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**AN ANALYSIS OF THE PROPOSED ANNUAL MARK-TO-MARKET  
TAXATION OF THE CAPITAL GAINS OF LONG-TERM INSURANCE  
POLICYHOLDERS**

**Student name:** Niel Johnson

**Student number:** JHNNIE001

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**Supervisor(s):** Afton Titus / Tracy Gutuza

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## DECLARATION

I, Niel Johnson, declare that this dissertation entitled, '*An analysis of the proposed annual mark-to-market taxation of the capital gains of long-term insurance policyholders*' is my own work, that all the sources used or quoted have been indicated and acknowledged by means of complete references, and that this dissertation was not previously submitted by me for a degree at any other university.

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## **Introduction**

This dissertation explores National Treasury's mark-to-market proposal which aims to tax the unrealised capital gains of long-term insurance policyholders on an annual basis. Although the proposal was ultimately rejected it remains under consideration.

The mark-to-market proposal is evaluated against its intended purpose. The intended purpose is understood to be the collection by the South African Revenue Service (SARS) of capital gains tax (CGT) which has been 'effectively withheld' from policyholders by the insurer. Having gained an understanding of the mark-to-market proposal and its intended purpose, the proposal will be measured against the following criteria:

- Does it succeed in recovering capital gains taxes which have been 'effectively withheld' from policyholders?
- What are the side-effects of the proposal, if any?

The practical implementation of the proposal falls outside the scope of this dissertation.

Chapter I provides a basic overview of capital gains tax and the taxation of the long-term insurance industry.

Chapter II describes the events which led to the proposal and ultimate withdrawal of mark-to-market taxation.

Chapter III explores the finer mechanics of CGT in the long-term insurance environment and considers the intended purpose of the mark-to-market proposal with this as background.

Chapter IV evaluates the theoretical outcome of the proposal against its intended purpose. As a start, a hypothetical case study determines the financial impact of the proposal under actual market conditions over the past ten years (2003 to 2012). This

is followed by an assessment of the appropriateness of the proposal in achieving its intended purpose, whereby certain side-effects of the proposal are pointed out.

Chapter V includes an analysis of the tax neutrality between a long-term insurance investment policy and a competitive alternative investment, in this case one in a portfolio of a collective investment scheme in securities (CIS).

Chapter VI sets out the findings arising from the research performed and concludes with recommendations.

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## Chapter I – Overview of capital gains tax and the four funds approach

In order to explore the impact of changes to the taxation of capital gains in the long-term insurance environment, it is essential to have a basic understanding of two of the more complex areas in South African tax law, namely capital gains tax and the four funds approach. This chapter provides a basic overview and is limited to that which is relevant to enable an understanding of the remainder of this dissertation.

### 1.1 Overview of capital gains tax

Gross income is defined as ‘the total amount, in cash or otherwise, received by or accrued to or in favour of such [person] ... during such year or period of assessment, excluding receipts or accruals of a capital nature...’.<sup>1</sup> By definition, gross income specifically excludes ‘receipts or accruals of a capital nature’. Accordingly capital income is not accounted for in taxable income by way of an inclusion in gross income. Instead the Eighth Schedule to the Income Tax Act 58 of 1962 (‘the Act’) provides for the calculation of a person’s taxable capital gain and it is this taxable capital gain which is included in the taxable income of that person.<sup>2</sup>

In its basic form, a capital gain arises where a capital asset is sold, or otherwise disposed of.<sup>3</sup> Any profit or loss from the disposal of a capital asset is referred to as a capital gain or capital loss and is subject to capital gains tax. With the CGT liability being triggered by a disposal or deemed disposal of an asset, this addresses any liquidity issues which could arise if taxes were charged on unrealised assets. SARS refers to this dependency on a disposal of an asset as a ‘realisation basis’ of taxation.<sup>4</sup>

The Eighth Schedule to the Act contains an intricate set of rules for the calculation of capital gains and losses which will not be covered here. What is important to note is that after the calculation of all the capital gains and losses from each asset disposal

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<sup>1</sup> Section 1 of the Income Tax Act 58 of 1962.

<sup>2</sup> Section 26A of the Income Tax Act 58 of 1962.

<sup>3</sup> Paragraph 2 of the Eighth Schedule of the Income Tax Act 58 of 1962.

<sup>4</sup> SARS *Guide to Capital Gains Tax* (2000) 24.

during a year of assessment, these are aggregated.<sup>5</sup> Where the net result is a profit, only a portion of this net capital gain is required to be included in taxable income.<sup>6</sup> The percentage to be included is commonly referred to as the ‘CGT inclusion rate’. A net capital loss is not subtracted from taxable income but can be carried forward for set-off against future capital gains.<sup>7</sup>

Since only a portion of the net capital gain is included in taxable income, the effective tax rate applicable to capital gains is lower than the rate applicable to a person’s normal income. As a result the concept of what constitutes a capital asset is one of the most debated tax issues in South Africa. In respect of the sale of an asset, courts have held that the intention with which an asset is acquired and ultimately realised is an important factor in determining whether the asset was of a capital nature and, in the absence of other factors indicating the contrary, is conclusive. Where this intention involved a scheme of profit-making from the sale of an asset, the receipt from the disposal of such asset is not on capital account and falls within the ambit of gross income.<sup>8</sup>

This dissertation does not intend to partake in this debate and assumes that all assets held and administered by long-term insurance companies (also ‘insurers’ or ‘life companies’) for the benefit of policyholders are of a capital nature. As such any referral to ‘asset’ will bear the meaning of an asset held on capital account.

## 1.2 *Overview of the four funds approach*

Long-term insurance companies are taxed in accordance with a unique model, the rules of which are contained in s 29A of the Act. In practice referred to as the ‘four funds approach’, this model caters for the separate taxation, on an accrual basis, of the insurer’s profits from the underwriting of insurance products on the one hand, and policyholder investment income on the other.<sup>9</sup>

<sup>5</sup> Paragraph 6 of the Eighth Schedule to the Income Tax Act 58 of 1962.

<sup>6</sup> Paragraph 10 of the Eighth Schedule to the Income Tax Act 58 of 1962.

<sup>7</sup> Paragraphs 8 to 10 of the Eighth Schedule to the Income Tax Act 58 of 1962.

<sup>8</sup> *CIR v Stott* 1928 AD 252, 3 SATC 253; *Natal Estates Ltd v SIR* 1975 (4) SA 77 (A), 37 SATC 193.

<sup>9</sup> PA Donaldson *An analysis of the appropriateness of the four funds approach for the taxation of life insurers in South Africa including a qualitative comparison to the recently enacted approach adopted in New Zealand and recommendations for improvement to the approach* MCom (UCT) (2011) iv.



The four funds approach was enacted in 1993 following its proposal by the Jacobs Committee. One of the key principles motivated by the Jacobs Committee was that '[t]he "trustee principle" should be adhered to in respect of all income representative of the insurer's constituent body of policyholders and should reflect all relevant aspects of their taxation, including the effective tax rate.'<sup>10</sup>

The trustee principle is pivotal to the four funds approach. It is a practical solution to the taxation of policyholder income. The life insurer acts as trustee on behalf of policyholders with regards to the calculation and collection of income taxes on policyholder investments.<sup>11</sup> As such the tax liability is administered on behalf of the policyholders in the hands of the life insurer.

Very importantly, this achieves the taxation of policyholder income on an accrual basis. This is essential because due to the long-term nature of long-term insurance products, '[t]axing the full savings element at the time of the benefit payment would be a deferral of tax which is unlikely to be acceptable to the revenue collectors.'<sup>12</sup> The taxing of policyholder income during the roll-up stage of the investment means that benefits paid to policyholders are almost always already after tax.<sup>13</sup>

The fact that the tax affairs are taken care of in the hands of the insurer further sidesteps the issue of policyholder liquidity. Clover explains, '[i]f the tax liability for income is passed on to the policyholder as the income accrues, there is the problem that tax becomes payable before the individual has access to the income that generated the tax liability'.<sup>14</sup> Taxing policyholder income in the hands of the insurer greatly reduces the administrative burden on policyholders, which is an important selling point of life policies.

On the contrary, one of the greatest weaknesses of the four funds approach also stems from the application of the trustee principle. Taxing policyholders centrally at the insurer level does not allow knowledge of each individual policyholder's

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<sup>10</sup> Jacobs Committee 'Report of the committee of investigation into the promotion of equal competition for funds in financial markets in South Africa' (1992) 89.

