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Managing Tax Risks Through Tax Indemnity Insurance

10 June 2024 *9 min read*

Taxpayers have multiple tax risk management options at their disposal when entering into complex transactions with each option having its own advantages and disadvantages. The complexity of the transaction and level of assurance required are often determinative when it comes to selecting the appropriate tax risk management option. The most common tax risk management option is to obtain an opinion from an independent SARS-registered tax practitioner and, to a lesser extent, an Advance Tax Ruling ("**ATR**") from the South African Revenue Service ("**SARS**").

An opinion obtained from independent SARS-registered tax practitioner is the cheapest tax risk management option and provides the taxpayer with protection against the imposition of an understatement penalty and potentially also underestimation penalty in the event of SARS assessing the taxpayer on the particular transaction on a basis contrary to what is outlined in the opinion. Certain requirements must, however, be satisfied for the understatement penalty protection to apply. The first set of requirements are that the taxpayer must have fully disclosed the transaction to SARS by no later than the date on which the return incorporating the transaction is due and that the opinion must have been issued to the taxpayer by no later than such date. The second set of requirements relate to the qualities of the opinion and require that it be based upon a full disclosure of the specific facts and circumstances in respect of the transaction and that it confirms that the taxpayer's position is more likely than not to be upheld in the event of the matter proceeding to court. Therefore, if a taxpayer obtains an opinion adhering to the above requirements and SARS assesses the taxpayer on the particular transaction in a manner that is contrary to what was outlined in the opinion, the taxpayer will only be required to settle the additional taxes, interest and possibly also the percentage-based penalty resulting from the additional assessment. In this case, the understatement penalty must be waived. The opinion, therefore, effectively acts as insurance against the imposition of an understatement penalty on the particular transaction. There is, however, a school of thought holding that the understatement penalty cannot be waived where it is imposed in respect of "impermissible avoidance arrangements" which refer to cases where SARS successfully invokes the General Anti-Avoidance Rule ("**GAAR**") in section 80A to 80L of the Income Tax Act, No 58 of 1962 or its corollary for Value-Added Tax ("**VAT**") purposes in section 73 of the Value-Added Tax Act, No 89 of 1991.[1] Proponents of this school of thought, therefore, hold that an opinion obtained from an independent SARS-registered tax practitioner adhering to the above requirements does not provide any protection against the standard 75% understatement penalty imposed in respect of "impermissible avoidance arrangements".

An ATR is issued by SARS to a particular taxpayer to provide certainty on the tax implications resulting from a transaction that the taxpayer proposes to undertake, but has not yet undertaken. An ATR is, however, only binding on SARS and the applicant(s) thereto and cannot be relied upon by other taxpayers. The only material difference between an ATR and an opinion obtained from an independent SARS-registered tax practitioner is that SARS is bound by the tax implications outlined in the ATR issued to the applicant(s) whereas the opinion has no binding effect on SARS. The level of assurance provided by an ATR is, therefore, substantially better than what is provided by an opinion as the applicant(s) has absolute certainty that the tax payable on the transaction is per the principles outlined by SARS in the ATR. The risk of SARS imposing any additional tax, understatement and percentage-based penalties and/or interest on the transaction down the line is, therefore, completely mitigated by obtaining an ATR. The ATR system does, however, have certain drawbacks including that (i) SARS and the taxpayer do not always agree on the tax implications in respect of the proposed transaction; (ii) the costs involved in obtaining an ATR is usually double the cost of an opinion as both the tax advisor and SARS charge fees for their time spent on the matter; and (iii) SARS is by law precluded from issuing an ATR on certain issues such as, *inter alia*, the application of the GAAR and the

substance over form principle. Taxpayers who are entering into transactions that are potentially susceptible to attack under the GAAR (usually Merger and Acquisition ("**M&A**") transactions) are, therefore, unable to mitigate their exposure to additional tax, the standard 75% understatement penalty and interest in the event of SARS assessing them under the GAAR. This lacunae can, however, be filled by tax indemnity insurance.

