SMALL AND MEDIUM ENTERPRISES: A RECOMMENDED CHECKLIST OF INDICATORS TO REDUCE THE PROBABILITY OF TAX ERRORS ON GROSS INCOME DEFINITION AND GENERAL DEDUCTION FORMULA

by

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DECLARATION

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I Zwakele Majola, declare that:

(Small and medium enterprises: a recommended checklist of indicators to reduce the probability of tax errors on gross income definition and general deduction formula)

is my own work and that all the sources that I have used or quoted have been indicated and acknowledged by means of complete references.

I further declare that I have not previously submitted this work, or part of it, for examination at Unisa for another qualification or at any other higher education institution.

____________________  __________________
Signed                     Date
ACKNOWLEDGMENTS AND DEDICATIONS

I would like to express my gratitude to the University of South Africa for granting me the opportunity to enrol for this dissertation and for the general university support.

I dedicate this dissertation to my:

I. Late adorable brother Knowledge Zamindlela Majola who passed away during the course of my studies. He had an affinity for education.

II. Late adorable parents David Moti Majola and Lucky Gloria Sehleselwe Majola who, when I was young, always made sure that I woke up on time for school.

III. Adorable children Nonzuko Jennifer Majola and Sakhiwo Brown Amaru Majola who are my source of inspiration in life.
ABSTRACT

Small and medium enterprises (SMEs) play a significant role in the economy. However, SMEs face a number of obstacles and impediments that prevent them from developing and growing.

Government has introduced a number of initiatives to help develop and promote SMEs but SMEs still face many remaining obstacles and impediments which include non-compliance with tax legislation.

The main purpose of this dissertation is thus to help SMEs increase their level of tax compliance by developing a checklist of indicators that will help SMEs reduce the probability of tax errors occurring in respect of the gross income definition and general deduction formula.

Other sections of the income tax and other tax types were not considered as the study was confined to the gross income definition and general deduction formula. These untouched areas may be considered in future research.
<table>
<thead>
<tr>
<th>ABBREVIATIONS</th>
<th>Full Form</th>
</tr>
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<tbody>
<tr>
<td>CIPC</td>
<td>Companies and Intellectual Property Commission</td>
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<td>CIR</td>
<td>Commissioner for Inland Revenue</td>
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<td>CSARS</td>
<td>Commissioner for the South African Revenue Service</td>
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<td>DTI</td>
<td>Department of Trade and Industry</td>
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<td>ITC</td>
<td>Income tax case</td>
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<td>MOI</td>
<td>Memorandum of Incorporation</td>
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<td>SAICA</td>
<td>South African Institute of Chartered Accountants</td>
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<td>SAIPA</td>
<td>South African Institute of Professional Accountants</td>
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<td>SAIT</td>
<td>South African Institute of Tax Professionals</td>
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<td>SARS</td>
<td>South African Revenue Service</td>
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<td>SATC</td>
<td>South African Tax Court</td>
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<td>SIR</td>
<td>Secretary for Inland Revenue</td>
</tr>
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<td>SME</td>
<td>Small and medium enterprise</td>
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<td>SMEs</td>
<td>Small and medium enterprises</td>
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<td>UNISA</td>
<td>University of South Africa</td>
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<td>VAT</td>
<td>Value Added Tax</td>
</tr>
<tr>
<td>VDP</td>
<td>Voluntary Disclosure Programme</td>
</tr>
</tbody>
</table>
TABLE OF CONTENTS

DECLARATION ...........................................................................................................i
ACKNOWLEDGMENTS AND DEDICATIONS ......................................................... ii
ABSTRACT ...............................................................................................................iii
ABBREVIATIONS .................................................................................................. iv

CHAPTER 1: OVERVIEW AND DELINEATION OF THE STUDY ................................. 1
  1.1 INTRODUCTION ............................................................................................. 1
  1.2 PROBLEM STATEMENT ............................................................................... 3
  1.3 THESIS STATEMENT ..................................................................................... 6
  1.4 RESEARCH OBJECTIVE ............................................................................. 6
  1.5 DELINEATION AND LIMITATION ................................................................. 6
  1.6 DEFINITION OF TERMS AND CONCEPTS ............................................... 7
  1.7 DEFINITION OF A SMALL AND MEDIUM ENTERPRISE (SME) .............. 7
  1.8 UNDERLYING ASSUMPTIONS .................................................................... 8
  1.9 RESEARCH METHOD .................................................................................. 9
  1.10 SIGNIFICANCE OF THE STUDY ................................................................. 10
  1.11 ETHICAL CONSIDERATIONS ................................................................... 10
  1.12 OVERVIEW OF THE CHAPTERS .............................................................. 10
  1.13 CONCLUSION ............................................................................................. 11

