**REPUBLIC OF SOUTH AFRICA**

**IN THE TAX COURT OF SOUTH AFRICA**
**HELD AT CAPE TOWN**

**CASE NO:** IT 45627

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|---|---|
| (1) | REPORTABLE: YES/NO |
| (2) | OF INTEREST TO OTHER JUDGES: YES/NO |
| (3) | REVISED. |
| …………………….. | ……………………….. |
| SIGNATURE | DATE |

In the matter between:

**W TAXPAYER** Appellant

and

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

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# J U D G M E N T

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**This judgment was handed down electronically by circulation to the parties' representatives by e-mail. The date and time for hand – down is deemed to be on the 14th of December 2021**

**CLOETE J:**

**Introduction**

[1] The appellant ("taxpayer") is a waste management company. It appeals against the additional assessments raised by the respondent ("SARS") for the 2015 and 2016 years of assessment, including the imposition of certain understatement penalties ("USPs") in relation thereto.

[2] The issues for determination are as follows:

[2.1] Whether the taxpayer was entitled to the allowances claimed in terms of section 12C(1)(*a*) of the Income Tax Act[1] ("ITA") for "machinery or plant" in respect of the construction of its landfill cells, allegedly used directly in the process of manufacture (in simple terms, 40% in the first year and 20% per year thereafter) or, as SARS contends, it is limited to an allowance of 5% per year as contemplated in section 37B(2)(*b*) as read with s 13 of the ITA;

[2.2] Whether the taxpayer was entitled to the allowances claimed for future expenditure in terms of section 24C of the ITA in respect of amounts included in its deduction calculations as "unwinding effect charged to interest", namely R11 594 000 (for 2015) and R12 661 000 (for 2016); and

[2.3] Whether SARS was entitled to levy USPs on the ground of "reasonable care not taken in completing return" in a "standard case" as provided in s 221 to section 223 of the Tax Administration Act[2] ("TAA") in respect of (a) the admitted understatement by the taxpayer of its interest income for the 2016 year of assessment by R25 910 000; and (b) the alleged understatement by the taxpayer of its taxable income for the 2015 and 2016 years by – as SARS contends – incorrectly claiming the section 24C allowances referred to above.

[3] SARS imposed a USP of 25% on each of (a) and (b) above. However during closing argument SARS conceded that, in respect of (a), the appropriate penalty to have levied was 15%, given that the taxpayer made voluntary disclosure after notification of commencement of the SARS audit. It is the taxpayer's assertion that SARS should not have levied any penalty at all, maintaining that the "understatements" were the result of a *bona fide* inadvertent error. It is also common cause that if the taxpayer succeeds on the section 24C issue, the USP levied in respect thereof must be set aside as a consequence.

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[1] 58 of 1962.

[2] 28 of 2011.

[4] A further ground of appeal was that SARS failed to afford the taxpayer the required 21 business days to respond to its letter of preliminary audit findings as envisaged in section 42(3) of the TAA. This ground was abandoned at the close of the taxpayer's case on the basis that, for pragmatic reasons, it had decided to opt rather for judgment on the merits.

[5] The taxpayer bears the burden of proof in terms of section 102(1) of the TAA, save for the issue in relation to the USP's where the burden of proof is on SARS in terms of section 102(2) of the TAA. The taxpayer adduced the evidence of its Group Technical Director (to whom I will refer as "E") and Financial Director (to whom I shall refer as "C"). SARS adduced the evidence of Ms Pretty Kekae ("Kekae") who was the auditor involved in the audit, the raising of the assessments and the levying of the USPs.

**The first issue: whether the taxpayer was entitled to the section 12C allowance**

[6] Section 12C reads in relevant part as follows:

> "**Deduction in respect of assets used by manufacturers… —**(1) In respect of any—
>
> (*a*) machinery or plant… owned by the taxpayer… and… used by the taxpayer directly in a process of manufacture carried on by the taxpayer or any other process carried on by the taxpayer which is of a similar nature;…"

(my emphasis)

[7] Section 12C(1)(*a*) thus applies to machinery or plant used directly in the process of manufacture or a process of a similar nature. The dispute is whether the taxpayer's landfill cells are used directly in a process of manufacture, or, as SARS contends, they are used in a process (the storage of waste) that is ancillary to a process that is similar to a process of manufacture, namely the treatment of leachate and the production of "treated leachate".

[8] Only if it is found that, as the taxpayer submits, its cells are used directly in a process of manufacture, is it necessary to consider the second leg of the enquiry, namely whether the cells constitute "plant" or "structures", since section 13 of the ITA deals with allowances claimable in respect of buildings (or permanent structures) used in a process of manufacture.

[9] The taxpayer initially claimed section 12C allowances of R48 947 694.61 for 2015 and R41 306 206.93 for 2016. During the course of the parties' subsequent interaction the amounts claimed were reduced to R30 848 537.63 for 2015 and R29 733 577.36 for 2016, and the dispute pertains to these amounts.

