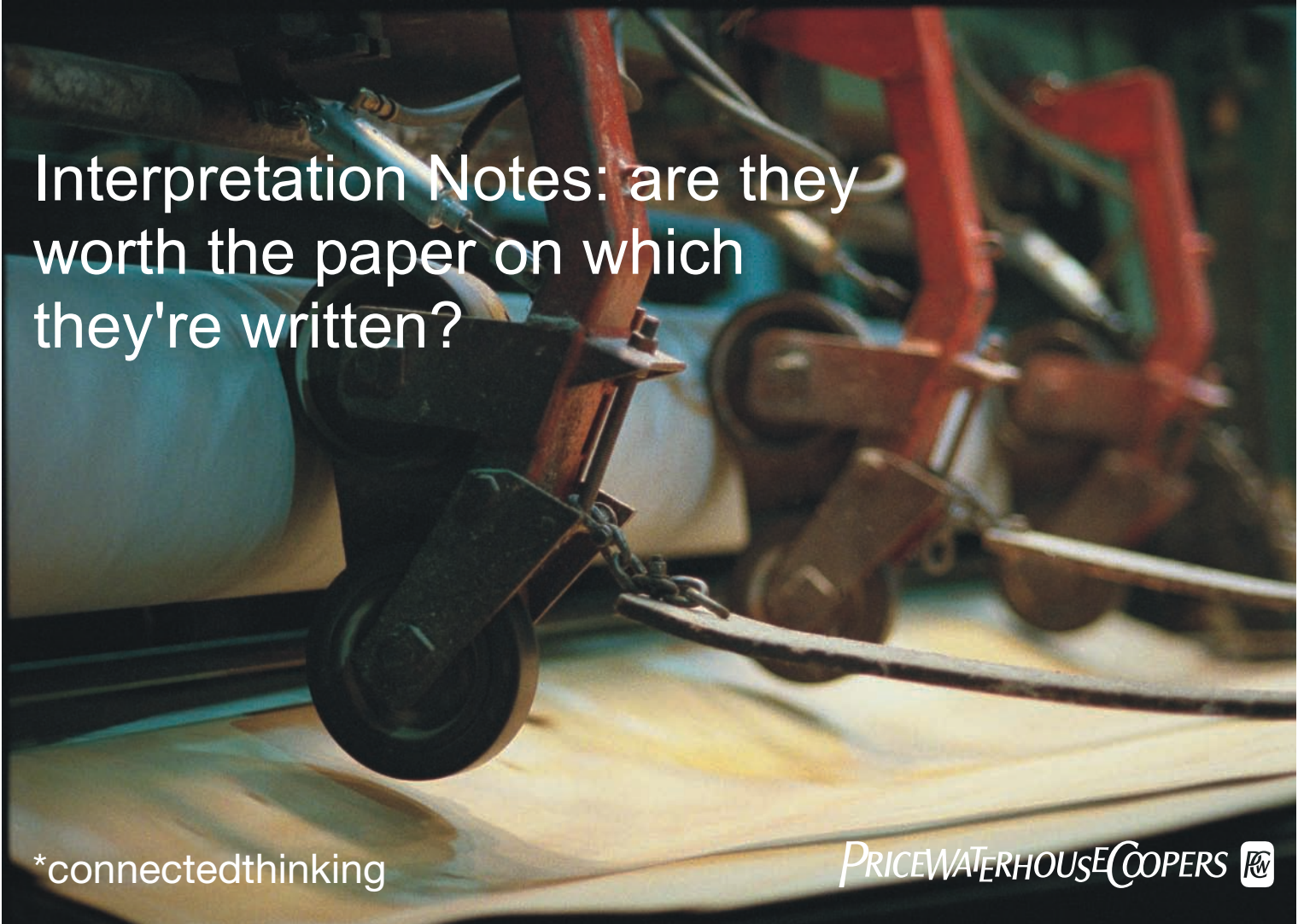


# Synopsis

September 2008

Tax today\*



Interpretation Notes: are they  
worth the paper on which  
they're written?