CHAPTER 2: LITERATURE REVIEW ....................................................................... 12
  2.1 INTRODUCTION ............................................................................................ 12
  2.2 GOVERNMENT’S EFFORTS TO PROMOTE SMEs ....................................... 12
  2.3 SMEs ARE SUSCEPTIBLE TO TAX MISTAKES ......................................... 13
  2.4 REGULATORY ENVIRONMENT .................................................................. 14
  2.5 ARBITRARY APPLICATION OF LAW .............................................................. 15
  2.6 CHALLENGES IN OBTAINING APPROPRIATE TAX ADVICE .................. 16
  2.7 ACTIONS TAKEN TO EASE THE TAX BURDEN OF SMEs ...................... 17
  2.8 COMPLIANCE COSTS .................................................................................. 17
  2.9 TAX AMNESTY FOR SMALL BUSINESS .................................................... 19
  2.10 VOLUNTARY DISCLOSURE PROGRAMME (VDP) ...................................... 20
  2.11 A SARS AUDITOR ..................................................................................... 20
CHAPTER 1: OVERVIEW AND DELINEATION OF THE STUDY

1.1 INTRODUCTION

“Small business is big business.” This statement by President Jacob Zuma \(^1\) during the State of the Nation (SONA) address reiterated the importance of small businesses in South Africa (SONA, 2015:10). The tax compliance of small businesses has similarly been a topical issue in South Africa (USAID, 2008:10).

Various articles (Smulders, Stiglingh, Franzsen & Fletcher [2012]; Stainbank [2010]; Coolidge [2012]) have been written about the tax-compliance burden faced by small and medium enterprises (SMEs). SMEs constitute the economic lifeblood of numerous South African households and are important from the point of view of creating new jobs and sustaining many families in the South African economy (the Foreign Investment Advisory Service of the World Bank Group [FIAS], 2007:10).

According to FIAS (2007:10), SMEs at the time contributed approximately 36% of South Africa’s gross domestic product (GDP) and employed approximately 68% of the workforce in the private sector. Subsequently, the National Credit Regulator (2011:7) suggested that SMEs contributed to the GDP within a range of 52% and 57% and also employed 61% of the South African workforce.

The National Credit Regulator (2011:7) emphasised that 91% of the formal businesses in South Africa are SMEs, and Phillip (2010:111) suggested that 83% of the SMEs are unregistered. It then follows that SMEs constitute the majority of the formal and informal businesses in South Africa. If the SMEs then constitute the majority of formal businesses, as the National Credit Regulator emphasised (2011:7), it goes without saying that the SMEs also constitute the greater part of the tax base.


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\(^{1}\) Jacob Zuma was the president of the Republic of South Africa at the time of writing this dissertation.
Small Business Development Strategy in South Africa), which helped to create an environment conducive to small-business development.

One of the government’s initiatives was the promulgation of the National Small Business Act 102 of 1996, which provided a legal framework for the state to develop and grow SMEs. In 2003, the South African government adopted the Integrated Small Business Development Strategy for the subsequent ten-year period (DTI, 2003: The Integrated Small Business Development Strategy in South Africa), which demonstrated the government’s resolve to help develop and grow SMEs.

The minister of finance in his 2015 budget speech made various statements demonstrating the South African government’s resolve to help develop and grow SMEs (own emphasis):

One of the strategic priorities to be pursued by government is unlocking the potential of small enterprises (National Treasury, Budget Speech, 2015:2). The Department of Small Business Development will spend approximately R3.5 billion on mentoring and training support to small businesses (National Treasury, Budget Speech, 2015:10). As from April 2015 a central database will be introduced whereby businesses will only register once in order to do business with the state, and this is likely to reduce the administrative burden of small enterprises (National Treasury, Budget Speech, 2015:17). The 2015 Budget tax proposals aim to introduce more tax incentives for small enterprises. (National Treasury, Budget Speech, 2015:18). Following the recommendations of the Davis Tax Committee generous tax regime that will be beneficial to SMEs was proposed (National Treasury, Budget Speech, 2015:19). For example, enterprises with a turnover of less than R335 000, will virtually pay no income tax. Furthermore, it is proposed that SARS will introduce “small business” desks in SARS offices to assist small enterprises with tax compliance (National Treasury, Budget Speech, 2015:19).

The views of the minister of finance on SMEs seem to follow President Jacob Zuma’s determination as outlined in his 2015 SONA to help SMEs to grow, as he intimated that “small business is big business”.

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From the foregoing it is clear that the South African government has understood the significance of the SMEs’ contribution to the economy and the impediments that they currently face; therefore, the government proposed various initiatives to assist the SMEs, as outlined above. This dissertation is accordingly inspired by the South African government’s resolve to help the SMEs.

The problem associated with SMEs that this dissertation would like to resolve lies in the domain of tax compliance. In order to provide solutions to the impediments and challenges faced by SMEs concerning tax compliance, research into tax-compliance matters associated with SMEs is needed.

