-term insurer in terms of s 28 of the Income Tax Act (No. 58 of 1962).
- ii) The „current tax position’ will try to incorporate the legislation and amendments applicable and in-force at the time of conducting and doing this research. The main pieces of legislation referred to are the Income Tax Act No.58 of 1962(ITA) and the Short-term Insurance Act No.53 of 1998 (SIA).

## **Analysis of Section 28 of the Income Tax Act No. of 1962**

### Income/Revenue Treatment

The starting point in this section revolves around the tax treatment of income or revenue earned from carrying on an insurance business. For most insurance companies the revenue stream comprises of premiums received from policyholders and the subsequent investment return/income obtained by investing profit margins earned on the premium income received.

The pre-amble to s 28 (2) (ITA) begins by addressing and spelling out the treatment of income *„derived by any person from the carrying on of short-term insurance business’*. It requires that a short-term insurer include in their taxable income all premiums and reinsurance premiums *„received and accrued in respect of the insurance or re-insurance of any risk’* , and any other amounts also derived from the carrying on of the short-term insurance business.

There are a couple of general things to note. Firstly, the carrying on of 'short-term insurance business' is defined in s 1 of the SIA as follows – *„means the business of providing or undertaking to provide policy benefits under short-term policies’*.

S 1 of the SIA also defines 'short-term policy' as meaning – *„an engineering policy, guarantee policy, liability policy, miscellaneous policy, motor policy, accident and health policy, property policy or transportation policy or a contract comprising a combination of any those policies; and includes a contract whereby any such contract is renewed or varied;’*

No further comment will be done in relation to the 'carrying on of short-term insurance business' as a detailed discussion has already been done on how short-term insurers operate in general and more specifically in South Africa (refer to Chapter One).

Secondly, the fact that the premiums and other income received or accrued must be 'in respect of' insurance or reinsurance of any risk clearly suggest that the carrying on of that insurance business must be the 'causa causans, direct or immediate cause' of the receipt or accrual of the premium and other income (Emslie, *et al.*, 2001: 35 - 36).

#### „Received by or Accrued to’

The requirements laid out in the s 28 (2) (ITA) pre-amble to include normal premiums and reinsurance premiums (premiums) in the taxable income calculation are consistent with the requirements set out by the normal taxation principles. In other words, if the gross income definition and requirements were applied to the premiums in question, they would undoubtedly meet the definition and qualify for an inclusion as gross income. The main reason for this consistency and concurrence between the two provisions is because both the gross income definition and the s 28 (2) (ITA) pre-amble are subject to and governed by the accrual principle. The accrual principle is very important as it applies to the calculation of taxable income for most businesses and taxpayers - in a nutshell it requires that revenues and expenses be accounted for as they are earned or incurred respectively.

However, to be more specific about the assertion & comparison above, the phrase 'received by or accrued to' used in the s 28 (2) (ITA) pre-amble also appears in the s 1 (ITA) gross income definition, and has in several instances been reviewed judicially. Eminent cases that have dealt with this phrase have concluded that amounts (in cash or kind) are said to have been received by the taxpayer if they have been received for 'the taxpayer's own benefit or behalf'. On the other hand amounts are said to have accrued when the taxpayer is

„unconditionally entitled’ (not due and payable) to the amounts agreed upon under the commercial agreement or transaction. (Emslie, *et al.*, 2001: 42, 66).

It is trite to point this out but the distinction between „entitled to’ and „due and payable’ is critical because in the normal course of a transaction they don’t necessarily occur at the same time (i.e. a taxpayer could be „unconditionally entitled’ to an amount but the amount not yet „due and payable).

The foregoing discussion on the accrual principle is strikingly relevant in the present context because when an insurer sells an insurance policy all the amounts that will be received under that insurance policy must be included in the insurer’s taxable income, regardless of the frequency or method of payment by the policyholder. The reason for this is because, by virtue of the binding insurance contract, the insurer is immediately „unconditionally entitled’ to the premium payments as stipulated by the agreement, notwithstanding the fact that some of the payments are due and payable at later date or in another year of assessment. The only thing that can postpone the insurer’s „unconditional entitlement’ to the premium payments would be a clause in the insurance contract which brings an element of conditionality to the aforesaid payments. The aforementioned explication is a „classic’ application and result of the accrual principle.

However, notwithstanding the aforementioned inclusion, a special concession applies to short-term insurers, which allows for the premium income to be adjusted, so as to reflect only that portion of premium income which has actually been earned. The unearned portion of premium income which is attributable to the unexpired term<sup>10</sup> of the policy is deferred to the next accounting/fiscal year in order to match the premium income to the time that the risks are outstanding.

It is important to note that this deferral of income is a special provision applicable only to short-term insurers i.e. ordinary taxpayers cannot defer „unearned income’ which has accrued to them (accrued in the sense that they are either unconditionally entitled to the amount or they have received the amount for their own benefit).

---

<sup>10</sup> The ‘unexpired term’ refers to the amount from the total premium income which would be returned to the policyholder if the policy was cancelled today.

This deferral of premium income to the policy period which has yet to be utilised or is still an on-going concern is done through the use of an unearned premium reserve (please see discussion below).

### Capital v Revenue

The consistency between the gross income definition and the s 28 (2) (ITA) pre-amble can be proved further by analysing the capital or revenue characterisation of premiums. To fall under gross income, amounts must be of a non-capital/revenue nature. Even though the s 28 (2) (ITA) pre-amble does not explicitly state this requirement, the next paragraph will explain and show why premiums received by a short-term insurer meet this non-capital/revenue nature requirement.

Premiums received by or accruing to a short-term insurer cannot be of a capital nature. This is because the purchase of insurance products under short-term policies only includes an element of „risk-protection’. For an insurer „risk-protection’ can rightly be described as a „normal-consumption\_good’ offered and sold to the general public, and for the policyholder, the purchase of „risk-protection’ can be described as an „act of normal-consumption’ (i.e. representative of a non-investment purpose by the policyholder).

The above is in stark contrast to long-term insurance contracts where policies are largely used as an investment or savings vehicle and the portion pertaining to risk-protection could be minimal or absent. In the latter case the role of the long-term insurer is to receive premiums from policyholders, with the sole purpose and mandate of investing and saving the premiums received on behalf and for the benefit of the policyholder - as such the premiums received by a long-term insurer cannot be gross income because upon receipt of the premiums an immediate obligation is created for the long-term insurer to return those funds at a future date to the policyholder. For the policyholder, using a long-term insurer as a means of keeping and growing funds can rightly be described as an „act of investment’ (i.e. capital purpose by the policyholder) as opposed to the „normal-consumption act’ mentioned above.

As alluded to the above and of importance is that premiums paid with the main purpose of obtaining a savings or investment vehicle will have a maturity date in which the insurer must return to the policyholder the premiums paid plus any investment return on the premiums. In most cases the payment upon maturity will take place even if no claims are made under the „risk-protection’ portion of the long-term insurance contract. Whereas with short-term

insurance policies there is no maturity date in which premiums paid plus the return on investment are paid back to the policyholder – any payment made by the short-term insurer to the policyholder will only take place in fulfilment of the insurer's obligation to provide 'risk-protection' services i.e. on receiving a claim from the policyholder.

Alternatively, using the 'fruit tree analogy' it becomes clear that the premiums received by an insurer under a short-term insurance policy are the fruit (income) of the insurance contract or the insurer's ability to provide 'risk protection' services (the tree). On the other hand, premiums received under a long-term insurance policy represent the tree itself, as the policyholder is placing his/her funds into the hands of the life insurer, with the purpose and intention of ensuring that those funds are invested and saved on their behalf (Emslie, *et al.*, 2001: 350 - 351).

The conclusion drawn from this sub-section is not to suggest that both the gross income definition and the s 28 (2) (ITA) pre-amble are applicable to premiums received by a short-term insurer. That view is wrong and would result in double taxation, which is contrary to the intention and purpose of the ITA and legislature; rather the above comparison between the two provisions served to illustrate that the s 28 (2) (ITA) pre-amble does not deviate from the basic accrual and capital/revenue principles laid down in the gross income definition.

### **Deductions applicable to the carrying on of short-term insurance business**

The s 28 (2) (ITA) pre-amble allows or stipulates that a short-term insurer in deriving its taxable income can make use of all the deductions enumerated in the s 28 (2) (ITA) sub-sections. The sub-sections are discussed below.

S 28 (2) (a) (ITA) is directed towards any amounts or liabilities incurred by a short-term insurer in respect of re-insurance premiums, and the aim of the provision is to provide tax relief for amounts incurred on such expenditure. Summarily stated, re-insurance is the purchase of insurance by an insurance company to cover policies issued and already in existence. This is mostly done by insurers as part of managing risk strategically and efficiently.

In a South African context this is a useful provision because a significant number of small short-term insurers are using re-insurance schemes mainly as a means to off-load risks for which they do not have sufficient capital and secondarily to diversify their product range and

offering. In fact, the emergence of a stable reinsurance market and service in South Africa is one of the main reasons that the contingency reserve<sup>11</sup> tax-deduction was withdrawn and repealed in 2001 by the South African Revenue Service (SARS, 2001).

Also of importance and note-worthy is that s 28 (2) (a) (ITA) above is subject to s 23 H (ITA). S 23 H (ITA) is a provision which places a limit on the amount of expenditure that a taxpayer may deduct because the service or benefit purchased and received extends beyond one year of assessment. This is generally known as the „spreading provision’ as it spreads the expenditure incurred over the time period with which the benefit obtained from the purchased service or good is enjoyed.

This measure is important as it ensures that a short-term insurer will not defer or postpone taxation liabilities (i.e. a tax benefit) by claiming a single deduction for all the re-insurance premiums that are obligatory or will be paid under a reinsurance contract or policy extending beyond one year of assessment. The ultimate effect is that the total reinsurance premium payments per the agreement are spread over the re-insurance contract period for tax purposes.

Were it not for the limit placed by s23H (ITA), short-term insurers would create a substantial tax loss in the first year as all the re-insurance premiums payable under the re-insurance contract are brought to tax with a single deduction. Inevitably the substantial tax loss made in year one will be subsequently offset by higher profits in year two, three and so on. While the total taxable income during the entire period which the re-insurance contract is in force is the same, the benefit however obtained by the insurer from deferring tax in year one is not diminished in any way because of the time value of money (i.e. tax not paid today or postponed is a saving).

S 28 (2) (b) ITA - part of an insurer’s business involves meeting its obligations towards policyholders. If and when the policyholder puts a claim for losses incurred, the insurer will make a pay-out to the policyholder in terms of the insurance contract as compensation for the incurred losses. A loss is said to have been incurred by the policyholder when the event

---

<sup>11</sup> A contingency reserve is an additional amount set aside by insurers as a means of increasing the solvency margin to levels that are in line with internationally accepted solvency margin levels. This additional reserve is deemed necessary to provide additional stability to an insurance provider, especially in the event of meeting any unusually severe claims arising as a result of, for example, natural disasters or other catastrophic, but unforeseen events (SARS, 2001).

insured against occurs. The amount expended by the insurer in making the pay-out to the policyholder is deductible under s 28 (2) (b) (ITA). It is important to note that the amount of the deduction must be reduced by any claims that have been recovered or are recoverable under a re-insurance contract.

In addition to the pay-out cost, the insurer can also claim under this provision all the costs and expenses (direct and allocated) arising and associated with making the actual pay-out to the policyholder. The reason why the additional costs are included as a deduction is because s 28 (2) (b) (ITA) states the following - *„the actual amount of the liability incurred in respect of the claims’*. In my view, the phrase *„actual liability’* as opposed to *„actual pay-out’* increases the scope and range of costs that are eligible for deduction under this provision; as long as the additional cost and expenses are causally linked and related to the claims processing and pay-out.

Reference to *„the actual amount incurred’* (i.e. actually incurred) in the above provision is very crucial because in *„insurance parlance’* it connotes that the claim submitted by the policyholder has been incurred, reported, adjusted and paid (or unpaid). The phrase *„actually incurred’* is also very important because it creates a distinction between s 28 (2) (b) (ITA) and the s 28 (2) (cA) (ITA) which deals with technical provisions. The distinction lies in the fact that the liability incurred by the short-term insurer under s 28 (2) (b) is not an estimate, but the actual amount that the insurer can quantify and is unconditionally liable to pay-out (i.e. there is no conjecture about the lodged claim and the amount to be paid-out).

Also of importance is that the actual amount of the liability incurred does not have to coincide with the actual payment or settlement of the liability i.e. it is possible that the actual liability is incurred in one fiscal year and subsequently paid or settled in another. As long as the actual amount is known and the insurer is unconditionally liable to settle the obligation, then the deduction under this provision is applicable. As will be seen in the next section, claims which have been reported and the insurer is uncertain as to the amount that will be paid out or whether it will in-fact make the pay-out must be estimated and are deductible under the technical provisions of s 28 (2) (cA) (ITA). In the latter case, the payment of such policyholder claims remain as a conditional liability from one fiscal year to another because

the short-term insurer has not completed or finalised crucial preliminary investigations<sup>12</sup> regarding the claim and the final amount to be paid-out.

For further clarification, the phrase ‚actually incurred’ is also used in s 11(a) (the general deduction\_formula) (ITA). The courts in several cases have considered the meaning of this term. It would thus follow that the court’s analysis and conclusion of this term under s 11(a) (ITA) would also apply under s (28) (b) (ITA).

An important and prominent case dealing with this phrase is *Port Elizabeth Electric Tramway Co Ltd v CIR (1936 CPD 241, 8 SATC 13)* where the court concluded that the term ‚actually incurred’ could not mean ‚necessarily incurred’ or ‚actually paid’. Instead it refers to the ‚coming into existence of an absolute and unconditional legal liability to pay irrespective of the fact that payment may only be made in the future’ (Emslie, *et al.*, 2001: 303 - 305).

This legal precedent is crucial as it supports the points discussed in the previous paragraph and ultimately shows that s 28 (2) (b) (ITA) is only applicable to claims pay-outs & expenses that have become fixed and determinable (i.e. actual, not an estimate), and secondly, that the coming into existence of an unconditional liability to make payment to a policyholder is not affected by the time or date in which the liability is actually paid-out or settled. As such the date of actual settlement does not preclude the s 28 (2) (b) (ITA) deduction.

S 28 (2) (cA) (ITA) is the provision dealing with insurance liabilities and technical provisions that are held by a short-term insurer. Needless to mention, this provision is generally important for short-term insurers but more-so for the purposes of this research because it is the nexus between tax legislation and insurance regulation. Most of the technical issues surrounding insurance liabilities and their important role will be discussed in Chapter Three, but the purpose of the following discussion is to simply outline the basic rules.

First, s 28 (2) (cA) (SIA) allows a deduction for liabilities held by a short-term insurer as contemplated by and determined in accordance with s 32 (1) (a) & (b) (SIA) for that year of assessment. In addition, if a deduction was claimed under s 28 (2) (b) (ITA), then it cannot

---

<sup>12</sup> The preliminary investigation refers to an insurer making an assessment of the claim lodged by the policyholder i.e. what caused the loss and damage, what are the legal issues that need to be resolved before pay-out, will the pay-out be in line with the terms agreed upon in the insurance contract and many other important and significant factors considered before settlement of the claim.

also qualify under s 28 (2) (cA) (ITA). As mentioned already, the difference between s 28 (2) (cA) (ITA) and s 28 (2) (b) (ITA) is pretty clear – the former relies mainly on estimates of future cash-outflows & liabilities and the latter relies on fixed, actual and determinable liabilities.

The liabilities allowable for tax-purposes and contemplated in s 32 (1) (a) & (b) (SIA) are liabilities that an insurer is supposed to hold statutorily; the preamble to s 32 (1) (SIA) imposes this very clearly by stating the following – *„liabilities of a short-term insurer shall include the following’*.

The individual insurance liabilities mentioned under S 32 (1) (a) & (b) (SIA) which are relevant for tax purposes are as follows:

- (a) The unearned premium provision, which must not be less than the amount calculated under Part II of Schedule 2 (s 32 (1) (b)) (SIA).
- (b) Amounts and claims that have been incurred and are reported but not yet paid (s 32 (1) (a) (i) (SIA),
- (c) Amounts and claims that have been incurred but not yet reported, and must not be less than the amount calculated under Part II of Schedule 2 (SIA), (s 32 (1) (a) (ii) (SIA).

As the s 32 (1) (a) (SIA) pre-ambles postulates, all the liabilities are an estimate of amounts that a short-term insurer anticipates will become payable as a result of claims incurred on short-term insurance policies. The fact that they are an estimate is what makes them subjective and a contentious issue for both insurance regulators and revenue authorities (see Chapter Three). Hence the important issue with insurance liabilities is the valuation method and process. As such short-term insurers will have to pay particular attention to the required valuation methods mainly because these methods are subjected to minor and major changes from time to time and secondly, appropriate and rigorous application of the valuation methods implies that the insurer is adhering to the regulatory rules, and as such can continue to operate with the full-backing and approval of the regulator and confidence from the public.

### **The current valuation methods**

First of all it is important to note that for reserves in Part (a) and (c) above, the valuations arrived at by using the prescribed methods below represent a *„minimum threshold’*. In

other words the final value which the insurer decides to place on its technical reserves at year end must be equal to or higher than this „minimum threshold’ - if it is below, then the insurer risks non-compliance. In terms of tax, the insurer would still get a deduction even if the valuation was higher than the „minimum threshold’, this is because s 28 (2) (cA) (ITA) simply states that the deduction is applicable as long as the provision was *„induded in the short-term insurer’s liabilities in respect of a year of assessment’*, as opposed to the deduction being limited to the „minimum threshold level’. However, it must be noted that s 28 (9) (ITA) provides room for SARS to challenge and adjust all the deductions that a short-term insurer claims under sub-section 2 of the principal provision. Therefore if the provisions are too excessive it’s not guaranteed that the entire amount will qualify for a deduction.

Part (a) – The unearned premium reserve (UPR) is a very important mechanism which enables only the „earned premium income’ from existing policies to be reflected in the insurer’s income statement or tax return. The only way to achieve the aforementioned is to defer the „unearned portion’ of total premium incomes „received or accrued’ to a future period which is representative of insurance cover to be provided for at that time (see Chapter Three for more details). Currently, the unearned premium reserve is calculated using the 365<sup>th</sup> method, in which the unexpired portion and risks of a policy are calculated using the time-based approach.

The actual formula is as follows -  $(A - B) \times (1 - C/D) + E$

In which formula –

**A** – Represents the gross premium as stipulated in the policy document for the full term of the policy, notwithstanding the method or frequency of the premium payments. And the computation must be done for and include the entire period for which each of those policies are in force or operative;

**B** – Represents the sum of the following for all the policies mentioned in **A** for the entire period in which they are in force:

(a) Total amount of premiums that have been refunded to the policyholder because of policy cancellations or variation of policy terms; plus

(b) Total amount that is payable by the insurer for re-insurance premiums for the policies mentioned in A; plus

(c) Total amounts payable by the insurer to independent intermediaries (i.e. insurance brokers such as Lloyd's of London, South Africa) in respect of policies concerned;

**C** – Represents the number of days for which the policy has been in force (i.e. from the date that it was signed up-to the day that this calculation is being done);

**D** – Represents the entire period for which risks are covered by the insurance policy (in days);

**E** – Represents the total amount of cash-back bonuses which will become payable by the insurer to the policyholder. Cash-back bonuses are a way of returning premiums received by the insurer to the policyholder, upon the happening of some event or circumstance specified in the policy document & agreement (FSB Insurance, 2011)

NB. The formula above is applicable only to a „typical short-term insurer’. Re-insurers have their own formula which falls beyond the scope of this study and outline.

Part (b) - For claims that have been incurred and reported but not yet paid (also known as the Reported Outstanding Claims Reserve). The valuation is on a „case estimates’ basis, and is normally conducted by claims experts and actuaries. The valuation must also include all the „allocated loss adjustment expenses’ anticipated by the insurer. „Allocated loss adjustment expenses’ refers to all future costs that are specifically and directly associated with settling of claims incurred e.g. litigation costs or police report and affidavit costs or moneys paid to outside special investigators for complex claims etc. The estimation should also take into account or subtract any amounts that will be recovered by virtue of re-insurance contracts.

There is no formula set out for this provision mainly because it pertains to insurance claims that have been reported, but not paid and fully determined, in which case the insurer is expected to know to a certain degree what the claims cost will be. As such the bottom line or key rule for this provision is that the valuation should be a „fair and reasonable estimate’ of the total amount the insurer anticipates to pay in the future (FSB Insurance, 2011).

Part (c) – This provision is for claims which have been incurred in the current year of assessment but not yet reported (IBNR). The valuation in this case is more problematic because the actual case claims are unknown – as such the estimation cannot be done based on the facts of any specific reported claim.

Up-until 31 December 2011 the valuation method applicable for the IBNR was an amount equal to *„7% of net premiums earned<sup>13</sup> by the insurer during the 12 months preceding the date on which the amount is calculated’* (FSB Insurance, 2010).

This factor or percentage method was hugely criticised for being too simplistic. In response to such criticisms, the FSB repealed the factor approach, and a new method was enacted from 1 January 2012 under the so-called *„Interim Measures’*. The next subsection will discuss the *„Interim Measures’* and the new IBNR valuation method under that regime.