[10] “Environmental capital expenditure” and “manufacturing capital expenditure” are depreciated in the same manner for tax purposes. The “process of manufacture” is not defined in the ITA. The parties are essentially in agreement that the principal characteristic of such a process is the alteration of a substance or material from one thing into something different. In the present case, for the taxpayer to qualify for the section 12C allowances claimed, what occurs in the landfill cells would thus have to amount to the alteration of the waste material or waste body into something different.

[11] As previously stated SARS contends that the “treatment” of the waste once it has reached the cells (in which, it is common cause, the waste is stored in perpetuity) is not a process of manufacture. Put differently, it is SARS’ case that the storage of the waste is ancillary to the treatment of the leachate process; the taxpayer does not manufacture leachate (which is an unwanted by-product); and the cells are, in fact, designed to minimise the forming of leachate.

[12] On the other hand it is the taxpayer’s case that the process of waste treatment involves an end-product, namely material safe for the environment, that differs substantially from the material received by the taxpayer from its customers, which is unsafe for the environment. This principal activity is the process of manufacture carried out by the taxpayer and differs significantly from “mere storage”. The taxpayer’s case is further that part of the leachate “process” of its waste treatment also occurs in the cells constructed by it for use in its business.

[13] Before turning to E’s testimony on the issue, it is convenient to touch briefly on the *‘plant’* versus *‘structures’* aspect. If the cells are “machinery or plant” ancillary to a process of manufacture or one of a similar nature, then they qualify as an “environmental treatment and recycling asset” as defined in section 37B of the ITA and the taxpayer is entitled to the allowances claimed. However, if they are “buildings” ancillary to a process of manufacture or one of a similar nature, they must be treated as an “environmental waste disposal asset” as defined in section 37B of the ITA and the 5% per year depreciation allowance applies.

[14] Section 37B of the ITA defines “environmental treatment and recycling asset” and “environmental waste disposal asset” as follows:

> “(1) For purposes of this section—
>
> **‘environmental treatment and recycling asset’** means any air, water and solid waste treatment and recycling plant or pollution control and monitoring equipment (and any improvements to the plant or equipment) if the plant or equipment is—
>
> (*a*) utilised in the course of a taxpayer’s trade that is ancillary to any process of manufacture or any other process which, in the opinion of the Commissioner, is of a similar nature; and

(*b*) required by any law of the Republic for purposes of complying with measures that protect the environment: and

**'environmental waste disposal asset'** means any air, water, and solid waste disposal site, dam, dump, reservoir, or other structure of a similar nature, or any improvement thereto, if the structure is—

(*a*) of a permanent nature;

(*b*) Utilised in the course of a taxpayer's trade in a process that is ancillary to any process of manufacture or any other process which, in the opinion of the Commissioner, is of a similar nature; and

(*c*) required by any law of the Republic for purposes of complying with the measures that protect the environment."

[15] I intend to focus only on those aspects of E's testimony that are directly relevant. Her evidence was that, broadly speaking, the taxpayer deals with three categories of waste, namely liquid waste, sludge and solid waste. Each of these waste streams "…get directed to a different part of the landfill site where the waste stream can then be pre-treated prior to disposal in the cell'.

[16] The liquid waste is stabilised and blended at the micro-encapsulation plant (or pug mill) resulting in "a final product generated… and that final product will then be land filled in the cell for final disposal". The sludge is treated in a concrete bunker(s) by blending it with chemicals and "…again this blended material would be the final product that will go to the landfill site for final disposal". As I understand it the bunkers are generally positioned above the cells, since when asked to explain what process actually occurs in a cell she responded *inter alia* that "the concrete bunkers… now that actually happens… on top of the cell where we have constructed the concrete bunkers and where that activity would happen".

[17] For solid waste, the processing does not involve treatment at the micro-encapsulation plant or bunker(s). Her evidence was not clear about where this treatment in fact takes place. During her evidence in chief she testified that it is blended with chemicals in a specially designated area on the site itself, and then "that blended material will be loaded into a tipper and… be taken to the cell… for the final disposal". In cross-examination she stated that "treatment of that waste will happen within the waste body and in the cell, and all of that final product will then be disposed of in that cell".

[18] When asked by the court to clarify this, she replied "…there would be dry waste that arrives, that does not need to go through a bunker or a pug mill, and that treatment of the waste will happen within the <u>waste body</u> and all of that final treated product <u>will then be disposed in that cell"</u> (my emphasis). This explanation seems to support her initial testimony.

[19] Her evidence was further that the taxpayer is required to "manage" certain by-products as part of its operation: "one of them is the leachate that gets produced, another one is landfill gas and also we have to deal with contaminated water. These are activities related to the disposal of the waste within the cell" and as she put it "…if you haven't disposed of waste in your cell you wouldn't be generating leachate or contaminated water". It is clear from her evidence that these by-products are generated by the waste body itself due to rainfall and biodegradation of the waste.

