THE TAX CONSEQUENCES OF THE TRANSFER OF TECHNICAL RESERVES BETWEEN SHORT-TERM INSURERS AS PART OF A PORTFOLIO TRANSFER

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ABSTRACT

This dissertation focusses on the tax implications of a portfolio transfer between short-term insurers. The commercial purpose of a portfolio transfer is for one insurer ('transferee') to effectively take over the insurance policies of another insurer ('transferor'), with no negative impact on the interest of the policy holders. In order to effect a portfolio transfer, the technical reserves recognised by the transferor in its Annual Financial Statements ('AFS') are transferred to the transferee along with the working capital backing these reserves. The working capital is essentially an amount of cash and other liquid assets equal to the net technical reserve value.

The research question that is addressed by this dissertation is:
Does the current income tax legislation sufficiently address the tax consequences of the transfer of technical reserves and working capital between short-term insurers as part of a portfolio transfer to yield a fair and reasonable result from a tax perspective?

In addressing the research question the dissertation analyses the nature of technical reserves from an accounting and regulatory perspective and considers the tax treatment thereof under the provisions of section 28 of the Income Tax Act No. 58 of 1962 ('IT Act'), which deals with the taxation of short-term insurance business. It considers the tax implications of a portfolio transfer of technical reserves from both the perspective of the transferor and the transferee and considers international practise in this regard.

This dissertation concludes that although the working capital will be included in the taxable income of the transferee (purchaser) there will not necessarily be a deduction from taxable income available for the transferor (seller). The transfer of technical reserves and working capital does not result in a profit or loss for either the transferor or the transferee and consequently such a transfer would be expected to be tax neutral. The tax treatment is therefore not in line with the commercial purpose of a portfolio transfer.

Amendments to section 28 are thus required to specifically confirm that a deduction of the working capital will be available for the transferor (seller) and that the amount be included in the income of the transferee (purchaser) as this will create certainty and

avoid inconsistent results from a tax policy perspective, especially given the significant values involved in these transactions.

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LIST OF ABBREVIATIONS

AFS	Annual Financial Statements
CIR	Commissioner for Inland Revenue
COT	Commissioner of Taxes
DAC	Deferred Acquisition Cost
EM	Explanatory Memorandum
EU	European Union
FINMA	Swiss Financial Market Supervisory Authority
GAAP	Generally Accepted Accounting Practise
IAS 37	International Accounting Standard 37
IBNR	Reserve for Incurred But Not Reported Claims
IFRS 4	International Financial Reporting Standard 4: Insurance Contracts
IFRS 17	International Financial Reporting Standard 17: Insurance Contracts
IN 94	Interpretation Note 94: Contingent liabilities assumed in the acquisition of a going concern
Insurance Act	Insurance Act No. 18 of 2017
IT Act	Income Tax Act No. 58 of 1962
ITC	Income Tax Case
KBI	Kommissaris van Binnelandse Inkomste
KBR	Key Business Relationship
OCR	Outstanding Claims Reserve
SAICA	The South African Institute of Chartered Accountants
SAM	Solvency Assessment and Management
SARS	South African Revenue Service
SOCI	Statement of Comprehensive Income
SOFP	Statement of Financial Position
STI Act	Short-term Insurance Act No. 53 of 1998
TCA	Taxes Consolidation Act 1997
TLAB	Taxation Laws Amendment Bill, 2012
UK	United Kingdom
UPR	Unearned Premium Reserve
US	United States
VOBA	Value of Business Acquired

CHAPTER 1: INTRODUCTION

1.1 Background

The tax treatment of the transfer of technical reserves and working capital between short-term insurers as part of a portfolio transfer remain an area of uncertainty. The commercial purpose of a portfolio transfer is for one insurer ('transferee') to effectively take over a specified portfolio of insurance policies of another insurer ('transferor'), with no negative impact on the interest of the policyholders.

A portfolio transfer is essentially similar to the sale of a business as a going concern which refers to "the circumstances in which a person sells all or part of a business which is capable of separate operation and constitutes an income-earning activity in its own right at the date of sale".[1] The insurance policies entered into by the transferor are binding on the transferee and the transferee is required to provide insurance services to these policyholders under the terms of the insurance contract concluded by the transferor and the policyholder. Hence the transferee is immediately able to conduct insurance business with these policyholders.

In order to effect a portfolio transfer, the technical reserves recognised by the transferor in its Annual Financial Statements ('AFS') are transferred to the transferee along with the working capital backing these reserves. The technical reserves and working capital so transferred essentially entails the transfer of the assets and liabilities of the going concern of the insurance business and the net value of these assets and liabilities should be zero.

The technical reserves typically consist of an Unearned Premium Reserve ('UPR'), Outstanding Claims Reserve ('OCR') and Reserve for Incurred But Not Reported Claims ('IBNR') from a liability perspective. The UPR represents premium income for insurance services not yet supplied and OCR and IBNR are provisions for claims incurred under these policies which have not yet been paid. The only typical technical asset reserve is Deferred Acquisition Cost ('DAC'), which represents commission expense in respect of

[1] Interpretation Note 94, 2016:paragraph 2

policies where the recognition of the premium is deferred due to the insurance service not yet having been supplied. The net position of technical reserves is almost always a net liability. The working capital is essentially an amount of cash and other liquid assets equal to the net technical reserve value.

In most instances the full purchase price of the portfolio transfer would be allocated to intangible assets such as Value of Business Acquired ('VOBA') and Key Business Relationships ('KBR') from the perspective of the transferee, resulting in no Day 1 profit or loss. Refer to Transaction 2 (Transferee) of the illustrative accounting entries below. This is because the net value of technical reserves and working capital (i.e. net asset value of the business) is zero. Refer to Transaction 1 of the illustrative accounting entries below. The purchase price therefore does not include an amount to "pay" for the net asset value of the business as would normally be the case with the sale of a business as a going concern. Where the particular book of business transferred does not contain valuable intangible assets that the transferee is willing to pay for, the transfer is often done with Rnil consideration.

The transferor could potentially realise a profit on the sale of the business as a going concern as indicated in Transaction 2 (Transferor) of the illustrative accounting entries below. However, please note that Transaction 2 is excluded from the scope of this dissertation as indicated in section 1.4.

Illustrative accounting entries of a portfolio transfer:

	Transferor		**Transferee**	
	Debit	**Credit**	**Debit**	**Credit**
Transaction 1: Transfer of assets and liabilities				
UPR	1,500,000			1,500,000
OCR	250,000			250,000
IBNR	200,000			200,000
Bank (Working Capital)		1,950,000	1,950,000	
	Transferor		**Transferee**	
	Debit	**Credit**	**Debit**	**Credit**

Transaction 2: Purchase price				
Bank (Purchase Price)	40,000,000			40,000,000
VOBA & KBR			40,000,000	
Profit on the sale of business		40,000,000		

Section 28(3) of the Income Tax Act No. 58 of 1962 ('IT Act') allows for the closing balance of the technical liability reserves net of the technical asset reserves at year end to be deducted from taxable income. Any amounts deducted from taxable income in respect of a prior year should be included in the taxable income of the next year in terms of section 28(4). The effect of these adjustments are in line with the adjustments in the Statement of Comprehensive Income ('SOCI') from an accounting perspective and consequently the impact on taxable income is equal to the impact on accounting profit before tax in respect of these particular transactions.

Example 1

The transferor has a December year-end and received premium income of R2 million in respect of policies effective from 1 July 2018 – 30 June 2019 and R3 million for the year thereafter. Due to the year ending halfway through the policies' effective period the UPR balance at 31 December 2018 is R1 million and R1.5 million at 31 December 2019. The claims reserve balances (OCR & IBNR) amounts to R250,000 and R450,000 at 31 December 2018 and 31 December 2019 respectively.

Illustrative SOCI and Tax Calculation of the transferor:

	December 2019	**December 2018**
SOCI		
Premium income	3,000,000.00	2,000,000.00
UPR	-500,000.00	-1,000,000.00
Claims provisions (OCR + IBNR)	-200,000.00	-250,000.00
Profit before tax	**2,300,000.00**	**750,000.00**

Taxable Income		
Profit before tax	2,300,000.00	750,000.00
Add back movement in accounting provisions		
UPR	500,000.00	1,000,000.00
Claims provisions (OCR + IBNR)	200,000.00	250,000.00
Deduct section 28 current year balances:		
UPR	-1,500,000.00	-1,000,000.00
Claims provisions (OCR + IBNR)	-450,000.00	-250,000.00
Add back section 28 prior year balances:		
UPR	1,000,000.00	-
Claims provisions (OCR + IBNR)	250,000.00	-
Taxable income	**2,300,000.00**	**750,000.00**

However, the implication of section 28 on a portfolio transfer would effectively be that the transferor would be taxed on the technical liability reserves transferred (seeing as the balance is included in the amount of technical liability reserves added back in respect of the prior year, whereas it is not included in the closing balance of the current year to be deducted) and the transferee would get a deduction of the technical liability reserves transferred.

Example 2

The same facts apply as in Example 1, except that a portfolio transfer occurred on 31 December 2019. This entailed the transfer of the technical reserves from the transferor to the transferee of R1,950,000 (UPR + OCR + IBNR) and the payment of R1,950,000 in cash by the transferor to the transferee in respect of the working capital.

The accounting entry for the portfolio transfer only affects the Statement of Financial Position ('SOFP'), being assets (Bank) and liability entries (UPR, OCR & IBNR) with no impact on the SOCI as indicated in Transaction 1 of the "Illustrative accounting entries of a portfolio transfer" above.

In this example the working capital is not included in taxable income for the transferee or allowed as a deduction from the taxable income of the transferor, seeing as the tax treatment of the working capital transferred is not addressed by section 28.

Illustrative SOCI and Tax Calculation of the transferor:

	December 2019	December 2018
<u>SOCI</u>		
Premium income	3,000,000.00	2,000,000.00
UPR	-500,000.00	-1,000,000.00
Claims provisions (OCR + IBNR)	-200,000.00	-250,000.00
Profit before tax	**2,300,000.00**	**750,000.00**
<u>Taxable Income</u>		
Profit before tax	2,300,000.00	750,000.00
<u>Add back movement in accounting provisions</u>		
UPR	500,000.00	1,000,000.00
Claims provisions (OCR + IBNR)	200,000.00	250,000.00
<u>Deduct section 28 current year balances:</u>		
UPR	-	-1,000,000.00
Claims provisions (OCR + IBNR)	-	-250,000.00
<u>Add back section 28 prior year balances:</u>		
UPR	1,000,000.00	-
Claims provisions (OCR + IBNR)	250,000.00	-
Taxable income	**4,250,000.00**	**750,000.00**

Illustrative SOCI and Tax Calculation of the transferee:

	December 2019	December 2018
<u>SOCI</u>		
Premium income	-	-
UPR	-	-
Claims provisions (OCR + IBNR)	-	-
Profit before tax	**-**	**-**

Taxable Income		
Profit before tax	-	-
Add back movement in accounting provisions		
UPR	-	-
Claims provisions (OCR + IBNR)	-	-
Deduct section 28 current year balances:		
UPR	-1,500,000.00	-
Claims provisions (OCR + IBNR)	-450,000.00	-
Add back section 28 prior year balances:		
UPR	-	-
Claims provisions (OCR + IBNR)	-	-
Taxable income	**-1,950,000.00**	**-**

In essence a portfolio transfer should not result in any adverse tax consequences. One insurer effectively takes over the insurance policies of another insurer and stands in the shoes of the other insurer, with no negative impact on the interest of the policyholders. In addition, the transfer of technical reserves and working capital portion of the transaction does not result in a profit or loss for either the transferor or transferee.

It is clear from Example 2 that the impact of the provisions currently contained in section 28 results in a recoupment of the total value of the technical reserves for the transferor and a deduction of this value for the transferee. In order for the tax treatment to be brought in line with the commercial purpose of a portfolio transfer it follows that the working capital would have to be included in the taxable income of the transferee and allowed as a deduction from the taxable income of the transferor. However, there are various uncertainties currently experienced when determining the tax treatment of the working capital.

This dissertation will analyse the tax treatment of the working capital from both the perspective of the transferor and the transferee to demonstrate the uncertainty currently experienced by insurers in this regard.

1.2 Research question

It is imperative that sufficient certainty regarding the tax rules exist in order for insurers to make decisions based on the expected tax consequences and to ensure that these rules are consistently applied for all portfolio transfers, especially due to the significant financial amounts involved in a portfolio transfer. The current level of uncertainty raises the level of risk associated with a portfolio transfer and makes the transaction more expensive for insurers, with the result that transactions that are crucial from a business perspective are delayed or discouraged.

The research question that will therefore be addressed by this dissertation is:

Does the current legislation sufficiently address the tax consequences of the transfer of technical reserves between short-term insurers as part of a portfolio transfer to yield a fair and reasonable result from a tax perspective?

1.3 Research method

The method this dissertation will use is a theoretical approach of legal interpretative research. The research can be categorised as doctrinal in nature which "provides a systematic exposition of the rules governing a particular legal category, analyses the relationships between rules, explains areas of difficulty and, perhaps, predicts future developments"[2].

The research is qualitative in nature and involves a study of the relevant legislation and case law, proposed amendments to the relevant legislation in 2011 and the related commentary, Interpretation Note 94 ('IN 94') issued by the South African Revenue Service ('SARS'), journal articles, etc. The research will also consider the tax treatment applied by other countries.

