INTERPRETATION NOTE 102 (Issue 2)

DATE: 12 May 2022

ACT : INCOME TAX ACT 58 OF 1962
SECTION : SECTION 29A
SUBJECT : CLASSIFICATION OF RISK POLICY

Preamble

In this Note unless the context indicates otherwise –

- **"insurer"** means any "long-term insurer" as defined in section 1 of the Long-term Insurance Act;
- **"Long-term Insurance Act"** means Act 52 of 1998;
- **"policy"** means "long-term policy" as defined in section 1 of the Long-term Insurance Act;
- **"section"** means a section of the Act;
- **"the Act"** means the Income Tax Act 58 of 1962;
- any other word or expression bears the meaning ascribed to it in the Act.

All binding general rulings referred to in this Note are available on the SARS website at **www.sars.gov.za**. Unless indicated otherwise, the latest issues of these documents should be consulted.

1. Purpose

This Note provides guidance on the interpretation and application of the definition of "risk policy" in section 29A(1).

2. Background

The taxable income derived by any insurer in respect of any year of assessment must be determined in accordance with the Act, but subject to sections 29A and 29B.[1]

Every insurer is required to establish five separate funds and to maintain such funds.[2] These funds form the foundation for the operation of section 29A as a whole. The taxable income derived by an insurer in respect of the untaxed policyholder fund, the individual policyholder fund, the company policyholder fund, the corporate fund and the risk policy fund must be determined separately in accordance with the Act as if each such fund had been a separate taxpayer.[3]

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1 Section 29A(2).
2 Section 29A(3).
3 Section 29A(10).

The risk policy fund[4] was introduced as one of the five funds because of concerns that the taxation of insurers under the previous four funds did not distinguish between investment and risk business. In practice, a risk policy will pay out a specified cash amount on the happening of an event regardless of the amount of investment income earned during the term of the policy. This could result in a loss in respect of a specific policy.[5] Section 29A was thus amended to provide that risk policies be taxed in the risk policy fund.

Some insurers requested guidance relating to which policies issued on or after 1 January 2016 can be classified as risk policies.

3. The law

The relevant sub-sections are quoted in the **Annexure**.

4. Application of the law

4.1 Meaning of a risk policy

Section 29A(1) defines a "risk policy" as a policy issued by an insurer during the insurer's year of assessment commencing on or after 1 January 2016 under which the benefits payable cannot exceed the amount of premiums receivable, except where all or substantially the whole of the policy benefits are payable due to death, disablement, illness or unemployment and excludes a contract of insurance under which annuities are being paid. Any policy relating to which an election has been made as envisaged in section 29A(13B) is also considered to be a risk policy.[6]

The word "benefits" in the definition of "risk policy" is not defined in either the Act or the Long-term Insurance Act. In attributing meaning to the word one has to have regard to its ordinary meaning and the context in which it is used.[7] Based on the definition of a contract of insurance in *Lake and others NNO v Reinsurance Corporation Ltd and others*[8] it is suggested that "benefits" mean the payment of money, or its equivalent, on the happening of a specified uncertain event in which the insured has some interest. The word "benefits" should, therefore, be interpreted widely to include all benefits payable under the policy, for example also a claims-free bonus as an optional additional benefit of a life policy.[9] The critical test in this regard is thus the contractual terms and conditions of the policy irrespective of the labelling of the specific benefits payable under the policy.

The test to determine whether a policy constitutes a risk policy is twofold. Firstly, the benefits payable under the policy cannot exceed the amounts of the premiums receivable. The reference to whether the benefits cannot exceed the premiums is aimed at benefits payable on an event other than death, disability, illness or unemployment.

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4 See Taxation Laws Amendment Act 43 of 2014 effective from 1 January 2016.

5 See Explanatory Memorandum on the Taxation Laws Amendment Bill, 2014.

6 See **4.4**.

7 *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA).

8 1967 (3) SA 124 (W) at 127. See also *Sydmore Engineering Works (Pty) Ltd v Fidelity Guards (Pty) Ltd* 1972 (1) SA 478 (W).

9 See Binding Private Ruling 250 "Risk policies".

A policy which has a surrender or maturity value in excess of premiums would, therefore, not be classified as a risk policy. A risk policy may, however, be cancelled and premiums refunded (within certain limited periods), but the policy cannot pay out any form of investment gain except on death, disability, illness or unemployment.

The second test is where the benefits do exceed the amount of premiums receivable, but all or substantially the whole of the policy benefits are payable due to death, disablement, illness or unemployment. Policies under which annuities are being paid are specifically excluded from being classified as a risk policy.