[20] She explained that the taxpayer is required to construct associated infrastructure to collect, store and dispose of these by-products and "so we have our main activity which is the waste disposal but we also have these other activities as part of that main process". In respect of leachate, she testified that "so as the site progressively moves along, for every new cell that we build we also have to build… an associated leachate dam [or tank] because as we move that activity every cell will continue producing by-products".

[21] Her evidence was further that from the leachate dam(s) the leachate is diverted to a leachate treating plant "where we would process that leachate and the final by-product of this process will then also be stabilised and land filled into the waste body". In re-examination she testified that once a cell is completed for storage purposes, it will nonetheless continue to produce leachate (and gas), but in declining quantities as part of the natural biodegradation process for a period of time, and that this is part of "the post-closure of that cell".

[22] The taxpayer's evidence thus established that the principal activity of the constructed cells is the final disposal of the waste streams and by-products such as leachate. As far as the positioning of the bunkers above the cells is concerned, there was no evidence that this is a requirement of the taxpayer's licence to operate so as to ensure compliance with the host of environmental laws and the like which govern its operations.

[23] The taxpayer relies on a number of authorities in support of its argument that the cells are nonetheless a direct, integral component of its "manufacturing" process. I consider each in turn.

[24] In *Secretary for Inland Revenue v Hersamar (Pty) Ltd*[3] the court confirmed that the question whether a taxpayer's operations constitute "a process of manufacture" is one of law and not fact. In that case the taxpayer was a metal merchant which claimed allowances in respect of certain new and unused machinery bought for the purpose of its trade, which was the purchase of scrap metal in many forms and the re-sale thereof after its preparation and processing.

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[3] 1967 (3) SA 177 (A).

[25] The machinery in question was used to compact and/or compress the metal into briquettes and blocks which had no purpose other than the supply to, and use by, foundries for smelting in their furnaces. It was held that although the briquettes and blocks were physically the same material as the scrap from which they were made, by use of the machinery they had become essentially different, and the machinery was thus used directly in a process of manufacture.

[26] However in the present case the evidence shows that the cells constructed by the taxpayer do not, on their own, cause the waste body and by-products to become essentially different. Rather, they have become essentially different before they are finally disposed of in the cells.

[27] In *Secretary for Inland Revenue v Cape Lime Company*[4] the taxpayer's business was to produce lime from raw material, namely natural deposits of limestone on its land ("the quarry"). Its plant was located on separate premises a few miles away. It had purchased two lorries for use mainly to transport the natural limestone to the plant for processing.

[28] It was necessary for the court to consider whether the "process of manufacture" commenced at the quarry or only with the later operations at the plant. It emerged that some of the limestone rock obtained from blasting at the quarry had to be subjected to further blasting at that site to reduce them to a manageable size, and thereafter fed into crushers at the plant and further reduced to a size suitable for feeding into kilns. The majority of the court found that the process of manufacture had thus commenced at the quarry, and the deductions claimed for the lorries were accordingly permissible, since they were used directly in the process of manufacture.

[29] A similar finding was made in *Commissioner for Inland Revenue v Stellenbosch Farmers Winery Ltd*[5] where the taxpayer claimed section 12C allowances in respect of tankers which it used to transport "raw wine" from various suppliers to its own premises for further processing until completion. Because of a shortage of space at the taxpayer's premises the grapes would first be de-stemmed, crushed, de-juiced and fermented at the various suppliers' premises. On these facts the court found that the process of manufacture had already commenced by the time the raw wine was transported in the tankers, and they were accordingly used directly in the "process of manufacture".

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[4] 1967 (4) SA 226 (A).
[5] 1989 (4) SA 772 (C).

[30] The taxpayer appears to assert that the significance of these two decisions is that since the manufacturing process had already commenced in each instance, the use of the lorries and tankers were held to be used directly in a process of manufacture.

[31] However in the present case the evidence established that the cells are used by the taxpayer to store the already "manufactured" products, as opposed, for example, to any deductions claimed in respect of its micro-encapsulation plant or bunkers. The reliance on these authorities does not assist the taxpayer.

[32] In *Secretary for Inland Revenue v Safranmark (Pty) Ltd*[6] the taxpayer's business was to prepare and sell fried chicken in a particular manner under a franchise agreement. It was obliged to adhere to a certain process. The majority of the court held that the deductions claimed in respect of the machinery used in that process were permissible since upon its completion (for purposes of sale) a different "compound" had been produced. This is distinguishable from the present case since, on the evidence, the process in the cells does not result in a different "compound".

[33] In *African Detinning Works (Pty) Ltd v Secretary for Inland Revenue*[7] the taxpayer claimed a building allowance and building investment allowance for a concrete apron constructed to store its raw materials, and which adjoined the outside walls of its factory. Although it was common cause that one of the requirements to qualify for this allowance was that the "improvement" was used in a process of manufacture, the court did not have to decide this issue, since it found that the apron was not, properly construed, an "improvement" to the taxpayer's factory. Accordingly no more need be said about it.

