Sagamore Hill.

TAX NEWSLETTER.

ISSUE 027 FEBRUARY, 2024.

VAT Insights for the Insurance Industry: Sale of Salvage by insurance businesses.

Every month, we do an analysis of the most downloaded tax case law from our database, where we have classified court case decision according to the class of tax that they fall in for ease of your perusal.

In this month's issue, we look into the taxation in the insurance sector, the guiding principles, and additional decided landmark cases in the insurance sector.

For the sake of this newsletter, we shall look at the case of Mandison Insurance Co Vs Kenya Revenue Authority where a comprehensive audit was conducted on Madison insurance and an assessment issued of corporate tax and Value added tax.

The appeal was grounded on the following issue.

1. That the responded erred in law and fact in finding that the appellant had a duty to charge VAT on sale of salvage vehicles.
2. The insurance compensation was removed from the definition of a supply under the VAT Act according to the Finance Act of 2007

The appellant case was as follows.

That the insurance industry operates under the principle of indemnity and doctrine of subrogation and that the mere act of the event of a loss, the mere occurrence of the event does not in itself entitle the insured to payment of the sum assured and stipulated in the policy. The doctrine of subrogation is designed to avoid unjust enrichment and reimburse the innocent party who has incurred a financial loss.
Further it was determined in the case of *Jindra Vs Clayton 199* , the right of subrogation is based on two premises.

i. An insured should not be allowed to recover twice of the same loss which would be the result if the insured recovers both from the insurer and the tortfeasor.
ii. A wrong doer should reimburse insurer for payments that the insurer has made to it's insured.

The appellant submitted that they cannot recover more than the established actual amount of his loss. The insured sum stipulates the amount of premium payable and also fixes the minimum liability of the insurer.

The appellant contended that the essence of the doctrine of subrogation is to lift a second recovery of compensation by an insured person who has already been compensated by insurer. Further, the presumption of doctrine of subrogation is that the insured person ought to receive compensation from the wrong doer the presumption based on the legal

understanding that the insured is the legal owner of the damaged property and ought to receive compensation for injury of property. The insurance company then indemnifies the owner without eliminating the right of compensation from the wrongdoer.
As it was explained in the case of *Mason Vs Sainbury 1782* that the implementation of the doctrine of subrogation by the insurer stepping in the place of the insured and using the name of the insured to recover compensation that would otherwise be due to the insured and noted that **"*Everyday the insurer is put in the place of the insured. The insurer uses the name of the insured. The case is clear"***
The appellant argued that under the doctrine of subrogation, there's no legal transfer of the subject property from the insured to the insurer as this would serve no purpose and in fact, the doctrine itself removes the need for such a transfer.
The doctrine of subrogation, further gives the insurer the advantage that would otherwise be available only to the insured to enable the insurer to recoup part or whole amount indemnified to the insured.
The appellant further contended that the monies received after the disposal of the salvage, is used to reimburse the insurer for the compensation already extended to the insured and that this is part of the agreement between the insurer and the insured without which the insured would not receive compensation from the insurer.

As regards the vatability of the proceed of the salvage, the appellant contended that the they form part of the compensation and are therefore exempt for VAT pursuant to an amendment vide Finance Act 2007 that removed from the definition of a supply in the then VAT Act CAP 476. This, therefore, meant that the sale of the salvage is a sale of the property of the insured and the compensation paid to the insurer which is then included in the indemnification of the insured.

The appellant also argued that VAT Act CAP 476 and VAT Act on the first schedule exempts that insurance and re-insurance services save for management and related insurance consultancy services, actuarial services, and services of insurance assessors and loss adjusters but neither of the Act defines insurance services. With the three services being expressly exempted for VAT, if the legislators had intended to have sale of salvage to be vatable, then the same should have been put in plain as the prior three services.

In dealing with ambiguity in law, the Kenyan courts had already decided in the case of *Keroche Industries Vs Kenya Revenue Authority 2007* that "***Taxation can only be done on clear words and that taxation cannot be***

intendment**… **where the legislator is not clear or where there are two or more possible meanings, the inclination of the court should be against a construction or interpretation which imposes a burden, tax or duty on the subject… since the current legislation involves taxation, where there is ambiguity, the schedule or any other provision should be construed strictly so as to impose a tax burden nor clearly provided for and in the event of any ambiguity it should be construed in favour of the appellant as against the taxman this being a penal legislation… the act is to be read as a whole, without attributing to any particular provisions or words.