<sup>11</sup> National Treasury 'Explanatory Memorandum on the Taxation Laws Amendment Bill' (2012) 60.

<sup>12</sup> RJ Clover 'Taxation of Life Insurance in South Africa Revisited' (2008) 8 *SAAJ I* at 3.

<sup>13</sup> Donaldson op cit (n9) 9; Clover op cit (n12) 4.

<sup>14</sup> Clover op cit (n12) 4.

effective tax rate for any year of assessment. Instead a single flat tax rate applies in respect of the taxation of individual policyholders' income. A 30 per cent tax rate was proposed as an appropriate average individual policyholder tax rate when the four funds approach was originally designed.<sup>15</sup> This proxy tax rate is a notorious weakness of the four funds approach, but an accepted pragmatic approach.<sup>16</sup>

To give effect to the trustee principle, s29A(4) of the Act requires the insurer to establish four separate funds, each effectively representing a separate taxpayer. One of these, the Corporate Fund ('CF'), represents the interest of the corporate entity conducting the insurance business. In practice the CF is commonly referred to as the shareholder.

The other three tax funds represent the interests of the policyholders. These are:

- the Individual Policyholder Fund ('IPF'),
- the Company Policyholder Fund ('CPF'), and
- the Untaxed Policyholder Fund ('UPF').

The reason for the three categories of policyholder funds is that each represents policyholders of a different nature who are normally taxed at different tax rates. The UPF includes mainly tax exempt policyholders (eg pension funds) and is itself exempt from tax. The CPF includes companies and is taxed at the company tax rate of 28 per cent. The IPF includes all other policyholders<sup>17</sup> (mainly individuals) and is taxed at 30 per cent.<sup>18</sup>

This dissertation will focus solely on individual policyholders as represented by the IPF. The UPF is not impacted by the mark-to-market proposal as it is a tax exempt body. Out of the remaining two policyholder funds the IPF accounts for the vast majority of insurance products. Any reference to 'policyholder' will accordingly be to an individual, unless otherwise stated.

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<sup>15</sup> Jacobs op cit (n10) 92.

<sup>16</sup> Donaldson op cit (n9) 48-9.

<sup>17</sup> Section 29(4)(a) of the Income Tax Act 58 of 1962.

<sup>18</sup> Section 3(d) of the Rates and Monetary Amounts and Amendment of Revenue Laws Act No 13 of 2012.

## **Chapter II – Proposal of the annual mark-to-market taxation of long-term insurance policyholders**

### *2.1 The 2012 budget speech – increase of the annual inclusion rate*

On 22 February 2012, Minister of Finance, Pravin Gordhan, in delivering the 2012 National Budget Speech, announced an increase in the capital gains inclusion rates. The increased rates were enacted on 13 March 2012 and are already effective, applying to years of assessment commencing on or after 1 March 2012.<sup>19</sup>

As noted in Chapter I, only a portion of a person's net capital gain is included in taxable income. Before 1 March 2012 individuals included only 25 per cent of their net capital gain in taxable income. This inclusion rate increased to 33.3 per cent effective 1 March 2012. The increase in the capital gains inclusion rate therefore increased the effective CGT rate of the IPF from 7.5 per cent to 10 per cent.<sup>20</sup> An amendment to paragraph 10 of the Eighth Schedule provides specifically for the new inclusion rates to apply in respect of an insurer's policyholder funds for asset disposals on or after 1 March 2012.<sup>21</sup>

### *2.2 Adverse impact on insurers' tax position*

The increase in the effective CGT rate posed an immediate problem to the tax position of insurers. Acting as trustees on behalf of millions of policyholders, life companies manage large asset portfolios for the benefit of their policyholders. In terms of the four funds approach the insurer withholds and pays over various taxes as proxy for those policyholders. This includes CGT on policyholder assets.

The problem facing life insurers following the increased CGT rates is one of timing and sprouts from the fact that there is often a lag between the insurer withholding CGT in its role as trustee and the payment thereof to SARS. Chapter III will explore the finer mechanics of CGT in the life environment and specifically consider the idea

<sup>19</sup> Section 9(1) of the Rates and Monetary Amounts and Amendment of Revenue Laws Act No 13 of 2012.

<sup>20</sup>  $30\% \times 25\% = 7.5\%$ ;  $30\% \times 33.3\% = 10\%$ .

<sup>21</sup> Section 105 of the Taxation Laws Amendment Act No 22 of 2012.

of ‘effectively withholding’ CGT as a trustee. For now it is enough to know that, at the time of withholding CGT from policyholders, the insurer had a certain expectation of the future CGT on unrealised capital gains, and that the CGT ultimately due on those gains will now have increased.

In practice, life insurers are the legal owners of the policyholder investment assets. Under the trustee principle policyholders have a notional ownership in the assets.<sup>22</sup> During a year of assessment certain policies may mature and disinvest from their notional interest in the portfolio, while new policies may enter the portfolio to acquire a notional interest. As a result of this continuous in and out flow of policyholder funds, there is often no need for the insurer to dispose of the underlying assets in order to fund benefit payments.<sup>23</sup> This results in an indefinite tax deferral which would not have existed if the notional ownership (where a notional disinvestment from the assets does not trigger CGT) was in fact a legal ownership (where disinvestment from the assets would trigger CGT).

Upon the notional disinvestment by a policyholder the insurer calculates and withholds an amount representing CGT on the notional disposal. The disconnection between notional and legal disposal creates a timing lag between the withholding of CGT and the payment thereof to SARS. The increase in the CGT inclusion rates means that, when the actual assets are disposed of, more tax is payable than what was previously withheld.

The following example was published by National Treasury to illustrate the problem:<sup>24</sup>

*Facts:*

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

<sup>22</sup> The concept of ‘notional ownership’ is covered in more detail in Chapter III.

<sup>23</sup> Benefit payments are also referred to as a “claims” or “policy pay-outs”.

<sup>24</sup> National Treasury Media Statement ‘Effective date of increased capital gains tax rates for long-term insurers and related matters’ (2011) 2.

*Result:*

*Long-term insurer allocates R92.50 of post-tax gain to Individual Policyholder A on 20 February 2012. This gain is based on the R100 unrealised gain in respect of Share X less reserving of R7.50 for the Capital Gains Tax (i.e. effective rate of 7.5 per cent on the notional gain of R100). Long-term insurer allocates R45 of post-tax gain to Policyholder B on 10 August 2012 (R50 realised gain less the capital gains tax of R5), less a further capital gains tax charge of R2.50 (2.5 per cent on the initial R100 gain which is realised on 10 August 2012).*

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

### 2.3 *Remedy: A once-off deemed disposal event*

On 16 April 2012 National Treasury published a Media Statement in response to life industry concerns which aimed to deal with this anomaly. It was proposed that all unrealised gains on policyholder assets as at the close of 29 February 2012 be realised by way of a deemed disposal and immediate reacquisition of the underlying assets (the ‘once-off deemed disposal event’).<sup>25</sup> The deemed disposal has the effect of taxing all gains accruing before 1 March 2012 at the old lower effective CGT rate of 7.5 per cent. The deemed reacquisition adjusts the base cost of policyholder assets to the asset values as at the close of 29 February 2012. As such unrealised capital gains are reset to zero and any subsequent disposal of an asset will trigger tax only on the gain or loss accumulating from 1 March 2012 onwards, with this amount taxable at the new CGT rate of 10 per cent.

The disadvantage of the once-off deemed disposal event is that it triggers the payment of tax on the unrealised gains of the entire<sup>26</sup> policyholder asset portfolio, without the actual realisation of the underlying assets. This drawback was accepted

<sup>25</sup> National Treasury op cit (n24) 3.

