REPUBLIC OF SOUTH AFRICA

IN THE TAX COURT OF SOUTH AFRICA
HELD AT CAPE TOWN

CASE NO: 24462

In the matter between:

APPELLANT COMPANY	**Appellant**
and	
THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE	**Respondent**

J U D G M E N T : 19 November 2018

DAVIS J

Introduction

[1] This case was triggered by an astounding loss made by the appellant as a result of an ill-advised series of investments in Country X. This mis-adventure has given rise to three disputes which require the determination of this court:

1. Whether a foreign exchange loss or foreign exchange gain was realised by appellant in respect of a particular transaction, referred to as the N transaction?

2. Whether part of the deduction claimed in respect of a cash incentive bonus should be added back and allowed in subsequent years of assessment?

3. Whether, if the appeal cannot be upheld on either or both of the first two issues, understatement penalties levied in respect of these transactions were correctly imposed, alternatively should they be waived in part or in full?

The factual matrix

[2] The key facts of this dispute appear to be common cause and the evidence which was led by appellant, in particular that of Mr P, who, at the relevant time, was the chief financial officer of appellant, does not create any material factual disputes.

[3] In brief, Holdco (Pty) Ltd (Holdco), a wholly owned subsidiary of appellant, acquired 75% of the issued share capital in a company formed in Country X, N Limited, (‘N’). It later acquired the remaining 25% of the issued share capital of N during its 2009 year of assessment. The N business required substantial capital from appellant to become commercially viable. From 2007 onwards, appellant made a number of shareholder loans to N which were all denominated in US dollars. By October 2011 a total amount of US$877 022 900,86 (of which US$346 000 000 was converted to preference share equity while the remainder of the outlay, being US$531 022 900,86 was made up of various loans) had been advanced by appellant to N.

[4] The evidence suggests compellingly that N was an ill-advised venture which continued to require substantial shareholder support to keep it liquid and capable of continuing its business in Country X. From 2009, the prospects of N repaying its loans in the short term appeared to be rather bleak. According to Mr P, by this time it was apparent that there was little prospect of appellant turning the N business around, although it continued to advance loans to it until October 2011.

[5] Finally, in October 2011 after an anxious process of boardroom deliberation and an attempt to sell the business to a third party, appellant sold its shareholder loans against N to O Limited (O) for US$100. This took place in appellant’s 2012 tax year of assessment.

[6] In terms of its audited financial statements for the 2013 financial year, the following appears:

> ‘[i]n determining the taxable income for the Annual Financial Statements ended 31 March 2012, Appellant included a foreign exchange (FX) gain to the value of R247 million on the realisation of the loan.’

[7] In its Income Tax return for the 2012 year of assessment delivered to respondent on 22 March 2013, appellant adopted a different approach. Instead of recognising a foreign exchange gain, it claimed a deduction in the amount of R3 961 295 256 (which become referred to as the R3.9 bn deduction) as a foreign exchange loss in terms of section 24I of the Income Tax Act 58 of 1962 as amended ('the Income Tax Act'). According to the second witness called by the appellant, Ms S who had joined appellant in November 2013, understandably the claim of a loss of R3.9 bn had a significant effect on appellant's income tax position for 2012. What otherwise would have been reflected as taxable income of R3.12 bn, giving rise to a tax liability of approximately R875 m, was now converted into a tax loss of R106 bn with a refund due of all the provisional tax already paid for that year, being the sum of R822 m.

[8] On 4 August 2016, respondent issued an additional assessment for the 2012 tax year, disallowing the deduction of R3.9 bn and assessing appellant to tax in the amount of R425 188 643 as a foreign exchange gain in terms of section 24I. In short this assessment became the first dispute.

[9] The second major dispute concerned cash incentive bonuses paid by appellant to dealers upon the connection of an initial subscriber contract in respect of a specific tariff plan in the amount of R178 788 421. This amount related to connections that V (Pty) Ltd (V') had made to the M Division of Appellant, which appellant contends were cash incentive bonuses for each subscription which V made on behalf of the M Division. Appellant claimed a deduction of R178 788 421. Respondent added back R136 531 542 in terms of section 23H(1)(*b*)(i) of the Income Tax Act. This amount is the subject matter of the second major dispute. The remaining dispute which follows consequently concerns understatement penalties.