This study is therefore confined to the tax-compliance impediments and challenges facing SMEs in respect of possible tax errors regarding the definition of gross income and the general deduction formula that are arguably relevant to SMEs. Other tax-compliance challenges faced by SMEs are beyond the scope of this study.

1.2 PROBLEM STATEMENT

What is the problem?

SARS conducts audits on a daily basis on taxpayers,² including SMEs. A study conducted by Smulders et al (2012:186) noted that SMEs find it difficult to be tax compliant due to the regressive nature of compliance costs. The compliance costs cause the SMEs’ tax burden to increase and consequently it becomes difficult to prevent tax-return errors. The common errors³ made by SMEs will, it is suggested, generally result in an audit finding in the event of a SARS audit.

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Audit findings may lead to penalties and interests \(^4\) being levied by the *fiscus* on small businesses that may ultimately threaten the going concern of these businesses. This study therefore develops and recommends a checklist of indicators for SMEs to reduce the probability of tax-return errors regarding the definition of gross income and the general deduction formula occurring.

### 1.2.1 Why must the problem be addressed?

The literature review (as delineated in the next chapter) highlights various challenges faced by SMEs that ultimately have an impact on their businesses’ tax compliance. Some of these challenges include the following: (i) compliance costs and (ii) the obstacles of dealing with the Revenue Authority. These challenges make it difficult for SMEs to be tax compliant and in the event of an audit, SARS will levy penalties and interest in the case of non-compliance by the SME concerned.

The foregoing challenges and impediments highlight the plight of taxpayer SMEs. If the SMEs’ plight of suffering penalties and interest due to tax-return errors remains unabated, it is suggested that a gradual erosion of the tax base is inevitable.

The above may be disastrous for the economy as a whole, as the SMEs arguably constitute a major portion of the tax base. The multiplier effect would not only be a diminishing tax base, but also include social costs such as job losses and an increase in crime in the country due to unemployment.

This suggested scenario highlights the catastrophic consequences of the collapse of SMEs in South Africa. For this purpose it is necessary to conduct research to help SMEs to remain tax compliant, and such research will benefit not only SMEs per se, but also the general public.

Various researchers and other entities have conducted research on SMEs in respect of important compliance matters. Stainbank (2010:57), for example, wrote about the *International Financial Reporting Standard for Small and Medium sized Entities*, and

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\(^4\) Chapters 15 and 16 of the *Tax Administration Act*, 28 of 2011, address the issue of penalties. Chapter 2 of the *Tax Administration Act* addresses the issue of interest.
Coolidge (2012:250) conducted a survey on tax compliance costs concerning SMEs in developing countries.

Smulders et al (2012:184) conducted a study similar to that of Coolidge (2012:250), but one that included the computation of the estimated tax-compliance cost for South African SMEs. FIAS (2007:3) also conducted a research on SMEs in respect of compliance costs and other tax burdens faced by SMEs.

Notwithstanding the above, it is suggested that none of these research efforts dealt specifically with the mitigation of possible tax errors regarding the definition of gross income and the general deduction formula associated with SMEs. This is the gap that this study seeks to address by ultimately developing a checklist of indicators for mitigating possible tax errors made by SMEs.

1.2.2 How is the problem addressed?
The study evaluates selected provisions of the Income Tax Act 58 of 1962 (“the Income Tax Act”) that will assist SMEs in addressing some of the problematic areas experienced by them in respect of the Income Tax Act, namely common tax errors emanating from the application of the definition of gross income and the general deduction formula.

Importantly, applicable case law is discussed and interpreted with specific reference to problematic income-tax issues experienced by SMEs that may lead to tax-return errors in respect of the definition of gross income and the general deduction formula. After identifying the problematic income-tax issues, a checklist of indicators will be formulated to assist SMEs in reducing the probability of the above-mentioned tax-return errors occurring.

1.2.3 To whom does the study matter?
The checklist of indicators will help both taxpayer SMEs and tax practitioners reduce the probability of making tax-return errors that may trigger an audit finding in the event of a SARS audit. The study will also help create a better understanding of the challenges faced by SMEs in respect of tax compliance.
1.3 THESIS STATEMENT
The research question addressed in the study is as follows: given the tax errors made by SMEs in respect of the definition of gross income and the general deduction formula, what solution can be produced to reduce the probability of these tax errors occurring?

The thesis statement derived from the above question is therefore as follows:

A checklist of indicators recommended for use by small and medium enterprises (SMEs) in reducing the probability of tax errors made in respect of the gross income definition and general deduction formula.

The income-tax issues identified through the analysis of the definition of gross income and the general deduction formula leading to possible tax errors by SMEs will constitute an independent variable that will inform and assist in formulating the checklist of indicators (dependent variable).

1.4 RESEARCH OBJECTIVE
The aim of the research is to develop a checklist of indicators that both taxpayer SMEs and tax practitioners may consider in reducing the probability of tax errors made in respect of the definition of gross income and the general deduction formula in the Income Tax Act.