[34] In *Ovation Recording Studios (Pty) Ltd v Commissioner for Inland Revenue*[8] the taxpayer operated a sound recording studio and claimed a section 12C allowance in respect of various items of equipment used in the process of producing master recording tapes. The court found that although the change brought about to the original tapes in the processes to which they were subjected by the taxpayer were minute and indiscernible to the eye, there was no reason to accord more weight to features of form or shape than to attributes of utility and value; and furthermore the taxpayer's activities drastically changed the original sounds produced by the musicians and artists. The court thus found that the equipment was used directly in a process of manufacture.

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[6] 1982 (1) SA 113 (A).
[7] 1982 (1) SA 797 (A).
[8] 1990 (3) SA 682 (A).

[35] However in the present case the evidence showed that the cells do not drastically change the waste body and by-products once they are stored, whether in terms of utility or value, but rather the contrary. This authority thus also does not assist the taxpayer.

[36] In *Formscaff Investments (Pty) Ltd v Commissioner for Inland Revenue*[9] the taxpayer claimed a machinery investment allowance in respect of shuttering and formwork (plant) which it leased to construction companies. The plant was used by these companies to create moulds in order to produce concrete objects such as slabs. It was not suggested by either party that the procedure adopted by the construction companies did not fall within a "process of manufacture". The issue was rather whether the plant leased to them was used by them in the process of manufacture carried out by them. The court found that it was, *inter alia* for the simple reason that the construction companies were engaged in an activity leading to an end product containing something essentially different from the original ingredients.

[37] To my mind this would apply to the taxpayer in the present case in respect of its micro-encapsulation plants and bunkers, irrespective of whether or not they are leased from third parties, but not to the cells themselves which are the <u>result</u>, as opposed to the <u>process</u>, of "manufacture". The subject matter of the present case is thus distinguishable.

[38] To sum up: I accept that the cells themselves are, as testified by E, constructed through various processes, but that is not what this case is about. It is whether the constructed cells are used <u>directly</u> in the "process of manufacture" of the taxpayer, namely the conversion of hazardous waste into waste that is safe for the environment. I also accept that the final product has to be stored somewhere. What I do not accept is that the final destination of the treated waste body and leachate, i.e. the cells, equates to the cells being used directly in that process of manufacture.

[39] I thus conclude that SARS is correct that the cells are used in a process (the storage of waste) that is ancillary to a process that is similar to a process of manufacture, namely the treatment of leachate and the production of "treated leachate".

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[9] 1993 94) SA 76 (TPD).

[40] Decisions of the tax court have no value as precedent. However, given the amounts involved and the importance of the issue to the parties, there is every prospect that this judgment will be appealed. It is accordingly nonetheless necessary to deal briefly with the *'plant'* versus *'structures'* debate since as was stated by the Constitutional Court in *Spilhaus Property v MTN*:[10]

> "The Supreme Court of Appeal itself has said that it is desirable, where possible, for a lower court to decide all issues raised in a matter before it. This applies equally to the Supreme Court of Appeal. This is more so where, as here, the final appeal court reverses its decision on the chosen limited point. This may impact on the fairness of an appeal hearing. Litigants are entitled to a decision on all issues raised, especially where they have an option of appealing further. The court to which an appeal lies also benefits from the reasoning on all issues."

[41] There is no dispute that once a cell is filled it is capped, closed and exists in perpetuity. The dispute is whether the cells constitute plant qualifying as an "environmental treatment and recycling asset' or structures qualifying as an 'environmental waste disposal asset".

[42] As set out above an ''environmental treatment and recycling asset" is a plant used in the course of a taxpayer's trade that is ancillary to a process of manufacture or one of a similar nature, and required by law for purposes of complying with measures that protect the environment. On the other hand an "environmental waste disposal asset" is a site, dam, dump, reservoir or other similar structure of a permanent nature, utilised for the same purpose as an environmental treatment and recycling asset and required by law for that same purpose.

[43] E testified that the cells are constructed by a process of excavation, the installation of a subsoil and drainage system (for the collection and draining away of any existing groundwater), the lining of the cell with a high density polyethylene plastic liner and thereafter a series of detection liners between the different barriers, followed by a primary barrier (an engineered clay liner). These processes are undertaken to prepare the cell for the depositing of the treated waste body and by-products. The separate capping process takes place once the cell is filled.

[44] A "dump" is defined in the Chambers Twentieth Century Dictionary *inter alia* as "a place for the discharge of loads, or for rubbish" and in the Oxford English Dictionary as "a site for depositing rubbish or waste". In turn "reservoir" is defined *inter alia* as "a receptacle for fluids… a large basin" and "a receptacle… designed to hold fluid". The waste and by-products deposited into the cells are a combination of solids/semi-solids and liquids.

