# TAX CONSEQUENCES OF RIOT INSURANCE PAYMENTS

*Businesses that are able to claim from the South African Special Risks Insurance Association (Sasria) for damage to premises or equipment from the July 2021 unrest need to be aware of the tax implications of payouts.*

The destruction of an asset is a capital gains tax event. To put it in legal terms (ie, drily), "you are deemed to have disposed of your asset".

If your office building, which some years ago cost R900,000 to build, burnt down (whether due to "insurrection" or otherwise), and you receive an insurance payment of R2 million, you have realised a capital gain of R1.1 million. If you did not have insurance against this event, you have incurred a capital loss.

Unfortunately, a capital loss does not reduce taxable income. A capital loss can only be used to reduce a capital gain. That means you will have to wait until you have a capital gain before you can use the capital loss.

If you have a short-term insurance policy covering your assets, you will probably only be able to claim if you have Sasria insurance. This is a separate policy which provides cover for special risks excluded by your short-term insurer. A Sasria policy covers losses arising from civil commotion, riot, strike, lock-out, public disorder, rebellion, revolution and terrorism, but not war or war-related activities. Cover will be provided in terms of the Sasria policy issued to you, which may not match your underlying cover. Cover is, however, subject to the underlying policy being in place and premiums having been paid.

Sasria is a VAT vendor. If you are a VAT vendor, you can claim back the VAT on your Sasria premiums from SARS, but you also have to pay VAT to SARS when you receive any indemnity payments from Sasria. In legal terms, "the indemnity payment is deemed to be consideration for a service". SARS regularly checks whether VAT vendors who received indemnity payments declared the VAT due on those payments, since it is often overlooked.

In terms of section 8(8) of the Value-Added Tax Act, 1991, VAT on indemnity payments must be paid if –

- the insured is registered for VAT;
- the insured loss was incurred in the course of carrying on an enterprise; and
- the insurer made an indemnity payment.

If the insured assets are replaced, the VAT vendor can end up in a tax-neutral position. For example, if a machine insured for R150,000 is destroyed, and the insurer pays out R150,000, the insured will become liable for output tax in the amount of R150,000 x (15/115) = R19,565. Assuming the insured business purchases a replacement machine for R150,000, the insured will then also become entitled to claim input tax of R150,000 x (15/115) = R19,565. As a result, the insured will end up in a tax-neutral position, as long as the insured asset is replaced.

Timing is important. Replacing the insured items in the same VAT period that the indemnity payment is received will avoid the problem of having to pay output VAT in one period, while only being able to claim input tax in a later period, when the asset is replaced.

Indemnity payments could also have income tax consequences. If you have a form of business interruption cover, any insurance payout that is intended to cover your lost revenue will also be taxable. Insurance payments for the loss of depreciable assets may result in taxable recoupments. For example, if you purchased computers for R100,000 in the previous tax year, and claimed R33,333 as depreciation in your tax return, your computers have a tax value of R66,666. If you insured your computers at their tax value, you would receive R66,666 and no recoupment will arise. However, if you insured your computers at their replacement value, and you receive an insurance payment which is more than the tax value of the computers, you will be taxed on a recoupment. Using this example, if you receive an insurance payout of R100,000, you will have to pay tax on a recoupment of R33,333. If you receive an insurance payout of R120,000, you will have a recoupment of R33,333 and a capital gain of R20,000.

If you decide to take the money and run (legally, of course) you will have to pay the capital gains tax and the income tax on the recoupment. If, however, you decide to replace the computers, you can get roll-over relief (which means you only pay the capital gains tax when you dispose of the replacement asset). To qualify for roll-over relief –

- you must "dispose of" the asset by way of theft or destruction;
- you must receive "proceeds" by way of compensation (ie, an insurance payout);
- the proceeds must be equal to or exceed the base cost of the asset;
- the full proceeds must be used to acquire a replacement asset(s) in South Africa;
- the contracts for the acquisition of the replacement asset(s) must be concluded within 12 months; and
- the replacement assets must be brought into use within three years.

So, the tax consequences of riot damage and loss to a business can be surprisingly complex and must be carefully considered. Ironically, even SARS may be out of pocket. Not everyone who receives an insurance payout will have to pay output VAT over to SARS, but Sasria is a VAT vendor and will be entitled to claim input VAT back from SARS on all of the indemnity payments made by it.

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Acts and Bills

- Value-Added Tax Act 89 of 1991: Section 8(8).

Tags: capital gains tax event; indemnity payments; output VAT; input VAT.