## **The Interim Measures**

### Introduction

As part of the wider regulatory reform taking place under the Solvency Assessment Management (SAM) regime, the FSB has also introduced *„Interim Measures’* which will be in place until the SAM framework is effective and fully implemented on 1 January 2015. The *„Interim Measures’* were mainly introduced to urgently address serious shortcomings<sup>14</sup> which existed in current insurance regulation and supervision, for which amendment and implementation could not be postponed further than 1 January 2012. In addition to the foregoing, the interim measures are expected to play a pivotal role by providing a *„staged progression and transition’* to the SAM framework. Moreover, given that these *„Interim Measures’* are a transitional step towards the SAM regime, their

---

<sup>13</sup> From the actual wording in the Insurance Act, ‘net premiums’ can be construed to mean the following - ‘the total amount of all premiums payable to the short-term insurer under short-term policies entered into by it in the 12 months preceding the date on which the IBNR amount is calculated less or reduced by the total amount payable by the short-term insurer as premiums under approved re-insurance policies in respect of the short-term policies concerned’ (FSB Insurance, 2011).

<sup>14</sup> The ‘serious shortcomings’ refer to current insurance regulation and supervision not complying with all the criteria and requirements of the insurance core principles championed by leading regulatory bodies such as the International Association of Insurance Supervisors (IAIS).

impact and requirements in general will be moderated and less stringent when compared with the requirements under the actual SAM framework (see Chapter Four).

#### What are the important „Interim Measures’ for Short-term Insurers??

The changes effected by the „interim measures’ are encompassing as they touch on all three pillars of the proposed SAM framework. The changes affecting Pillar 2 and 3 will not be discussed as they fall outside the scope of this research. However, of real importance are the quantitative measures that affect Pillar 1 – namely a change in the formula and method used to compute and value the „Incurred but Not Reported’ (IBNR).

#### New Valuation method for IBNR under „Interim Measures’

The method of valuing the IBNR for short-term insurers has been a regulatory priority for the FSB and other affiliates for a while. The main reason for this is because the old valuation regime was merely based on a „simple-factor approach’ (refer to previous subsection), and this simplistic approach resulted in technical provisions valuations on the balance sheet not taking into account or accurately reflecting the risks that an insurer was actually exposed to. However, the interim quantitative measures will in some way obviate this problem by initiating a move from the „simple factor-based approach’ to a „standard formula-based approach’ which tries to incorporate the different risks that insurers are exposed to in the different classes of insurance business conducted.

The new formula was enacted through Board Notice 169 of 2011 - National Treasury, Government Gazette No. 34175, 28 October 2011, Board Notice 169 of 2011, Part 4.2, Financial Services Board, Registrar of Short-term Insurance, (Short-term Insurance Act, 1998 (Act No. 53 of 1998)). The calculation is done using a table with pre-defined insurance business categories and percentages but the basic formula is as follows -

Formula for IBNR calculation:  $\sum_{k=1}^8 - \sum_{i=0}^5 NEP_{k,j-i} * f_{k,i}$

The FSB explains that the formula was derived and calibrated from the results of a quantitative impact study conducted in August 2010, as well as the input and judgement from various actuarial experts (FSB Insurance, 2011).

No doubt, the formula and its methodology are quite different to the „7% of net written premiums’ approach, especially in the sense that the calculation recognises that different insurance products and business classes carry and present different risks for insurers. To that end the formula introduces the concept of „segmentation’ – which in a nutshell requires insurers to categorise and group their insurance products into different business classes<sup>15</sup> and then perform the calculation by applying the prescribed yearly percentages to the net premium earned by the insurer in each business class for the last six years. This principle of „segmentation’ will be revisited in Chapter Four because it is a very fundamental and important part of the proposed principles under the SAM regime.

However, the new formula has not been without its criticisms and shortcomings. The feedback and response received by the FSB from a selected group of short-term insurers and other affiliates mainly noted that the different classes of insurance business stipulated under this formula were too broad (i.e. for some insurance products it was difficult to identify which category of business class they rightly fit into because of the uniqueness of the insurance product sold), and as a consequence some of the results and output from this new formula have been slightly inaccurate and in some cases completely wrong and false (FSB Insurance, 2011).

In terms of impact assessment, the FSB confirmed in a verbal discussion that the IBNR calculations achieved from the above formula have not been materially different from amounts obtained from the previous approach – and that this is true for most (if not all) short-term insurers across the board (Hantie van Heerden – HOD: FSB Insurance Department, 10 August 2012).

In my view, notwithstanding the narrowness of the business classes and parameters set under the above formula or the negligible and immaterial impact on the pre-existing

---

<sup>15</sup> The business classes covered and to be used in conjunction with this IBNR formula include – accident and health, engineering, guarantee, liability, miscellaneous, motor, property and transportation (FSB Insurance, 2011).

IBNR amounts or any other negative factors, it is clear and undeniable that this formula is a positive shift from the previous approach, and more importantly it is a great mechanism and step to prepare short-term insurers for the more onerous, principles based and rigorous valuation methods under the SAM framework.

### **Other provisions in s 28 (ITA)**

The core provisions of s 28 (ITA) have been elaborated and discussed in the preceding sub-sections, however, there are other provisions which are also important in implementing the core provisions and as such will be outlined briefly.

S 28 (5) (ITA) requires for the previous year technical provisions amounts as per s 28 (2) (cA) (ITA) to be included in the income of the short-term insurer in the current year of assessment. This is an important provision as it ensures that estimated claims cost from the previous year do not get a double deduction at year end when all the technical provisions are valued afresh (more on this in Chapter 3).

S 28 (6) (ITA) stipulates that s 11 (a) (ITA) (the general deduction formula) cannot be applied to any deduction claimed under s 28 (2) (ITA).

S 28 (6) (ITA) also removes the s 23 (e) (ITA) prohibition for the technical reserves deduction under s 28 (2) (cA) (ITA). Ordinarily, any amounts that are carried to any reserve, provision or fund are prohibited from getting any tax-deduction because of s (23) (e) (ITA). However, because of s 28 (6) (ITA) this measure will not apply to reserves maintained by short-term insurers in terms of s 28 (2) (cA) (ITA).

At this point it is worth noting that „reserves’ used in the context of short-term insurance represent the setting aside of amounts in order to meet future certain and uncertain liabilities. This is quite different to the normal use and meaning of the word, which in many instances refers to amounts carried into a „surplus profits fund or retained income account’.

S 28 (7), (8), (10) and (11) (ITA) will not be discussed as they fall beyond the scope of this study and Chapter. They deal with controlled foreign companies carrying on short-term insurance business outside South Africa, whereas the focus of this Chapter is to

outline the tax provisions & issues for „typical short-term insurers’ i.e. resident & conducting short-term insurance business only in South Africa.

## **CHAPTER THREE: THEORETICAL VIEW ON TECHNICAL RESERVES**

### **Introduction**

As alluded to the regulatory changes affecting short-term insurers will have a significant economic impact on many aspects of the insurance business and industry as a whole, and one of those aspects is the important issue of taxation. As established from Chapter Two, the one area in short-term insurance taxation that is directly connected to insurance regulation revolves around technical provisions – as such any regulatory reform in that area will have a knock-on effect in terms of tax.

All other tax issues that arise from the insurance regulatory changes are very important and worth the discussion and debate, but they do not carry the same weight as the aforementioned issue. This is because of the strong and direct link that technical reserves create between statutory insurance regulation and the tax provisions applicable to short-term insurers.

As such this Chapter has been devoted to a theoretical discussion and perspective on „technical reserves’ that short-term insurers hold statutorily (or in some cases voluntarily).

The main objective sought from this theoretical perspective is to clearly outline and discuss the important role played by technical reserves in the carrying on of an insurance business, which in turn should assist in understanding potential tax issues and problems that often arise from technical reserving policies. Furthermore, this discussion should bring more of an appreciation to the issues discussed in Chapters Two, Four and Five.

At the outset, it is important to point out that matters surrounding technical reserves are generally difficult, complex by nature and in most cases a function and responsibility handled by actuarial experts. As such this Chapter will restrict the theoretical perspective only to those issues that are important and relevant in a tax context. Some of the aspects that will be discussed include *inter-alia*:

- a) An analysis of the link and relationship that exist between tax laws and insurance regulation (i.e. regulators v/s tax-administrators),

- b) The role of technical/ loss reserves in an insurance business and how they operate, and
- c) Characterisation of the various loss reserves an insurer maintains and reasons for such characterisation.

The research information and literature used in this Chapter were obtained from various sources. Throughout the analyses and discussion a clear distinction will be made between the views and ideas obtained and presented from another author and my views or comments by italicizing the views of the other author. It is however, worth mentioning that the main source of information for this discussion was obtained from articles produced and published by the Organisation for Economic Co-operation and Development (OECD). In my view, the OECD articles are hugely appropriate for this section and discussion as they provide a view and opinion which transcends country borders and jurisdictions; and as such can be described as well-rounded, balanced and holistic.

### **Revenue authorities and Insurance Regulatory Bodies**

Before discussing some of the technical aspects regarding insurance reserves, a preliminary discussion on the relationship between tax and insurance regulation is important. This „preliminary discussion’ is important, firstly, because amendments from either party or area will most likely affect or influence the other; and secondly, because of the complexities generally associated with insurance companies it only makes sense for taxation authorities to rely on the oversight and expertise provided by insurance regulators - which expertise revenue authorities may lack completely or may not readily have. A clear example of the latter point is the reliance that taxation authorities place on the specialised skills provided by insurance regulators in stipulating, auditing and evaluating the appropriate levels of technical reserves that an insurer is supposed to hold.

In terms of their objectives, taxation and regulatory regimes generally share the same objective but for different reasons. The main objective for both regimes can be stated as follows - *seeking to measure the economic well-being and strength of financial institutions*. However, for the regulatory regime the reason for this objective is to ensure that the *financial institution’s solvency and financial stability/health is maintained, which in turn would guarantee the adequate protection of policyholders or depositors*; whereas

the main reason for the taxation regime *is to accurately determine the taxation capacity of the financial institution* (OECD, 1999).

In the context of insurance as opposed to other forms of financial services, the contrast can further be explained and elaborated by stating that insurance regulators are mostly focused on the *economic balance sheet of the insurer to ensure that the insurer is sound and is meeting the solvency and minimum capital requirements by valuing assets conservatively and accurately, creating special reserves for future liabilities/obligations and computing profits and earnings that can be returned to investors*. In other words the *income earned in a year is not a priority for insurance regulators and in most cases regulators will favour rules that allow smoothing of income fluctuations over the business cycle (i.e. guarding against the over-statement of profits and capital amounts)* (OECD, 1999).

Whereas, the tax regime is acutely focused on *„collecting revenue that is properly owed based upon current year’s profit*. In pursuing this objective tax authorities will ensure that *tax avoidance is minimised by ensuring that correct, objective and less conservative estimates for tax deductions are used by insurers in computing their taxable income figure (i.e. guarding against the under-statement or minimisation of reported income)* (OECD, 1999).

In my view, the different objectives held by insurance regulators and tax authorities are all unique and important but it is worth-mentioning that the objectives held by insurance regulators are in some ways pre-eminent. It is common cause and understandable that the collection and preservation of government revenues is a vital and important issue but even more important on the other hand is the *adequate protection of citizens and policyholders by the establishment of a sound insurance sector and financial system, a corner stone of which is rigorous financial & insurance regulation*. Bearing in mind that *robust and comprehensive regulation is a fundamental goal of sound economic policy & stability, and an important condition for effective and sustained economic growth* (OECD, 1999).

Hence, in light of the above policy objectives and considerations, it is imperative by all standards for tax system rules to support and adopt most (if not all) of the *rules, estimates and deductions mandated under a regulatory regime*. Such support and promotion of the regulatory regime by the tax system can take place by for example *allowing deductions*

*for general or contingent reserves, providing tax benefits as a way of incentivising better disclosure and compliance with regulatory authorities or giving tax-breaks for capital-expenditures incurred in developing complex, expensive and mandatory actuarial internal models* (OECD, 1999). The last point will be revisited in Chapter Four and Five, because presently in South Africa, short-term insurers cannot claim any tax-deductions for expenditures incurred in researching, developing or improving internal models as recommended and stipulated by the new regulatory regime.

### **Role of Technical Provisions in an Insurance Business AND how they operate**

In order to understand the indispensable role played by technical provisions in an insurance business, it is first of all important to understand the 'nature of insurance'. The latter was explained thoroughly in Chapter One, but this section will briefly re-hash some basic and crucial aspects as a prelude and more importantly for the building of a context before discussing and elaborating on technical provisions.

#### Two things to note:

- (a) Firstly, for the sake of keeping the discussion simple, the term 'technical provisions' collectively refers to all the various reserves that an insurer holds; distinctions between the different reserves will be drawn in the next sub-section.
- (b) Secondly, under this sub-section 'technical provisions' has the same meaning as 'loss reserves' - both phrases will be used interchangeably throughout the discussion.

An insurance provider will *pool risks among a large number of risk averse persons, each person will pay a relatively small amount (premium) to be indemnified against the risk of a relatively bigger, unknown and unexpected financial loss* (OECD, 1999). The amount or pricing of premiums are set by the insurance provider and the 'premium price' takes into account future expected losses and claims from the pool of insured persons.

Therefore, insurance stands in stark contrast to other types of normal businesses because with insurance, the insurer is paid today for a future service and fulfilment of an obligation that is unknown in terms of whether or not it will actually materialise and if its materialisation is guaranteed then the timing and magnitude of the loss and obligation are unknown. However, because the future liability is not yet fully fixed and determinable does not mean or imply that

the obligation must be ignored entirely or not taken into account by the insurer. Instead, for the sake of presenting a true picture with respect to solvency requirements, the financial position and general state of affairs, the insurer must create technical provisions which are representative of future payments to be made to policyholders, arising from insurance policies in force.

To support the view given in the preceding paragraph is a succinct and accurate definition of ‚loss\_reserve’ given by David F. Bradford *et al.*, (1997), and it states the following – *the loss reserve is a liability that expresses the amount the company expects to pay out in the future to cover indemnity payments that will come due on policies already written and to cover the costs of dealing with the associated claims.*

In terms of financial performance, loss reserves play an important role by smoothing<sup>16</sup> year on year profits and the subsequent tax-liability. This is important for insurers because of the time lag that exist between the assumption of liabilities for claims that have been incurred and the date in which those claims become fully fixed and determinable (i.e. when the amount of the liability is categorically known and there is no doubt that the insurer will make the pay-out).

Ordinarily, accounting and tax rules work differently i.e. any cost cannot be expensed or deducted until it is fully determined and has no element of contingency. If this view were applied to insurers it would produce distorted and erratic financial results, both in terms of the year-on-year bottom line and tax-liability. The aforementioned ‚distortion’ is primarily caused by the fact that policyholder claims expenses are the most significant and material amount that an insurer will report on the income statement and balance sheet, as such the timing of the expense or deduction has very noticeable ramifications.

To support the preceding assertion, the following illustration and explication is done to show the effects of applying normal tax and accounting rules to short-term insurers: The immediate result of applying the normal tax rules is to place short-term insurers in a position where they cannot expense or deduct significant claims costs incurred in the current year of assessment, because they are not yet fixed and fully determinable. The effect of disallowing that significant expense or deduction is to create a disproportionately large profit for the insurer in

---

<sup>16</sup> Smoothing refers to the practice of reducing the volatility or variability of reported profits. This is not a misstatement or fraudulent reporting of profits, it’s merely an attempt to produce and report financial results which are realistic and paint an accurate picture of the financial performance of the company.

a single year. In terms of tax, this means that the insurer will have a disproportionately large tax-liability in a single year, which by all accounts is unfair because the insurer is paying too much tax, at least sooner than expected or anticipated.

On the other hand, in a later year of assessment when the claims cost become fixed and fully determinable, the result of applying the normal tax and accounting rules would be to allow an expense or deduction in that later year of assessment. The effect of allowing the expense and deduction in that year of assessment is to create a disproportionately large net-loss for the insurer. In terms of tax, this means that the insurer will incur a disproportionately large tax-loss, which is also unfair for revenue authorities as it signals a tax-deferral and an unnecessary delay in the collection of government revenue, at least for the near-future as the tax-loss will have to be reversed in full by profits/income made in future years of assessment. Hence, to avoid such a distortion of the reported results, financial performance of the company and tax-liability, the loss reserve (as defined above) is included in the insurer's financial accounting statements, statutory return, and tax return as a means of deducting the claims costs in the year in which they are incurred, notwithstanding the fact that they are not yet fully fixed and determinable.

The „smoothing' provided by loss reserves will most likely engender investor confidence and positive sentiment, as well as increase the insurer's viability as a business – mainly because the insurer's share or stock price is predictable and unlikely to fluctuate because of very stable and steady year or year financial results, performance and earnings stream. On the flip-side, if net-profits are fluctuating yearly because of a lack of „loss reserves smoothing', then the insurer's stock price and market capitalisation are also going to fluctuate in response to the unstable net profits. Such fluctuations and a lack of predictability are bad for investor-confidence, and could ultimately lead to a questioning of the insurer's credibility with consumers and commercial rating agencies.

Normally the worry from tax authorities is that insurers will seek to abuse loss reserves under the pretext of „smoothing income and earnings'. Those worries are a legitimate concern, and that's why tighter and objective regulatory controls are needed as a „checks and balances', to ensure that insurers are not manipulating earnings for the purposes of avoiding tax or any other reason which jeopardises the true picture or reflection of the company's financial position and performance.

In addition to portraying the true financial position and performance of an insurer, technical provisions are also important as they ultimately guarantee the preparedness and ability of an insurer in meeting future obligations as and when they become due and payable.

Lastly, besides the fact that it makes business and accounting sense for insurers to maintain loss reserves (as shown above), it's however not an option for insurers to maintain loss reserves - it is a statutory requirement. An insurer will therefore jeopardise its continued existence and operations if it does not comply and show an appropriate loss reserves value on its balance sheet.

Having established the role played by technical provisions in an insurance business, the next important issue revolves around the valuation process. Valuing loss reserves is generally problematic for two main reasons:-

- a) Firstly, because all valuations for loss reserves are an estimate and are therefore subjective and open to argument, and
- b) Secondly, because loss reserves are in most cases the largest single liability on an insurer's balance sheet, this makes the valuation process critical and material, because even a relatively small movement or percentage change in the loss reserves can result in a significant effect on the insurer's bottom line, tax-liability and a whole range of other qualitative issues.

The initial mechanical valuation process of technical reserves is normally carried out by actuaries. In a nutshell, the actuarial department will gather *historic data and information about its own loss experience and that of the entire industry; after which various statistical techniques and formulae are applied to that data as a way of predicting or producing a range within which the future loss claim payments and expenses will fall* (David F. Bradford *et al.*, 1997).

However, as David F. Bradford *et al.*, (1997) correctly suggest – *actuaries produce the range within which reserves should be set, but they do not have the final say on the actual loss reserves value to be placed on the balance sheet. That decision rests squarely with senior management, as they have the full and untrammelled discretionary power to set and decide on the value of loss reserves.* This observation and finding is very important as it shows that other factors besides pure actuarial formulae and parameters contribute to

the actual level of technical provisions as reported on the balance sheet and deducted in the income statement and tax return.

An example of an important factor that makes technical provisions a managerial decision is the effect that technical provisions have on the perceived *„overall financial strength of the company’* (David F. Bradford *et al.*, 1997). This is vital because the perceived financial strength of an insurer will affect its credit rating by various commercial rating agencies, and that in turn will have an effect on its credibility with consumers and more importantly its future prospects in retaining and increasing its market share and foothold.

The general position is that *„large technical provisions are associated with or may signal an increased risk of the insurer’s insolvency; and if the provisions continue to increase then insurance regulators will intervene and monitor the insurer in order to improve the its financial position. In light of the aforementioned, technical reserves could therefore be open and subject to manipulation. In this case management, notwithstanding the actuarial computations submitted, will deliberately depress and understate loss reserves as a way of avoiding state regulatory intervention/scrutiny and a subsequent downgrade of its credit-rating by investors and independent analyst’* (David F. Bradford *et al.*, 1997).

It is important to note that state regulators will normally set a threshold for the minimum amount to be set aside for loss reserves. However, this minimum amount might not necessarily be reflective of the insurer’s real liability and risk exposure - as such an insurer might still be above that minimum threshold but at the same time be in a dangerously bad financial situation. In-fact one of the aspects that will be changed by the SAM regime (Chapter Four) is that there won’t be a minimum threshold for technical reserves – instead the valuation process will be based on the *„best estimate plus risk margin’*. This in my view is a positive shift as short-term insurers in South Africa will not be able to conceal any financial trouble, merely because they are above a minimum threshold computed by using a set of standard formulae and parameters.

In terms of the insurer’s business model and strategic decision making – the valuation process and policy adopted by an insurer is vital because accurate and consistent valuations of technical provisions will enable the insurer to know and find out how large the claims on written business are; which in turn would provide useful information for the insurer’s premium pricing decisions and future growth forecast. This last point is tangentially relevant to the tax issues being discussed, but is still important as it shows

that the accurate valuation of technical provisions does not only benefit regulators and tax-authorities, but rather they serve the interest of every stakeholder.

Suffice to say, the valuation of loss reserves is a very complex exercise, not only because of the initial „subjective mechanical valuation process’ but because there are many other factors at play, each bearing serious consequences for the insurer.

### **Characterisation of Technical Provisions Allowed for Tax Purposes**

For the sake of addressing one issue, the previous sub-section did not elaborate on the actual different types of reserves that insurers are allowed to maintain. This sub-section will therefore enumerate and discuss some of the reserves that insurers hold statutorily and voluntarily. In addition a distinction will be drawn between reserves which are generally known to be deductible for tax-purposes, and those reserves which might not be deductible. In the latter case the reserves-deduction will depend on the specific tax-rules applicable in that particular jurisdiction.