<sup>26</sup> Subsequently the once-off deemed disposal rules were amended to scope out certain instruments. These relate largely to interest bearing instruments which are not expected to produce significant capital gains.

by the industry as a compromise for the special dispensation to make use of the lower tax rate.<sup>27</sup> In order to fund the tax payment an outflow of policyholder assets is required. To remedy the negative impact of this unexpected cash outflow on liquidity, the tax on the deemed disposal event is spread over a period of four years.<sup>28</sup>

In addition to the above, National Treasury briefly raised the question of whether unrealised capital gains on policyholder assets should simply be taxed on an annual mark-to-market basis (the 'mark-to-market proposal' or 'the proposal').<sup>29</sup> This would mean effectively having a deemed disposal, similar to the one on 29 February 2012, at the end of each year of assessment of an insurer. In July 2012 the draft Taxation Laws Amendment Bill 2012 was published and included a new section, Section 29B, titled 'Mark-to-market taxation in respect of long-term insurers'. As expected, this section included the details in respect of the once-off deemed disposal event. Surprisingly it also provided for the mark-to-market proposal.<sup>30</sup>

#### 2.4 *Life industry objections*

Various meetings between National Treasury, long-term insurance industry stakeholders and SARS followed. Although in agreement with the once-off deemed disposal event, the industry objected to the mark-to-market proposal. The opposition was mainly for two reasons:

- 1) An annual tax on the growth in policyholder assets would erode policyholder investment returns because of the law of compound returns; and
- 2) A tax on unrealised capital gains would put strain on liquidity exactly because the assets being taxed remain unrealised.<sup>31</sup>

Although the draft s29B did provide for the CGT liability arising on each deemed disposal to be spread over a period of four years,<sup>32</sup> this provides only temporary

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<sup>27</sup> ASISA Letter to: Chief Director of Legal Tax Design, National Treasury (28 February 2012).

<sup>28</sup> National Treasury op cit (n24) 4.

<sup>29</sup> National Treasury op cit (n24) 4-5.

<sup>30</sup> Section 70(1) of the Draft Taxation Laws Amendment Bill, 2012.

<sup>31</sup> ASISA op cit (n27).

relief. After four years each payment would again represent four quarters and will only have the effect of smoothing payments. There would thus no longer be any tax deferral in relation to unrealised capital growth.

National Treasury agreed to put the mark-to-market proposal on hold and to review this as part of an ongoing project whereby the entire four funds tax model is being reviewed.<sup>33</sup> The final version of the Taxation Laws Amendment Bill 2012 was published on 25 October 2012 (promulgated on 1 February 2013) with s29B remaining in place under the heading 'Mark-to-market taxation in respect of long-term insurers'. It provides only for the once-off deemed disposal on 29 February 2012 but not for the mark-to-market proposal. It is certainly clear that National Treasury has not completely withdrawn the proposal, but is merely reconsidering pending further investigation.

The purpose of this dissertation is to assist with this investigation.

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<sup>32</sup> Section 70(1) of the Draft Taxation Laws Amendment Bill, 2012.

<sup>33</sup> Standing Committee on Finance (SCOF) 'Report-Back Hearings: Draft Taxation Laws Amendments Bill, 2012 and Tax Administration Laws Amendment Bill, 2012' (2012) 18.

## Chapter III – Understanding the mark-to-market proposal

### 3.1 *Understanding the mechanics of CGT in the life insurance environment*

#### 3.1.1 *Build-up of policyholder assets*

In terms of the four funds approach, the insurer is required to place<sup>34</sup> in each policyholder fund assets with a market value equal to the value of policyholder liabilities.<sup>35</sup> In general terms, the policyholder liabilities represent the present value of expected future benefit payments to policyholders, actuarially determined in terms of the prescribed statutory valuation method.<sup>36</sup> The assets referred to are funded from policyholder contributions in the form of premiums. These assets produce investment returns, mainly in the form of dividends, interest, rental and capital growth. In terms of the trustee principle, the investment returns are taxable in the hands of the insurer and hence only the after-tax investment return can be applied for the benefit of policyholders. While dividends, interest and rental is taxed as it is earned, capital growth remains unrealised and untaxed until the asset is disposed. This is in accordance with the realisation basis of the Eighth Schedule of the Act as discussed in Chapter I.

The policyholder asset base thus comprises of net policyholder contributions (ie premiums less claims and expenses),<sup>37</sup> taxed investment income (including realised capital gains), and untaxed unrealised capital gains.

For investment income (ie interest, dividends, rental) it is a theoretically simple exercise to deduct tax from the gross return, allocate the net return to policyholders and pay the tax component over to SARS.<sup>38</sup> In similar fashion, where policyholder assets have been disposed of during a year of assessment the insurer allocates any

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<sup>34</sup> 'Place' under the conceptual four funds model means 'allocate' or 'attribute'.

<sup>35</sup> Section 29A(4) of the Income Tax Act 58 of 1962.

<sup>36</sup> Schedule 3 to the Long Term Insurance Act 52 of 1998.

<sup>37</sup> Expenses and the insurer's profits are also taken from the policyholder asset base, but for the remainder of this discussion it can be accepted that these have already been stripped from the policy premium.

<sup>38</sup> Policyholder investment income is to a large extent subject to the standard income tax rules while s 29A(11) prescribes special rules for expense allowances (outside the scope of this paper).



realised capital gains from those disposals only after deducting the related CGT charge, which amount is included in the tax liability to SARS. However, where policyholder assets remain unrealised but have grown in market value, the gain remains unrealised and as such does yet not attract tax. This does not mean the insurer can allocate the entire gain for the benefit of policyholders without any regard for tax as CGT *will* become due on the gain but only upon the eventual realisation of the asset.

### *3.1.2 Deferred tax on unrealised investments*

The concept of deferred tax recognises that current events have future tax consequences. With regards to the above scenario of investment assets, unrealised capital growth of an asset stands to be taxed upon the future disposal of that asset. It is therefore appropriate to reserve for this future CGT liability.<sup>39</sup> The amount available for allocation to policyholders should be reduced by the unrealised CGT which the return would attract in case of its disposal. Practically this is done by recognising the existence of a deferred tax liability in addition to the policyholder liability, and allocating assets for the purpose of meeting this future liability. The insurer accordingly holds sufficient policyholder assets not only to service future policyholder claims, but also to meet the deferred CGT liability.

### *3.1.3 CGT reserve*

It is interesting to consider the assets held in relation to the deferred CGT liability (the 'CGT reserve'). These assets continue to produce investment returns and these returns continue to be available for the benefit of policyholders. The deferral of CGT until time of disposal facilitates the opportunity for greater investment returns. This is the essence of the tax benefit inherent in the construct of the CGT regime.

Consider as an example a person purchasing shares in Company X for R100. At the end of the tax year the value of the shares is R150. The unrealised gain on the investment is R50 which includes a CGT reserve of R5 (assuming an effective CGT

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<sup>39</sup> F Kruger (FIA) (personal communications held on 17 January 2013).

rate of 10 per cent). If the CGT had to be paid at the end of the tax year the taxpayer would have had to sell some shares to free up cash. This would mean a reduced capital base (fewer shares) and accordingly a smaller entitlement to any future dividends and capital growth from the investment.

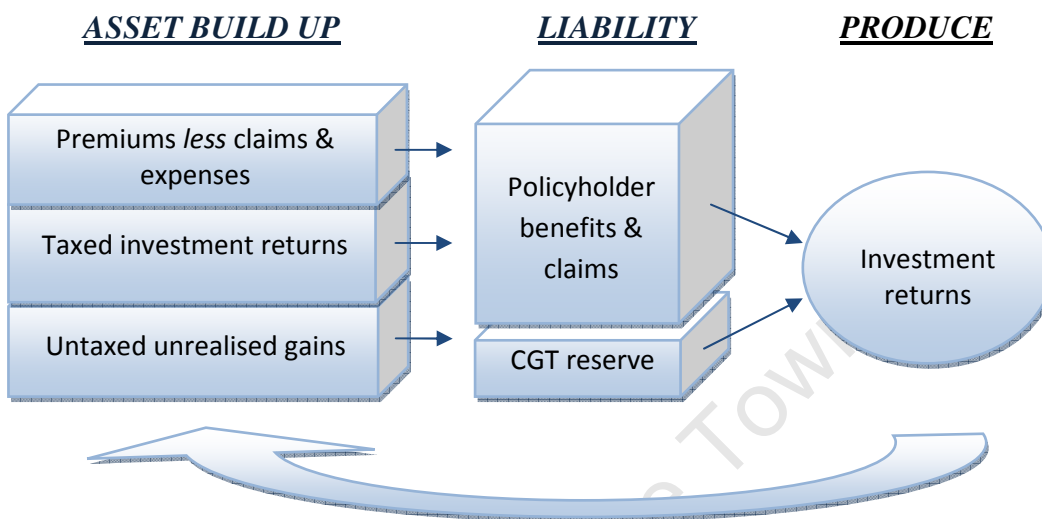


Figure 1: An illustration of the build-up of the policyholder asset base, reserving for CGT in addition to the policyholder liability, and the continued fruits of the CGT reserve

### 3.2 Understanding the mark-to-market proposal

#### 3.2.1 The intended purpose

National Treasury, in advocating the annual mark-to-market proposal, commented:

*This annual taxation would be consistent with the approach already taken by long-term insurers, most or all of whom are annually setting aside capital gains tax potentially payable in respect of policyholder assets. This amount should accordingly be paid over on an annual basis as capital gains tax is effectively being withheld by the long-term insurer in its role as trustee. A mark-to-market approach would also be consistent with the growing trend to shift towards applying a mark-to-market system for treating financial products for financial reporting purposes.<sup>40</sup>*

The above paragraph reflects the view of National Treasury in respect of the collection of CGT on policyholder investment returns (also referred to as

<sup>40</sup> National Treasury op cit (n24) 4.

policyholder ‘savings’) from the insurer under the trustee principle. There does however appear to be an oversight in that there is no distinction between two very different components of the CGT reserve. The annual ‘setting aside [of] capital gains tax potentially payable’ refers to the insurer’s process of reserving for future CGT as mentioned in the previous section. This does however not equate to an amount which is ‘effectively being withheld’ as is suggested in the above comment. The following sections aim to clearly draw the distinction between the ‘setting aside’ of CGT and the ‘effective withholding’ thereof.