1.5 DELINEATION AND LIMITATION
The study is, in the main, limited to a discussion and interpretation of selected income-tax provisions, namely the definition of gross income and the general deduction formula. Other fiscal statutes are excluded for the purpose of the study.

To a limited extent, reference is made to the Tax Administration Act 28 of 2011. The study does not physically engage SMEs, as it is limited to the theoretical analysis and interpretation of legislation and case law. Not all technically complex tax issues are addressed in the study: the study is confined to the definition of gross income and the general deduction formula.\(^5\)

\(^5\) See chapter 5 of this dissertation for recommendations.
1.6 DEFINITION OF TERMS AND CONCEPTS

Small and medium enterprises (SMEs) – see the broad definition of an SME in 1.7 below. The South African Revenue Service (SARS) is an organ of state as established by section 2 of the South African Revenue Act 34 of 1997.

An audit finding is the discrepancy between what was declared on the return and what should have been declared, leading to an additional assessment as envisaged in section 92 of the Tax Administration Act 28 of 2011.

The checklist, for the purpose of this dissertation, constitutes the end result of this study: it is a tool that helps taxpayer SMEs evaluate the accuracy of their tax information.

Tax compliance, for the purpose of this dissertation, refers to the accurate completion and timely submission of tax returns and the timely payment of taxes.

Probability refers to the chance that something will happen. In the context of the dissertation statement it refers to the likelihood of tax-return errors occurring. As this is a qualitative research, a quantitative measure need not, for the purpose of this study, be attributed to the term.

1.7 DEFINITION OF A SMALL AND MEDIUM ENTERPRISE (SME)

Small and medium enterprises are found in both the formal and the informal economy. They are often owner-managed or family-run businesses. SMEs are not restricted to a specific industry, but are found in various industries, sectors and segments. Put differently, SMEs are also found in both fragmented and consolidated markets.

The turnover of SMEs is often smaller than that of corporations or big businesses. This is in accordance with the definition of an SME in terms of the National Small Business Act 102 of 1996 (“the National Small Business Act”), in which a “small enterprise” is defined as follows:

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7 A fragmented market normally consists of small businesses competing with one another but without anyone of them dominating.

8 A consolidated market is normally made up of a few market players controlling a significant market share.

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“A separate and distinct business entity, together with its branches or subsidiaries, if any, including cooperative enterprises, managed by one owner or more predominantly carried on in any sector or sub-sector of the economy mentioned in column 1 of the Schedule (of the National Small Business Act) and classified as a micro-, a very small, a small or a medium enterprise by satisfying the criteria mentioned in columns 3, 4 and 5 of the Schedule.”

The National Small Business Act also defines a “small business organisation” as follows:

“Any entity, whether or not incorporated or registered under any law, consisting mainly of persons carrying on small enterprise concerns in any economic sector, and established for the purpose of promoting the interests of or representing small enterprise concerns, and includes any federation consisting wholly or partly of such association, and any branch of such organisation.”

For the purpose of this study, the definition of SME may be understood to include both foregoing definitions.

It is difficult to state the amount of turnover generated by an SME, inter alia due to the fact that industries differ in size (e.g. the construction industry may be bigger than the agriculture industry), so that the turnover of an SME in one industry may be higher than that of an SME in another industry. Under the Income Tax Act, the turnover of a “small business corporation” is stated to be an amount not exceeding R20 million (s 12E(4)(a) of the Income Tax Act). The Income Tax Act contains its own definition of a small business.9

1.8 UNDERLYING ASSUMPTIONS

The study was conducted from a taxpayer’s perspective and in the main sought to provide the taxpayer with solutions in respect of reducing the probability of tax errors pertaining to the definition of gross income and the general deduction formula. An assumption therefore exists that taxpayers are rational and wish to comply with their obligations under the Income Tax Act. The audit procedures of a SARS auditor suggested throughout the dissertation are

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deduced from the general auditing principles that vouch the completeness of income and the validity and accuracy of expenditure.\textsuperscript{10}

\textbf{1.9 RESEARCH METHOD}

The research method used is a qualitative one contributing towards the development of a checklist of indicators regarding probable tax errors made by SMEs in respect of the definition of gross income and the general deduction formula.

Qualitative research is founded on a philosophical viewpoint that it is interpretivist in nature in the sense that it is concerned with how the world is interpreted and understood (Schurink, 2003:3). This study is qualitative in nature as it seeks to identify and interpret a number of relevant legislative provisions applicable to SMEs and to understand the tax problems commonly experienced by SMEs.

This method of research is similar to the doctrinal approach of research. The doctrinal approach is found within the framework of legal research and consists of two processes, namely the identification of legislation and the interpretation of that legislation (Hutchinson & Duncan, 2012:20).

