THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

JUDGMENT

Not Reportable

Case No: 76/2018

In the matter between:

PURLISH HOLDINGS (PROPRIETARY) LIMITED **APPELLANT**

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE **RESPONDENT**

Neutral citation: *Purlish Holdings v The Commissioner for the South African Revenue Service* (76/18) [2019] ZASCA 04 (26 February 2019)

Coram: Ponnan, Van der Merwe and Molemela JJA

Heard: 13 November 2018

Delivered: 26 February 2019

Summary: Appeal against imposition of understatement penalties – the appellant's conduct fell within the category listed in items *(a)* to *(d)* of the definition of 'understatement' in s 221 of the Tax Administration Act – SARS suffered prejudice – no bona fide or inadvertent error – the imposition of penalties was justified – the increase of understatement penalties by the Tax Court incompetent and set aside.

ORDER

On appeal from: Tax Court of South Africa, held in Gauteng (Nkosi-Thomas J) sitting as court of first instance:

1. The appeal is upheld to the limited extent set out in paragraph 2 below.
2. Paragraphs 2, 3, 4 and 5 of the order of the Tax Court is set aside and paragraph 6 is renumbered to read 2.

JUDGMENT

Molemela JA (Ponnan and Van der Merwe JJA concurring)

Introduction

[1] At issue in this appeal against the decision of the Tax Court sitting in Gauteng (Nkosi-Thomas AJ and two other members), is the South African Revenue Services (SARS)'s entitlement to payment of understatement penalties by the appellant, in accordance with the provisions of s 222 (1) of the Tax Administration Act 28 of 2011 (the TAA), for the 2011, 2012, 2013 and 2014 years of assessment and, if so, the quantum thereof.

Background facts

[2] The appellant, Purlish Holdings (Pty) Ltd, having paid provisional income tax to SARS, applied for a refund of the amount paid on the basis that it had not yet commenced trading. At that stage, the appellant had not registered as a vendor in terms of the Value-Added Tax Act 89 of 1981 and consequently did not submit VAT returns for the period in question. SARS decided to perform audits in respect of both corporate income tax (CIT) and value added tax (VAT). SARS proceeded to issue assessments in respect of CIT and VAT and thereafter levied understatement

penalties. Aggrieved by those decisions, the appellant lodged objections as contemplated in the TAA. The SARS committee that considered the objections confirmed the imposition of understatement penalties but applied lower rates, thereby reducing the quantum of the understatement penalties. The appellant lodged appeals against those decisions to the Tax Court. The Tax Court dismissed the appeals and increased the rate of the understatement penalties to 100 percent of the assessed tax in respect of both CIT and VAT.

[3] The Tax Court issued the following order:

'1. The taxpayer's appeal against the levying of understatement penalties in respect of income tax and VAT for the 2011-2014 years of assessment is dismissed.

2. The Commissioner's understatement penalty of 25 per cent in respect of income tax is set aside.

3. The understatement penalty of 100% is imposed in respect of income tax for the 2011-2014 years of assessment.

4. The Commissioner's understatement penalty of 50 per cent in respect of VAT is set aside.

5. The understatement penalty of 100 per cent is imposed in respect of the understatement of VAT payable in respect of 12/2010, 02/2011 and 12/2012.

6. Each party is to pay its own costs.'

This appeal is with leave of the Tax Court.

[4] The only *viva voce* testimony adduced at the Tax Court was presented by Mrs Porter, an operational specialist within the SARS audit department. She testified that the appellant's income tax return in respect of the 2011 year of assessment was submitted to SARS on 19 April 2012, while the returns for the 2012 to 2014 years of assessment were submitted on 29 January 2015. According to Mrs Porter, the returns submitted on behalf of the appellant in April 2012 declared no income or expenditure in respect of the 2011 financial year. The returns for the 2012 to 2014 financial years reflected the status of the company as dormant. The words 'never traded' were printed in the space reserved for the details of the company. According to Mrs Porter, tax returns that reflect that a taxpayer had neither received income nor incurred expenses are, in tax parlance, referred to as 'nil returns'. All the tax returns submitted by the appellant were thus considered to be 'nil returns'. At the time of the rendition of the 'nil

returns', the appellant had already paid provisional tax in the amount of R13 777 347.74. The appellant's submission of 'nil returns', if properly assessed as such, would have resulted in this amount being reflected as a credit in its tax account.