### 3.2.2 ‘Annually setting aside’

There is no significant difference between an insurer setting aside assets in respect of deferred CGT, and any other taxpayer in the same position. For the life company this means that the assets so set aside will not flow to policyholders in the form of future benefit payments, but is designated for potential future tax payments. Any other taxpayer investing on their own behalf will be in the same position. Take a company that owns an investment asset which grows in value. There is always a portion of the unrealised capital growth which will not be for its own benefit but will translate into a future tax charge following the disposal of the asset. The company will thus never be entitled to the full gain on the investment.<sup>41</sup> However, at current, the capital gain remains unrealised and as such the taxpayer is entitled to the returns produced by the entire capital base, including those from the portion of assets designated for a potential future tax payment.

### 3.2.3 ‘Effectively being withheld’

It is important to understand what is meant by ‘effectively withheld’. National Treasury cites this as the reason why unrealised gains should be taxed on an annual basis.

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<sup>41</sup> Accounting practice (IAS 12.20) in fact requires the recognition of a deferred tax liability on balance sheet to reduce the net asset value by the future tax component. The effect of this is that a company would recognise only the after-tax gain on the investment as a profit even though the tax liability has not yet been triggered. International Accounting Standards Board *International Financial Reporting Standards*, 2011.

The withholding of taxes from policyholders can best be illustrated by considering the example of a linked-investment policy.<sup>42</sup> The policyholder contributes a lump sum with the policy benefit being linked to the market value of Share A. The insurer purchases Share A in the market. The value of share A gradually increases over the policy term, producing an unrealised gain. On an ongoing basis the insurer provides for deferred CGT by notionally ‘setting aside’ a portion of the shareholding for this future tax payment. However, the amount is not ‘effectively withheld’ seeing as the policyholder remains entitled to investment returns on the entire shareholding. When the policy matures the insurer pays out the policyholder benefit equal to the market value of the shareholding *less* the amount which was continuously ‘set aside’ for CGT. The policyholder no longer has any entitlement to the return on those assets ‘set aside’. This is the point at which CGT is ‘effectively withheld’.

This concept relies on the basis that there is a link between the policyholder owning a policy and the insurer owning assets in support of the potential policy pay-out. National Treasury refers to this link using the term ‘notional policyholder ownership’.<sup>43</sup> Although the legal arrangement is such that the insurer has legal ownership of policyholder assets, it is ultimately the policyholder who is entitled to the fruits associated with ownership of those assets. (The trustee principle again comes through strongly). The idea of notional ownership by a policyholder means that events at the policyholder level are important when determining tax consequences of policyholder assets. Upon a policy pay-out the policyholder realises the financial benefits intrinsic in the assets notionally owned via the policy. The policyholder effectively disinvests from the policy assets – the notional ownership is interrupted. This notional disposal is in sync with the ‘effective withholding’ of CGT by the insurer.

It has already been demonstrated that although there is a continuous reserving for deferred CGT, this does not reduce the capital base from which policyholder returns are produced. Even though some assets have been ‘set aside’ for future tax payments they continue to produce investment returns for policyholders. Accordingly this

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<sup>42</sup> Under a linked investment policy the value of the policy is derived from the value of the underlying assets. The investment mimics a direct investment in the underlying assets.

<sup>43</sup> National Treasury op cit (n11) 61.

capital cannot be regarded as having been ‘effectively withheld’ without there being an interruption of notional ownership.

As mentioned Chapter II, there is often a timing lag between the withholding of CGT from policyholders and the payment thereof to SARS. This happens where an unrealised gain on an asset has been allocated against a policy liability, a portion of the asset has been ‘set aside’ for meeting the related deferred CGT liability, that policy has subsequently been settled<sup>44</sup> but the asset remains unrealised. In such a case notional ownership of that asset by the policyholder has been interrupted and the related CGT is considered to have been ‘effectively withheld’ from the policyholder, yet the CGT reserve remains unrealised (ie the CGT is not paid to SARS).

The CGT reserve can accordingly be split into two separate components, one relating to existing policy liabilities (‘in-force policies’) and the other relating to settled policy liabilities. Only the second category is representative of CGT which has been ‘effectively withheld’ from policyholders.

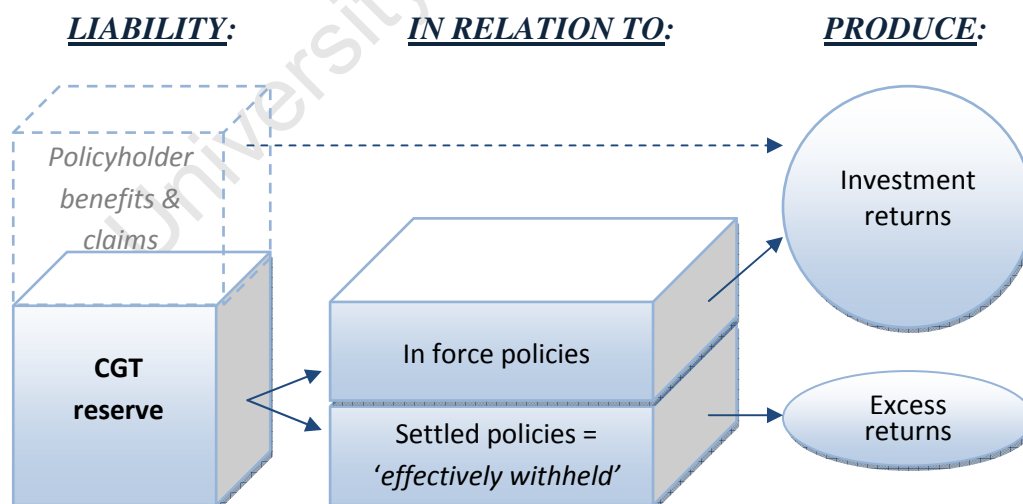


Figure 2: Building onto Figure 1, an illustration of the two components of the CGT reserve and how this results in producing excess returns.

<sup>44</sup> The term ‘settled’ refers to the extinguishing of a policy liability and will be used throughout this paper. Various occurrences can result in ‘settlement’, for example a claim / benefit payment, policy maturity, lapse, or cancellation.

### 3.2.4 *An unusual benefit – ‘excess returns’*

The CGT reserve having been ‘effectively withheld’ continues to produce investment returns. Seeing as it relates to settled policy liabilities, these are ‘excess returns’ over and above the returns from the asset base notionally owned by policyholders.

Consider as an example an asset portfolio comprising of a single investment property. As the property grows in value, this unrealised gain is allocated against the various policies which are notionally invested in the property. A portion of the asset growth is also ‘set aside’ in respect of deferred CGT. When a single policy matures the insurer does not dispose of the entire property but instead funds the claim from working capital. The asset portion held in relation to the deferred CGT on the unrealised gain allocated to that particular policy thus remains on hand. The property continues to produce the same returns as previously, but there is now one less policy sharing in the total return. This clearly presents a benefit which would not otherwise have been available had the notional CGT charge actually been paid over to SARS.

