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TAX & EXCHANGE CONTROL **ALERT**

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An exception(al) finding: The Tax Court grants an exception in respect of SARS' statement of grounds of assessment

In *A v the Commissioner for the South African Revenue Service* (Case No 24643) (as yet unreported) heard by the Tax Court sitting in Johannesburg, the applicant (Taxpayer) took exception to SARS' Rule 31 Statement.

In the context of a tax dispute between the South African Revenue Service (SARS) and a taxpayer, once the dispute reaches the appeal stage, the taxpayer can elect for the appeal to be heard by the Tax Court, without the parties first trying to resolve the dispute in terms of the alternative dispute resolution (ADR) process. Once the taxpayer elects for the appeal to be heard by the Tax Court, SARS must file its statement of grounds of assessment in terms of Rule 31 (Rule 31 Statement) of the rules promulgated in terms of section 103 of the Tax Administration Act 28 of 2011 (TAA) (Tax Court Rules).

In terms of Rule 31(2) of the Tax Court Rules, the Rule 31 Statement must set out a clear and concise statement of -

- The consolidated grounds of the disputed assessment;
- Which of the facts or the legal grounds in the notice of appeal under rule 10 are admitted and which of those facts or legal grounds are opposed; and
- The material facts and legal grounds upon which SARS relies in opposing the appeal.

In *A v the Commissioner for the South African Revenue Service* (Case No 24643) (as yet unreported) heard by the Tax Court sitting in Johannesburg, the applicant (Taxpayer) took exception to SARS' Rule 31 Statement.

Facts

In summary, the facts were as follows:

- The Taxpayer's exception is framed in the alternative in that it firstly states that SARS' Rule 31 Statement lacked averments necessary to sustain a finding of gross negligence and the imposition of an understatement penalty at the rate of 100%. In the alternative, the exception complains that the Rule 31 Statement is vague and embarrassing as it failed to explain the basis upon which SARS opposes the Taxpayer's appeal against the imposition of the understatement penalty (USP) at the rate of 100%;
- In the further alternative, the Taxpayer argued that the Rule 31 Statement fails to set out a clear and concise statement of material facts upon which SARS relies in opposing the appellant's appeal against the USP at the rate of 100%;

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An exception(al) finding: The Tax Court grants an exception in respect of SARS' statement of grounds of assessment*...continued*

The Tax Court considered the USP percentage table in the TAA, which distinguishes between different kinds of behaviour and the penalty percentages that flow from the different behaviours.

- The relevant passage in the Rule 31 Statement in respect of which the Taxpayer took exception appeared in paragraph 22 and stated the following:

  "22.1 The appellant neglected to provide complete and accurate information together with the submission of his annual income tax returns for the tax year in dispute;

  22.2 The facts uncovered during the audit fell in the sole knowledge of the appellant, these facts the appellant failed to disclose to SARS;

  22.3 It is SARS' contention that there was no bona fide inadvertent error on the part of the appellant when he completed and submitted his tax returns;

  22.4 SARS deems the conduct of the appellant as stipulated above to fall under the category of gross negligence in completing a return as listed in the understatement penalty percentage table of section 22(3)(1) of the Tax Administration Act."

Judgment

Firstly, the Tax Court stated that it was common cause between the parties that the onus rests upon SARS in respect of the imposition of a USP. This is clear from section 102(2) of the TAA which states that "*the burden of proving whether an estimate under section 95 is reasonable or the facts on which SARS based the imposition of an understatement penalty under Chapter 16, is upon SARS.*"

The Tax Court then proceeded to state that the real question it needs to answer in considering the exception, is whether the averments contained in paragraph 22 of the Rule 31 Statement suffice for the purposes of Rule 31 of the Tax Court Rules. With reference to Rule 31(1)(c) and Rule 32(2)(c) of the Tax Court Rules, the latter of which deals with what must be set out in the Taxpayer's statement of grounds of appeal (Rule 32 Statement), the Tax Court noted that the Rule 31 Statement and Rule 32 Statement must state"... *facts and legal grounds that are sufficiently clearly and concisely specified so as to know what issues proceed to an appeal.*"

The question is then whether the matters that are raised in paragraph 22 of the Rule 31 Statement, suffice to meet the requirement that the facts are set out in compliance with Rule 31, in a manner sufficient to define the issues that are to proceed on appeal.