The foreign exchange dispute

[10] The dispute with regard to the deduction of R3.9 bn turns on the interpretation of section 24I of the Income Tax Act which is headed 'gains or losses on foreign exchange transactions'. Section 24I(3) which is the charging section provides as follows:

> In determining the taxable income of any person contemplated in subsection (2), there shall be included in or deducted from the income, as the case may be, of that person—
>
> (*a*) any exchange difference in respect of an exchange item of or in relation to that person, subject to subsection (10);

Subsection 24I(10) is thus of material significance. To the extent relevant it reads:

> …, no exchange difference arising during any year of assessment in respect of an exchange item shall in terms of this section be included in or deducted from the income of—
>
> (*a*) any resident in respect of any exchange difference determined on the translation of an exchange item to which that resident and any company are parties, where that company is—
>
> (i) a connected person in relation to that resident;...
>
> Provided that where that exchange item is realised during any year of assessment. The exchange difference in respect of that exchange item shall be determined by multiplying that exchange item by the difference between the ruling exchange rate on the date on which that exchange item is realised and the ruling exchange rate on transaction date, after taking into account any exchange difference included in or deducted from the income of that person in terms of this section in respect of that exchange item...

The following definitions contained in section 24I are also important:

"Exchange difference" means:

> 'the foreign exchange gain or foreign exchange loss in respect of an exchange item during the year of assessment determined by multiplying such exchange item by the difference between—
>
> (*a*) the ruling exchange rate on transaction date in respect of such exchange item during that year of assessment, and—
>
> (i) the ruling exchange rate at which such exchange item is realised during that year of assessment; or
>
> (ii) the ruling exchange rate at which such exchange item is
>
> (iii) translated at the end of that year of assessment.

An "exchange difference" is accordingly either a "foreign exchange gain" or a "foreign exchange loss" determined in the manner set out in this definition.

"Realised" means, in relation to an exchange item that is a loan or advance or debt in any foreign currency:

> 'when and to the extent to which payment is received or made in respect of such debt, or when and to the extent to which such debt is settled or disposed of in any other manner'.

"Ruling exchange rate" means:

> 'In relation to an exchange item, where such exchange item is—
>
> (*a*) a loan or advance or debt in foreign currency on—
>
> (i) transaction date, the spot rate on such date;

(ii) the date it is translated, the spot rate on such date; or

(iii) the date it is realised, the spot rate such date:

Provided that where the rate prescribed in respect of a loan or advance or debt in terms of this definition is the spot rate on transaction date or the spot rate on the date on which such loan or advance or debt is realised, an any consideration paid or payable or received or receivable in respect of the acquisition or disposal of such loan or advance or debt was determined by applying a rate other than such spot rate on transaction date or date realised, such spot rate shall be deemed to be the acquisition rate or disposal rate, as the case may be;'

The "spot rate" is defined in section 1 of the Income Tax Act as the appropriate quoted exchange rate at a specific time by any authorised dealer in foreign exchange for the delivery of currency.

"Exchange item" of or in relation to a person means:

'an amount on a foreign currency—

…

(*a*) owing by or to that person in respect of a loan or advance or a debt incurred by or payable to such person:

"Transaction date" means, in relation to a loan or advance owing to a person:

'the date on which the amount payable in respect of such loan or advance was paid to another person or the date on which such loan or advance was acquired by such person in any other manner,'

"Acquisition rate" means 'the exchange rate in respect of an exchange item obtained by dividing the amount of the expenditure incurred for the acquisition of such exchange item by the foreign currency amount in respect of such exchange item', and

"Disposal rate" means 'the exchange rate in respect of an exchange item obtained by dividing the amount received or accrued in respect of the disposal of such exchange item by the foreign currency amount in respect of such exchange item'.

So much for the relevant provisions of section 24I. I turn to deal with appellant's argument.

Appellant's case

[11] Because N was a controlled foreign company in relation to appellant, and the two companies were thus connected persons as defined in section 1 of the Income Tax Act in relation to each other, the provisions of section 24I(10) of the Act must apply. Reading the first part of subsection (10), no amount shall be included in or deducted from the income of a resident which relates to exchange differences where such differences relate to an exchange

item in which the resident and connected company are parties; that is the difference is not actually realised but is restated at the end of the relevant tax year.

