REPUBLIC OF SOUTH AFRICA

IN THE TAX COURT SOUTH AFRICA

HELD AT MEGAWATT PARK, GAUTENG

(1) REPORTABLE: YES/NO
(2) OF INTEREST TO OTHER JUDGES:YES/NO

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DATE SIGNATURE

CASE NO: IT 14247

In the matter between:

ABC (PTY) LTD **APPELLANT**

AND

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

JUDGMENT

NKOSI-THOMAS AJ:

Introduction

[1] At issue in this appeal is SARS's entitlement to levy understatement penalties, in accordance with the provisions of section 222(1) of the Tax Administration Act 28 of 2011 (the TAA), for the 2011, 2012, 2013 and 2014 years of assessment (the appellant will henceforth be referred to as the taxpayer).

[2] The said penalties relate to the understatement of the taxpayer's income tax and the VAT payable in respect of the above tax years.

[3] According to the Rule 38 Pre-Trial minute dated 11 July 2017:

[3.1] *"The Appellant still maintains that there was no under declaration in its income tax returns for the years in dispute.*

[3.2] *The issue to be argued is whether the Respondent was justified in levying the understatement penalty (USP) against the Appellant."*

[4] SARS had initially levied 100% penalty in respect of both the income tax and the VAT understatements. The taxpayer objected thereto.

[5] Consequently, SARS reduced the penalty to 25% in respect of its income tax understatement and to 50% in respect in respect of the VAT understatement.

[6] SARS proffered the following reason for the above 'decision' in respect of the income tax reduction:[1]

> "*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%)'"*

[1] IT Pleadings Bundle, Page 19, para 1.8.

[7] In respect of the reduction of the previously levied VAT understatement penalty, SARS proffered the following reason for its 'decision': [2]

> "*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%)'."*

[8] SARS maintains that it is entitled to levy penalties as there were understatement/s, as defined in section 221 of the TAA, in respect of the taxpayer's taxable income and Value Added Tax (VAT) payable for the 2011 to 2014 years of assessment. The taxpayer contends otherwise.

[9] SARS maintained, further, that the understatement penalties levied by it at the reduced percentages of 25% and 50% respectively, are in all the circumstances of this matter, lenient and thus, fall properly to be increased by this Court, in the exercise of its discretionary powers provided for in section 129(3) of the TAA.

[10] 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.*"

[11] The word *'understatement'* is defined in section 221 of the TAA to mean any prejudice to SARS or the *fiscus* as a result of *inter alia*:

[11.1] a default in rendering a return;

[11.2] an omission from a return; or

[11.3] an incorrect statement in a return.

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[2] VAT Pleadings Bundle, Page 23, para 1.9.

[12] Before us, the taxpayer did not dispute:

[12.1] In respect of income tax, that its returns contained *"an omission"* or *"an incorrect statement"* within the contemplation of section 221 of the TAA; and

[12.2] In respect of the VAT payable, that it was *"in default in rendering the return"* as contemplated in section 221 of the TAA.

[13] The taxpayer contends, however, that the conceded "*omission*" and "*default*" did not result in any *"prejudice to SARS or the fiscus"* as envisaged in section 221 of the TAA.

[14] In terms of section 102(2) of the TAA, SARS bears the burden of proving the facts upon which it relies for its imposition of an understatement penalty.

[15] SARS, accordingly, proceeded to lead oral evidence with a view to discharging that burden of proof.

[16] Before I deal with the evidence led by SARS, I propose to deal, firstly, with the material common cause facts.

The Material Common Cause Facts

[17] The taxpayer is an investment company that, also, renders financial advisory services to Black Economic Empowerment (BEE) entities in respect of which services it receives remuneration.

[18] The taxpayer submitted its income tax return, in respect of the 2011 year of assessment on 19 April 2012 and those in respect of the 2012 to 2014 years of assessment, on 29 January 2015.