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# Interpretation Notes – binding on whom?



For a number of years SARS has issued Interpretation Notes on various aspects of the laws that it administers. The public is given to understand that these are an indication of the manner in which SARS will apply these laws. A recent decision casts doubt on this understanding.

In Interpretation Note No. 33 dated 4 July 2005, SARS set out the basis upon which persons are entitled to claim a deduction in respect of assessed losses. This comprehensive exposition contains an indication that, while it is SARS's view that, in order to obtain such a deduction, a company must carry on a trade and derive income from such trade, SARS would be prepared, on a case by case basis, to allow an assessed loss where no income has been derived in a year of assessment as long as the company has proved that a trade was carried on during the year of assessment. It states that this concession "is limited to cases where it is clear that a trade has, in fact, been carried on."

There follows an example of a company, which commences farming and plants trees that will mature and bear fruit after four years and which earns no income in the first three years but only incurs expenses. The Interpretation Note states:

"Despite the fact that the company derived no income from trade during the [first three] tax years, SARS will permit the company to carry forward its [first three years'] assessed losses and set them off against the income derived in the [fourth] tax year. The reason for the failure to derive any income during the years in question clearly stems from the nature of the company's trade."

It is therefore surprising to find that SARS has apparently not applied this Interpretation Note in a matter heard in the Gauteng Income Tax Court in *Income Tax Case No. 1830 70 SATC 123*.

In this matter a company whose principal business was the licensing of a computer program that it had developed had a brought forward assessed loss from 2003, principally from development expenditure incurred in relation to the computer program. In 2004 it derived small amounts of income unrelated to trade and incurred further expenses related to development of the program. It sought to claim deduction of its current losses and the assessed loss from the previous year.

SARS disallowed the assessed loss.

Disallowance of the assessed loss was surprising, as, in principle, there would appear to be no difference between a loss incurred in the development of a royalty-producing asset and a loss incurred in the development of an orchard from which to harvest produce. It is therefore a matter of concern that SARS was not prepared to make a concession to this taxpayer on the same basis as set out in its example in the Interpretation Note.

The Income Tax Court was called upon to determine the application of section 20(1) of the Income Tax Act, but was requested to consider one issue in priority to all the other issues, namely, whether, for the section to apply, it was necessary that the company should have derived income from trade. On a strict reading of the relevant legislation, it had no option but to find in favour of SARS in this regard.

This matter highlights the problems associated with Interpretation Notes. Commentators have long questioned their validity and effect. They are intended to indicate how SARS will apply legislation. They should act as a beacon to taxpayers that, provided their circumstances are consistent with those enumerated in the relevant interpretation note, they should expect to be assessed on the basis set out. The problem is that these interpretations are not binding on SARS. As the Court concluded:

“...the Commissioner cannot (and clearly did not intend to) change the law by making concessions to address unintended results.” (our emphasis)

That being so, are Interpretation Notes worth the paper on which they're written?

## In brief

### Official rate of interest increased

The Minister of Finance has, by notice in the Government Gazette of 29 August 2008, announced that the official rate of interest (which may apply to determine whether a loan has resulted in a fringe benefit or a deemed distribution subject to STC) increased from 12% to 13% with effect from 1 September 2008.

### Penalty for failure to file a return and employees' tax withheld

With effect from 29 August 2008, employers who fail timeously to file the annual return of remuneration paid and employees' tax withheld may become liable to a penalty equal to 10% of the amount of employees' tax deducted or withheld from remuneration during the period to which the return relates.

# Tax litigation enters its seventh year

## Extraordinary court application in King case

The litigation between SARS and the entrepreneur, David King – which has now dragged on for seven years – is the most fiercely-contested and protracted forensic tax battle in South African history.