[12] As it read in the relevant tax years, section 24I(10) contained two provisos, the first of which applies to the present dispute. The foreign exchange item, being the amount of the foreign currency owing to appellant, could not be realised while the loan subsisted in terms of the proviso to section 24I(10). Appellant had to include this foreign exchange gain or deduct the foreign exchange loss in respect of this loan when the exchange item was "realised". The loan was realised when it was sold by appellant to O in the 2012 year of assessment.

[13] The question which then became the focal point of appellant's case was the phrase contained in the first proviso being 'the ruling exchange rate, In particular, appellant referred to paragraph (a) of the definition of exchange rate which provides:

> 'Provided that where the rate prescribed in respect of a loan or advance or debt in terms of this definition is the spot rate on transaction date or the spot rate on the date on which such loan or advance or debt is realised, and any consideration paid or payable or received or receivable in respect of the acquisition or disposal of such loan or advance or debt was determined by applying a rate other than such spot rate on transaction date or date realised, such spot rate shall be deemed to be the acquisition rate or disposal rate, as the case may be.'

[14] Appellant contended that the critical issue which, in its view, was dispositive of the dispute, was the meaning of the words 'determined by applying a rate other than such spot rate on transaction date or date realised ...'. In the event that a rate other than the spot rate was applied, when the loan with a face value of US$531 m was disposed of for US$100, appellant contends that this is the rate to be applied in this case. If the proceeds received for the loan, namely US$100, were calculated by discounting the face value of US$531 m by applying a particular discount rate, this arrangement would have fallen within the meaning of the word 'rate'. Therefore, on this line of argument, when a loan with a face value of US$531 m was disposed of for US$100, it was not the spot rate which was applied but 'a rate other than such spot rate', namely the estimated value of the loan. The relevant rate was a discount rate which depended on an assessment of the outstanding loan.

[15] Appellant contended that according to the proviso in paragraph (a) of the definition of ruling exchange rate, the spot rate on disposal was deemed to be the disposal rate as defined in section 24I(1). Thus, the exchange rate in respect of the loan was to be obtained by dividing the US$100 by the foreign currency amount in respect of the loan. This meant that a foreign exchange loss arose from this transaction and fell within the scope of section 24I(3). Expressed differently, the amount of US$100 received by appellant in respect of the disposal of the N loan (converted into a rand amount by applying the spot rate on the date on which it

was received by or accrued to appellant) divided by the amount of the loan (US$531 m) constituted the disposal rate in respect of the loan.

[16] A related argument raised by appellant ran thus: the first proviso to the definition of ruling exchange rate and particularly the words, 'was determined by applying a rate other than such spot rate on the date realised' applied in this case. It was thus contended if the words 'was determined by applying a rate' are strictly interpreted, without due regard to context, then the proviso would only apply if the parties to the disposal of the loan were to agree a rate which they were then to apply in determining the relevant consideration for the loan. Appellant argued that the correct interpretation of the words 'was determined by applying a rate' was that the parties were not required to have agreed the disposal rate in order for the proviso to apply. They were merely required to have agreed the consideration for the disposal. That consideration, which was stated in rands divided by the amount of the exchange rate, stated in the relevant foreign currency, would give rise to the relevant disposal rate. If that disposal rate differs from the spot rate, the consideration had been determined by applying a rate other than such spot rate as contemplated in the proviso.

[17] Turning to the definition of the disposal rate, upon the parties agreeing the consideration for the disposal, a disposal rate would then exist. That rate would be equal to the consideration in rands divided by the amount of the exchange item stated in the relevant foreign currency. There is nothing in the wording which would indicate that the disposal rate was agreed to by the parties; the rate was based upon a consideration agreed by the parties and not upon the rate applied in determining the relevant consideration. Accordingly, the words was determined by applying the rate' should not be strictly construed but should be applied as follows: the amount of US$100 received by appellant in respect of the disposal of the N loan converted into a rand amount, divided by the amount of the loan US$531 m was the disposal rate in respect of that loan. If this interpretation, as contended for by appellant, was correct, the transaction would result in a foreign exchange loss of R3 961 295 256.