Tax indemnity insurance, which is predominantly provided by non-resident insurers, provides cover to a taxpayer against the risk of SARS assessing the taxpayer on a particular transaction in a manner contrary to what is outlined in the professional tax advice obtained by the taxpayer. The taxpayer is generally able to arrange cover not only for any additional tax on the particular transaction, but also for the interest, understatement and percentage-based penalties and defence costs. Tax risks of up to R10 billion can be insured and the cover is usually grossed-up to take into account in the tax that must be paid by the taxpayer on the receipt of the policy benefits, should the risk materialise. The cover period is typically seven years and can be increased up to ten years. The underwriting process usually entails the taxpayer obtaining an opinion from an independent SARS-registered tax practitioner which is then sent to the South African insurance broker (which acts as intermediary between the taxpayer and the non-resident insurer), together with full details of the transaction and the relevant agreements. The insurer then assesses and, if acceptable, insures the risk against the payment of an upfront lump sum premium by the taxpayer. The lump sum premium is based on the risk and total cover required by the taxpayer and can be as low as 3% of the total cover required by the taxpayer. The tax indemnity insurance option is the most expensive tax risk management option given the insurance premium and the requirement for the taxpayer to obtain independent tax advice. It is, however, the only tax risk management option that provides the taxpayer with complete protection against the risk of SARS assessing the particular transaction under the GAAR and/or in a manner inconsistent with what is outlined in the opinion obtained by the taxpayer. In this regard, the taxpayer will still be liable for the additional tax, the standard 75% understatement penalty (in a GAAR case), possibly the percentage-based penalty and interest in the event of SARS assessing the taxpayer under the GAAR. The taxpayer will, however, receive the insurance pay out to enable it to settle its legal costs and the final tax liability.

Almost any type of tax risk can be covered by tax indemnity insurance including, *inter alia*, the following:

- The GAAR and substance over form principle;
- The application of any specific anti-avoidance rule;
- The disallowance of reduced South African withholding tax rates under an applicable double tax agreement as a result of the application of the principal purpose test and/or beneficial ownership test;
- Transfer pricing adjustments;
- Employees' tax and employment tax incentive adjustments; and
- Valuation disputes.

Taxpayers obtaining tax indemnity insurance must carefully consider the tax implications in respect of the insurance. The payment of the insurance premium might require the insured to reverse charge VAT at 15% where the insurance cover relates to an M&A transaction. Further, the receipt of the policy benefits will result in tax implications for the taxpayer depending on the nature of the insured transaction. Lastly, exchange control approval must be obtained for the payment of the insurance premium which, in some cases, might require the taxpayer to obtain approval from the Financial Sector Conduct Authority.

The table below provides a summary of the main features of the three tax risk management options considered in this article.

	Opinion	**ATR**	**Tax Indemnity Insurance**
Must additional tax be paid if SARS assesses taxpayer?	Yes	N/A – SARS cannot assess taxpayer contrary to positions outlined in ATR	Yes
Must understatement penalty be paid if SARS issues an additional assessment?	No, unless the understatement penalty is issued in respect of an "impermissible avoidance arrangement"	N/A – SARS cannot assess taxpayer contrary to positions outlined in ATR	Yes

Must percentage-based penalty be paid if SARS issues an additional assessment?	Possibly	N/A – SARS cannot assess taxpayer contrary to positions outlined in ATR	Yes
Must interest be paid if SARS issues an additional assessment?	Yes	N/A – SARS cannot assess taxpayer contrary to positions outlined in ATR	Yes
Cost	Lowest	Twice the amount of an opinion	Most expensive
When must the tax risk management option be obtained?	Can be after implementation of transaction but must be prior to due date of return incorporating the transaction	Before the implementation of the transaction	Can be after implementation of transaction but ideally prior to due date of return incorporating the transaction

In conclusion, each of the above tax risk management options represents an arrow in the quiver to effectively manage tax risks, based on the complexity of the transaction and the level of assurance required by the taxpayer. Tax indemnity insurance provides unique benefits when it comes to managing the tax risks associated with M&A transactions which is why its popularity as a tax risk management tool is increasing.

Footnotes

[1] The validity of this school of thought becomes questionable when having regard to the findings in two recent cases handed down by the Supreme Court of Appeal, namely *CSARS v Coronation Investment Management SA (Pty) Ltd* 85 SATC 413, [2023] 2 All SA 44 (SCA) and *CSARS v The Thistle Trust* 85 SATC 347, 2023 (2) SA 120 (SCA).



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