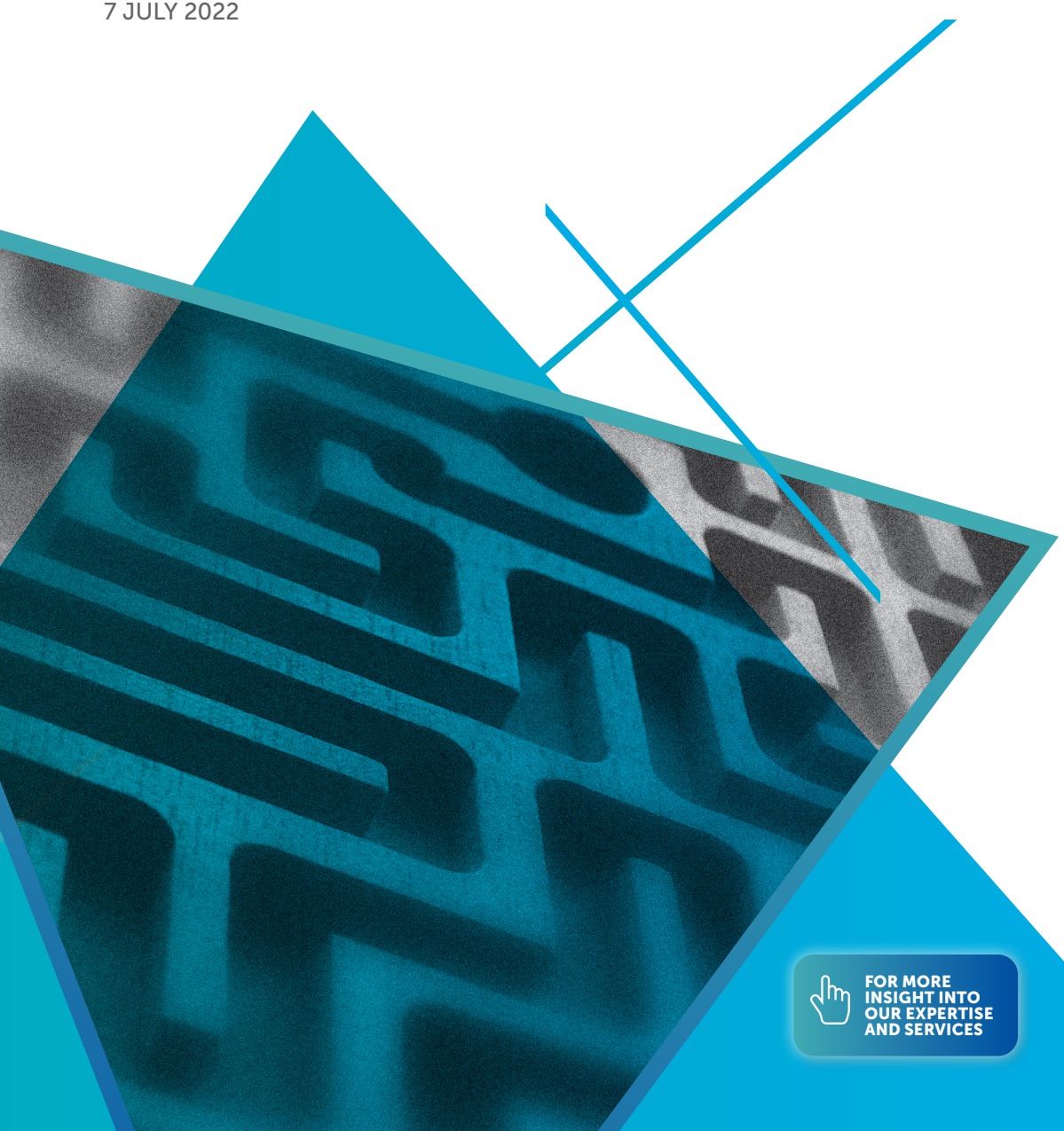
# TAX & EXCHANGE CONTROL

## ALERT

7 JULY 2022



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### Taxpayers beware – record keeping is fundamentally important

In the recent Tax Court judgment of *Taxpayer Z v Commissioner of the South African Revenue Services* (Case No. 35448) (16 March 2022), the court had to determine the consequences arising from the questionable actions of the *"controlling mind"* of the taxpayer – both in respect of the tax position they adopted and the manner in which they engaged with the South African Revenue Service (SARS).