Evaluation

[18] As respondent noted, this dispute depends on the proper interpretation of the wording as employed in section 24I. It is a notoriously complicated and poorly drafted section. Nonetheless, a court is required to give the provision an interpretation that follows fundamental principles relating to the interpretation of a statute. Relying on *Smyth v Investec Bank* 2018 (1) SA 494 (SCA) at para 29, respondent contends that the logical starting point must be the language employed by section 24I, read within the context of the overall scheme of the relevant legislation, in this case the Income Tax Act; that is with due regard to the purpose of the provision and against the background of the production of the relevant statute. If recourse is had to the sentence's meaning, that is to the words actually employed by the legislature

without more, the words 'applying a rate' may support the meaning contended for by the appellant. But this would surely be an inadequate approach to interpretation. In this case, the assertive content of the words is also important; that is the content determined by the context surrounding the use of the language employed, read together with the semantic content thereof.[1]

[19] Turning to section 24I, the legislative purpose of this provision was to divine a mechanism whereby basic principles of Income Tax Act could be employed by way of a deduction or an inclusion in circumstances where the relevant transaction had been concluded in a currency other than the rand.

[20] The provision was introduced to deal with the problem of how to tax gains or losses caused by fluctuations in the value of the rand in circumstances where the underlying transaction had been concluded in a foreign currency. In *Caltex Oil SA (Pty) Ltd v SIR* 1975 (1) SA 655 (A) the problem of converting expenditure in a foreign currency was fully canvassed for the first time. At that time, the Income Tax Act did not have a relevant provision. In the explanatory memorandum to the Bill which introduced section 24I in 1993 the following was then said:

> '[Section 24I has] the object of treating, for tax purposes, all gains made and losses incurred in respect of foreign exchange transactions in a manner which takes into account as far as possible the principles of fairness, simplicity, economic reality, current tax principles and generally accepted accounting practice.
>
> As a starting point it has been taken that gains and losses on foreign exchange transactions mainly represent finance charges. Accordingly, a consequence of this approach is that the gains and losses of losses of this nature have to be brought into account for tax purposes at the end of a year of assessment irrespective of whether they have been realized or not. In addition, this approach also has the effect that such a gain or loss is taken into account against income, regardless of whether it is of a capital nature or not.'

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[1] The assertive content of the words employed is determined by what a reasonable reader or hearer of the relevant words would consider its meaning. In difficult cases the interpreter will need to have recourse to the implicated content of the words' sentences used. The latter depends on the norms that govern the form of expression which is the subject of interpretation. In the case of statutory interpretation that means recourse to the principles chosen to deal with nature of a statute and its meaning: for example the *contra fiscum* rule fits in at this stage of an interpretative enquiry into tax legislation. The present case, in my view, is not such a borderline case so that the assertive content is sufficient to provide a clear interpretative answer. See A. Marmor 'Textualism in Context', University of Southern California Law School, Working Papers Series. Paper 90 (2012).

[21] Section 25D headed 'determination of taxable income in foreign currency' must also be considered in this context. It provides:

> 'Subject to subsections (2), (3) and (4), any amount received by or accrued to, or expenditure or loss incurred by, a person during any year of assessment in any currency other than the currency of the Republic must be translated to the currency of the Republic by applying the spot rate on the date on which that amount was so received or accrued or expenditure or loss was so incurred.'

[22] This section was designed to ensure that amounts, which fall to be taken into account in the determination of taxable income, are converted into rands at a defined exchange rate, thus avoiding disputes as to the rand value of what was received or expended. By contrast, the proviso to section 24I(10) in respect of which this dispute has been concerned, deals with the difficulty of an application of a rate other than the spot rate.

[23] The question therefore arises: Is the "rate" a discount rate or a rate which is attributable to the conversion of the foreign currency into rands? Viewed within the purpose of section 24I, it would appear that the word "rate", when used in the relevant proviso, must mean an exchange rate; that is a rate which reflects the value of a particular currency in question. The purpose of the section is to solve the problem of amounts to be included in or deducted for tax purposes where these amounts are denominated in a currency other than the rand. This meaning would also accord with the definition of acquisition rate, which refers specifically to the exchange rate in respect of an exchange item'. Similar wording is employed with regard to disposal rate.

[24] Thus, when the semantic and the assertive content of section 24I are read as a whole in order to interpret the relevant proviso to a ruling exchange rate, it follows that what the legislature had in mind was an exchange rate as opposed to a discount rate. In this manner, section 24I is given its proper meaning; that is a section which facilitates the conversion of foreign currency into rands as opposed to serving as a form of a general deduction for a loss which had little to do with exchange rate fluctuations and everything to do with what appellant conceded was a disastrous investment.