The requirements of paragraph (*a*)(*i*) and (*ii*) in the definition of "risk policy" are applied separately to a policy. A policy that does not meet the requirement in (*a*)(*i*) can still qualify as a risk policy under the requirement in (*a*)(*ii*). If a policy is a risk policy under the first test, there is no need for the second test.

It is important to note that a risk policy may result in the payment of benefits in instalments under certain circumstances that can only be determined at the time that a claim arises. This does not necessarily result in a separate policy that pays annuities. Each case will thus have to be considered on its own facts and circumstances.

The test to determine whether a policy constitutes a risk policy "issued" during any year of assessment commencing on or after 1 January 2016 must be applied when the policy commences. This test includes the effect of any options included in the policy and considers the expected life of the policy. A policy that, for example provides for a potential surrender value in excess of premiums after 5 years, would from the start not qualify as a risk policy.

The only reclassification of a policy could occur when the policy is varied other than by options included in it (see **4.3.2**). In such a case a policy may be treated as an entirely new policy.

The classification of a policy should be done on the day that it is issued, that is, a day 1 test and not an on-going evaluation unless the terms and conditions of the policy change. An insurer also cannot apply a discounted cash flow basis, but should look forward with reference to all possible policy benefits that will be payable under the actuarial calculations over the lifetime of the policy, irrespective of the fact that a risk event may otherwise occur immediately.

4.2 Meaning of substantially the whole

The definition of "risk policy" initially required the policy benefits to be solely payable due to death, disablement, illness or unemployment. Some insurers were concerned that this definition was too restrictive because the word "solely" excludes predominantly life products which have small investment benefits, for example, a policy that has a savings element.

The definition of "risk policy" was subsequently amended to replace the word "solely" with "all or substantially the whole".[10]

[10] See Taxation Law Amendment Act 25 of 2015.

Although the expression “substantially the whole” is used in various other sections it is not defined in the Act. In Binding General Ruling 20 “Interpretation of the Expression ‘Substantially the Whole’ ” it is stated that the expression “substantially the whole” is regarded by SARS to mean 90% or more. Public benefit organisations, recreational clubs and membership organisations, however, operate in an uncertain environment which makes proper planning difficult. In these circumstances SARS accepts a percentage of not less than 85%. The insurance industry, however, operates in a different environment and is able to more accurately determine their cash flows attributable to specific policy benefits. “Substantially the whole” for purposes of section 29A is, therefore, regarded as 90% or more.

The same meaning of the expression “substantially the whole” can also be applied to the definition of “risk policy” where the primary objective of the policy is to provide benefits due to death, disablement, illness or unemployment with incidental non-risk policy benefits. The rights and obligations of each policy will determine whether the “substantially the whole” requirement has been met. An example is a hospital plan policy which has a cash back benefit where the cashback benefit is less than 10% of the total benefits payable under the policy. Such a policy will be classified as a risk policy despite the accidental savings element.[11]

In order to give effect to the manner in which the insurance business is conducted, products having similar contractual rights and obligations could be grouped together as a class or sub-class of policies. The respective classes or sub-classes of policies should, however, comply with the “substantially the whole” requirement to qualify as risk policies.

4.3 Date of issue of a policy

The definition of “risk policy” requires a policy to be issued by the insurer. The date of issue depends on the facts of each case.

4.3.1 A new policy

A policy is issued following the conclusion of a contract. A contract is concluded when an offer is accepted by the other party and the latter has been informed of the acceptance. Both the offer and acceptance must comply with certain requirements.[12]

Generally a contract comes into existence when the acceptance of the offer is communicated to the offeror. There are, however, exceptions to this general rule. With a commercial contract the offeror may authorise the offeree to use postal communication. In such a case the contract comes into existence at the moment when the letter of acceptance is handed in at the post office. This principle does not apply if the postal services are not operating normally at the time of acceptance. In a case where the offer is accepted by telefacsimile transmission the contract will come into existence analogous to contracts made *inter praesentes* (face to face), in other words the information theory applies.[13]

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11 See **4.1** for a discussion of the meaning of “benefit”.

12 See ADJ van Rensburg et al “Contract” 9 (Third Edition Volume) LAWSA [on line] (My LexisNexis: 31 October 2014 in paragraph 299.

13 See above in paragraph 306 and 307.

A contract concluded between parties by means of data messages is concluded at the time when and place where the acceptance of the offer was received by the offeror.[14] A data message is regarded as having been received by the addressee when the complete data message enters an information system designated or used for that purpose by the addressee and is capable of being retrieved and processed by him or her.[15]

The mere issuing of the policy, however, does not mean that it has commenced. The policy may, however, commence at a later date. The parties may specify a commencement date in the policy or the policy may be made subject to certain suspensive conditions in which case it will only commence upon such commencement date or the fulfilment of the conditions.