The course of events, as recently summarised by the Gauteng High Court, is that King was arrested in 2002 on some 322 charges, including fraud, money-laundering, racketeering and contravention of the Income Tax Act and the Exchange Control Act.

The prosecution docket comprises some 200 000 pages and the indictment runs to 800 pages. The state has estimated that it will call about 100 witnesses at the trial.

As the court observed –

“That the impending trial is going to be a marathon, complex, involved and acrimonious legal battle admits of no doubt.”

SARS is desperate to have the trial commence. One of its prospective witnesses has already died. Others are in bad health, and some are in their 70’s and may not have long to live. Witnesses’ recollection of events long past may be fading with each passing day.

But the taxpayer and his legal team – mindful, perhaps, of Demosthenes’ sage counsel in 338 BC that he who fights and runs away will live to fight another day, have taken every technical preliminary legal point, and have applied for postponement after postponement of the trial.

Press reports suggest that King has to date outlaid R150 million on legal fees. SARS claims that he owes R900 million in tax.

This, then, is the background to one of the most extraordinary court applications to find its way into the law reports. (*Director of Public Prosecutions v King* [2008] ZAGPHC 118; judgment given on 24 April 2008.)

### An unprecedented court application

Essentially, what had happened was that the court had fixed 28 July 2008 as the date when the trial must finally commence.

Although King and his lawyers had given no intimation that, come that day, they would apply for yet another postponement, SARS did not need a clairvoyant to tell them that this was more than a possibility.

So, in a desperate attempt to pre-empt an application, on the assigned trial date, for yet another postponement, SARS applied to the Gauteng High Court three months in advance of the trial date to ask the court to hand down an order that effectively said to King – we, the High Court, are telling you now (in April 2008) that, if you apply for yet another postponement on the date assigned for trial, namely 28 July 2008, we won’t grant it.

For King’s legal team, this was a slow ball that just begged to be hit over the grandstand, and they did so with relish.