[25] It was this investment which caused the face value of a loan of US $531 m to decline to no more than a value of US$100. Section 24I enables the amount in foreign currency to be brought into account as rands for the purposes of taxation. It is not to be seen as a secondary general deduction provision.

[26] In summary, section 24I cannot be treated as a provision which permits of a general deduction, in the same way as does section 11(*a*) of the Income Tax Act. That section expressly provides not only for expenditure but also for losses to be deducted. However, section 11(*a*) does not permit a deduction in the present case, a point which was clearly and

correctly treated as common cause. By contrast, section 24I deals with losses or gains caused by foreign exchange fluctuations. It is not applicable to a 'business' loss of the kind incurred by appellant.

[27] For this reason, the argument of appellant stands to be dismissed in that it invoked the provision involving exchange rate gains and losses in order to deduct a commercial loss which was completely unconnected to foreign exchange currency differences and hence to a provision, section 24I, which is not a self-standing deduction provision.

The cash incentive bonus dispute

[28] This dispute concerns respondent's decision to allow a deduction of only R42 256 879 from a cash incentive "bonus" payment of R178 788 421 made by appellant to V as "deal incentives" in the 2012 year of assessment. It was common cause that appellant paid the amount of R178 788 421 to V in 2012. Ordinarily, expenditure of this nature would be deductible in terms of the so called general deduction formula pursuant to sections 11(*a*) and 23(*g*) of the Act. However, respondent has invoked the provisions of section 23H of the Act to limit the deduction permitted in the year of incurral, which had the effect of spreading the deduction over a number of tax years. This dispute does not concern the quantum of the amount incurred to V. This is common cause. The question is whether section 23H(1) applies to this set of transactions.

The background to the payment

[29] The amounts in question were paid to V pursuant to 'deal incentive letters' on 28 June 2011 and 30 September 2011 respectively. These letters record the contractual arrangements between appellant and V pertaining to the latest business of facilitating the conclusion of 24 month contracts with customers.

[30] The letter of 28 June 2011 applies for the period 1 July 2011 – 30 September 2011. It provides thus:

> 1. Deal Incentive Bonus
>
> 1.1 For each new connection, with respect to the particular tariff plan, the Dealer will be paid a once off deal incentive bonus (inclusive of VAT) per connection based on the following deal incentive bonus rates:
>
> a) Once off flat deal incentive bonus (inclusive of VAT) that will be paid per new connection on fixed term 24 (twenty four) months contracts.

TARIFF PLAN	DEAL INCENTIVE BONUS
Saver 2	R1 500

b) Additional once off deal incentive bonus (inclusive of VAT) that will be paid per new connection on fixed term 24 (twenty four) months contracts, based on the number of connections as set out in the table below:

TARIFF PLAN	ADDITIONAL DEAL INCENTIVE BONUS	TARGET
Saver 2	R1 000	40 000+

[31] Paragraph 3 entitled "churn" (that is a loss of a customer during the contract) provides as follows:

'3.1 A churn rate 0% (zero percent) will be applicable for each (Saver 2) contract sold by the dealer, during the above deal period for the duration of that contract's 24 (twenty four) month period.

3.2 A fixed amount of R1 000 (inclusive of VAT) per churned customer will be payable to X.

3.3 In addition, R200.00 (two hundred rand) inclusive of VAT) fee will be charged to the dealer for each contract where there is a change of ownership required during the initial 24 month contract period.'

[32] The second letter of 30 September 2011 applies to new 24 month contracts to be entered into before 31 March 2012, The letter again provides for a dealer incentive bonus of R1 500 for each new connection of a "Saver to Tariff Plan" an additional once off bonus of R1 000 was also payable. There is no express "churn" clause, but, clause 4.1 provided that the dealer has the option to cancel a line prior to a conclusion that the 24 month period in which event the fee of R1 000 will be payable by V to appellant for each line so cancelled.

[33] From the evidence it appears that the payments, which were made, were split as follows:

1. an amount of R52 631 578.95 which were the cash incentive bonuses in respect of the first letter

2. an amount of R78 940 789.47 which was made up of the cash incentive bonus in respect of the second letter

3. an amount of R47 216 052,63 which was made up of the additional R5 000 cash bonus referred to in the second letter.

[34] In its explanation for these payments, appellant stated that it anticipated that the contracts would be profitable over the full contract period, notwithstanding that a large proportion of the costs would be incurred at the commencement of the contract in the form of deal incentive bonuses paid to V following the conclusion of the 24 month contracts.