The characterisation of reserves is important as each reserve addresses certain problems and questions which arise when computing an insurer’s taxable income. An example of such problems would include – (1) How much premium is earned and unearned? (2) What is the appropriate treatment of claims which are known but have not been finalised? (3) What is the correct measure for claims that are completely unknown? (4) What is the correct treatment of funds set aside to counter future, unexpected and significant claims? Etc. Each of these points will be addressed in the discussion below.

According to the OECD (1999), the reserves needed for the basic adjustment of an insurer’s year on year profits and cash-flows include –

- 1) *Unearned premium reserves*
- 2) *Unexpired risks reserves*
- 3) *„Future contingent risks’ reserves*. These can be broken down further into categories depending on the nature of the „future risk exposure’ e.g. *equalisation reserves, catastrophic reserves, rate stabilisation reserves, investment valuation reserves*
- 4) *Outstanding Losses reserve (reported and not reported)* (OECD, 1999).

Reserves in Items (1) – (3) are called „*prospæctive reserves*’ and are related to claims that have not been incurred (i.e. future risks and contingencies). The reserve in Item (4) is

called a „*retrospective reserve*’ and is related to claims that have been incurred (i.e. the risks insured against have already materialised) (Outreville Francois J, 1998).

### **Unearned Premium Reserves**

The unearned premium reserve (UPR) appears on a short-term insurer’s balance sheet as a technical provision/liability and is allowed as a deduction in computing both underwriting and taxable income. As such the UPR will be analysed from both a balance sheet and underwriting income perspective.

In terms of the underwriting income calculation, the UPR plays an important role as it is directly linked with the adjustments needed in respect of premium incomes received or accruing to the insurer from policies in force. The adjustments to premium incomes are necessary because of the „accrual principle’ which results in all premiums receivable from an insurance policy being included in the insurer’s income. The „accrual principle’ was discussed at great length in Chapter Two and will not be repeated. However, suffice to say, the application and results of this principle are widely accepted from a theoretical perspective and this can be confirmed by an OECD (1999) article stating that - *the concept of due and receivable starts when the underwriter agrees to underwrite a person; whether the premiums are payable at the inception of the contract or on a periodic basis, all of the premium is due and receivable at the point that the insurer accepts to provide the insurance coverage.*

Given the effects of the „accrual principle’, the UPR will therefore ensure that premium incomes are spread over the term of the insurance contract, to match it to the risks accrued and outstanding in each accounting year. The premium incomes matched to the risks covered in a particular year are referred to as „earned income’, and premium incomes matched to insurance risks to be covered in the future are referred to as „unearned income’.

On a year to year basis, the UPR closing balance would typically include the UPR closing balance from the previous year plus current year unearned premium incomes less amounts of premiums accrued in the past but earned in the current year. Inevitably, movements in the UPR calculation will have an effect on the „earned premium’ amount to be reflected in the current year assessment. That effect can be seen in the methodology used to calculate the „earned premium’ amount and is summarily stated as follows – all premium

incomes accrued or received in the current year plus the UPR balance from the previous year less the UPR\_balance at the end of the current year of assessment.

According to the OECD (1999), there are three methods generally used to compute the actual UPR year-end amount, and the methods are as follows: *the percentage apportionment (defers a fixed portion of premiums to the subsequent accounting year), 24<sup>th</sup> basis (defers premiums based on an allocation of premiums on a fortnightly basis) and the daily basis (also called the 365<sup>th</sup> method - it defers premiums according to the day they were written). All three methods operate on the assumption that claims will be incurred uniformly over the term of the contract period.*

The method currently mandated for use in South Africa is the 'daily basis OR 365<sup>th</sup> method'. The main reason, inevitably, is because among all three methods it produces the most even spread of premium incomes and insurance risks over the contract period, which in turn ensures that the UPR is not overstated in any of the accounting or fiscal years of assessment (see Chapter Two for the 365<sup>th</sup> formula applicable to South African short-term insurers).

From a balance sheet perspective, the UPR is classified as a technical provision (liability or future obligation) mainly for two reasons – firstly, in the case where the insurer has actually received the premiums in one upfront-payment, then the deferred portion of premium incomes represents an amount of funds which must be readily returned or refunded back to the policyholder in the event of the insurance contract being cancelled before expiry date; secondly, notwithstanding the payment method agreed upon between the policyholder and insurer, the real important aspect about the UPR or deferred unearned premiums is that they represent claims and liabilities which may result (i.e. contingent) because of future risks underwritten by the insurer today, and for which an amount must be set aside to fully meet and support those policyholder claims in the future. This last point is crucial because the UPR does not in any way represent liabilities for claims which have been incurred.

Lastly, all movements in UPR balances, as reflected in the balance sheet and income statement for accounting purposes, are invariably and justifiably allowed for tax-purposes because such movements accurately compute the insurer's 'earned premium' income for the year, which in turn ensures that the insurer is being taxed on revenue and profits which have arisen from or can rightly be attributed to the correct year of assessment.

### **Unexpired Risks Reserves (URR)**

The computation of the UPR (above) is predicated *„around the notion and assumption that risks from an insurance contract are accrued evenly throughout the term of the policy; this is also referred to as “pro-rata temporis” (lat)’* (i.e. the 365<sup>th</sup> method typically proves this assumption). This assumption is not always true mainly because in reality the *„risks from an insurance policy and the resulting claims may not be incurred uniformly or evenly over the contract period’*. If the latter is indeed the case, then the insurer will tend to experience higher or lower levels of risk over the contract period, which in turn will lead to a fluctuation in policyholder claims over the same contract period. It is however important to note that in order to prove and support this uneven distribution of future risk and claims, *„the insurer will have to produce and show historic data, samples and actuarial analyses’*; a lack of such proof means that the insurer will have to return to the *„default position & assumption’* as stipulated by the UPR calculation and formulae (OECD, 1999)

So for the purposes of accurately matching unevenly accrued and outstanding risks to premium incomes, insurance regulators will allow insurers to use the URR as a means of deferring or setting aside additional amounts for future unexpired risks. The deferring of additional amounts to those already reflected in the *„UPR deferral’* results in a further lowering of the yearly reported *„earned premium’* income.

The role of the URR is best illustrated by using a short and simple example – If an insurer underwrites a three year insurance policy in which a total of R150 is receivable in premium incomes over the contract period - the UPR closing balance in year one (Jan – Dec) will be R100, leaving R50 as *„earned premium income’* (i.e. R150 divided by the term of the contract – three years). However, let’s say the insurer can prove with historical data and actuarial opinion that 90% of the risks will accrue in year two and three, as opposed to the 66.6% calculated under the UPR approach; in that case an adjustment is needed in the form of the URR which will add an extra 23.4% (i.e. 90% less 66.6%) to the percentage portion of unexpired risks, and in turn R35 (i.e. R135 – R100) is added to the UPR balance, so that the total reserve for unexpired risks and unearned premium at the end of year one is now R135 (i.e. 90% of the risk to be accrued in years two and three). The correct *„earned premium income’* for year one will be R15 (i.e. 10% of risks accrued in year one).

According to the OECD (1999), the URR is „*usudly accepted for tax-purposes*’, and this is because the URR only seeks to correct the „UPR assumption’ mentioned above, which may not be true and applicable for every insurance policy sold, and in doing so is correctly apportioning and allocating the „earned premium’ income in line with the risks accrued or „actually covered’ in a particular year of assessment (OECD, 1999).

However, notwithstanding the fact that the URR is meant to match risks and premium incomes more accurately, sometimes it can be open to abuse because it is a „voluntary reserve’ and there is no actual formula applicable in its derivation. As such, intentionally or unintentionally, an insurer might over-inflate the URR amount, thereby reducing both underwriting and taxable income. The possibility of minimising or avoiding tax from the year on year URR movements is a worrisome problem for revenue authorities, and could ultimately lead policymakers to completely disallow the URR tax-deduction.

South Africa is a clear example of the preceding paragraph. Initially, s 28 (2) (cA) of the Income Tax Act (No. 58 of 1962) (ITA) allowed a deduction for the URR amount but the Revenue Laws Amendment – Clause 40, Act No. 60 2008 repealed the deduction with effect from 1 January 2009. The clause stated that „*liabilities in respect of unexpired risk provisions as contemplated in s 32 (1) (d) of the Short-term Insurance Act (No. 53 of 1998) (SIA) may not be included for the purposes of s 28 (2) (cA) (ITA)*’. The main reasons given by the South African National Treasury and Revenue Service (SARS) is that „*some short-term insurers in their tax returns were infrequently combining and aggregating the liabilities contemplated in sections 32 (1) (b) & (d) (SIA) (i.e. the unearned premium reserve and unexpired risk reserve)*’ (SARS, 2008).

The SARS Explanatory Memorandum does not elaborate beyond the quote above but it is clear on the face of it that SARS and the National Treasury were concerned with the commingling and murkiness that surrounded the UPR & URR which in all likely-hood could have resulted in an unfavourable result and position for SARS. In my view, this is a legitimate concern because even though in principle the UPR and URR serve the same purpose of deferring all „future unexpired risks’, it’s still important to note that for regulatory and tax purposes their derivation and the ensuing tax-deduction must be kept distinct and crystal clear – anything short of that would justifiably raise questions with revenue authorities.

## **Outstanding Losses Reserve**

The outstanding losses reserves are directly linked only to claims that have occurred. The total outstanding losses reserve is further split between incurred claims which **have been reported (claims reserves)** and incurred claims which **have not been reported (IBNR)** at year end. The distinction is crucial because different valuation methods are applicable for the two categories.

## **Claims Incurred and Reported**

When insurers receive a claim from a policyholder, the actual „claims processing cycle“<sup>17</sup> is a complex, rigorous and protracted exercise. In some cases it could take as long as two to four years to finalise the pay-out - this is especially true in the case of long-tailed insurance business such as medical malpractice or worker’s compensation. In any case, if a claim is lodged by a policyholder and the „claims processing cycle“ is not yet complete by year-end, then the insurer will have to create a provision on its balance sheet representing a liability which is uncertain in terms of timing (i.e. when it will be settled) and amount (i.e. the actual settlement costs). The valuation process for this reserve is not the subject of much debate because the insurer is aware of the reported claim, and as such can make an estimate based on the policy agreement, specific facts provided by the policyholder and all the costs that will be incurred in processing the pay-out.

In terms of computing taxable income, the claim’s incurred and reported reserve qualifies for a tax-deduction. The reasons for this were described at great length in Chapter Two, and in the sub-section above. In a nutshell both discussions concluded that „a deduction for claims incurred and reported“ was not precluded merely because the amount was not fixed and determinable. This is a special concession applicable only to insurers and is widely accepted as being correct and plausible from a theoretical perspective (OECD, 1999).

It is however important to note that the reported and unpaid claims reserve must be evaluated at the end of each year of assessment; *„this will ensure that all claims not*

---

<sup>17</sup> The ‘claims processing cycle’ is comprised of the following in sequence – Loss Reporting (proof & notice of loss), Loss Processing (verification of validity if coverage, estimation of loss reserve and adjustment expenses), Loss\_Adjustment (Investigation and Loss evaluation), Loss Settlement (mode and timing of payment) and Loss\_Recording (loss reserve evaluation, subrogation & arbitration, co-insurance & re-insurance) (Outreville Francois J, 1998).

*finalised from the previous year which have been finalised in the current year are not again included in the current year balance* '. The finalised claims will in effect reduce the reserve balance, but at the same time increase the paid losses account with the amount of the finalised claims. The initial reduction in the reserve will increase taxable income, but the increase is directly offset by the tax-deduction recorded by the insurer under 'claims actually paid' for finalised pay-outs, and so the tax-effect is nil. The year-on-year tax calculation between the 'claims reserves' and the 'claims actually paid' can be summarised as follows – *'tax deduction for claims losses actually paid in the current year plus a tax-deduction for the excess of the current year claims reserves balance over the previous end of year balance for claims reserves* (David F. Bradford *et al.*, 1997).

What is important to note about the computation above is that the insurer cannot claim a deduction for amounts actually paid but at the same time not reduce the claims reserve balance. That shifting of losses between paid and unpaid claims accounts must take place otherwise the insurer will in effect get a double deduction for the same expenditure.

The aforementioned was a concern for SARS and the National Treasury in 2010, as they noticed that there was an *'overlap relating to liabilities actually incurred during a year of assessment and the claims reserve determined under the Short-term Insurance Act'*, and in their view *'this overlap could lead to a double deduction if left unresolved'*. As such, through the Revenue Laws Amendment - Clause 51 Act No. 7 2012, a new provision was inserted into s 28 (2) (cA) (ITA) which ultimately states that a short-term insurer will not be able to get a deduction under s28 (2) (cA) (ITA) if they have claimed the deduction under s 28 (2) (b) (ITA) – the latter deals with claims liabilities which have actually been incurred (SARS, 2010).

In short, the enactment above decisively and unequivocally closed the loophole that some short-term insurers might have been using to obtain a double deduction from both the technical provisions (claims reserve and IBNR) and the actual claims expenditure.

### **Claims Incurred But Not Reported (IBNR)**

In any year of assessment an insurer will have claims which have been incurred but not reported by the time the insurer draws up and finalises the financial statements and records. Normally this will happen because the *'insurable event has occurred without the insured being aware of it, and the insured will only report the claim when the problem or*

*loss becomes apparent*'. There are many examples of insurance policies which exhibit this claims pattern, but a classic and common example is an insurance policy associated with *'dread diseases'*<sup>18</sup> or *'cancer conditions'* that take a long time to develop (OECD, 1999).

Typically the policyholder will get infected or exposed to the disease, and the symptoms will only manifest at a later stage, at which point the policyholder realizes that they urgently need insurance cover. The theoretical position applicable to such a scenario is that *the claim is incurred by the insurer when the disease is initially contracted, and that the insurer's liability to settle the claim arises at that time, and not when the disease is diagnosed at a much later stage*. As such, an insurer will have to *create a provision on its balance sheet representing future claims that may be reported once the disease and ensuing loss are detected by the policyholder* (OECD, 1999). This theoretical perspective was given in the context of a *'disease insurance policy'* to illustrate the point more clearly, but the concept is very much applicable to any policy for which a loss is incurred in a particular year of assessment but for some reason is not reported to the insurer in that same year of assessment.

In terms of computing taxable income, the IBNR is commonly accepted as a tax-deductible provision. The same principle and concession that was applicable to the *'claims reserves'* above also applies to the IBNR - summarily stated, the principle ensures that a tax-deduction is not precluded for incurred insurance claims simply because they are not yet fully fixed and determinable. In this case (i.e. IBNR) the fact that the claims have not been reported at all is inconsequential in deciding whether or not they qualify for a tax-deduction. As alluded to in the previous paragraph, the claims are deemed to have been incurred at the time when the insured event occurs and not when the event is actually reported or made known.

From the above, it is safe to conclude that the deductibility of the IBNR is not a contentious matter. However, the real issue that is normally a source of controversy when it comes to the IBNR is the valuation method. The IBNR is the most complex of all technical provisions because the claims have not been reported but the insurer knows

---

<sup>18</sup> The diseases referred to in this case are normally work related, for example workers exposed to asbestos, chemicals in a factory or some sort of nuclear disaster; but the scope of the IBNR is certainly wider than the aforementioned illnesses, it merely relates to claims which have been incurred but for some reason not reported to the insurer by year-end.

from previous trends that certain claims have been incurred, and as such must make a provision for this future, unknown liability.

The valuation process for the IBNR has largely become an actuarial function which is complex, sophisticated and very unique for each insurer. However, it is worth mentioning and summarising some of the key aspects that make up the actuarial models and parameters that are used in the valuation process. Firstly, an insurer will have to *„gather information and data providing tangible statistics with which actuaries can perform various calculations and derivations. The data collected will comprise of „past incurred losses & trends’ as well as „future expected losses based on data volatility’*. In working through the data, actuaries will ensure that *„fortuitous events are isolated from the IBNR calculation, as they could distort the reserves structure & formulae ’*, furthermore, *„lines of insurance business exhibiting similar loss patterns are grouped so that loss development reviews and the ensuing IBNR calculations are done independently & separately for types of businesses which are known or thought to be different (R.L. Bornhuetter et al.1972: 181 -190).*

In addition to the rigorous process above, an insurer must constantly revise and upgrade its actuarial models and reserving structures by *„periodically reviewing the level of reserves from two perspectives – firstly, it must determine year on year changes in the reserve levels and identify if the change is because of changing risk exposure; secondly, the reserves established at the prior year-end must be continuously monitored to see if the loss developments observed during the year reflects what was contemplated when the reserve was established (back-testing); and to the extent that the actual development is different from the expected reserves, then the actuarial model must be revised and modified’ (R.L. Bornhuetter et al. 1972: 181 -190).*

The summary above shows that the setting and valuing of the IBNR is a complex exercise and is far from an exact science. It is this complexity and enormous amount of personal judgement and opinion which makes revenue authorities very mindful and weary of this provision. The obvious priority for revenue authorities is to ensure that the IBNR is not used in any way possible to depress underwriting income, which in turn leads to lower levels of taxable income.

In a South African context, the immediate concern and worry from SARS & Treasury regarding the IBNR revolved around amounts being claimed under the provision

applicable to „claims actually incurred’ (s28 (2) (b) (ITA)) without a thorough and rigorous corresponding adjustment to the IBNR balance. This in effect gave the insurer a double-deduction. Fortunately, as mentioned earlier these concerns were addressed legislatively in 2010 by explicitly prohibiting a full deduction under both sections. This obviously places insurers in a more difficult position as they cannot by law include the „claims actually incurred’ in their IBNR or claims reserves estimation value.

### **Catastrophe OR Contingency reserves**

As mentioned above, contingency or catastrophe reserves are created for certain future contingent risks. It is important to note that reserves of this nature can be divided into different categories depending on the type of future risk that the insurer is guarding against but the underlying premise for their creation is the same throughout. As such the phrase „contingency reserves’ will be used in the discussion below to represent all the different reserves which fall under this class.

Firstly, the fundamental difference between the „Outstanding Losses Reserves’ (i.e. IBNR and claims outstanding) and „contingency reserves’ is that the former represent claims which have been incurred and in the latter they represent claims which have not yet been incurred. Contingency reserves are particularly useful if the insurer is subjected to the following risk coverage:

- a) *The possibility of a single event giving rise a significant number of claims & third party claims from property damages & civil law suits which could arise from aggrieved parties (victims) especially if the event was caused to a large extent by negligence & carelessness. Common examples of such once-off events include – oil or chemical spills, nuclear meltdown/disaster, major earthquakes, unpredictable changes in climate conditions causing severe flooding and droughts etc; or*
- b) *If the insurer is involved in particular lines of insurance which are actually known to have a high or unusual standard deviation of claims incurred. This is particularly true especially if an insurer provides insurance cover related to complex finance and derivative transactions e.g. credit life insurance or credit default swaps (OECD, 1999)*

In both (a) and (b) the underlying premise or issue is that if any of the risks occur or materialise then the insurer *will incur significant and more than normal financial losses, which sometimes could pose a risk on the insurer’s credibility and even more important*

*its solvency position.* So in order to avert the adverse effects of such financial losses, insurers will maintain a contingency reserve with the sole purpose of *„smoothing income, reducing volatility and improving the consistency of financial performance over time* (OECD, 1999).

From a tax perspective, *there is very little theoretical justification for allowing a tax-deduction for transfers into a contingency reserve.* First of all, in terms of drawing a contrast between the contingency reserves and the outstanding losses reserves – the special concession applicable to the latter reserves cannot apply to the former, simply because contingency reserves represent future claims which have not been incurred. As such, it is very difficult to consider/allow the deduction of an amount for which the incurral has not taken place to start with. In most cases revenue authorities will disallow the deduction based on the notion that *the correct present value of tax will in any case be collected when the claims are incurred and recognised in that future year of assessment* (OECD, 1999).

Secondly in terms of comparison, it is common cause that the UPR is also a provision for future claims and risks which have not been incurred but it is important to recognise that the UPR is justifiably allowed in the income statement or tax-return as a deduction because it is a component needed and necessary to adjust the year on year *„earned premium income*’ (see above). The latter point is the reason why the UPR is allowed as a deduction and the contingency reserve is not. In other words the contingency reserve is representative of future claims which have not been incurred but does not have a consistent, special and necessary role in terms of adjusting year on year underwriting profits.

The other major reason the contingent reserve is not allowed as a deduction is because *„amounts transferred into the contingency reserve are usually an arbitrary proportion of premium income*’, and this is understandable because the events mentioned in part (a) and (b) above are not predictable in any way possible (i.e. one cannot predict the next earthquake or drought etc). Hence, it is this *„arbitrary basis*’ or inability to compute a reasonable and explicable estimate of the future liability and risk exposure that is worrisome to revenue authorities and as such will in most cases lead to the complete disallowance of the deduction (OECD, 1999).

As mentioned in Chapter Two, in 2001 the South African Revenue Service and National Treasury (SARS & National Treasury) repealed the contingency reserve tax-deduction for short-term insurers primarily because of a growing and vibrant re-insurance sector. This notion of using re-insurance *as a way of reducing the risk and effects of catastrophic events is theoretically and widely accepted as being plausible*. It is however important to still consider the pros and cons of reinsurance schemes versus maintaining a contingency reserve. This consideration is crucial because the real question to be asked is which method will fare better or withstand the huge financial losses if a calamitous event were to take place?? This question, though crucial, falls outside the scope of this research study and impact assessment - as such the various arguments applicable in addressing that question will not be put forward.

However, besides a vibrant re-insurance sector, there are also two other reasons why in South Africa the case against contingency reserves is very strong.

