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TAX & EXCHANGE CONTROL **ALERT**

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SARS' decision to audit: Can it be taken on review?

The High Court of South Africa had to determine whether the decision taken by the South African Revenue Service (SARS) to audit a taxpayer constituted administrative action and whether the said decision was capable of being reviewed under South African administrative law.

Administrative action (being the exercise of public powers and the performance of public functions by organs of state) may be taken on review by members of the public that have been adversely affected by a decision that is taken by any public authority.

In the recent judgment of *Cart Blanche Marketing CC and others v CSARS* (26244/15) [2020] ZAGPJHC (31 August 2020), the High Court of South Africa had to determine whether the decision taken by the South African Revenue Service (SARS) to audit a taxpayer constituted administrative action and whether the said decision was capable of being reviewed under South African administrative law.

Facts

The first two applicants in this case were close corporations involved in the supply of commercial transport services to their clients. The third applicant was a member of each of the first two applicants.

In 2014, SARS selected the applicants for audit in accordance with section 40 of the Tax Administration Act 28 of 2011 (TAA). This decision was made following investigations into the customs, income tax and value added tax (VAT) compliance of the applicants, which investigations were undertaken after SARS' Tax and Customs Enforcement Unit was made aware of "*suspicious activities*" that had come to light pursuant to the ongoing customs litigation between SARS and various companies that were affiliated with the applicants.

In the notice informing the applicants of the intended audit, they were advised that the audit was based on a risk assessment that had been done by SARS and they were requested to make available certain records to facilitate a proper audit. After the failure by the applicants to provide the necessary records, SARS conducted the audit on the basis of the documentation in its possession and subsequently informed the applicants of its intention to issue additional assessments in respect of income taxes that had been underpaid.

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SARS contended that the decision to audit did not constitute administrative action that was capable of being reviewed, alternatively that the decision was lawful and should therefore not be set aside.

On 24 March 2015, the applicants informed SARS that they would be instituting review proceedings, contending that the decision to audit on a risk assessment basis was unlawful as no income tax risk pertaining to the applicants had been established by SARS. In support of this contention, the applicants argued that –

1. SARS' failure to provide the written risk assessment served as proof that no risk assessment existed at the time that the decision was made; and
2. the issuance in the past of tax clearance certificates demonstrated that they had always been fully compliant with all of their obligations under the tax Acts.

The applicants further advised SARS that the review proceedings would be instituted by no later than 14 April 2015 and requested that SARS refrain from proceeding with the audit or issuance of further assessments until such time as the review had been finalised. However, on 13 April 2015, SARS issued the additional income tax assessments and refused to suspend the obligation to make payment of the disputed tax raised by means of those assessments.

In the review proceedings that followed, the applicants sought to review SARS' decision to audit on the basis that the decision was unlawful given that the decision was –

1. taken for an ulterior purpose;
2. taken for a reason not authorised by the empowering legislation (being the TAA);
3. irrational; and
4. taken in bad faith.

In opposing the review application, SARS contended that the decision to audit did not constitute administrative action that was capable of being reviewed, alternatively that the decision was lawful and should therefore not be set aside.

Judgment

Decisions by organs of state can be reviewed either on the basis of the provisions of the Promotion of Administrative Justice Act 3 of 2000 (PAJA), alternatively on the principle of legality to the extent that PAJA does not apply. In the present matter, PAJA did not find application and as such, the court had to consider whether the decision by SARS to audit was reviewable under the principle of legality. In order to make this determination, the court undertook a step by step analysis of the application of the facts of this case to the elements underlying the principle of legality.

The powers bestowed on SARS by the empowering provision (section 40 of the TAA)

The court highlighted that one of the purposes of the TAA is to ensure the effective and efficient collection of tax by prescribing the powers and duties of persons engaged in the administration of a tax Act, including SARS. This should be understood in conjunction with the SARS Act 34 of 1997, which states that SARS must secure the efficient and effective, and widest possible, enforcement of the tax Acts in order to effectively collect revenue (amongst other objectives). On this basis, it was held that SARS is not only empowered to use the available administrative mechanisms to collect all taxes, but is also legally obliged to do so in order to properly carry out its functions.

