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ALERT

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Flipping the script: When is a tax debt actually established?

Can the Commissioner for the South African Revenue Service (SARS) set off a company's tax liability against its value-added tax (VAT) refunds due to that company, in circumstances where the tax liability concerns a period prior to the company entering business rescue, but was only determined/quantified after the company had already entered into business rescue? This was the question that was before the High Court in Johannesburg in the matter of *Henque 3935 CC t/a PQ Clothing Outlet v Commissioner for SARS* (2020/35790) [2023] ZAGPJHC 186.

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In this article, we discuss the case and the court's interesting findings. However, before doing so, we provide context by setting out some background regarding the business rescue process in South Africa as it had an impact on the court's determination of the issues.

What is business rescue?

In terms of section 128(1)(b) of the Companies Act 71 of 2008 (Companies Act) business rescue is a legal process that is designed to "*facilitate the rehabilitation*" of an entity that is financially distressed by:

- temporarily appointing a business rescue practitioner (BRP) who supervises and manages the affairs of the entity;
- placing a temporary moratorium on the rights of claimants against the entity or against any property in the possession of the entity; and
- allowing for a business rescue plan to be developed.

By placing a temporary moratorium on the rights of claimants, the Companies Act effectively ring-fences the debts of the entity that have accrued prior to the commencement of business rescue. It is these debts that the plan focuses on to 'rehabilitate' or 'rescue' the entity.

In terms of section 154(2) of the Companies Act, no creditor, including SARS, if owed unpaid taxes which were **due and payable** prior to the commencement of business rescue, can enforce the debt except in terms of the business rescue plan. Post-commencement debts (referred to as post-commencement finance in the Companies Act), however, are dealt with in terms of section 135 of the Companies Act and are not affected or compromised by the business rescue plan. Section 135 of the Companies Act creates preferent claims in respect of post-commencement finance obtained by the company and specifies the ranking of these claims.

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It should therefore be noted that SARS would typically prefer that its tax debts and claims against the entity in business rescue constitute *"post-commencement finance"* as opposed to pre-business rescue claims. This would place SARS in a better position to recover taxes due to it from the entity under business rescue. This formed the crux of the issue in this matter.

The facts

Henque (the applicant), a South African tax resident close corporation, submitted its 2017 tax return in terms of which it claimed to have made a loss of R46,000. At the same time, it had accumulated tax credits for VAT, in the amount of R1,018,820.80, for which it was entitled to a refund.

On 29 November 2017 SARS issued a notice of assessment to Henque in which it recognised that an income tax refund was due to Henque. The assessment was based solely on the claims made by Henque in its 2017 income tax return. In the same notice, SARS informed Henque that it was to be subjected to an audit in respect of its 2017 tax year.

On 31 January 2018, Henque placed itself into voluntary business rescue. The first meeting of creditors and employees was held on 12 February 2018.

The audit into Henque's tax affairs for the 2017 tax year was completed by SARS on 4 April 2018. In terms of the audit findings, Henque was found to have actually produced taxable income of R16,793,724 for the 2017 tax year as opposed to having realised a loss of R46,000, as claimed in its income tax return. The additional assessment, which reflected an amount payable by Henque of R5,620,571.03, was issued by SARS on 1 May 2018. Notably, the "*due date*" in the additional assessment was 1 May 2018, whereas the "*second date*" (being the date when the amount owing is to be paid) was 31 May 2018.

In relation to the business rescue proceedings, the BRP published Henque's business rescue plan on 31 May 2018 (i.e. subsequent to the issue of the additional assessment). The business rescue plan recognised a tax liability for VAT (R2,467,810) and for pay-as-you-earn tax (PAYE) (R568,728). Therefore, the total tax liability owed to SARS pre-commencement of business rescue proceedings was R3,036,538 according to the business rescue plan. The business rescue plan did not include the income tax liability for 2017, despite it having been issued to Henque as an additional assessment by the time the business rescue plan was published. According to the plan, SARS would receive only 15% of its claim.

The business rescue plan was adopted by the creditors at a meeting that was held on 13 June 2018. SARS was not present at the creditors' meeting (there was a dispute between the parties as to whether SARS was

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adequately notified of the meeting and provided with a copy of the business rescue plan). Those creditors whose claims were accepted by the BRP were paid but for SARS' claim.

On 2 August 2018, a SARS employee addressed a letter to the BRP stating that SARS was not kept informed of the business rescue proceedings and would therefore approach the court for an order setting aside the business rescue proceedings. The BRP responded to SARS' letter on the same day, requesting that SARS send a copy of its claim against Henque for adjudication.