The first reason revolves around s 20 (assessed losses) (ITA) which allows taxpayers to carry over a tax-loss from one year of assessment to another. In terms of short-term insurers this is relatively significant because if the insurer suffers significant losses because of a catastrophic event, then the insurer is entitled to carry-forward the huge loss to the following year (years), in which case no tax will be payable until the loss is reversed in full. The tax-relief resulting from the „assessed loss carried forward’ will certainly make SARS and National Treasury very reluctant to provide the insurer with more tax-relief in the form of a contingency reserve allowance.

The second reason revolves around the current insurance regulation and the newly proposed SAM regime. Firstly, the contingency reserve requirement was repealed by the FSB in 2011 through Board Notice 169 of 2011. This essentially means that from 1 January 2012, short-term insurers don’t have to show a contingency reserve liability on their yearly statutory return. Furthermore, the newly proposed SAM framework also stipulates that as part of the economic balance sheet the „contingency reserve’ will not be a separate liability, but instead it must be integrated into the „solvency capital requirement’<sup>19</sup>. This development from a regulatory perspective certainly means that a tax-deduction for the contingency reserve can no longer be envisaged, because the reserve

---

<sup>19</sup> This development is also in line with the Solvency II regime which has eliminated the requirement for the claims and equalisation reserves. The ‘claims & equalisation reserves’ and ‘contingency reserves’ are both created and based on the same underlying premise discussed at the start of the above sub-section.

doesn't exist for regulatory purposes to begin with, and as such SARS and National Treasury won't have a reliable basis on which to provide the deduction – even if they intended to do so (FSB, 2011).

From the above, it is clear that contingency reserves are not deductible for tax purposes (theoretically and in a South African context). However, it is important to note that government policy overrides theoretical considerations. This means that if a government for some reason strongly favours contingency reserves over reinsurance schemes, then they will do everything in their power (including tax-incentives & deductions) to ensure that insurers maintain contingency reserves. Therefore, contingency reserves will only be deductible for tax-purposes if there is a government policy or objective to be achieved from such an allowance (an example of one such objective is to use contingency reserves tax-deductions to make the local insurance market more competitive and attractive to foreign investors, which foreign investments would strengthen the overall insurance market position and lead to a virtuous cycle of economic growth and benefits).

## CHAPTER FOUR: REGULATORY CHANGES IN SOUTH AFRICA

### Introduction

As mentioned in Chapter One, the main objective of this research is to assess the tax-impact caused by the new insurance legislation, and part of that assessment necessarily includes a clear enunciation and explaining of the proposed regulatory reform. This clear outline should provide a stark contrast and comparison with the current rules which were discussed in Chapter Two.

Currently, there is a whole range of different insurance regulatory changes underway, which all have a unique and significant impact on insurers, but this Chapter will only outline and discuss the requirements of the proposed Solvency Assessment and Management regime (SAM). SAM is one of the most important regulatory reforms that insurers will have to comply with - it touches on some of the core insurance principles that affect and are applicable to the operations of an insurance business. Some of the crucial aspects and principles it addresses revolve around capital adequacy requirements, solvency issues, financial reporting and risk assessment.

The analyses in this Chapter will consist of a broad overview and description of the SAM framework, and most importantly a detailed discussion on those regulatory changes that will have a direct impact and bearing on the taxation of short-term insurers.

### Solvency Assessment and Management - Broad overview

The SAM regime is a risk-based<sup>20</sup> solvency regime applicable to all South African insurers (life and non-life), which is closely in line with international standards set and advocated by leading insurance regulatory/supervisory bodies<sup>21</sup>. The Financial Services Board (FSB) has stated that the SAM framework will be **based** on the **Solvency II**<sup>22</sup> capital adequacy, risk

---

<sup>20</sup> A risk based regime refers to a system of calculating an insurer's capital and solvency requirements with reference to the degree of risk assumed by the insurer. In other words a risk based regime will ensure that an insurer is capitalized according to the inherent riskiness of the type of insurance they sell – higher-risk types of insurance will most likely necessitate higher levels of capital.

<sup>21</sup> Some of the leading insurance regulatory/supervisory bodies include – a) International Association of Insurance Supervisors (IAIS), b) European Insurance And Occupational Pensions Authority (EIOPA), c) Financial Services Authority, United Kingdom (FSA), d) National Association of Insurance Commissioners (NAIC).

<sup>22</sup> Solvency II is an EU-wide initiative and directive which codifies and harmonises European Union insurance regulation. It is mainly concerned with the amount of capital that EU-insurance companies must hold to reduce the risk of insolvency, as well as enhancing consumer protection. Solvency II is currently scheduled to come into effect on 1 January 2014 (this date is subject to change) (Wikipedia 2012).

governance and risk disclosure regime being implemented for European insurers and reinsurers. SAM will adopt and follow Solvency II principles, which mainly include regulation based on the utilisation of the three pillar structure: – Pillar 1 – Quantitative requirements; Pillar 2 - Systems of governance and risk management; Pillar 3 – Reporting, disclosure and transparency requirements. However, of great importance is that the SAM regime will be formulated to suit the circumstances of the South African insurance industry and environment<sup>23</sup>, notwithstanding the fact that it is an adaptation of the Solvency II framework and principles in its entirety (FSB – SAM Roadmap, 2010).

In terms of credibility and wide-spread media support, Solvency II has achieved and taken the pole position when compared with other regulatory frameworks. Most of its success as a model-framework is attributed to its stability, consistency, alignment of the economic balance sheet with risk management and lastly the overwhelming support and approval it has enjoyed from the EU parliament. And given South Africa's inextricable ties with Europe as a whole in terms of export trade, businesses, capital markets etc, Solvency II is the best option with which the South African insurance regulatory regime is modelled after.

Like Solvency II, SAM will be designed so that its impact on insurers will depend on the size of the insurer's activities and operations – the FSB have called this the „proportionality principle'<sup>24</sup>. This principle will ensure that all regulatory requirements are applied in a manner which is proportionate to the nature, scale and complexity of the risks inherent in the insurer's business. The obvious purpose and result of this principle is that regulatory requirements imposed on small-medium sized insurers will not be as onerous as the requirements imposed on large, well-established insurers. Whilst this principle is noble and very important in practice, the outline and discussion in this Chapter will not distinguish the applicability of regulatory requirements based on the size of the insurer's operations (FSB – SAM Roadmap, 2010).

---

<sup>23</sup> This is also known as Solvency II 3<sup>rd</sup> country equivalence.

<sup>24</sup> An example of the 'proportionality principle' would be to ensure that when smaller insurers are calculating their capital requirements and technical reserves they are not subjected to the complex and sophisticated Solvency II standard formulae but instead they will use proxy calculations for parts of the standard formulae as well as simplified internal models (FSB – SAM Roadmap, 2010).

### **Purpose/Objective of the SAM regime**

In addition to an alignment with international standards and norms, there are also more pressing and critical objectives in implementing the SAM framework. The most pre-eminent and important objective out of all is the adequate protection of policyholders and beneficiaries<sup>25</sup>. This objective is necessary as it will ensure that insurers are able to meet their obligations towards policyholders and are able to continue their operations in the event of unforeseen and catastrophic circumstances. The aforementioned is primarily achieved by ensuring that an insurer has sufficient capital resources, as well as efficient management systems and formulae that accurately calculate and represent the economic-risk taken on by an insurer. It is also important to note that the protection of policyholders does not only relate to preventing failure but also ensures that customers are treated fairly by assessing if practices by an insurer are prejudicial in any way to beneficiaries - to that end, other qualitative requirements under the SAM framework are aimed at addressing this aspect of policyholder protection (FSB – SAM Roadmap, 2010).

Other crucial objectives of the SAM framework besides policyholder protection can be distilled into the following points –

- a) Develop a proportionate, economic-risk based approach to insurance supervision;
- b) Providing an early warning system to regulators if and when capital falls below the required level;
- c) Align capital requirements with underlying risks of an insurer;
- d) Promote and maintain confidence in the financial stability and soundness of the insurance industry;
- e) Encourage insurers to assess their own risk levels by the use and development of comprehensive internal and actuarial capital models; and
- f) Ensuring that South African based insurers can continue doing business with foreign and international partners, without any concerns or worries raised with respect to the quality of their domestic supervisory or regulatory system (FSB – SAM Roadmap, 2010).

### **The Three Pillars**

As mentioned earlier, the SAM framework will consist of three pillars, each dealing with a unique and important element of insurance regulation. However, for the purposes of this

---

<sup>25</sup> For the purposes of SAM and Solvency II, the term Beneficiary can be construed to mean any natural or legal person who is entitled to a right under an insurance contract.

research study, the most important inquiry has been to identify and focus on those regulatory changes that will have a direct impact on the taxation of Short-term Insurers. As already shown in Chapter Two and Three, the connection between insurance regulation and tax-legislation generally revolves around technical provisions and liabilities.

Briefly stated, this strong connection arises from the fact that insurance regulators with the intention of maintaining the probity and stability of the insurance sector require insurers to set aside and create liabilities which represent expected future claims from policyholders, and at the same time treasury and revenue authorities provide tax-deductions for the creation of those liabilities. Therefore any change in the manner or method in which those provisions and liabilities are calculated will precipitate a response from tax authorities.

The most important part of the SAM framework for the purposes of this dissertation is Pillar 1. Within Pillar 1, the focus will be on the new approach that will be used to compute and calculate technical provisions and reserves.

Broadly speaking, Pillar 1 of SAM stipulates the quantitative requirements that insurers must satisfy in order to show that they have sufficient financial resources, and its main objective is to ensure solvency requirements are continuously met by insurers. Pillar 1 is based on the fundamental concept of an economic balance sheet, which „integrates the interdependencies between all the assets and liabilities, calculated at market consistent values’. The next subsection will elaborate further on the valuation of technical reserves under Pillar 1.

Pillar 2 is concerned with the effectiveness of „risk management systems and sound governance structures’ that an insurer uses in the day-to-day running of its business. The main components of this pillar include an insurer’s ability to carry out an accurate „Own Risk and Solvency Assessment\_(ORSA)’, and 2ndly, the systems and structures in place must allow and enable the FSB to efficiently carry out the „Supervisory Review Process (SRP) (FSB – SAM Roadmap, 2010).

Lastly, Pillar 3 is concerned with the transparency and market discipline of an insurer. One of the key elements in achieving this objective is public disclosure and risk-based statutory reporting requirements for all insurers. In pursuit of such reporting and disclosure standards, the regulatory rules under SAM will require that all material information is publicly disclosed

e.g. an insurer's overall risk policy, basis of valuation for assets and technical provisions, financial and investment performance and any other information that could result in any material breaches of the minimum capital requirements and the solvency capital requirement (FSB – SAM Roadmap, 2010).

Ostensibly, Pillars 2 and 3 do not have a direct impact on the taxation of short-term insurers but they are still important because all three pillars are inextricably linked and interdependent. In other words all three pillars are designed to work in a coherent fashion to achieve one goal - which is to establish greater confidence levels in the overall solvency position of each individual insurance provider.

### **Pillar 1 and the Valuation of Technical Provisions**

There are two aspects about this sub-section which are important and worth mentioning:

- i) Firstly, the quantitative requirements prescribed under Pillar 1 of the SAM regime are largely based on and influenced by Solvency II principles - as such, for the purposes of getting better guidance on the newly proposed valuation principles, this sub-section will among other sources refer to the actual Solvency II Framework Directive, Level 1\_Text (Solvency II Directive) proposed to the EU Parliament in 2009.
- ii) Secondly, this sub-section will point out the salient features of the new valuation principles without getting entangled in the finer detail – for to do so would neglect the main issue which is to assess the overall impact for tax purposes.

As established in Chapters Two and Three, technical provisions<sup>26</sup> represent future expenses and obligations that will be payable to beneficiaries and policyholders as a result of the risks under an insurance contract materialising. They have an element of contingency as they are not fixed and determinable, and as such are valued by means of estimations and in some cases complex formulae and parameters.

---

<sup>26</sup> Recap from Chapter Two - In a South African context, the Short-term Insurance Technical provisions used for regulatory purposes include the sum of:

- (a) The Unearned Premium Reserve (UPR),
- (b) The additional amount for the unexpired risk provision (URP), (Not deductible for tax purposes)
- (c) The claims outstanding provision for cases incurred and reported and
- (d) The claims outstanding provision for cases incurred and not reported (IBNR) or not enough reported (IBNER). (s32 (1) of the Short-term Insurance Act 53 of 1998, as amended).

However, because the valuation of these provisions is largely an estimate and subjective, it can sometimes present opportunities for insurers to defer and avoid tax, which could lead to tax disputes and an uneven application of tax among insurance companies. For short-term insurers the tax-deferral is particularly true and significant in the case of long-tail business where there is a lengthy delay between the year in which the underwritten risks materialise (i.e. assumption of liability) and the emergence and actual settlement of claims. It should therefore be the principal objective and purpose of any set of valuation principles to reduce this element of estimation, bias and subjectivity.

Chapter VI, Section 2, Articles 75 to 86 of the Solvency II Directive stipulates the rules relating to the valuation of technical provisions. The relevant provisions will be discussed below (FSA - Solvency II, 2012).

### **General Rule – ‘Arm’s Length Transaction’**

Firstly, the general proposition and underlying premise regarding the valuation of all insurance liabilities is set out in Article 75 of the Solvency II Directive; it requires that insurers value liabilities at an amount for which they could be „transferred, or settled, between knowledgeable willing parties in an arm’s length transaction’ (FSA - Solvency II, 2012).

The phrase „arm’s length transaction’ has been used and explained in a South African context, more specifically in tax anti-avoidance legislation and case law but that in my view would not restrict or diminish the meaning of the phrase when used in another context or instance other than tax anti-avoidance legislation and case law.

In terms of s80A (c) (ii) (ITA), „arm’s length’ can be construed as meaning or referring to a transaction which produces or creates normal rights and obligations between the transacting parties. The „normality’ of a transaction is a factual and circumstantial issue, which boils down to the „means and manner’ in which the transaction is actually carried.

From a judicial perspective, the leading case on the meaning of this phrase is *Hicklin v Secretary for Inland Revenue* (1980 (1) SA 481 (A)). The key dictum from this judgement can be put as follows – *„an arm’s length transaction connoted that each party*

*was independent of the other and, in so dealing, would strive to get the utmost possible advantage out of the transaction for himself. In an arm's length agreement the rights and obligations created were more likely to be regarded as normal than abnormal. Also of importance is that the transacting parties do not have to be at arm's length, they merely have to transact as if they were at arm's length'* (Emslie, et al., 2001: 937).

Article 76 of the Solvency II Directive requires that insurers establish and calculate technical provisions in a prudent, reliable and objective manner. It also states that the valuation of technical provisions must correspond to and be in line with the current amount that an insurer would have to pay if they were to transfer their insurance obligation to another insurer (i.e. fair/arm's length value) (FSA - Solvency II, 2012).

Furthermore, as a general rule, the calculation of all technical provisions –

- a) Must be valued using the cash-flow model approach,
- b) The cash-flows in (a) must be separated into hedge-able and non-hedge-able components, and
- c) Must be market consistent (i.e. done in accordance with the arm's length transaction principle, as well as up-to date information provided by financial markets) and based on generally available data on the insurer's underwriting risks (FSA - Solvency II, 2012).

### **Specific rules *vis a vis* the Valuation process**

The actual methodology to be followed in calculating technical provisions is set out in Articles 77 to 82 and 86 of the Solvency II Directive.

Article 77 states that the value of technical provisions is the sum of a best estimate figure and a risk margin. It is important to note that both values are calculated separately. After their summation they must take into account any amounts which an insurer will recover by virtue of any re-insurance agreements (Article 81) (FSA - Solvency II, 2012).

The best estimate will be calculated by using the probability-weighted average (i.e. the mean) of future cash-flows. This calculation must also take into account the time value of money, and the rate to be used for discounting is the relevant risk-free interest rate term

structure<sup>27</sup> or an appropriate market consistent discount rate. Furthermore, the best estimate calculation must be based on credible information and realistic assumptions, as well as adequate, applicable and relevant actuarial and statistical methods. Therefore the best estimate can summarily be stated as the present value of actuarially computed future cash-in and out-flows required to settle insurance obligations over the period of the insurance contract (FSA - Solvency II, 2012).

The risk margin is added to the best estimate figure to ensure that the value of the technical provisions is equivalent to the amount that the insurer would be expected to pay in order to meet the insurance obligations (i.e. the arm's length value). The risk margin is calculated by determining the cost associated with using the insurer's own capital to meet and support all future obligations towards policyholders (i.e. the weighted average cost of capital – WACC) (FSA - Solvency II, 2012).

Notwithstanding the „best estimate and risk margin' above, Article 77 also states that an insurer will not be required to calculate the best estimate and risk margin if and when the insurer's future obligations towards policyholders can be replicated reliably using financial instruments for which a reliable market value is observable (hedge-able risks)<sup>28</sup>. In which case the value of projected future cash-flows as represented by technical provisions are determined and dictated by the market value of those financial instruments (NB. Discounting is not required if the value of technical provisions is obtainable from an actively traded financial instrument) (FSA - Solvency II, 2012).

Article 78 provides for additional components that must be included and taken into account by insurers in the „best estimate & risk margin' calculation of technical reserves under Article 77. These components include: -

- (a) All expenses that will be incurred in servicing insurance obligations (i.e. claims allocated and unallocated loss adjustment expenses),
- (b) General inflation and more specifically expenses and claims inflation, and

---

<sup>27</sup> The risk free rate represents the rate of return on a riskless asset or an investment with no-risk, including the risk of default e.g. government securities and bonds.

<sup>28</sup> This method of valuing technical reserves is normally applicable when the risks associated with the liability are fully hedge-able against a financial instrument for which a market-consistent valuation/price is easily obtainable. Of importance is that the insurer must show that the aforementioned risks are being hedged in a sufficiently deep, liquid and transparent market (i.e. a market where volumes of transactions are conducted with minimal effect on prices).

(c) Other amounts which insurers expect to make in favour of policyholders and beneficiaries e.g. future discretionary pay-outs, cash-backs bonuses etc. The amounts must still be included in the technical provisions estimate even if the insurer has not contractually guaranteed to make the payment.

d) With respect to the unearned premium reserve, the contract boundaries for every insurance contract must be clearly determined because this has a direct effect on the future projected cash-flow amount. Under Solvency II, a contract boundary refers to the insurance policy „contract term’, and all the cash in-flows expected to fall in that term (FSA - Solvency II, 2012).

In addition to the Article 78 inclusions, Article 79 also charges insurers to include in their technical provisions calculations the value of any financial guarantees (e.g. credit default swaps) and contractual options included in insurance policies/contracts (FSA - Solvency II, 2012).

Article 80 ensures that insurers do not lump together different levels of risks from different lines of insurance products in calculating technical provisions. A lack of distinction in the different levels of risk will inevitably result in wrong statistical and actuarial models being derived to calculate the technical reserves. As such this article proposes and stipulates that in calculating technical reserves insurers must distinguish and segment their insurance obligations on the basis of homogenous risk groups or by similar lines of insurance business/products i.e. the „segmentation principle’ (FSA - Solvency II, 2012).

Article 81 stipulates the treatment and calculation of amounts that an insurer will recover from re-insurance contracts. Firstly, these amounts are important as they must be taken into account in valuing technical provisions and secondly their actual calculation must include the risk and expected losses arising from counterparty default (FSA - Solvency II, 2012).

Article 82 stresses the need for effective internal processes and models that enable insurers to use complete and accurate information as well as making appropriate approximations in the process of valuing technical provisions. It also stipulates that if an insurer has insufficient information and as a consequence cannot derive a reliable

actuarial method applicable to future obligations, then the insurer would have to make an appropriate approximate based on a „case-by-case’ approach (FSA - Solvency II, 2012).

Article 83 requires that insurers must compare their technical provisions estimate with actual experience. The purpose of this back-testing approach is to ensure that any deviations between estimates and experience calculations are remedied by adjusting assumptions and information used in deriving actuarial methods and formulae (FSA - Solvency II, 2012).

Articles 84 and 85 state that an insurer must be able at any-time to prove the appropriateness and adequacy of the level of technical provisions held. Secondly, it also empowers supervisory and regulatory bodies with the ability to instruct insurers to increase (or some cases decrease) the level of technical reserves (FSA - Solvency II, 2012).

Article 86 provides a summary of the actual implementing measures that would be published in a separate document giving a detailed exposition and prescription on how actuarial and statistical methodologies/formulae will be applied in calculating technical provisions (i.e. best estimate, risk margin, inflation, allocated and unallocated loss adjustment expenses, discounting and appropriate interest rates etc) (FSA - Solvency II, 2012).

### **Conclusion**

If anything, the above summary shows that the regulatory changes to be proposed under SAM are a monumental shift from the old simple-factor or formula approach to a very complex and rigorous „market consistent and risk adjusted measurement of technical liabilities<sup>29</sup>’ approach. The formulae, parameters and models to be used by actuaries in this new approach and methodology will be based on the actual risks and unique circumstances/data of the individual insurer.

However, the „brass tacks’ question from this change in valuation method revolves around whether tax policy-setters in South Africa (i.e. National Treasury) will accept the

---

<sup>29</sup> This is also referred to as the Fair value approach.

new valuation principles. If they accept then the next step in assessing the impact is to determine the effect that the new valuation methods have on current level of reserves.

The questions above will be fully addressed in Chapter Five by presenting independent views and opinions obtained on the issues raised and analysing the results of the „SAM Quantitative Impact Study 1’. Suffice to say whenever there is a change in the method of valuing reserves, especially one that is unprecedented and monumental as in this instance, there is normally a once-off increase or decrease in the levels of reserves. That net-change will have an enormous and unusual impact on the taxable income figure reflected by the insurer in that particular year of transition.