[19] The above tax returns stated that the taxpayer neither received any income nor incurred any expenditure during the above tax periods. In other words, the taxpayer rendered returns referred to, in tax parlance, as "*nil returns".*

[20] At the time of the above rendition of the "*nil returns*" by the taxpayer, it had already paid provisional tax in respect of the 2011 to 2014 years of assessment in the total amount of R13 777 347.74 made up as follows:

[20.1] In respect of the 2011 year of assessment – R1 363 025;

[20.2] In respect of the 2012 year of assessment – R6 300 000; and

[20.3] In respect of the 2013 year of assessment – R4 818 004.

[21] The rendering of the "*nil returns*" resulted in a credit balance in the taxpayer's tax account that entitled the taxpayer to a tax refund.

[22] In so far as the taxpayer's VAT obligations are concerned, the taxpayer neither registered for VAT nor rendered any VAT returns for the 2011 to 2014 years of assessment.

[23] That was so despite the fact that the taxpayer was actively trading and was, in the course thereof, charging for VAT.

[24] In that regard the taxpayer, on 5 January 2011, entered into a consultancy agreement. In terms thereof, the taxpayer would:

[24.1] "*act as a financial adviser and manager to … in connection with all matters relating on-going management of the Company and provide financial advice to the Company relating to the ultimate liquidation or realisation through a dividend in specie or a cash dividend of the XYZ Ltd investment ("the* ***Transactions****"). The nature of this engagement is therefore expected to be on-going for a period of twelve months from signature";* and

[24.2] *"assist the Company in analysing, structuring, negotiating and effecting any proposed Transaction …"* [3]

[3] Discovery Volume 1, page 104.

[25] In terms of the agreement, the taxpayer would be paid a total fee of R12 500 000, inclusive of VAT in cash.[4]

[26] On 1 November 2012, the taxpayer concluded yet another consultancy agreement.[5]

[27] In terms thereof, the taxpayer:

[27.1] "*would act as a financial and operational advisor …in matter(s) relating to transactions, whether from a mergers and acquisitions perspective, or from a strategic commercial arrangement with current and future partners.";* and

[27.2] *"is engaged for a period of 1 year [and] the total fee payable … is R10 000 000 (inclusive of VAT) in cash."*

[28] As stated above, the taxpayer does not dispute the non- rendition of VAT returns. Its only contention is that its non-rendition of the VAT returns did not result in any *"prejudice to SARS or the fiscus*" as envisaged in section 221 of the TAA.

[29] SARS subsequently raised VAT assessments in respect of the taxpayer. No objection has been lodged against these assessments.

The Evidence

[30] SARS led the evidence of Ms T, the Operational Specialist within SARS's Audit Department, to whom the audit of the taxpayer was assigned.

[31] According to her unchallenged evidence:

[31.1] A refund claim by a certain Mr P, of the amount of R13 777 347.74 paid by the taxpayer in provisional tax, raised a suspicion regarding the tax affairs of the taxpayer. The taxpayer had alleged that it had not traded during the tax years in question;

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4 Discovery Volume 1, page 105.

5 Discovery Volume 1, page 112.

[31.2] The main areas of concern were the source of funds and how the taxpayer arrived at the provisional tax amount;

[31.3] On 11 May 2015 Ms. T contacted Mr P in order to determine the basis for the provisional tax payment given the allegation that the taxpayer had not been trading during the relevant tax period. Mr P pleaded ignorance; confirmed that the company was not trading during the period under review and referred Ms. T to Ms. H, the only director of the taxpayer at the time;

[31.4] Upon contacting Ms. H on 11 May 2015, she similarly pleaded ignorance concerning both the source and the basis for the provisional payment;

[31.5] On 14 May 2015 Ms. T received a call from Ms. S who subsequently sent Ms. T certain tax computations on the basis of which that provisional tax had been made;

[31.6] On 20 May 2015 Ms. T received an electronic mail from Mr P, attached to which were the same tax computations documents received from Ms. S on 14 May 2015;

[31.7] On 21 May 2015, Ms. T asked for a general power of attorney of Mr P authorising him to act on behalf of the taxpayer, after which request Mr P completely disappeared from the scene.