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The court also held that the selection of a person for audit results in an investigative process being set in motion and that this does not constitute a decision capable of review as the process has not yet come to completion such that the rights of that person will have been affected.

In terms of section 40 of the TAA, SARS has the power to select a person for audit on the basis of any consideration relevant for the proper administration of a tax Act. To this end, it is worth noting that "*administration of a tax Act*" includes obtaining full information in relation to anything that may affect the liability of a person for tax in respect of a previous, current or future tax period. It was the finding of the court that there would be no limitation to the considerations on which a decision to select a taxpayer for audit is to be founded to the extent that the intended audit is to be undertaken for the proper administration of a tax Act.

The purpose behind SARS' exercise of the powers bestowed by section 40

When SARS informed the applicants of its intention to audit, it advised the applicants of the scope of the audits and the documents that were to be provided in order to facilitate the process. The court found that each of the requested documents were of the kind that would prove or disprove the correctness of the VAT and income tax returns filed by the applicants and that SARS would achieve no ulterior purpose by requesting the relevant documents. As such, it was apparent to the court that every enquiry directed by SARS was relevant for the administration of a tax Act.

The "ripeness" of the matter for litigation

The "*ripeness*" of a matter refers to the suitability of a matter to be adjudicated by a competent court. At issue here is generally the timing in respect of which proceedings are instituted and whether it is appropriate for the matter to be subject to litigation at that time.

In order for a decision to be reviewed, that decision must have had an adverse effect on the rights of a person in a manner that has a direct and external legal effect. To this end, the court noted that the request for documents by SARS could not have prejudiced the applicants as the applicants had a statutory obligation (in terms of section 29 of the TAA) to keep the relevant documents for a prescribed period of time.

The court also held that the selection of a person for audit results in an investigative process being set in motion and that this does not constitute a decision capable of review as the process has not yet come to completion such that the rights of that person will have been affected. In this regard, the court gave extensive consideration to the provisions of section 42 of the TAA which provides that –

1. during an audit, SARS must provide the taxpayer with a report indicating the stage of completion of the audit;
2. upon the conclusion of the audit SARS must indicate the outcome of the audit, including the grounds for any proposed assessment or decision; and
3. a taxpayer must respond in writing to the facts and conclusions drawn by SARS pursuant to the audit.

The court found that section 42 affords a taxpayer reasonable opportunity to make representations regarding the audit findings by SARS and that it performs a function similar to that of section 3 of PAJA (which requires that representations be made by the aggrieved party before review proceedings can be instituted). It was held that section 42 had been available to each of the applicants but that none of them had elected to make use thereof.

SARS' decision to audit: Can it be taken on review?*...continued*

The court concluded that the decision taken by SARS to audit the applicants did not constitute administrative action that stood to be reviewed and the review application was dismissed with costs.

Ultimately, the court decided that if the processes contained in section 42 had been exhausted, the decision by SARS may (at that time) have reached the required degree of ripeness such that the decision would be subject to review.

The application of the principle of subsidiarity

The principle of subsidiarity prescribes that where legislation has been enacted to give effect to a right, a litigant must rely on that legislation (rather than a constitutional provision) in order to give effect to that right, or alternatively the litigant must challenge that legislation as being inconsistent with the Constitution.

The court found that section 42 of the TAA, as well as the processes relevant to the tax court, give effect to the constitutional rights that the applicants sought to protect by instituting the review application. As such, it would have been more apt for the applicants to have pursued those processes in terms of the specific tax legislation rather than to institute the review proceedings. In addition, the applicants did not challenge the constitutional validity of the appeal processes contained in the TAA. For these reasons, the court held that the applicants had breached the subsidiarity principle and that it could not entertain the review application.