[2] Hutchinson & Duncan, 2012:101

The countries selected for this dissertation include the United Kingdom, Switzerland and Irelandon the basis that the tax legislation of short-term insurers (also referred to as general insurers in certain countries) in these countries is based on International Financial Reporting Standards ('IFRS'), which aligns to the approach adopted in South Africa.

A detailed analysis of the nature of the technical reserves transferred as part of a portfolio transfer will be provided in order to apply the legal principles obtained from the sources studied, to identify the relevant issues from an income tax perspective and to draw an effective and meaningful conclusion in this regard. The research will focus on the tax treatment of the working capital and technical reserve assets and liabilities both from the perspective of the transferee and transferor.

The relevance and necessity of the proposed amendments contained in the Tax Law Amendment Bill of 2011, as published on 2 June 2011, will also be analysed to conclude on the need for legislative changes. These changes will be considered in the light of portfolio transfers specifically and could potentially be incorporated as part of section 28, seeing as the changes were already discarded in respect of general contingent liabilities transferred as part of the sale of a business as a going concern.

1.4 Limitations

It should be noted that the Short-term Insurance Act No. 53 of 1998 ('STI Act') was effectively replaced by the Insurance Act No. 18 of 2017 ('Insurance Act') during 2018, however, this dissertation references the STI Act for definitions of technical reserves as it was more prescriptive and contained formulas for each type of reserve (in line with IFRS) where the current Insurance Act merely refers to "insurance obligations". The research is further limited to the technical reserves recognised by most short-term insurers. Contingency Reserves and Unexpired Risk Provisions are specifically excluded as these are only recognised by some short-term insurers in very particular circumstances.

It should further be noted that IFRS 4 will be replaced by IFRS 17 as of 1 January 2022. Under the new accounting standard, the method of reserving will change significantly. However, seeing as section 28(3) of the IT Act effectively refers to "amounts recognised as insurance liabilities, in accordance with IFRS", the change in reserving method from IFRS 4 to IFRS 17 will not impact the principles discussed in this dissertation.

The dissertation is limited to the transfer of assets and liabilities part of a portfolio transfer as contained in Transaction 1 of the "Illustrative accounting entries of a portfolio transfer" example in section 1.1 above. Consequently, the tax consequences of the payment / receipt of the actual purchase price, the recognition of VOBA and KBR by the transferee and the profit on the sale of business that could materialise for the transferor will not be considered.

In analysing the tax treatment of the working capital, this dissertation does not address whether it is of a revenue or capital nature seeing as section 28 does not make reference to capital and revenue. Further to this, it would only introduce additional complexity to be considered without having an impact on the discussion and the current proposed solution to the issue.

Lastly, it should be noted that, although similar principles would apply to reinsurance, this dissertation will only focus on direct insurance.

1.5 Structure of dissertation

This dissertation is structured in the following manner:

Chapter 1 sets out the background to the tax treatment of the transfer of technical reserves and working capital between short-term insurers as part of a portfolio transfer. It demonstrates that the current tax treatment is not in line with the commercial purpose of a portfolio transfer.

Chapter 2 provides a detailed analysis of the technical reserves related to premium, commission and claims of a short-term insurer from an accounting, regulatory and tax perspective and concludes on the recognition criteria and purpose of the tax legislation in this regard.

Chapter 3 summarises what a portfolio transfer entails and considers the tax implications of the technical reserves and the working capital transferred from both the perspective of the transferor and the transferee. The chapter concludes on the current tax treatment of portfolio transfers.

Chapter 4 considers the tax implications of portfolio transfers from an international perspective and concludes on the tax result achieved by tax legislation internationally.

Chapter 5 considers whether the current tax treatment of a portfolio transfer yields a fair and reasonable result from a tax perspective and considers potential recommendations in terms of legislative changes to ensure that the result is in line with the purpose of the tax legislation.

Chapter 6 concludes with a summary of the main findings per chapter.

CHAPTER 2: TECHNICAL RESERVES OF SHORT-TERM INSURERS

2.1 Technical reserves from an accounting perspective

Short-term insurers apply IFRS 4 to account for insurance contracts. However, the standard does not provide comprehensive guidance on the treatment of insurance contracts and essentially allows short-term insurers to continue to apply previous generally accepted accounting practice ('GAAP') in many instances. In this regard, The South African Institute of Chartered Accountants ('SAICA') issued Circular 2/2007 during January 2007 which should be read with IFRS 4 to provide guidance on the recognition and measurement of insurance contracts.[3]

Consequently, IFRS 4 does not contain detailed definitions for technical reserves. The Standard broadly defines "insurance asset" as "an insurer's net contractual rights under an insurance contract" and "insurance liability" as "an insurer's net contractual obligations under an insurance contract"[4], which effectively encompass the technical reserves recognised by a short-term insurer, however, it provides little insight into the nature of these reserves.

SAICA Circular 2/2007 confirms the application of the annual basis of accounting for short-term insurers. Under this basis of accounting "the underwriting result disclosed in the financial statements is determined at the end of the accounting period that reflects the profit or loss that arises from providing insurance cover during that period. This would include anticipated losses arising in subsequent periods in respect of commitments entered into prior to the end of the accounting period and any adjustments to claims provisions raised during earlier accounting periods."[5]

"Underwriting" is defined as "sign and accept liability under (an insurance policy), thus guaranteeing payment in case loss or damage occurs"[6] and it follows that the underwriting result, as referred to in the Circular above, refers to the insurance result i.e.

[3] SAICA Circular 2/2007, 2007:paragraph .02
[4] IFRS 4 Appendix A, 2004
[5] SAICA Circular 2/2007, 2007:paragraph .08
[6] Oxford Dictionaries, 2019

gross insurance profit or loss of a short-term insurer. The underwriting result of a short-term insurer is essentially calculated as insurance premiums received less commission, claims and other insurance related expenses incurred. It is this annual basis of accounting, confirmed by SAICA Circular 2/2007, which by implication led to the recognition of the technical reserves of a short-term insurer as will be explained in the paragraphs to follow.

2.1.1 Premium

"Gross written premiums in an accounting period comprise all premiums relating to policies incepting in the accounting period. They include the premiums for the whole period of risk covered by the policies regardless of whether or not these are wholly due for payment in the accounting period."[7]

In line with the annual basis of accounting, it then follows that any amount of gross written premium that does not relate to the current accounting period (referred to as an 'underwriting year') should be allocated to the underwriting year it relates to.

"Earned premium relates to the risks covered during the accounting period. Some policies incepting in previous accounting periods will not have expired and the portion of the written premium relating to the unexpired period of these policies is carried forward as unearned premium and is treated as earned premium in the current accounting period or, where appropriate, future accounting periods. Premium written in the current accounting period is treated as earned premium except to the extent that it relates to unexpired periods of risk at the balance sheet date."[8] The unearned premium referred to in this paragraph of SAICA Circular 2/2007 is the first of the technical reserves recognised by a short-term insurer.

Unearned premium is the portion of the gross written premium that does not relate to the current underwriting year and is carried forward to the next year in the form of a technical reserve referred to as UPR. If gross written premium is received / recognised

[7] SAICA Circular 2/2007, 2007:paragraph .11
[8] SAICA Circular 2/2007, 2007:paragraph .23

by a short-term insurer in respect of an annual policy at the end of the first quarter of its underwriting period (i.e. if the period is a year 25% of it will relate to the subsequent year), it follows that even though gross written premium will be recognised as income for the full premium amount, it will effectively be reduced by 25% due to the portion of the gross written premium relating to the next underwriting year. This 25% portion of premium will be recognised as a debit to the SOCI and a credit to UPR, effectively creating a technical liability. During the following underwriting year this reserve containing 25% of the prior year's gross written premium will be released in order to reflect income in the SOCI by crediting the SOCI and clearing the UPR technical liability with a debit entry.

The effect of this UPR entry is thus to ensure that only premium income relating to insurance cover provided during the current underwriting year is recognised in the SOCI. Hence, the UPR technical liability represents premium income in respect of insurance services to be provided in the following underwriting year i.e. premium not yet earned by the short-term insurer.

2.1.2 Commission

Similar to premium income, the commission expense relating to a policy is also recognised during the underwriting year it relates to. "Commissions paid to intermediaries are accounted for over the risk period of the policy to which they relate. The portion of commission which is deferred to subsequent accounting periods is termed a 'deferred acquisition cost'."[9] The DAC referred to in this paragraph is also a technical reserve recognised by a short-term insurer.

If gross written premium is received / recognised by a short-term insurer at the end of the first quarter of its underwriting period, the commission expense will follow the same accrual pattern as the premium income. Hence, the commission expense will be recognised in full as an expense in the SOCI. However, it will effectively be reduced by 25% due to the portion of the commission relating to the next underwriting year. This 25% portion of commission will be recognised as a credit to the SOCI and a debit to DAC,

[9] SAICA Circular 2/2007, 2007:paragraph .48

effectively creating a technical asset. During the following underwriting year this reserve containing 25% of the prior year's commission will be released in order to reflect an expense in the SOCI by debiting the SOCI and clearing the DAC technical asset with a credit entry.

The effect of this DAC entry is thus to ensure that only commission expenditure relating to the current underwriting year is recognised in the SOCI. Hence, the DAC technical asset represents commission expenditure not yet incurred by the short-term insurer.

2.1.3 Claims

"Provision is made at the balance sheet date for the expected ultimate cost of settlement of all claims incurred in respect of events up to that date, whether reported or not, together with related claims handling expenses, less amounts already paid. If a liability exists but there is uncertainty as to its eventual amount, an estimate is made."[10]

It follows that the last of the technical liabilities relate to estimated claims payments to be made in future. The first being OCR which relates to claim events that have already occurred and have been reported by policyholders but not yet paid and the second being IBNR relating to claim events that already occurred but the claim has not yet been reported by policyholders.

"In determining the claims liability, an insurer distinguishes between uncertainty as to whether or not a claims event has occurred and uncertainty over the eventual outcome of a claims event that has occurred and been reported. A liability is also recognised for claims events that have occurred but have not yet been reported. The liability is measured based on appropriate statistical and other techniques which address any uncertainty due to the fact that the resulting loss to the policyholder may not manifest itself until a considerable period after the end of the accounting period (perhaps several years) and in consequence may not be reported until then."[11]

[10] SAICA Circular 2/2007, 2007:paragraph .26
[11] SAICA Circular 2/2007, 2007:paragraph .28

The claims reserves are simply recognised by processing a debit entry to the SOCI for the accrual of the claims expense and a credit entry to the respective claims reserves being OCR and IBNR.

The effect of these OCR and IBNR entries are thus to ensure that claims expenditure relating to the current underwriting year is recognised in the SOCI. Hence, the OCR and IBNR technical liabilities represent claims expenditure incurred[12]but not yet paid by the short-term insurer.

2.1.4 Liability, provision or contingent liability?

It is further necessary to determine whether these technical reserves qualify as a liability, provision or contingent liability from an accounting perspective, as this will impact the tax treatment of the working capital.

International Accounting Standard 37 ('IAS 37') defines a liability as a "present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits"[13]. UPR qualifies as a liability on the basis that the obligation to deliver insurance services in the following underwriting period arose from the past event when the risk cover was contracted in terms of the insurance policy and / or premium was received from the policyholder during the previous underwriting period. The settlement thereof is the delivery of insurance services during the following underwriting period during which there will be an outflow of economic benefits in the form of the various resources required to deliver these insurance services.

OCR also qualifies as a liability seeing as it is a present obligation which arose from a past event, being the occurrence of a claim event and the settlement thereof will result in an outflow of resources in the form of a physical cash settlement of the claim to the policyholder. However, it should be noted that the amount recognised as OCR is an initial

[12] The word incurred is used from an accounting perspective and should not be interpreted as necessarily meaning actually and unconditionally incurred from a tax perspective.
[13] IAS 37, 1998:paragraph 10

claim estimate which is subject to a claim assessment procedure after which the final claim amount is finalised and paid. In terms of IAS 37 where an entity has a "liability of uncertain timing or amount" a provision should be recognised. It follows that OCR will qualify as an accounting provision.

IBNR is recognised for claim events that occurred e.g. a fire in Knysna, however, no claims have been reported by policyholders. Once a claim is reported by a policyholder, it is derecognised as IBNR and transferred to OCR instead. Therefore, IBNR does not qualify as a liability and consequently also not as a provision on the basis that it is not a present obligation.

IAS 37 defines a contingent liability as "either a possible obligation where the outcome is uncertain and not wholly within the control of the entity or a present obligation which does not meet the recognition criteria of provisions"[14] Consequently IBNR would qualify as a contingent liability as defined, seeing as it is a possible obligation (the claims event occurred and policyholders could report claims) where the outcome is uncertain and not wholly within the control of the short-term insurer (the decision whether a policyholder will submit a claim against his insurance policy or not). It should be noted that contingent liabilities are only recognised in the AFS when specifically allowed in terms of other standards such as business combinations (IFRS 3) and IFRS 4. It follows that the nature of IBNR is that of a contingent liability which would typically not be recognised as a liability in the AFS, however it is specifically recognised as a liability in terms of IFRS 4.

2.2 Technical reserves from a regulatory[15] perspective

It should be noted that prior to the enactment of the Insurance Act during 2018, the tax regime of technical reserves was based on the values as calculated for regulatory return purposes prescribed by the STI Act. However, the Taxation Laws Amendment Act, No. 25 of 2015 and No. 15 of 2016 introduced amendments to section 28(3) of the IT Act which effectively changed the tax regime to be based on IFRS reserves instead. However, it is

[14] IAS 37, 1998:paragraph 10
[15] The term "Regulatory" in this dissertation refers to the insurance specific regulations such as the Insurance Act, STI Act, etc.

still relevant for the purpose of this dissertation to analyse technical reserves from a regulatory perspective, seeing as portfolio transfers are governed by the Insurance Act and as it provides insight into the tax principles that were effectively approved and contained in section 28(3).