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[10] 2019 (4) SA 406 (CC) at para [44].

[45] There can be little doubt that the taxpayer's cells are structures which are permanent in nature. Moreover, and as established by E's testimony, they are in reality no different to a combination of a dump and a reservoir. "Plant" on the other hand denotes something that has a measure of durability and is used in the carrying on, or promotion of, the taxpayer's trade, even if ancillary thereto, as is borne out by the following authority as well as two tax court decisions to which the taxpayer referred.

[46] In *Blue Circle Cement Ltd v Commissioner for Inland Revenue*[11] the court held that "the enquiry is thus whether the items alleged to be 'plant' constituted fixtures, implements, machinery or apparatus used in carrying on any industrial process".[12]

[47] In that case the court had to consider whether a railway line (a fixture) constructed by the taxpayer to convey limestone from a site to its factory constituted "plant". It held that it did by applying the "functional test" (adopted in English law), namely that one has to pose the general question as to how the subject matter was used and whether it was employed to carry on or to promote the taxpayer's business activities.[13]

[48] Given that the trade carried on by the taxpayer was the manufacture of cement, commencing at the site where the limestone was quarried, crushed and separated into usable and non-usable material, and after being conveyed on the railway line to the taxpayer's factory, was subject to further processes, the court concluded that the railway line met the characteristics of "plant".

[49] In *ITC 1468*[14] the taxpayer was a shoe manufacturer that used cutting knives and lasts in the course of its production process. The court applied the test in *Blue Circle Cement* and found that both items of equipment met the threshold, since without them the machines operated in the taxpayer's factory could not perform the functions they were intended to perform in the production process.

[50] In *ITC 1469*[15] the court again applied the *Blue Circle Cement* test to lithographic plates, embossing dies, cutting and creasing rules and creasing matrixes used by the taxpayer in the course of conducting its business of printing and packaging. It was common cause that the items were not "machinery".

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[11] 1984 (2) SA 764 (A).
[12] At 773B.
[13] At 773H-774D.
[14] 52 SATC 32.
[15] 52 SATC 40.

[51] The court found that the taxpayer's appeal had to be dismissed on two interrelated grounds. First, the items possessed a degree of durability too low to warrant them being designated as "plant" since they were simply used in the course of one job and then discarded; and second, adopting a common sense approach to which the items were put, they were all consumables and could by no stretch of the imagination be regarded as "plant".

[52] It is not necessary to repeat what I have already stated about the cells in the present case constituting the final disposal units upon conclusion of the "manufacturing process", but to my mind pretty much the same considerations apply. Upon application of the functional test the cells are not used to "carry on or promote the taxpayer's business". Moreover they cannot be re-used once filled, capped, closed and rehabilitated. They do not constitute "plant" but are "structures" which meet the characteristics of a "dump" and/or "reservoir" and as such qualify as "environmental waste disposal assets". I would thus conclude that SARS is correct on this score as well.

**The second issue: whether the taxpayer was entitled to the section 24C allowance**

[53] As previously stated this dispute only pertains to amounts included in the taxpayer's deduction calculations as *'unwinding effect charged to interest'*. It is common cause that these were included in the total deduction claimed for future expenditure in respect of the treatment of leachate, rehabilitation capping costs and post-closure rehabilitation of the landfill cells in terms of section 24C of the ITA.

[54] For a taxpayer to be entitled to claim such an allowance the following requirements must be met: (a) the income for any year of assessment must include or consist of an amount received or accrued under a contract; (b) the Commissioner must be satisfied that all or part of that amount will be used to finance expenditure which will be incurred by the taxpayer in a subsequent year of assessment in performing its obligations under the contract; (c) the expenditure must either be that which will be allowed as a deduction from income when incurred in a subsequent year of assessment, or that which will be incurred in a subsequent year of assessment on the acquisition of an asset for which any deduction will be allowed under the ITA; and (d) the income received and future expense to be incurred must arise from the same contract.

[55] SARS requested a detailed analysis of the amounts claimed under "unwinding effect charged to interest". In its response, the taxpayer explained that it is required in terms of International Financial Reporting Standards ("IFRS") to adjust all provisions, contingent liabilities and contingent assets to reflect their present day values so as to take into account the time value of money:

> 'If for example the rehabilitation expenses will be incurred in 12 years upon closure of the landfill site, the discount unwinds over the period of 12 years in recognition that the closer the year in which the rehabilitation expenses must be incurred, the more cash will be required to cover the future rehabilitation expenses.
>
> In our example of a present value of rehabilitation costs of R400 and the future rehabilitation costs determined as R1 000, the "Unwinding effect charged to interest" is the gradual increase of the R400 value of a 12-year period to reach R1 000 in year 12 upon closure of the site. In other words, an aggregate amount of R600 is released to the income statement over a 12-year period.
>
> The amounts of (2016) R12 661 000 and (2015) R11 594 000 under the heading "Unwinding effect charged to interest" is that portion of the discount that unwound in those years (as a finance expense in profit and loss). As is explained in 2.2.1, these amounts formed part of the section 24C allowance claimed for income tax.'