The information is collected through reviewing printed material in the form of legislation and case law. The review of legislation and case law will then identify problematic income-tax issues experienced by SMEs that will be used for deriving the checklist of indicators that will hopefully prevent possible tax-return errors.

This study does not have a hypothesis to prove or disprove and therefore the direction of testing is from observations to theory – that is, the identification of possible tax-return errors through the analysis carried out in chapters 3 and 4 will be used for deriving the checklist of indicators constituting the outcome of this dissertation. In other words, the contents of the checklist of indicators are unknown at this point of the dissertation, until such time as the analysis in chapters 3 and 4 of this dissertation has been carried out. This study will interpret

relevant legislation in order to identify problematic issues (observations) that will be used for developing a checklist of indicators (general principle), as explained by Smit (1997:20).

1.10 SIGNIFICANCE OF THE STUDY
The study is of both theoretical and practical significance.

The study is of theoretical significance in that it takes a stance on the tax issues discussed under the definition of gross income and the general deduction formula. Such a position can stimulate further debate in both academic circles and the accounting profession, resulting in an enhanced knowledge of the tax body.

The research is of practical significance in that the proposed checklist of indicators can serve as a guideline in helping taxpayer SMEs minimise the probability of making errors when completing their tax returns.

1.11 ETHICAL CONSIDERATIONS
This study is conducted largely for the benefit of taxpayer SMEs in order to increase their level of tax compliance. The study should therefore be viewed in the context of promoting proper tax planning as opposed to tax evasion, which is illegal. The analysis conducted in this study is also underpinned by ethical values such as integrity, honesty and objectivity. These ethical values are, it is suggested, essential in satisfying the rules of natural justice and the principle of legality.

1.12 OVERVIEW OF THE CHAPTERS
The dissertation consists of five chapters. Below follows the layout of each of the next four chapters:

Chapter 2 expands on the literature review, highlighting further challenges and impediments that have an impact on the tax compliance of SMEs.

Chapter 3 discusses selected contentious income-tax issues relating to the definition of gross income that could lead to possible tax-return errors.
Chapter 4 discusses selected contentious income-tax issues relating to the general deduction formula that may lead to possible tax-return errors.

Chapter 5 contains a summary of the previous chapters, draws overall conclusions and makes recommendations and sets out the proposed checklist of indicators.

1.13 CONCLUSION
The aim of this chapter was to provide an overview of what the study is all about. The introduction provided background information and the context in which the study was conducted. The problem statement, research objective, dissertation statement, significance of the study and overview of the next few chapters were, among others, also explained.

The next chapter contains the literature review flowing from the beginning of this chapter and provides the context of the research.
CHAPTER 2: LITERATURE REVIEW

2.1 INTRODUCTION

It is an indisputable fact that small and medium enterprises (SMEs) play a significant role in the South African economy. This significance was mentioned in the previous chapter, where it was stated that SMEs employ a substantial portion of the labour force and make a noteworthy contribution to South Africa’s gross domestic product (GDP).

It is important to understand the environment in which SMEs operate or find themselves in before solutions for helping SMEs reduce the probability of tax-return errors that may trigger a SARS audit finding can be devised. This chapter provides a background to the obstacles and impediments faced by SMEs in South Africa. These impediments, it is submitted, ultimately increase the SMEs’ tax-compliance burden.

2.2 GOVERNMENT’S EFFORTS TO PROMOTE SMEs

After the democratic breakthrough in 1994, the South African government in 1995 tabled a White Paper on the National Strategy for the Development and Promotion of Small Businesses in South Africa. The paper contained various strategies for helping to develop and promote small businesses in South Africa, and also called for the creation of a Small Business Development Agency.

Subsequent to this White Paper, the National Small Business Act 102 of 1996 (“the National Small Business Act”) was promulgated. The National Small Business Act catered for the creation of various institutions or agencies tasked with the development and promotion of SMEs. One of those institutions was the Ntsika Small Business Development Agency, the primary task of which was to promote the development of small businesses in South Africa. The promulgation of the National Small Business Act was, it is suggested, a sign of serious

11 As stated in the previous chapter, approximately 68% of the workforce in the private sector is employed by SMEs.
12 As stated in the previous chapter, SMEs contribute approximately 36% of the country’s GDP.
14 Supra.
15 Supra.
intent by the South African government to create an environment conducive to the development and promotion of small businesses in South Africa.

In 2004, the Small Enterprise Development Agency (SEDA) was established through the amalgamation of previously existing institutions (SEDA, 2014:1). Recently, the current government created a ministry dedicated to SMEs, namely the Department of Small Business Development. This department was still at the embryonic stage at the time of writing this dissertation.

SMEs are still faced with many challenges and impediments, such as access to finance and non-tax-compliance, despite the South African government’s concerted efforts over the years to help develop and promote SMEs. The various sections of this chapter that follow continue to discuss and analyse the challenges and impediments that have a bearing on the tax compliance of SMEs.