Ultimately SARS claimed R8,131,225.67 from Henque. The claim consisted of: (i) a VAT claim of R2,840,005.05; (ii) a PAYE claim of R20,705,86; (iii) an Unemployment Insurance Fund claim of R104,819.02; (iv) a skills development levy claim of R64,334.60; and (v) an income tax claim of R5,101,361.14 (the figure claimed was different from the amount reflected in the additional assessment). However, SARS acknowledged that the claim for income tax (R5,101,361.14), although raised on 4 April 2018 (alternatively 1 May 2018), was a pre business rescue commencement debt. As such, SARS would have to recover this debt in terms of the business rescue plan. As for the rest, SARS adopted the view that these were post-commencement debts. Therefore, on SARS' view, Henque owed it R3,029,894.53. At the same time, SARS owed Henque a VAT refund of R1,018,820.80.

Initially SARS had conceded to the fact that the VAT refund could not be off-set against the amount owed by Henque and that the refund was due and payable to Henque. However, in an email transmitted on 13 May 2019, SARS appeared to have changed its tune. Not only did it back-track on its concession regarding the off-setting of the VAT refund, SARS claimed that the income tax for the 2017 tax year had only become due and payable on 31 May 2018 when the additional assessment was completed. In other words, it alleged that the tax debt only arose when the amount owing under the additional assessment was due and payable, being the "*second date*" which was 31 May 2018. On that basis, SARS argued that it constituted a post-commencement debt.

As such, Henque objected to SARS' decision to set-off the VAT refund against the income tax liability for the 2017 tax year. The court was therefore asked to determine whether (i) the 2017 additional assessment constituted a pre-commencement debt; and (ii) if SARS was permitted to set-off the VAT refund due to Henque against the 2017 additional assessment.

What constitutes a tax debt?

A "*tax debt*" is defined in section 1 of the Tax Administration Act 28 of 2011 (TAA) as an amount referred to in section 169(1). Section 169(1) in turn defines a "*tax debt*" as an amount of tax "*due and payable*" in terms of a

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tax act. The key issue before the court was therefore whether the income tax liability was "*due and payable*" before or after the commencement of the business rescue proceedings.

Key arguments raised by the applicant and SARS

Notwithstanding the fact that SARS had initially acknowledged that the claim for income tax was a pre-commencement debt, in terms of its pleadings before the court it claimed that the income tax for the 2017 tax year had only become "*due and payable*" on 31 May 2018 when the additional assessment was completed and, therefore, constituted a post-commencement debt. SARS was further of the view that the refund owed to Henque could be set-off against the tax debt owed. SARS, therefore, withheld the VAT refund due despite requests from Henque for the refund to be paid out and SARS' own initial concession that the refunds were payable (and would be paid) to Henque.

Henque, on the other hand, was of the view that although the income tax additional assessment was completed post the commencement of the business rescue proceedings, this did not change the fact that the liability for the 2017 income tax arose and was due on 28 February 2017, being its financial and tax year-end. In this regard, Henque submitted that an assessment, including an additional assessment, of the liability subsequent to 28 February 2017 only quantified the liability. It did not create the liability.

Henque's submission was anchored on the fact that income tax is assessed under the Income Tax Act 58 of 1962 (ITA) on an annual basis, and is based on the total taxable income received by or accrued to any person during the year of assessment as determined under the provisions of the ITA, with due regard to the exemptions, deductions and allowances prescribed in the ITA and applicable during that period. Henque specifically relied on section 5(1)(d) of the ITA, which states that income tax shall be paid annually in respect of income received by or accrued to or in favour of any company during every financial year of such company.

Therefore, it was Henque's view that the amount assessed in terms of the additional assessment was a pre-commencement debt to be dealt with in terms of the business rescue plan. Henque was further of the view that the VAT refund of R1,018,820.80, which related to the February 2018 tax period, could not be set-off against the assessed amount.

Judgment

In arriving at its judgment, the court referred to and relied on a Namibian Supreme Court case (*Esselman v Secretary of Finance* [1991] (3) SA 681 (NmSC)) which considered whether a liability arises for the payment of taxes in circumstances where a proper income tax assessment has yet to be made and served on the person upon whom the liability rests. In this regard, the court quoted a dictum from the

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Namibian case which, according to the court, succinctly sums up the legal position in a single sentence: *"In my view, section 5 merely established generally the liability to pay tax, but does not make tax payable before it has been assessed."*

In terms of the ITA (similar to the Namibian ordinance regarding taxation), normal tax is imposed in terms of section 5(1) in respect of taxable income received by or accrued to a taxpayer. As noted above, taxable income must be determined by the taxpayer on an annual basis and in that respect, it is arguable that the tax liability arises at the end of each financial year and not necessarily when the actual assessment is raised.

The court noted that when SARS issues a notice of assessment it has to specify the amount to be paid as well as the date when payment is to be made. According to the court's reading of section 5(1)(d) of the ITA in the context of sections 1, 92 and 96 of the TAA it is *"unquestionably clear"* that income tax only becomes due and payable when the assessment or additional assessment is made and issued to the taxpayer.