[56] The taxpayer later explained that:

> "…the 'unwinding effect charged to interest' is disclosed as such for accounting purposes and relates to the present value difference of the future costs to be incurred by [the taxpayer] (i.e. the discounting effect of revaluing the face value of the future expenditure for accounting purposes, to today's money). Section 24C allowance makes provision for an allowance on the total future expenditure and not just the discounted amount. Hence the accounting adjustment, being the "unwinding effect charged to interest" should form part of the future expenditure allowance as the income received in advance has to inter alia, cover the cost of the total future expenditure. Accordingly, the 'unwinding effect charged to interest' would fall within the ambit of section 24C of the ITA…"

[57] SARS refused to allow the deductions on two grounds set out in its rule 31 statement:

> "101 On a level of principle, SARS contends that the adjustment of the face value of future expenses to present day values, cannot qualify as a deduction under section 24C. These are finance costs…
>
> 105 As regards the calculation of the amounts, SARS essentially contends that the Taxpayer has not discharged the onus of proving the quantification of the amounts…"

[58] In its rule 32 statement the taxpayer disputed the first ground and merely noted the second. In his testimony C, with reference to a hypothetical example set out in a detailed spreadsheet explained that, for accounting purposes "the particular aspects of the rehabilitation provision is found in International Accounting Standards 37, and that deals with provisions and contingent liabilities. So, that governs how we account, and… the auditors would audit on that basis. And, what we are looking at here is provisioning for an obligation that would crystallise in the future and… the key elements of it… [are] needed to be present valued…".

[59] He also explained that the taxpayer relies on consulting engineers to calculate the capacity of each cell in order to determine how many tons of waste it will be able to receive over the period. This is done in year one when the taxpayer constructs a cell at the commencement of operations: "…in this example, it is a million tons. The consulting engineers further give us information regarding the future capping of the cell… they work out their engineering measurements in terms of the different quantities of components that will be required. They do a civil estimation of those elements and they produce a cost… they do not tell us the future costs, they tell us if we had to… [indistinct] the cell further, the licence conditions today, what that cost would be in construction terms".

[60] C's evidence was further that the rationale for this exercise is to estimate the future expenditure upfront so that it can be incorporated in the overall cost to the customer: "We need to have these numbers otherwise we could find that we undercharged a customer. So, when we get to the future time in the future, we might not have enough money put aside, so it is important that we cost these…" (i.e. upfront).

[61] It is that best estimate of future cost which is then claimed as an s 24C allowance over the best estimate of the period it will take for the cell to be finally capped, closed and rehabilitated. It appears from his evidence that a recalculation is done in each year to reflect the deductions claimed as accurately as possible.

[62] His testimony was also that the total anticipated cost is projected forward using the expected rate of inflation, and then discounted back to present day value for accounting purposes. The taxpayer typically uses the Government risk free long bond rate for this purpose. It is the resulting figure that is reflected in the annual financial statements. All that "unwinding of interest" means is that the taxpayer is simply moving the discount one year forward in each year.

> "…And under the accounting standards, where we have charged the rehabilitation expense to cost of sales typically, that is where we expense it to, the unwinding element IFRS 37 requires us to, not to expense it to that area of the income statement, but to expense it to the finance costs area of the income statement.

> So, it is not something that we are doing as [the taxpayer], the statement requires us to show that expense as an interest line. It is not paid, it is just where we are putting it on the income statement, so had it not been for the discounting, we would have showed it in the cost of sales as rehabilitation…"

[63] Put differently, the deductions claimed are not actually a finance cost, but have been reflected as one because that is what the taxpayer is required to do in terms of international accounting standards practice.

[64] C disputed that in the circumstances the allowances claimed constitute finance costs: "I would say they are not finance costs, because you know we are not paying anyone. It is just where we are putting it on the income statement…" and later "…you are catching up that discount, slowly but surely, so when you get to the final amount, it is the same".

[65] None of this testimony was disputed in cross-examination. Counsel for SARS however appropriately took C to the taxpayer's letter to SARS of 29 May 2018[16] in which the actual deductions were reflected, and gave him the opportunity to explain the rationale with reference to those figures as well as how they had been calculated. His explanation was clear, cogent and credible.

[66] In short therefore there was ultimately no dispute that the allowances claimed were not finance costs, and that the taxpayer discharged the onus of proving the section 24C requirements. Counsel for SARS rightly conceded in argument that she could not take its stance in relation to "finance costs" any further, and was constrained to confine herself to the submission in the heads of argument that "the problem is that the taxpayer did not present any facts (apart from hypothetical figures) justifying the calculation of the amounts. SARS contends that the taxpayer has failed to discharge the onus…".