There are two potential beneficiaries of these excess returns, namely the remaining policyholders and the insurer itself.<sup>45</sup> One possibility is that the insurer prices the excess returns into the policyholder liabilities, thereby effectively passing on the benefit to policyholders. Where excess returns are not included in the policyholder liabilities, policyholder assets have grown by more than the related policyholder liabilities. Under the theory of the four funds approach, the excess returns will be transferred out of the policyholder asset base and added to the insurer’s asset base. This transfer of assets will be taxed as income in the hands of the insurer.<sup>46</sup>

The fairness in the excess returns will be addressed in the next chapter as part of the evaluation of the mark-to-market proposal.

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<sup>45</sup> F Kruger (FIA) (personal communications held on 17 January 2013).

<sup>46</sup> In terms of s29A(7) of the Income Tax Act 58 of 1962. This ‘transfer’ is outside the scope of this dissertation.

## Chapter IV – Evaluation of the mark-to-market proposal

To recap, the intended purpose of the proposed mark-to-market taxation of long-term insurers is the collection of capital gains tax which have been ‘effectively withheld’ from policyholders. The basis for this motion is the notional ownership of the policyholder assets by the policyholders themselves. Accordingly events at the policyholder level should reflect in the actual tax transactions. Where a notional ownership is interrupted, this is equivalent to a notional disposal of assets and should accordingly be deemed to give rise to CGT. Further support for the proposal is the emergence of an unusual benefit in the form of excess returns.

The mark-to-market proposal will now be evaluated against its intended purpose. The first step will be a look at the financial impact of the application of the mark-to-market rules to the insurance environment.

### *4.1 Financial impact of the application of the drafted mark-to-market rules to the insurance environment*

In addition to the once-off deemed disposal of policyholder assets on 29 February 2012, the original draft s29B – as published on 5 July 2012 –<sup>47</sup> provided for a further deemed disposal of policyholder assets on the last day of each year of assessment of an insurer. The amount for which the assets are deemed to be disposed and reacquired depends on which one of three categories the asset falls into (debt, derivative or other) but effectively comes to fair value or market value, hence ‘mark-to-market’ taxation. Twenty-five per cent of the total gain or loss is included in each of the current and following three years of assessment. The purpose of spreading the tax liability was to smooth the impact of potentially volatile market conditions.<sup>48</sup>

The following simplified example is based on actual market conditions over the past ten years and illustrates the financial impact of mark-to-market taxation in its proposed form.

<sup>47</sup> Section 70(1) of the Draft Taxation Laws Amendment Bill 2012.

<sup>48</sup> National Treasury ‘Draft Explanatory Memorandum on the Taxation Laws Amendment Bill’ (2012) 66.

*Example:*

On 1 January 2003 an insurer receives R1 billion lump sum premiums from policyholders. This is invested into a portfolio of assets which exactly tracks the JSE All Share index.<sup>49</sup> In accordance with its investment mandate the insurer annually disposes of 20 per cent of all policyholder assets and acquires replacement assets of equal value (therefore a ‘churn rate’ of 20 per cent per year). For sake of simplicity, (i) the effective CGT rate is assumed to be 10 per cent over the entire period of time, (ii) there are no premiums or claims cash flows during the period, (iii), there is no other income (eg interest, dividends), and (iv) no regard is given to the effect of the once-off deemed disposal event which occurred on 29 February 2012.

*Results:*

The following table compares certain aspects after ten years, as at 31 December 2012, under the current law versus under the mark-to-market proposal, including (i) value of policyholder assets, (ii) investment return over the period, (iii) value of the CGT reserve, and (iv) amount of tax collected by SARS:<sup>50</sup>

Assumptions:

Index: JSE All Share - capital (J203)

Period: 10 years (2003 - 2012)

Initial investment: R1 billion

Asset churn rate: 20% pa

CGT rate: 10%

RESULTS (Rm):	No MTM	With MTM	Difference	Diff %
<b>Insurer:</b>				
Policyholder assets	4 124	3 826	-298	-7.2%
Pre-tax return	3 187	3 082	-105	-3.3%
Deferred CGT reserve	255	51	-204	-79.9%
<b>SARS:</b>				
Tax collected	64	257	193	302.9%

<sup>49</sup> JSE All Share index market data obtained from I-Net Bridge.

<sup>50</sup> Calculations are included in Appendix A to this paper.



Over the ten year period the value of policyholder assets is reduced by R298 million (7.2 per cent) under mark-to-market taxation. Almost two-thirds<sup>51</sup> of this is a result of accelerated tax payments to SARS (R193 million) while the remaining third is a consequential loss of investment returns (R105 million).

It is quite evident that mark-to-market does succeed in collecting taxes on unrealised gains much quicker than before. This is achieved by more regular tax extractions from the policyholder asset base. This does however come at a price – the savings on the original capital contribution of R1 billion was eroded by R105 million, or 10.5 per cent, over the ten year period. Mark-to-market taxation reduced the annualised investment return on policyholder assets from 15.4 per cent<sup>52</sup> to 15.1 per cent.<sup>53</sup>

#### 4.2 *Misdirected mechanism*

In the previous chapter it was pointed out that National Treasury's motivation for mark-to-market taxation failed to recognise and distinguish between two different components of the CGT reserve. To further illustrate this, National Treasury stated that:

*[I]nsurers subtract notional tax from the gain or loss [on] policyholder investments on a continual basis. This notional subtraction means that each policyholder is indirectly taxed on each policyholder's allocable growth... Insurers set aside these notional taxes for future payment to SARS via deferred tax reserves.<sup>54</sup>*

As stated previously, the 'setting aside' of assets for future CGT payments merely earmarks those assets for another purpose. It is not a deduction of those assets from a policyholder's notional ownership, nor a removal of a policyholder's right to returns from those assets. As a result of not drawing this distinction the mark-to-market proposal inappropriately targets the collection of CGT on *all* unrealised capital gains on policyholder assets, not just the portion of CGT 'effectively withheld'.

In the above example, an additional R193 million worth of tax was collected by SARS. While a portion of this amount may rightfully be regarded as 'effectively

<sup>51</sup> R 193 million / R 298 million = 65%.

<sup>52</sup>  $[1 + (3\,187 / 1\,000)]^{(1/10)} - 1 = 15.4\%$ .

<sup>53</sup>  $[1 + (3\,082 / 1\,000)]^{(1/10)} - 1 = 15.1\%$ .

<sup>54</sup> National Treasury op cit (n48) 63.

withheld' from settled policies, there may also be a portion relating to CGT on unrealised capital gains attributed to in force policies.

The recovery of CGT on unrealised capital gains attributed to in force policies effectively strips much of the tax deferral benefit afforded by the CGT regime. The mark-to-market proposal potentially results in an even quicker collection of CGT than the intended purpose aims for. Unrealised gains are being taxed regardless of events at the policyholder level.

It is apparent that in an effort to recover CGT 'effectively withheld' from policyholders but not paid to SARS, mark-to-market taxation goes to the extreme and recovers CGT on all unrealised policyholder gains. The continuous taxation of unrealised capital gains attributed to in force policies raises a justifiable concern as to the erosive impact on policyholder savings. In my opinion the intended purpose which the mark-to-market proposal seeks lies somewhere between current practice and mark-to-market taxation.

#### *4.3 The relevance of mark-to-market taxation to pure risk business*

In Chapter III it was determined that the 'effective withholding' of CGT, which underpins the intended purpose of mark-to-market taxation, is based on the notional ownership of policyholder assets by policyholders. National Treasury used the analogy to effectively illustrate the impact of the increased CGT rates on insurers.<sup>55</sup> It also assisted greatly in explaining the 'effective withholding' concept in Chapter III. Whether notional ownership is a feature of all insurance business requires further investigation.

Over the years the four funds approach has been subjected to numerous critical evaluations by field experts. More recently some authors<sup>56</sup> have proposed that long-term insurance business ought to be split into a risk and an investment component and that these should be taxed separately and potentially under different principles.

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<sup>55</sup> Refer Chapter II.

<sup>56</sup> Clover op cit (n12) 40; Donaldson op cit (n9) 86.

The lack of segregation of risk and investment business was raised as a problematic area even at the time of implementation of the four funds approach.<sup>57</sup>

‘Pure risk’ business has been described to entail ‘the pooling of risks where there is a zero sum game for the group as a whole, after allowing for expenses, profit for the underwriter and interim reserving for fluctuations’.<sup>58</sup> Theoretically, where the insurer accurately prices risk products, over time total premiums will exceed total claims only by the insurer’s profit and expenses. Accordingly normal income tax principles can be applied in taxing premiums as gross income, allowing for the deduction of claims and expenses, and adjusting for actuarial reserving.<sup>59</sup> Taxing premiums less claims and expenses effectively taxes only the underwriting profits built into the product premiums. Actuarial reserving serves to effectively defer premiums in order to match its timing with that of claims.<sup>60</sup>

When considering the differences in the nature of risk and investment business, there is a key distinction when it comes to the concept of notional ownership. While investment policyholders can be regarded as the notional owners of the related policyholder assets, this is not the case for policyholders under risk policies.