# Taxpayers beware – record keeping is fundamentally important

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## FACTS

The taxpayer was a close corporation engaged in, among other things, the construction business. The business was operated by the taxpayer in conjunction with two associated entities, which respectively provided the taxpayer with (i) various leased vehicles and drivers; and (ii) maintenance services in respect of the vehicles used by the taxpayer. As consideration for these services, the taxpayer reduced the loan accounts owing by each associated enterprise with the amounts (totalling approximately R16 million) invoiced for services rendered.

In its 2014 tax return, the taxpayer claimed the amounts incurred in respect of the aforementioned services as "*management fee*" deductions from its taxable income. The taxpayer also claimed various amounts that it had "*donated*" as deductions. However, it transpired that the amounts allegedly donated were either not proper donations, or they were not made to a registered public benefit organisation such that a deduction could be claimed in terms of section 18A of the Income Tax Act 58 of 1962 (ITA).

Subsequent to the submission of the 2014 tax return, SARS notified the taxpayer that its return had been selected for verification in terms of section 40 of the Tax Administration Act 28 of 2011 (TAA). Thereafter SARS requested the taxpayer to provide certain relevant documents and information.

Over a period of approximately six years, SARS and the taxpayer exchanged correspondence in terms of which SARS requested further documents and the taxpayer, for the most part, failed to fully co-operate with SARS and make the necessary documents available. Of particular importance in respect of the documents that were ultimately provided by the taxpayer was that:

- only two invoices were provided to SARS, and these invoices did not detail the specific transactions (and related information) comprising the globular amounts reflected in the invoices;
- the taxpayer's representatives conceded that the response it provided to SARS in respect of the management fees did not enable SARS to properly establish the nature of the services or the year in which they were rendered; and
- the documents contained incorrect and conflicting information.

# Taxpayers beware – record keeping is fundamentally important

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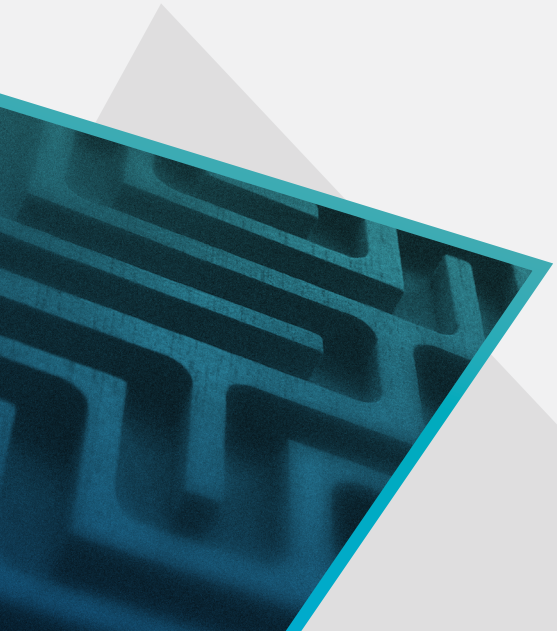

SARS ultimately issued the taxpayer with an assessment in terms of which it disallowed the management fees claimed by the taxpayer and imposed interest (in terms of section 89*quat* of the ITA) and understatement penalties.

Prior to the hearing of the appeal the taxpayer conceded, in respect of the donated amounts, that (i) it had received advice – prior to the 2014 tax year – that the amounts claimed by it did not constitute deductible donations; (ii) that it in any event continued to incorrectly claim such amounts in subsequent tax years; and (iii) that it should not have claimed such amounts as deductible donations. As such, the donation deductions incorrectly claimed by the taxpayer were relevant to the appeal only on the basis that SARS had imposed an understatement penalty of 125% in respect thereof (on the grounds that the taxpayer had been grossly negligent on a repeated basis).

