

AN ANALYSIS OF CERTAIN ASPECTS OF THE VALUE-ADDED TAX
TREATMENT OF THE SHORT-TERM INSURANCE INDUSTRY

by

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An Analysis of Certain Aspects of the Value-Added Tax Treatment of the Short-Term Insurance Industry

1. A Short Introduction to Value-Added Tax

Value-Added Tax (“VAT”) is a tax¹ levied on the domestic² consumption of certain goods as well as the consumption of certain services in terms of the Value-Added Tax Act³ (“the Act”). The intention on introduction of the Act was that VAT would be a broad based tax, in the sense that the tax would be levied on the consumption of as many goods and services as was possible. VAT is typically a multi stage non-cumulative tax and is invoice driven. This means that a tax invoice forms the basis for input and output taxes.⁴

In terms of the charging section of the Act⁵, VAT is levied and paid:

“(a) on the supply by any vendor of goods and services supplied by him on or after the commencement date⁶ in the course or furtherance of any enterprise carried on by him ... calculated at the rate of 14% on the value of the supply concerned”

¹ More specifically an indirect tax, as opposed to a direct tax such as income tax, since it is levied on consumption rather than earnings.

² I.e. in the Republic of South Africa.

³ Act No 89 of 1991, as amended.

⁴ Refer to the discussion at the end of this paragraph.

⁵ S 7(1).

⁶ The commencement date of the Act was 30 September 1991.

This is made subject to the exemptions, exceptions, deductions and adjustments provided for in the Act.

There are clearly a number of special terms that are used in the charging section. These terms are defined in the Act⁷. The first of these definitions is that of “*goods*” which is defined as, *inter alia*, corporeal movable things, fixed property and any real right in any such thing or fixed property, but excluding, *inter alia*, money.

The term “*services*” is defined to mean anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money and other items referred to in the definition of goods.

“*Supply*” includes all forms of supply, irrespective of where the supply is effected and any derivative of the word supply has to be construed accordingly.

The definition of enterprise is crucial. This term is comprehensively defined to include, *inter alia*, in the case of any vendor⁸, any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied

⁷ In terms of s 1 of the Act.

⁸ See the discussion later in this paragraph.

to any person for a consideration, whether or not for profit, including any enterprise or activity carried on in the form of any commercial, financial, industrial, mining, farming, fishing or professional concern or other concern of a continuing nature or in the form of an association or club.

In turn, a number of the terms that are used in this definition are defined. The first of these is the term “*vendor*” which is any person who is or is required to be registered under the Act. Consideration is also defined and includes, in relation to the supply of goods or services to any person, “*any payment made or to be made ... whether in money or otherwise, or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods or services, whether by that person or any other person ...*.” Finally, the term “*person*” is defined, since the supply has to take place to a person for it to have taken place as part of an enterprise as defined. This definition (which is also not exhaustive, as with most of the others) is also very wide and includes any company, any body of persons and any trust fund.

It was mentioned earlier that VAT is a multi-stage tax. While this means that vendors have to charge VAT throughout the production, distribution and retail stages on supplies made and that VAT is paid on purchases, due to the input and output system that is peculiar to VAT it does not mean that VAT is a cumulative tax. The very fact that vendors are both leviers and payers of VAT necessitates the distinction between input and output tax to make VAT work and avoid a

cascading effect. More specifically, input tax is the VAT incurred by a vendor within the production, distribution or retail chain on goods or services it acquires. Output tax, on the other hand, is the VAT levied by vendors on supplies of goods or services made by them throughout these stages. Any vendor within the multi-stage system is entitled to claim his input taxes incurred as a credit against his output taxes. This system of credits and debits continues until the end user is reached who, because he is not a vendor, will not be entitled to an input tax credit and will therefore bear the full amount of VAT which is passed onto him through the chain.

VAT is generally levied at the standard rate of tax, which currently is 14%.

Certain suppliers of goods or services are, however, subject to a so-called zero rate⁹, while other suppliers are exempt from VAT.¹⁰ These aspects will be discussed in more detail in paragraphs 3.2 and 3.3 below.

2. General Overview of those activities of Short-Term Insurers relevant to this analysis

“Insurance” is defined in the Act¹¹ as meaning “ ... *insurance or guarantee against loss, damage, injury or risk of any kind whatever, whether pursuant to*

⁹ S 11 of the Act.

¹⁰ S 12 of the Act.

¹¹ S 1 of the Act. The definition in the New Zealand Goods and Services Tax Act, 1985, as amended, is adopted in s. 1 and the wording is in substance the same.

any contract or law, and includes reinsurance ; ‘contract of insurance’¹² includes a policy of insurance, an insurance cover, and a renewal of a contract of insurance :” Specifically excluded from the definition is “ ... the provision, or transfer of ownership, of a long-term insurance policy or the provision of reinsurance of any such policy ...”,¹³ it being a financial service under section 2 of the Act. The definition therefore broadly states what type of business is regarded as being included when a reference is made to insurance in the Act.

In general legal terms the business of a short-term insurer consists of writing policies of insurance for the payment of a premium in terms of which the insurer undertakes to indemnify the insured against loss, subject to certain conditions.¹⁴ The insurer often also makes various charges on the insured such as policy charges and relevant broking fees. Often insurance brokers are also involved in the transaction. Where intermediaries are involved, commissions may be payable. In the event of a claim under a policy, provision could be made for indemnity payment or for reinstatement of the loss. Various excesses may apply. The insurer becomes the owner of the damaged goods in case of total loss or destruction or obtains a claim against a third party due to the operation of subrogation or there could be salvage. Very often third parties are paid directly by

¹² Also refer to the discussion at par 3.1 *infra*.