The Tax Court considered the USP percentage table in the TAA, which distinguishes between different kinds of behaviour and the penalty percentages that flow from the different behaviours. The penalty percentages increase with the differentiation in the behaviour, with "gross negligence" in a standard case resulting in a penalty percentage of 100%, which is the percentage that SARS alleges in the Rule 31 Statement should apply.

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An exception(al) finding: The Tax Court grants an exception in respect of SARS' statement of grounds of assessment*...continued*

The Tax Court considered the contents of paragraph 22 of the Rule 31 Statement and held that it does not go far enough to meet the requirements of Rule 31 and in particular the facts that are relied upon and needed to be pleaded.

The Tax Court considered the contents of paragraph 22 of the Rule 31 Statement and held that it does not go far enough to meet the requirements of Rule 31 and in particular the facts that are relied upon and needed to be pleaded, as stipulated for in Rule 31(2)(b) and 31(2)(c). The Tax Court's reasons for this finding can be summarised as follows:

- In paragraph 22.2 of the Rule 31 Statement, it was pleaded that facts were uncovered in the course of the audit, but paragraph 22.2 does not state what these facts are and why the failure to disclose them to SARS gave rise to gross negligence. At the very least, this should be explained in a summary and concise fashion.
- This explanation is necessary because without some averments as to why failure on the part of the Taxpayer was grossly negligent, there is no basis on which the Taxpayer can know why SARS considers his conduct to be grossly negligent, rather than merely negligent or whether it constitutes a "substantial understatement", as contemplated in section 223 of the TAA.
- The behaviours tabulated in section 223 point towards differentiated forms of culpability. In order to differentiate the behaviour, it is necessary to understand by reference to some facts SARS has uncovered why the deviation from the standard of reasonable care is so great, that it amounts to gross negligence, rather than ordinary negligence or simply a substantial understatement.
- The determination of the relevant behaviour is not purely a matter of evidence, but is something where certain facts would have to be proved to show that gross negligence is present and that gross negligence must have something to do with what facts were not disclosed and why SARS believes that the failure to disclose those facts constitute gross negligence, as opposed to mere negligence or innocent understatement.
- Something more is required in order to place the Taxpayer in a position to know the case that it must meet and then to meaningfully plead in its Rule 32 Statement as to which facts it admits and which facts it denies for the purposes of determining those matters that will proceed as the issues on appeal.
- Absent the essential facts that SARS relies upon as to why there is gross negligence, the pleadings will simply be a bare denial of gross negligence and that will not be helpful for the purposes of explaining the true dispute that must be resolved on appeal.

Pursuant to finding in favour of the Taxpayer and that the Rule 31 Statement lacks averments necessary to sustain a finding of gross negligence and the imposition of a USP at the rate of 100%, it further granted SARS 15 days in order to remedy the defect in the Rule 31 Statement.

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An exception(al) finding: The Tax Court grants an exception in respect of SARS' statement of grounds of assessment*...continued*

Once a taxpayer has received SARS' Rule 31 Statement in a particular matter, it can consider taking an exception if the taxpayer believes that the Rule 31 Statement lacks averments necessary to sustain a particular finding, including a finding regarding the USP to be imposed.

Observations

In recent times, a number of tax disputes heard by the Tax Court and the Supreme Court of Appeal (SCA) have dealt with the issue of USPs, such as the SCA judgment in *Purlish Holdings v The Commissioner for the South African Revenue Service* (76/2018) [2019] ZASCA 4 (26 February 2019), which we wrote on in our Tax & Exchange Control Alert of 8 March 2019.