2.3 SMEs ARE SUSCEPTIBLE TO TAX MISTAKES

It is suggested that SMEs are susceptible to non-tax-compliance in that they often make errors in connection with their tax affairs. In other words, SMEs are likely to default when it comes to complying with tax-administration legislation.

On the one hand, SMEs often make a variety of costly mistakes, including inaccurate bookkeeping and expenditure on matters not ranking for a tax deduction (s 23(b) of the Income Tax Act 58 of 1962).

On the other hand, these costly mistakes can be overcome through a number of preventative measures, possibly including employing a competent bookkeeper, devising monthly cash-

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flow plans and annual business forecasting.\textsuperscript{19} A survey carried out by the South African Institute of Tax Professionals suggested that 65\% of tax professionals noted that the most daunting challenge as far as SMEs are concerned, is tax compliance.\textsuperscript{20}

2.4 REGULATORY ENVIRONMENT

SMEs face other major challenges, including access not only to finance, but also to the regulatory environment in the form of the bureaucracy (SAIPA, 2013:7). It is suggested that the first matters that a business owner\textsuperscript{21} must comply with before establishing a company in South Africa are the obligations imposed by the Companies and Intellectual Property Commission (CIPC). Companies in arrears as far as the submission of their annual return to the CIPC is concerned are automatically deregistered, meaning that they are no longer legitimate and de jure lose their separate legal identity.\textsuperscript{22} Consequently, the company directors become jointly and severally liable for the company’s debts when the company can no longer settle its liabilities in the ordinary course of its business (s 77 of the Companies Act 71 of 2008 (“the Companies Act”)).

Companies previously registered under the Companies Act of 1973 were, in accordance with the provisions of the Act, required to re-lodge their memorandum of incorporation (MOI) with the CIPC before 30 April 2013.\textsuperscript{23} Failure to re-submit the MOI in terms of the new Companies Act would render the previously submitted MOI void and invalid, should the MOI provisions be in conflict with the provisions of the Companies Act of 2008 (s 4 in schedule 5 of the Companies Act).

After registering with the CIPC, the applicable tax type must be registered with SARS. It is a criminal offence to conduct a business without being registered for income tax (s 234(a) of the Tax Administration Act 28 of 2011).

\textsuperscript{19} Supra.
\textsuperscript{21} Seeking to incorporate a company.
\textsuperscript{23} Supra.
Where a taxpayer is obliged to register for tax and fails to do so, SARS, out of its own volition, may register the taxpayer for the applicable tax type (s 22(5) of the Tax Administration Act 28 of 2011). Apart from the challenges posed by the CIPC, both taxpayers and tax practitioners consider registering for value-added tax (VAT) a cumbersome process.

The difficulties concerning VAT registration were compounded by additional measures introduced by SARS in 2008 for combating the registration of fraudulent businesses. Recently there had been a number of registrations of fraudulent businesses with a view of claiming VAT refunds.

Whilst it was understandable that SARS would introduce additional measures, those measures made the process of VAT registration a cumbersome one. SMEs were hardest hit by this cumbersome process, as their compliance costs have been found to be regressive in nature. It is hoped that the recently (2015) introduced single registration process will ease the burden of tax registration for SMEs.

2.5 ARBITRARY APPLICATION OF LAW

Registered SMEs may find themselves at a disadvantage compared with unregistered SMEs if SARS were to focus excessively on registered businesses as opposed to unregistered ones. Registered SMEs are likely to incur increased compliance costs as a result of SARS excessive focus, whereas unregistered SMEs may not incur such costs. It is suggested that selective enforcement of tax legislation by targeting registered businesses and ignoring unregistered ones may amount to a violation of the constitutional right to equality (s 9 of the Constitution of the Republic of South Africa, 1996).

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25 For example, three months bank statements and sales invoices to prove that the taxpayer is trading.


28 The regressiveness of compliance costs is explained in detail under 2.8 “compliance costs” of this chapter.

Furthermore, in *City Council of Pretoria v Walker*\(^{30}\) selective enforcement of rules was held to be unconstitutional. This case is a *locus classicus*\(^{31}\) in demonstrating the constitutionality of legislation and the unconstitutionality of its unfair enforcement. Selective or unequal enforcement of rules may also invite lawlessness in that registered businesses may turn to illegal conduct upon realising that their unregistered competitors do not suffer any consequences.

The victims here are not only legitimate businesses, but also the government, in that it loses revenue in the form of taxes. Other victims are commerce and industry, as they depend on the government for infrastructural development to support them. For large corporations the regulated environment and dealing with SARS may be less of a compliance burden, but for small businesses these are fairly time-consuming and costly, making it more difficult to remain tax compliant, and causing some SMEs to prefer to remain unregistered. SARS should thus ensure that selective enforcement of tax rules does not happen.