Further, the appellant contended that the insurance business is define in the Insurance Act "***The business of undertaking liability by way of insurance in respect of any loss of life and personal injury and any loss or damage including liability to pay compensation contingent upon the happening of a specified event***… The Act further provides that insurance business included "…***any business incidental to insurance business so defined".*** This therefore meant that the sale of salvage is purely incidental to the business carried out by the insurer, that of undertaking liability and therefore it ceases to be taxable as it falls under the exempt services as per the exempt schedule and third schedule of the repealed VAT Act CAP 476. Further, the appellant argued that the definition of the insurance business does not exclude the sale of goods.

As regards whether there was a supply for VAT purposes, the appellant argued that the acquisition of the right to sell does not constitute a supply as was decided in **Australian Tax Office in tax ruling of 2006/10** that where a payment of money or supply is made by an insurer in the course of settling a calling under an insurance that ***that supply is not taxable supply. For example, where an insurer takes possession of salvage from an insured, there is not taxable supply made by the insured***.

The appellant also argued that in case where the insured choses to retain the salvage vehicle and receive a top up of the amount to reinstate the motor vehicle, they would not be required to account for VAT on the salvage. This is not any different from the case where the insured is indemnified from the full loss since the salvage amount is utilised to reduce the amount indemnified.

The respondent's case was as follows.

The respondent argued that the sale of the salvage motor vehicle was not any different from the sale or disposal of waste materials or second hand spare parts. The repealed Act stated that ***The sale, supply or delivery of goods to another person and any other disposal of taxable goods or provision of taxable supplies.***

The responded contended that the sale of the motor vehicle and the salvage did not fall under the exempt schedule of the repeal and current VAT Acts and that the sale or disposal of the salvage by the appellant constitutes a taxable

supply under the meaning of *Supply and taxable goods* under the VAT Act.

The responded further contended that the tax point of the supply was not to be defined by the accounting terms as the same had already been defined in the VAT Act to be, the date of the invoice, date of payment or the date when the goods are sold.

On whether the sale of the salvage was a stand-alone business transaction, it was argued that the contract of law was applicable as it was decided in the case of Insurance company of East Africa Vs Marwa Distribution Limited 2005, that *... a policy document issued by the insurer constitutes a contract to insure and the premium is the consideration for the promise to indemnify the insured if the event takes place.*

The revenue authority was of the view that it did not matter what the accounting treatment was for the disposal of the salvage but rather that the insurer requires the insured to surrender the log book, therefore, the insurer sells the salvage vehicle on their own right. The submission of the ownership documents discharged the insured the rights over the ownership of the salvage.
Further, it was argued that the relationship between insurer and the insured ends upon indemnification and whatever remains after that is the property of the insurer and has no relationship with the premiums paid by the insured.

As regards the treatment of the amount realised on the sale of the salvage and whether this constituted part of the indemnity, they contend that, as it was decided in the case of *Castellan Vs Preston* the judge explained that the doctrine of subrogation "…*introduced in favour of the underwriters in order to prevent them having to pay more than full indemnity… in order to prevent the assured recovering more than a full indemnity."* In light of the foregoing, the responded submitted that the disposal of the salvage is income to the appellant chargeable to VAT.

In spite of the earlier meetings held between the respondent and Association of Kenya Insurer (AKI), where it was agreed that the members of AKI would charge VAT on sale of salvage motor vehicle, and also that the Revenue Authority would consider abandonment of tax arrears prior to that period, the revenue authority declined and informed AKI to have all it's members charge VAT on sale of salvages.

Analysis and Findings

The tribunal noted that there was a limitation to the doctrine of subrogation as found in ***Halsbury Law England Vol 25, 4th Edition paragraph 333*** that ***The principle of subrogation is limited***

or qualified in its application by the following conditions.

1. ***The underwriter is entitled only to those remedies, rights or other advantages which are available to the assured himself.***
2. ***The underwriter is subrogated only to those rights (and I might add restriction) possessed by the assured in respect of the thing to which the contract of insurance relates.***

The tribunal also relied on the decision of the case of **Vinu K Patel V Shiva Carriers 2012** where the court ruled that ***The doctrine of subrogation allows the underwriter or insurance company to step into the shoes of the assured, subject to the limit that the insurer or underwriter shall have only every right of the assured.*** This meant that if the assured could have exercised a certain right and the exercise of such right is limited by statute, the underwriter cannot have any greater right than the assured would have. The doctrine is not, and does not create a new cause of action of its own. It enables the insurer to, so to speak **"Run with the assured."**

The tribunal found that the sale of salvage was part of the compensation process as first compensating the insured and then selling the salvage was solely to make it easy to indemnify the insured, other than having to keep the insured waiting until the salvage is sold for them to receive the compensation intended to indemnify them.