In this regard, it is important to note that the definitions per the Insurance Act are very vague, similar to that of IFRS 4 and hence this dissertation will analyse the definitions of the STI Act in order to understand the nature of the technical reserves[16]. This approach is further supported by the fact that section 28(3) only referenced the reserves as contained in the STI Act and once the Insurance Act was promulgated it was changed to refer to IFRS.

2.2.1 Premium and Commission

In terms of section 32(1)(b) of the STI Act the technical reserve liability recognised in respect of a premium is "an unearned premium provision, being an amount not less than the amount calculated in accordance with Part II of Schedule 2".

The formula prescribed by Part II of Schedule 2 effectively results in the same answer as achieved from an IFRS perspective (based on IFRS 4 read with SAICA Circular 2/2007), seeing as the formula calculates the unearned premium provision as being the portion of the total amount of written premium less corresponding commission as relates to the following underwriting period. It is important to note that no separate DAC technical reserve asset is recognised from a regulatory perspective. The unearned premium provision for regulatory purposes is therefore equal to IFRS UPR less IFRS DAC.

2.2.2 Claims

In terms of section 32(1)(a) of the STI Act the technical reserve liabilities recognised in respect of claims are:

[16] The definitions in the Insurance Act are now aligned to Solvency Assessment Management ('SAM') where the terms OCR and IBNR are not used anymore, however, the nature of the liability remains unchanged.

“the amount which the short-term insurer estimates will become payable in respect of claims incurred under short-term insurance policies –

(i) and reported but not yet paid, reduced by the amount which it estimates will be paid in respect of those claims under approved reinsurance policies;

(ii) but not yet reported, reduced by the amount which it estimates will be paid in respect of those claims under approved reinsurance policies, being an amount not less than the amount calculated in accordance with Part II of Schedule 2;”

In this regard Part II of Schedule 2 merely prescribes the formula for calculating the minimum amount to be recognised as IBNR and is not relevant for purposes of this dissertation. The claims provisions from a regulatory perspective are thus in line with IFRS OCR (refer to section 32(1)(a)(i)) and IFRS IBNR (refer to section 32(1)(a)(ii)) in terms of the nature of the reserves, however the calculation methods might differ.

2.3 Technical reserves from a tax perspective

The tax treatment of technical reserves is prescribed by section 28(3) and 28(4) of the IT Act. These sections state the following:

“(3) Notwithstanding section 23(e), for the purpose of determining the taxable income derived during any year of assessment by any short-term insurer that is a resident from carrying on short-term insurance business, there shall be allowed as a deduction from the income of that short-term insurer … amounts recognised as insurance liabilities, in accordance with IFRS by that short-term insurer in its audited annual financial statements, relating to –

(a) premiums; and

(b) claims;

reduced by –

(i) The amounts recognised as recoverable under policies of reinsurance … ; and

(ii) The amounts recognised as deferred acquisition costs in accordance with IFRS as reported by the insurer to shareholders in the audited annual financial statements;

(4) The total of all amounts deducted from the income of a short-term insurer in respect of a year of assessment in terms of subsection (3) shall be included in the income of that short-term insurer in the following year of assessment."

Section 23(e) states that "no deduction shall in any case be made in respect of … income carried to any reserve fund …".

From the above (the words "Notwithstanding section 23(e)") it is clear that the deduction in respect of any income carried to a reserve fund that is disallowed in terms of section 23(e) is not applicable to short-term insurers. The closing balance of technical reserves recognised by a short-term insurer in its AFS in respect of premium (UPR) and claims (OCR and IBNR) reduced by DAC are specifically allowed as a deduction from the taxable income of a short-term insurer in terms of section 28(3).

Similarly, the opening balance of these technical reserves, recognised by a short-term insurer in its AFS in respect of premium (UPR) and claims (OCR and IBNR) reduced by DAC should be included in the taxable income of a short-term insurer in terms of section 28(4).

The intention of the tax legislation contained in sections 28(3) and (4) is explained in the Explanatory Memorandum ('EM') to the Taxation Laws Amendment Bill ('TLAB') of 2012[17]. It states that:
"Although most taxpayers are not allowed to deduct reserves, specific rules exist that allow short-term insurers to do otherwise (i.e. section 28). Unlike most taxpayers, the reserves of short-term insurers are strictly regulated in terms of amount and use (and are dedicated to protect public clients). These deviations are the justification for allowing short-term insurers to deduct their reserves."

The effect of the sections above are demonstrated for each type of technical reserve in the paragraphs to follow.

[17] EM to the TLAB, 2012:paragraph 3.5

2.3.1 Premium

The total gross written premium income accrued to a short-term insurer in terms of IFRS is included in taxable income in terms of section 28(2)(a) which states that "a premium received by or accrued to that person in respect of a short-term insurance policy issued by that short-term insurer prior to the date of commencement of risk cover under that policy shall be deemed to have been received by or accrued to that short-term insurer on the date of commencement of the risk cover under that policy".

The effect of section 28(2) and (3) on premium income is that only the premium income accrued in respect of the particular underwriting year per the AFS is included in taxable income for that particular year of assessment. This is best demonstrated with an example.

<u>Example 3</u>

The insurer has a December year-end and received premium income of R2 million in respect of policies effective from 1 July 2018 – 30 June 2019 and R3 million for the year thereafter.

The UPR balance at 31 December 2018 is R1 million and R1.5 million at 31 December 2019.

Illustrative SOCI and Tax Calculation:

	December 2019	**December 2018**
<u>SOCI</u>		
Premium income	3,000,000.00	2,000,000.00
UPR	-500,000.00	-1,000,000.00
Profit before tax	**2,500,000.00**	**1,000,000.00**

Taxable Income		
Profit before tax	2,500,000.00	1,000,000.00
Add back movement in accounting provisions	500,000.00	1,000,000.00
Deduct section 28(3) current year balances	-1,500,000.00	-1,000,000.00
Add back section 28(4) prior year balances	1,000,000.00	-
Taxable income	**2,500,000.00**	**1,000,000.00**

From the example above taxable income will include the full R2,000,000 and R3,000,000 premium income in respect of 2018 and 2019 respectively in terms of section 28(2). This is achieved by adding back the accounting provisions in the tax calculation to profit before tax.

Taxable income is then reduced by the closing balance of UPR of R1,000,000 in terms of section 28(3) and increased by Rnil in terms of section 28(4) for the year ended December 2018. Effectively only 50% (representing half of the year) of premium income (R1,000,000) will be taxed in year 1, being the total premium received / recognised in respect of which insurance cover has been provided in year 1 and in line with the amount of premium recognised as income in the AFS for the year.

For the year ending December 2019 the taxable income is reduced by the closing balance of UPR of R1,500,000 in terms of section 28(3) and increased by R1,000,000 in terms of section 28(4). This effectively includes the remaining 50% of 2018 premium income (R1,000,000) earned during 2019 in taxable income and reduces the premium income of 2019 by 50% so as only to include the earned premium for 2019 (R1,500,000) in taxable income and defer the unearned 50% of premium income to 2020. The total earned premium income included in taxable income is therefore in line with the amount of premium recognised as income in the AFS for the year.

2.3.2 Commission

The total commission expense incurred by a short-term insurer in terms of IFRS is allowed as a deduction from taxable income in terms of the general deduction formula in section 11(a) and will not be subject to the limitations imposed by section 23H in terms of section 28(2)(d)(i) which states that “section 23H shall not apply to expenditure … incurred in respect of a short-term policy issued by a short-term insurer”.

Section 23H defers the deduction of expenses over the period to which the benefit resulting from those expenses relate to, except in certain limited defined circumstances.

It follows that section 28(2) will allow all commission incurred to be deducted as an expense in terms of section 11(a) regardless of whether the service will still be provided by the broker beyond the year of assessment. This is because the purpose of section 23H is now actually achieved by means of section 28(3).

The effect of section 28(2) and (3) on commission expense is that only the commission expense incurred in respect of the particular underwriting year per the AFS is included in taxable income for that particular year of assessment.

This can be demonstrated in terms of a similar example to the above.

Example 4

The same facts apply as in Example 3. Commission is calculated as 20% of premium income.

Illustrative SOCI and Tax Calculation:

	December 2019	**December 2018**
SOCI		
Premium income	3,000,000.00	2,000,000.00
UPR	-500,000.00	-1,000,000.00
Commission expense	-600,000.00	-400,000.00
DAC	100,000.00	200,000.00
Profit before tax	**2,000,000.00**	**800,000.00**

Taxable Income		
Profit before tax	2,000,000.00	800,000.00
Add back movement in accounting provisions	400,000.00	800,000.00
Deduct section 28(3) current year balances	-1,200,000.00	-800,000.00
Add back section 28(4) prior year balances	800,000.00	-
Taxable income	**2,000,000.00**	**800,000.00**

From this example it follows that the same principles apply to commission as is applicable to premium. The provisions contained in section 28 effectively achieve the same result in taxable income as was reflected in the SOCI to allow for commission as a deduction from taxable income during the year in which the premium income was earned and, consequently the commission expense was incurred. Hence only 50% of the commission expense is allowed as a deduction from taxable income in 2018, being R200,000 and during 2019 the deduction is the remaining 50% commission expense of 2018 (R200,000) plus the 50% commission expense in respect of 2019 (R300,000) being R500,000 in total.

2.3.3 Claims

The total claim expense incurred by a short-term insurer in terms of IFRS is included as a deduction from taxable income in terms of section 28(2)(c) which states that "an amount of expenditure payable by that short-term insurer in respect of any claim in terms of a short-term insurance policy may be deducted in terms of section 11(a) to the extent that the amount has been paid by that short-term insurer and to the extent that the amount has been paid by the short-term insurer, sections 23(c) and 23H shall not apply to that expenditure".

Section 23(c) states that "no deductions shall in any case be made in respect of … any loss or expense, the deduction of which would otherwise be allowable, to the extent to which it is recoverable under any contract of insurance, guarantee, security or indemnity".

This provision allows for all finalised actual claim payments to insureds to be deducted from taxable income, regardless of whether it is recoverable under a contract of insurance (which is often the case in respect of reinsurance contracts entered into by short-term insurers).

The effect of section 28(2) and (3) on claim expenditure is that all the claim expenditure relating to the particular underwriting year per the AFS are included as a deduction from taxable income for that particular year of assessment.

This can be demonstrated in terms of a very simplistic example.

Example 5

Claims paid during the 2018 underwriting year amount to R1,000,000 and the closing balance of the claim reserves (OCR and IBNR) as at 31 December 2018 amount to R250,000. During 2019 the full R250,000 claims reserves are settled in cash and additional reserves of R450,000 are recognised. New claims incurred and physically paid during 2019 amounts to R1,250,000.

Illustrative SOCI and Tax Calculation:

	December 2019	**December 2018**
SOCI		
Claims paid	-1,500,000.00	-1,000,000.00
Claims provisions (movement in OCR + IBNR)	-200,000.00	-250,000.00
Profit before tax	**-1,700,000.00**	**-1,250,000.00**
Taxable Income		
Profit before tax	-1,700,000.00	-1,250,000.00
Add back movement in accounting provisions	200,000.00	250,000.00
Deduct section 28(3) current year balances	-450,000.00	-250,000.00
Add back section 28(4) prior year balances	250,000.00	-
Taxable income	**-1,700,000.00**	**-1,250,000.00**

The example illustrates that the full claims expense of R1,250,000 recognised in the AFS for 2018 is allowed as a deduction for tax purposes, being the actual claims paid of R1,000,000 plus the claims provision of R250,000.

During 2019 the deduction of R1,700,000 effectively includes the claims incurred and settled during 2019 of R1,250,000 plus the additional reserves of R450,000. The actual claims paid, of R250,000, relating to the prior year reserves are not allowed as a deduction as this amount was already deducted from taxable income during 2018.

2.4 Conclusion

Based on the analysis above, the nature of the technical reserves recognised in the AFS in terms of IFRS are in line with the nature of the technical reserves from a regulatory perspective and hence included in a portfolio transfer as prescribed by the Insurance Act.

The purpose of technical reserves from an accounting perspective is to ensure that only premium income earned and commission expenditure incurred are recognised in the particular underwriting year / financial year in respect of which the premium is earned i.e. the risk cover period of the insurance contract. Claims are recognised in the underwriting year / financial year during which they are incurred, regardless of when payment occurs.

The tax treatment of technical reserves is in line with the accounting treatment and hence premium income is taxed in the year of assessment when the insurance service is delivered and commission and claims expenditure is allowed as a deduction in the year of assessment during which the expenditure is incurred, regardless of when payment occurs.

CHAPTER 3: PORTFOLIO TRANSFERS

3.1 What is a portfolio transfer?

A portfolio transfer between short-term insurers refers to the sale of the insurance business of the transferor insurer to the transferee insurer. These transactions entail the transfer of specified insurance policies from the transferor to the transferee without having any negative impact on the affected policyholders. The transferee insurer effectively takes the place of the transferor and becomes the insurer for the insurance policies transferred. The transfer of the insurance business includes not only the transfer of the specified policies but also any technical reserves recognised by the transferor in respect of these specified policies and the working capital backing these reserves.

Portfolio transfers are governed by section 50 of the Insurance Act, which states the following in respect of transfers of business:

"50. (1) An insurer … may not, without the approval of the Prudential Authority, transfer all or any part of its assets and liabilities relating to its insurance business to another insurer.