[67] To my mind the following considerations come into play. First, C gave an explanation during his testimony of how those figures were calculated. Second, SARS had all of the financial documentation and information which was either initially provided by the taxpayer or requested by SARS at the time when it disallowed these deductions.

[68] Third, it may fairly be assumed that SARS auditors such as Ms Kekae (who holds a B.Com degree) are qualified, trained and sufficiently experienced to scrutinise and understand documentation and information of this nature. Fourth, common sense dictates that if an explanation is provided by a taxpayer by way of a hypothetical example, it must surely be entitled to assume with confidence that the auditor concerned will be able to apply that hypothetical example to the figures before him or her as reflected on documents such as

[16] At p237 of the Trial Bundle: it was erroneously referred to during C's testimony as being dated 25 June 2018.

financial statements and tax computations. One can also reasonably expect that SARS auditors are familiar with the IFRS.

[69] Fifth, not a shred of evidence was adduced by SARS in rebuttal that, notwithstanding C's testimony, Kekae was still unable to comprehend how the actual deductions claimed were calculated and made up. Indeed her testimony showed that she is accustomed to scrutinising and understanding financial statements and the like when she gave evidence about the USP's which SARS imposed.

[70] Taking all of these considerations into account I conclude that it would be placing form over substance, and pandering to artificiality, to find that the taxpayer failed to discharge its onus. It follows that the taxpayer's appeal succeeds on this issue.

**The third issue: whether SARS was entitled to impose the USPs**

[71] The USP imposed in respect of the s 24C allowances claimed must be set aside since, as previously stated, it is common cause that if the taxpayer succeeds on the section 24C issue the attendant USP must fall away.

[72] It is thus only necessary to consider the (revised) USP of 15% levied in respect of the admitted understatement by the taxpayer of its interest income for the 2016 year of assessment by R25 910 000. This in turn involves a consideration of whether it was a result of "reasonable care not taken in completing return" or occurred as a result of "a *bona fide* inadvertent error".

[73] The taxpayer contends that the understatement was a *bona fide* inadvertent error for the following reasons:

> "The management of [the taxpayer] took a decision to reduce the loan balance payable by W… Uganda by reducing the interest that accrued on the loan. Journal entries were processed and [the taxpayer] mistakenly debited the amount to finance income instead of debiting the amount to an impairment account. Management subsequently identified the error during the audit of the 2017 financial year that occurred after the 2016 return was submitted.
>
> [The taxpayer] was not aware of the error when completing its tax return for the 2016 tax period, and this only came to the attention of management after the submission of the tax return. SARS was further informed that the error was identified by [the taxpayer] during the financial audit of the 2017 financial year which was after submission of the 2016 tax return, and the commencement of the SARS audit.
>
> [The taxpayer] honestly believed that it had correctly disclosed all amounts in such return and that all statements made by it in the return were correct.

> [The taxpayer] at all times acted in good faith and there was never any intention to avoid or evade taxation."

[74] SARS accepts that the taxpayer did not act intentionally or in a grossly negligent manner in making the understatement. It contends however that given *inter alia* the materiality of the amount the taxpayer failed to exercise reasonable care in doing so.

[75] E gave no evidence, nor was she cross-examined, on the issue. C's brief testimony in chief on the issue was that at the time of the understatement the taxpayer was in an assessed loss position. However he rightly stated that this was not relevant because the interest on the Ugandan loan "is significant so it would have been assessed in any event".

[76] During cross-examination C made the following concessions. In general there is a duty on a taxpayer to submit accurate returns, which includes the duty to put "some effort" into checking their accuracy before submission to SARS. He is a chartered accountant and, generally speaking, such an individual should have the necessary skills to review returns and identify errors.

[77] Further, although C himself did not perform the tax computations for the taxpayer in the 2015 and 2016 years of assessment, he did not review them prior to submission to SARS, although he accepted that in his capacity as financial director of the taxpayer he bore ultimate responsibility for the accuracy of both the returns and tax computations.

[78] According to C the taxpayer's returns were completed by the taxpayer's tax manager who is also a chartered accountant. C also conceded that it was SARS who first identified the error and not the taxpayer itself, and that the error was material.