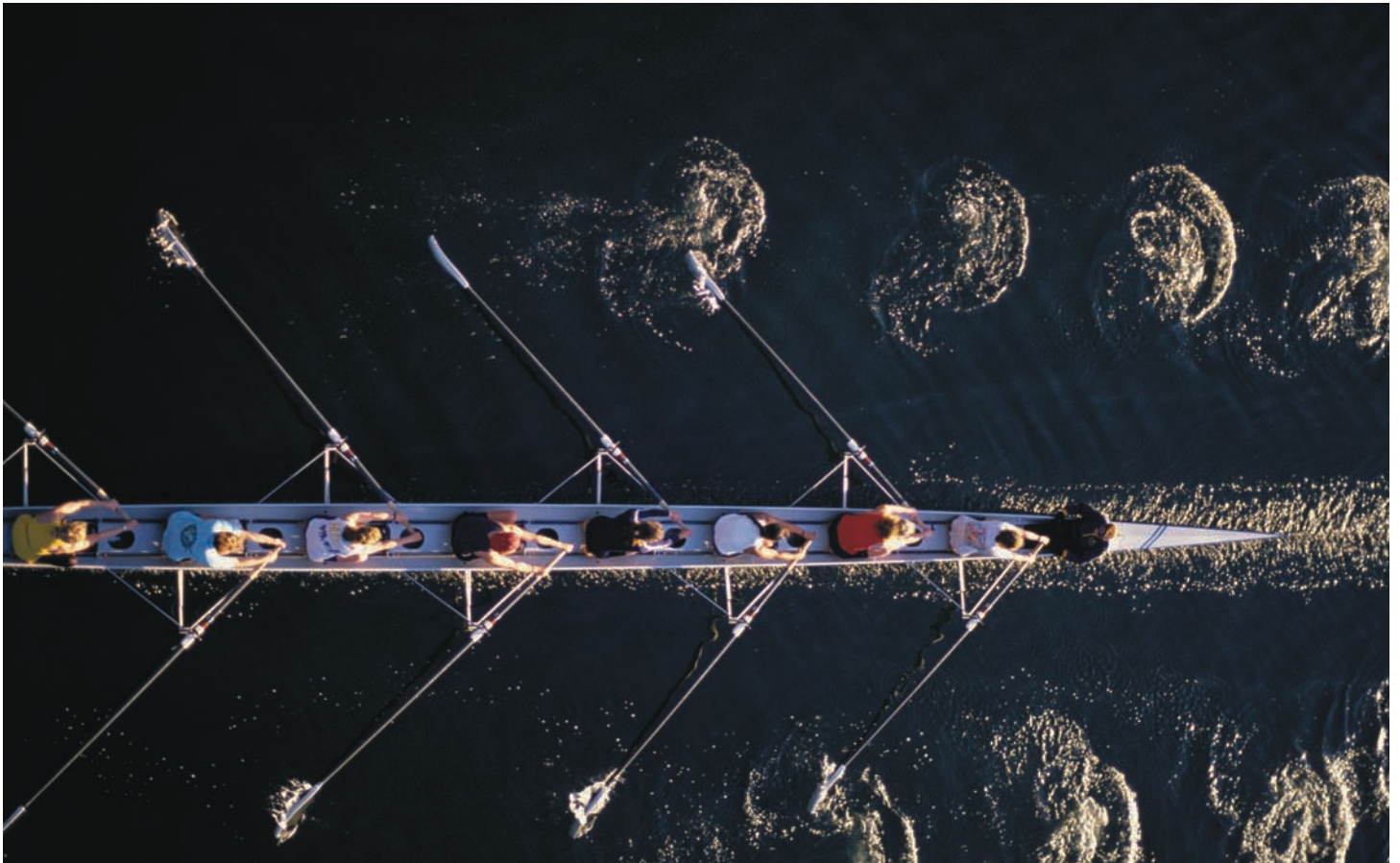
After all, how can a court possibly agree to tie its own hands, three months in advance, and rule that, irrespective of what the grounds for the (as yet purely hypothetical) application for postponement might be, the court would refuse to grant it?

King’s counsel duly tore into SARS’s application for a pre-emptive refusal of a future, hypothetical postponement.

The application, he argued, was “not only premature but seriously ill-conceived”. He contended that it would be inappropriate for the judge, at this juncture, three months ahead of the trial date –

“to decide this application, as it requests [the judge] to assume the position of a clairvoyant or a person who has prophetic foresight to know and foresee what will happen on [the assigned trial date of] 28 July 2008. The gravamen of his contention is that it is only the trial court which will be better suited [sic] to deal with any application for a postponement which can only be brought on 28 July 2008. ... [I]t is the trial court which will have to decide such an application on the facts put before it on that day.”

