MAKING AN IMPACT THAT MATTERS since 1845

Africa Insurance Outlook 2022

Impact of IFRS 17 on the tax base of long-term insurers in South Africa

Impact of IFRS 17 on the tax base of long-term insurers in South Africa

As insurers are well aware, the current financial reporting standard for insurance contracts (i.e. IFRS 4) will be replaced by a new reporting standard (i.e. IFRS 17) effective for reporting periods starting on or after 1 January 2023. The implementation of IFRS 17 will likely have a material impact on, among others, the carrying value and nature of policyholder liabilities in the financial statements and the profit profiles of insurers for reporting purposes. The policyholder liabilities recognised for IFRS purposes are currently taken into account in the determination of the taxable profits for long-term insurers. The transition to IFRS 17, therefore, potentially has significant corporate tax implications for insurers both at and after the transition date.

While the national legislature has acknowledged that changes to the current tax basis may be needed to mitigate the impact of the transition to IFRS 17, there is no clarity yet on what such changes may entail. Consequently, it will be important for insurers to anticipate the likely impact and to prepare accordingly.

Currently, the income tax regime for long-term insurers (the so-called 'five funds' tax regime) is based on the premise of insurance profits being taxed at the corporate tax rate, with such insurance profits determined based on the IFRS policyholder's liability values and certain adjustments required for tax purposes. The most significant of these adjustments relates to recognised negative actuarial liabilities being zeroised for tax, to the extent that they exceed positive liabilities in a tax fund. In addition to insurance profits, long-term insurers are also subject to tax on other income earned and are also liable for policyholder taxes in respect of net investment income earned in certain policyholder tax funds.

The transition to IFRS 17 is not expected to have a significant impact on other income and policyholder taxes incurred by long-term insurers. The focus of the following will therefore lie on understanding the differences between the insurance profits of IFRS 4 and IFRS 17, and the impact this has on the existing tax basis.

Reasons for significant accounting profit adjustments

As explained above, the tax value of insurance profits is directly linked to the IFRS value thereof and hence tax would be payable on any day one transitional IFRS profit adjustment (including any retained earnings impact), which could be significant. The impact on profits at transition to IFRS 17 could be positive or negative and depends on the extent to which profit recognition under IFRS 4 deviates from that under IFRS 17 retrospectively. In turn, this is dependent on the extent to which the value of IFRS 4 policyholder liabilities differ from the IFRS 17 carrying amount of the groups of insurance contracts.

The IFRS 4 and IFRS 17 liabilities may differ due to the following, although the below is not intended to be an exhaustive list:

- The extent to which the margins contained within the IFRS 4 liabilities result in a different margin for risk, compared to the risk adjustment under IFRS 17.
- The methodology, granularity and extent to which zeroisation was used under IFRS 4 to delay profit emergence and hence results in a different profit recognition pattern to that under IFRS 17. Under IFRS 17 the emergence of profit is driven by the Contractual Service Margin (CSM) which can be thought of as a mechanism to zeroise profits on day one of a contract.
- The transition approach used to determine the IFRS 17 transition balance sheet. The use of fair value, for example, will lead to a different opening CSM to that calculated under a fully retrospective approach.
- The choice of coverage units. Coverage units are a new concept brought about by IFRS 17, designed to release profit in line with service provided.
- The outcome of the IFRS 17 expense attribution exercise, through the impact on the Risk Adjustment and CSM components of policyholder liabilities.

For completeness, onerous contracts and the need to separate reinsurance contracts should not create significant differences beyond those described above.

There is therefore no single outcome that is expected for all long-term insurers in the industry. Results will differ depending on the current approach to reserving for policyholder liabilities under IFRS 4 (which allows for significant differences between insurers) and the extent to which this produces different results to IFRS 17, resulting in a different pattern of profit emergence.

Key considerations

For a tax director or CFO of a long-term insurer, the following considerations should be top of mind when it comes to the tax impact of IFRS 17.