The key principle derived from this judgment is that once a taxpayer has received SARS' Rule 31 Statement in a particular matter, it can consider taking an exception if the taxpayer believes that the Rule 31 Statement lacks averments necessary to sustain a particular finding, including a finding regarding the USP to be imposed. It is important to note that if the exception is allowed, the Tax Court would likely give SARS an opportunity to remedy the defect. The taxpayer would then have to file a Rule 32 Statement in response to the amended Rule 31 Statement.

Therefore, where an exception is allowed, such as in the case discussed in this article, it simply compels SARS to state the facts on which it relies at an earlier stage, following which the taxpayer would likely be better placed to respond to SARS' allegations in its Rule 32 Statement.

Louis Botha

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Is a debt a loan for tax purposes?

It was held in *Solaglass Finance* that if the funds constitute floating or circulating capital, that is, stock in trade, the loss suffered as a result of the loan will be revenue and not capital in nature.

It is trite that a loss or expenditure resulting from an advance of funds is deductible under section 11(a) of the Income Tax Act 58 of 1962 (Act), provided it meets the requirements under the section. One of the requirements of section 11(a), is that the loss or expenditure in question, must not be of a capital nature.

In answering the question whether the loss or expenditure incurred is of a capital nature, one must distinguish between fixed capital, which is deployed in order to equip the income earning structure of the business and floating capital, where the capital employed in a business is constantly changing form, from goods to money and *vice versa* as part of the taxpayer's income-earning operations.

In the ordinary course, a loss resulting from funds advanced as fixed capital, will constitute a loss of a capital nature. Therefore, in the event that the funds become irrecoverable, the loss would not be deductible under section 11(a) of the Act.

However, in *Solaglass Finance Co (Pty) Ltd v Commissioner for Inland Revenue 1991* (2) SA 257 (A), it was held that where a taxpayer can show that it has been carrying on the business of banking or money-lending, a loss incurred by the taxpayer as a result of an irrecoverable loan will be deductible, provided it also meets the other requirements of section 11(a). In respect of the requirement in section 11(a) that the loss suffered must not be capital in nature, it was held in *Solaglass Finance* that if the funds constitute floating or circulating capital, that is, stock in trade, the loss suffered as a result of the loan will be revenue and not capital in nature.

Where a taxpayer is owed a debt and the debt becomes irrecoverable, the taxpayer would suffer a loss that would only be deductible in terms of section 11(a) of the Act, if all the requirements of the section are met, including the requirement that the debt must not be capital in nature. The question regarding the deductibility of a debt that had become irrecoverable, arose in the judgment handed down by the Tax Court, Cape Town in *Taxpayer v Commissioner for the South African Revenue Service* [2019] ZATC 3 (15 November 2019). In this matter, the question was whether funds advanced in the context of a consignment sale agreement between two subsidiaries of a holding company constituted fixed capital and were as such not deductible under section 11(a).

Background

The taxpayer (Taxpayer) and D Exporters (Pty) Ltd (D) were subsidiaries of XYZ Holdings (Pty) Ltd and both conducted the business of purchasing fruit locally and selling it to the export market. In 2014, one of the Taxpayer's major suppliers of fruit, E (Pty) Ltd (E) was in financial difficulty. The Taxpayer acquired E's business pertaining to F fruit with the aim of ensuring the continued supply of F fruit. The major asset purchased was the F fruit and the purchase price for the F fruit made up the bulk of the purchase price paid for the E business.

Because of the prevailing circumstances, the Taxpayer had to finance the purchase price for the E business, by agreeing to sell the F fruit to D, which would issue *pro forma* invoices to V Exchange. In turn, V Exchange provided finance to the

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Is a debt a loan for tax purposes?
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The Tax Court reasoned that the fact that an amount written off was advanced as a loan, is not itself determinative of whether it is capital or revenue in nature.