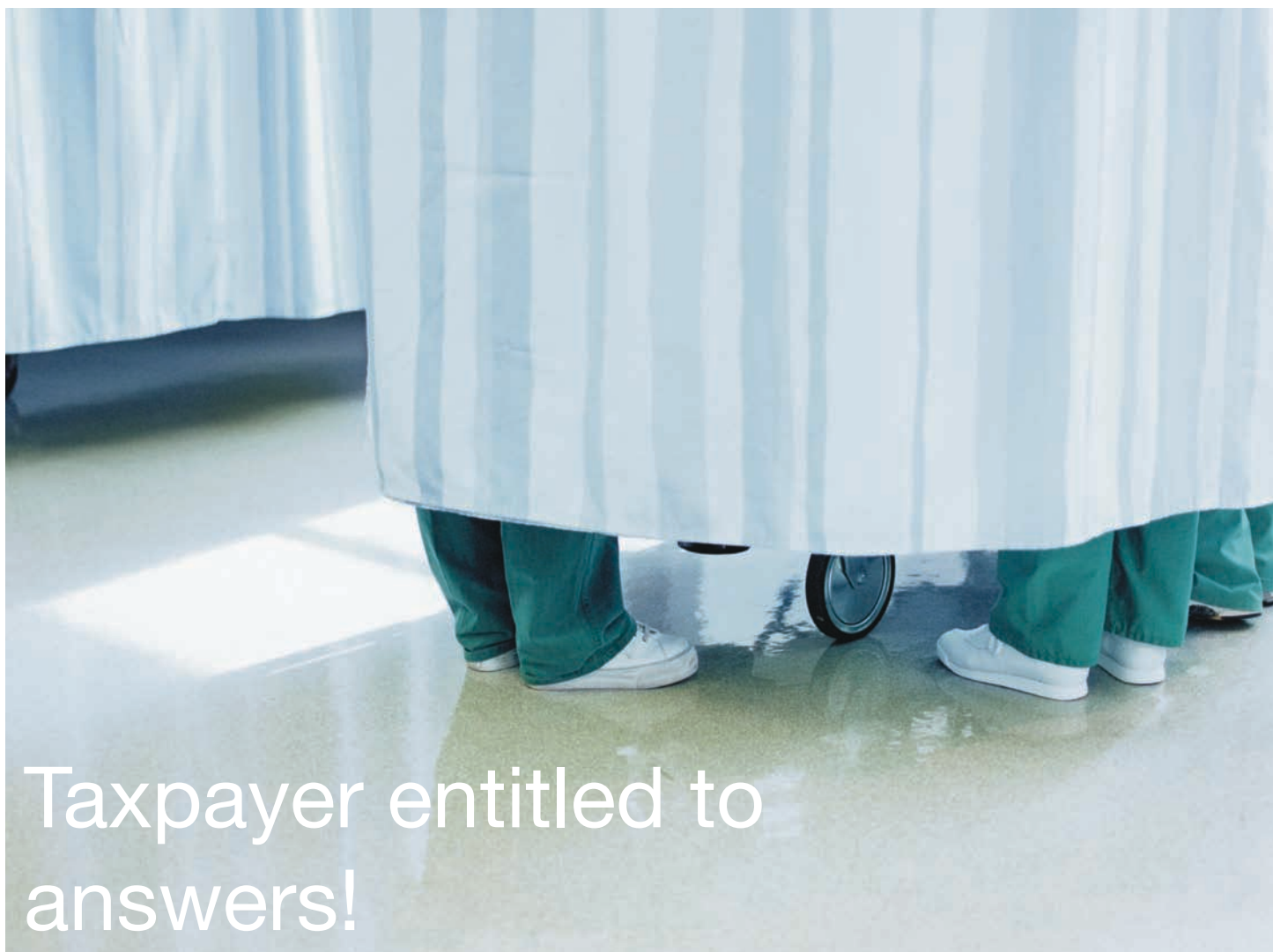
The taxpayer and his legal team – mindful, perhaps, of Demosthenes’ sage counsel in 338 BC that *he who fights and runs away will live to fight another day*, have taken every technical preliminary legal point, and have applied for postponement after postponement of the trial.



These arguments found favour with the court, which ruled that –

“this application is premature as it attempts to anticipate what [the taxpayer, Mr King] might do on 28 July 2008. What is clear is that [at this juncture, King] has not applied for a postponement of the case. There is therefore no application for me to consider. ... It follows that I find that this application, well intended as it may be, was seriously ill-conceived. ... The case is postponed to 28 July 2008 being the trial date”.

*[Postscript: it has since been reported in the press that, on the trial date of 28 July 2008, King’s legal team argued that he had, in the interim, “made a deal” with SARS which cleared him of any criminal wrongdoing. SARS’s counsel denied knowledge of any such deal and argued that, in any event, only the National Prosecuting Authority could decide not to proceed with a prosecution. The trial is scheduled to continue in November.]*



# Taxpayer entitled to answers!

## SARS's obligation to give reasons for an assessment

SARS's statutory powers are fearsome, but they must of course be exercised in accordance with law, that is to say, in compliance with the provisions of the applicable legislation and in accordance with the Constitution.