[32] According to Ms. T, SARS suffered prejudice as a result of the taxpayer's non-rendition of VAT returns and the misstatements in the income tax returns. That prejudice, as I understand the evidence, was in the form of the opportunity cost flowing directly from the non-rendition of VAT returns and the taxpayer's misstatements in respect of taxable income earned during the 2011 to 2014 years of assessment. Furthermore, Ms. T referred to the prejudice flowing from extensive audit and the resource allocation attendant thereupon.

[33] Based on the above, SARS levied penalties in the order of 100% of the income tax and VAT payable during the 2011 to 2014 years of assessment. That percentage was based on section 223(1)(iv)(3) of the TAA. In terms thereof, a 100% penalty must be levied by SARS in a case where the understatement was brought about by the gross negligence of the taxpayer and the case is a standard one.

[34] Subsequently, the taxpayer lodged an objection against the levied penalties in terms of section 104 of the TAA.

[35] Consequently, SARS reduced the penalty to 25% in respect of income tax and to 50% in respect of VAT. In this regard, SARS took the view that, because it had the taxpayer's funds in its possession throughout, the appropriate penalty to be levied, in respect of income tax, should be in terms of section 223(1)(iii)(3), whose effect was to characterise the behaviour of the taxpayer as failure to take reasonable care. In so far as VAT is concerned, SARS characterised the behaviour of the taxpayer as an absence of reasonable grounds for the tax position taken.

[36] Ms. T maintains that the penalties thus imposed were too lenient and that this Court should, in the exercise of its discretion, increase them to 100% in respect of both the income tax and VAT amount payable.

[37] Ms. T made a good impression to this Court. Most of her evidence remained unchallenged under cross-examination. She came across as knowledgeable both technically and factually. This Court has found no reason to disbelieve her evidence.

[38] No evidence was led on behalf of the taxpayer.

Did SARS suffer prejudice?

[39] As stated above, the taxpayer conceded the "*omission"* in the income tax returns rendered and "*default"* as regards the rendition of VAT returns.

[40] The issue that arises in this appeal is whether it can be said, in the circumstances of this matter, that SARS and / or the *fiscus* suffered any prejudice as a result of the "*omission*" and the "*default"* aforesaid and whether the penalties levied by SARS fall properly to be increased.

[41] The uncontroverted evidence before us is that SARS suffered prejudice in the form of the opportunity cost occasioned by its delayed recovery of the income tax and VAT amounts due to it. Although SARS had the funds in its possession, throughout, it was not entitled to the use thereof as the funds were reflected as a credit in the account of the taxpayer (for which Mr P sought a refund from SARS). Indeed, the interest that accrued to the funds during the time when SARS had the funds in its possession was for the taxpayer's account.

[42] Public funds are derived mainly from two sources, namely, contributions by citizens through taxation and public borrowings whose repayment is borne by taxpayers.

[43] Taxes are a compulsory contribution to the *fiscus* to finance government activities. Taxes are computed at rates established by law and are the primary source of government income. The funds thus collected by SARS through taxation are, through a Parliamentary budgetary process, allocated to various departments at national, provincial or local government. It is through these allocations that departments secure and use [appropriate] government money.

[44] *In casu* the taxpayer's provisional tax refund could not form part of the budgetary process as it was held by SARS for the benefit of the taxpayer.

[45] Accordingly, although SARS was in possession of the funds, it could not use the funds to fund governmental activities in the manner set out above.

[46] It is thus difficult to fathom the contention that SARS, and indeed the *fiscus,* was not prejudiced by the taxpayer's conceded "*omission*" and "*default*". The view that we take of this matter is that SARS and the *fiscus* were prejudiced by the taxpayer's

actions, and that that prejudice includes the resource allocation flowing from the taxpayer's aforesaid "*omission"* and "*default*" as well as opportunity cost to SARS occasioned by its delayed recovery of the income tax and VAT amounts due to it (which while it stood to the credit of the taxpayer SARS could not use it to fund governmental activities).

[47] It follows that SARS has discharged its onus of proving an "understatement" by the taxpayer of its income tax and VAT within the contemplation of section 221 of the TAA.

[48] Flowing from the above is the question whether SARS should levy a penalty in respect of the understatement, and if so, the quantum thereof.

[49] We now turn to that question.