(2) ...

(3) …

(4) The Prudential Authority must only grant an approval referred to under subsections (1) to (3) if the Prudential Authority is satisfied—

(a) that the transfer, transaction or change will not impede the financial soundness of an insurer or controlling company that is a party to the transfer, transaction or change;

(b) in the case of an insurer, that the transfer, transaction or change does not negatively impact on the interest of policyholders;

(c) in the case of a controlling company, that the transfer, transaction or change does not negatively impact on the interests of policyholders of the insurers that are part of the insurance group; and

(d) that any prescribed procedures have been complied with.

(5) The Prudential Authority may—

(a) prescribe the requirements that an insurer and controlling company must comply with in respect of transfers, transactions or changes, which may include requirements for informing and consulting policyholders through appropriate media; and
(b) appoint a person, at the cost of the insurer or controlling company, to assess the transfer, transaction or change and express a view on the desirability or otherwise thereof."

It is clear from the above that portfolio transfers are strictly governed by the Prudential Authority and that the interest of policyholders may not be negatively impacted by these transactions. Consequently, the transfer of the technical reserves and working capital would almost always be equal and does not create a profit or loss as the transferee merely replaces the transferor as insurer of these policies.

It should be noted that the transfer of the working capital is not based on a voluntary agreement by the transferor and the transferee, it is a requirement of the Prudential Authority that the working capital supporting the technical reserves should be transferred as well. This requirement to transfer the working capital is not stated explicitly in the Insurance Act, however, the applications that need to be completed from a regulatory perspective before a portfolio transfer is approved includes this as a requirement to be complied with.

The technical reserves and working capital so transferred essentially comprise the assets and liabilities of the going concern of the insurance business and the net value of these assets and liabilities is typically zero. This is because the working capital backing each reserve is equal to the reserve. If, for example, the gross written premium in respect of a full year is received by a short-term insurer at the end of the first quarter of its underwriting period (for insurance cover to be provided from that date until the end of the first quarter of the following underwriting period) and a portfolio transfer occurs at the end of its current underwriting period then the working capital in respect of the UPR liability of 25% of gross written premium would be equal to the same amount as represents the cash received for premiums in respect of insurance cover to be provided by the transferee during the following underwriting year.

The same principle applies to DAC except that it is the inverse of UPR being a technical reserve that is an asset, hence the working capital “received” (by means of reducing the working capital paid to the transferee in respect of the UPR, OCR & IBNR reserves) represents the cash withheld by the transferor for commission already incurred in respect of insurance cover to be provided by the transferee after the portfolio transfer.

The working capital transferred in respect of the OCR represents the cash reserved by the transferor to be able to pay claims that were already reported on these policies prior to the portfolio transfer. As previously discussed, the OCR is essentially a provision for an actual expense incurred of which the amount is uncertain, seeing as the final claim payment amount still needs to be refined through a claims assessment process.

The working capital transferred in respect of the IBNR represents the cash reserved by the transferor to be able to pay claims in respect of claim events that occurred and where the transferor expects policyholders to report claims, however, these claims have not actually been reported prior to the portfolio transfer. It was previously discussed that this is similar to a contingent liability in that this is a possible obligation (the claims event occurred but it is uncertain whether policyholders will actually report the claims) where the outcome is uncertain and not wholly within the control of the short-term insurer. Here the uncertainty is not only the amount which will be finalised through a claims assessment process, but also whether or not the policyholders affected by the claims event will actually submit a claim or not.

By transferring these claim reserves along with the cash to be able to settle the provision for OCR and IBNR, it could be argued that the transferor is paying the transferee to assume these liabilities. However, this is not typically stated explicitly in the legal agreements to effect a portfolio transfer.

3.2 The tax implications of a portfolio transfer for the transferor

3.2.1 Technical reserves transferred

The tax implications of the transfer of the technical reserves are sufficiently addressed by the current provisions contained in section 28 of the IT Act. The transferor would have deducted the closing balance of technical reserves in accordance with section 28(3) as at the end of its last financial period. This balance will be included as a recoupment in terms of section 28(4) during the year in which the portfolio transfer occurs with no closing balance to be deducted in terms of section 28(3). Consequently, this results in an increase in taxable income with the amount of net technical liabilities transferred, calculated as UPR less DAC plus OCR plus IBNR.

This can be demonstrated with reference to the values used in Example 1 and Example 2 (refer to 1.1 Background). The total taxable income of R2,300,000 in Example 1 increased with the full value of the technical reserves transferred of R1,950,000 to a total taxable income of R4,250,000 in Example 2.

This treatment is in line with normal tax principles in that the increase in taxable income of R1,950,000 is merely a recoupment of a previous reduction in terms of section 28(3), however, the fact that cash is disbursed in the form of the working capital being transferred and there is no mechanism for this to be deducted for tax purposes (see below), causes a mismatch in this regard as will be addressed in detail in the following section (3.2.2 Cash paid in respect of working capital).

However, this treatment is not in line with the commercial nature of a portfolio transfer where no profit or loss is realised by the transferor in the year of transfer. Further to this, it is also not in line with the general principle that insurance income and expenses are included in taxable income during the year when the income / expenditure is incurred as concluded on in Chapter 2. However, it is first necessary to consider the tax implications of the working capital before a meaningful conclusion can be drawn.

3.2.2 Cash paid in respect of working capital

In order to determine the deductibility of the payment of working capital by the transferor to the transferee it should firstly be considered whether the amount qualifies for a tax deduction in terms of the positive test contained in s11(a) and secondly the negative test contained in s23(g) of the IT Act. The requirements of both these tests need to be satisfied before a tax deduction will be allowed.

In terms of s11(a) "there shall be allowed as deductions from the income of such person so derived expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature"

3.2.2.1 Expenditure and losses

The words "expenditure" and "losses" referred to in section 11(a) are not defined in the Act and hence one has to refer to the relevant case law in this regard. The distinction between these words were explained as follows in *Joffe & Co (Pty) Ltd v Commissioner of Inland Revenue ('CIR')*[18]*:*

"Collins Essential English Dictionary (1988) William Collins Sons & Co Ltd defines "expenditure" as "the total amount of money that is spent on something" and "loss" as "the fact of no longer having something or of having less of it than you had before".

"In relation to trading operations the word [loss] is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money."

In *Commissioner of Taxes* ('*COT') v Rendle*[19] a distinction was drawn between designed and fortuitous expenditure:

[18] *Joffe & Co (Pty) Ltd v CIR*, 1946:360
[19] *COT v Rendle*, 1965:329

"For the purposes of this case, expenditure incurred for the purpose of trade may be grouped broadly under two heads. First, money voluntarily and designedly spent by the taxpayer for the purpose of his trade; and second, money which is what I might call involuntarily spent because of some mischance or misfortune which has overtaken the taxpayer. For the sake of convenience, I will refer to the first type of expenditure as 'designed expenditure', and to the second as 'fortuitous expenditure'."

The working capital paid by the transferor to the transferee qualifies as apayment required in terms of the insurance regulations, but designedly spent, seeing as the parties decided independently to enter into the legal agreement effecting the portfolio transfer in which it was contractually agreed to pay the working capital. The fact that the legal agreements are often vague regarding the transfer of technical reserves and working capital, does not change the fact that expenditure is incurred, because in instances where the wording does not specifically state this, there would still be an annexure included stipulating the values of technical reserves to be transferred and the working capital to be paid. This is further supported by the fact that the transfer of the technical reserves is accompanied by an actual cash payment in respect of the working capital which is a requirement of the Prudential Authority (otherwise the transfer would be prohibited).

Thus, it is clear from the above that the amount paid represents a voluntary payment of money designedly spent and hence the payment of the working capital qualifies as expenditure.

3.2.2.2 Actually incurred

In order to qualify for a deduction, expenditure must have been actually incurred during the year of assessment. The term "actually incurred" means that the taxpayer should have a definite liability or must have suffered a loss and it cannot be a contingent expense. This was confirmed in *Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste ('KBI')*[20].

[20] *Nasionale Pers Bpk v KBI*, 1986:67-68

In this regard the expenditure is actually incurred on the basis that it is contractually arranged in the portfolio transfer agreement that the transferor will pay an amount of working capital equal to the net amount of technical reserves to the transferee and the amount of cash is physically transferred between the parties, hence there is a definite liability and the amount is actually paid.

3.2.2.3 During the year of assessment

A further requirement that needs to be met is that, as stated in *Sub-Nigel Ltd v CIR*[21], the expenditure and losses must be claimed as a deduction from taxable income during the year of assessment in which they were incurred.

This condition is satisfied in that the deductibility of the working capital is considered in the same year of assessment during which the portfolio transfer agreement is concluded and effective and typically coincides with the year of assessment that the actual payment occurs.

3.2.2.4 In the production of income

It should be noted that in referring to "income" reference is made to the word as defined in section 1 of the IT Act, being gross income less exempt income. However, when referring to the income of a short-term insurer for purposes of this dissertation, the reference is specifically made to income included in underwriting result, being premium income. A short-term insurer does not earn any exempt premium income, only exempt investment income which is not relevant for this dissertation, so the income being referred to here will be gross premium income.

The words 'in the production of income' were interpreted in *Port Elizabeth Electric Tramway Company v CIR*[22] as meaning the following with regards to expenses:

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[21] *Sub-Nigel Ltd v CIR*, 1948:391
[22] *Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936:16-18

"The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible."

"The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it."

In *CIR v Genn & Co. (Pty) Ltd*[23] the court expanded on the meaning of "that they may be regarded as part of the cost of performing it" in the following manner:

"...that it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation."

Another principle to determine whether expenditure is incurred in the production of income was determined in *CIR v Nemojim (Pty) Ltd*[24] as follows:

"Generally, in deciding whether moneys outlaid by a taxpayer constitute expenditure incurred in the production of the income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure and what the expenditure actually effects..."

This principle was later confirmed in *CIR v Standard Bank of South Africa Ltd*[25].

It was concluded in *Sub-Nigel Ltd v CIR*[26] that 'incurred in the production of the income' does not mean that it is necessary to prove that the specific expenditure incurred

[23] *CIR v Genn & Co. (Pty) Ltd*, 1955:299
[24] *CIR v Nemojim (Pty) Ltd,* 1983:256
[25] *CIR v Standard Bank of South Africa Ltd,* 1985:196
[26] *Sub-Nigel Ltd v CIR*, 1948:394

generated a specific part of the income for that particular year of assessment. It is only necessary to prove that the expenditure incurred was with the intention to earn income.

"It seems to me clear on the authorities that the court is not concerned whether a particular item of expenditure produced any part of the income: what it is concerned with is whether that item of expenditure was incurred for the purposes of earning income."

The Sub-Nigel case confirmed that it is not necessary to demonstrate that the expenditure incurred resulted in an increase in taxable income in the current year in order to qualify as being deductible. It could only lead to an increase in taxable income in future years, as long as the expenditure was laid out for the purposes of earning income at some future point it will be deductible.[27] However, this does not confirm that expenditure incurred in respect of income earned in the past is deductible.

In this regard one can refer to the legal precedent created by the *Provider v COT*[28] case. In this case the taxpayer was able to prove that amounts paid upon retirement to employees in respect of services provided in the past (i.e. in the production of income in the past) was not paid to compensate the employees for past service. It was demonstrated that because the amounts paid to the retirees were a well-established policy implemented by the taxpayer it promoted a loyal and content culture amongst current employees, motivating them to remain in the employment of the taxpayer to generate income for him, going forward. The expenditure was therefore allowed as a deduction as the purpose of the expenditure was to ensure the future production of income for the employer by the current employees.

It is imperative that a taxpayer has strong arguments why the expenditure is incurred in the production of income going forward and not just in the production of income earned previously in order to qualify for a deduction from taxable income. It was demonstrated in the *WF Johnstone & Co Ltd v CIR*[29] case that if a taxpayer fails this onus of proof the amount will not be deductible. In this case the employer paid a lump sum to an employee

[27] *Sub-Nigel Ltd v CIR*, 1948:394
[28] *Provider v COT*, 1950
[29] *W F Johnstone & Co Ltd v CIR*, 1951

upon retirement as compensation for his long and dedicated services to the company and was unable to prove that the effect of the expenditure was to generate current / future income. The court thus held that the expenditure incurred was not in the production of income on the basis that the employee had left the company and was unable to generate any further income for the taxpayer.

It follows from the above that the criteria that can be used to determine whether expenditure is incurred in the production of income can be summarised as follows:

- Was the activity giving rise to the expenditure performed for the purpose of generating income?
- Was such expenditure so closely connected to the activity that it may be regarded as part of the cost of performing the activity?
- Is it proper, natural or reasonable to regard the expenditure as part of the cost of performing the activity?
- Expenditure could form part of the cost whether it is necessary for its performance, attached to it by chance or incurred for the more efficient performance of such operation.
- What was the purpose of the act giving rise to the expenditure and what did it effect?
- It is not necessary for the particular expenditure incurred to have resulted in additional income, as long as the intention of incurring the expenditure was to generate income.
- Was the expenditure incurred to generate future taxable income? If not directly (e.g. retirement payment to compensate employee for past service), was it indirectly incurred to earn future taxable income by promoting current employees / clients to generate future taxable income (and be compensated in future by means of a retirement payment)?

In this regard the payment of the working capital can be analysed in various ways. The working capital could be considered as a mere cash payment being one of the assets transferred in the sale of the insurance business as a going concern, it could be said that the payment of the working capital is a payment made by the transferor to the transferee to assume the technical reserves so transferred and perform insurance services on behalf of the transferor or there could be an argument that the working capital needs to be analysed in respect of each reserve to assess the tax implications.