The definition of “understatement” as defined in terms of s 221 of the Tax Administration Act, *inter alia* comprises a “default in rendering a tax return”. The understatement as reflected by the taxpayer, is imposed by SARS in terms of ss 222 and 223 of the Tax Administration Act. The understatement penalty percentage is imposed in accordance with a penalty percentage table (section 223 of the Tax Administration Act), which can run up to the maximum of 200% depending on the circumstances of the case. SARS can thus use the above mentioned penalty percentage table to penalise unregistered SMEs. In this way, remaining unregistered for tax may not be beneficial.

### 2.6 CHALLENGES IN OBTAINING APPROPRIATE TAX ADVICE

SMEs are required to be tax-compliant because they operate in a regulated environment. Due to the excessive cost of accounting services, it is suggested that some SMEs choose to enlist the services of unqualified tax practitioners as for them tax compliance is a daunting task.\(^{32}\)

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\(^{30}\) (1998 (3) BCLR 257 (CC).

\(^{31}\) “a classic example”

Thus a SARS audit on such SMEs may have dire consequences in that an audit finding may result in non-compliance penalties (s 208 of the Tax Administration Act) and interest (s 187 of the Tax Administration Act) levied on them. In such a scenario, the costs incurred are not only the accounting fees paid by the SME, but also the penalties and interest charged by SARS because of an audit finding largely resulting from the SME having employed an unqualified tax practitioner.

2.7 ACTIONS TAKEN TO EASE THE TAX BURDEN OF SMEs

The aspects discussed above caused SARS to institute changes as far as tax practitioners are concerned. In order to become a tax practitioner, one must first be registered with an appropriate professional body before registering with SARS. Examples of such professional bodies are the South African Institute of Professional Accountants (SAIPA), the South African Institute of Tax Professionals (SAIT) and the South African Institute of Chartered Accountants (SAICA).

In the recent past, there was no need to belong to a professional body before registering with SARS, but changes brought about by legislation have changed the way in which business must now be conducted (s 240 of the Tax Administration Act). By enforcing a regulated practice of taxation, the tax-practitioner industry will both go a long way in stamping out unscrupulous behaviour by its practitioners and help small businesses to have access to suitably qualified tax practitioners.

The single registration process introduced by SARS as from 12 May 2014 is expected to ease the burden of tax compliance as far as SMEs are concerned.

2.8 COMPLIANCE COSTS

Recent attempts to distinguish between accounting and tax-compliance costs met with some difficulty because of the overlap between the two types of cost (Smulders et al, 2012:204).

33 See s 240(a) of the Tax Administration Act 28 of 2011.
Such difficulty stems from the fact that financial information is also compiled for tax purposes. In the course of the year, financial information is compiled on a regular basis in order to complete monthly tax returns, and in this regard financial information and tax information are more or less similar in nature. It is therefore submitted that a distinction between the two types is not necessarily useful for the purpose of this study.

The compliance costs for SMEs constitute a higher percentage of their turnover as is the case for big corporations. This is because SMEs generally have smaller turnovers than corporations, as may be seen in figure 1 below.

### Figure 1: Annual accounting costs as a percentage of turnover

![Graph showing the cost of internal accounting activities as a percentage of turnover](image)

**Source:** Smulders et al (2012:207).

In figure 1 it may be seen how the accounting costs of the business as a percentage of turnover decrease in the event of a sudden increase in turnover. Compliance costs are therefore regressive in nature. In other words, a business with a smaller turnover will spend a larger percentage of its revenue on tax compliance than is the case with a business with a larger turnover. Alternatively it may be said that the percentage of accounting costs on turnover decreases as the turnover of the business increases.

Businesses with high costs (of both a fixed and a variable nature) will report lower profit margins than is the case with businesses with lower costs (of both a fixed and a variable
Businesses with a higher percentage of fixed costs experience even greater risks, as they are unable to vary fixed costs with production activity levels. Tax compliance costs characteristically have a fixed cost, as they do not vary with production activity levels. Tax-compliance costs are thus a problem for SMEs, particularly for those in the start-up to early stages of development. It is suggested that the fact that some SMEs collapse or remain unregistered may be attributed to the regressive nature of continuing compliance costs.

Whereas initially compliance with the International Financial Reporting Standards (IFRS) caused the accounting costs for SMEs to increase, South Africa’s adoption of the IFRS for SMEs in 2007 caused the compliance burden to decrease (Stainbank, 2010:57).

2.9 TAX AMNESTY FOR SMALL BUSINESSES

In his 2006 budget speech (Treasury Budget Speech, 2006:17), the minister of finance announced that from 1 August 2006 right through to 31 May 2007 there would be a tax amnesty for small businesses in order to afford these businesses an opportunity to regularise their tax affairs.

This meant that taxpayer SMEs whose application for tax amnesty was approved were subject to a tax-amnesty levy (s 6(1) of the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006) varying from 0% to 5%, depending on the level of taxable income. The penalty for “coming clean” was less than the additional tax (now referred to as an understatement penalty), penalties and interest that would have been charged by SARS upon an audit or investigation.