Conclusion on the reviewability of the decision to audit

The court concluded that the decision taken by SARS to audit the applicants did not constitute administrative action that stood to be reviewed and the review application was dismissed with costs.

Comment

Although the TAA bestows very broad powers on SARS in order to enable it to effectively collect revenue, it is worth noting that the TAA also contains provisions and processes aimed at giving effect to taxpayers' rights. As such, it is important for taxpayers to understand the type, and extent, of the rights provided for, and how to ensure that those rights are protected and enforced to the fullest extent.

While SARS' decision to audit in this case was not subject to review, it does not necessarily mean that all other decisions taken by SARS are not subject to review in terms of administrative law. For example, where SARS has rejected a taxpayer's application to suspend payment of tax in terms of section 164 of the TAA, such a decision can be taken on review.

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Binding General Ruling 55: A further potential VAT cost to residential property developers

The temporary letting of residential units developed for sale is regarded to be a "*change in use*" of the unit for VAT purposes.

Property developers who develop residential properties for the purpose of sale, but who temporarily let such properties due to adverse market conditions until a buyer can be found, may find themselves again in a cash flow squeeze and out of pocket of the VAT costs incurred on developing such properties, in view of the recent Binding General Ruling 55 (BGR 55) issued by the South African Revenue Service (SARS) on 10 September 2020.

The development of residential properties by property developers for the purpose of sale is an enterprise activity and the sale of each property constitutes a taxable supply by the developer. An input tax deduction may be claimed by a VAT registered developer of the VAT on expenses incurred in developing the properties for the purpose of making such taxable supplies. The property developers are required to account for VAT at the standard rate on the sale of each developed unit.

Notwithstanding a developer's intention to sell the developed property, it often happens that in adverse market conditions the developer is unable to find a buyer at the required selling price. The property developer may then opt to let the property unit temporarily to generate some cash flow until such time as market conditions are more favourable and a suitable buyer can be found.

The letting of residential property as a dwelling is exempt from VAT. Consequently, the temporary letting of residential units developed for sale is regarded to be a "change in use" of the unit for VAT purposes, from a taxable purpose to an exempt application. The developer is then required to make an adjustment in terms of section 18(1) of the VAT Act as a means of repaying the VAT previously claimed on the development cost. However, section 10(7) requires that an adjustment in terms of section 18(1) is to be made on the full open market value of the unit as at the date on which the property is let, as opposed to repaying only the actual input tax previously claimed.

It was recognised by the Minister of Finance in his 2010 budget review that the requirement that developers must account for VAT on the open market value of the units temporarily let, is disproportionate to the exempt income received by the owners of the properties and that options should be investigated to determine a more reasonable method in dealing with the temporary letting of residential properties developed for resale.

Residential property developers were then afforded temporary relief with the introduction of section 18B of the VAT Act on 10 January 2012. In terms of section 18B, no change in use adjustment was required to be performed until the expiry of a 36-month relief period which commenced from the time the property was first let, or at the time when the property was applied permanently for letting as a dwelling as contemplated by section 18B(3). The temporary relief provided under section 18B ceased to apply on 1 January 2018.

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Binding General Ruling 55: A further potential VAT cost to residential property developers*...continued*

BGR 55 does not reflect the correct VAT position where the units are only temporarily let.

When the temporary relief measures under section 18B were introduced, it was recognised in the *Explanatory Memorandum on the Taxation Laws Amendment Bill*, 2011 that the VAT payments due upon the temporary letting of the residential units undercut the cash-flow gains otherwise associated with temporary letting and may even force certain developers into insolvency. It was further stated that section 18B was introduced as a short-term measure to the cash flow problem faced by developers, whilst seeking a more permanent solution.