Day one adjustment

As discussed above, a key consideration is the tax impact of any large day one IFRS adjustments. Anecdotally, it is anticipated that the transition to IFRS 17 will likely give rise to significant additional day one profits across the long-term insurance industry. Given how the current tax regime operates, these increased profits will result in increased tax payable on transition which may place certain insurers under severe liquidity strain. The extent of the impact will depend on a number of factors such as the quantum of the expected IFRS profit adjustment, the availability of accumulated deficits in specific tax funds to absorb the impact, and whether an insurer is in an overall net negative liability position in a tax fund which provides tax relief to the extent that such negative liabilities are disregarded for tax purposes in that specific tax year.

Business as usual (BAU) impact
Besides the day one impact on transition, the future profit profile of insurers could also change and the BAU impact that IFRS 17 has on the accounting profit over the remaining term of the affected policies will also impact the insurers' tax profits in the medium- to long-term. It is recommended that insurers model the expected day one as well as BAU impact of transitioning to IFRS 17, as this may be used as a basis for lobbying the legislature for an appropriate phase-in period of the expected day one impact, or possibly for a different tax basis to apply under IFRS 17.

Tax legislation uncertainty
The National Treasury has proposed in the 2022 Budget Review that changes be made to relevant income tax provisions to mitigate the tax impact of IFRS 17 on the cash flow and profit profiles of insurers. However, there is no indication from the legislature as to what the nature of these changes may entail. The National Treasury has commenced interactions with industry bodies and other industry participants on the expected tax impact of IFRS 17, but such interactions are at a preliminary stage and there is no indication of what these interactions may produce.

Historically, where there has been a change in the valuation basis of liabilities for tax purposes, the legislature has acceded to providing a phase-in of the transition tax impact over a period of time. It is likely that this is something that will also be considered for the IFRS 17 transition. Another aspect presumably to be deliberated in the interaction with National Treasury would be the appropriateness of the current tax basis, but more specifically the treatment of zeroising negative liabilities.

Systems changes and availability of information
Given that IFRS 17 will fundamentally transform the disclosure of income, expenditure, assets and liabilities on the face of the statement of comprehensive income and the statement of financial performance, insurers may encounter challenges in reconciling the data reflected in the financial statements and the data required to support the income tax return submission. Assuming no change to the current tax basis, insurers will still be required to allocate policies and the corresponding assets, liabilities, income and expenditure across the five tax funds. Policyholder taxes in the individual policyholder fund and company policyholder fund will still be required to be determined based on existing tax principles and will require insurers to support the actual legal nature of underlying investment income streams and expenses, as well as the proper allocation of these to each of the tax funds. As such, insurers will still need to maintain the existing granularity of data to support such submissions to the tax authority, irrespective of how these items will be recognised and disclosed for accounting purposes under IFRS 17.

In this regard, specific attention should also be paid to the allocation of the CSM across the five tax funds to meet the tax requirements in this regard.

The way forward

Given that IFRS 17 will be effective from 1 January 2023, any legislative changes impacting tax would need to be finalised prior to that date. Industry interactions with the National Treasury are expected to continue throughout this year and culminate in proposed changes to be enacted as part of the 2022 cycle of tax amendments. As noted, the legislature has not provided any indication as to what changes may be likely. However, we expect industry participants to lobby for the necessary tax amendments and expect consensus to be achieved at least on the introduction of a phase-in of the expected day one tax impact. This view is supported by the current experience in the United Kingdom where the HMRC, after consulting industry participants, has indicated its intention to spread the once-off transitional IFRS 17 profits and losses for tax purposes to mitigate the tax cash flow and regulatory impacts of the accountancy change and consequent volatility in tax receipts.

In this regard, we recommend that insurers ensure that adequate modelling of day one and BAU IFRS 17 profit and tax impacts are expedited and discussed with the legislature to achieve a suitable phase-in period. In addition, we recommend that insurers assess the system, model and data requirements that will be required to support income tax return submissions going forward and how these will interact with expected changes to accommodate IFRS 17.

Authors

Philip Cronje
Partner, Tax & Legal
Insurance Sector Tax Leader
Deloitte Africa
philipcronje@deloitte.co.za

Byron Flynn
Senior Manager, Tax
Deloitte Africa
bflynn@deloitte.co.za

Lloyd Balshaw
Senior Manager, Actuarial &
Insurance Solutions
Deloitte Africa
lbalshaw@deloitte.co.za

Peter Walters
Manager, Actuarial &
Insurance Solutions
Deloitte Africa
pewalters@deloitte.co.za