Tax & Exchange Control

ALERT

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KIETI LAW LLP, KENYA

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Revised financials and a shotgun approach: Another chapter in an ongoing Tax Court dispute

Earlier this year, in our Tax and Exchange Control Alert of 2 February 2023, we discussed a Tax Court judgment where the South African Revenue Service (SARS) requested the Tax Court to order that a matter, prior to its hearing, be referred back to SARS in terms of section 129(2)(c) of the Tax Administration Act 28 of 2011 (TAA). This was pursuant to a taxpayer alleging during the alternative dispute resolution (ADR) process that previous financial statements provided were incorrect. The Tax Court declined to grant the order as it held that it was not competent to do so in terms of the section – such an order could only be made pursuant to the hearing of the matter.

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Earlier this year, in our Tax and Exchange Control Alert of 2 February 2023, we discussed a Tax Court judgment where the South African Revenue Service (SARS) requested the Tax Court to order that a matter, prior to its hearing, be referred back to SARS in terms of section 129(2)(c) of the Tax Administration Act 28 of 2011 (TAA). This was pursuant to a taxpayer alleging during the alternative dispute resolution (ADR) process that previous financial statements provided were incorrect. The Tax Court declined to grant the order as it held that it was not competent to do so in terms of the section – such an order could only be made pursuant to the hearing of the matter.

Following the Tax Court's judgment in this matter, SARS brought a further interlocutory application dealing with, amongst other things, the discovery of additional documents and the possible imposition of an increased understatement penalty. We discuss these issues here in the judgment of *Taxpayer DK v Commissioner for the South African Revenue Service*, decided on 15 March 2023.

The issue of discovery

The question in this regard revolved around the application of Rule 36(6) of the rules promulgated under section 103 of the TAA (Rules), which deals with the discovery of additional documents. SARS brought an application requesting the court to compel the taxpayer to discover certain additional documents. The court first considered the ambit of SARS' rights to request discovery. Whereas SARS argued that this power was broad, considering the definition of "*relevant material*" in section 1 of the TAA read with the broad powers conferred on SARS in terms of section 3 of the TAA, the taxpayer argued that in an appeal the Tax Court is confined to ordering discovery in terms of the Rules only. The court agreed with the taxpayer's contention, meaning that it was limited to considering the discovery request in terms of Rule 36(6). The crux of the court's reasoning in this regard was that one should draw a distinction between the powers SARS exercises as an investigator and the rights it has to discovery as a litigant in an appeal.

The court then moved on to the question as to which of SARS' document requests exceeded its discovery rights as a litigant. Firstly, the court held that requests relating to the taxpayer's financial information in foreign jurisdictions were not relevant to the current dispute and these documents need not be discovered by the taxpayer. In considering the remaining document requests, the Tax Court considered that in its grounds of appeal, the taxpayer argued that SARS' contention that funds advanced by him to a certain

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Company A in the 2014 and 2015 tax years constituted an understatement of income, did not constitute gross income, was overstated and was incorrect. It also considered the taxpayer's contention in its grounds of appeal that an amount classified as an understatement of interest income was overstated and incorrect.

SARS' request that certain journal entries referred to by the taxpayer in arguing that the previous version(s) of the financial statements should be discovered, was granted by the Tax Court as they were relevant to the issues in dispute and as SARS disputed their incorrectness. The court agreed with SARS' reliance on the judgment in *GB Mining & Exploration (Pty) Ltd v Commissioner for the South African Revenue Service* 2015 (4) SA 605 (SCA) where it was held that if incorrect information was included in balance sheets or accounts, evidence would have to be presented explaining the precise nature and extent of the incorrect information and how it was included.

It was further held in that case that all relevant supporting documentation to verify the correct information would have to be submitted, along with a full explanatory note to clarify the amendment. The Tax Court concluded that the journal entries in question were examples of the supporting documentation referred to in *GB Mining*.

In relation to SARS' remaining requests for discovery in terms of Rule 36(6), the Tax Court held as follows:

- The request for invoices issued by the taxpayer's accountants to him was declined, as the information was held to be irrelevant.
- In relation to a request for correspondence between the taxpayer and his accountants, it was held that some of the information would be relevant, but the way the request was framed was overbroad, which would require the discovery of irrelevant documentation as the request contained no restrictions as to content and duration. Although correspondence between them regarding the reconstruction of the financial statements during the period when the error was realised and corrected may be relevant, it was not for the court to rewrite it and therefore it was declined.

Understatement penalties

In relation to this issue, a key point in dispute was SARS' attempt at amending its Rule 31 Statement of Grounds of Assessment (Rule 31 Statement), to introduce a higher understatement penalty pursuant to the taxpayer's argument that the previous versions of the financial statements provided were incorrect. Specifically, SARS wished to impose an understatement penalty of 125%, on the basis that the taxpayer's behaviour constituted "*gross negligence*" and was obstructive. As part of the proposed amendment to the Rule 31 Statement, SARS

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alleged that the taxpayer's conduct *"...as evidenced in the declarations made during the objection & appeal process and post appeal, is illustrative of a conscious, elaborate and well thought effort as opposed to an innocent error."*

However, SARS' argument that if the taxpayer was found to have altered his financials on the facts, the concealment was worthy of a higher level of penalty for the taxpayer's understatement, was rejected by the Tax Court. It held that this is not a new case brought on by the Tax Court's decision in the interlocutory application (which SARS argued justified this amendment and other less contentious amendments to the Rule 31 Statement), as this has always been SARS' position. Furthermore, given the prejudice that would be suffered by the taxpayer, it was held that the amendment should not be made now.

Comment

It is not often that a Tax Court case involves multiple interlocutory applications, but while one appreciates the additional cost that may have been caused for the parties, the case assists with the interpretation of provisions that are not often in dispute before the Tax Court. For example, on the issue of discovery, the court's rationale for only compelling discovery of certain documents in terms of Rule 36(6) is sensible. In particular, the principle that SARS' rights as litigant are different to its rights as an investigator (at audit stage) is an important finding and appears to be consistent with the scheme of the TAA.

On the understatement penalty issue, although the court did not deal with the issue in detail, its finding that SARS could not amend its Rule 31 Statement to impose a higher understatement penalty, appears consistent with the significant amount of jurisprudence dealing with Rule 31(3). Furthermore, it is also consistent with the Supreme Court of Appeal's judgment in *Purlish Holdings (Proprietary) Limited v The Commissioner for the South African Revenue Service* (76/18) [2019] ZASCA 04, discussed in our Tax and Exchange Control Alert of 8 March 2019.

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BBBEE STATUS: LEVEL ONE 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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