On the most part, the real concern is if the new valuation rules result in a much lower level of reserves – this in-effect would result in a significant tax burden and exposure for the insurer as a huge portion of reserves are released to taxable income. In light of this extra-ordinary tax-liability, it will be important and incumbent on revenue authorities to take some measures and steps which would provide a concession or tax relief for short-term insurers in that year of transition. All the possible options to ease this burden will be discussed and analysed in Chapter Five, and the most appropriate and practicable will be recommended.

### **Internal Model (SAM Framework) - Research & Development Expenditures**

Another aspect which has arisen because of the regulatory changes taking place in South Africa is an issue directly related with the costs that insurers will be called upon to expend in order to implement the SAM framework. Given the enormity of the SAM framework, there are multiple areas and facets<sup>30</sup> of the insurance business that will require revamping and significant change; as such considerable amounts of working capital will be needed to meet a variety of costs. However, notwithstanding the importance of the other costs involved in the implementation process, this section will focus only on the costs that insurers will expend on the Research, Development, Building and Approval of the „Internal Model’<sup>31</sup>.

---

<sup>30</sup> An example of the areas of the insurance business and sector that will need an overhaul as part of the regulatory reform include - risk management systems, data storage systems, administrative systems, software design, information technology systems, reporting systems and corporate governance Structures.

<sup>31</sup> Internal Models may also be referred to as ‘economic capital models’, ‘risk-based capital models, or ‘business models’.

What exactly an „Internal Model’ is will be defined and discussed in a moment, but for now it is worth noting that the costs incurred in developing this „Internal Model’ are particularly important and vital for insurers because they are expended for a purpose which falls at the heart of the SAM framework – which is an accurate and reliable computation of the solvency and minimum capital requirements.

The solvency and minimum capital requirements are justifiably the most important quantitative calculation under the SAM framework, simply because they represent a fundamental and core aspect of the regulation and oversight conducted by the FSB which guarantees the much needed protection for policyholders and investors.

However, the real question to be determined in this section is whether the costs and expenditures described above are in-fact deductible for the purposes of computing the short-term insurer’s tax-liability?? This is an important question because according to the FSB, at the outset of the SAM regime in 2009/2010, short-term insurers voiced their concerns and worries about the non-deductibility of amounts incurred in developing „Internal Models’ (FSB – SAM Interim Measures, 2011).

Given these worries and concerns, the discussion in the next sub-section will merely lay a platform describing why these amounts and expenditures might not be deductible for tax purposes. This explication will be based on current tax legislation and significant tax law pronouncements relevant to the issue.

Chapter Five will continue this discussion by looking firstly, at the credibility of the tax-concerns raised by short-term insurers *vis-a-vis* these expenditures, and secondly, the possibility and merits (up-sides and down-sides) of enacting new provisions which would give tax-deductions to short-term insurers for such expenditures. In my view this discussion is warranted especially given that the extent, magnitude and impact of the SAM framework – in-fact it is the biggest regulatory reform project ever undertaken for the insurance sector in South Africa. Other important and significant factors will be pointed-out and debated in that discussion in an attempt to reach and give a balanced, well-rounded conclusion on the matter.

## **Current Tax Position**

Before presenting and discussing the current tax position on this matter, it is crucial to establish what an „Internal Model’ is and its purpose in the day-to-day business of a short-term insurer?? Initial guidance on this has been obtained from two leading and reputable insurance supervisory bodies, namely the International Association of Insurance Supervisors (IAIS) and the International Actuarial Association (IAA).

According to the IAIS an „Internal Model’ refers to *„a risk management system developed by an insurer to analyse and assess the overall risk position, both quantitatively and qualitatively. This risk assessment should result in the insurer determining its own specific risk profile and economic capital needs’*; and more specifically in the context of this study, *„it means to determine the regulatory capital requirements and the defined level of safety under the rules of a solvency regime’* (International Association of Insurance Supervisors (IAIS); 2007).

At its core, the „Internal Model’ will be a *„mathematical representation of the insurer’s business operations, it can take many forms and vary from simple and standardized calculations to extremely complex formulae and computer programmes. The series of formulae and computer programmes derived will be based on past empirical data and assumptions regarding the insurer’s future experience with respect to a variety of factors including risk drivers, as well as management operating policies’* (International Actuarial Association (IAA), 2010).

Notwithstanding the determination of individual risks and the required economic capital, the real purpose of an „Internal Model’ in a „business/management context’ is to ensure that *„all of the risks associated with an insurer’s functions are integrated fully into its business plan and objectives, with the ultimate benefit of allowing the insurer to plan strategically, make optimal decisions and understand the effects of changes in business activities (such as writing new business) on its risk profile, financial performance and position and economic growth* (International Association of Insurance Supervisors (IAIS), 2007).

The complexity associated with the establishment of any „Internal Model’ will depend on the *„nature, scale and complexity of the insurer’s business risk, and as such the*

*establishment of an internal model will have to be proportionate, suitable and fit-for-purpose*. Most of the costs associated with the Research & Development of an „Internal Model’ arise mainly from the following areas:

- (a) Modelling and Research process. This refers to the underlying design of the internal model, based on certain target criteria e.g. *„the required confidence level, risk measure and time horizon which the insurer considers appropriate to its risk tolerance and business plans*’,
- (b) Construction and Development process. This involves a significant amount of costs and resources on IT (Information Technology) Software and Hardware, Computer Programming and Data cleaning.
- (c) Validation process. This process calls for the insurer to review and validate its own internal model so as to ensure the appropriateness of the model as part of its risk and capital management processes and decision making tool. The „validation process’ will normally consists of three tests, namely a *„statistical quality test, calibration test, and use-test (also includes back-testing)*’, all of which are rigorous and stringent.
- (d) Implementation process and continual upgrades to the „Internal Model’. This process ensures that the insurer is actually using its model as a key and important tool in strategic decision making. The „Internal Model’ must also be subjected to constant reviews, analyses and upgrades, to ensure that the underlying assumptions and model specifications are still relevant and appropriate to the insurer’s risk exposure (International Association of Insurance Supervisors (IAIS), 2007).

From the above, it is clear that the development and approval of an „Internal Model’ is a painstaking, rigorous and costly exercise. Under the proposed SAM framework, insurers in order to calculate their Solvency Capital Requirement, along with other key quantitative indicators will have two choices, namely, a fully developed, FSB approved „Internal Model’ or the Standard Formula calculation, prescribed under the Solvency II Directive Level 1 Text.

Having explained what an „Internal Model’ is and its relevance to the SAM framework, attention is now turned towards the taxation aspects of the matter. The „first port of call’ would be to identify any specific provision that would most-likely provide relief for such expenditures before applying the so-called general deduction

formula. (**\*sections mentioned from here-on refer only to provisions of the Income Tax Act No.58 of 1962 (as amended)**)

Firstly, the amounts and costs incurred in establishing an „Internal Model’ can rightfully and correctly be characterised or categorised as „Research and Development Expenditures’. There is no ambiguity surrounding that characterisation. As such the closest or most specific tax-provision that would be applicable to such expenditures is s11D, which deals with expenditures incurred for „Scientific or Technological Research and Development’.

In my view, the initial definition in s11D (1)<sup>32</sup> stipulating the nature of research and development activities qualifying for a tax-deduction seems to fit in perfectly with the nature of research and development work to be undertaken and incurred by insurers under the SAM framework (i.e. „Internal Model’ development). However, the relief „falls flat’ because of **s11D (8)** (effective from 1 April 2012) which specifically prohibits the deduction under **s11D (2) & (3)** in respect of the following expenditures:

- (a) *„Market research, market testing or sales promotion’;*
- (b) *„Administration, financing, compliance or similar expenditure’;*
- (c) *„Routine testing, analysis, collection of information or quality control in the normal course of business’ and*
- (d) *„Development of internal business processes unless those internal business processes are mainly intended for sale or for the granting the use or right of use.....’*

Only the parts of s11D (8) precluding the deduction for the expenditures in question have been listed.

To a certain extent the prohibitions listed in s11D (8) are understandable as businesses (especially in the financial sector) consistently rely on the development and design of

---

<sup>32</sup> A summary of s11D (1) definition of ‘research and development’ is as follows: ‘systematic investigative or experimental activities which result in the discovery of non-obvious scientific or technological knowledge, or the creation of an invention, design, computer programme or the knowledge essential to the use of such invention, design, or computer programme. In addition the research and development must result in a better functioning, performing and reliable invention, design, computer programme or knowledge (Definition effective from 1 April 2012).

internal/management control systems, computer programmes and other similar projects; and to allow a deduction for such research & development work would go against the „real purpose and intention“<sup>33</sup> of s11 D and could ultimately „open up a floodgate“ of unjustifiably and endlessly awarding tax-deductions to financial intermediaries and businesses for systems they develop and upgrade on a continual basis as part of their business operations. Hence, the real discussion in Chapter Five will be to assess if there is anything out of the ordinary that would warrant the enactment of a tax-deduction for the Research and Development expenditures incurred under the SAM framework.

It is therefore needless and unnecessary to consider or discuss any other aspects of s11D as insurers across the board are not in any position able to make use of the provision. Notwithstanding its non-applicability to insurers, s11 D was still mentioned so that if any new recommendations are made in Chapter Five regarding the „Internal Model Research and Development Expenditures“, all existing avenues and options for the taxpayer would have been explored and the most-likely outcome established (in this case the result of applying the s11 D option has been established i.e. it's not applicable).

Moreover, for the sake of clarity and completeness, there is also no specific provision which would allow a short-term insurer to amortize or write-off (over a certain period) the expenditures in question - a discussion on this is unwarranted as the requirements of those amortization provisions are very straightforward in terms of who they apply to and under what circumstance; and after a thorough analysis it is safe to conclude that none them are applicable to the present case and circumstances.

The remaining option is to consider whether s 11 (a) or the so-called general deduction formula is in-fact applicable to the expenditures in question.

---

<sup>33</sup> From the plain and literal meaning of s11D - its 'real purpose and intention' can be construed as wanting to incentivise the exploration and development of new products, materials, devices, processes and knowledge by companies and firms; such discoveries should at least result in a direct benefit to customers and society at large by increasing or improving the quality of products and services offered. While the development of internal processes and systems by financial intermediaries and businesses is important, it does not however result in a substantially new product or service offering for consumers. Instead the new systems only tighten and make more secure the measures and controls that were already in place.

S 11 (a) (read with s23 (g)) will allow a deduction of expenditure from income if all of the following criteria are met:

- (a) The expenditure must be in respect of income derived from the carrying on of any trade and must have been laid out or expended for the purposes of trade;
- (b) The expenditure (and losses) must actually be incurred in the production of income; and
- (c) The expenditure and losses must not be of a capital nature.

Criteria (a) and (b) are not in any way contentious as the „Internal Model’ expenditures would have been incurred – (a) „in the carrying on of a trade’, (b) „for the purposes of trade’ and (c) „in the production of income’. As such the two criteria do not warrant any further discussion. However, the real problem that hinders the application of s11 (a) to the expenditures in question solely revolves around criterion (c) – „expenditures of a capital nature’. The arguments in favour of this notion and conclusion will not be elaborated in detail as the characterisation of the expenditures in question is not a „border line’ or „tricky issue’ which could swing either side depending on how the arguments are put forward. The fact of the matter is that these expenditures are of a capital nature, and there are two perspectives that I will briefly put forward to support my conclusion.

Firstly, the fact that these research and development expenditures incurred under the SAM framework would have been deductible under s11D (2) & (3) had it not been for the prohibition in s11D (8) implies that these expenditures are inherently of a capital nature. This is because the main purpose of s11D is to provide a special deduction for certain expenditures that have fallen short of the initial capital v revenue test under s11 (a). Therefore, the general proposition in support of the above is that any amount that initially qualifies under the s11D (1), (2) & (3) definitions is of a capital nature, and any disallowance that follows by virtue of any another provision in s11D does not discard or diminish that initial finding or fact - that it is an expenditure of a capital nature.

Secondly, the phrase „of a capital nature’ is not defined in the Income Tax Act, in which case guidance and reference is sought from court pronouncements that have comprehensively dealt with the meaning of this phrase. There are several cases that

have touched on this matter and the preliminary finding and theme that arises from each of the cases before establishing or applying the other specific principles and tests is that the *„true character of the transaction and not its form must be looked at to determine whether it is of a capital or revenue expenditure; and that its true character and nature are a matter of fact to be established from the unique circumstances of the taxpayer’*. In short, this implies that the *„external factors or appearance’<sup>34</sup>* of a transaction are not in any-way determinative in characterising the expenditures incurred but rather the critical inquiry revolves around establishing *„the real purpose of the expenditure’*. For if the *„expenditure has been incurred with the purpose of acquiring or establishing a capital asset/structure then the amounts incurred are of a capital nature and if on the other hand they have been incurred with the purpose of supporting the day-to-day income-earning operations then they are revenue in nature’* (Emslie, *et al.*, 2001: 352 - 357).

The *„purpose question’* above can also be stated in following manner – *„money purposefully spent on creating an income-producing concern or a source of future profits is of a capital nature, whereas money purposefully spent in working that income-producing concern or source of future profits is revenue in nature’* (Emslie, *et al.*, 2001: 350 - 351).

The principles and tests established from the above case law will now be applied to the current facts.

From the previous discussion describing an *„Internal Model’*, it is very clear that the ultimate purpose of the various expenditures incurred in building the *„Internal Model’* are aimed at creating a capital asset/structure from which economic benefits are expected to flow. The *„economic benefits’* and output to be obtained from using the *„Internal Model’* would summarily include the *„valuation of insurance liabilities, financial condition analysis, stress and scenario testing, analysis of asset/liability mismatches and the refinement of investment policy, pricing of insurance products,*

---

<sup>34</sup> Examples of some ‘external factors’ that might have a bearing on the capital v revenue argument are (1) The method & pattern of payments for the expenditures incurred, (2) The nature of the benefit (enduring or fleeting) to be obtained and enjoyed from the asset purchased/constructed as a result of the expenditures incurred, (3) The regularity & recurrence of the expenditures in question, (4) The nature and character of money or capital employed on the various expenditures i.e. floating capital v fixed capital.

*evaluation of re-insurance programs, evaluation of various management and bonus strategies and analysis of general market risk'* (International Actuarial Association (IAA), 2010).

More specifically in the context of the SAM regime, the main output and purpose of constructing the 'Internal Model' is the accurate computation and derivation of the solvency and minimum capital requirements.

Lastly, the 'Internal Model' can also be described as a source of future profits because the economic benefits and accurate output obtained from its use will enable management and the board of directors to make well-informed, prudent, optimal and strategic decisions on all aspects of the insurance business, which should in turn lead to increased and sustainable economic growth in the future.

Therefore, it is safe to conclude that any expenditure incurred in the building of an 'Internal Model' is of a capital nature, and this includes all future amounts that are incurred on an on-going basis to enhance, improve or revise the 'Internal Model'.

NB. Future amounts incurred to improve or revise the model are also of a capital nature because they are more closely linked with the enhancing of a capital asset as opposed to the day-to-day operations of the insurer which involve the actual use of the 'Internal Model'.

### **Conclusion**

The assessment above shows that in the current tax-environment short-term insurers will not get any tax-relief for the 'Research and Development Expenditures' incurred in the building of an 'Internal Model' (as described above). In the first, the amounts do not qualify for the s11D special deduction, and in the second, they fall short of the capital v/s revenue test in s11 (a) and consequently don't qualify for a deduction under that provision. As such no recourse is currently available for insurers on this matter.

Hence, Chapter Five will have a discussion, with the ultimate purpose of evaluating and assessing if there are any merits in taking extra steps to give short-term insurers some tax-relief for the 'Research and Development' expenditures they incur *vis a vis*

the building, construction and approval of the „Internal Model’, (as stipulated under the SAM framework).

## **CHAPTER FIVE: TAX IMPACT AND RECOMMENDATIONS MOVING FORWARD**

### **Introduction**

The purpose of this Chapter is to comment and continue the discussion on the issues raised in Chapter Four. Chapter Four outlined the regulatory changes which have had a direct impact on the taxation of short-term insurers. The main issues revolved around the newly proposed valuation principles for technical provisions, as well as tax-issues surrounding the implementation process with respect to the SAM framework, more specifically the tax-deductibility of „Internal Model’ Research and Development costs.

It is important to point out that the FSB has comprehensively laid-out the ground rules and direction applicable to this new regime but it is also apparent and fair to say that the entire framework is still in its „development stage’ and that certain ideas or concepts are still evolving. This obviously means that there are a wide range of issues that still need to be worked through before implementation date (1 January 2015). In light of the aforementioned, the ultimate objective at the end of this discussion would be to reach and draw reasonable conclusions *vis-a-vis* the issues raised and to do so after a thorough assessment of all the information that is known to date about the new regulatory framework.

There are two main aspects to this Chapter. The first aspect intends to juxtapose the current valuation system and the newly proposed regime by outlining and explaining succinctly what the new rules actually mean for the individual technical provisions as discussed in Chapters Two and Three. After such comparison there are two fundamental questions which will be addressed with the main goal of putting forward an appropriate fiscal response to the aforementioned changes.

The second aspect will debate the merits or justifications (if any) for the National Treasury of South Africa to grant tax-deductions to short-term insurers for amounts incurred with respect to the research and development of the „Internal Model’ as required under the SAM framework. A background discussion regarding the non-

deductibility of these expenditures in the current tax-environment was already done in Chapter Four, as such this Chapter will only discuss if any extra steps (legislatively) are necessary to ensure that short-term insurers do in-fact get a deduction for such expenditures.

### **The differences between SAM and the current regulatory rules**

The analysis in Chapter Four was very important as it put the regulatory changes in context and ultimately set a good platform for discussions in this Chapter. However, in terms of technical provisions, Chapter Four only gave a thorough exposition and analysis of the proposed valuation rules - as such this section will begin by breaking down and stating in exact terms what the new rules mean for each of the individual technical provisions allowed for tax-purposes in South Africa.

Firstly, just as a reminder and without over-simplifying the principles discussed in Chapter Four, the central theme and core issue with respect to the new valuation system under the SAM framework can summarily be stated as follows – a market consistent valuation of all insurance liabilities which ensures that a marked-to-market value is placed on all technical provisions. In the case of future liability cash outflows which can be replicated or reproduced from marketable assets, then the value of that liability must be derived from the market price of that asset. In all other cases where the liability cash-flows cannot be reproduced by a marketable asset and price, then a significant amount of judgement will be required to produce a best-estimate of future cash-outflows, as well as a risk-margin – the summation of these two components should produce or at the very least be a very close approximation of a market-consistent valuation of the insurer's technical provisions (i.e. an arm's length value). Furthermore, in making the best-estimate of future cash-outflows, the insurer must include all elements that would affect and closely resemble the fair or market value of the liability today - the „other elements' affecting the liability's market value today would include *inter-alia* – discounting future cash-flows to present value, claims inflation adjustments, the inclusion of all future expenses related with the liability settlement, including of all future discretionary or mandatory pay-backs and bonuses to policyholders and the segmentation of insurance lines according to the inherent riskiness of the product, etc.

Unearned Premium Reserve (UPR) – Under the current regime, the UPR is calculated by using the 365<sup>th</sup> method, in which the UPR balance will invariably reflect a time-based portion of risks that are unexpired. Of importance is that the 365<sup>th</sup> methodology assumes that risks are evenly accrued under an insurance contract, but as shown in Chapter Three, this is not necessarily true for every insurance policy and coverage of risks. Hence, under the current regime in order to match-up the risks covered in a year more accurately, the insurer will make use of the Unexpired Risk Reserve (URR) (see Chapter Three).

The main change in terms of the SAM framework is that the UPR amount will be determined by using a value that reflects a projection of expected future cash in-flows – the valuation must use and show clear policy contract boundaries. Furthermore, the projected future cash in-flow amount must be discounted, and must take into account an allowance for expenses (i.e. allocated and unallocated loss adjustment and administration expenditures). The general consensus and understanding is that if the UPR takes into account an allowance for future expenditures today, then expected profit or underwriting income from the policy is released upfront as a lower UPR balance is shown at year end, as opposed to the current regime where expenses are taken into account over the policy's lifetime, and as a consequence profits are released from the UPR gradually and progressively.

Also of importance is that the new valuation principle does not operate on the current UPR assumption mentioned above. This means that the insurer can make an accurate projection of future cash in-flows based on the actual level of risks to be covered in the future.

Reported Outstanding Claims Reserve – Under the current regime, the claims reserves is valued by claims experts and actuaries, who ensure that the claims reserves value reflects the best estimate on a case by case basis. The best estimate also includes all the allocated loss adjustment expenses (i.e. costs that are directly incurred in settling the policyholder claim).

Under the new SAM framework, claims experts are still expected to follow the same process in deriving the best estimate but they are required to discount the initial best estimate figure. The discounting is done so as to allow for expected timing of future cash-outflows and payment patterns. Secondly, under the SAM framework claims experts will have to include the unallocated loss adjustment expenses in the best estimate value – this is in addition to the allocated and direct policy cost already included under the current regime. Lastly, in addition to the initial best estimate value, insurers are required to separately compute a risk margin value which is added to the best estimate in order to guarantee that the final claims reserves amount represents the market value.

Incurred but Not Reported (IBNR) – Up-until 31 December 2011, the applicable formula was the 7 % of Net Written Premiums; allocated loss adjustment expenses were added to the calculation. From 1 January 2012, a new formula was introduced by the FSB which calculates the IBNR reserve using the „segmented insurance lines’ approach, and predetermined industry percentages applicable to each line of insurance business.