Accounting practice, which gives effect to the substance of arrangements over the legal form<sup>61</sup> thereof, distinguishes between insurance contracts and investment contracts. In terms of International Financial Reporting Standard (IFRS) 4, a defining feature of an insurance contract is that an insurer ‘accepts significant insurance risk’. Insurance risk is defined as ‘risk other than financial risk’.<sup>62</sup>

Under a pure risk policy an insurer assumes significant insurance risk in that the policy pay-out is dependent on an uncertain future event (the ‘insured event’). The insured event may be uncertain with regards to timing (eg whole of life policy) or

<sup>57</sup> TE Hartwig ‘Taxation of life insurance’ (1994) X(I) TASSA 196 at 200-1.

<sup>58</sup> Hartwig op cit (n57) 199.

<sup>59</sup> Ibid.

<sup>60</sup> Clover adequately illustrates the impact of a lack of actuarial reserving in the case of a cluster of single premium whole of life policies (ie the policy pays out only upon death of the insured). The insurer would show a large amount of taxable income at inception of the business, and tax losses for all subsequent years. Clover op cit (n12) 3.

<sup>61</sup> International Accounting Standards Board op cit (n41) Conceptual Framework.

<sup>62</sup> International Accounting Standards Board op cit (n41) IFRS 4 – Definitions.

with regards to its actual occurrence (eg income protection policy). The happening of the insured event is effectively outside of the control of both the policyholder and the insurer. This is important because this means that a policyholder's entitlement to any benefit from a pure risk policy is contingent on the insured event. As a policyholder only has a conditional right to benefit payments out of the policyholder asset base, it cannot be said that there is a notional ownership of those assets. There is no such link between the ownership of assets and the policy benefits payable to enable the inference of notional ownership. The substance of risk business therefore is in line with the legal form thereof, in that the insurer really is the beneficial owner of the policyholder assets. Conceptually there is no notional ownership by policyholders of the assets held in relation to the insurer's risk liability.

Further support for the lack of notional ownership in the policyholder under a pure risk policy is that the investment returns produced by assets held in relation to risk business cannot be designated for any particular policyholder. Again, this is because policy pay-outs are conditional on an insured event. Rather, these investment returns add to the capital base available to fund future claims of the policyholder group as a whole. As part of premium pricing, the insurer takes into account an expectation of investment returns on policyholder assets and this expected return reduces the premiums charged to policyholders.<sup>63</sup>

The trustee principle is thus irrelevant. In substance the insurer is the owner of an asset base which is managed to support the contractual obligations under risk policies. Donaldson, in researching the revamped New Zealand model for taxation of long-term insurance, notes that the trustee principle has indeed been removed from the taxation of risk business.<sup>64</sup> Under the New Zealand approach 'the risk portion of premiums, investment income, claims, expenses and policyholder reserves are taxable / deductible in the ... [shareholder fund]'.<sup>65</sup>

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<sup>63</sup> F Kruger (FIA) (personal communications held on 17 January 2013).

<sup>64</sup> Donaldson op cit (n9) 77-8.

<sup>65</sup> Donaldson op cit (n9) 77-8.

It is interesting to note that South African short-term insurance is taxed in line with these principles.<sup>66</sup> Apart from contract terms, there is very little difference in the business model of short- and long-term pure risk products. This further strengthens the case for a removal of long-term risk business from the trustee principle.

In my opinion risk business should be removed from the scope of mark-to-market taxation for the following reasons:

- There is no concept of notional ownership of the policyholder assets as a policyholder under a risk policy has only a conditional right to benefit payments in respect of which the insurer holds assets.
- The lack of notional ownership in policyholders means that the concept of ‘effectively withheld’ does not feature in risk business.
- It is the insurer’s actions in managing the assets which should trigger tax, not those of policyholders.
- No portion of the deferred CGT benefit can be applied to any individual in particular. Assets are held to meet the expected policyholder liabilities of the group of policyholders, therefore the group benefits as a whole.
- Mark-to-market taxation of risk products will deteriorate the savings potential of the related asset base and will ultimately result in higher premiums for policyholders.

#### *4.4 Consideration of the mark-to-market proposal on investment business*

The trustee principle has been found to be relevant in its application to investment business. It successfully taxes policyholder savings on an accrual basis in the hands of the insurer. The concept of notional ownership fittingly applies to investment business as a policyholder has a vested right to benefit payments in respect of which

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<sup>66</sup> Donaldson op cit (n9) 33.

the insurer holds assets. Accordingly there is a link between the policyholder's rights under the policy and the ownership of policyholder assets.

As discussed in Chapter III, under the four funds approach there is a potential unusual benefit in the form of excess returns arising on that part of the CGT reserve which has been 'effectively withheld' from policyholders. Following a policy payout, there is no longer a notional ownership by any policyholder to the assets 'set aside' in respect of CGT attributed to that policy. Yet those assets continue to produce investment returns. These can either be absorbed by the insurer or applied for the benefit of the policyholders.

SARS made the following comment as part of its response to written representations on the Taxation Laws Amendment Bill, 2005:

*The long run policy goal is to create more neutrality in the tax treatment on the returns of capital invested by individuals. Clearly, from a tax policy perspective one would like to strive for equity and neutrality in order to create an environment conducive to retirement savings with the maximum utilization of competitive market forces that tend to reduce transaction costs in the long-term savings market, with commensurate higher investment returns for individual policyholders.<sup>67</sup>*

Neutrality in the taxation of different types of investments has always been a crucial factor on which the four funds model is based. Next to the trustee principle, this was another one of the key principles in the original design of the four funds model. It is not only tax neutrality between different investment vehicles which should endure under the four funds model, but also competitive neutrality between the insurance industry and other financial industries.<sup>68</sup>

Clearly, where excess returns accrue to the insurer this would be considered an undue benefit seeing as the insurer is merely a trustee and should not have entitlement to investment returns on capital held for the benefit of policyholders. The

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<sup>67</sup> Clover op cit (n12) 29.

<sup>68</sup> Hartwig op cit (n57) 199-203.

situation where policyholders receive excess returns also constitutes an undue benefit which is not available to other forms of investment.

The mark-to-market proposal would therefore appropriately remove either of these undue benefits. Mark-to-market does however come with significant concerns over its potential side-effects on the erosion of policyholder savings.

It would therefore be appropriate to compare the overall CGT rules applicable to a long-term investment policy against an alternative investment opportunity. In the next chapter a comparison to the taxation of CISs is performed to identify whether there is neutrality between the taxation of these investments.

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## **Chapter V – Comparison of the CGT rules applicable to an investment policy in the IPF versus an investment in a portfolio of a collective investment scheme in securities**

The main issue with the annual mark-to-market taxation of policyholder capital gains lies in the potentially erosive impact on policyholder savings. This affects the competitiveness of investment product offerings by long-term insurers. It was also highlighted that there is potentially an undue benefit afforded to investment policies when compared to alternative savings media, in the form of excess returns.

This chapter will compare the CGT rules applicable to an individual investment policy against those applicable to an investment by an individual in portfolio of a collective investment scheme in securities ('CIS'). This is believed to be an appropriate comparison as both an investment policy and a CIS rely on the trustee principle. A CIS holds and administers a portfolio of assets on behalf of investors. The total asset portfolio is notionally subdivided into a number of units of equal value. An investor in a CIS owns a participatory interest in the portfolio which is represented by a number of units out of the total pool of units, and is accordingly referred to as a 'unit holder'. While the legal ownership of the assets remains with the CIS, the notional ownership thereof by the investors is given effect by way of this unitisation. Similar to an investment policy, a CIS offers investors the opportunity to invest even small amounts into diversified asset portfolios.<sup>69</sup>

The taxation of a CIS is akin to that of a trust. On the condition that any income which accrues to a CIS is distributed to its unit holders within 12 months of receipt, the income is deemed to accrue directly to the unit holder on the date of distribution. Income which is not distributed within the said 12 month period is taxed in the hands of the CIS at the 40 per cent<sup>70</sup> tax rate applicable to trusts.<sup>71</sup>

A capital gain or loss is determined in the hands of a unit holder in respect of the participatory interest held upon the disposal of that participatory interest. The capital

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<sup>69</sup> M Botha et al. *The South African Financial Planning Handbook* (2008) 529.