Section 51 of the Long-term Insurance Act suspends a policy until payment of the first premium. It is, however, possible for a policy to commence in circumstances where no premium has been paid or no arrangements have been made as contemplated in that section. The effect of section 51 is merely that the insurer may not provide policy benefits pending receipt of the premium or until arrangements had been made. It is however possible to provide cover pending receipt of the premium or the making of arrangements. A policy is in effect once cover commences. A policy will therefore be issued for purposes of section 29A –

- on the date that the contract is concluded;
- where a later date is specified in the policy on that date; or
- if the policy is made subject to a suspensive condition on the date of fulfilment of the condition.

The right of a policyholder to cancel a policy within the cooling off period[16] does not result in a policy not having been issued as explained above.

Although it can be determined with certainty when a new policy is issued, uncertainty exists on the effect of amendments to an existing policy.

4.3.2 Amendments to an existing policy

Amends to a policy can be done in a large range of circumstances.[17] These amendments may sometimes result in the creation of a new policy.

Examples of amendments that do not result in a new policy include:

- Automatic increments (where the benefits, and potentially the premiums rise over time in a way built into the contract from the outset).
- Voluntary increments (where the contract gives the policy holder the right to opt for increments to apply).

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14 Section 22 of the Electronic Communications and Transactions Act 25 of 2002.

15 See above section 23.

16 See Rule 4 of Chapter 3 of the Replacement of the Policyholder Protection Rules (Long-term Insurance) published in Government Notice 1407 in *Government Gazette* 41321 of 15 December 2017.

17 The definition of “long-term policy” in section 1 of the Long-term Insurance Act provides for the variation of a policy.

- Buy back of benefits (where there is an option to reduce the benefits and obtain a repayment of premiums).
- Rights to amend further or altered cover in certain eventualities, for example, moving home, divorce, some of which could certainly result in a new policy (e.g. two policies in place of a joint one following divorce).

Examples of changes that may result in novation where a new contract arises out of an existing one include:

- Conversion options (where the policy holder can switch to a policy that is not a risk policy).
- Changes or extensions to cover, the terms of which are freshly determined at the time, unless specifically allowed by the policy.

Novation occurs where the rights and obligations under an existing contract come to an end and are replaced with new rights and obligations under a new contract.

A person can generally freely cede the rights under a contract. This will not result in novation. The position is, however, different with obligations. An obligation cannot be transferred from one debtor to another. It can only be "transferred" by means of a tri-partite agreement under which the existing parties to an agreement agree that the current debtor may be replaced with a new debtor. This results in a novation of the contract, where the one contract comes to an end and is replaced with a new contract. A transfer of obligations will only happen in exceptional circumstances, for example where one insurance company is replaced with another insurance company.

If a novation occurs after 1 January 2016 a new contract will come into force commencing after that date. However, to the extent that insurance business is transferred with the sanction of the High Court under the Long-term Insurance Act and the new insurer steps into the shoes of the old insurer and tax relief is granted in terms of the Act, for purposes of section 29A the tax dispensation of the old insurer will continue in the new insurer and therefore a new policy does not come into force.

A replacement of a beneficiary in a policy will normally not result in a novation. A policyholder may nominate a beneficiary under a policy. Such a nomination is revocable during the life of the policyholder who may change beneficiaries without impacting the policy. The nominated beneficiary, before acceptance of the benefits, which may only happen following the death of the policyholder, has no personal right to claim the benefits and merely has a *spes (hope)*. Replacement of beneficiaries will therefore in the normal course not result in a novation and therefore a new policy will not come into force.

The above refers to so-called revocable nominations, i.e. it can be revoked by the policyholder before his or her death. The position is different in the case of an irrevocable nomination. In such a case the beneficiary, once accepting the benefits (during the life of the policyholder), will have a personal right against the insurer to claim the benefits at the death of the policyholder. To the extent that such a personal right is ceded to a third party, it will not impact the policy.

A more common scenario may be a case where an existing policy is amended and new benefits or new insured lives are added. Under these circumstances it has to be established on a case by case basis whether the adding of new assured lives constitutes a totally new agreement or a valid amendment under an existing agreement.

In the case of an amendment it will be necessary to determine whether the amendment constitutes in substance a new policy, i.e. a policy providing for totally new premiums and benefits in which case the amendment will result in a new policy or whether the amendment constitutes a mere change to existing benefits allowed under the policy. To the extent that insured lives may be added under a policy, a new policy will not come into force (for example key-man risk policies taken out by a corporate).