The statutory provision

[35] Section 23H(1), insofar as it is relevant, provides as follows:

> 'Where any person has during any year of assessment actually incurred any expenditure (other than expenditure incurred in respect of the acquisition of any trading stock)—
>
> (*a*) Which is allowable as a deduction in terms of the provisions of section 11(*a*) …; and
>
> (*b*) In respect of—
>
> …
>
> (ii) any other benefit, the period to which the expenditure relates extends beyond such year of assessment.
>
> the amount of the expenditure in respect of which a deduction shall be allowable in terms of such section in the said year and any subsequent year of assessment, shall be limited to, in the case of expenditure incurred in respect of—
>
> …
>
> (iii) any other benefit to which the such expenditure relates... an amount which bears to the total amount of such expenditure the same ratio as the number of months in such year during which such person will enjoy such benefit bears to the total number of months during which such person will enjoy such benefit or where the period of such benefit is not determinable, such period over which the benefit is likely to be enjoyed.'

[36] Silke on South African Income Tax (the Memorial Edition: Volume 2 at para 7.10B) says the following:

> 'But s 23H introduces into the determination of taxable income a so-called matching concept which has to be complied with when financial statements are prepared in accordance with generally accepted accounting practice. In other words, the concept 'actually incurred' as the basis for the claiming of deductions, is modified. The effective consequence is that any deduction for pre-paid expenditure is deferred and then spread across the years of assessment during which the goods are supplied, the services are rendered or the benefits are enjoyed.'

[37] The wording of section 23H(1) provides that, notwithstanding that a taxpayer has complied with all the requirements of section 11(*a*), it must show that the benefit to which the expenditure relates does not extend beyond the relevant year of assessment. If it does so, section 23H applies.

[38] It is the appellant's case that, in terms of these letters, which comprise the agreement between the appellant and V, a once off incentive bonus was to be paid for each new connection effected by V. The connections were to be made prior to 30 September 2011, being the date which the agreement ended. According to appellant, V was legally bound to effect such connections by 30 September 2011, that is prior to the end of the relevant year of assessment of 31 March 2012. By contrast, respondent contends that the appellant did not incur the incentive bonus expenditure merely to establish a new connection with a customer. It did so to gain access to subscriber payments over the full period of the contract. In other words, the 'real' benefit which flowed to appellant, in respondent's view, from the payment of the cash incentive bonus was not the conclusion of the contract but the actual fees that flowed from each of these subscription agreements over its term.

[39] Respondent referred to the 24 month contract which stated "the period to which the expenditure relates". The subscription fees were "the benefit in respect of which the expenditure were incurred.' On this basis, respondent contends it could not be said that appellant enjoyed any benefit immediately upon the conclusion of the new contract. It had no benefit to show for the obligation at that time which sounded in money. It was only when the connection turned into fee income that appellant could be said to enjoy monetary benefits. This was supported. in respondent's view, by appellant's profitability forecasts, in that it was prepared to incur the upfront expenditure because it knew well that it would receive a great amount of income over the period of the contract, which would render the entire package profitable.

[40] To a large extent, the respondent relies on the argument that, as the purpose of these incentives was to "lock in" customers for a period of 24 months, the expenditure was incurred to ensure that appellant enjoyed the benefit of a 24 month contract. Respondent's argument was that the benefit, which was related to the expenditure, extended beyond the tax year of assessment in which the expenditure was actually incurred.

[41] The explanatory memorandum which accompanied the bill which preceded the enactment of section 23H (Explanatory Memorandum on Taxation Laws Amendment Bill 2000 at 35) said the following:

> 'In this regard a new section 23H is proposed, which provides that where any person has incurred any expenditure, which is or was allowable as a deduction in terms of the provisions of s 11(*a*). (*b*), (*c*) or (*d*) of the Income Tax Act, 1962, the amount allowed to be deducted in any year of assessment shall be limited to the expenditure relating to goods supplied, services rendered or benefits the person will become entitled to during the relevant year of assessment.'

[42] It would appear that the purpose of this section is to ensure that a complete deduction of expenditure would not be related to any goods supplied, services rendered or benefits which accrued to the taxpayer to which the latter would only become entitled, in considerable part, after the end of the relevant tax year.