¹³ A discussion of the VAT treatment of the long-term insurance industry falls outside the scope hereof. It should, however, be mentioned that personal accident insurance falls within the definition of “insurance” in the Act and is subject to VAT; this type of insurance is essentially short-term in nature – see D M Davis, *Gordon and Getz on The South African Law of Insurance*, Juta and Co Ltd, Fourth Edition (1993), p464.

¹⁴ Refer to *Gordon and Getz*, p 16 vn 37 and to M F B Reinecke and S W J van der Merwe, *General Principles of Insurance*, Butterworths, 1989, par 20 for definitions of insurance.

the insurer in reinstating the insured. Each of these transactions and the ones surrounding them may or may not have VAT consequences.

It will be sought in what follows to discuss certain of the VAT consequences arising from some of the activities of short term insurers and highlight and suggest solutions to certain potential problems identified. The list of consequences (and difficulties!) is, however, by no means exhaustive.

3. The Application of the Act to certain aspects of the Short-Term Insurance Industry

3.1. Short-term Insurance Enterprise

A short-term insurer conducts an enterprise during the course of which it supplies services to its insured. The consideration for the supply of these services takes on the form of the payment of a premium by the insured to the insurer. This payment attracts VAT at the standard rate in the case of most policies.¹⁵ However, there are a number of policies, due to the nature of the service which is supplied in

¹⁵ In terms of the Act the time of supply determines when VAT has to be paid or accounted for. The general rule in terms of s 9(1) of the Act is that the supply is deemed to have taken place at the time of the issuing of an invoice by the supplier or the recipient in respect of the supply or of the time when payment of consideration is received by the supplier in respect of the supply, whichever is the earlier. The discussion of the mechanics surrounding the accounting for VAT, the basis of registration for VAT and the calculation of VAT in the ordinary course falls outside the scope hereof.

terms of those policies which are zero rated or exempt.¹⁶ According to the short term insurance industry's official VAT manual¹⁷ " ... *it is the contract of insurance that is the supply of a service and not the underlying subject matter of the insurance.* " As an example it is stated that money policies¹⁸ will be subject to VAT as they fall within the definition of insurance although the supply of the subject-matter of insurance in this case, namely money, is exempt. However, the first-mentioned statement is slightly misleading. It is not really the contract of insurance that is the supply of the service, but that which is supplied by the insurer to the insured, namely the indemnification. The fact that this indemnification may take the form of money is, however, irrelevant. The supply is not the supply of money, it is a supply of an indemnity against the loss of money.¹⁹

This example of the confusion that could arise regarding the application of VAT principles clearly indicates that the legal consequences of transactions have to be analysed completely before one is able to determine the VAT consequences of a particular transaction. This applies particularly in the case of the insurance industry.

¹⁶ See par 3.2 and par 3.3 *infra*.

¹⁷ The South African Insurance Association, *Manual for the Industry*, issued in 1992 and not updated as at the date hereof, p 4.

¹⁸ I.e. policies in terms of which the insured is indemnified against the loss of money.

¹⁹ However, it is not only indemnity insurance that is caught in the VAT net, but all short term insurance, i.e. also those categories of short term insurance which cannot be classified as indemnity insurance, such as personal accident policies - refer to *Gordon and Getz* p 465 and vn 14 *supra*.

3.2. Zero Rated Insurance Supplies

3.2.1 Specific Zero Rating of Insurance

In terms of section 11(2)(d) of the Act, the supply of certain insurance services is to be charged at a rate of 0%.²⁰ More specifically, it is provided in section 11(2)(d) that where “*the services comprise the insuring or the arranging of the insurance ... of passengers or goods to which any provision of paragraph (a), (b) or (c)...*” of section 12 “... *applies ...* “ then those services are zero rated for VAT purposes.

Paragraph (a) referred to here provides for the zero rating of services (which are not ancillary transport services²¹), comprising of the transport of passengers or goods from one place outside the Republic to another place outside the Republic, or from a place in the Republic to a place in an export country,²² or from a place in an export country to a place in the Republic.

Paragraph (b) referred to provides for the zero rating of services comprising of the transport of passengers from a place in the Republic to another place in the

²⁰ Essentially, a zero rated supply is a taxable supply made by a vendor which is taxed at a rate of 0%.

²¹ These are services relating to the transport services, but subsidiary thereto, such as baggage handling services.

²² Defined in s 1 of the Act as any country other than the Republic, subject to contrary notice in the Government Gazette.

Republic to the extent that transport is by aircraft and constitutes “*international carriage*” as defined in Article 1 of the Convention set out in the Schedule to the Carriage by Air Act, 1946.²³

In terms of paragraph (c) services comprising the transport of goods from a place in the Republic to another place in the Republic to the extent that those services are supplied by the same supplier as part of the supply of services to which paragraph (a) *supra* applies are zero rated.²⁴ Included specifically are ancillary transport services.

3.2.2 General Zero Rating which could apply to Insurance

There are also other instances where the provision of insurance can be zero rated.

In terms of section 11(2)(g) of the Act services are zero rated if supplied directly in respect of:

- movable property situated outside the Republic when the services are rendered;
- certain goods which are temporarily in the Republic;²⁵ or
- certain goods used on foreign going ships or foreign going aircraft.

²³ An example of such a zero rated service would be a flight from Johannesburg to Cape Town as part of an international flight to London.

²⁴ It is submitted that a transport supplier who has sub-contracted the service will still qualify for zero rating on its supply if it legally remains the supplier of the service.

²⁵ Provided they do not become property of the importer and are exempt from tax on importation.