<sup>70</sup> Paragraph 3 of the Taxation Laws Amendment Act No 22 of 2012.

<sup>71</sup> Section 25BA of the Income Tax Act 58 of 1962.



gain or loss is calculated with reference to the proceeds from the disposal and base cost of that participatory interest.<sup>72</sup> A disposal of portfolio assets by the CIS itself is not an event which triggers CGT.<sup>73</sup>

This presents the first and foremost difference in the taxation of an investment policy versus a CIS – timing. In terms of the four funds approach policyholder capital gains are taxed under the realisation rules of the Eighth Schedule with CGT triggered by a disposal of portfolio assets. The taxation of capital gains in a CIS is disconnected from the disposal of portfolio assets. Instead it is taxed in the hands of the unit holders when the benefits from the investment (ie capital and returns) are paid to the unit holder. The notional units in the CIS effectively represent the investment asset and a disposal thereof equates to a disposal of the underlying assets. This is a special concession which affords investors the benefit of enjoying capital growth in a managed portfolio, with tax only charged at the time of disinvestment. On the contrary policyholders suffer periodic bites out of their capital base as a result of actual asset disposals in the normal course of the asset management activities of the insurer.

The same principle does not apply to non-capital investment returns from a CIS (eg interest, dividends) as these are taxed on an accrual basis in accordance with standard income tax laws. This is consistent with the treatment of investment policies. The main difference here is that an insurer pays over the tax on behalf of the policyholders who receive after-tax benefits, while unit holders are liable for their own tax affairs as part of their personal income tax returns.

This does however give rise to another significant difference in the taxation of a policy versus a CIS – the tax rate. The IPF is taxed at a flat rate of 30 per cent.<sup>74</sup> Policies are thus taxed at an effective CGT rate of 10 per cent. Unit holders in a CIS are taxed at their individual marginal tax rates. The marginal CGT rates currently range from 6 per cent<sup>75</sup> to 13.3 per cent.<sup>76</sup> This rate differential presents apparent

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<sup>72</sup> Paragraphs 61(1) & 61(2) of the Eighth Schedule to the Income Tax Act 58 of 1962.

<sup>73</sup> Paragraph 61(3) of the Eighth Schedule to the Income Tax Act 58 of 1962.

<sup>74</sup> Refer Chapter I – 1.2 ‘Overview of the four funds approach’.

<sup>75</sup> Minimum marginal rate of 18% x CGT inclusion rate of 33.3%.

<sup>76</sup> Maximum marginal rate of 40% x CGT inclusion rate of 33.3%.

advantages to high income earners, offering investment opportunities at beneficial tax rates. The income group that stands to benefit earns taxable income over R793 000 per annum.<sup>77</sup> Individuals earning less than this effectively pay more taxes on investment income in a long-term policy than they would in a CIS.

A further consequence of the insurer as proxy is that the annual CGT exclusion amounts available to individuals (currently R30 000 or R300 000 in the event of death)<sup>78</sup> are not utilised in determining the CGT liability on policyholder savings.<sup>79</sup>

From the above analysis the following is evident:

- The four funds approach charges CGT on a continual basis based on asset disposals within the asset portfolio. Although the full amount of tax is only withheld from policy benefits at maturity, some of the CGT would already have been stripped from the asset portfolio and paid over to SARS. An investor in a CIS pays CGT only on disinvestment.
- The CGT rate applicable to individual investment policy savings is 10 per cent. The CGT rate applicable to CIS savings ranges between 6 to 13.3 per cent. The taxation of an investment policy therefore prejudices against low income earners and benefits high income earners.
- The annual CGT exclusions can be utilised against capital gains arising in a CIS but not against those from an investment policy.

Under current laws, there is already unfavourable taxation of investment policies when compared to CISs. While the issue of the average tax rate can be either beneficial or detrimental, it is important to recognise that for the vast majority of South African taxpayers CGT in a life policy is more expensive than in a CIS.<sup>80</sup> This

<sup>77</sup> Using the tax tables and primary rebate, the tax chargeable on taxable income of R793 000 of an individual under 65 years of age is R237 900.  $R237\,900 / R793\,000 = 30\%$ .

<sup>78</sup> Paragraph 5 of the Eighth Schedule to the Income Tax Act 58 of 1962.

<sup>79</sup> Similarly, the interest exemptions of s 10(1)(i) are not utilised.

<sup>80</sup> According to the most recent 2012 Tax Statistics published by SARS, only 2.6% of individual taxpayers earn taxable income over R 750 000. This accounts for only 18.8% of taxable income. (SARS, 2012:A2.1.1).

issue is not limited to CGT and is relevant to all taxable investment income in the policyholder fund.

While the existence of a potential undue benefit to investment policies has been recognised, this should not be addressed in isolation without any regard of the other inconsistencies which have been pointed out.

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## Chapter VI – Summary of findings & proposals

### 6.1 *Summary of findings from the evaluation of the mark-to-market proposal*

As a first step in evaluating the mark-to-market proposal, the intended purpose of the proposal had to be understood. The intended purpose was interpreted to be the collection of CGT which has been ‘effectively withheld’ from policyholders by insurers. For CGT to be considered ‘effectively withheld’ there has to be an interruption of policyholder notional ownership.

It was established that the proposal does succeed in the earlier collection of CGT which has been ‘effectively withheld’ from policyholders. However, the basis argued in favour of mark-to-market taxation was misdirected at the entire CGT reserve instead of only the portion thereof relating to settled policies. Consequently, it is not only ‘effectively withheld’ CGT which is collected, but CGT on the entire unrealised gain from policyholder assets. This raised concern over the potentially erosive side-effect on policyholder savings potential.

I am in strong agreement with the intended purpose of the mark-to-market proposal. I would however like to qualify the motivation for the proposal by doing away with any regard for the ‘setting aside’ of assets for CGT reserving. My interpretation of the intended purpose of the mark-to-market proposal reads:

Where there is a valid notional ownership of policyholder assets by policyholders, the settlement of a policy liability gives rise to the effective withholding of any allocable CGT. Such CGT should be paid over to SARS without any deferral to subsequent tax years.

This is effectively the alignment of the CGT trigger with notional disinvestments by policyholders.

An argument was put forward to exclude pure risk business from any mark-to-market considerations. This is based on a lack of notional ownership in the

policyholders and accordingly CGT on the related asset base cannot be considered to be 'effectively withheld' when policy liabilities are settled. The substance of a risk contract is such that the insurer really is the beneficial owner of policyholder assets and as such it is disposals at the insurer level which should trigger tax, not events at the policyholder level. Should mark-to-market taxation be applied to risk business, any foregone investment returns will have to be recouped by way of increased policy premiums (ie more expensive risk products).

A much stronger argument exists for a change to the taxation of investment business. There is good reason to align the timing of the taxation of capital gains with policy benefit payments. However, mark-to-market taxation does not achieve this without creating a serious concern over potentially adverse consequences to policyholder savings. This is especially important in the light of the existing differences in tax treatment of investment policies compared to similar investment alternatives.

## 6.2 *Proposals*

### General

It is proposed that before any attempt is made to recover CGT 'effectively withheld' from policyholders, the taxation of risk and investment business be segregated and each component taxed independently.

For risk business, it is proposed that the current realisation basis of CGT be maintained as it resembles more closely the substance of the transactions than any alignment with policyholder events would. The indefinite deferral of CGT on investment growth is part of the nature of the structure and there are no benefits to any individuals in particular. The gains serve the policyholder fund as a whole and where there is no realisation event there is no reason for tax.

It is further recommended that the concern over the insurer receiving a potential undue benefit by not passing back excess returns to policyholders be addressed by the Financial Services Board's 'Treating Customers Fairly' initiative. This may

include transparency reporting, for example annually comparing an insurer's recovery of taxes from policyholders versus the payment of taxes to SARS.

The taxation of investment business should be revisited as a whole. This does not imply a complete overhaul of the trustee principle, but a refinement thereof with specific focus on all identified weaknesses (not only those raised in this research dissertation). The intended purpose of the mark-to-market proposal should feature as only one of a number of items to be addressed. At the very least, if a move to a tax basis aligned with notional disinvestments is considered (similar to that of a CIS), the current realisation basis of CGT on asset disposals should be brought into question at the same time.