An important right that most tax legislation gives the taxpayer is the right to require SARS to give reasons for its discretionary decisions.

Thus, the rules pertaining to procedures in the Tax Court, promulgated in terms of section 107A of the Income Tax Act, provide under rule 3 that –

“(1)(a) Any taxpayer who is aggrieved by any assessment may, by written notice delivered to the Commissioner within 30 days after the date of the assessment request the Commissioner to furnish reasons for the assessment.

...

(2) Where, in the opinion of the Commissioner, adequate reasons have already been provided, the Commissioner must, within 30 days after receipt [of the aforesaid notice] notify the taxpayer in writing, which notice must refer to the documents wherein such reasons were provided.”

## The taxpayer's entitlement to demand the reasons for the Commissioners discretionary decisions

An important judgment which throws light on the crucial issue of what constitute "adequate reasons" is that of the Gauteng Tax Court in *Qwa-Qwa Cash and Carry (Pty) Ltd v CSARS* [2005] ZAGPHC 121.

In this case, a taxpayer claimed to have exported goods to customers in Lesotho. If this were true, those goods would be zero-rated for purposes of value-added tax.

However, SARS did not accept that the goods had really been exported, and issued an assessment for VAT at the standard rate plus 200% additional tax.

The taxpayer, exercising his rights under rule 3(1)(a), quoted above, requested reasons for the assessment. SARS replied that adequate reasons had already been provided.

This, then, set the scene for the court to embark on an in-depth analysis of a taxpayer's right to reasons, and what constitutes the giving of "adequate reasons" by SARS.

## The rules for the procedures of the Tax Court

Rule 26 of the rules for procedures in the Tax Court provides that any decision by the Commissioner in the exercise of his discretion under specified rules is subject to objection and appeal.

Rule 26(1)(b) provides that, on such appeal, the Tax Court may make an order remitting the matter for reconsideration by the Commissioner,

with or without directions to provide such reasons as in the opinion of the court are adequate.

In *Qwa-Qwa Cash and Carry (Pty) Ltd* the court pointed out that, in the context of value-added tax, if the taxpayer does not properly calculate the VAT due by him, the Commissioner can make an assessment of the amount properly due. Where the taxpayer has made a return of tax, and SARS exercises this power, it is effectively overriding the taxpayer's calculation.

The court also pointed out that, in terms of the VAT Act, where the taxpayer fails to pay the VAT due by him, a penalty and interest are triggered automatically, in other words, without the exercise of any discretion by the Commissioner.

By contrast, additional tax in terms of section 60 is payable only where the VAT vendor has failed to perform a duty *with intent to evade tax* or to secure an undue refund of tax.

Additional tax is therefore payable only where the Commissioner, in his discretion, has decided that the taxpayer had the requisite *intent to evade tax* or to obtain an undue refund. A further discretionary decision must then be taken to determine the amount of such additional tax.

Section 73 of the VAT Act deals with schemes to obtain undue tax benefits, and provides that, if the Commissioner is satisfied that a scheme which created the tax benefit has been carried out, he must determine the liability for tax and the amount of such tax, as though the scheme had not been entered into.

This, said the court, requires two distinct discretionary decisions to be taken by the Commissioner – the first being whether a scheme has been carried out with the requisite intent, and secondly what the correct amount of tax is.

The court pointed out that, in the present case –

the making of the 'additional' assessment by the Commissioner involved the exercise of several distinct statutory powers. The taxpayer, by virtue of the provisions of rule 3(1)(a) is entitled to request the Commissioner to furnish reasons for the assessment. This applies to all the aforementioned components of an assessment.