While this zero rating does not specifically refer to the supply of insurance, it is submitted that it will apply in respect of services consisting of insurance services rendered in respect of movable property in a country outside the Republic.²⁶

3.2.3 Some Other Instances of Zero Rating

A further instance of zero rating in the supply of short term insurance services will occur where the insurance service is supplied for and to a person who is not a resident of the Republic and who is outside the Republic at the time the services are rendered, provided that the insurance is not supplied directly in connection with land or in the improvement thereto in the Republic or movable property in the Republic.²⁷

Similarly, in terms of section 11(2)(f), local insurance in respect of land situated in an export country will enjoy zero rating.

However, where the provision of insurance is to a vendor for the purposes of his branch or main business situated in an export country,²⁸ the supply will not be

²⁶ The implication of this statement is that s 11(2)(g) is not exhaustive.

²⁷ Refer to s 11(2)(l) of the Act and VAT Ruling No 176, published by the Commissioner for Inland Revenue and reproduced with permission of the Government Printer in Urquhart, Lategan and Legg, *Value-Added Tax*, Butterworths, Loose Leaf Legislation Edition, Issue 15, November 1997.

²⁸ In cases where the provisions of par (ii) of the proviso to the definition of enterprise in s 1 are applicable, i.e. where the branch or main business is permanently located at premises outside the Republic, it can be separately identified and a separate system of accounting is maintained by the concern in respect of the branch or enterprise.

zero rated on the basis of section 11(2) (o), as it is clearly only services which are supplied by a vendor to or for purposes of his own branch or main business, which enjoy zero rating in terms of section 11(2)(o)²⁹.

3.3. Exempt Insurance Supplies

Certain supplies are exempt from VAT in terms of section 12 of the Act, for example financial services.³⁰ Previously certain short-term insurance policies were exempt from VAT on the basis that they comprise of the supply of financial services, namely indemnities given or received under credit guarantee insurance. The definition of financial services in section 2 of the Act has, however, been amended with effect from 1 October 1996³¹ so as to remove the exemption that existed in respect of certain financial services including services relating to “*the provision, taking, variation or release of a guarantee, indemnity, security or bond in respect of the performance of obligations under a cheque, credit agreement, equity security, debt security or participatory security,*”³²

²⁹ The deeming provision of s 8(9) is also not of assistance.

³⁰ As defined in s 2 of the Act.

³¹ In terms of s 19 of Act No 37 of 1996.

³² S 12(1)(h). The supply of financial services (as defined in s 2 of the Act) is exempt from VAT in terms of s 12(a) of the Act. The issue of a debt security, equity security or participatory security or the provision of credit remains a financial service - refer to VAT Ruling No 105, reproduced in Urquhart, Lategan and Legg. Also refer to VAT Ruling No 300, reproduced in Urquhart, Lategan and Legg. The change has an influence on both the income and claims side of policies. Premiums previously exempt will now bear VAT at the standard rate. On indemnity payments to vendors under such policies, VAT will, however, now also arise under s 8(8) - refer to the discussion of s 8(8) *infra*.

It is submitted that this means that credit guarantee policies are now subject to VAT whereas they were previously exempted.

4. The VAT Effect of Performance under Short Term Insurance Contracts

4.1. Monetary Indemnities

Section 8(8) of the Act reads as follows^{32A}:

“For the purposes of this Act, except section 16(3), where a vendor receives any indemnity payment under a contract of insurance or is indemnified under a contract of insurance by the payment of an amount of money to another person, that payment or indemnification, as the case may be, shall, to the extent that it relates to a loss incurred in the course of carrying on an enterprise, be deemed to be consideration received for a supply of services performed on the day of receipt of that payment or on the date of payment to such other person, as the case may be, by that vendor in the course or furtherance of his enterprise: Provided that this subsection shall not apply in respect of any indemnity payment received or indemnification under a contract of insurance where the supply of services contemplated by that contract is not a supply subject to tax under section

^{32A}

As is the case with the definition of “insurance”, the wording of the corresponding provision in the New Zealand Goods and Services Tax Act, 1985, as amended, is followed closely.

7(1)(a): Provided further that this subsection shall not apply in respect of any indemnity payment received by a vendor under a contract of insurance to the extent that such payment relates to the total reinstatement of goods, stolen or damaged beyond economic repair, in respect of the acquisition of which by the vendor a deduction of input tax under section 16(3) was denied in terms of section 17(2) or would have been denied if these sections had been applicable prior to the commencement date.”

The effect of this section is to deem that a service is provided by the insured³³, who is a vendor, to the insurer³⁴ in respect of which the indemnity payment is the consideration. The result of this is that the insured³⁵ becomes liable for the output tax on the amount of the indemnity payment received or made to a third party as contemplated in section 8(8).

The insurer on the other hand, who ostensibly has to pay such amount to the insured³⁶, generally³⁷ becomes entitled to claim an amount akin to input tax.³⁸

³³ In the course or furtherance of his enterprise.

³⁴ Also a vendor.

³⁵ Even where the payment is made directly to a third party - see s 8(8) and par 4.1.6 *infra*.

³⁶ Refer to the discussion in par 4.1.1 *infra*.

³⁷ Save for the instances where input tax cannot be claimed, e.g. in the case of motor-vehicles supplied otherwise than in the ordinary course of business.

³⁸ Equal to the tax fraction of the payment made by him. Under s 16(3)(c).

Last-mentioned rather guarded statement already raises questions regarding the operation of section 8(8). It will be sought to discuss and analyse some of these questions next.

4.1.1 Obligation to Indemnify

The initial question that arises is whether section 8(8) of the Act imposes an obligation on the insurer to pay the amount of VAT to the insured in addition to the amount of the indemnity payment.

