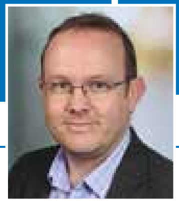

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Changes to VAT COMPLIANCE RULES

The mechanics of the South African Value-Added Tax (VAT) system result in the VAT output payable by a supplier to be claimable as input by the recipient while the ultimate amount of VAT is borne by the final consumer. This is on the basis that indirect tax, which the VAT Act levies on transactions, should be borne by the consumer and not by the supplier in the value chain. Vendors are, therefore, in a neutral position from a VAT perspective, taking this output tax and input tax into account.

The South African Revenue Service (SARS) is under tremendous pressure to maintain its tax collections in the slowing economy and increasingly disregards this broader principle of the tax system and enforces the letter (as opposed to the spirit) of the law. SARS thereby collects tax from suppliers even in instances where there was no apparent loss to the fiscus. Furthermore, when SARS assesses the supplier for such tax, it imposes 10% late payment penalties and interest typically for five years and imposes understatement penalties (USP) ranging between 0% and 150% (generally 25%) for all defaults in respect of VAT tax periods since 1 October 2012.

Given the criticism which SARS received last year for its failure to reach its collection targets, SARS can be expected to be even more vigorous in the short to medium term. This is especially troubling for short-term insurers.

Our VAT Act is largely based on the New Zeeland Goods and Services Tax Act, which is one of the few VAT systems globally where short-term insurance and related services were included in the VAT net. As was the case in New Zealand, the short-term insurance industry sought clarity from SARS at the time in the form of a ruling, aimed to overcome industry specific difficulties due to the rigid provisions of the VAT Act. SARS provided the industry with a VAT specific ruling in 1991, effective 1 September 1991. As things progressed, more difficulties and uncertainties arose resulting in many members applying for private rulings.

During the first decade or so of the VAT system, SARS' process of issuing rulings was uncoordinated and substantially different from these processes today. At the time, SARS officials at different offices issued rulings to any taxpayer who applied, leading to "ruling shopping" at different SARS branches to obtain better results.

"Ruling shopping" was not limited to insurers and resulted in many conflicting rulings. Some rulings were simply incorrect. This caused inconsistency and confusion in the market.

SARS withdrew all rulings in 2007 and invited affected parties to reapply for rulings. The South African Insurance

Association (SAIA), with KPMG's assistance, negotiated with SARS for a short-term insurance industry specific ruling which would address the difficulties and intricacies of the industry. Quite unexpectedly, however, SARS issued Binding General Ruling 14 (BGR14), effective 1 July 2014, followed by SARS's publication of VAT421 Guide for Short-Term Insurance.

BGR14 disregarded quite a number of the industry's input and effectively ignored critical issues. Perhaps as a consequence of the industry's subsequent consultation with National Treasury on the matter, SARS undertook to revise the ruling, which culminated in the second issue of BGR14, effective 1 September 2016. Two separate rulings shortly followed pertaining to reinsurance (BGR32) and travel insurance (BGR37) respectively. SARS updated the VAT guide.

Having finalised these three insurance industry specific VAT rulings and the VAT guide, and given SARS' ever increasing vigilance in enforcement efforts, SARS can be expected to sharpen their pencils to maximise the collection of VAT (for as much as five years), penalties, and interest.

These rulings require:
- Amendments to existing documents such as policies of insurance, bordereaux, commission statements and agreements of loss or claim settlement agreements;
- Addenda to intermediary agreements; and
- Certain VAT specific agreements to be entered into.

KPMG performed reviews at several short-term insurers and reinsurers to determine their compliance with these rulings and to provide insight into the financial implications of what is often taken to be administrative or documentary non-compliance.

Many insurers and intermediaries were surprised to learn that such administrative non-compliance could have dire financial consequences which required tax-related accounting provisions to be raised which were significant compared to the financial results of these entities.

The typical issues are summarised as follows:
- When an insurer makes a recovery from a third party in terms of subrogation, in the form of cash, such receipt is generally not subject to VAT and the insurer needs not account for VAT in respect thereof. However, where the recovery is in the form of a disposal of goods (example: a written-off vehicle) such a disposal constitutes a taxable supply and the insurer should invoice and account for VAT accordingly. These supplies are often not invoiced for, however, and as a result, the VAT is not accounted for correctly or timeously. This non-compliance is mostly as a consequence of ignorance or weak internal controls.

  The same rules apply where an auctioneer facilitates salvage sales on behalf of the insurer. While different rules may apply for invoicing purposes, VAT on these sales should still be accounted for in the correct tax period.