Understatement Penalties and their Measure

[50] The purpose to be served by levying penalties such as the ones we are concerned with *in casu* was articulated in such cases as *Commissioner for Inland Revenue v McNeil,*[6] in which the Court was dealing with a similar provision, namely, section 65 of the Income Tax Act 31 of 1941. There, the following was stated as to its purpose:

> *"…to ensure, if possible, that returns shall be honest and accurate. Its amount depends only indirectly on the size of the taxpayer's income: directly it depends on the size of his default. It does not conform with ordinary usage to speak of a tax on misconduct as a kind of tax on income. Where a tax takes the form of a percentage of a tax on income it is natural to regard it as itself a tax on income. But a percentage of a penalty imposed for failure to make a return or for an omission from a return or for an incorrect statement in a return is not at all like a tax on income."* [7]

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6 22 SATC 374.

7 The Court was seized with a similar provision – section 65 of the Income Tax Act 31 of 1941.

[51] In *Federal Commissioner of Taxes v Trantwein*[8] Evatt J in dealing with a section similar to section 65 referred to above, said:

> *"The object of the section is to impose a heavy penalty so as to ensure the accuracy of returns, upon which the whole income tax system of the Commonwealth is based. The penalty is imposed 'y way of additional tax' but as I endeavoured to point out in Richardson's case, although the penalty is collected via the machinery of assessment, the section is definitely a penal provision."*

[52] Section 222(1) of the TAA contains a similar provision. In terms thereof, 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.

[53] Section 222(2) of the TAA provides that the understatement penalty is the amount resulting from "*the highest applicable understatement penalty percentage, in accordance with the table in section 223*", to each shortfall determined under subsections (3) and (4) in relation to each understatement in the return.

[54] In terms of section 222(3)(*a*) the shortfall is the sum of the difference between the amount of tax properly chargeable for the tax period and the amount of tax that would have been chargeable if the "understatement" were accepted.

[55] In my judgment, the provisions of section 222(3)(*b*) and (*c*) are not applicable *in casu* since there is neither "*the amount properly refundable for the tax period*" nor "*an amount of assessed loss … properly carried forward*" therein referred to.

[56] I say so because according to the evidence, a downwards adjustment of the taxable income was effected by SARS in order to make provision for the VAT component included in the consultancy agreements which necessarily formed a part thereof, since the taxpayer had charged for VAT in circumstances where it had neither registered nor declared that VAT.

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[8] 4 A.T.D. 92 at p. 96.

[57] On that analysis, no amount fell properly to be refunded to the taxpayer as the surplus resulting from the downwards adjustment fell to be set-off against the VAT liability.

[58] Applying the provisions of section 222(3)(*a*) to determine the understatement penalty in respect income for the tax years 2011 to 2014 yields amounts that match the assessed income tax in respect of the relevant tax years as nil returns were rendered.

[59] Accordingly, the penalties levied:

[59.1] in respect of income tax are:

[59.1.1] In the 2011 tax year – R1 330 410;

[59.1.2] In the 2012 tax year – R5 508 366.92;

[59.1.3] In the 2013 tax year – R4 246 492.88;

[59.1.4] In the 2014 tax year – R571 511.24;

[59.2] in respect of VAT are:

[59.2.1] In 2010/12 – R1 228 070;

[59.2.2] In 2011/02 – R1 535 088;

[59.2.3] In 2012/12 – R2 113 160.

[60] Although the Tax Practitioner appearing for the taxpayer urged that nil returns were rendered without the taxpayer's knowledge or authority via e-filing (for which the alleged unauthorised person would have had access to the taxpayer's passwords and login credentials), no evidence whatsoever was led to shed light on the circumstances leading to the rendition of the said nil returns. It was contended that the taxpayer was simply in default as regards the rendition of income tax returns.

[61] This contention is much of a muchness as both the nil returns and the non-rendition of tax returns lead to the same outcome as regards the amount of the shortfall on the basis of which penalties are chargeable.

[62] The question that confronts us, at this stage, is whether these percentages of 25% and 50% as applicable to the USP for income tax and VAT respectively represent "*the highest applicable understatement penalty percentage in accordance with the table in section 223*" as set out in section 222(2) of the TAA. SARS contends that they do not. Consequently, SARS contends that these percentages fall to be adjusted upwards by this Court.