Under the SAM framework, the valuation is different because the IBNR is arrived at by making the best estimate. The best estimate must be discounted, it must include both allocated and unallocated loss adjustment expenses, with a detailed report on how the overheads have been allocated to the reserve. Furthermore, the actuarial and statistical models used in the estimation process must take cognisance of the different risk levels borne by the different classes of insurance products, failure to do so will inevitably produce spurious estimations and valuations. Lastly, as with the „claims reserves’ above a risk margin must also be computed and added to the initial best estimate figure.

NB. For both the Claims Reserve and IBNR, the best estimate and risk margin valuation technique is superseded if the risk associated with either technical provision can be reproduced or replicated by a marketable financial asset with an easily obtainable market price. The latter valuation option **does not exist** under the current regime.

### **Question 1**

The South African Revenue Service and National Treasury (SARS and National Treasury) have currently mandated that as a starting point insurance obligations deductible for tax-purposes be determined in accordance with the current regulatory rules (see Chapter Two), subject to adjustments by the Commissioner. Given that the aforementioned „status quo’ is about to change because of the proposed rules and transition to the SAM framework, the all important question is whether or not SARS and National Treasury will accept the new valuation principles as discussed in Chapter Four and above??

The answer to this question is important because if SARS and National Treasury agrees with the new rules, then Question 2 below must be addressed. If however, SARS and National Treasury disagree and reject the proposed framework, then the only option (by default) is for SARS and National Treasury to draft and formulate their own set of rules which adequately serve their interest.

My view on Question 1 - From a very general and practical perspective, it is highly unlikely and remote for SARS to not accept the proposed rules because of the manner in which the FSB has galvanised and engaged all stakeholders (including SARS and National Treasury) affected by the SAM regime. This has been done with the main purpose of ensuring that every stakeholder’s voice and opinion is heard in the many SAM forum structures that would follow before implementation date. In-fact, at the outset of the SAM framework proposal in November 2010, the FSB formed a whole range of Task-Groups, each with a special mandate of assessing the impact of the SAM proposals on different and particular aspects of the economy. As mentioned in Chapter One, a Tax-Task Group was also formed as part of this engagement process, with a special role and mandate of liaising with SARS and National Treasury (with the objective of assessing the potential tax-position of insurers post SAM-implementation). In my view, this level of engagement and dialogue between all stake-holders shows that this regime is being championed and spearheaded by the FSB, but at the same time it is being structured to serve the interest of all stakeholders and affected parties (FSB – SAM Roadmap, 2010).

Notwithstanding the practical perspective above, there are three other important reasons why SARS and National Treasury should accept the proposed rules under SAM. Firstly, if SARS were to adopt their own set of rules, this means that short-term insurers would have to carry out and produce three different valuations for technical provisions at the end of the each year assessment - the three valuations would primarily be for – a) statutory purposes (FSB regulation), b) financial statements & public accounts (IFRS 4, Phase II) and c) the tax\_return (SARS requirements). Having three different, mandatory valuation techniques inevitably places an unnecessary burden on short-term insurers, especially in terms of the increased compliance costs and expertise needed to complete all three calculations. Therefore, without overstressing the argument, an introduction of a third basis for calculating technical provisions by SARS and National Treasury would not fully serve the interest of short-term insurers.

Secondly, as discussed and concluded in Chapter Three, it is in the full interest of tax-authorities to rely on the oversight and regulation that insurance regulators provide with respect to the insurance market and companies. This is mainly because insurance regulators have all the necessary expertise, skill and manpower required to deal with and identify the unique challenges that insurers face, and as such are best positioned to stipulate the rules and regulations that are applicable to insurers. In line with the aforementioned conclusion, it is my view that the FSB is ostensibly more equipped and suited than SARS and National Treasury to set insurance regulation, and more specifically in this case to stipulate the valuation methodologies applicable to technical reserves. As such, SARS and National Treasury must rely and take advantage of the expertise that inherently resides within the FSB.

Thirdly, the SAM framework in its entirety has been adopted from and largely influenced by Solvency II principles - and there is a general consensus and understanding in the global insurance industry that the Solvency II principles are rigorous and of superior quality. This favourability stems from the fact that Solvency II is deemed to be the „most advanced, consistent and stable of all regulatory regimes’. From an accounting perspective, IFRS 4\_(Phase II) is still under development but early signs show that most of its standards fall in line with the

Solvency II principles, and this similarity in „framework principles and standards’ will and should bring about a significant degree and amount of convergence between insurance regulation and accounting treatment (Actuarial Society of South Africa – Convention, 2009). In my view, the aforementioned benefits and global dominance of Solvency II, makes a very compelling case for SARS and National Treasury to rally behind the FSB in implementing the Solvency II principles in a South African context (i.e. SAM framework), as opposed to the formulation of their own different technical reserves valuation regime.

Other views on Question 1 – In order to get an independent perspective on whether SARS and National Treasury would accept the new valuation methods proposed under SAM framework, an opinion was obtained from an FSB Official who is part of the SAM Tax Task\_Group. He verbally confirmed that in their several high level discussions and meetings with SARS and National Treasury, the latter are agreeable and do not object to the newly proposed valuation principles under SAM. Although this independent view was expressed in a very equivocal manner and not an official statement, it nonetheless serves to confirm the general direction and conclusions expressed in the previous discussion (Marthinus (Tienie) Hamman – FSB: SAM Tax Task Group, 6 July 2012).

## **Question 2**

On the basis and assumption that SARS and National Treasury will accept the new valuation principles as proposed and stipulated by the SAM framework, the next question is to establish what it all means for tax-purposes and if any amendments will be necessary moving\_forward?? This question is multi-dimensional as there are a few aspects which need to be considered in order to provide and arrive at a well-balanced response.

The starting point is to describe the tax issues that normally arise when there is a transition from one set of valuation rules to another - this issue was briefly discussed in Chapter Four, but this section will carry-out a more detailed analysis.

As alluded to in Chapters Two and Three, technical provisions are in most cases the biggest liability that an insurer will have on the balance sheet. This is because at any given time the current level of reserves would have accumulated over a considerable period of time. As the insurer underwrites and sells more insurance policies in each year, the amount set aside for future obligations also increases. The „actual build-up’ of technical provisions in most cases can be described as a steady increase which moves in tandem with the insurer’s organic growth (OECD, 1999).

NB. „Steady increase’ in this case does not mean that the percentage increase in each year of assessment is exactly the same but rather it is a year on year percentage increase which falls within a certain predictable range.

However, in the year of transition (in this case 2015) the closing balance of reserves will be calculated using the new valuation rules, in which case there will be a change (increase or decrease) in the level of reserves which has not been caused by or is attributable to an increase in expected future claims. Rather, the aforementioned change would have been precipitated by the fact that the technical reserves closing balance from the previous year was calculated using the old valuation rules and the current year-end balance has been calculated using the new valuation rules. This net-change will filter through to the income statement and tax-return as the year on year technical reserves balances are taken into account in computing both underwriting and taxable income.

In some cases the transition can have a significant effect on the underwriting and taxable income, merely because of the sheer size and materiality that is associated with technical provisions. A „case in point’ or example to illustrate the aforementioned is when the Senate and House of Representatives (i.e. Congress) of the United States of America passed the Tax\_Reform Act of 1986 which placed a requirement for all non-life insurers to discount their technical provisions for the purposes of calculating taxable income. In practice and reality this discounting requirement resulted in a significant reduction in the level of technical reserves and the Internal Revenue Service of that country provided transitional relief to all insurers in the form of the „fresh start’ rule or concession (see below). This concession in-effect ensured that the transition from one set of valuation rules to the other did not result in any tax-liability for non-life insurers (David F. Bradford *et al.*, 1997).

Therefore, in order to take decisive action (as in the above example), in terms of whether to provide transitional relief or not, the initial quantitative impact of the new regime must be ascertained. To that end, the FSB as part of their initial impact assessment of the SAM framework conducted the „SA Quantitative Impact Study 1, (2010/2011)’ (QIS 1), in which insurers had to give quantitative and qualitative feedback to the FSB on some key areas falling under Pillar 1.

In terms of technical provisions, the QIS 1 report broke down the results by spreading the responses from short-term insurers in terms of the „10<sup>th</sup> percentile, inter-quartile range and 90<sup>th</sup> percentile’ – the results can be shown as follows:

- 1) Tier 1 – the lower 10 % of short-term insurers stated that their level of technical reserves under SAM would be between 38 – 59% ( $\pm$ ) of the current level of reserves.
- 2) Tier 2 – the middle 50 % of short-term insurers stated that their level of technical reserves under SAM would be between 60 – 105% ( $\pm$ ) of the current level of reserves.
- 3) Tier 3 – the top 10% of short-term insurers stated that their level of technical reserves under SAM would be between 106 – 122% ( $\pm$ ) of the current level of reserves (FSB – SAM QIS 1 Results, 2011).

Whilst the above results are appreciated, there are however some disconcerting issues arising from the entire impact assessment report, which in my view make the results equivocal and not a very reliable basis for any further conclusions. Two examples of issues that greatly compromise the accuracy of the aforementioned results would include –

- a) Firstly, the fact that only 50% of short-term insurers participated - understandably the survey was not compulsory but greater participation from all short-term insurers across the spectrum would have been a preferred option;
- 4) Secondly and more worrying - with respect to the actual technical provisions valuation process under SAM, the report showed that 61% of insurers were not yet fully prepared for the SAM calculation because of data or methodology problems; more specifically a majority of short-term insurers reportedly struggled with the projected cash-flow method for the UPR and the discounted cash-flow calculations (best-estimate and risk margin) for both the IBNR and Claims reserve (FSB – SAM QIS 1 Results, 2011).

The above concerns are important because any misjudgement, misunderstanding or miscalculation on the short-term insurer's part could materially distort and skew the overall results and picture. As such, it is my view that more work will have to be done before making any categorical conclusions with respect to the overall impact of SAM on the level of technical provisions.

To support my analysis of the QIS 1 report is an independent view given by the South African Insurance Association (SAIA) SAM Programme Manager, who stated *via email* that – „*notwithstanding the SA QIS 1 report, it is too early to say what the final impact of SAM will be on technical reserves. Furthermore, that the FSB has recently commenced with the SA QIS 2 but realistically speaking the SAM effect on technical reserves will be better understood when the FSB completes the SA QIS 3 in 2013*’ (Nico Esterhuizen – SAIA: Programme Manager (SAM Tax Task Group), 30 July 2012).

### **What are the options??**

Given that the above information from the QIS 1 report is inconclusive, this subsection will lay-out and discuss the options that SARS and the National Treasury must have in place or at least consider in the year in which the quantitative impact on technical reserves is definitively and categorically known (i.e. 2013 or 2014).

It is important to note that these options are „concessionary’ in nature, meaning that they will only apply if the level of technical reserves are lowered drastically (or moderately) by the SAM valuation principles; in which case there will be an increased or more than normal tax-burden on the insurer in that year of transition (i.e. 2015). In any other case where the new valuation rules result in a higher level of reserves, the concessions are unnecessary and inconsequential because the net-increase will result either in a lower taxable income amount for the insurer or a tax-loss which will be reversed by net-income/profits in subsequent years of assessment.

The OECD (1999) enumerates four options which can be adopted for transitional relief, and can summarily be stated as follows –

- a) No Transition – this means that the insurer will not get any tax-relief for the change in technical reserves (i.e. any increase in the tax-liability must be paid as normal).
- b) Grandfathering – this means that the new valuation methods will only apply to newly issued policies (i.e. issued from year of transition), whilst all other existing policies will continue to be calculated using the old valuation rules (i.e. policies issued before year of transition). This method provides a „concessionary benefit’ in the sense that the existing levels of reserves have not been allowed to change in the first place, meaning that any resulting or knock-on tax effect has been prevented.
- c) Fresh start- this is when the new valuation methods are applied to old and new policies, but the net-change which takes place in the old policies or existing reserves because of the shift in valuation methods is ignored completely. This option is highly favoured by insurers as it turns the deferral of tax through technical reserving into a permanent tax-deduction. In terms of the mechanical process/calculation, the fresh start will require that in the year of transition, the opening balance of technical reserves be recalculated using the new valuation method – this will ensure that the net-decrease in existing reserves caused by the change in valuation methods is not filtered through into the Income statement and Tax return as an income inclusion.
- d) Pro-rating – this means that the net-decrease in reserves arising from the change in valuation methods is calculated as normal but the net-change in reserves is spread over a number of years, depending on the size of the amounts in question.

My view - Which option is the most appropriate??

The views or opinions expressed in this segment are largely conjectural, mainly because most of the information that is critical and needed in reaching a firm conclusion on this matter is largely unknown and will only be available in medium to long term (see discussion above on QIS 1). The appropriateness of each option will be evaluated.

Option (a) (no transition) will only be appropriate if the net-decrease in technical reserves is immaterial to the point where the resulting tax-liability does not warrant or call for any tax-relief/concession. However, if the net-decrease in reserves is drastic then the „no transition’ option will be inappropriate as insurers have to shoulder a

disproportionately large tax-liability in a single year of assessment and for which relief must be sought from the remaining options below.

Option (b) (grandfathering) is not a feasible or workable option because its „concessionary terms’ go against the core principles of the SAM regime – which is to value all liabilities and technical provisions using the new methodology. In other words the „market-consistent rules’ under SAM cannot be applied partially and selectively to a group of policies or technical provisions.

Option (c) (fresh start). Although this option is favoured by most insurers, the fresh start in my view is unlikely to be adopted by SARS and National Treasury as a means of granting transitional relief. It is an unlikely option for following reasons –

- (i) Firstly, the fresh start does not result in a „win-win’ situation for both SARS and the insurer i.e. the insurer is the only party that gains from the concession as the entire tax-liability resulting from the change in valuation rules is „forgiven’ - this might elicit unfavourable and negative views from the tax-policy setters i.e. National Treasury.
- (ii) Secondly, out of all the concessionary options, the fresh start is the most vulnerable to abuse by insurers i.e. an insurer might take advantage of the fresh start concessions by deliberately strengthening reserves in a year prior to the transition year, with the knowledge that a large portion of the reserve will be reduced in the following year with no resulting tax-consequences. Once again, the possibility of such tax-avoidance and abuse makes it an unfavourable option for tax-policy setters.
- (iii) Lastly, it seems as though the fresh start works best when applied as a „blanket concession’ as in the example given earlier where the „discounting requirement’ invariably resulted in lower reserves for insurers across the board. However, under SAM a „blanket concession’ is impracticable because the impact of SAM on technical provisions will vary amongst short-term insurers. This variation is because the SAM valuation process not only addresses one issue (e.g. discounting) but it is a multi-faceted calculation which incorporates many factors in order to arrive at a market-consistent value and each factor will have a different effect on the final valuation.

Option (d) (pro-rating) - in my view this is the most appropriate and plausible transitional relief option, as it results in a ‚balanced approach or intermediate position’. It is balanced in the sense that SARS and National Treasury will recognize the fact that an insurer in the year of transition will have a disproportionately large tax-liability but instead of ‚forgiving’ the entire amount, SARS and National Treasury will allow insurers to spread the amount over several years. This arrangement also serves the interest of an insurer because the insurer will not be subjected to a significant amount of taxes in one year of assessment. In other words this option is a ‚win-win’ situation for both SARS and National Treasury and short-term insurers i.e. SARS and National Treasury won’t lose any revenue from the reduced levels of reserves and at the same time the insurer will still pay their fair share of increased taxes but over a number of years.

Secondly, pro-rating in my view could be a favourable option for SARS and National Treasury because it can be enacted without being a blanket concession i.e. it can be structured so that an insurer can apply for and negotiate on specific terms with SARS for the tax-concession. The actual agreement and relief obtained by the insurer will depend on *inter-alia* the actual change in reserves and the impact relative to the insurer’s income. The aforementioned ‚insurer specific negotiations and concessions’ might increase work for SARS administratively but nonetheless are still important and particularly relevant given that the results and impact under the SAM regime will be varied across the board – and as such might not be best addressed by a general or widespread concession.

### **Conclusion**

The year of transition from the current regulatory system to the SAM framework is 1 January 2015. By that time the FSB would have gathered enough information for tax-policy setters to work on and make well-informed decisions. However, as of now, when all factors are taken into account, my conclusion is that Option (d) is the most conceivable and feasible form of relief that the South African National Treasury should provide to short-term insurers in 2015, if the need ever arises.

The aforementioned statement was made on the presumption that the National Treasury and SARS will accept the new valuation principles as proposed by the SAM regime.

### **Tax-Deductions for Internal Model ‘Research and Development’ costs**

This sub-section will continue the discussion presented in Chapter Four in connection with the tax-deductibility of expenditures incurred by insurers in Researching, Developing and Building an „Internal Model’ (as defined in Chapter Four). As concluded in that earlier discussion, the expenditures in question cannot be deducted or amortized under the current provisions of the Income Tax Act (No. 58 of 1962), as such this section will discuss the pros and cons of granting short-term insurers tax-deductions for the aforesaid expenditures.

As noted in Chapter Four, the issue of granting tax-deductions with respect to the expenditures in question was initially brought to the attention of the FSB by short-term insurers, and rightly so because the SAM framework is the largest regulatory reform project that all insurers have been subjected to in South Africa. Given its magnitude the implementation costs that have been incurred to-date or forecasted by insurers across the board are enormous and unprecedented. In-fact the PWC 5<sup>th</sup> Biennial Insurance Report (June 2012) showed that the extra-ordinary costs associated with implementing the SAM framework is one area which insurers and industry affiliates have consistently criticized as being too burdensome and excessive<sup>35</sup>.

The aforementioned criticism has also been advanced in Europe where the Solvency II implementation costs are at an unprecedented level and have taken their toll on insurers – in the same breath it is also worth mentioning that Revenue Authorities in some European Union countries are allowing insurers to claim tax-deductions for expenditures incurred in respect of the Research and Development of the Internal Model (as prescribed under Solvency II). In the United Kingdom (U.K.) for example, their Research and Development tax-deductions are not as restricted as here in South Africa i.e. they also apply to expenditures incurred on customising, enhancing and integrating software packages for internal use or

---

<sup>35</sup> The PWC Biennial Insurance Report (June 2012) also states that the implementation costs for a single short-term insurer could be in the range of R50 – R100 million. Even though the costs are spread over the next three years, they are still an indication of the level of expenditures associated with this regulatory reform. Meanwhile, the absolute minimum capital requirement has also be increased from R10 – R15 million.

expenditures incurred on building internal models and parameters, data governance systems and methodologies etc (KPMG - Financial Services, United Kingdom, 2012).

Important to note – the tax-concessions above (i.e. granted in most EU countries) do not necessarily mean or imply that South Africa should follow suit and grant the same concessions. This is because South African and U.K. insurers for example operate under different business and socio-economic environments and as such tax-policy objectives and considerations will differ. Instead the above example is only a hint to the fact that the discussion and consideration for having such tax-concessions introduced here in South Africa is worth having, and the segment below aims to have that discussion and debate.

From a general and theoretical perspective, the onslaught of regulations by governments on private businesses is viewed as impeding and strangling the growth and expansion of business and economic success. In other words, regulatory reform is normally seen as going against the forces and principles of capitalism and the free market, where profit is the ultimate goal and self-regulation is favoured as a means of correcting any imbalances in the market. Unfortunately, in practice and reality self-regulation does not work (i.e. the 2008 global financial crisis is a testament to this point), as such governments must intervene by setting rules which will prevent its citizens from abuse and unfair treatment, and such regulation could not be more appropriate than in the insurance industry where one party makes future promises in return for a series of payments.

So, the broader point is that regulation is needed in the financial and insurance industries, but on the other hand imposers of regulations must also be cognisant of the consequences that the imposed regulation will have, and in addition provide ways to alleviate some of the undesirable consequences. On the most part, the undesirable consequences revolve around the implementation costs, and the important issue in that context is how to reduce or subsidize such costs without compromising the regulatory reform process. In this regard, the notion or idea is that government can play a key-role by granting tax-deductions as a means of

lowering implementation costs and also as a way of incentivising thorough and successful implementation of the regulatory reforms.

Returning to the issue at hand, short-term insurers have been impacted quite significantly by the SAM framework. In terms of implementation costs, the impact is quite unique because the short-term insurance market in South Africa is comprised of many small-to-medium sized insurance companies, and only a few big companies that dominate the market. This fact or assertion is supported by a February 2012 short-term insurance market report done by Moneyweb which showed that the top six primary<sup>36</sup> short-term insurers in South Africa held approximately 61% of the market share. Meanwhile the total number of registered primary short-term insurers according to the FSB (Annual Report, 2011) stands at ninety nine - this therefore means that 94% of primary short-term insurers in the market only hold approximately 39% of the market share.

The latter finding is very important and significant because it has been noted by reliable studies that regulatory burdens and requirements are always a major obstacle and challenge for small-to-medium firms simply because they tend to be poorly equipped to deal with the complex, rigorous and costly issues arising from regulation (OECD, 1997). The aforementioned is also true and applicable in the present context as it is foreseeable that many of the small short-term insurers will struggle to implement and adopt the SAM framework, simply because of their already limited working capital base and lack of sufficient expertise. In some cases the steep regulatory requirements and costs will cause small short-term insurers to cut back on certain high-risk and return insurance products as a way of reducing regulatory costs or merging with other small-insurers in order to meet the solvency & minimum capital requirements or in the worst-case scenario closing operations because the regulatory requirements have not been met. In-fact in an article from Fin24 on the 15<sup>th</sup> March 2011, Ian Kirk of Santam Limited expressed the same sentiment as he stated that the ultimate effect of the proposed regulations „*would almost certainly see a diminishing in the number of insurance providers*

---

<sup>36</sup> 'Primary' in this case refers to short-term insurers excluding reinsurers.