Asset transferred in the sale of the insurance business as going concern

As indicated above, it could be argued that the working capital transferred is one of the assets transferred in the sale of the insurance business or relevant part thereof. However, in this regard (even though the capital vs revenue nature of the working capital is specifically excluded from the scope of this dissertation) it is important to note that the 8th Schedule to the IT Act specifically excludes cash / currency from the definition of an asset:

"…includes – (a) property of whatever nature, whether moveable or immovable, corporeal or incorporeal, excluding any currency…"

Consequently, the working capital will not trigger any tax consequences from a capital gains tax perspective as there is no "asset" being disposed of by the transferor. However, it requires a detailed analysis of whether or not the transfer of the working capital will be deductible from an income tax perspective seeing as it cannot merely be treated as a capital asset. It is therefore necessary to analyse the transfer of the working capital i.e. cash against the criteria identified from the case law quoted above, in order to determine whether the expenditure incurred was in the production of income.

The activity giving rise to the payment of the working capital would be the portfolio transfer agreement entered into, in which it is agreed that the insurance policies and the reserves relating to these insurance policies will be transferred from the transferor to the transferee.

It is possible to extend the interpretation of the activity to conducting short-term insurance business which generates premium income and that a portfolio transfer is simply one of the activities to ensure that a particular insurer manages a profitable book of insurance policies in order to derive insurance premium income in future. It can further be argued that the transferor is incurring the cost to ensure that policyholders (current and future policyholders in general, not only the policyholders impacted by the portfolio transfer) trust the transferor to be loyal to them and be satisfied with the quality of insurance services provided to ensure a loyal customer base in the form of happy and content policyholders who generate future income in the form of future policy premiums because the policyholders are assured that their needs will be taken care of even in the event of a portfolio transfer in future.

Hence, it can be concluded that the activity giving rise to the expenditure is for the purpose of generating income. However, this is a wide interpretation to argue and thus poses a more difficult burden of proof to overcome. In addition, the transferor would have to be able to prove that the particular facts and circumstances which led to the portfolio transfer were indeed 'in the production of the income'.

The payment of the working capital is so closely connected to the portfolio transfer that it can be regarded as part of the cost of performing the portfolio transfer seeing as it is a requirement of the agreement that the working capital be transferred. The transfer of the working capital is one of the steps required in order to complete the portfolio transfer and therefore it is proper and reasonable to regard the payment of the working capital as part of the cost of the portfolio transfer, regardless of whether one is looking at the activity as being the portfolio transfer or the short-term insurance business, as a whole.

When looking at the activity as being the portfolio transfer it follows that the expenditure is necessary for its performance as indicated in the previous paragraph. Alternatively, when a wider interpretation is followed, by looking at the activity as the insurance business as a whole, then it could be considered incurred for the more efficient performance of such operation.

The purpose of the portfolio transfer would be to transfer a particular portfolio of insurance policies from one insurer to another insurer without any negative impact on the policyholders and without generating a profit or loss for either the transferor or transferee. The effect of making payment of the working capital would thus be to enable the transferee to provide insurance services and pay claim settlements in respect of claims events that occurred prior to the date of the portfolio transfer to policyholders who concluded insurance policies with the transferor prior to the portfolio transfer. This does not in itself generate income, however, holistically when looking at the activity as the short-term insurance business as a whole, then it can be argued that it is in the production of income provided that the transferor will continue to provide short-term insurance services after the portfolio transfer.

Based on the above it is not impossible to argue that the expenditure was incurred in the production of income, however, it is dependent on very particular facts and circumstances and could be a high hurdle to overcome.

Payment to the transferee to assume the technical reserves of the transferor and perform insurance services on behalf of the transferor in respect of these reserves

It could also be argued that the working capital paid is an amount incurred by the transferor to compensate the transferee for the service of taking over its insurance policies (which includes technical reserves). The purpose of the expenditure incurred from the perspective of the transferor is then to ensure that the insurance policies for which it previously received premium income continues to be serviced. This expenditure incurred will again build a trust relationship with current and future policyholders as it demonstrates that the transferor will ensure that the needs of policyholders are taken care of even though there is a change in insurer. Hence the expense can be considered in the production of income as this will ensure future income in the form of future policy premiums from existing and future policyholders.

As noted in subsection 3.1, this is not typically clearly articulated in the legal agreements which effect a portfolio transfer, and this lack of clear explanation could be problematic to substantiate this argument. The court held in the *Ackermans Ltd v CSARS*[30] case that the seller was not allowed a deduction on the basis that expenditure was not actually incurred by the seller seeing as the wording of the sale agreement did not create an obligation for the seller to pay the purchaser for assuming its accounting contingent liabilities.

[30] *Ackermans Ltd v CSARS,* 2010:6

"The fact that Ackermans rid itself of liabilities by accepting a lesser purchase price than it would have received had it retained the liabilities, does not mean in fact or in law that it incurred expenditure to the extent that the purchase price was reduced by the liabilities".

This case highlighted the need for clarification of the position of both the seller and the purchaser when contingent liabilities are assumed in the sale of a business as a going concern. This principle similarly applies to the transfer of technical reserves as it is submitted that the transferor and transferee would need to explicitly include in the sale agreement that the working capital is paid by the transferor to the transferee as compensation to assume its technical reserves and to continue to provide insurance services to these policyholders.

It should be noted that a critical difference between the facts and circumstances of this case and a portfolio transfer is the fact that a portfolio transfer cannot occur without the transfer of both the technical reserves and the working capital backing these reserves. It is a regulatory requirement that the working capital be paid and the transferee does not elect whether or not to pay for the technical reserves, nor can it negotiate the price which it is willing to pay as would be the case in a normal sale of business agreement. Hence, even if the agreement might not explicitly state that the transferee will assume the technical reserves and continue to provide insurance services to these policyholders, it might not be necessary seeing as this is a regulatory requirement that the transferee must adhere to. It could thus be argued that when reading the agreement along with the regulatory requirements of a portfolio transfer the transaction does actually occur in fact and in law, which would be in contrast to the *Ackermans (supra)* case.

However, even if the legal agreements were to be drafted appropriately (or the argument per the previous paragraph to suffice) to support this argument, it would still be necessary to determine whether the expenditure is incurred in the production of income.

When evaluating the expenditure based on the criteria summarised from the various case law quoted above, it can be argued that the expenditure incurred will be in the production of income including both premium income earned prior to the portfolio transfer as well as current and future premium income earned. This is because the activity giving rise to the payment of the working capital is for the purpose of ensuring that the insurance policies are serviced until the end of the term in respect of which the insurance premium was previously paid to the transferor. The transferor is effectively paying the transferee to perform the insurance services on its behalf.

However, the mere fact that the transferor is paying another insurer to ensure that its insurance policies remain serviced, creates confidence with current and future policyholders and builds trust as it demonstrates that the transferor will ensure that the needs of policyholders are taken care of even though there is a change in insurer. Thus future income is secured in the form of policy premiums from existing and future policyholders.

It can be argued that such an activity is so closely connected that it may be considered part of the cost of performing the activity. This is because the cost of actually servicing the insurance policies is effectively just outsourced to the transferee and the nature of the costs incurred to service the insurance contracts are similar in nature to the payment of these costs (the transferor has no option but to provide working capital equal to the reserves i.e. it may not, for example, agree to retain the reserves connected to the policies transferred and to pay them when they become due). In this case the expenditure would be necessary for the performance of the insurance service and not attached by chance or incurred for the more efficient performance of the activity. It would further be proper and reasonable to regard the expenditure as part of the cost of performing the activity because it is expected in terms of a portfolio transfer that the transferee will take over the insurance policies and be responsible to perform the insurance services in this regard.

The purpose of the expenditure is for the transferee to perform insurance services in respect of the payment of the pre-existing liabilities reflected in the technical reserves and the effect is exactly that. The transferee was compensated to deliver insurance services which it will do, as it is governed by section 50 of the Insurance Act to do so.

The last hurdle could be problematic though, being that the particular expenditure incurred will not result in future income for the transferor but rather it is incurred in respect of premium income earned in the past, when the policies being transferred as part of the portfolio transfer incepted. The gross written premium in respect of the policies transferred in a portfolio transfer will have already been included in the income of the transferor in terms of the deeming provision contained in section 28(2)(a) (refer to paragraph 2.3.1 Premium).

In most instances the transferor of a policy portfolio should be able to argue that the expenditure is incurred to generate the income received for the portfolio transfer itself, refer to Transaction 2 (Transferor) of the "Illustrative accounting entries of a portfolio transfer" example in section 1.1. However, as was previously indicated, the transaction could potentially occur at a purchase price of Rnil i.e. no amount paid over and above the payment of the working capital, if the particular book of business transferred does not contain valuable intangible assets (such as VOBA and KBR) that the transferee is willing to pay for.

In such instances the transferor could argue that the working capital represents the costs it always intended to spend to ensure that the insurance policies entered into are serviced. Whether this was by actually providing insurance cover to policyholders and paying claims to the policyholder as and when they occur or whether it be by paying this amount to another insurer to assure policyholders that their needs will be met by the transferee even after the portfolio transfer.

The *Sub-Nigel Ltd v CIR*[31] case confirmed that expenditure is incurred in the production of income as long as it was laid out for the purposes of earning income at some future point. Read with this, the *Provider v COT*[32] case established that it is possible to argue that expenditure incurred when ceasing to trade was actually incurred in the production of future income, provided the transferor can prove that the purpose of the expenditure was not only to make payment to the transferee to service the insurance policies on its behalf but more so it was incurred (and is generally incurred) in order to build trust amongst

[31] *Sub-Nigel Ltd v CIR*, 1948:394
[32] *Provider v COT*, 1950

current and future policyholders by ensuring them that their risks under the insurance policy will be covered regardless of whether a portfolio transfer occurs or not, because the transferor will make the necessary arrangements. This will build a loyal client base of current and future policyholders to ensure a solid pipeline of future premium income.

Even if the transferor will not earn any future premium income from current or future policyholders seeing as it will cease to trade, it was clear upfront when the insurance policy was concluded and throughout the period that the policyholders' claims would be covered. This created ongoing trust amongst policyholders to continue to pay premiums and for new policyholders to insure with the transferor. Thus, by the time the payment of the working capital is made, the transferor has already satisfied the income requirement.

In contradiction to the above it could also be argued that the mere fact that a portfolio transfer occurs, indicates that the transferor will no longer be earning insurance income from the policies included in the portfolio transfer and as such any future expenditure incurred in respect of these insurance policies will not be in the production of income. This is particularly applicable when an insurer ceases to trade and the portfolio transfer includes all the insurance policies that it has written on its insurance license.

It is clear from the analysis above that there is a lot of uncertainty and that there are several arguments in support of and opposing whether the payment of the working capital is indeed incurred in the production of income. The arguments could also differ significantly depending on the facts and circumstances applicable to the particular portfolio transfer such as whether the transferor will cease to trade and / or whether the transferee is willing to pay for any intangible assets forming part of the portfolio transfer.

Analysis per reserve

When analysing the working capital per reserve, there are essentially two transactions to consider:

1. UPR less DAC

   This payment represents a payment of premium net of commission to provide insurance services i.e. provide insurance cover and pay out claims arising from claim events after the effective date of the portfolio transfer. This part of the working capital would represent a payment made for the provision of a service and all the arguments stated in the subsection "*Payment to the transferee to assume the technical reserves of the transferor and perform insurance services on behalf of the transferor in respect of these reserves*" would similarly apply.

2. OCR plus IBNR

   This amount effectively covers the transferee for the claim settlements to be paid to policyholders subsequent to the portfolio transfer, arising from claim events that occurred prior to the effective date of the portfolio transfer.

   When the portion of the working capital covering these amounts is paid to the transferee it is effectively the same as if the transferor were to pay the policyholders directly. This is because the claim expenditure incurred is deductible for tax purposes during the year in which the expenditure is incurred, as was concluded in Chapter 2. This payment is made to the transferee in order to pay the final claim settlement to the various policyholders on behalf of the transferor. Seeing as the claim events occurred prior to the effective date of the portfolio transfer it is an expense incurred by the transferor and consequently the expenditure should be deductible from the taxable income of the transferor based on the best estimate amount at that stage even though the final claim payment will only be made to the policyholder by the transferee at a later stage when the claim is finalised. Any changes in the amount should then impact the taxable income of the transferee.

When evaluating this expenditure based on the criteria summarised from the various case law quoted above, it can be argued that the expenditure incurred will be in the production of income albeit premium income earned prior to the portfolio transfer. The transferor has already satisfied the ‘in the production of income’ requirement when the insurance policy was concluded with the policyholder, seeing as it was clear upfront that any claims expenditure under the policy of insurance will be covered. This created trust amongst policyholders throughout the period that the transferor would satisfy their claims and demonstrates that the transferor was trading.

This is because the activity giving rise to the payment of the working capital in respect of the OCR plus IBNR is specifically to ensure that the claim settlement is paid to the policyholders in this regard. The transferor is effectively paying the transferee to make claims settlement payments to policyholders on its behalf.

It can be argued that such an activity is “so closely connected”[33] that it may be considered part of the cost of performing the activity. This is because the cost of actually paying the claim settlement is an integral part of providing insurance services in respect of an insurance policy. In this case the expenditure would be necessary for the performance of the insurance service and not attached by chance. It would further be proper and reasonable to regard the expenditure as part of the cost of performing the activity because it is expected in terms of a portfolio transfer that the transferee will take over the insurance policies and be responsible to make claim settlement payments to the policyholders that have already arisen.