It was further found that even though the insurer retains the salvages from the insured, to either diminish the cost or reimburse themselves, this does not amount to sale as it is part of insurance business which is exempt for VAT.

As regards the ambiguity in the VAT Acts, the tribunal maintained that indeed there's an ambiguity in the VAT Act, however, as earlier held by the high court in Keroche Vs KRA, that such ambiguity must be construed to favour the tax payer, and that in the literal interpretation of tax laws, the "***the taxation can only be done on clear words that taxation cannot be on intendment."***

On the definition of insurance business, the tribunal relied on the definition in the Insurance Act, specifically the clause that states "***and any business incidental to insurance business"*** which the appellant submitted should be upheld in holding that the sale of salvages is incidental to insurance business thus it should be exempt from VAT. Further, it was held that this is an incidental service to insurance business and such it is an insurance service that is thus exempt from charge of VAT as provided by the VAT Acts.

On the surrender of the logbooks for purposes of the sale of the salvage, though it may be considered an acquisition, the right to sell salvage does not constitute a taxable supply as title does not change to the insurer. The insurer, it was held, only takes possession and not ownership of motor salvages from the insured and as such

there was no taxable supply.

The tribunal further found that the amounts realised upon disposal of the salvage, were used to diminish the loss suffered by the insurer after indemnifying the insured. As such, the proceeds from the sale of salvage is part of compensation paid to the insured which is exempt for VAT. The sale of the salvage was therefore taken to be a sale of property of the insured and the compensation paid to the insured takes into account this amount realised from sale of salvage and as such, the proceeds are integral part of indemnification to the insured.

The tribunal found that indemnifying the insured, results in no gain to any person, rather, the person is restored to the initial position so that they are put in the same position they were before the loss. The amount recovered from the wrong doer, would legally belong to the insured. As such, the principle of subrogation comes into limit this profit that would accrue to the insured by applying these funds to diminish the amount paid by the insurer.

The tribunal further found that insurance business is not confined to issuing of the policy or to the continuance in force of the policy, but extends up to and includes the day when the policy matures for whatever reason and the actual claim is examined, settled and paid. The insurance company in this case is engaging in insurance business right through the period and according to the service of checking and settling the claim as well as sale of salvage is all under the umbrella, as it were, of what constitutes insurance business. The sale of salvage, then forms part of normal business undertaken by the insurance company and therefore should not be considered separate and distinct from the insurance business. This then puts an end to the question on whether the sale of salvage is an additional business to the insurance business and therefore justifiably exempt for VAT.

The tribunal found that the case where the insured person opts to retain the salvage and receive a top up of the amount required to reinstate the motor vehicle they would not be required to account for VAT on the salvage. This is not any different from a case where full indemnity for the loss has been given to an insured since the salvage amount replaces the amount the insured had been indemnified with.

As regards the VAT previously paid by the appellant, the tribunal decided that since the appellant decided to voluntarily pay VAT, they cannot claim for a refund of the same. The appellant ought to have made a provision of the same in the appeal of the same pending the determination of the case, or sought conservatory orders as the matter was

yet to be determined.

In light of the foregoing, the appeal was allowed and the demand notice by the respondent requiring the appellant to pay VAT on the sale of salvage vehicles was set aside.

Our commentaries.
There have been very interesting disputes in the insurance sector and we will in a very brief manner, have a look at an additional case for your knowledge.
In summary, the following pointers are the take away from the above case.

1. the VAT law exempts insurance and reinsurance services from VAT, except where the services relate to management and insurance related consultancy services, actuarial services and services of insurance assessors and loss adjustors. This therefore meant that if the sale of salvage motor vehicle was meant to be vatable, then this should have been captured in the listing of the items that should attract VAT in the insurance services.
2. The definition of insurance business as is in the Insurance Act includes any business incidental to the core insurance business. As such, the sale of the salvage is incidental to the core insurance business.
3. The insurance contracts are contracts of indemnity, as such, the insured in only intended to be returned to the initial financial position. This therefore means that there's no gain on the part of the insured. The insured taking possession of the salvage would translate to a gain.
4. The doctrine of subrogation implies that there is no supply where the insurer assumes the roles of the insured and subsequently acquires limited rights to the salvage.

5. There is no legal transfer of the salvage from the insured to the insurer. As such, VAT cannot be applied where there's no change in ownership of the goods. One cannot give, what they do not have.
6. The insurance company pursues the wrongdoer in the name of the insured, but gets to keep the monetary proceeds should there be any. All court proceedings are on behalf of the insured.

Access tax case laws classified in the class tax that they fall in from our database here. We have done the heavy lifting for you.

Talk to us
info@sagamorehill.co.ke