*in SA, as the capital requirements and associated costs of compliance were increasing significantly’.*

Therefore, on the basis of ensuring that small-to-medium short-term insurers in South Africa weather the regulatory reform requirements and costs over the next three to six years, I would support the granting of a tax-deduction for the expenditures in question, solely as a means of subsidizing the expenditures incurred *vis a vis* the SAM framework. The tax-deduction does not have to be the entire amount (or more) of the expenditure incurred, but it must be structured in way that ensures that the resulting tax-saving has a positive effect on the insurer’s SAM implementation process, bottom line and survival.

In connection with the aforementioned, it is also important to note that the general thrust behind maintaining the survival of small-to-medium short-term insurers is based on two crucial and eminent factors – they are given below:

- a) Firstly, in South Africa it has been proven that small-to-medium companies across the spectrum are the biggest source of employment, job creation and economic growth - in terms of actual statistics, it is estimated that 73% of the work-force in South Africa is employed by firms with less than 50 people (SBP Business Environment Specialist, 2009). This finding is significant and particularly relevant to the short-term insurance market where an overwhelming majority of participants are small-to-medium firms, which inevitably makes them an important factor and driver of job creation and broad-based/equitable economic growth. As such their survival and preservation from the steep and rigorous demands of regulatory reform should be a top priority, and in my view part of that preservation can be done by granting tax-deductions for the expenditures in question;
- b) The second issue revolves around competition. It is common cause that a healthy insurance market is one where potential consumers have a wide range of insurance providers to choose from. This therefore means that fewer participants in the short-term insurance market reduce this level of choice and competition. The latter position is untenable as it could lead to higher prices and consumer abuse as a small cluster of short-term insurers control the market. As such, the survival of small-to-medium short-term insurers is

important and critical as it helps maintain the „status quo’ in terms of a healthy and competitive insurance market.

Apart from ensuring that many small-to-medium short-term insurers maintain their existence, the granting of a tax-deduction for such research and development costs can also be used as a tool to incentivise small short-term insurers to build and develop their own internal models for calculating the solvency capital requirement, along with other quantitative measures. A tax-incentive in this case is relevant for two reasons – firstly, according to the FSB, many small short-term insurers in South Africa have traditionally not built or maintained internal models; secondly, under the SAM framework the development of an „Internal Model’ is not mandatory requirement i.e. if an insurer does not build an internal model voluntarily, then they have an option to use the pre-determined standard formula calibrated by the FSB. In light of the foregoing reasons, a tax-deduction would be one of the most effective methods and initiatives to embolden the enthusiasm of small short-term insurers to incur expenditures for the building and developing of their own „Internal Models’ as opposed to relying on the standard formula.

It is also important to note that incentivising insurers to move away from the standard formula towards a customised „Internal Model’ is necessary because it is a widely held view that there are clear advantages and benefits of having an „Internal Model’ versus not having one. Some of the benefits of having a customised „Internal Model’ include *inter alia*:

- 1) Firstly, helping an insurer understand its risk exposure at a detailed granular level - mainly because all the insurance risks must be assessed in full and incorporated into the Solvency Capital Requirement level;
- 2) Secondly, an „Internal Model’ allows an insurer to look at various risk measures and levels of confidence when ascertaining the solvency capital requirement level;
- 3) Thirdly, an Internal Model enables an insurer to perform a detailed review of profit and losses from each line of insurance business – this should give the insurer a competitive advantage; and

- 4) Lastly, an „Internal Model’ would assist the FSB and rating agencies in carrying out year-end or ad-hoc supervisory reviews on an insurer, with the ultimate benefit of obtaining a full assessment of the insurer’s risks, quantitative capital requirements and credibility at any point in time.

In connection with all of the above points, the FSB has stated that the proportionality principle (see Chapter Four) will also apply to the „Internal Model Research and Development’. The ultimate objective of this principle is to ensure that the „Research, Development and Approval’ process is not as complex, rigorous and costly for small-to-medium short-term insurers. Although this is a great initiative to lower costs for small short-term insurers, it however does not detract from the immediate incentives and tax-savings that will be open and accessible to small insurers if the aforesaid deductions are granted.

However, notwithstanding the above, there is one issue which must be addressed if small-to-medium short-term insurers are granted tax-deductions for the expenditures in question. The issue can be framed as follows – the parameters and assumptions of an „Internal Model’ are not static i.e. they will change at least on a yearly basis depending on the insurer’s current risk exposure, mix of insurance products sold, economic environment, internal and external factors etc. As a consequence an insurer will continually adjust and improve the „Internal Model’, and will incur expenditures<sup>37</sup> in the process.

So, the problem question for SARS and National Treasury is where to draw the line with tax-deductions for capital expenditures that are incurred on a continual and yearly basis to adjust or update the model (i.e. should they allow deductions for the expenditures incurred in subsequent years)?? In my view, the deductions for the „Internal Model’ development should only be allowed for the „initial build up which lasts until the first FSB approval’. The main reason for this view-point is because up-until the „first FSB approval’ the tax-incentive would have achieved its critical objective of driving and shifting the insurer away from the standard

---

<sup>37</sup> In my view expenditures incurred to improve or upgrade a capital asset are of a capital nature; in this case the fact that the upgrade is on a yearly basis does not discard the initial finding that they are more closely linked to the enhancing of the capital structure as opposed to the insurer’s operations, as such no deduction would be available under s 11 (a) (ITA) (see case-law discussion in Chapter Four).

formula method towards a more rigorous, reliable and FSB approved model; all other costs incurred after that point fall outside the purview of the objectives sought by the tax-incentive. In other words after the initial approval, it is the short-term insurer's responsibility to incur and shoulder any extra costs as a means of guaranteeing that the „Internal Model' assumptions and parameters are still relevant and up-to date.

NB: The emphasis in the entire discussion above has been on small-to-medium short-term insurers as opposed to the larger and well-established short-term insurers. The main reason for this discretion and limitation on the tax-deduction recipients is because small-to-medium short-term insurers are more vulnerable to the dangers and downsides of regulatory reform than well-established insurers. In other words the impact of tighter and costly regulatory reform on well-established short-term insurers is to reduce their retained income and organic growth/expansion for the near future but it won't necessarily jeopardise or endanger the insurer's survival or result in the insurer cutting back on some lines of insurance products. Furthermore, as noted by the FSB, larger and well-established short-term insurers have always maintained costly and complex „Internal Models' because of their inherent ability to do so, as such the tax-deduction incentives applicable to smaller short-term insurers to encourage them to „Research and Develop' their own „Internal Models' would be pointless and futile for the larger and well-established short-term insurers.

## **Conclusion**

From the above discussion, the general thrust and point is that small-to-medium and emerging short-term insurers must be protected from the negative effects of regulatory reform. In other words, existing small short-term insurers must not lose their current share of the market or competitive edge because of a failure to meet the challenges and costs associated with regulation; and for emerging or aspiring short-term insurance businesses regulatory challenges and costs must not be a barrier to successful market penetration. With that purpose in mind, it is my view that the expenditures incurred in „Researching, Developing and Building an Internal Model' (as required by the SAM framework) must be deductible for tax-purposes, only to the extent that the insurer is a small-to-medium business. As

described and mentioned above, there are decent and compelling policy considerations and arguments which support this conclusion

## CHAPTER SIX: MAIN CONCLUSION

The main objective of this Research Paper was to „to assess and analyse the impact that the proposed changes in insurance regulation will have on the taxation of short-term insurers, with an aim to put forward or recommend an appropriate fiscal response’. Several other issues were raised as a means of achieving this objective – these issues were subsequently addressed in the succeeding chapters. The main purpose of this final Chapter is to outline how exactly those questions were addressed and what it means in terms of the bigger picture.

The basic rationale and methodology used to carry out this impact assessment and analyses was to thoroughly identify some of the areas in the taxation of short-term insurers that will most-likely be affected by this regulatory reform – that analysis was restricted only to the principal tax-provision applicable to short-term insurers. Another significant area discussed as part of the regulatory reform analysis was the implementation process, more specifically in this regard was the tax-deductibility of costs incurred by short-term insurers in „Researching, Developing and Building’ the „Internal Model’.

Chapter Outline – In line with the methodology above, Chapter One gave a synopsis and overview of the general outlook and state of the Short-term Insurance Industry in South Africa. Chapter Two gave a thorough review and analysis of the principal tax-provision applicable to the taxation of short-term insurers (i.e. s 28 (ITA)). Chapter Three gave a theoretical perspective on technical provisions (i.e. an area which is directly affected by the newly proposed regulatory reform) - the perspectives given in Chapter Three were not necessarily aligned with any jurisdiction but rather were based on what makes sense in theory. Chapter Four gave an enunciation and detailed exposition of the newly proposed regulatory framework. Chapter Five makes a comparison and states in exact terms the differences between Chapters Two and Four (i.e. the current and proposed regulatory frameworks) – several questions and implications related to the taxation of short-term insurers are raised after the aforesaid comparison, and after

an analysis of all the relevant issues a conclusion and response is given to each of the questions raised.

The first important issue was to ascertain and explain the connection that exists between insurance regulation and tax legislation i.e. the Income Tax Act No. 58 of 1962 (ITA) and the Short-term Insurance Act No. 53 of 1998 (SIA). As shown in Chapter Two, the link between the two pieces of legislation revolves around technical provisions. In a nutshell, the Income Tax Act allows short-term insurers to deduct from their income specific insurance liabilities (i.e. technical provisions) as determined in accordance with the Short-term Insurance Act - as such any changes or reform in the latter Act will certainly have an effect on the former. The latter finding also led to the conclusion that the valuation of those insurance liabilities is the real issue that is a source of contention between regulatory-authorities and tax-administrators. This contention stems from the fact that the values placed on these insurance liabilities represent an estimate of what the short-term insurer supposes or deems will be the insurance liability arising from future policyholder claims, and because it is an estimate it is subject to bias and error.

Having established from Chapter Two that technical provisions will be the central issue in terms of the newly proposed regulatory reform, the next important issue was to put technical provisions in context, in other words highlighting the role and importance of technical provisions from a theoretical perspective. This discussion was meant to give a better appreciation of the valuation issues discussed in Chapters Two, Four and Five. Some of the important findings from that discussion included:

- a) Firstly, that notwithstanding the differing and competing objectives between tax-administrators and insurance regulators, it is still vital and imperative for tax-administrators to rely on the expertise and supervision given by insurance regulators with respect to insurance companies;
- b) Secondly, that all technical provisions have an indispensable and pivotal role when it comes to the computation of an insurer's taxable and underwriting income. In other words the concession given to insurers from applying the

normal tax and accounting rules through the use of technical provisions is supported by plausible reasoning and makes sense at every level;

- c) Lastly, that the valuation of technical provisions is a complex and perplexing exercise, not merely because it is an actuarial science or the amounts involved are estimates but mostly because there are a whole range of non-quantitative formulae and factors that contribute to the actual valuation as reported by the short-term insurer.

The third issue that had to be addressed revolved around the actual regulatory reform. In this case the Solvency Assessment Management (SAM) regime was put into perspective (i.e. its objectives and how it will be implemented etc). However, the main thrust in breaking down the SAM framework was to describe the new valuation principles for technical provisions, with an aim to contrast and show how starkly different they are to the old valuation system. Given the real and severe differences between the current and proposed regimes, the main question borne out by that discussion *was whether or not the South African Revenue Service and National Treasury (SARS and National Treasury) should accept the new valuation rules (see answer below)??* This question is very significant because SARS and National Treasury pay very close attention to technical provision valuations – in-fact the South African Revenue Amendment Bills in 2007, 2008 and 2010 which touched on technical provisions, only serve to show and prove that they do care about the valuation process.

The other crucial discussion under the SAM regime „exposition’ was the tax-treatment of costs incurred for the purposes of the developing the „Internal Model’ (as required by the SAM framework). The most important conclusion from that discussion was that none of those expenditures are tax-deductible under the current Income Tax Act provisions. The next inquiry after the aforesaid conclusion *was whether or not short-term insurers deserve some tax relief for the expenditures in question (see answer below)??* In my view this inquiry is important and warranted (especially for short-term insurers) because of the extraordinary and unprecedented costs involved in implementing the SAM framework.

The last issue addressed by this research paper was to assess and breakdown the impact precipitated by the SAM framework from a tax-perspective (i.e. an appropriate fiscal response). After a thorough comparison and contrast of the current and proposed regulatory regimes in Chapter Five the important issue was whether or not SARS and National Treasury are agreeable to this transition. The answer to that question is not yet known unequivocally because there is no official response yet from the respective authorities but after my own thorough assessment and the perspective of an independent expert, there are compelling reasons for SARS and National Treasury to accept the valuation rules as proposed by the SAM framework. If however, they reject the proposed rules, then they will have to draft their own rules, which stipulate how short-term insurers must value technical reserves for the purposes of their yearly tax-return. As concluded in earlier discussions, the formulation of valuation rules by SARS and National Treasury is not much of a feasible and viable option both from a theoretical and practical point of view.

On the presumption that SARS and National Treasury will accept the valuation rules as proposed by the SAM framework, the next issue that had to be *addressed and considered are the tax-issues commonly encountered when there is a transition from one valuation method to another??* As pointed out in Chapters Three, technical provisions are materially significant and any slight movement or change in valuation methods could result in an extra-ordinary tax-burden for the insurer. Therefore with an aim and purpose of ensuring that short-term insurers are not exposed to a significant tax-burden in the year of transition (i.e. 2015), it is strongly recommended that SARS and National Treasury put in place „concessionary measures’ applicable to the transition from one set of valuation rules to another. In my view, putting concessionary measures in place is crucial as it is rooted in two important aspects of any tax-system, namely „equity/fairness and certainty’. In other words, as a general rule short-term insurers must not be subjected to an unrealistic amount of taxes for which they don’t have the immediate capacity and ability to pay (equity), and secondly, „concessionary measures’ ultimately give short-term insurers the guarantee and assurance to continue their operations as normal without the fear of having a disproportionately and unusually large tax-liability in the year of transition (certainty).

As established in Chapter Five, there is presently no reliable data which can give an indication of the quantitative impact that the proposed valuation rules will have on the current level of technical provisions. However, in the face of limited information and data an attempt was made to recommend or put forward the most appropriate transitional „concessionary measure’. In that analysis the most favoured form of transitional relief was the „intermediate position’, and this is mainly because it results in a favourable outcome for both SARS and the short-term insurer, as the extra tax-burden is not waived completely but rather is spread over a number of years depending on the size of the liability, and many other significant factors.

The second major question or issue addressed under „an appropriate fiscal response’ revolved around the „Research and Development’ costs incurred *vis a vis* the „Internal Model’. The central issue in this regard was whether or not any extra steps should be taken to ensure that short-term insurers get some relief for the expenditures in question. The main conclusion to that issue was a recommendation and support for the enactment of such tax-deductions but with a restriction and special proviso, namely – only applicable to small-to-medium short-term insurers (the distinction between large and small insurers can be ascertained by reference to actual market share or gross written premiums and customer base). The centre-piece of the argument in support of that conclusion was based on the fact that granting such tax-deductions would be one of the many positive steps which can be taken to ensure that small-to-medium short-term insurers are able to survive in the face steep regulatory challenges and costs. The survival of small-to-medium insurers and businesses in general is of paramount importance, especially given that in South Africa there is a staggeringly high number of unemployment and one of the most reliable and proven methods of reducing these high unemployment levels is to support and champion the survival of all small-to-medium enterprises, as opposed to imperilling their existence by a lack of support and inaction.



## BIBLIOGRAPHY

### Books

Emslie T S, Davis D M, Hutton S J, Olivier L, 2001 *Income Tax Cases and Materials*, 3<sup>rd</sup> Edition, The Taxpayer.

John Birds, Norma J Hird, 2004, *Birds' Modern Insurance Law*, 6<sup>th</sup> Edition, London Sweet & Maxwell.

John Lowry, Phillip Rawlings, Robert Merkin, 2011, *Insurance Law: Doctrines and Principles*, 3<sup>rd</sup> Edition, Oxford and Portland, Oregon.

MFB Reinecke, SWJ Van Der Merwe, 1989, *General Principles of Insurance*, Durban Butterworths.

### Electronic Sources

Actuarial Society of South Africa – Convention. (2009). *Market Consistent Value of Liabilities - David Jewell*. [Internet]. Available From:

<[https://docs.google.com/viewer?a=v&q=cache:OFqKl6zMoNYJ:www.actuarialsociety.org.za/Portals/1/Documents/67d68d5d-c491-4146-8bfd-](https://docs.google.com/viewer?a=v&q=cache:OFqKl6zMoNYJ:www.actuarialsociety.org.za/Portals/1/Documents/67d68d5d-c491-4146-8bfd-13c0b009365a.pdf+Actuarial+Society+of+South+Africa,+Market+Consistent+Value+of+Liabilities,+David+Jewell,+2009+Convention&hl=en&gl=za&pid=bl&srcid=ADGEEESicDfG_PHPGT5H8lzhKCWZ0uW9tthy1DbCFdvqPUecESxA6OFIrSJ8ZaLudpBrmULSO0BAvuK88LS6ivIZuMejTZw5bKQp-oL7fETVlqyZ275bQcXT1ipuhlPO9AfvWCqlg5nEO&sig=AHIEtbQxXG2eyQAFgP2BKuIQRfynDa4saA)

[13c0b009365a.pdf+Actuarial+Society+of+South+Africa,+Market+Consistent+Value+of+Liabilities,+David+Jewell,+2009+Convention&hl=en&gl=za&pid=bl&srcid=ADGEEESicDfG\\_PHPGT5H8lzhKCWZ0uW9tthy1DbCFdvqPUecESxA6OFIrSJ8ZaLudpBrmULSO0BAvuK88LS6ivIZuMejTZw5bKQp-](https://docs.google.com/viewer?a=v&q=cache:OFqKl6zMoNYJ:www.actuarialsociety.org.za/Portals/1/Documents/67d68d5d-c491-4146-8bfd-13c0b009365a.pdf+Actuarial+Society+of+South+Africa,+Market+Consistent+Value+of+Liabilities,+David+Jewell,+2009+Convention&hl=en&gl=za&pid=bl&srcid=ADGEEESicDfG_PHPGT5H8lzhKCWZ0uW9tthy1DbCFdvqPUecESxA6OFIrSJ8ZaLudpBrmULSO0BAvuK88LS6ivIZuMejTZw5bKQp-oL7fETVlqyZ275bQcXT1ipuhlPO9AfvWCqlg5nEO&sig=AHIEtbQxXG2eyQAFgP2BKuIQRfynDa4saA)

[oL7fETVlqyZ275bQcXT1ipuhlPO9AfvWCqlg5nEO&sig=AHIEtbQxXG2eyQAFgP2BKuIQRfynDa4saA](https://docs.google.com/viewer?a=v&q=cache:OFqKl6zMoNYJ:www.actuarialsociety.org.za/Portals/1/Documents/67d68d5d-c491-4146-8bfd-13c0b009365a.pdf+Actuarial+Society+of+South+Africa,+Market+Consistent+Value+of+Liabilities,+David+Jewell,+2009+Convention&hl=en&gl=za&pid=bl&srcid=ADGEEESicDfG_PHPGT5H8lzhKCWZ0uW9tthy1DbCFdvqPUecESxA6OFIrSJ8ZaLudpBrmULSO0BAvuK88LS6ivIZuMejTZw5bKQp-oL7fETVlqyZ275bQcXT1ipuhlPO9AfvWCqlg5nEO&sig=AHIEtbQxXG2eyQAFgP2BKuIQRfynDa4saA)> [Accessed April – August 2012].

Esterhuizen, N. ([nico@saia.co.za](mailto:nico@saia.co.za)) 2012 *SAM Framework - Analysis of the SA QIS 1 Results* [Personal e-mail, 30 July 2012] to E. Chivaura ([echivaura@gmail.com](mailto:echivaura@gmail.com)).

Fin24 - Financial Services. (2011). *Short-term insurance under pressure*. [Internet]. Available From: <<http://m.news24.com/fin24/Companies/Financial-Services/Short-term-insurance-under-pressure-20110315>> [Accessed April - August 2012].

FSA Solvency II. (2012). *Solvency II Level 1 Text Directives, 25 November 2009 [PDF]*. [Internet]. Available From: <<http://www.fsa.gov.uk/solvency2>> [Accessed April – August 2012].

FSB Insurance Department. (2011). *SAM Report on the results of 1<sup>st</sup> South African Quantitative Impact Study – SA QIS 1*. [Internet]. Available From: <[https://docs.google.com/viewer?a=v&q=cache:1CWUa26ppYAJ:ftp://ftp.fsb.co.za/public/insurance/SAM/SAQIS1/SAQIS1\\_Results\\_20111215.pdf+FSB+%E2%80%93+SAM+QIS+1+Results,+2011&hl=en&gl=za&pid=bl&srcid=ADGEEShRrj3iHVoxzaU00jEcpaXjADAYPWIs1C\\_uJWFEkVZ3T10Oo-SUomH5mAdcpUvk7skfRLk68r8oUvByPe5GOLNpH4pmc4HTGftA1tYS\\_Nq51dPOwV2xtyuU52DR4Ch0w40XThDU&sig=AHIEtbT5LQa4Gfu2WwIQrjxysqcL7WTVnA](https://docs.google.com/viewer?a=v&q=cache:1CWUa26ppYAJ:ftp://ftp.fsb.co.za/public/insurance/SAM/SAQIS1/SAQIS1_Results_20111215.pdf+FSB+%E2%80%93+SAM+QIS+1+Results,+2011&hl=en&gl=za&pid=bl&srcid=ADGEEShRrj3iHVoxzaU00jEcpaXjADAYPWIs1C_uJWFEkVZ3T10Oo-SUomH5mAdcpUvk7skfRLk68r8oUvByPe5GOLNpH4pmc4HTGftA1tYS_Nq51dPOwV2xtyuU52DR4Ch0w40XThDU&sig=AHIEtbT5LQa4Gfu2WwIQrjxysqcL7WTVnA)> [Accessed April – August 2012].