The purpose of the expenditure is for the transferee to make claim settlement payments to policyholders on behalf of the transferor and the effect from the perspective of the OCR portion of the reserve is exactly that. The transferee was paid an amount to be in a position to settle claims that were incurred prior to the effective date of the portfolio transfer and it is governed by section 50 of the Insurance Act to do so. The final claim amount paid to the policyholders might differ based on the

[33] *Joffe & Co (Pty) Ltd v CIR*, 1946:355 and *Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936:16

claims assessment process, however, the payment was made based on the best estimate amount available at the date of the portfolio transfer.

From the perspective of the IBNR portion of the reserve there are more uncertainties in that some or all policyholders the transferor expected to be negatively impacted by a particular claims event might not submit claims under their insurance policies. In this instance the effect could in some instances be that an amount was paid to the transferee to settle claims on behalf of the transferor and that these claims then never occur. However, this is still in line with the normal operation of the IBNR reserves. At the time the transferee confirms that no claims will be logged by policyholders in respect of a particular claims event for which IBNR was reserved, this reserve will be released and the transferee will be taxed on this amount (in that a lesser amount will be deducted in terms of section 28(3) than was added back in terms of section 28(4) at the end of that particular year of assessment).

The last hurdle could be similarly problematic as was discussed in the subsection "*Payment to the transferee to assume the technical reserves of the transferor and perform insurance services on behalf of the transferor in respect of these reserves*", being that the particular expenditure incurred will again not result in future income for the transferor but rather it is incurred in respect of premium income earned in the past. Similar arguments apply in this instance, except that it might be easier to argue that claims specific expenditure will be deductible in respect of premiums earned in the past, seeing as it is the norm to incur claims related expenditure after premiums have been earned and the time delays are often significant. This is because policy premiums are mostly paid in advance and relate to the period for which insurance cover is provided in terms of the insurance policy. When an insurer enters into a risk attaching policy for instance, where a premium may be payable upfront to buy insurance cover for the next 5 years, then it could happen that a claim payment is made several years after the policy premium was earned (but still within the 5 year cover boundary). Seeing as the cost is still incurred in order to service the insurance policy which it had entered into initially when providing insurance cover for this 5 year period, the cost will be deductible. This is because the 'in the production of income' requirement was met upfront when entering into the insurance policy as explained above.

Even though the above can be argued, it is still imperative for expenditure incurred to be in the production of future income and in this regard it is important to note that even though the settlement of a claim will always relate to premium income earned in the past, the income requirement was already met upfront when entering into the insurance policy. It is also similarly incurred to build trust amongst policyholders (past, current and future policyholders) that the insurer will deliver on its promises made and will pay claims as and when they arise, thereby securing future income in the form of policy premiums from existing and future policyholders.

3.2.2.5 For the purposes of trade

The requirement that the expenditure should be incurred "in the production of income" goes hand in hand with the negative test in s23(g) which states the following "no deductions shall in any case be made in respect of … any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade".

The expense needs to be incurred as a "necessary concomitant" of the taxpayer's trade as was confirmed in *Joffe & Co (Pty) Ltd v CIR*[34].

Case law in respect of the deductibility of expenditure incurred when a taxpayer ceases to trade is inconsistent. The general principle that seems to be applied is that if the expenditure was incurred in the production of income whilst the business was still carrying on a trade, it will continue to be deductible when the business cease to trade. This view is supported by *Income Tax Case ('ITC') 729*[35], where a taxpayer was allowed to continue deducting pensions payable which were assumed as an obligation whilst the business was still in operation and actively carrying on a trade. There are however also

[34] *Joffe & Co (Pty) Ltd v CIR*, 1946:358
[35] *ITC 729*, 1951

examples such as *ITC 1171*[36] and *ITC 1672*[37] where SARS disallowed expenditure incurred after ceasing to trade on the basis that the taxpayer's election to continue to incur the expense subsequent to ceasing its trade was not for the purpose of earning income and therefore does not constitute an allowable deduction from taxable income.

Silke[38] confirms that generally "it is submitted, once a business has finally ceased any expenditure incurred subsequent to its cessation cannot constitute expenditure 'actually incurred in the production of income' within the meaning of s 11(a)."

In instances where the portfolio transfer only includes a portion of the insurance policies written by that insurer and not all policies written by that insurer, it could be argued that portfolio transfers whilst continuing to trade in short-term insurance are simply an inevitable part of carrying on that business. This is based on the fact that an insurer will manage its portfolios of insurance policies to maximise the return on investment of its investors. Should it identify any poor performing books of business or books of business in particular niche risk areas where it does not necessarily have the required expertise or economies of scale to best manage the insurance risk, it might elect to transfer the portfolio of insurance policies to another insurer who might be able to manage the book more profitably. There is however always the argument that the transferor is actually ceasing to trade in respect of the particular insurance policies transferred and that it can therefore not conclusively be said that the expense is incurred as an inevitable concomitant of trade. However, it still remains an inevitable concomitant of trade to fulfil the risk the policyholder insured with the insurer and since the transferor would be required from a regulatory perspective to pay the working capital to the transferee to enable the transferee to fulfil this risk on its behalf it follows that it can be argued that the payment of the working capital must be an inevitable concomitant of trade on this basis.

Further to this, should the insurer cease to trade and the portfolio transfer includes all the insurance policies that it has written on its insurance license, the payment of the working capital does not at first sight appear to be incurred for the purposes of trade.

[36] *ITC 1171*, 1971
[37] *ITC 1672*, 1998
[38] Koker & Williams, 2019:paragraph 7.17

However, the cost was still incurred in order to ensure that the insurance policies the transferor entered into continue to be serviced and therefore the fact that the insurer will cease to trade thereafter should not prevent the insurer from deducting this expenditure from its taxable income.

3.2.2.6 Not of a capital nature

The last requirement is that the expenditure should not be of a capital nature. This requirement is specifically excluded from the scope of this dissertation as indicated in section 1.4.

3.3 The tax implications of a portfolio transfer for the transferee

3.3.1 Technical reserves assumed

The tax treatment of the technical reserves would be in accordance with section 28(3) as discussed in detail in section 2.3 Technical reserves from a tax perspective, which effectively means that the transferee would be entitled to a tax deduction of the net technical liabilities transferred, calculated as UPR less DAC plus OCR plus IBNR. The tax implications of the transfer of the technical reserves are thus sufficiently addressed by the current provisions contained in section 28 of the IT Act.

This can be demonstrated with reference to the values used in Example 2 (refer to 1.1 Background) where taxable income decreased with an amount of R1,950,000, being the full value of the technical reserves transferred.

This treatment is not, however, in line with the commercial nature of a portfolio transfer where no profit or loss is realised by the transferor. Further to this, it is not in line with the general principle that insurance income and expenses are included in taxable income during the year when the income / expenditure is incurred as concluded on in Chapter 2. However, similar to the position of the transferor, it is first necessary to consider the tax implications of the working capital before a meaningful conclusion can be drawn.

3.3.2 Cash received in respect of the working capital

In order to determine the tax implications of the working capital received by the transferee, it should first be determined whether such income qualifies as gross income as defined in section 1 of the Act in which case the profit would be subject to income tax at 28%.

The definition is as follows:

"(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
(ii) …,
during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, … , certain amounts, whether of a capital nature or not, ..."

It was confirmed in *CIR vs Butcher Bros*[39] that the amount must be quantifiable in order to be included in gross income. Seeing as the working capital is calculated as the net amount of technical reserves transferred and the amount is specified in the sale agreement, it can be said that that the amount is quantifiable.

In order to satisfy the condition 'in cash or otherwise', it was confirmed in *Lategan v CIR*[40] that the taxpayer must be unconditionally entitled to the income in any form of property, including debts and rights of action. Seeing as a physical cash payment is received, this condition is satisfied.

The reference to received by or accrued to indicates that the income will be included in taxable income upon the earlier of these two dates and not on both dates, as was confirmed in *CIR v Delfos*[41]. In this instance the working capital is typically received on a date specified in the sale agreement and the date of receipt and accrual typically are on

[39] *CIR v Butcher Bros (Pty) Ltd*, 1945:31825
[40] *Lategan v CIR,* 1926:20
[41] *CIR v Delfos*, 1933:251

the same day or very close to each other, hence this requirement is not considered problematic in the current scenario.

Seeing as a short-term insurer is a company which is formed with the main purpose to generate profit, the onus to be discharged by a company to prove that a transaction is of a capital nature is more difficult than that of an individual. It was previously indicated that this dissertation will not address the question whether the amount received is of a capital or revenue nature, however, this statement still holds ground in respect of the fact that the amount should be included in taxable income. This is on the basis that a short-term insurer is a company with the main objective of generating profit and therefore an even more difficult onus of proof to be discharged by a company than proving that income is capital in nature would be that it does not qualify as income in either a revenue or capital form.

It therefore follows that the working capital received by the transferee would qualify as gross income to be included in the taxable income of the transferee.

3.4 Conclusion

From the analysis above it is clear that the current tax treatment of the technical reserves when a portfolio transfer occurs from both the perspective of the transferor and the transferee are sufficiently addressed by section 28.

However, the tax treatment of the working capital is problematic from the perspective of the transferor with regards to whether the expenditure is 'incurred' 'in the production of income' and 'for the purpose of trade'. There are various interpretations and arguments that can be applied resulting in a conclusion that the tax deductibility of the working capital is uncertain from the perspective of the transferor and different conclusions can be reached based on the particular facts and circumstances giving rise to the portfolio transfer. It is however, nevertheless clear that the working capital will be included in the taxable income of the transferee.

CHAPTER 4: TAX IMPLICATIONS OF PORTFOLIO TRANSFERS INTERNATIONALLY

When looking at portfolio transfers from an international perspective, there is very little literature available to provide insight seeing as this is a very complex and specific scenario within an already specialised area of taxation.

For the purpose of this dissertation guidance was obtained from the research paper that was drafted for the Financial Services Board to assess the impact of the implementation of the SAM principles on the taxation of insurers in jurisdictions comparable to South Africa[42]. SAM is basically a risk-based supervisory framework which was issued by the Financial Services Board to align the regulatory capital requirements of insurers to the underlying risk of the insurer and to promote the adoption of more sophisticated risk monitoring and risk management tools by insurers. This SAM research paper considered various international countries and identified a selected list of jurisdictions as the "most relevant to South Africa in terms of the basis of taxation, the regulatory environment, size and state of development of the economy, and any other relevant factors".[43]

From this list, the jurisdictions selected for this dissertation as indicated in Chapter 1 include the United Kingdom, Switzerland and Ireland on the basis that the tax legislation of short-term insurers (also referred to as general insurers in certain countries) in these countries is based on International Financial Reporting Standards ('IFRS'), which aligns to the approach adopted in South Africa. It is also important to note that the accounting profits are the starting point for the tax calculations of all these countries with specific tax adjustments to calculate the taxable income, similar to the approach adopted in South Africa.

For each country a brief summary of the tax treatment as summarised in the research paper is provided if it is relevant to this dissertation, followed by the treatment of portfolio transfers specifically.

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[42] Solvency Assessment and Management Tax Working Group 2, 2012
[43] Solvency Assessment and Management Tax Working Group 2, 2012:4

4.1 United Kingdom

“The basis of the tax computation is the profit for accounting purposes. EU-listed groups are required to use IFRS, other entities may use UK GAAP, although it is expected that the accounting bases will merge over time.

The technical reserves (unpaid/outstanding claims, IBNR and unexpired risk) for accounting purposes are deductible for tax purposes provided they do not exceed the “appropriate amount”. The General Insurers‘ Technical Reserves (Appropriate Amount) Tax Regulations introduced in 2009 require general insurers to give confirmation to HMRC that the amount of liabilities (including unpaid claims reported, IBNR and unexpired risk) stated in the accounts is not an excessive estimate of the liabilities (i.e. appropriate). The confirmation must be founded on or supported by an opinion in writing given to the general insurer by an actuary or a suitably skilled person (which may include a director or employee of the general insurer) stating that the amount of liabilities is not an excessive estimate. If the liabilities are considered to be in excess of the appropriate amount then the corporation tax deduction is restricted.”[44]

Tax Treatment of Portfolio Transfers

In the UK there is specific tax legislation (similar to section 28 from a South African perspective) prescribing the tax treatment of technical reserves. This is referred to as the “General Insurers‘ Technical Reserves (Appropriate Amount) (Tax) Regulations” as discussed in the extract above.

The current tax implications of a portfolio transfer of technical reserves and working capital are as follows from both the perspective of the transferor and transferee:
“Assuming that the assets and labilities are held at fair market value for tax and accounting purposes, then tax would follow the accounts. On this basis … then there would be no profit or loss on disposal.” [45]

[44] Solvency Assessment and Management Tax Working Group 2, 2012:11
[45] Barnes (Deloitte), personal communication 2019, December 2

4.2 Switzerland

"Tax is based on the statutory accounts i.e. financial reporting/accounting which is Swiss GAAP but certain listed companies use IFRS or US GAAP. No distinction is made between long-term and short-term insurers."[46]

Tax Treatment of Portfolio Transfers

The Swiss do not have any specific tax legislation (similar to section 28 from a South African perspective) prescribing the tax treatment of technical reserves. "Provisions need to be commercially justified in order to be allowed for tax purposes. Technical reserves that are accepted by the regulator (Swiss Financial Market Supervisory Authority FINMA) are, in general, equally accepted for tax purposes." [47]

The current tax implications of a portfolio transfer of technical reserves and working capital are as follows:
Transferor: Income tax is only due if a gain is realised through the transfer.[48]
Transferee: No income tax should be due.