The question arises whether a policy can be re-allocated after it has been issued. The assets relating to a policy will remain in the risk policy fund for the duration of the policy, notwithstanding the fact that the policy terms might be varied throughout the term of the policy and which might result in the value of the benefits payable due to a risk event falling below the 90% threshold, provided a new policy is not issued. The assets in relation to the risk policy will only be reallocated to the untaxed fund if an annuity becomes payable in terms of that particular policy.

4.4 Reinsurance arrangements

4.4.1 Allocation of new policies

Section 29A(1) defines “owner” in relation to a policy to mean the person who is entitled to enforce any benefit provided for in the policy. The definition stipulates further that where a policy has been reinsured by one insurer with another insurer, the reinsurance policy shall be deemed to be owned by the owner of the insurance policy so insured.

A reinsurer must, therefore, have regard to the “owner” of the policy when it allocates same to the respective policyholder funds contemplated in section 29A(4), namely, the untaxed policyholder fund, the individual policyholder fund and the company policyholder fund. This means that where an insurer allocates a policy to a specific policyholder fund a reinsurer must follow the same allocation, for example if the insurer has allocated a policy to the individual policyholder fund, the reinsurer must allocate the policy to the individual policyholder fund as well.

Since the introduction of the risk policy fund an insurer and a reinsurer must, however, first determine whether a particular policy issued during any year of assessment commencing on or after 1 January 2016 meets the requirements of a risk policy, regardless of the “owner” in relation to that policy. A reinsurer must, therefore, independently determine whether any new policy so issued is a risk policy, regardless of the approach taken by the insurer. The allocation by the insurer to the respective policyholder funds must only be followed by the reinsurer if the policy issued does not meet the definition and requirements of a “risk policy”.

4.4.2 Date of issue of a reinsurance policy

The date of issue of a reinsurance policy by a reinsurer must independently be determined without having regard to the date of issue of the original policy which is reinsured. If, for example, a reinsurer writes a treaty during any year of assessment commencing on or after 1 January 2016 taking over a book of in-force policies written prior to that date, it will be regarded as a new policy issued after that date. A treaty that existed prior to 1 January 2016 will not constitute a new policy if any further policies

are added to the same treaty on or after 1 January 2016. Further policies under such treaty will be assigned to the policyholder funds in proportion to the allocation established on 31 December 2015 under the previous look through basis as defined in ”owner” in section 29A(1).

A reinsurance treaty that is simply renewed (for example, the renewal of underlying FAC slips, or the change in terms and conditions through addenda to the original agreement) at the end of a guaranteed period or lives are added to an existing treaty will not constitute a new policy even though it is a risk policy for the insurer.

The terms of the reinsurance treaties will therefore require no changes to take effect of the introduction of the risk policy fund and the requirement to classify policies as risk policies.

5. Conclusion

The risk policy fund has been introduced as a fifth fund for insurers to distinguish between investment and risk business. Any policy issued by an insurer during any year of assessment commencing on or after 1 January 2016 meeting the requirements of the definition of “risk policy” must be allocated to the risk policy fund.

The rights and obligations of each policy will determine whether the requirement of “substantially the whole” has been met. In order to give effect to the manner in which the insurance business is conducted, products having similar contractual rights and obligations could be grouped together as a class or sub-class of policies. The respective classes or sub-classes of policies should, however, comply with the “substantially the whole” requirement to qualify as risk policies.

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Annexure – The law

Section 29A

"**owner"**, in relation to a policy, means the person who is entitled to enforce any benefit provided for in the policy: Provided that where a policy has been—

(a) ceded or pledged solely for the purpose of providing security for the performance of any obligation, the owner shall be the person who retains the beneficial interest in such policy; or

(b) reinsured by one insurer with another insurer, the reinsurance policy shall be deemed to be owned by the owner of the insurance policy so insured;

"risk policy" means—

(a) any policy issued by the insurer during any year of assessment of that insurer commencing on or after 1 January 2016 under which the benefits payable –

(i) cannot exceed the amount of premiums receivable, except where all or substantially the whole of the policy benefits are payable due to death, disablement, illness or unemployment and excludes a contract of insurance in terms of which annuities are being paid; or

(ii) other than benefits payable due to death, disablement, illness or unemployment, cannot exceed the amount of premiums receivable and excludes a contract of insurance in terms of which annuities are being paid; or

(b) any policy in respect of which an election has been made as contemplated in subsection (13B);

"risk policy fund" means the fund contemplated in subsection 4(e);