[43] Narrowly construed, expenditure which is incurred and is subject to a section 11(*a*) deduction can have a benefit that flows beyond the end of the year. For example, a company incurs R100 in advertising and pays the R100 during the year in question. The benefit of this advertising campaign may inure for a number of years depending on the effectiveness thereof. But it could not be suggested that the expenditure should not be deducted in the year it was incurred and indeed paid. For it to be otherwise, section 11(*a*) would almost inevitably preclude deductions in which the benefit could be argued to be effective over a number of years.

[44] In this case, it is clear from the incentive letters that, once V ensured that a connection took place in terms of a fixed 24 month contract, appellant was obligated to pay it the relevant incentive bonus as set out in the incentive bonus letter. The benefit that was attached to the expenditure was the conclusion of the contract with the customer in question. To that end, appellant was prepared to enter into a contract with V in terms of which once the customer had concluded the twenty four month fixed contract, an obligation to pay V was immediately triggered. In short, V rendered all the services which it was obligated to do in terms of the incentive letters and for which the payment of R178 788 421 was made by appellant. In my view, there is no basis upon which to add back and disallow R136 531 542 of the expenditure in appellant's 2012 year of assessment, by way of an application of the provisions of section 23H.

Understatement respective penalties

[45] The understatement penalty issue arises in the light of the finding to which I have arrived in respect of appellant's treatment of the N transaction. Respondent imposed an understatement penalty in respect of the 2012 year of assessment in an amount of R91 232 665.64 which was made up as follows:

> '1. R79 921 973.77 in respect of the foreign exchange loss claimed in respect of the N transaction;
>
> 2. R7 487 808.69 in respect of alleged foreign exchange gain calculated by SARS in respect of the N transaction;
>
> 3 R3 822 883.18 in respect of the deduction claimed in respect of the M Division cash incentive bonus.'

[46] Respondent contends that appellant's conduct constituted a substantial understatement of its tax liability. In its view, it was a standard case which warranted a 10% penalty as contemplated in section 223 of the Tax Administration Act 28 of 2011 (TAA).

The relevant legislation

[47] Section 222 of the TAA provides thus:

> '(1) In the event that 'an understatement' by a taxpayer, the taxpayer must pay, in addition to the 'tax' payable for the relevant tax period, the understatement penalty determined under subsection (2) unless the 'understatement' results from a *bona fide* inadvertent error.
>
> (2) The understatement penalty is the amount resulting from applying the highest applicable understatement penalty percentage in accordance with the table in s 223 to each shortfall determined under subsections (3) and (4) in relation to each understatement in return.'

[48] Section 223 entitled 'understatement penalty percentage table' provides, inter alia, that the understatement penalty percentage for a substantial understatement which is regarded as a standard case is 10%. Section 223(3) then provides:

> (3) SARS must remit a 'penalty' imposed for a 'substantial understatement' if SARS is satisfied that the taxpayer—
>
> (*a*) made full disclosure of the arrangement, as defined in s 34, that gave rise to the prejudice to SARS or the fiscus by no later than the date that the relevant return was due; and
>
> (*b*) was in possession of an opinion by an independent registered tax practitioner that —
>
> (i) was issued by no later than the date that the relevant return was due;

(ii) was based upon full disclosure of the specific facts and circumstances of the arrangement and, in the case of any opinion regarding the applicability of the substance over form doctrine or the anti avoidance provisions of a Tax Act, this requirement cannot be met unless the taxpayer is able to demonstrate that all of the steps in or parts of the arrangement were fully disclosed to the tax practitioner, whether or not the taxpayer was a direct party to the steps in question; and

(iii) confirmed that the taxpayer's position is more likely than not to be upheld if the matter proceeds to court.'

[49] Understatement is defined as follows:

'any prejudice to SARS or the facts as a result of –

(*a*) a default in rendering a return;

(*b*) an omission from a return;

(*c*) an incorrect statement in a return;

(*d*) if no return is required, the failure to pay the correct amount of tax; or

(*e*) an 'impermissible avoidance arrangement'.'

[50] A substantial understatement is defined in section 221 as 'a case where the prejudice to SARS or the fiscus exceeds the greater of five percent of the amount of 'tax properly chargeable or refundable under a Tax Act or the relevant tax period or R1 000 000.

The present dispute

[51] It is common cause that the penalty was imposed on the basis that there has been 'a substantial understatement' constituting 'a standard case', resulting in a penalty of 10% of the tax that otherwise would have been paid.