It seems that no effort was made to find a permanent solution to the problem during the period that the temporary relief under section 18B applied. Consequently, with effect from 1 January 2018, residential property developers are again required to perform the change in use adjustment in terms of section 18(1) on the open market value when the unit is let as a dwelling. However, the difficulties which are created by section 18(1) for property developers still remain, i.e. the requirement to account for output tax on the open market value of the unit is disproportionate to the exempt income received and it places a severe cash flow burden on the developer.

SARS previously stated in its VAT News 14 (March 2000), that where a section 18(1) adjustment was made on the temporary letting of a unit and the developer subsequently sells the unit, the developer was entitled to deduct the total amount of VAT previously paid under section 18(1), against the output tax payable when the unit is subsequently sold. This was, however, in contradiction to section 18(4) of the VAT Act, which provides for a deduction to be made only on the lesser of the adjusted cost or the open market value of the unit. Notwithstanding this contradiction, SARS nevertheless allowed input tax deductions in accordance with VAT News 14, that is, until recently upon the issuing of BGR 55.

In terms of BGR 55, SARS now holds the view that the subsequent sale of a dwelling in respect of which the developer has accounted for VAT in accordance with section 18(1) (or 18(3B)), is not subject to VAT at all and the purchaser will instead be liable for transfer duty on the acquisition of such dwelling.

BGR 55 stipulates the correct VAT position regarding units where the developer has permanently changed its intention regarding the units and the developer now holds them as capital assets to generate residential rental income. However, in our view, BGR 55 does not reflect the correct VAT position where the units are only temporarily let, and the intention of the developer remains to sell them when a buyer at a suitable price is found.

In terms of BGR 55, a developer who performs a section 18(1) adjustment when units developed for sale are temporarily let is not required to account for output tax when the unit is subsequently sold as it no longer constitutes an enterprise asset of the developer. This seems to be

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Binding General Ruling 55: A further potential VAT cost to residential property developers...*continued*

Since BGR 55 is not binding on taxpayers, residential property developers are best advised to consider the correct application of the provisions of the VAT Act in view of their specific circumstances.

on the basis that SARS contemplates a permanent change in the application of the unit, even if it is only let for a very short period. However, if it remains the intention of the developer to sell the units as soon as buyers can be found, and the developer still reflects the units in its financial records as assets held for sale, there is no permanent change in the use or application of the unit. Such units are sold in the course or furtherance of an enterprise carried on by the developer and attracts VAT in terms of section 7(1)(a) of the VAT Act. The developer is then entitled to an input tax deduction in terms of section 18(4) on the adjusted cost of the property sold.

Whilst the eventual sale of residential units which were temporarily let will not attract VAT or transfer duty if the selling price is below the R1 million transfer duty threshold, it effectively attracts VAT on the market value when the unit is first let by the developer. However, units sold at prices in excess of the transfer duty threshold will attract VAT on their open market value when the units are first let as well as transfer duty on the selling price when the units are sold.

A binding general ruling such as BGR 55 is issued under section 89 of the Tax Administration Act 28 of 2011. It is initiated by SARS and represents the general view of SARS on the interpretation and application of a legislative provision. As a BGR is binding on SARS, but not on taxpayers, it may be cited in proceedings before SARS or the courts by either SARS or a taxpayer (Croome & Olivier: *Tax Administration*, paragraph 13.5.1). Since BGR 55 is not binding on taxpayers, residential property developers are best advised to consider the correct application of the provisions of the VAT Act in view of their specific circumstances.

It is regrettable that the real problem as identified in the 2010 budget review, namely, that the requirement to account for VAT on the open market value of the units temporarily let is disproportionate to the exempt income received by the developer, and that it undercuts the cash-flow gains otherwise associated with temporary letting and may even force certain developers into insolvency, is not being addressed. Both the New Zealand and Australian tax authorities have successfully addressed this issue, and guidance could easily be drawn from them to find a suitable solution in a South African context.

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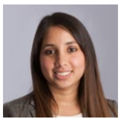

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BBBEE STATUS: LEVEL TWO CONTRIBUTOR

Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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