The original notice of assessment was issued by SARS on 29 November 2017 and the additional assessment was made on 4 April 2018 and issued to Henque on 1 May 2018. The notice of the additional assessment identified the "*due date*" to be 1 May 2018 and the "*second date*" to be 31 May 2018, which is the date by when the assessed amount is to be paid to SARS before interest starts running.

The court held that the amount assessed only became due and payable on 31 May 2018 – i.e. this is when it became a *"tax debt"* as defined.

The court further held that:

> *"... section 5(1) of the Income Tax Act only establishes 'generally the liability' but that in terms of the relevant provisions of the TAA ... the tax became due and payable when the additional assessment was made. Only when it was quantified and became due and payable did it become a debt. The additional assessment constitutes the important event that transforms a general liability into an actual one."*

The court, therefore, concluded that the 2017 additional assessment was not a pre-commencement debt. The question whether SARS can set-off a company's tax liability against the VAT refunds due to that company where the tax liability concerns a period prior to the company entering into business rescue, but was only determined/quantified after the company had already entered into business rescue, was therefore answered in the affirmative..

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Observations

While the court made use of the phrase *"unquestionably clear"* in its judgment, there are a few issues that warrant further interrogation and discussion. For example, it is unclear why the court referred to and relied solely on foreign case law, which merely has persuasive value, when South Africa has several cases that deal with the specific issues before the court.

In this context, the court's judgment does not address the judgments handed down in the recent case of the *Commissioner for SARS v Dr Christoffel Hendrik Wiese and Others* [2022] JOL 55368 (WCC) and the Supreme Court of Appeal judgment in *Singh v Commissioner, South African Revenue Service* 65 SATC 203.

As noted in a previous tax alert, the court in *Wiese* held that it would be *"unbusinesslike but will also emasculate the very purpose of the TAA as a whole"* to require an assessment to first be issued before there is a *"tax debt"* for purposes of section 183 of the TAA.

Although the court in *Wiese* had to determine the meaning of what constitutes a tax debt within the context of section 183 of the TAA, the court made it clear that SARS did not have to issue an assessment to establish a tax debt under those circumstances. The court in *Wiese* noted that the debt exists irrespective of whether the taxpayer or SARS made an assessment. Based on this interpretation of what constitutes a tax debt, Henque's contention that the liability for the 2017 income tax arose and was due on 28 February 2017 could well have been upheld. Although the court in *Wiese* took a broad approach to the meaning of what constitutes a *"tax debt"*, the court in the *Henque* case seems to have gone in the opposite direction, which creates much jurisprudential uncertainty.

It may be that the *Wiese* case can be distinguished from the *Henque* case on the basis that, *inter alia*, the *Wiese* case involved the application of the General Anti-Avoidance Rules (GAAR) and hence its interpretation of what constituted a *"tax debt"* was informed by this context. It is therefore a pity that the court in *Henque* did not address the *Wiese* case, which it could have done as *Wiese* was handed down a few months before the *Henque* case was heard.

The *Singh* case, on the other hand, related to a VAT assessment in terms of which SARS had obtained judgment for the amount payable before it had issued the assessment to the taxpayer. This case is distinguishable from the other two cases in that SARS did not follow the correct procedure insofar as notifying the taxpayer of the tax debt prior to obtaining judgment in respect thereof. However, the court still held that the assessing of a taxpayer to tax is to retrospectively render the tax due and payable

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when it ought to have been paid i.e. a tax debt exists irrespective of whether the taxpayer or SARS has made an assessment. In this regard, the court noted:

> *"... an amount is due when the correctness of the amount has been ascertained either because it is reflected as due in the taxpayer's return or because the circumstances set out in section 32(5) had been applicable (in both of which cases it is both due and payable) or if there is a dispute after the procedures relating to objection and appeal have been exhausted (in which case the amount so ascertained was due and payable with the return)."*

Based on the *Singh* case, one would have thought that the court in the *Henque* case may have found that the debt arose on 29 November 2017 when SARS issued the original notice of assessment based on Henque's income tax return and not when the additional assessment was issued. Having said that, the *Singh* case dealt with VAT and not income tax, which have different assessment mechanisms and therefore it would have been helpful if the court in this case had dealt with *Singh*.

Furthermore, it could be argued that the court may have come to a different finding *in casu* because in terms of the original notice of assessment a refund was due to Henque as opposed to there being an amount due *"and payable"* by Henque. The question therefore arises as to whether the court could have come to a different finding if the original notice of assessment recognised an amount payable by Henque.

Whatever the outcome may have been there is much uncertainty now as to what constitutes a *"tax debt"* and in what context. It will be interesting to see if the *Henque* case goes on appeal to the higher courts in circumstances where much needed clarity in this area of tax law is sought.

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