[63] The understatement penalty percentages applied by SARS, in accordance with the section 223 table were:

[63.1] In respect of income tax understatement, those attributable to a standard case for behaviour characterised as "*reasonable care not taken in completing return*"; and

[63.2] In respect of the VAT, those attributable to a standard case for behaviour characterised as *"no reasonable grounds for 'tax position' taken".*

Income Tax Penalties

[64] As the taxpayer made understatements in its tax returns for the tax years 2011 to 2014,[9] it follows that it "*must pay … the understatement penalty*" in accordance with section 222(2) of the TAA. SARS is obliged to levy "*the highest applicable understatement penalty percentage in accordance with the table in section 223*".

[65] In my judgment the highest applicable understatement penalty percentage in accordance with the table in section 223 is the one applicable to *"gross negligence"* of a standard type, in respect of which 100% of the shortfall is payable.

[9] Dossier Vol 1, pages 28 – 37.

[66] '*Gross negligence*' was described in *Transnet Ltd t/a Portnet v The Owners of the Mv "Stella Tingas"and Another*[10] in the following terms:

> *"Gross negligence is not an exact concept capable of precise definition… conduct may depart so radically from the standard of the reasonable person as to amount to gross negligence … It follows that … it is necessary in each case to determine whether the deviation from what is reasonable is so marked as to justify it being condemned as gross. The Roman notion of culpa lata included both extreme negligence and what today we would call recklessness in the narrow sense or dolus eventualis."*

[67] The SCA, in an earlier case – *S v Dhlamini* [11], described gross negligence as including an attitude or state of mind characterised by "*an entire failure to give consideration to the consequences of one's actions, in other words, an attitude of reckless disregard of such consequences".*

[68] The conduct of the taxpayer described above amounts to 'gross negligence'. Accordingly, the understatement penalty payable in this regard is 100% of the shortfall, that shortfall being the amount of the assessed taxes in each tax year referred to above.

VAT Penalties

[69] As regards VAT, a failure to both register for VAT and to render VAT returns in circumstances where the taxpayer was charging for VAT, constitutes behaviour much more serious than "*no reasonable grounds taken for a 'tax position'*.

[70] That behaviour ought properly to be characterised as "*gross negligence*" of a standard type.

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[10] 2003 (2) SA 473 (SCA); See also *S v Van Zyl 1969 (1) SA 553 (A) and Philotex (Pty) Ltd and others v Snyman and others 1998 (2) SA 138 (SCA) at 143C–J.*

[11] 1988 (2) SA 302 (A) at 308D—E.

[71] Similarly, the 50% understatement penalty imposed by SARS falls to be increased to 100% in order to accord with the 'gross negligent' character of the taxpayer's understatement.

[72] It is, indeed, so that the question on appeal to this Court is not only whether the Commissioner's decision was correct or not, but how this Court should exercise its own discretion on the evidence before it. [12]

[73] I am in respectful agreement with the submission made by SARS that the understatement penalties levied in respect of both the income tax and VAT are unduly lenient.

[74] Given the gross negligent character of taxpayer's understatement, the highest applicable understatement penalty is 100% in respect of both the income tax and the VAT understatement.

Order

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

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

[75.2] The Commissioner's understatement penalty of 25% in respect of income tax is set aside.

[75.3] The understatement penalty of 100% is imposed in respect of income tax for the 2011 to 2014 years of assessment.

[75.4] The Commissioner's understatement penalty of 50% in respect of VAT is set aside.

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[12] *Commissioner for the South African Revenue Service v Afri-Guard (Pty) Ltd* 2016 JDR 1197 (GJ) At para [60].

[75.5] The understatement penalty of 100% is imposed in respect of the understatement of VAT payable in respect of 12/2010,02/ 2011 and 12/2012.

[75.6] Each party is to pay its own costs.

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NKOSI-THOMAS AJ

Acting Judge of the High Court,

Gauteng Local Division, Johannesburg

DATE OF HEARING: 03 August 2017

DATE OF JUDGMENT: 18 August 2017