[52] It would appear that the understatement in this case was as a result of an incorrect statement in appellant's return which was based upon the latter's interpretation of section 24I of the Act. There was much debate as to whether appellant was entitled to contend that the understatement in respect of the N transaction was due to a 'bona fide inadvertent error'.

[53] In ITC 1890: 79 SATC 62 at paras 45–48 the court dealt with the question of a bona fide inadvertent error which it considered had to an innocent mistake by a taxpayer on his or her own, resulting in an understatement while acting in good faith and while acting without the intention to deceive'. In ITC 1890 the dispute concerned section 24C of the Act. Significantly in that case, the taxpayer relied on an opinion from a tax expert which the court considered "went beyond giving a tax opinion on what section 24C meant". Nonetheless, given

the complexity of the section and the fact that the taxpayer had relied thereon, the court remitted the penalty imposed by respondent.

[54] There can be no doubt that in ITC1890, the entire dispute turned on competing meanings of section 24C of the Act. In this case, in respect of a dispute which turned on the interpretation of section 24I, this court has found that there is no merit in the interpretation offered by appellant. But that is not the test in respect of the issue of understatement penalties. The test is whether through any deliberate planning to understate the liability to tax or, alternatively, in good faith the appellant, relying on legal advice, sought a deduction which has proved not to be allowable. The opinions offered to appellant were detailed and were provided by distinguished counsel being leading experts in the field of tax. The opinions dealt with what is unquestionably a complex and not particularly elegantly drafted section of the Act. See Silke on South African Income Tax (the Memorial Edition) Volume 2 page 17.8 A.

[55] Presumably aware that the existence of these opinions was an obstacle to the imposition of the penalty. Mr Sholto-Douglas who appeared with Mr Janisch, Mr Cassim and Mr Tjiana for respondent submitted that appellant had never requested respondent to remit the penalty on the basis that it had received legal advice. Thus, in his view, the raising of this issue belatedly in an amendment to the Rule 32 statement constituted a new ground of appeal which had not previously been raised as an objection, pertaining to a decision which was itself not the subject of an objection.

[56] However, in terms of Rule 34, the issues on appeal will be those contained in the statement of grounds of assessment read together with the statement of grounds of appeal and, if any, the reply to the grounds of appeal. Respondent recorded that whether it was correct in imposing a penalty of 10% in terms of section 233 of the TAA was one of the issues in dispute. This is confirmed in the pre-trial minute where reference was made to section 233 (which, of course, should read as a reference to section 223). There does not appear to have been any objection from respondent to that which was set out in the pre-trial minute as being an issue in dispute. Furthermore, as part of its auditing process, respondent requested the two opinions and on 5 August 2016 in its finalisation audit letter it stated the following:

> 'Appellant sought legal opinions from senior counsel [opinion of Adv. PJJ Marais dated 11 July 2012 (PJJ Marais') and of Adv. Peter Solomon SC dated November 2012] on the calculation of the foreign exchange difference. Relying on the interpretation and principles expressed by senior counsel, Appellant recalculated the foreign exchange difference and concluded that a foreign exchange loss of R 3961 295 256 should be realised instead of a foreign exchange gain…'

[57] Once the two legal opinions are taken into account, in my view, it is justified to conclude that appellant committed a bona fide inadvertent error when it claimed a deduction of part of the costs of the N transactions. Appellant produced a tax return in which it claimed a deduction based on two legal opinions from extremely senior legal practitioners. The deduction was claimed in good faith and in a transparent fashion which proved to be incorrect. In my view, the understatement penalty in respect of the N transaction should not have been imposed.

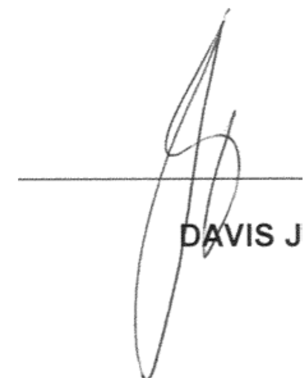
The order

[58] On the basis of these findings, the following order is made:

1. Appellant's appeal is upheld in part and its income tax assessment for the 2012 year of assessment is altered as follows:

   1.1 The deduction of R136 531 542 in respect of the cash incentive bonus paid by appellant to V is to be allowed.

   1.2 The understatement penalties imposed in appellant's income tax assessment for the 2012 year of assessment are set aside



DAVIS J