The Act³⁹ contemplates that the end-recipient of goods or services should bear the VAT chargeable in respect of those goods or services.⁴⁰ However, it is not provided for in the Act that the vendor supplier of goods or services has a statutory right of recovery of VAT against the recipient of goods or services supplied. In other words, while it is the obligation of the supplier of the goods or services to account for the output tax to the Revenue and while it is not foreseen by the Act that such supplier is the party that is actually out of pocket,⁴¹ the Act also does not provide to the supplier of the goods or services a right of recovery *ex lege*.⁴² This is different to the position that pertained under the Sales Tax regime,

³⁹ Specifically in its charging sections (*s 7 et al*) and read as a whole.

⁴⁰ This does not detract from a vendor's ability to claim an input tax credit in respect of VAT incurred in the making of supplies subject to VAT. Because the recipient of the supply who is not a vendor, is unable to claim such an input credit, the liability for VAT ultimately falls on such a recipient.

⁴¹ Ignoring for the moment the fact that there is an input tax element to VAT.

⁴² Except in the limited circumstances provided for in s 67(1) of the Act.

where a specific provision was made for a seller to recover from the purchaser the sales tax attributable to a particular sale.

Section 64 of the Act provides that all prices charged by a vendor are deemed to include the VAT payable. This clearly contemplates that if a vendor wishes to recover the VAT element of a transaction that this must be done by including the VAT element in the overall price. If the vendor fails to include the VAT element in a price which is charged, there is no mechanism by which the vendor is entitled to recover the VAT charged from the recipient of the supply.

If one takes the consequence hereof to its logical conclusion in an application of section 8(8), assuming that as a result of the deeming provisions of the section the insurer is the recipient of the service the supply of which is deemed to have taken place, then it appears that because there is also not a mechanism in section 8(8) which enables the insured to claim the VAT element from the insurer, there is not an obligation on the insurer to add on or to include a VAT element in the indemnity payment. However, it is submitted that the insured is not entirely without relief. Under the general principles applicable to indemnity insurance, the insured is entitled, as a general rule, to be restored to the position which he was prior to the loss.⁴³

⁴³ See Reinecke and van der Merwe par 202 - "...the broad aim to be achieved by compensation is clear, namely to restore the insured financially to a position similar to that which he occupied regarding the insured interest before the event insured against took place, subject to the limitations contained in the policy." Also see Gordon & Getz, p248. This does not include consequential loss, which may be expressly insured against; those cases fall outside the scope of this analysis.

Under the general sales tax regime this often⁴⁴ implied that the insurer had to, in addition to the value of any item the subject of a claim, pay to the insured an amount equal to the sales tax arising on the purchase of such an item. Similarly the insurer is required to fully indemnify the insured and in order that the insured should not suffer a loss, the insurer should pay the amount of the VAT arising by virtue of the application of section 8(8), to the insured.

However, it should be noted that the reasoning in this regard is different to that which applied in respect of sales tax.

The addition of sales tax to the amount of a claim was justified on the basis that the insured would have to pay the amount of sales tax in order to replace an item which had been lost or destroyed. Under the VAT system an insured will similarly need to pay VAT to acquire new goods to replace those lost or destroyed, but will of course be entitled to an input credit equal to the amount of the VAT so expended, provided that the insured is a registered vendor.⁴⁵ It will accordingly not be necessary in cases where the insured is a vendor for the insurer to take VAT payable on the acquisition of replacement goods into account in determining the value of a claim⁴⁶, since the vendor will be entitled to an input credit on the goods which are the subject of the claim. However, an additional

⁴⁴ In the writer's experience.

⁴⁵ And that the goods were used in the making of taxable supplies.

⁴⁶ It is not suggested that an insurer can or cannot take benefits such as price reductions on bulk purchasing which may be available to the insured into account. This issue and other related issues fall outside the scope of this analysis.

VAT charge arises by virtue of the application of section 8(8) and it is submitted that the insurer should be liable to reimburse this amount to the insured under the general principles of indemnity insurance⁴⁷.

In circumstances when the insured is not a vendor, section 8(8) will of course not apply but, in those circumstances, the insured will incur a VAT charge in replacing any goods lost or destroyed, but will not be entitled to an input credit⁴⁸ and the insurer should accordingly add the amount of VAT concerned to the amount of the claim.

The principles of indemnity insurance would therefore in most instances⁴⁹ result therein that the shortfall arising due to the application of section 8(8) to have to be made good to the insured in order to place him in the same position in which he would have been but for the loss which he had suffered. In other words the sum insured needs to be increased to cater for the VAT element arising pursuant to section 8(8).

In this regard difficulties could arise in attempting to quantify an appropriate amount in terms of any particular policy. If the policy is subject to a maximum limit, then the insured is only entitled to indemnification up to the limit. Section 8(8) would therefore not compel the insurer to add VAT to an indemnity payment

⁴⁷ See vn 43 *supra*.

⁴⁸ Due to its non-vendor status.

⁴⁹ See the discussion in the following paragraph for circumstances where this will not be the case.

when that payment is the maximum payable in terms of the policy. If the contractually agreed limit of the policy is reached then there is nothing in section 8(8), or anywhere else in the Act, which will require the insurer to exceed the contractually stipulated amount of its liability. This approach is in accordance with the principles as set out in section 64 of the Act. A failure to make allowance for VAT in calculating the relevant amount of cover could lead to a situation of under-insurance and an application of average.⁵⁰ In this regard it is suggested that average should be applied to the amount of the policy in the usual way⁵¹ given the amount of the indemnity payment to be made. To that indemnity payment must be added the VAT element pursuant to section 8(8), which will probably bring the actual amount to be paid to an amount closer to the actual policy limit.⁵²

4.1.2 Calculation of Policy Limits

The section 8(8) output tax is calculated on the “payment” made by the insurer which may not be the same amount as the loss suffered by the insured, for example due to the operation of average as described *supra* and the impact of

⁵⁰ This is the principle that if a person is insured for less than the insurable value he is deemed to be his own insurer for the uninsured balance. For example, if a motor-vehicle worth R200 000 is insured for R100 000 and there is damage to it of R100 000, the insured can recover only R50 000. Refer to MFB Reinecke and SWJ van der Merwe, par 207 on p202.

