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Developments in respect of value-added tax

While the last few years have seen a low extent of activity in respect of VAT legislation specifically related to the insurance industry, the last twelve months have seen two notable developments for South African insurers which we explore in this article.

Indemnities by way of reinstatement

The most welcome and long outstanding matter that has finally been addressed is the clarification of the treatment of output VAT imposed on and documentary evidence required by an insured party in respect of indemnities by way of reinstatement. This relates to instances where assets of the insured party are repaired or replaced by the insurer, commonly referred to as "reinstatement".

The insurance industry treated these transactions for VAT purposes consistently with the written approval granted by the South African Revenue Service (SARS), in that output VAT was not imposed on the insured party in respect of indemnities by way of reinstatement. However, the VAT treatment of these transactions caused a fair amount of debate when section 72 of the VAT Act was amended in 2019.

The debate arose in respect of section 8(8) of the VAT Act, which triggers a deemed supply for the insured VAT vendor in relation to indemnity payments. This section of the VAT Act was intended to deal with cash indemnities paid by an insurer to an insured or a third-party in respect of third-party damages. Given the wording of this section of the VAT Act, SARS, after almost 30 years, interpreted the wording as including payments made to suppliers of goods or services where the insurer contracts with aforesaid suppliers to reinstate a damage. The interpretation applied by SARS would have resulted in all payments made by insurers to indemnify insureds, whether by way of cash indemnity payments or indemnities by way of reinstatement, which resulted in output tax being payable by insured parties registered as VAT vendors.

The purpose of the section 72 amendment of the VAT Act was to give SARS the discretionary power to issue rulings to overcome difficulties, anomalies or incongruities, for as long as the ruling does not have the effect of substantially increasing or reducing the VAT liability due by VAT vendors. This section was subsequently amended to limit its application, since it had the effect of SARS becoming a law maker, as opposed to an administrator of an Act of Parliament.

One of the qualifying criteria introduced in section 72 of the VAT Act was that these rulings may not be in contrast with the construct of the VAT Act. Following the amendment to section 72 of the VAT Act issued in 2019, SARS had a change of heart which caused intensive debate, the necessity for at least two senior counsel opinions, continuous negotiation and multiple submissions for amendments to National Treasury, all of which were driven by the South African Insurance Association (SAIA).

These efforts paid off when section 8(8) of the VAT Act was amended and section 8(8A) was introduced with effect from January 2024. SARS released an updated BGR 14 (Issue 4) on 22 May 2024 to take the amendments into account. The effect was essentially the same as what the original section 72 ruling achieved (pre-2019 amendments), however, this application is now based on specific provisions in the VAT Act. In summary, there will be no output VAT imposed on the insured party in respect of indemnities by way of reinstatement. Output VAT will now only be imposed on the insured party, third-party or the third-party's insurer (in the event of a third-party claim) in respect of cash indemnity payments.

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Capitec case

Another development during the year and of importance to insurers is in respect of the judgement in the Capitec case, a landmark case heard in the Constitutional Court. This case dealt with credit insurance which Capitec supplied free of charge to its debtors in respect of loans provided. This case considered whether or not Capitec was correct in having claimed a section 16(3)(c) deduction in terms of the VAT Act, when it credited its debtors accounts by the indemnity amount that arose as a result of the occurrence of the "insured event", being death or retrenchment.

Section 16(3)(c) of the VAT Act provides for a deduction of an amount equal to the tax fraction of any payment made to indemnify another person in terms of any contract of insurance, but only if the contract of insurance is a taxable supply.

Another important section of the VAT Act to consider in respect of this judgement is section 10(23) of the VAT Act, which provides that where a supply is made for no consideration, the value of the supply is deemed to be nil.

Initially, the Tax Court found in favour of Capitec. Thereafter, the Supreme Court of Appeal found in favour of SARS. The Supreme Court of Appeal was of the opinion that no deduction can be claimed since the "insurance" provided was in respect of debt, the creation of which is exempt from VAT. The Constitutional Court, similar to the lower courts, was not asked to consider if the credit insurance provided was indeed insurance, but rather whether the insurance provided was in fact a taxable supply for no consideration, as envisaged in section 10(23) of the VAT Act, and if so, whether a deduction in terms of section 16(3(c) of the VAT Act is claimable.

The Constitutional Court held that the insurance service is factually provided without any charge, on the basis that the loan agreements with customers stipulated that Capitec provides the credit insurance cover free of charge. The Constitutional Court further held that section 10(23) of the VAT Act does indeed find application in the circumstances.

Regarding the deductibility of the tax fraction in terms of section 16(3)(c) of the VAT Act, the Constitutional Court confirmed that no apportionment provisions exist in the VAT Act dealing with deductions, such as the deduction by insurers in respect of indemnity payments made under a taxable contract of insurance. The Constitutional Court nevertheless considered the apportionment of the claim, on the basis that the service provided by Capitec at no charge also involved taxable fees and the credit insurance in question, with the result that the credit insurance was actually supplied partially in the course of making taxable supplies. On this basis, and without any specific legislative provisions, the Constitutional Court held that it is correct in law, based on a number of Income Tax cases, that apportionment of deductions is to be applied in certain circumstances where the legislation does not specifically cater for the same, but where it is fair and reasonable within the construct of the statute. On this basis the Constitutional Court referred the matter back to SARS to consider issuing a section 72 ruling under the VAT Act to facilitate the appropriate apportionment of the deduction.

The court went on to further to suggest that SARS should have pro-actively considered an appropriate method of apportionment and issued a section 72 ruling in terms of the VAT Act, despite the fact that Capitec did not believe that apportionment is necessary and consequently did not apply for such a ruling.

The decisions by the Constitutional Court in this matter sparked widespread commentary and debate, and placed SARS in a very difficult position, given the basis of the decisions. The case further raised questions on what the wider implications of these decisions could be on other industries or transactions. For example, does the Constitutional Court's interpretation apply to non-life insurers whereby input VAT deductions on indemnities might need to be apportioned, by virtue of the fact that non-life insurers also earn exempt investment income?

SARS, in our view, was equally placed in a very difficult position to give effect to the judgement, considering that the amendment to section 72 of the VAT Act was introduced to ensure that SARS is not in a position to effectively make the law, by virtue of rulings issued in terms of section 72 of the VAT Act. To pro-actively issue a section 72 ruling in terms of the VAT Act whilst it believed that no deduction could be made, could potentially amount to SARS contravening this requirement.

Another debate that has arisen is whether the cover provided is in fact insurance as defined in the VAT Act, and if so, whether the cover in question was envisaged by the lawmaker when the VAT Act was introduced. Even if the cover provided is insurance, the question is whether the cover provided actually constitutes life insurance cover in the conventional sense. Since the VAT Act defines the term "insurance" broadly, to include any cover provided in terms of a contract/agreement, with no specific requirement for premiums to be payable, one cannot have regard to the Insurance Act for guidance in this regard. While, the VAT Act does make reference to life insurance as defined in the Insurance Act, which is exempt in terms of the VAT Act, the cover provided by Capitec does not constitute life insurance and therefore does not have relevance in this regard.

Given the substantial deviation in the conventional interpretation of the relevant sections to date, and the potential wider impact these decisions may have, it is believed that SARS will in all probability consider legislative amendments to avoid any obscure results and to give effect to the legislator's original intention, i.e. to include the supply of non-life insurance in the VAT Act. Until then, it remains to be seen how SARS will interpret and apply the judgements in practice.