#### Separation of linked investment business

One of the most recent recommendations for improvement of the four funds approach was to not only separate the taxation of risk and investment business, but in addition to separate linked investment products from other investment products.<sup>81</sup> In addition to the four tax funds, linked investment products can then be treated for tax purposes in an entirely separate tax fund. The basis for this is that linked investment products function in a similar way to CISs. The link between the policyholder's financial rights under the linked investment policy and the assets held by the insurer in respect of the policy is so direct that the insurer can easily attribute investment returns to specific policyholders. This direct allocation of investment returns enables the taxation of those savings in a way similar to that of CISs. For one, savings can potentially be taxed at the tax rates of the underlying policyholders. In addition, CGT can be charged on policyholder disinvestments and the realisation basis can thus be eradicated.<sup>82</sup>

This dissertation strongly supports the theory behind this proposal. It maintains the trustee principle and gives effect to notional ownership by aligning the trigger of CGT with policy benefit payments. However, this deals only with linked investment policies.

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<sup>81</sup> Donaldson op cit (n9) 80-1.

<sup>82</sup> Donaldson op cit (n9) 83.

### Alternative proposal to mark-to-market in respect of non-linked investment business

It is a difficult task to align CGT with notional policyholder disinvestments for non-linked investments. This is because of practical difficulties in the allocation of investment income to specific policyholders.<sup>83</sup>

If a single pool of assets were managed for a single group of policyholders, all policyholders would share the different components of the investment income produced by those assets (eg interest, dividends, capital gains) proportionally. It follows that any benefit payments, being analogous to notional policyholder disinvestments, could be viewed as a deemed disposal of a proportionate share of the pool of assets. For example, where there is a pool of assets of R100, and during a year R30 is paid out to policyholders, the insurer may be deemed to have realised 30% of the asset base and be taxed on 30% of the existing unrealised gains. This deemed realised gain should be reduced by any actual realised gains arising from asset disposals. Alternatively, the realisation basis of CGT could be withdrawn completely.

What this alternative proposal would achieve is an alignment of the trigger for CGT with the notional disinvestment by policyholders. Importantly, CGT will be triggered regardless of whether the insurer funds benefit payments from working capital or by actually realising policyholder assets. This addresses the root cause of the timing lag between CGT being 'effectively withheld' from policyholders and the payment thereof to SARS. It does however rely heavily on the assumption that all policyholders share proportionally in the entire policyholder asset base.

The problem with this assumption can best be illustrated by considering an extreme example. A large block of risk averse investment policies matures in a single year, with no other maturities. The insurer invested the policyholder premiums in corporate bonds and timed the maturity of these bonds with the maturity of the policies. The benefit payments are accordingly funded out of the proceeds from disinvestment of the bonds. There was no realised gain on the disposal of these

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<sup>83</sup> Donaldson op cit (n9) 80.

bonds (because of the nature of the asset which was held to maturity). However, in terms of the alternative proposal a portion of any existing unrealised capital gains on hand is deemed to be realised.

A final recommendation is therefore to further explore the feasibility of this alternative as part of the current four funds review project. It should be tested under different case scenarios, in consultation with industry stakeholders, to determine the sensitivity on the underlying assumption. Practical and implementation issues should also be considered. In my opinion, this alternative fits neatly with the theory of notional ownership, much more so than mark-to-market taxation.

University of Cape Town



## **Conclusion**

Based on the research performed the mark-to-market proposal should not be implemented while the taxation of risk and savings business remains consolidated. In the event that the taxation of risk and savings business become segregated, the risk component should not be subjected to mark-to-market taxation as there is no basis for such a tax and it will ultimately increase the cost of risk products in South Africa. In the savings environment there is a strong argument in favour of the intended purpose of the proposal. However, mark-to-market taxation is not considered an appropriate mechanism to achieve the stated intended purpose. There is a potentially negative impact on policyholder savings. Instead it is proposed that CGT under the trustee principle be changed from a tax on asset disposals to a tax on notional policyholder disinvestments. This will result more closely in tax neutrality between investment policies and alternative forms of savings.

### Appendix A - Financial analysis of the impact of mark-to-mark taxation on the policyholder asset base

Results:	No MTM	With MTM	
Policyholder assets	4 123.65	3 825.53	A
Pre-tax return	3 187.40	3 082.41	B
Deferred CGT reserve	254.99	51.37	C
Tax collected	-63.75	-256.87	D

	<u>Dec-02</u>	<u>Dec-03</u>	<u>Dec-04</u>	<u>Dec-05</u>	<u>Dec-06</u>	<u>Dec-07</u>	<u>Dec-08</u>	<u>Dec-09</u>	<u>Dec-10</u>	<u>Dec-11</u>	<u>Dec-12</u>	<u>TOTALS</u>	
<b>ASSUMPTIONS:</b>													
JSE All Share index (J203)	9 277	10 387	12 657	18 097	24 915	28 958	21 509	27 666	32 119	31 986	39 250		
Annual realisation factor	20%	20%	20%	20%	20%	20%	20%	20%	20%	20%	20%		
Initial investment	1 000												
Market growth		12.0%	21.9%	43.0%	37.7%	16.2%	-25.7%	28.6%	16.1%	-0.4%	22.7%		
<b>NO MARK-TO-MARKET</b>													
Unrealised growth		95.72	195.30	466.40	581.12	342.66	-629.58	520.42	376.33	-11.24	612.80	2 549.92	B
Realised gains		23.93	48.82	116.60	145.28	85.66	-157.39	130.10	94.08	-2.81	153.20	637.48	B
Less: CGT payment		-2.39	-4.88	-11.66	-14.53	-8.57	-	-	-6.68	-	-15.04		
<b>POLICYHOLDER ASSETS (BN)</b>	1 000.00	1 117.25	1 356.50	1 927.83	2 639.70	3 059.45	2 272.48	2 923.00	3 386.73	3 372.68	4 123.65		A
<b>DEFERRED CGT RESERVE</b>		9.57	29.10	75.74	133.85	168.12	105.16	157.20	194.84	193.71	254.99		C
<b>ACTUAL CGT PAID</b>		-2.39	-7.28	-18.94	-33.46	-42.03	-42.03	-42.03	-48.71	-48.71	-63.75		D
<b>MARK-TO-MARKET</b>													
Unrealised growth		95.72	194.88	462.90	571.08	332.44	-602.78	493.89	354.59	-10.54	573.74	2 465.92	B
Less: MTM payment		-2.39	-7.26	-18.84	-33.11	-39.03	-19.09	-19.87	-14.45	-5.88	-35.29	-195.22	
Realised gains		23.93	48.72	115.73	142.77	83.11	-150.69	123.47	88.65	-2.64	143.44	616.48	B
Less: CGT payment		-2.39	-4.87	-11.57	-14.28	-8.31	-	-	-6.14	-	-14.08	-61.65	
<b>POLICYHOLDER ASSETS (BN)</b>	1 000.00	1 114.86	1 346.33	1 894.54	2 561.00	2 929.21	2 156.65	2 754.14	3 176.78	3 157.72	3 825.53		A
<b>DEFERRED CGT RESERVE</b>		9.33	28.09	72.50	126.30	155.64	93.45	140.85	174.87	173.22	51.37		C
<b>ACTUAL CGT PAID</b>		-4.79	-16.92	-47.33	-94.72	-142.07	-161.16	-181.03	-201.62	-207.50	-256.87		D
<i>Calculations MTM (spreading):</i>													
Unrealised gains	-	95.72	194.88	462.90	571.08	332.44	-602.78	493.89	354.59	-10.54	573.74		
Deferred CGT	-	9.57	29.06	75.35	132.46	165.70	105.42	154.81	190.27	189.22	246.59		
Current year	-	9.57	19.49	46.29	57.11	33.24	-60.28	49.39	35.46	-1.05	57.37		
MTM - yr 1	-	2.39	4.87	11.57	14.28	8.31	-15.07	12.35	8.86	-0.26	14.34		
MTM - yr 2	-	2.39	4.87	11.57	14.28	8.31	-15.07	12.35	8.86	-0.26	14.34		
MTM - yr 3	-	2.39	4.87	11.57	14.28	8.31	-15.07	12.35	8.86	-0.26	14.34		
MTM - yr 4	-	2.39	4.87	11.57	14.28	8.31	-15.07	12.35	8.86	-0.26	14.34		

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