[5] Mrs Porter testified that the audit was essentially prompted by the magnitude of the refund sought by one Mr Tshepo Sekele (Sekele), who claimed to be representing the director of the appellant. He claimed a refund of the entire amount paid as provisional tax on the basis that the appellant had not traded in the tax years in question. Mrs Porter's suspicions regarding the tax affairs of the appellant became heightened when, during a telephonic interview, Sekele was unable to explain the basis for the substantial provisional income tax paid by the appellant, given the claim that it had not yet started trading. He referred Mrs Porter to the director, Ms Magadla, who did not deny that nil returns had been submitted and in fact said that the appellant had no income as it had not yet commenced trading. A few days later, Mrs Porter received a telephone call from a Ms Cuba, who subsequently sent tax computations explaining the basis on which the provisional income tax was paid. About a week later, she received an e-mail from Sekele, to which the same documents previously supplied by Ms Cuba were attached. Mrs Porter then requested Sekele to furnish her with a general power of attorney authorising him to act on behalf of the appellant. She never heard from Sekele again.

[6] SARS conducted a CIT audit for the period 2011 to 2014 and a VAT audit for the period 2010 to 2012. During the audit processes that followed, the appellant was requested to submit its tax computations and financial statements for the tax years in issue. Despite the returns indicating that the appellant was not a party to a contract of which it had undertaken to conduct any activity, it was discovered that the appellant had concluded consultancy agreements in terms of which it had earned substantial income in the period 2011 to 2014. Despite earning this income, the appellant had filed 'nil returns'. Furthermore, despite the consultancy agreements clearly stipulating that the fees payable to the appellant were inclusive of VAT, it had not rendered any VAT returns for the 2010 to 2012 years of assessment. According to Mrs Porter, the appellant only registered for VAT when the tax audit was already underway. Pursuant to the tax audit, SARS issued assessments in respect of both CIT and VAT.

[7] The assessments raised by SARS in respect of income tax were as follows:

(i)	2011 year of assessment Income Tax payable	R43 053.64
	Capital Gains Tax payable	R1 287 356.84
(ii)	2012 year of assessment	
	Income Tax payable	R5 508 366.92
(iii)	2013 year of assessment	
	Income Tax payable	R4 426 492.88
(iv)	2014 year of assessment	
	Income Tax payable	R147 617.40

[8] In respect of the tax period 12/2010 for which the appellant received R10 000 000.00 for the operational advisory services it rendered, which was inclusive of VAT, its VAT liability on that amount was calculated as R1 228 070.18. In respect of the R12 500 000.00 received in the 02/2011 tax period, the VAT liability amounted to R1 535 087.72. In respect of the tax period 12/2012, for which the appellant had received the amount of R17 207 160.00, its VAT liability was a sum of R2 113 160.00.

[9] In addition to issuing the aforesaid assessments, SARS also levied interest plus 100 per cent understatement penalties in respect of CIT and VAT. It regarded the appellant's declaration of a zero income and non-rendition of the correct income tax as constituting gross negligence. Similarly, the appellant's failure to register for VAT was considered to constitute gross negligence. Accordingly, understatement penalties were levied in respect of both CIT and VAT at the applicable rate of 100 per cent in terms of s 223 of the TAA.

[10] The appellant objected to the interest and understatement penalties. On 18 February 2016, the objection in respect of the interest was allowed. The objection relating to the imposition of understatement penalties was partially allowed. The understatement penalties for income tax were reduced from 100 per cent to 25 per cent, while those relating to VAT were reduced to 50 per cent. SARS proffered the following reason for the reduction of penalties in respect of income tax: 'Based on your grounds of objection submitted, the behaviour with regards to the understatement

penalty raised was revised from “gross negligence” (100%) to “reasonable care not taken when completing the return” (25%)’. The reason for the reduction of the VAT understatement penalty was stated as follows: ‘Based on your grounds of objection submitted, the “behaviour” with regards to the understatement penalty raised was revised from “gross negligence” (100%) to “no reasonable grounds for tax position taken (50%)”.’

[11] Although the appellant made various allegations in its statement of grounds of appeal filed in terms of Rule 32 of the South African Revenue Services Rules[1] (Rule 32 Statement), the parties later agreed, as reflected in the pre-trial minutes, that the only issue to be argued in the Tax Court was whether SARS was justified in levying understatement penalties against the appellant. However, the Tax Court found that the appellant had been grossly negligent in its tax affairs and accordingly increased the understatement penalties to 100 per cent.

[12] The first issue in this appeal relates to whether or not SARS has proven that it is entitled to impose understatement penalties in terms of s 222 of the TAA. Section 221 of the TAA defines the term ‘understatement’ as:

‘any prejudice to SARS or the *fiscus* in respect of a tax period as a result of—

(a) a default in rendering a return;

(b) an omission from a return;

(c) an incorrect statement in a return; or

(d) if no return is required, the failure to pay the correct amount of tax.’

[13] Section 222(1) reads as follows:

‘In the event of an “understatement” by a taxpayer, the taxpayer must pay, in addition to the “tax” payable for the relevant tax period, the understatement penalty determined under subsection (2) unless the “understatement” results from a bona fide inadvertent error.’