⁵¹ I.e. as described in the previous footnote.

⁵² E.g. in the example used earlier to explain average, the VAT element pursuant to s 8(8) would be added to and calculated on the amount of R50 000, as opposed to on the amount of R100 000 and then added to the R50 000.

deductibles, policy limits and the like⁵³. In circumstances where the indemnity payment is less than the amount of the loss, the liability for VAT will not be calculated with reference to the loss, but by reference to the payment being made and it would therefore be inappropriate to provide in the contract of insurance for a sum insured grossed up for VAT on the assumption that VAT will be calculated on an amount equal to the loss. The result is that it is very difficult for insurers and insured to provide in the contract between them for an absolute safeguard that will always work effectively to avoid the VAT arising by virtue of section 8(8) not leading to policy limits being exceeded.

4.1.3 Discrepancy in Treatment

An additional complication arises in this regard, in that section 8(8) only applies to monetary indemnities and in circumstances where an insurer elects to reinstate or repair, section 8(8) will not apply at all.⁵⁴ More specifically, one could have a situation where, as a result of the application of section 8(8) to monetary indemnities only, as opposed to reinstatements as well, the insured finds itself in the invidious position of being restricted to a policy limit where indemnification takes place by way of a monetary indemnity, while had indemnification taken the form of reinstatement, the policy limit would not have been exceeded.

⁵³

See par 4.3 *infra*.

⁵⁴

Refer to the discussion at 4.2 of the VAT position in relation to reinstatement.

4.1.4 Suggested Solutions

Rather than attempt to cater for the effect of section 8(8) in the amount of the sum insured, the policy should be worded in such a way that the insurer undertakes to cover, in addition to any amount for which the insurer may be liable, the section 8(8) liability. Accordingly sums insured, policy limits and the like would all be expressed as being exclusive of VAT, in the case of vendors and the effect of section 8(8) would be dealt with separately by way of a specific provision in the policy. The advantage of this approach would be that it avoids the difficulties of attempting to quantify an appropriate amount that may be required to provide for the section 8(8) liability and will be self-adjusting in the event of changes in the rate of VAT. This gives rise to the interesting question whether the separate VAT payment suggested would qualify as an 'indemnity payment' as contemplated in section 8(8) with the result that there arises an output tax liability on this payment as well. It is submitted because this payment is of an amount resulting from an application of section 8(8) and does not constitute a payment for a loss separate and arising independently of the original loss being indemnified, that section 8(8) could not find application to this payment. (As opposed to, for example, the position that would have prevailed had the insured taken cover separately to insure against losses arising as a result of an application of section 8(8).)

Alternatively an industry agreement should be reached that insurers would, irrespective of the wording of policies, pay any amounts necessary to cover the

amount of the section 8(8) liability. If this industry agreement was to be concluded and implemented, it could have the same effect as an amendment to policy wordings, but of course would not have the same legal standing as an amendment to the policy. If in any particular instance the insurer were, for whatever reason to depart from the industry agreement, or the agreement were to fall away, an insured would have no recourse and would be potentially exposed to the additional section 8(8) liability. From the point of view of the insured, the only safe way of insuring cover against any section 8(8) liability, would be to insist that the policy will then be amended in order to specifically provide for this.

In this regard it must be noted that an insurer would not be obliged to indemnify an insured for the section 8(8) liability, if the result thereof was that the insurer became liable for an amount in excess of the policy limit, in the absence of specific provisions to the contrary. In other words, although the general principles of indemnity insurance would require an insurer to make good the liability suffered by the insured arising out of the provisions of section 8(8) of the Act, that general principle would be subject to any specific terms and conditions of a policy and to any policy limits imposed.

4.1.5 Other Issues

Section 8(8), *inter alia*, provides that the section applies “ ... *for purposes of this Act, except section 16(3) ...* “. Section 16(3) in turn deals with a vendor’s ability

to claim certain amounts as a deduction from its output tax attributable to that period. Although it now seems to be acceptable practice,⁵⁵ there was, on the introduction of VAT in 1991, some confusion in the industry⁵⁶ as to whether the insurer was able to claim an amount in terms of section 16(3) in respect of VAT arising as the result of the provisions of section 8(8), since that section specifically excludes the operation of section 16(3). Indeed, *prima facie*, there appears to be a conflict between the provisions of section 8(8) and section 16(3). Section 16(3) reads, *inter alia*, that “ *the amount of tax payable in respect of a tax period shall be calculated by deducting from the sum of the amounts of output tax of the vendor which are attributable to that period ... (c) an amount equal to the tax fraction of any payment made during the tax period by the vendor to indemnify another person in terms of any contract of insurance: ...*”⁵⁷

Section 16(3)(c) therefore entitles a vendor who has paid an amount in order to indemnify any person under a contract of insurance, to deduct from his output tax an amount equal to the tax fraction⁵⁸ of the amount of the payment.