Taxpayer to acquire the E business, based on the purchase commitment made by D. The terms of the consignment sale were that the sale price was not fixed upfront, but the Taxpayer would receive whatever D was able to sell the fruit for after the deduction of D's costs. From an accounting perspective, the price of the fruit sold to D was included in the Taxpayer's trading revenue for 2014 and the cost of the fruit acquired from E was included in its cost of sales line.

D lacked the infrastructure to enable it to market the fruit. Therefore, the Taxpayer and D also agreed that the Taxpayer would provide the necessary resources and incur the expenditure for items such as shipping and logistics and charge D an equivalent amount for doing so. This was necessary because in order for the Taxpayer to receive anything from the sale of fruit to D, D had to sell the fruit in the export market.

In the Tax Court the evidence of the Taxpayer was that the trading operation involving the fruit from E was not as successful as had been hoped and that D was indebted to the Taxpayer in the amount of R18,273,271.26. At the end of the 2014-year D had no resources to settle its indebtedness and the amount was written off. This gave rise to a loss in the hands of the Taxpayer.

D accounted for the written off debt as additional income and declared this amount as part of its taxable income. SARS agreed that this was the proper tax treatment of the amount in D's books.

The Taxpayer however, accounted for the written off amount as a loan between itself and D. When the Taxpayer claimed this loss as a deduction, SARS took the view that the loss in the hands of the Taxpayer was of a capital rather than a revenue nature because the net debt of D to the Taxpayer was accounted for by the Taxpayer as a loan.

Judgment

In determining whether the amount written off by the Taxpayer was capital or revenue in nature, the Tax Court reasoned that the fact that an amount written off was advanced as a loan, is not itself determinative of whether it is capital or revenue in nature. This is because the accounting treatment applied by the Taxpayer is not determinative of either the legal or correct tax position. The question is always one of substance rather than form, considering the facts of the case.

The Tax Court explained that what is important are the circumstances giving rise to the indebtedness. To this end the Tax Court highlighted that one must analyse the nature of the capital to which the expenditure or loss relates. It further highlighted the distinction between fixed capital, on the one hand, which is deployed to equip the business on a non-recurring basis and is capital in nature, and floating capital, on the other, which frequently changes form from money to goods and *vice versa* and is regarded as revenue.

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Is a debt a loan for tax purposes?

...continued

What is of consequence is whether the expenditure or loss is a result of funds advanced as fixed capital in order to equip the taxpayer's income-earning structure, thereby being capital in nature or as floating capital forming part of the taxpayer's trading activities, thereby being revenue in nature.

According to the Tax Court, the fact that the account in the books of the Taxpayer ought not to have been called a loan account, but rather a trading or control account was of little significance since this was not itself determinative of the nature of the expenditure or loss. It was evident to the Tax Court that the Taxpayer could have made a trading profit on the fruit but did not, with the result that it suffered a trading loss after writing off D's debts. The loss was not as a result of an investment concerned with supporting an extraneous business of D. Instead, it was an indebtedness that arose from the Taxpayer's trading activities with D.

On this basis the Tax Court concluded that the amount owing to the Taxpayer, was related to the sale of E fruit to D on consignment, taking account of payments made in part-settlement of D's indebtedness on that account. It did not amount to a deployment of the Taxpayer's fixed capital in order to equip its income-earning structure. This, according to the Tax Court, was a clear example of the deployment of floating capital as it was not intended to remain outstanding, but intended to be converted back into cash in the ordinary conduct of the Taxpayer's trade.

Observations

In this judgment the Tax Court highlighted that the difference in the tax treatment of a loss or expenditure resulting from an advance of funds is dependent on whether the loss or expenditure is of a capital or revenue nature. This determination is made by having regard to the circumstances in which the loss or expenditure is incurred.

Importantly, whether a taxpayer accounts for the funds advanced as a loan or a debt is not determinative, but one must look at the nature of the funds advanced. What is of consequence is whether the expenditure or loss is a result of funds advanced as fixed capital in order to equip the taxpayer's income-earning structure, thereby being capital in nature or as floating capital forming part of the taxpayer's trading activities, thereby being revenue in nature.

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