[14] Section 222(2) provides for the computation of the understatement penalty. It reads thus:

‘The understatement penalty is the amount resulting from applying the highest applicable understatement penalty percentage in accordance with the table in section 223 to each

[1] Rules promulgated under s 103 of the TAA, published in Government Notice 37819 on 11 July 2014.

shortfall determined under subsections (3) and (4) in relation to each understatement in a return.'

[15] The understatement penalty percentages are set out in the table embodied in s 223(1) of the TAA. They vary, depending on the behaviour associated with the understatement. In instances where a taxpayer is considered to fall under the category referred to as a 'standard case', the following rates are prescribed in the table. 10 per cent in respect of conduct constituting 'substantial understatement'; 25 per cent where it is considered that reasonable care was not taken in completing the tax return; 50 per cent where there are no reasonable grounds for the 'tax position' taken by the taxpayer; 75 per cent for 'impermissible avoidance arrangement'; 100 per cent where the taxpayer's conduct constitutes gross negligence; and 150 per cent in the event of intentional tax evasion.

[16] It is evident from the definition of 'understatement' in s 221 that for an understatement to arise, any of the actions or omissions referred to in item *(a)* to *(e)* of that definition must result in some prejudice to SARS or the *fiscus*. In this matter, it is common cause that the appellant did not render VAT returns. The appellant's admitted failure to submit VAT returns clearly falls within the category of conduct set out in item *(a)* of the definition of 'understatement'.

[17] SARS considered the appellant's conduct in relation to the income tax returns to fall within the category of conduct described in item *(c)* of the definition of 'understatement'. It is indeed so, that in its Rule 32 statement, the appellant denied having filed 'nil returns'. The difficulty for the appellant is that although it disputed having submitted 'nil returns' and having ever been represented by Sekele, it did not challenge Mrs Porter's testimony that the 'nil' returns' were submitted electronically using a username, password and an electronic-file identity number that could only have been known by the appellant. That Sekele indeed purported to be acting on behalf of the appellant in pursuing the refund is borne out by the e-mails exchanged between him and Mrs Porter, to which some documents related to the financial affairs of the appellant were attached. Sekele's assertion that the appellant was not a trading company was advanced as his justification for seeking a refund of the provisional tax that the appellant had paid. Significantly, Mrs Porter's evidence that the sole director

of the appellant, Ms Magadla, had re-iterated the earlier assertion made by Sekele pertaining to the appellant allegedly being a non-trading company, was not challenged under cross-examination. Mrs Porter's evidence was not contradicted.

[18] Considering that SARS had clearly stated in its statement of grounds of assessment and opposing appeal filed in terms of Rule 31 (Rule 31 Statement) that the 'nil returns' and the non-rendition of the correct CIT returns were the reasons why understatement penalties were imposed, one would have expected the appellant to have adduced some evidence in refutation, especially in relation to the alleged submission of 'nil returns'. It is thus inescapable that the appellant indeed filed 'nil returns'.

[19] The submission of incorrect information in returns falls squarely within the provisions of item *(c)* of the definition of 'understatement'. I also agree with SARS' submission that a failure to declare income constitutes conduct listed in item *(b)* of the definition of 'understatement'. Indeed, even on the acceptance of the appellant's version that it did not submit tax returns to SARS, item *(a)* of the definition would still have been triggered. What now remains is to evaluate whether the aforesaid conduct, being conduct envisaged in items *(a)*, *(b)* and *(c)* of the 'understatement' definition stipulated in s 221 of the TAA, caused any prejudice to SARS.

[20] In terms of s 102(2) of the TAA, the burden of proving the facts on which SARS based the imposition of an understatement penalty rests on SARS.[2] Furthermore, the Tax Court is, in terms of s 129(3) of the TAA, enjoined to decide an appeal against an understatement policy on the basis that the burden of proof is

[2] Section 102(2) of the TAA provides:
'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.'

upon SARS.[3] Given the aforesaid burden of proof, I am inclined to find merit in the appellant's contention that SARS must not only show that the taxpayer committed the conduct set out in items *(a)* to *(d)* of the definition of 'understatement' in s 221 of the TAA, but also that such conduct caused it (SARS) or the *fiscus* to suffer prejudice.

[21] The appellant denies that SARS suffered any prejudice. It contends, inter alia, that SARS was precluded from relying on Mrs Porter's testimony regarding the prejudice allegedly suffered by SARS, as such an averment was not made in its Rule 31 Statement. It contends that since Rule 34 of the SARS Rules confines the issues to be determined in an appeal to those stated in the Rule 31 and Rule 32 Statements, the Tax Court erred in taking cognizance of Mrs Porter's testimony relating to prejudice suffered by SARS. This contention is without any foundation and requires no further consideration, because SARS did indeed assert prejudice as is evident from the following averment made in SARS' Rule 31 Statement in relation to CIT:

'When the "nil returns" were processed, the result was a credit balance in favour of [the appellant], which entitled [the appellant] to a refund'.