It is arguable that because section 8(8) deals exclusively with the position of the insured and not with the position of the insurer at all, the inclusion of the words ‘except section 16(3)’ in the section was necessary to prevent a claim for input tax

⁵⁵ Urquhart, Lategan & Legg, par 5.1.8. and VAT Ruling No 224 quoted in Urquhart, Lategan and Legg.

⁵⁶ In the writer’s experience.

⁵⁷ S 16(3)(c).

⁵⁸ Defined in s 1 of the Act.

by the insured. There is merit in this argument, specifically if regard is had to the effect of section 8(8), namely to give rise to a liability on the part of the insured to account for output tax on the amount of the indemnity payment contemplated in the section and to the specific wording of the section.⁵⁹ It is submitted that this argument forms a logically acceptable basis for justification of the wording of section 8(8) in this regard.

4.1.6. Section 8(8) and Direct Payments to Third Parties

On promulgation of the Act in 1991, section 8(8) simply referred to an indemnity payment under a contract of insurance. This raised the possibility that section 8(8) did not cover the situation where an indemnity payment was made directly to a third party.⁶⁰ An amendment to the Act⁶¹ placed it beyond doubt that under these circumstances, section 8(8) applies. The effect of this amendment is that the VAT element of the indemnity payment, if any, is not payable to the third party, but to the insured even though the indemnity payment itself may be made to directly to the third party concerned. The amendment only makes it clear that section 8(8) does apply to these circumstances. It does not change the incidence of VAT. Therefore, where an insurer makes an indemnity payment to a third

⁵⁹ Such as the references to payments of indemnity "received" as opposed to such amounts being made or incurred.

⁶⁰ Although, in terms of general principles of indemnity insurance the party being indemnified under these circumstances would still be the insured under the contract of insurance and the insurer was simply discharging the insured's liability to a third party which arises either in delict or in contract (such as in the case of a guarantee policy).

⁶¹ *Per s 15(1) of the Taxation Laws Amendment Act, 136 of 1992.*

party, who is also a vendor, the recipient is not liable for output tax. The output tax liability remains that of the insured so that the VAT element of the indemnity payment is, as stated earlier, still payable to the insured.

4.2. Reinstatement

Section 8(8) only deals with monetary indemnities under contracts of insurance.⁶²

Where physical reinstatement takes place, the insurer will purchase the lost item and reinstate the insured (or a third party, for example if that is what the contract of insurance requires or provides for). Reinstatement may also take the form of repairing the damaged property. In all these cases⁶³ the insurer, in acquiring the goods or services for the purposes of reinstatement will be liable for VAT on those goods or services in the normal course.

4.2.1 Charge to Output Tax

The first question that arises is whether the insurer will be obliged to charge output tax on the value of the goods or services forming the subject-matter of the reinstatement, which is being supplied to the insured. Although such supply does constitute a supply by a vendor of goods or services in the course or furtherance of an enterprise carried on by the insurer, it is clear that the 'consideration'⁶⁴ in

⁶² See s 8(8) quoted in par 4.1 *supra*.

⁶³ Of course with the exception of goods or services which are exempt or zero-rated.

⁶⁴ As defined in s 1 of the Act.

respect of a contract of insurance and an indemnification in respect thereof, is the premium paid by the insured to the insurer. Thus no consideration can be said to have been made for the supply of goods or services in terms of a reinstatement⁶⁵ (since the consideration in the form of the premium is for the contract of insurance and the indemnification in respect thereof) so that no output tax liability will arise in respect of such reinstatement.

The conclusion therefore is that an insurer is not obliged to levy any output tax where a reinstatement is made.⁶⁶

4.2.2 Insurers' Entitlement to Input Tax on Reinstatement

A further question that arises is whether the insurer will be entitled to the VAT paid by it in the process of reinstatement as an input tax.

The wording of section 16(3)(c) would seem to imply that section 16(3)(c) does not apply where a reinstatement takes place.⁶⁷ Therefore the insurer would, in terms of section 16(3)(c), not be entitled to make an adjustment to its output tax for VAT incurred by it in the process of reinstatement. It is, however, submitted that an insurer would be entitled to an input tax credit in terms of the remaining

⁶⁵ The provisions of the Act relating to connected persons will generally not apply here.

⁶⁶ Irrespective of whether the insured is a vendor for VAT purposes or not.

⁶⁷ Since s 16(3)(c) applies where any 'payment' has been made to indemnify a person in terms of any contract of insurance.

provisions of section 16(3) in respect of goods or services acquired by it in the process of reinstatement, provided it is wholly for the purposes of consumption, use or supply in the course of the making of taxable supplies by the insurer.

There would therefore in principle seem to be nothing to preclude an insurer from deducting any VAT paid by him in the process of reinstatement, in terms of section 16(3)(a) or (b) and provided that the provisions of section 16(2) of the Act⁶⁸ have been complied with. It is therefore submitted that, irrespective of whether the insured is a vendor or a non-vendor, the insurer would be entitled to an input tax credit for any amount of VAT incurred by him in the process of reinstatement⁶⁹.

4.3. Deductibles or Excesses

Earlier⁷⁰, mention was made of influences on policy payments such as deductibles. This is an important aspect for VAT purposes.

In determining the correct method of calculating settlement figures when deductibles or insurance excesses are involved, one may compare the position that would have applied prior to the introduction of VAT (and ignoring for the

⁶⁸ In terms of which VAT invoices are required, *inter alia*, for a successful claim of input tax.

⁶⁹ Refer to VAT Ruling No 224, reproduced in Urquhart, Lategan and Legg. It is submitted that this would also apply where an input tax credit would have been denied to an insured, e.g. in the case of reinstatement of a motorcar.