It thus follows that the portion of a portfolio transfer included within the scope of this dissertation does not have any tax consequences for either the transferor or transferee from a Swiss perspective.

4.3 Ireland

"The basis of the tax computation is the profit for accounting purposes. EU-listed groups are required to use IFRS, other entities may use Irish GAAP.

[46] Solvency Assessment and Management Tax Working Group 2, 2012:12
[47] Gruendel (Deloitte), personal communication 2019, December 13
[48] It should be noted that the realised gain referred to relates to Transaction 2 (Transferor) of the "Illustrative accounting entries of a portfolio transfer" example in section 1.1 and is excluded from the scope of this dissertation.

Solvency II changes to the regulatory returns are not expected to result in changes to the tax computation. However, should IFRS change in time to align more closely to Solvency II there may be a tax impact. As an indication, changes on first time adoption of IFRS were phased in for tax over 5 years."[49]

Tax Treatment of Portfolio Transfers

Ireland does not have any specific tax legislation (similar to section 28 from a South African perspective) prescribing the tax treatment of technical reserves. "In accordance with s76A Taxes Consolidation Act ('TCA') 1997, in respect of trading profits, Irish tax law follows generally accepted accounting practice subject to any adjustment required or authorised by law in computing such profits or gains of a company for tax purposes. On the basis that they are properly estimated in accordance with generally accepted accounting practice, are incurred wholly and exclusively for the purpose of the trade and are not specifically disallowable, they should be deductible for Irish tax purposes." [50]

The current tax implications of a portfolio transfer of technical reserves and working capital are as follows from both the perspective of the transferor and transferee:
"On the assumption that the reserves are appropriately valued, then we would not expect to see any tax implications for the transferor or transferee. ... We have also assumed this is a transaction between 3rd parties on an arm's length basis."

4.4 Conclusion

From an international perspective all of the countries included in the analysis for this dissertation confirmed that a portfolio transfer of technical reserves as included within the scope of this dissertation does not result in any tax consequences. This treatment is in line with the accounting treatment of a portfolio transfer and in line with the purpose of the tax legislation.

[49] Solvency Assessment and Management Tax Working Group 2, 2012:11
[50] Webb (Deloitte), personal communication 2019, November 4

CHAPTER 5: IS THE CURRENT TAX TREATMENT FAIR AND REASONABLE?

5.1 Premium

It was concluded in Chapter 2 that the purpose of the current short-term insurance tax legislation is that premium income is taxed in the year of assessment when the insurance service is delivered, regardless of when payment occurs.

However, the application of the current tax provisions would not result in this outcome when a portfolio transfer occurs. In terms of section 28(2)(a) the gross written premium will be included in taxable income on the date of commencement of risk i.e. the date that the insurance cover incepts. If a portfolio transfer did not occur, the current provisions contained in section 28(3) and 28(4) would result in this income only being taxed during the year in which the premium income accrues i.e. insurance cover is provided as demonstrated in Example 4.

However, the effect that a portfolio transfer has on the provisions of section 28(3) and 28(4) is not in line with the purpose of the tax legislation seeing as the income will be taxed at the time the portfolio transfer occurs i.e. not in line with the basis of accrual and the party who issued the insurance policy will be taxed as opposed to each party providing a taxable insurance service being taxed.

Refer to Example 1 and 2. The effect of the portfolio transfer is that the transferor will be taxed on the full premium income of R3m as at December 2019. The transferee will qualify for a deduction from taxable income of R1.5m as at December 2019, without any amount being included in taxable income. This benefit is only a timing difference as the R1.5m deduction will be added to taxable income as at December 2020. It thus currently cannot be concluded that the result yielded by the tax legislation is fair and reasonable.

In order for the tax legislation to achieve the desired purpose, it is required that the working capital in respect of the UPR is included in taxable income when a portfolio transfer occurs. This will be in line and similar to the current provision contained in section 28(2)(a) to include the amount in the taxable income of the transferee. A specific deduction would then need to be added from the perspective of the transferor.

Should the suggested amendments[51] be incorporated into the tax legislation the revised result for Example 2 would be as follows (note that December 2018 was eliminated for the transferee seeing as all balances are zero and December 2020 was added to demonstrate the end result of the amendments).

Illustrative SOCI and Tax Calculation of the transferor:

	December 2019	**December 2018**
SOCI		
Premium income	3,000,000.00	2,000,000.00
UPR	-500,000.00	-1,000,000.00
Claims provisions (OCR + IBNR)*	-200,000.00	-250,000.00
Profit before tax	**2,300,000.00**	**750,000.00**
Taxable Income		
Profit before tax	2,300,000.00	750,000.00
Add back movement in accounting provisions		
UPR	500,000.00	1,000,000.00
Claims provisions (OCR + IBNR)*	200,000.00	250,000.00
Deduct section 28 current year balances:		
UPR	-	-1,000,000.00
Claims provisions (OCR + IBNR)*	-	-250,000.00
Add back section 28 prior year balances:		
UPR	1,000,000.00	-
Claims provisions (OCR + IBNR)*	250,000.00	-
Portfolio Transfer adjustment:		
UPR	-1,500,000.00	
Claims provisions (OCR + IBNR)*	-450,000.00	
Taxable income	**2,300,000.00**	**750,000.00**

[51] The deduction of the working capital for the transferor and the inclusion thereof in taxable income of the transferee is referred to as a "Portfolio Transfer adjustment".

Illustrative SOCI and Tax Calculation of the transferee:

	December 2020	December 2019
<u>SOCI</u>		
Premium income	-	-
UPR	-	-
Claims provisions (OCR + IBNR)*	-	-
Profit before tax	**-**	**-**
<u>Taxable Income</u>		
Profit before tax	-	-
<u>Add back movement in accounting provisions</u>		
UPR	-	-
Claims provisions (OCR + IBNR)*	-	-
<u>Deduct section 28 current year balances:</u>		
UPR	-	-1,500,000.00
Claims provisions (OCR + IBNR)*	-	-450,000.00
<u>Add back section 28 prior year balances:</u>		
UPR	1,500,000.00	-
Claims provisions (OCR + IBNR)*	450,000.00	-
<u>Portfolio Transfer adjustment:</u>		
UPR	-	1,500,000.00
Claims provisions (OCR + IBNR)*	-	450,000.00
Taxable income	**1,950,000.00**	**-**

**Claims were included in this example to remain comparable to the initial Example 2.*

It is clear from the above that the transferor is now only taxed on the portion of premium related to the period during which insurance services was provided by the transferor i.e. the R1.5m relating to the 6 months prior to the portfolio transfer. These services are being taxed during the 2019 year of assessment in line with the accrual of the income. The remainder of the R1.5m premium income will be taxed in the hands of the transferee during 2020 when insurance services are provided by the transferee.

These amendments will have no negative impact on the fiscus as the net position remains unchanged, however, the impact for each individual tax payer would be in line with the purpose of the tax legislation and there would be absolute certainty on the tax treatment of portfolio transfers as opposed to the current uncertainty as is clearly demonstrated in Chapter 3. This would yield a result that is fair and reasonable from a tax perspective.

5.2 Commission

It was concluded in Chapter 2 that the purpose of the current short-term insurance tax legislation is that commission expenditure is allowed as a deduction in the year of assessment during which the expenditure is incurred, regardless of when payment occurs.

However, the application of the current tax provisions would not result in this outcome when a portfolio transfer occurs. The total commission expense incurred by a short-term insurer in terms of IFRS is allowed as a deduction from taxable income in terms of the general deduction formula in section 11(a) and will not be subject to the limitations imposed by section 23H as stated in section 28(2)(d)(i). The effect of section 28(2) and (3) on commission expenditure if no portfolio transfer occurs, is that only the commission expense incurred in respect of the particular underwriting year per the AFS is included in taxable income for that particular year of assessment as demonstrated in Example 4.

The effect that a portfolio transfer has on the provisions of section 28(3) and 28(4) is not in line with the purpose of the tax legislation seeing as the commission expense will now be deducted at the time the portfolio transfer occurs i.e. not in line with the basis of accrual and the party who issued the insurance policy will be claiming the deduction as opposed to each party incurring the commission expense being able to claim the deduction from taxable income.

Seeing as the principles applicable to commission are exactly the same as premium (commission is just the inverse of premium), the same example as the one used in premium above was used to demonstrate the amendments required for commission. Assume commission is calculated as 20% of premium income, claims have been ignored for the purposes of this explanation.

The effect of the portfolio transfer is that the transferor will enjoy a deduction of the full commission expense of R600k as at December 2019. The transferee will have an inclusion in taxable income of R300k as at December 2019, without being allowed any deduction.

This is only a timing difference as the R300k inclusion will be deducted from taxable income as at December 2020. It thus currently cannot be concluded that the result yielded by the tax legislation is fair and reasonable, seeing as the transferor enjoyed a deduction of R300k in respect of expenditure it will never incur and the transferee will effectively not receive a deduction from taxable income, because it will be countered by the amount included in taxable income

In order for the tax legislation to achieve the desired purpose, it is required that the working capital in respect of the DAC is deducted from taxable income of the transferee and specifically included in the taxable income of the transferor when a portfolio transfer occurs.

Illustrative SOCI and Tax Calculation of the transferor:

	December 2019	**December 2018**
SOCI		
Premium income	3,000,000.00	2,000,000.00
UPR	-500,000.00	-1,000,000.00
Commission expense	-600,000.00	-400,000.00
DAC	100,000.00	200,000.00
Profit before tax	**2,000,000.00**	**800,000.00**
Taxable Income		
Profit before tax	2,000,000.00	800,000.00
Add back movement in accounting provisions		
UPR	500,000.00	1,000,000.00
DAC	-100,000.00	-200,000.00
Deduct section 28 current year balances:		
UPR	-	-1,000,000.00
DAC	-	200,000.00
Add back section 28 prior year balances:		
UPR	1,000,000.00	-
DAC	-200,000.00	-
Portfolio Transfer adjustment:		
UPR	-1,500,000.00	
DAC	300,000.00	
Taxable income	**2,000,000.00**	**800,000.00**

Illustrative SOCI and Tax Calculation of the transferee:

	December 2020	December 2019
<u>SOCI</u>		
Premium income	-	-
UPR	-	-
Commission expense		
DAC	-	-
Profit before tax	**-**	**-**
<u>Taxable Income</u>		
Profit before tax	-	-
<u>Add back movement in accounting provisions</u>		
UPR	-	-
DAC	-	-
<u>Deduct section 28 current year balances:</u>		
UPR	-	-1,500,000.00
DAC	-	300,000.00
<u>Add back section 28 prior year balances:</u>		
UPR	1,500,000.00	-
DAC	-300,000.00	-
<u>Portfolio Transfer adjustment:</u>		
UPR	-	1,500,000.00
DAC	-	-300,000.00
Taxable income	**1,200,000.00**	**-**

It is clear from the above that the transferor is now only deducting the portion of commission related to the period during which insurance services was provided by the transferor i.e. the R300,000 relating to the 6 months prior to the portfolio transfer. These services are being deducted during the 2019 year of assessment in line with the accrual of the expenditure. The remainder of the R300,000 commission will be deductible in the hands of the transferee during 2020 when insurance services are provided by the transferee and commission expenditure incurred.

5.3 Claims

From an accounting perspective claims are recognised in the underwriting year / financial year during which they are incurred, regardless of when payment occurs and it was confirmed in Chapter 2 that the purpose of the current short-term insurance tax legislation is aligned.

This outcome is achieved from a tax perspective in that section 28(2) allows all claim payments as a deduction from taxable income without taking into account any limitations (in respect of sections 23(c) and 23H), section 28(3) allows any OCR and IBNR provisions as at year end as a deduction and the opening balance of OCR and IBNR is included in taxable income i.t.o. section 28(4).

The impact of a portfolio transfer on the tax treatment of claims is that the transferor will be taxed on the full amount reserved in respect of OCR and IBNR to date if the amounts weren't paid at the time of the portfolio transfer and the transferee will be allowed a deduction of this amount.

This is demonstrated with reference to Example 1 & 2. The total claims reserves of R450,000 is included in the taxable income of the transferor. The transferee will qualify for a deduction from taxable income of R450,000 as at December 2019, without any amount being included in taxable income. This benefit is not just a timing difference as was the case for premium. Even though the R450,000 deduction will be added to taxable income as at December 2020, this inclusion in taxable income will eventually net off to the deduction from taxable income during the year of assessment when the transferee physically pays the claim settlement to the policyholder. The result is thus that claims are not allowed as a deduction when they are incurred and also not when they are paid. Based on the current legislation an immediate deduction is available for the transferee (who is not the party who incurred the claims cost) at the time the portfolio transfer occurred. It is clear that the absurd result achieved by the current tax legislation is not fair and reasonable.

In order for the tax legislation to achieve the desired purpose, it is required that the working capital in respect of the OCR and IBNR is included in taxable income of the transferee and allowed as a specific deduction from the taxable income of the transferor when a portfolio transfer occurs. Should the suggested amendments be incorporated into the tax legislation the revised result for Example 2 would be as per the illustrative examples included in subsection 5 Premium.

It is clear from these examples that the transferor would now be able to deduct the balance of OCR and IBNR reserved in respect of claims incurred until the date of the portfolio transfer and the transferee will not receive a deduction again when the claim settlements are actually paid due to the section 28(4) inclusion. The transferee would only receive a deduction from taxable income should these reserves not be sufficient and additional reserves are incurred after the portfolio transfer. This is in line with the current tax principles to allow as a deduction from taxable income the amount of claims incurred during a particular year of assessment, which would be a fair and reasonable result from a tax perspective.