## What are "adequate reasons"?

The court quoted with approval the decision of the Australian courts in *Ansett Transport Industries (Operations) Pty Ltd v Wraith* (1983) 48 ALR 500 at 507 in which it was held that the decision-maker must –

explain his decision in a way which will enable a person aggrieved to say, in effect: 'even though I may not agree with it, I now understand why the decision went against me. I am now in a position to decide whether that decision has involved an unwarranted finding of fact, or an error of law, which is worth challenging.'

This requires that the decision-maker should set out his understanding of the relevant law, any findings of fact on which his conclusions depend (especially if those facts have been in dispute) and the reasoning process which led him to those conclusions. He should do so in clear and unambiguous language, not in vague generalities or the formal language of legislation.

To the same effect, *Hoexter, The New Constitutional and Administrative Law*, expresses the view that –

reasons are not really reasons unless they are properly informative. They must explain why

*The court said that the taxpayer “has been referred to a myriad of documents from which to discern by himself what those reasons might be”, and said that SARS had failed to answer the specific questions that the taxpayer had asked in its request for reasons.*

action was taken or not taken; otherwise they are better described as findings or other information.

These views have been adopted by SARS itself, for its own publication, *Guide on Dispute Resolution*, states that an obligation to provide adequate reasons –

requires the decision-maker to explain his decision in a way which will enable a person aggrieved to say, in effect: ‘Even though I may not agree with it, I now understand why the decision went against me’. The aggrieved person, ideally, should be in a position to decide whether that decision is worth challenging.

The court in *Qwa-Qwa Cash and Carry* went on to observe that –

The hand of the Commissioner can rest heavily on the taxpayer. The assessment of the Commissioner may be based on highly complex facts, and legal considerations. ... The reasons furnished by [SARS] must be clear and unambiguous.

The court said that it is difficult to lay down a general rule as to what constitutes adequate or proper reasons, and that each case must depend upon its own facts and went on to quote with approval from *R an International Supply Company (Pty) Ltd v Mpumulanga Gaming Board* 1999 (8) BCLR 918 where Kirk-Cohen J said that –

On the one hand it is not necessary for an administrative body to spoon-feed an

aggrieved party seeking reasons; on the other hand the administrative body cannot expect an aggrieved party to seek justification for the reasons from a myriad of documents where such reasons cannot reasonably be determined."

In the present case, SARS, relying on certain dicta in *Alliance Cash and Carry (Pty) Ltd v CSARS* 2002 (1) SA 789 (T), argued that the taxpayer in question ought to be able to prove, from documents in its own possession, that it had in fact exported the goods in issue.

The court did not accept this argument, and said that SARS had given no adequate reasons to support and explain its decision to override the taxpayer’s calculation of the VAT that was due, nor its determination of the amount of such VAT, nor the basis of its decision that the taxpayer had had the intent to evade the payment of tax, nor the manner in which SARS had determined the amount of additional tax payable.

The court said that the taxpayer “has been referred to a myriad of documents from which to discern by himself what those reasons might be”, and said that SARS had failed to answer the specific questions that the taxpayer had asked in its request for reasons.

In the result, the Tax Court held that the taxpayer was entitled to answers to the

questions it had posed to SARS in regard to the assessment.

Those reasons, said the court, were essential to enable the taxpayer to formulate its objection to the assessment. The court went on to say that if it were to sanction SARS’s attitude to the request for such reasons –

[the taxpayer] would have to perform the impossible task of distilling [SARS’s] reasons from twenty letters which do not speak for themselves and none of which contain clearly formulated reasons before formulating its objection.

In terms of its powers under the rules, the Tax Court remitted the taxpayer’s request for reasons to SARS for reconsideration, with the direction to give adequate reasons for the exercise of its various statutory powers embodied in the disputed assessment, and to structure those reasons so as to set out the relevant statutory provisions, the findings of fact on which the conclusions were based and the reasoning process which led SARS to those conclusions.