⁷⁰ In par 2.

moment the effect of GST). For the purpose of the various examples used here, it will be assumed that the insured is a vendor and that a loss of R1m is suffered and that a policy deductible of R200 000 applies. It is assumed that a standard rate of VAT of 10% applies. Prior to the introduction of VAT the position would have been as follows:

Loss	R1m
Deductible	<u>R200 000</u>
Payment by Insurer	<u>R800 000</u>

It will be noted that the cost to the insurer is R800 000 and the cost to the insured is R200 000.

It is submitted that the introduction of VAT should in principle not affect the ultimate cost to the parties. After all it is assumed that both parties in the example are vendors and as stated earlier, VAT is a tax on the end-user (non-vendor) of goods and services.⁷¹

After the introduction of VAT, it is submitted that the calculation would look as follows:

Loss	R1m
------	-----

⁷¹ See par 1 *supra*.

Deductible (Excess)	<u>R200 000</u>
Total	R800 000
VAT (at 10%) payable under s. 8(8)	<u>R80 000</u>
Payment Due (including VAT)	R880 000
Less input credit equal to the tax fraction ⁷² (s. 16(3)(c))	<u>R80 000</u>
Cost to Insurer	R800 000

The cost to the insurer is therefore R800 000 and the cost to the insured is R200 000.⁷³ It will be noted that the cost now remains the same for both parties as it was prior to the introduction of VAT.

Note that in the example the loss of R1m excludes VAT thereon of R100 000, since that should be recoverable by the insured as an input tax credit.⁷⁴

The above example assumes a direct cash reimbursement by the insurer to the insured; accordingly the provisions of section 8(8) of the Act are applicable. The VAT liability arising in terms of section 8(8) is to be calculated on the amount

⁷² As defined in s 1 of the Act.

⁷³ While the payment to the insured by the insurer is R880 000, the insured has to account for VAT of R80 000 to the Revenue. There is no VAT effect of the excess to the insured, since there is no supply of goods or services. For a more comprehensive discussion of this aspect, see the discussion *infra* at the end of this paragraph.

⁷⁴ In other words, the purchase by the insured would carry VAT of R100 000, but provided the requirements in this regard are fulfilled, the insured will qualify for his input.

received by the insured⁷⁵. The example is therefore in accordance with the requirements of section 8(8) of the Act, because in terms of section 8(8) the VAT liability is not calculated on the loss suffered by the insured, but by reference to the payment made by the insurer to the insured or to a third party on behalf of the insured.⁷⁶

The situation is more complicated in the case of repair or reinstatement by the insurer, where the insurer commissions repair to the damaged article. This is typical of motor vehicle claims. (It is emphasized that the position here is of a vendor motor-vehicle dealer and that the position where an input tax credit is denied in respect of motor vehicles owned by vendors other than motor vehicle dealers is not considered.) In the case of this claim, it is submitted that the claim should be handled as follows (it being assumed, as earlier, that all the parties are vendors and that the standard rate of VAT is 10%):

Loss	R1m
Add VAT of 10%	<u>R100 000</u>
Total	R1 100 000
Amount paid by insurer to third party supplier	R880 000
Less s. 16(3)(a) or (b) input tax credit claimable by insurer ⁷⁷	<u>R80 000</u>
Total Cost to insurer	R800 000

⁷⁵ Or on the actual payment to a third party on behalf of the insured – see par 4.1.6 *supra*.

⁷⁶ See the discussion in par 4.1.2 *supra*.

⁷⁷ Refer to the discussion under par 4.2.2 *supra*.

Amount payable by insured to third party supplier ⁷⁸	R220 000
Less input credit claimable by insured ⁷⁹	<u>R20 000</u>
Total cost to the insured	R200 000

Again, the parties' net cost is the same before and after the introduction of VAT. Although the initial cash outlay by the insurer and the insured is inclusive of VAT, since both parties are vendors they are entitled to input tax credits⁸⁰ in regard to the amount of the VAT paid by them, which will effectively recoup that expenditure from the Revenue. Section 8(8) is not applicable in this case since the insurer is reinstating the insured by way of repairing or replacing the goods and not by way of monetary indemnity.⁸¹

It is submitted that an alternative method of handling the claim in the case of repair or reinstatement would be as follows (all assumptions being carried over from the previous example):

Loss	R1m
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⁷⁸ The insured would have to make payment of the amount of the excess out of his own pocket to the third party supplier, who would charge the insured VAT if it is assumed that such supplier is a vendor. The insured, it having been assumed earlier that it is a vendor itself would then become entitled to an input tax credit under s 16(3)(a) or (b) as illustrated in the next step of this example.

⁷⁹ Refer to vn 74 *supra* and note that the full amount of the VAT arising from the transaction qualifies for deduction, being a claim of input tax under s 16(3)(a) or (b).

⁸⁰ It is submitted that in both cases the claim would be under s 16(3)(a) or (b), as the case may be; not under s 16(3)(c) in the case of the insurer as the expense incurred by it here is not in respect of a payment made by the insurer to indemnify the insured in terms of a contract of insurance. Instead, the payment would be in terms of a contract between the insurer and the third party supplier with the result that general VAT principles would apply. The third party supplier would have to issue separate VAT invoices to the insured and the insurer respectively. Refer to vn 68 *supra*.

⁸¹ As stated earlier, s 8(8) is only applicable in the case of monetary indemnities – par 4.2 *supra*.

Add VAT	<u>R100 000</u>
Total paid by the insurer to the third party supplier	R1 100 000
Less input credit claimed by the insurer ⁸²	<u>R100 000</u>
	R1 000 000
Less deductible paid by the insured to the insurer	<u>R200 000</u>
Total cost to the insurer	R800 000

Again cost to the insurer and the insured respectively is R800 000 and R200 000.