5.4 Proposed legislative changes

It was demonstrated in the previous paragraphs that a fair and reasonable result could be achieved from a tax perspective, should the working capital be included in the taxable income of the transferee and allowed as a deduction from the taxable income of the transferor.

This would be in line with the proposed amendments that were contained in the Draft Tax Law Amendment Bill of 2011 issued on 2 June 2011 ('the Bill'). These amendments were aimed at addressing the uncertainties experienced when contingent liabilities are assumed in the sale of a business as a going concern, by providing clear guidance as to the tax treatment to be applied by both the purchaser and the seller. These proposed amendments effectively confirmed that a deduction of the expense will be available for the seller and that the amount be included in the income of the purchaser, similar to what is suggested in respect of the working capital for the transferor (seller) and transferee (purchaser) in this dissertation.

The proposed amendment in respect of the seller read as follows:

"36. (1) The Income Tax Act, 1962, is hereby amended by the insertion after section 11E of the following section:

"Deduction of contingent liabilities discharged as part of disposal of going concern

11F. Where, in terms of any transaction, a person disposes of a business undertaking as a going concern to a purchaser and—

(a) that person is, in terms of that transaction, partially or fully relieved of any contingent liability of that person as a result of the assumption of that contingent liability by that purchaser;

(b) the consideration payable by the purchaser in terms of that transaction has been determined by that person and that purchaser after taking into account the assumption of the contingent liability by that purchaser; and

(c) the contingent liability relates to that business undertaking,

the fair market value of that contingent liability must, on the date of that disposal and for the purposes of determining the taxable income derived by that person from carrying on a trade, be deemed to be an amount of expenditure actually incurred in the production of the income of that person derived from trade."

This conclusively confirms that a deduction will be available to the seller. A similar deeming provision could potentially be incorporated in section 28 in respect of an amount paid by the transferor insurer to the transferee insurer as required in terms of the Insurance Act and regulated by the Prudential Authority to assume the technical reserves that forms part of a portfolio transfer. This provision would then specifically deem the amount of working capital paid to be expenditure actually incurred in the production of the income of the transferor for the purpose of trade. This will then provide absolute clarity in respect of all the arguments that were discussed in Chapter 3.

The amendment relating the purchaser read as follows:

"53. (1) The Income Tax Act, 1962, is hereby amended by the insertion after section 24C of the following section:

"Inclusion and allowance in respect of contingent liabilities assumed as part of acquisition of going concern

24CA. (1) Where, in terms of any transaction, a person acquires a business undertaking as a going concern from a seller and—

(a) that seller is, in terms of that transaction, partially or fully relieved of any contingent liability of that seller as a result of the assumption of that contingent liability by that person;

(b) the consideration payable by the person in terms of that transaction has been determined by that seller and that person after taking into account the assumption of the contingent liability by that person;

(c) the contingent liability relates to that business undertaking,

the fair market value of that contingent liability must be included in the income of that person for the year of assessment during which that disposal is made.

(2) Where, during any year of assessment, an amount is included in the income of a person in terms of subsection (1) by virtue of the assumption by that person of a contingent liability as contemplated in that subsection, any expenditure of that person in respect of that contingent liability that is likely to be incurred by that person in a future year of assessment must be allowed as a deduction for the year of assessment in which it is so included if, but for the contingency, it would have been allowed as a deduction in that year of assessment.

(3) The amount that is allowed as a deduction from the income of a person in any year of assessment in terms of subsection (2) must be deemed to be an amount received by or accrued to that person in the following year of assessment."

The effect of the suggested amendment is that the purchaser will include such amount in its taxable income, together with a deduction (based on its latest best estimate of the amount payable) which would result in a Rnil impact on taxable income in the year the transaction occurs if such estimate remains unchanged. Should the estimate increase, the purchaser will be entitled to a deduction of the amount in excess of the original estimate and should the amount be less than the original estimate, then the purchaser will effectively be taxed on the difference. However, such deduction will again be included in the taxable income of that purchaser until such time as the contingent liability is actually paid. This results in no deduction for the purchaser of the original estimate, as it has already been claimed as a deduction by the seller. However, should the actual expenditure incurred exceed the initial estimate, the purchaser will be entitled to a deduction from taxable income of the amount paid in excess of the original estimate and taxed on the difference should the amount be less than the initial estimate.

This legislation is in line with what is currently achieved by section 28, especially when looking at the claims reserves where the amount is allowed as a deduction in terms of section 28(3) based on the best estimate of the liability at the point in time when the claim cost is incurred (e.g. the amounts reserved as OCR & IBNR) instead of when the claims are actually paid.

A similar provision could thus be contained in section 28 to allow for the amount received by the transferee insurer from the transferor insurer, as required in terms of the Insurance Act and regulated by the Prudential Authority to assume the technical reserves that forms part of a portfolio transfer, to specifically be included in the taxable income of the transferee during the year the portfolio transfer occurs. There would not be a need for provisions similar to section 24CA(2) and (3) as this will already be achieved by the current section 28. Refer to the illustrative examples contained in Chapter 4.1 – 4.3 where this was demonstrated.

Unfortunately these amendments were withdrawn on the basis that differing views existed as to whether the purchaser or the seller should be entitled to the deduction[52]. It was consequently decided that the matter be resolved by the release of a binding general ruling or interpretation note to clarify the tax treatment. In response to this SARS issued IN94.

With regards to short-term insurance it is highly unlikely that a similar view would exist due to the complex nature of the taxation of short-term insurance and the difficulties specific to a portfolio transfer as discussed in Chapter 3 and 4. It is also important to note the specific wording used in the EM to the TLAB of 2012 to substantiate the reasons for the legislative changes that were made to section 28 to "create more certainty"[53]. This is

[52] National Treasury & SARS:14
[53] EM to the TLAB, 2012:paragraph 3.5

in line with the proposal in this dissertation to amend section 28 to specifically prescribe the tax treatment of the working capital when a portfolio transfer occurs.

A fair and reasonable result could also be achieved by provisions stipulating a non-deduction and non-inclusion of the working capital and reserves related to a portfolio transfer, as this would achieve a similar result to what is reflected in the SOCI. However, this would ultimately lead to more complex legislation, seeing as the current legislation already addresses the recoupment of the technical reserves for the transferor and the deduction for the transferee in line with the normal technical reserve rules contained in section 28.

Based on the current proposed legislative changes, the only additional legislation would be a specific inclusion / deduction in respect of the working capital. Hence no changes would be required to the treatment of the technical reserves based on the current section 28.

5.5 Conclusion

Chapter 4.1 – 4.3 concluded that the result achieved by the current tax legislation when a portfolio transfer occurs is not fair and reasonable on the basis that it is not in line with the purpose of the short-term insurance tax legislation. Premiums are currently taxed in the hands of the transferor at the date the portfolio transfer occurs instead of being taxed as insurance services are rendered and in the hands of the insurer rendering these services. Commission is currently deducted in full by the transferor at the date the portfolio transfer occurs instead of being deductible as these services are being provided by the brokers in the hands of the insurer incurring this expense. Lastly claims incurred up until the date of the portfolio transfer which is not yet paid as at that date are being allowed as a deduction in full in the hands of the transferee on the date of the portfolio transfer, instead of being allowed as a deduction as and when they are incurred and by the insurer who actually incurred the claims cost.

In order to derive a fair and reasonable result from a tax perspective, it is necessary that the working capital be allowed as a specific deduction from the taxable income of the transferor and a specific inclusion in the taxable income of the transferee as was discussed in Chapter 4.4.

These amendments will have no negative impact on the fiscus as the net position remains unchanged, however, the impact for each individual taxpayer would be in line with the purpose of the tax legislation and there would be absolute certainty on the tax treatment of portfolio transfers as opposed to the current uncertainty as is clearly demonstrated in Chapter 3. This would yield a result that is fair and reasonable from a tax perspective.

CHAPTER 6: CONCLUSIONS AND RECOMMENDATIONS

6.1 Introduction

The purpose of this dissertation has been to establish whether the current legislation sufficiently addresses the tax consequences of the transfer of technical reserves between short-term insurers as part of a portfolio transfer to yield a fair and reasonable result from a tax perspective.

This question was addressed in the following manner:

Chapter 2 provided a detailed analysis of the technical reserves related to premium, commission and claims of a short-term insurer from an accounting, regulatory and tax perspective and concluded on the recognition criteria and purpose of the tax legislation in this regard.

Chapter 3 summarised what a portfolio transfer entails and considered the tax implications of the technical reserves and the working capital transferred from both the perspective of the transferor and the transferee. It demonstrated the current uncertainty experienced by short-term insurers when determining the tax implications of a portfolio transfer.

Chapter 4 addressed the tax implications of portfolio transfers from an international perspective.

Chapter 5 assessed whether the current tax treatment of a portfolio transfer yields a fair and reasonable result from a tax perspective and considered potential recommendations in terms of legislative changes to ensure that the result is in line with the purpose of the tax legislation.

A summary of the issues, conclusions and ultimately recommendations transpiring from the preceding chapters are outlined below.

6.2 Chapter 2: Technical reserves of short-term insurers

Based on the analysis in Chapter 2, the nature of the technical reserves recognised in the AFS in terms of IFRS are in line with the nature of the technical reserves from a regulatory perspective and hence included in a portfolio transfer as prescribed by the Insurance Act.

It was concluded that the purpose of technical reserves from an accounting perspective is to ensure that only premium income earned and commission expenditure incurred are recognised in the particular underwriting year / financial year in respect of which the premium is earned i.e. the risk cover period of the insurance contract. Claims are recognised in the underwriting year / financial year during which they are incurred, regardless of when payment occurs.

The tax treatment of technical reserves is therefore in line with the accounting treatment and hence premium income is taxed in the year of assessment when the insurance service is delivered and commission and claims expenditure is allowed as a deduction in the year of assessment during which the expenditure is incurred, regardless of when payment occurs.

6.3 Chapter 3: Portfolio transfers

Chapter 3 demonstrated that the current tax treatment of the technical reserves when a portfolio transfer occurs from both the perspective of the transferor and the transferee are sufficiently addressed by section 28.

The chapter continued with an in depth analysis of the tax treatment of the working capital, especially from the perspective of the transferor. The tax treatment of the working capital is problematic from the perspective of the transferor with regards to whether the expenditure is 'incurred' 'in the production of income' and 'for the purpose of trade'. There are various interpretations and arguments that can be applied resulting in a conclusion that the tax deductibility of the working capital is uncertain from the perspective of the transferor and different conclusions can be reached based on the particular facts and circumstances giving rise to the portfolio transfer. It is however, nevertheless clear that the working capital will be included in the taxable income of the transferee.

6.4 Chapter 4: Tax implications of portfolio transfers internationally

From an international perspective all of the countries included in the analysis for the purpose of this dissertation confirmed that a portfolio transfer of technical reserves as included within the scope of this dissertation does not result in any tax consequences. This treatment is in line with the accounting treatment of a portfolio transfer and in line with the purpose of the tax legislation.

6.5 Chapter 5: Is the current tax treatment fair and reasonable?

This chapter concluded that the result achieved by the current tax legislation when a portfolio transfer occurs is not fair and reasonable on the basis that it is not in line with the purpose of the short-term insurance tax legislation. Premiums are currently taxed in the hands of the transferor at the date the portfolio transfer occurs instead of being taxed as insurance services are rendered and in the hands of the insurer rendering these services.

Commission is currently deducted in full by the transferor at the date the portfolio transfer occurs instead of being deductible as these services are being provided by the brokers in the hands of the insurer incurring this expense. Lastly claims incurred up until the date of the portfolio transfer which are not yet paid as at that date are being allowed as a deduction in full in the hands of the transferee on the date of the portfolio transfer, instead of being allowed as a deduction as and when they are incurred and by the insurer who actually incurred the claims cost.

In order to derive a fair and reasonable result from a tax perspective, Chapter 4 concluded that it is necessary that the working capital be allowed as a specific deduction from the taxable income of the transferor and a specific inclusion in the taxable income of the transferee.

These amendments will not have a negative impact on the fiscus as the net position remains unchanged, however, the impact for each individual taxpayer would be in line with the purpose of the tax legislation and there would be absolute certainty on the tax treatment of portfolio transfers as opposed to the current uncertainty as is clearly demonstrated in Chapter 3.

This would then yield a result that is fair and reasonable from a tax perspective.

6.6 Final remarks and recommendations

It is clear from the analysis above that there is a lot of uncertainty and that there are several arguments in support of and opposing whether the payment of the working capital would qualify as a deduction from taxable income. The arguments could also differ significantly depending on the facts and circumstances applicable to the particular portfolio transfer such as whether the transferor will cease to trade. These factors all contribute to the need for clarity from a legislative perspective as it is not desirable for the tax implications of a portfolio transfer to yield such inconsistent results.

It is imperative that sufficient certainty regarding the tax rules exist in order for insurers to make decisions based on the expected tax consequences and to ensure that these rules are consistently applied for all portfolio transfers, especially due to the significant financial amounts involved in a portfolio transfer. The current level of uncertainty raise the level of risk associated with a portfolio transfer and makes the transaction more expensive for insurers, with the result that transactions that are crucial from a business perspective are delayed or discouraged.

The conclusion reached in this dissertation is to specifically address this issue within the tax legislation by introducing additional provisions to specifically allow the payment of the working capital as a deduction from the taxable income of the transferor and an inclusion in the taxable income of the transferee, will create certainty and ensure consistency of the tax implications of portfolio transfers in the insurance industry.

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