FSB Insurance Department. (2010). *Solvency Assessment and Management (SAM) Roadmap*. [Internet]. Available From: <[https://docs.google.com/viewer?a=v&q=cache:eIVaB-jUdsoJ:ftp://ftp.fsb.co.za/public/media/SAMROADMAP2010.pdf+Solvency+Assessment+and+Management+\(SAM\)+Roadmap+2010&hl=en&gl=za&pid=bl&srcid=ADGEEShCr7p18Zkef9m9hJ90GBUTGdy\\_3GQ6qO4UqDC\\_fl\\_6mcdOVUQuqji0SIKn7GNafybrJ6E51NDkeyAp\\_bNOv0EVH5yai6ul8OIV6PvWEY7\\_GddoCY1WzTp-zQU-lmlPYdPjfoJH&sig=AHIEtbTkQwZs6Th0jmcFsyfucIqD9NkMBg](https://docs.google.com/viewer?a=v&q=cache:eIVaB-jUdsoJ:ftp://ftp.fsb.co.za/public/media/SAMROADMAP2010.pdf+Solvency+Assessment+and+Management+(SAM)+Roadmap+2010&hl=en&gl=za&pid=bl&srcid=ADGEEShCr7p18Zkef9m9hJ90GBUTGdy_3GQ6qO4UqDC_fl_6mcdOVUQuqji0SIKn7GNafybrJ6E51NDkeyAp_bNOv0EVH5yai6ul8OIV6PvWEY7_GddoCY1WzTp-zQU-lmlPYdPjfoJH&sig=AHIEtbTkQwZs6Th0jmcFsyfucIqD9NkMBg)> [Accessed April – August 2012].

FSB Insurance Department. (2010). *National Treasury, Government Gazette No. 32993, 1 March 2010, Board Notice 27 of 2010, Part 4.3, Financial Services Board, Registrar of Short-term Insurance, (Short-term Insurance Act, 1998 (Act No. 53 of 1998))*. [Internet]. Available From: <[https://docs.google.com/viewer?a=v&q=cache:d380cbETH7MJ:www.greengazette.co.za/documents/national-gazette-32993-of-01-mar-2010-vol-537\\_20100301-GGN-32993.pdf](https://docs.google.com/viewer?a=v&q=cache:d380cbETH7MJ:www.greengazette.co.za/documents/national-gazette-32993-of-01-mar-2010-vol-537_20100301-GGN-32993.pdf)> [Accessed April – August 2012].

d+Notice+27+of+2010,+Part+4.3,+Financial+Services+Board,+Registrar+of&hl=en&gl=za  
&pid=bl&srcid=ADGEESiRhM2lUc2PmLXuNS5GZ0bKrFEgseSfcIf\_bWoY44zvJzwKbqZ  
2cmpwBEarqOmbxTsl8ViJkzCttVkYBdX-pO8DGdpStLEyPQ-  
ncB5hKsOkgl82FbHJLt3CBsPuvT5Ouzd5mD\_s&sig=AHIEtbRfZ7ZTk2YJ0sLR9ka5jvX6q  
1TgHA> [April – August 2012].

FSB Insurance Department. (2011). *National Treasury, Government Gazette No. 34175, 28 October 2011, Board Notice 169 of 2011, Part 4.1.1, Financial Services Board, Registrar of Short-term Insurance, (Short-term Insurance Act, 1998 (Act No. 53 of 1998)).* [Internet].

Available From:

<[https://docs.google.com/viewer?a=v&q=cache:lFpShq8RLRQJ:ftp://ftp.fsb.co.za/public/insurance/BoardNotice169of2011p3top25.pdf+Board+Notice+169+of+2011,+Financial+Service+Board,+Registrar+of&hl=en&gl=za&pid=bl&srcid=ADGEESgdlrhYNTToGHah\\_hpPeEMuGU1GREyFPAvMc6yaU\\_3L7aG2VV9VF2jmbtcZoHrh3cxCvmCAcyJEV4ZlnM7NcMDg6x5qVJ3TmD4CDKeoN9ZJrjeYhdt3xt0bm-uZ7Sphsr10hCQd3&sig=AHIEtbR2oD1KmrWwVdfdCj4vbITQEgFA9Q](https://docs.google.com/viewer?a=v&q=cache:lFpShq8RLRQJ:ftp://ftp.fsb.co.za/public/insurance/BoardNotice169of2011p3top25.pdf+Board+Notice+169+of+2011,+Financial+Service+Board,+Registrar+of&hl=en&gl=za&pid=bl&srcid=ADGEESgdlrhYNTToGHah_hpPeEMuGU1GREyFPAvMc6yaU_3L7aG2VV9VF2jmbtcZoHrh3cxCvmCAcyJEV4ZlnM7NcMDg6x5qVJ3TmD4CDKeoN9ZJrjeYhdt3xt0bm-uZ7Sphsr10hCQd3&sig=AHIEtbR2oD1KmrWwVdfdCj4vbITQEgFA9Q)> [Accessed April – August 2012].

FSB Insurance Department. (2011). *SAM Interim Measures Insurance Regulatory Seminar, 12 & 19 October.* [Internet]. Available from:

<[https://docs.google.com/viewer?a=v&q=cache:fd0CyFTSRXsJ:ftp://ftp.fsb.co.za/public/insurance/SAM/InterimMeasures/IM\\_Prescribedreqcalculation.pdf+SAM+Interim+Measures+Insurance+Regulatory+Seminar,&hl=en&gl=za&pid=bl&srcid=ADGEEShY\\_pcHFSO2rya151ekPyR0MQq9y337mQOSXwBK0HLg-zToC3TD4\\_wK3rQEzZbYpAir\\_LrVR5J6peGNQUYRTTgWQfdtq3gHBLFEG9vCTA52UbHYzftkL27BtpB3KQE\\_Zkp46tjz&sig=AHIEtbSKd1YfJa3d6zBxP\\_fBg3kXNEf4ng](https://docs.google.com/viewer?a=v&q=cache:fd0CyFTSRXsJ:ftp://ftp.fsb.co.za/public/insurance/SAM/InterimMeasures/IM_Prescribedreqcalculation.pdf+SAM+Interim+Measures+Insurance+Regulatory+Seminar,&hl=en&gl=za&pid=bl&srcid=ADGEEShY_pcHFSO2rya151ekPyR0MQq9y337mQOSXwBK0HLg-zToC3TD4_wK3rQEzZbYpAir_LrVR5J6peGNQUYRTTgWQfdtq3gHBLFEG9vCTA52UbHYzftkL27BtpB3KQE_Zkp46tjz&sig=AHIEtbSKd1YfJa3d6zBxP_fBg3kXNEf4ng)> [Accessed April – August 2012].

FSB. (2011). *Annual Report.* [Internet]. Available From:

<<http://www.fsb.co.za/communication/reports.htm>> [Accessed April - August 2012].

International Actuarial Association (IAA). (2010). *Note on the use of Internal Models for Risk and Capital Management Purposes by Insurers.* [Internet]. Available From:

<[http://webcache.googleusercontent.com/search?q=cache:mKGsWUo4qbkJ:www.actuaries.org/CTTEES\\_SOLV/Documents/Internal\\_Models\\_EN.pdf+International+Actuarial+Association+\(IAA\);+Note+on+the+use+of+Internal+Models+for+Risk+and+Capital+Management+Purposes+by+Insurers,+November+2010&hl=en&gl=za](http://webcache.googleusercontent.com/search?q=cache:mKGsWUo4qbkJ:www.actuaries.org/CTTEES_SOLV/Documents/Internal_Models_EN.pdf+International+Actuarial+Association+(IAA);+Note+on+the+use+of+Internal+Models+for+Risk+and+Capital+Management+Purposes+by+Insurers,+November+2010&hl=en&gl=za)> [Accessed April - August 2012].

International Association of Insurance Supervisors (IAIS). (2007). *Guidance Paper on the use of Internal Models for Risk and Capital Management Purposes by Insurers*. [Internet]. Available from:

<[http://webcache.googleusercontent.com/search?q=cache:C5y-sX54gm0J:www.iaisweb.org/\\_temp/2\\_2\\_7\\_Guidance\\_paper\\_on\\_the\\_use\\_of\\_internal\\_models\\_for\\_risk\\_and\\_capital\\_management\\_by\\_insurers.pdf+International+Association+of+Insurance+Supervisors+\(IAIS\);+Guidance+Paper+on+the+use+of+Internal+Models+for+Risk+and+Capital+Management+Purposes+by+Insurers,+19+October+2007,&hl=en&gl=za](http://webcache.googleusercontent.com/search?q=cache:C5y-sX54gm0J:www.iaisweb.org/_temp/2_2_7_Guidance_paper_on_the_use_of_internal_models_for_risk_and_capital_management_by_insurers.pdf+International+Association+of+Insurance+Supervisors+(IAIS);+Guidance+Paper+on+the+use+of+Internal+Models+for+Risk+and+Capital+Management+Purposes+by+Insurers,+19+October+2007,&hl=en&gl=za)> [Accessed April - August 2012].

KPMG Financial Services - United Kingdom. (2012). *Business and Industry Issue: Are insurers maximising their research and development claims?* [Internet]. Available From: <<http://www.kpmg.com/uk/en/issuesandinsights/articlespublications/pages/insurers-maximising-research-development-claims.aspx>> [Accessed April - August 2012].

MONEYWEB. (2012). *Economic Trends: Big Insurance players losing market share*. [Internet]. Available From: <<http://www.moneyweb.co.za/mw/content/en/moneyweb-economic-trends?oid=561659&sn=2009%20Detail>> [Accessed April - August 2012].

National Bureau of Economic Research. (1997). *The Influence of Income Tax Rules on Insurance Reserves, Working Paper Series No 5902, JEL Nos. G22, G38, H25. David F. Bradford, Kyle D. Logue*. [Internet]. Available From: <<http://www.nber.org/papers/w5902>> [April – August 2012].

OECD. (1997). *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices*. [Internet]. Available From:

<[https://docs.google.com/viewer?a=v&q=cache:RYcAjpTVeuoJ:www.oecd.org/dataoecd/10/59/2090740.pdf+small+businesses+job+creation&hl=en&gl=za&pid=bl&srcid=ADGEESjy-mlGGWvP9qyhgF\\_JrgJECozwbEdU0K4n3i2fGjSTU8uCuVfs2pCm2\\_ffVd1OvLnFEN6i4V](https://docs.google.com/viewer?a=v&q=cache:RYcAjpTVeuoJ:www.oecd.org/dataoecd/10/59/2090740.pdf+small+businesses+job+creation&hl=en&gl=za&pid=bl&srcid=ADGEESjy-mlGGWvP9qyhgF_JrgJECozwbEdU0K4n3i2fGjSTU8uCuVfs2pCm2_ffVd1OvLnFEN6i4V)>

6sH08kTTYUcKjR2\_iAQ5hKq24EbGZ-

OUBqf\_qldZfJcmwf2TJc7q49OULzWuG&sig=AHIEtbTPjUT4mU1oNS0NjfVrX\_\_QXZza  
DQ> [Accessed April – August 2012].

OECD. (1999). *Committee on Fiscal Affairs, Taxing Insurance Companies, Insurance and Private Pensions Compendium For Emerging Economies, Book 1, Part 1:7)a, 1999.*

[Internet]. Available From:

<[https://docs.google.com/viewer?a=v&q=cache:\\_ZiZ53tV7XoJ:www.oecd.org/dataoecd/47/10/1815278.pdf+OECD+%E2%80%93+Committee+on+Fiscal+Affairs,+Insurance+and+Private+Pensions+Compendium+For+Emerging+Economies,+Book+1,+Part+1:7&hl=en&gl=za&pid=bl&srcid=ADGEEsJpBvIzVtF3IHuRWOx\\_rEI8FLbhdWACn\\_-ORqWrJ9-](https://docs.google.com/viewer?a=v&q=cache:_ZiZ53tV7XoJ:www.oecd.org/dataoecd/47/10/1815278.pdf+OECD+%E2%80%93+Committee+on+Fiscal+Affairs,+Insurance+and+Private+Pensions+Compendium+For+Emerging+Economies,+Book+1,+Part+1:7&hl=en&gl=za&pid=bl&srcid=ADGEEsJpBvIzVtF3IHuRWOx_rEI8FLbhdWACn_-ORqWrJ9-)

[LYF5yExIyuMRCRAk8abinPgm2Cc\\_ZtdglFkxXXwG5RObWW1jFdVwd2U7L0DV64vbQMZoBW-TUz6vBc7HF-hFFsNfOmSu2&sig=AHIEtbS6Z2MgjSIf0Xk48mDXvjw1Ohk6eg](https://docs.google.com/viewer?a=v&q=cache:_ZiZ53tV7XoJ:www.oecd.org/dataoecd/47/10/1815278.pdf+OECD+%E2%80%93+Committee+on+Fiscal+Affairs,+Insurance+and+Private+Pensions+Compendium+For+Emerging+Economies,+Book+1,+Part+1:7&hl=en&gl=za&pid=bl&srcid=ADGEEsJpBvIzVtF3IHuRWOx_rEI8FLbhdWACn_-ORqWrJ9-LYF5yExIyuMRCRAk8abinPgm2Cc_ZtdglFkxXXwG5RObWW1jFdVwd2U7L0DV64vbQMZoBW-TUz6vBc7HF-hFFsNfOmSu2&sig=AHIEtbS6Z2MgjSIf0Xk48mDXvjw1Ohk6eg)>  
[April – August 2012].

Outreville Francois J. (1998). *Theory and Practice of Insurance - Kluwer Academic Publishers* [Internet]. Available From:

[http://books.google.co.za/books?id=CoSYojFGf-](http://books.google.co.za/books?id=CoSYojFGf-cC&pg=PA234&lpg=PA234&dq=unearned+premium+reserve&source=bl&ots=QIPuwsSAxL&sig=vPx6E-ZVol4Xjvh_IO3dNK8fuMI&hl=en&sa=X&ei=WI8VULWMNdO7hAez74DQDA&ved=0CDEQuwUwAA#v=onepage&q=unearned%20premium%20reserve&f=false)

[cC&pg=PA234&lpg=PA234&dq=unearned+premium+reserve&source=bl&ots=QIPuwsSAxL&sig=vPx6E-ZVol4Xjvh\\_IO3dNK8fuMI&hl=en&sa=X&ei=WI8VULWMNdO7hAez74DQDA&ved=0CDEQuwUwAA#v=onepage&q=unearned%20premium%20reserve&f=false](http://books.google.co.za/books?id=CoSYojFGf-cC&pg=PA234&lpg=PA234&dq=unearned+premium+reserve&source=bl&ots=QIPuwsSAxL&sig=vPx6E-ZVol4Xjvh_IO3dNK8fuMI&hl=en&sa=X&ei=WI8VULWMNdO7hAez74DQDA&ved=0CDEQuwUwAA#v=onepage&q=unearned%20premium%20reserve&f=false)> [Accessed April – August 2012].

PWC. (2011). *South African Insurance Industry Analysis*. [Internet]. Available From:

<<http://www.pwc.co.za/en/publications/insurance-industry-analysis.jhtml>>

[Accessed April–August 2012].

PWC. (2012). *Maximising value from today's opportunities, Strategic and Emerging Issues in South African Insurance 2012, Fifth Edition*. [Internet]. Available From:

<<http://www.pwc.co.za/en/publications/insurance-survey-south-africa.jhtml>>

[Accessed April – August 2012].

R L Bornhuetter & R E Ferguson. (1972). *The Actuary and IBNR: 181 – 190*. [Internet]. Available:

<[https://docs.google.com/viewer?a=v&q=cache:4Q3NAg0Amg4J:bb.shufe.edu.cn/bbcswebdav/institution/%25E9%2587%2591%25E8%259E%258D%25E5%25AD%25A6%25E9%2599%25A2/teacherweb/2004000099/ExtensiveReading05.pdf+&hl=en&gl=za&pid=bl&srcid=ADGEESjic6yG0ZIymbFz\\_BVi\\_hgLGoH8XaRRAM-ScMjuWCCEn1VINXGpnILzu2PS\\_oC5ArFPAYr7oLJ6hJBafld0sqhlpTfXMxe1-r1a\\_qmNplProlDkqejsBex33DHkWmuqxUkuBqYw&sig=AHIEtbRv6rho6jWyxZ9u9y3BS0BXaxgNZQ](https://docs.google.com/viewer?a=v&q=cache:4Q3NAg0Amg4J:bb.shufe.edu.cn/bbcswebdav/institution/%25E9%2587%2591%25E8%259E%258D%25E5%25AD%25A6%25E9%2599%25A2/teacherweb/2004000099/ExtensiveReading05.pdf+&hl=en&gl=za&pid=bl&srcid=ADGEESjic6yG0ZIymbFz_BVi_hgLGoH8XaRRAM-ScMjuWCCEn1VINXGpnILzu2PS_oC5ArFPAYr7oLJ6hJBafld0sqhlpTfXMxe1-r1a_qmNplProlDkqejsBex33DHkWmuqxUkuBqYw&sig=AHIEtbRv6rho6jWyxZ9u9y3BS0BXaxgNZQ)> [April – August 2012].

SARS. (2001). *Short-term Insurance Business: Withdrawal of Contingency reserve Gazette No: 22560, Notice No: 743, 17 August 2001*. [Internet]. Available From:

<<http://www.sars.gov.za/home.asp?pid=4576>> [Accessed April – August 2012].

SBP Business Environment Specialist. (2009). *Small Business Development in South Africa – Time to re-assess* [Internet]. Available From:

<[https://docs.google.com/viewer?a=v&q=cache:C3vJRzqBD0MJ:www.africa.fnst-freiheit.org/news/sbp-alert-smme-development-in-sa-august-09-digital.pdf+small+businesses+job+creation&hl=en&gl=za&pid=bl&srcid=ADGEESho\\_RyfQuO811-49DA5hpDL8vbw5ZxJsUxV8TtvCtAW7wbjTNhWhJdZnH\\_wLSBZri46iShFeVtg\\_Cha2cWdIKpBGdAE9ZSAw8j5C9ZLM0W06veTupH1Cl-DvXUaesvhoCz7k2dQ&sig=AHIEtbREd1qTOQR3spXvxTvM8TYZdvJxyg](https://docs.google.com/viewer?a=v&q=cache:C3vJRzqBD0MJ:www.africa.fnst-freiheit.org/news/sbp-alert-smme-development-in-sa-august-09-digital.pdf+small+businesses+job+creation&hl=en&gl=za&pid=bl&srcid=ADGEESho_RyfQuO811-49DA5hpDL8vbw5ZxJsUxV8TtvCtAW7wbjTNhWhJdZnH_wLSBZri46iShFeVtg_Cha2cWdIKpBGdAE9ZSAw8j5C9ZLM0W06veTupH1Cl-DvXUaesvhoCz7k2dQ&sig=AHIEtbREd1qTOQR3spXvxTvM8TYZdvJxyg)> [Accessed April – August 2012].

South African Insurance Association (SAIA). (2011). *Annual Reviews*. [Internet]. Available From: <<http://www.saia.co.za/about/annual-reviews.html>> [Accessed April - August 2012].

Wikipedia. (2012). *Financial Services Board (South Africa)*. [Internet]. Available From: <[http://en.wikipedia.org/wiki/Financial\\_Services\\_Board\\_\(South\\_Africa\)](http://en.wikipedia.org/wiki/Financial_Services_Board_(South_Africa))> [Accessed April - August 2012].

YOUTUBE. (2012). *South Africa's Insurance Sector with Victor Muguto*. [Internet]. Available From: <<http://www.youtube.com/watch?v=rpzprUa1HTI>> [Accessed April – August 2012].

## **South African government publications, legislation and explanatory memoranda**

South Africa - National Treasury, South African Revenue Services (SARS). 2008. *Explanatory Memorandum on the Revenue Amendment Bill, 2008*. Pretoria: Government Printer.

South Africa - National Treasury, South African Revenue Services (SARS). 2010. *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010*. Pretoria: Government Printer.

South Africa. 1962. *Income Tax Act No. 58 of 1962*. Pretoria: Government Printer.

South Africa. 1998. *Short-term Insurance Act No 53 of 1998*. Pretoria: Government Printer.

## **Personal Communication**

Hantie van Heerden - HOD: FSB Insurance Department, [hantie.vanheerden@fsb.co.za](mailto:hantie.vanheerden@fsb.co.za) 2012. [Personal and Verbal Communication] August 10.

Marthinus (Tienie) Hamman – FSB: SAM Tax Task Group, [Marthinus.hamman@fsb.co.za](mailto:Marthinus.hamman@fsb.co.za) 2012. [Personal and Verbal Communication] July 6.

Richard Masson – Marsh Insurance Brokers, Incorporating Alexander Forbes, [Richard.masson@marsh.com](mailto:Richard.masson@marsh.com) 2012. [Personal and Verbal Communication] May 22.