It is considered that this latter method is the theoretically (for obvious reasons) and also practically more correct method as it avoids the need for the third party supplier to have to issue separate VAT invoices and the complications associated with the third party having to look to two parties for payment in respect of what is in essence one transaction.

There is no justification to attempt to levy VAT on the payment of the deductible⁸³ by the insured to the insurer. In terms of section 7 of the Act, VAT is levied, *inter alia*, on the supply by a vendor of goods or services. It is submitted that the payment of the deductible by the insured to the insurer is not in respect of the supply of goods or services by the insurer; instead, it is submitted, the consideration for that supply is represented by the premium paid on the policy.⁸⁴

⁸² Because the claim does not arise as a result of a payment in terms of a contract of insurance, but in terms of a contract with the third party supplier, the full amount of the VAT is claimable.

⁸³ I.e. the excess.

⁸⁴ See par 3.1 *supra*.

It is submitted that the deductible is simply that portion of the loss for which the insurer is, in terms of the policy, not liable.⁸⁵ It is submitted that the payment of the deductible is therefore a financial adjustment between the parties pursuant to the provisions of the policy and is not a payment in relation to the supply of goods or services. The insurer is therefore not obliged to issue a tax invoice in respect of the payment of the deductible, nor need any VAT be levied in respect of that payment. It is submitted that the same applies where an insured recovers the amount of his excess from a third party. No VAT liability would arise, including under section 8(8), as there is no receipt under a contract of insurance⁸⁶.

5. CONCLUSION

Certain implications for the short-term insurance industry arise as a result of the application of VAT principles to it. A selection of these issues are identified and discussed above, including:

- 1) Whether an insurer is obligated to pay the amount of VAT arising from section 8(8) of the Act to an insured and it is concluded that it must where the insured is unable to recover such VAT. However policy limits could override this.
- 2) Difficulties that could arise in attempting to quantify an appropriate policy limit. It is concluded that because VAT is calculated on the amount of the

⁸⁵ Refer to MFB Reinecke and SWJ van der Merwe par 207 on p 203 and to vn 73 *supra*.
⁸⁶ As contemplated in s 8(8).

indemnity payment, it may be difficult to provide in the contract between the insurer and the insured for a policy limit which would always ensure that section 8(8) VAT does not result in an excess over that limit. (After all, it does not make much commercial sense if the policy merely provided for a limit equal to the aggregate of the loss and VAT.) This could also place an insured entitled to a monetary indemnity only at a disadvantage to one entitled to reinstatement too.

The suggestion is made that sums insured, policy limits and the like are expressed as being exclusive of VAT in the case of vendor insured and that the effect of section 8(8) be dealt with specifically in the policy. Any such separate VAT payment in respect of the section 8(8) VAT concerned should not give rise to a further section 8(8) VAT liability, since the suggestion is not that there is separate cover for losses arising due to an application of section 8(8).

Alternatively, an industry agreement whereby insurers undertake to pay any amount necessary to cover the amount of the section 8(8) liability is suggested. Of course such agreement would only be legally enforceable by a specific insured if the specific policy was amended.

- 3) Specific attention is drawn to the application of section 8(8) where payments under policies are made direct to third parties.
- 4) It is also concluded that section 8(8) regulates only the position of the insured and not that of the insurer.

- 5) It is pointed out that section 8(8) does not deal with reinstatement. In this regard it is submitted that no output tax liability on the part of the insurer arises in respect of the supply in the course of the reinstatement. It is also submitted that there is no bar to the insurer claiming input tax incurred on goods and services acquired by them in the process of reinstatement, irrespective of the VAT status of the relevant insured.
- 6) The possible effects on the parties where there are deductibles and excesses are illustrated. It is submitted that the calculations of the section 8(8) VAT and the amount of the input tax that arises are based on the amount of the payment under the policy. It is illustrated that the position that prevailed before the introduction of VAT remains insofar as the net cost to the insured and the insurer has remained unchanged. It is submitted that there is no VAT leviable on the payment of a deductible by an insured to an insurer.
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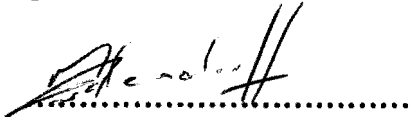
Summary

An overview of applicable VAT principles and general overview of the activities of Short-Term Insurers providing a basis for the discussion is given. The application of VAT principles to certain aspects of the Short Term Insurance Industry is discussed, including VAT Zero Rating and Exemption and the VAT effect on performance under Short Term Insurance contracts. Monetary indemnities are distinguished from reinstatement. It is concluded insurers' obligation to indemnify compel insurers, subject to policy limits, to pay VAT to their insured. The influence of policy limits is considered. Attention is drawn to difficulties in setting policy limits; a suggestion is made that sums insured, policy limits and the like should exclude VAT to overcome potential problems. The alternative of an industry agreement is mooted. Indemnity performance to third parties is discussed. Section 8(8) regulates the position of the insured only. The effect of deductibles and excesses is investigated.

Key Words

Value-added Tax; Insurance; Short-term; Indemnity; Tax; Zero Rating; Exempt; Monetary Indemnities; Reinstatement; Section 8(8); Policy Limits; Direct Payments to third parties; Output Tax; Input Tax; Deductible; Excess.

I declare that '*An Analysis of Certain Aspects of the Value-Added Tax Treatment of the Short-Term Insurance Industry*' is my own work and that all sources that I have used or quoted have been indicated and acknowledged by means of complete references.

A handwritten signature in black ink, appearing to read 'M J Adendorff', is written over a horizontal dotted line.

M J Adendorff