- Zero rating provisions of the VAT Act are limited in extent and application. Firstly, a limited number of transactions can be zero rated depending on the nature of the transaction. Secondly, zero rating is subject to the supplier complying with documentary requirements. In this regard, SARS published Interpretation Note 31 (IN31) which lists the documents which should be obtained, the timelines within which the documents should be obtained, and confirms the implications of non-compliance. Any non-compliance will require the supplier to account for VAT at 14% as if the VAT was included in the income concerned, due for the tax period within which the deadline expired. Should the supplier thereafter, generally within a period of four or so years, obtain the necessary documents, the supplier may claim an input tax adjustment of the VAT so accounted for. It follows that, depending on the nature of the income concerned, this could firstly have dire cash flow constraints and secondly, the penalties and interest will be a permanent cost of non-compliance.

  A common error noted in this regard is that certain income streams are simply incorrectly treated as zero rated. Where correctly classified as zero rated, however, the necessary supporting documentation is almost never obtained.

- Several issues relate to input tax.
  An input tax deduction should be supported by a tax invoice, and it should be on file at the time that the deduction is made. The same rules apply to the VAT incurred in respect of brokerage or commission expenses (including cedants' commission) and other intermediation and claims handling costs, etc. However, many members of the industry issue bordereaux in lieu of tax invoices. BGRs 14 and 32 provide that bordereaux may serve as tax invoices, provided that these meet all the requirements of a tax invoice except the words "tax invoice", "invoice" or "VAT invoice". Insurers and reinsurers often claim input tax on brokerage, commission and cedants' commission pre-maturely, mainly as a result of insufficient documentation being held at the time of claiming the input tax.

  Where the tax invoice or bordereaux in question is issued by the payee (i.e. recipient of a supply, such as the insurer or reinsurer in the case of brokerage, commission or cedants' commission), the BGRs further confirm that the rules relating to self-invoicing should be observed. In terms of these rules, which apply to all industries, a recipient may issue a self-generated tax invoice on prior approval from SARS. SARS provided general approval in terms of BGR15 which sets out the conditions on which such approval is granted. SARS also issued Interpretation Note 56 (IN56) which elaborates on these conditions.

In terms of BGR15, IN56 and the BGRs for insurance, if read together, SARS provides that the insurer or reinsurer may claim the input tax only where the parties, inter alia, concluded a written agreement for self-invoicing to apply. Where such an agreement does not exist, or the agreement fails to contain the necessary provisions as contemplated, the insurer or reinsurer is not entitled to deduct the VAT incurred unless and until the supplier, be it the intermediary or cedant, issues a conventional tax invoice. Many insurers and reinsurers deduct input tax without complying with the requirements of the said BGR15 and IN56, leaving them exposed.

The correct VAT treatment of the VAT incurred on car rental costs incurred by the insurer, where the car is used by the insured while his/her vehicle is being repaired, depends on the contractual relationship between the insurer, the insured and the car rental service provider. In many, if not most cases, the VAT incurred cannot be claimed as input tax by the insurer, given the contractual arrangements between the parties.

Input tax is erroneously claimed on ex gratia payments in cash. SARS ruled in 1991 and again in BGR14 that no input tax may be claimed on ex gratia payments, since these payments do not constitute indemnity payments under contracts of insurance. It is thus clear that the industry has been aware of this treatment for many years. However, what we noted is that insurers exercise insufficient internal control to ensure that ex gratia payments are not factored in when calculating input tax.

— Cash back bonuses present difficulties which insurers often underestimate. The VAT treatment depends on the contractual arrangement for the insured's eligibility for the benefit. The VAT guide provides that where the bonus constitutes a reduction of the premium previously charged, the reduction should be documented by way of a credit note without which the insurer will not be entitled to deduct input tax relating to the VAT incurred on the bonus. The above-mentioned guide effectively provides that a policy document could constitute such a credit note where the policy contains certain prescribed minimum information. It should be noted, however, that where the bonus constitutes an incentive payable to the insured in respect of, in response to, or for the inducement of better risk management by the insured, the payment constitutes "consideration" as defined, for a supply of "services" by the insured. Such a payment therefore does not constitute a reduction in premium and the insurer can only deduct the VAT incurred where the insured is a VAT registered person who issued the insurer with a tax invoice for such payment.

The tax invoice, or in the case of a reduction of premium, a credit note where the policy document does not comply, should be issued and be on file at the time that the insurer submits the VAT return in which the insurer deducts the VAT incurred in respect of the cash back payment.

As can be seen from the above, these issues are mostly caused by administrative non-compliance. Considering the VAT system's input tax and output tax principles, the errors do not necessarily result in a loss to the fisc. However, in each of the instances in which input tax is prematurely deducted, or the relevant documentation in support of input tax claims or the application of zero rated is not obtained timeously, the liability for tax, interest and penalties could have significant financial implications for the entity concerned.

KPMG recommends that members of the industry familiarise themselves with the unexpected pitfalls and have regular reviews conducted, to ensure that the VAT risk is properly managed and entrenched in the relevant processes and procedures. In addition, training on these aspects is encouraged, to reduce the VAT risks.