SARS further averred as follows in relation to VAT:

'The fact that the vendor failed to account for the output VAT, created a shortfall in its tax liability resulting from the difference between the tax properly chargeable and the tax due resulting from the failure to account for such output VAT, thus creating a loss to the *fiscus*.'

[22] Another point raised by the appellant was that, given the fact that the appellant had indeed paid provisional tax due to SARS in excess of its assessed tax liability by about R1.3 million, it could simply have been set off against the amount standing to its credit in its tax account, such payment meant that there was no prejudice to SARS.

[23] I turn now to consider whether SARS showed that it suffered prejudice as contemplated by s 221 of the TAA. Mrs Porter identified SARS' prejudice as the time, resources and costs incurred in considering the appellant's request for a refund. She explained that an upfront payment of provisional tax is credited to the taxpayer's tax

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[3] Section 129(3) of the TAA provides that:
'In the case of an appeal against an understatement penalty imposed by SARS under a tax Act, the tax court must decide the matter on the basis that the burden of proof is upon SARS and may reduce, confirm or increase the understatement penalty.'

account. It is only once the relevant tax returns are submitted that SARS can do an assessment to determine whether there is an amount owing by or due to the taxpayer. She pointed out that the submission of 'nil returns', if assessed as such, would have had the effect of conferring on the appellant an entitlement to a refund. This would have resulted in all the funds paid in by the appellant being reflected as a credit in the appellant's account with SARS, as a result of which SARS was unable to channel such funds for the relevant governmental activities. This evidence was not challenged under cross-examination. Mrs Porter further stated that SARS would have suffered substantial financial loss if it had acceded to the appellant's request for a refund without conducting an audit. It is also clear that had it not been for the audit, the appellant's liability to pay VAT would not have been exposed, as it had not registered for VAT. Further to that, Mrs Porter testified that the resource allocation in the form of additional time and human capital necessitated by the extensive audit also constituted prejudice to SARS, as such resources could have utilised for other matters. Given the circumstances of this matter, I agree that the use of additional SARS resources for purposes of auditing the appellant's tax affairs indeed prejudiced SARS. As correctly conceded by counsel for the appellant in argument before this court, prejudice is not only determinable in financial terms.

[24] I am accordingly satisfied that SARS has proven that there were understatements as contemplated by s 221. I am unable to find that the understatements were as a result of a bona fide inadvertent error, as the appellant did not adduce any evidence to that effect. There is nothing, in the evidence, that suggests an error of that nature. It follows that the Tax Court correctly found that SARS had discharged its onus of proving the appellant's 'understatement' of its CIT and VAT within the contemplation of s 221 of the TAA.

[25] The next question is whether the Tax Court was entitled to increase the understatement penalties levied by SARS. Section 129(3) of the TAA empowers the Tax Court to increase an understatement penalty.[4] But, that only arises if the issue has

[4] Section 129(3) of the TAA provides: 'in the case of an appeal against an understatement penalty imposed by SARS under a tax Act, the Tax Court must decide the matter on the basis that the burden of proof is upon SARS and may reduce, confirm or increase the understatement penalty so imposed'.

been properly raised for adjudication before that court. This is determined by Rule 34, which provides:

'The issues in an appeal to the tax court will be those contained in the statement of the grounds of assessment and opposing the appeal read with the statement of the grounds of appeal and, if any, the reply to the grounds of appeal.'

It was fairly conceded by counsel for SARS, that SARS had never raised the issue of the increase of the reduced penalties for adjudication before the Tax Court. In its Rule 31 statement, SARS only sought to justify the reduced penalties. It follows that it was incompetent for the Tax Court to have increased the reduced penalties. To that extent the appeal against the decision of the Tax Court must succeed. It follows that the understatement penalties of 100 per cent imposed by the Tax Court in respect of both income tax and VAT for the relevant periods must be set aside and SARS' understatement penalty of 25 per cent in respect of income tax and 50 per cent in respect of VAT reinstated. Accordingly paragraphs 2 to 5 of the order of the Tax Court falls to be set aside.

Costs

[26] Given that both parties have been partially successful in this appeal, it is appropriate that each party pay its own costs of the appeal.

[27] In the result, the following order is made:

1. The appeal is upheld to the limited extent set out in paragraph 2 below.
2. Paragraphs 2, 3, 4 and 5 of the order of the Tax Court is set aside and paragraph 6 is renumbered to read 2.

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M B Molemela

Judge of Appeal

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