## JUDGMENT

The onus of establishing whether any particular expense item is deductible for income tax purposes rests with the taxpayer. In the present instance, the critical error with the taxpayer's case in respect of the management fees was that it was unable to provide the necessary documentary proof of the expenses that were incurred by it. To this end, SARS contended that invoices between related parties are insufficient to show that the services had been rendered and that it was necessary for the taxpayer to provide details to prove that the work had been done (such as the identification of the vehicles involved and when the work was performed).

A further problem faced by the taxpayer in discharging the burden of proof was that the evidence given on its behalf during the hearing was inconsistent and contradicted the information that it had previously provided to SARS.

On the basis that the taxpayer could not properly demonstrate that the services in respect of which the expenditure had been incurred had actually been rendered to it, the court found that the taxpayer had not discharged its burden of proof and the management fees were, as a result, disallowed.

When considering the understatement penalties imposed by SARS, the court took cognisance of:

- the taxpayer's failure to provide proper documentation in respect of the management fees and the fact that the accounting records demonstrated a complete departure from normal and reasonable accounting standards;
- the taxpayer's disregard for the requirements for claiming donations as deductions;

# Taxpayers beware – record keeping is fundamentally important

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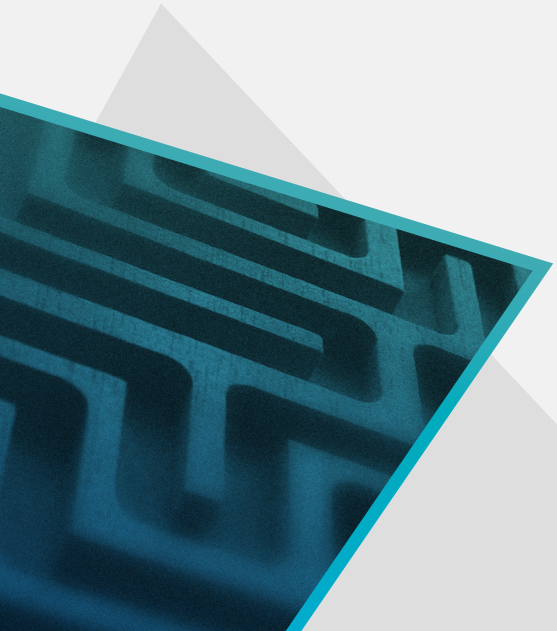

- the concession, after several years, by the taxpayer's representative that she was aware that the payments claimed as charitable deductions were not in fact donations that stood to be claimed as a deduction in terms of section 18A of the ITA and yet the deductions were still claimed;
- the inconsistent and contradictory nature of the evidence provided by the taxpayer's representative during the verification process and the hearing of the matter;
- the previous audit engagement between SARS and the taxpayer (such that the taxpayer was considered to be a repeat offender); and
- the fact that the *"controlling mind"* of a large entity (or group of entities) cannot rely, for an extended period of time, on ignorance as an excuse for not being aware of the state of their accounting records and any such continued ignorance is indicative of reckless behaviour.

On the basis of the factors set out above, the court took the view that SARS would in fact have been entitled to assess the taxpayer as falling into the *"intentional tax evasion"* understatement penalty category, rather than the *"gross negligence"* category as the taxpayer's conduct (by means of its representative) *"seemed to be arguably designed to evade the taxes payable"*. As such, the understatement penalty imposed by SARS was upheld by the court.

Lastly, on the basis that the taxpayer did not contend that the underpayment of its 2014 taxes was beyond its control, the court held that the interest in terms of section 89*quat* of the ITA had been properly imposed. The appeal was therefore dismissed with a partial cost award being made for the benefit of SARS.

## COMMENT

This case is a clear warning to taxpayers that the burden of proving whether an amount is deductible for tax purposes rests with the taxpayer and it is of critical importance that accurate and complete records are maintained by taxpayers in order to discharge this burden. The obligation on taxpayers to maintain relevant records is prescribed in section 29 of the TAA, which requires the said records to be maintained for a period of five years (barring certain circumstances).

This judgment also serves as a reminder to taxpayer litigants that it is necessary to be adequately prepared when a matter is to be heard in the Tax Court as ill-preparedness could result in a *"shot-gun"* approach (as described by the Tax Court) in adducing documentary evidence in court. This may have adverse consequences and the awarding of a cost order in terms of section 130 of the TAA.

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