[79] When asked to respond on SARS' contention that reasonable care was not taken in completion of the return he replied:

> "I think we didn't agree with that. You know, it's levels of reasonability. So in this instance, you know… would a reasonable person [have] said anything different. And in our view the person that completed the tax return was a chartered accountant, our tax manager, and they were closely involved in the affairs of the company, and they didn't pick it up at the time. So, you know, the fact that I had reviewed it who had lesser knowledge of the intimacy of the details, would that have changed matters? I don't believe it would have quite frankly in the bigger picture…"

[80] Kekae testified that she did not regard the understatement to be a bona fide inadvertent error because:

> "…you know taking into account the taxpayer's, the size of the business and that, one would take into account what would a reasonable person do in this regard taking into account the circumstances of the taxpayer. That would be their tax knowledge, their qualification and the size of the business and the amount involved…'

And later:

> "…with regard to the understatement of interest income what I took into account was how the error was firstly discovered M'Lady. On the financial statements… let me just confirm on my audit findings, I think it was Note 20 M'Lady of the annual financial statements where we noticed that when we check comparative figures M'Lady, when we check the current year to the previous years we noticed that there was a difference in the amount. In that year the amount was around R34 million and the next year the interest income was around R80 million. Then we issued the letter, the first letter to the taxpayer to say that the taxpayer should explain why there is such a difference. When the taxpayer responded to that letter they, you know on the first time then they conceded that they have made an error with regard to that amount. So the decision to recommend the 25% [revised to 15%] was based on the fact that when you see, on the financial statements M'Lady… it's glaring that there is an understatement there's a difference of a lot of amount. So we based that we could see it clearly easily, and that taking into account of the taxpayer's business and that their returns would have been prepared by duly qualified chartered accountants as SARS we felt… no reasonable care was taken when completing the return…"

[81] As to prejudice, it was her testimony that despite the fact that the taxpayer had a huge assessed loss at the time, the understatement would have increased its assessed loss for that particular year. Although she conceded during cross-examination that, once the error was corrected, the potential financial prejudice fell away. *Purlish Holdings*[17] has confirmed that "prejudice" as contemplated in the definition of "understatement" in section 221 of the ITA is not only determinable in financial terms. It is fair to accept that the time and resources spent by Kekae, which would otherwise have been put to other use, also constitute prejudice.

[82] During argument counsel for the taxpayer submitted that where a taxpayer claims a deduction or allowance in the bona fide belief that it was correctly deductible for income tax purposes, this is a classic example of an error that is inadvertent.

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[17] *Purlish Holdings v The Commissioner for the South African Revenue Service* (76/18) [2019] ZASCA 04 (26 February 2019) at para [23].

[83] I am mindful that the tax court exercises an original discretion in considering whether to confirm (or reduce or increase) a USP: *CIR v Da Costa.*[18] In my view SARS was correct in reaching the conclusion that it did for the following reasons.

[84] First, it was the taxpayer's own management which took a decision to reduce the loan payable by reducing the interest that accrued on the loan. Accordingly this decision was not based on outside professional advice. Second, the taxpayer is a large company which employs its own tax manager (a chartered accountant) for the purpose *inter alia* of ensuring that its returns to SARS are accurate.

[85] Third, the tax manager should reasonably have realised that the sizeable sum of almost R26 million which came about as a consequence of that management decision needed to treated with reasonable care and caution. Fourth, SARS picked up the error because, as was the undisputed testimony of Kekae, it was a glaring one.

[86] In these circumstances it is not necessary to delve into those decisions of the tax court which have sought to grapple with the meaning of "inadvertent". The fact of the matter is that, on the evidence before us, the taxpayer failed to exercise reasonable care in completing its return. Moreover it was open to the taxpayer to have adduced the evidence of the tax manager concerned in rebuttal of Kekae's testimony but it did not do so. It is not for us to speculate on what informed the tax manager's decision to treat the understated income in the tax return in the manner in which he or she did. It follows therefore that SARS has discharged its onus on this aspect.

**Conclusion and costs**

[87] The members of this court agree with my conclusions on the facts. Section 130(1) of the TAA provides *inter alia* that a tax court may make an order for costs in favour of a party if (a) the SARS' grounds of assessment or "decision"; or (b) the taxpayer's grounds of appeal, are held to be unreasonable.

[88] In the exercise of my discretion I do not believe that any costs order is warranted in the particular circumstances of this matter. Neither party can fairly be found to have acted unreasonably.

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[18] 1985 (3) SA 768 (A) at 774J.

[89] The following order is made:

1. The appeal succeeds to the extent set out in paragraphs 2 to 4 below;

2. The respondent's decision to disallow the deductions claimed by the appellant in terms of section 24C of the Income Tax Act 58 of 1962 as *'unwinding effect charged to interest'* in its 2015 and 2016 years of assessment is set aside;

3. The respondent's decision to impose an understatement penalty as a consequence of its decision to disallow the deductions claimed by the appellant in paragraph 2 above is set aside;

4. The respondent's decision to impose an understatement penalty of 25% (twenty-five percent) in respect of the understatement by the appellant of its interest income in the 2016 year of assessment is set aside and substituted with the imposition of an understatement penalty of 15% (fifteen percent);

5. Save as set out in paragraphs 2 to 4 above the appeal is dismissed; and

6. No order is made as to costs.

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**J I CLOETE**

Mr T J Ledwaba – Accountant Member

Dr S Smith – Commercial Member

**Heard:** 22, 23 and 25 November 2021

**Delivered:** 14 December 2021