The amnesty for small businesses was a significant attempt by the South African government to help SMEs to be tax compliant. This was followed by the introduction of a voluntary disclosure programme (VDP) catering for all taxpayers, including SMEs, in 2010.

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35 From the general knowledge of subtracting expenses from revenue and the difference then representing either a profit or a loss.

2.10 VOLUNTARY DISCLOSURE PROGRAMME (VDP)

Following the success or failure of the amnesty for small businesses, the government introduced a VDP administered under the Voluntary Disclosure Programme and Taxation Laws Second Amendment Act 8 of 2010 in 2010. One condition for a VDP application was that amnesty could not be sought for a matter already under SARS investigation. The VDP was a tax amnesty that extended beyond small businesses and included all other entities and individuals.

The Voluntary Disclosure Programme and Taxation Laws Second Amendment Act 8 of 2010 were subsequently repealed with the introduction of the Tax Administration Act 28 of 2011. SARS’s VDP has been administered under the Tax Administration Act\(^\text{37}\) since 1 October 2012.

The VDP may be of benefit to SMEs, particularly the unregistered or non-tax-compliant ones. To benefit from the relief granted in terms of the VDP, the taxpayer SME has to voluntarily subject itself to a SARS audit or investigation (s 229 of the Tax Administration Act).

2.11 A SARS AUDITOR

It is important to address the concept “SARS auditor”, so that the taxpayer SME can have an idea of the type of person that the SME is likely to deal with in the event of a SARS audit. Based on an assessment of job advertisements on the SARS website,\(^\text{38}\) in the case of a junior auditor, the SME should expect to deal with someone with a national diploma or a bachelor’s degree in the field of accounting, auditing and taxation, whereas in the case of a senior auditor, the SME is likely to deal with someone with a Bachelor of Commerce degree with articles from an accounting firm, or a chartered accountant.

Whatever the case, in the event of a SARS audit, the taxpayer SME will be dealing with people who are conversant with tax law. The statutory mandate of a SARS auditor is derived from time to time, auditor jobs (together with the job requirements) are advertised at the following website address: SARS. 2015. “Job Seekers Home”. [Online] Available at: http://www.sars.gov.za/Careers/Pages/Vacancies.aspx (Accessed: 28 October 2015)


\(^{38}\) From time to time, auditor jobs (together with the job requirements) are advertised at the following website address: SARS. 2015. “Job Seekers Home”. [Online] Available at: http://www.sars.gov.za/Careers/Pages/Vacancies.aspx (Accessed: 28 October 2015)
from section 6 and 10 of the Tax Administration Act\textsuperscript{39}, that provide for the Commissioner’s powers of carrying out audits as required being delegated to a SARS official. Thus enquiries by a SARS auditor should not be ignored, as failure to resolve such queries in a satisfactory manner is likely to lead to an audit finding that may result in penalties and interest. To try to prove that an audit finding should be set aside as invalid\textsuperscript{40} may not be an easy and straightforward thing to do – it may in fact be very time- and resource-consuming.

\textbf{2.12 CONCLUSION}

This chapter highlighted various challenges and impediments faced by SMEs, including a complex regulatory environment and issues related specifically to non-tax-compliance. By highlighting and evaluating these challenges and impediments one should get an idea of the background to and the developmental history of SMEs in South Africa.

This chapter both set the scene for and provided the context in which problematic income-tax issues set out in chapters 3 and 4 will be discussed so that the probability of tax-return errors that may culminate in a SARS audit finding may be reduced.

\textsuperscript{39} 28 of 2011.

\textsuperscript{40} An “invalid audit finding” is an erroneous finding by SARS that cannot be supported by legislation.
CHAPTER 3: INCOME TAX ISSUES RELATING TO GROSS INCOME DEFINITION

3.1 INTRODUCTION

It was highlighted in chapter 1 that the main purpose of this dissertation is to produce a checklist of indicators from the gross income definition and general deduction formula. This will assist in guiding SMEs in the compilation of financial information for income tax purposes, in order to minimise the chances of making tax errors that may culminate in a SARS audit finding in the event of an audit of the SME. This chapter is thus the first of two chapters that addresses the core of this dissertation.

Furthermore, the analysis in this chapter is conducted in the context of a resident taxpayer. Non-residents are excluded from the analysis unless stated otherwise. The income part of the checklist is confined to analysing sales revenue i.e. the gross income definition. Special inclusions as described in the Income Tax Act are excluded.

The analysis of the income tax issues relating to the gross income definition is underpinned by the purposive approach to statutory interpretation as opposed to a literal approach. The literal approach requires the application of ordinary grammatical meaning to words in order to understand a provision in a piece of legislation (Goldswain, 2012:32; Botha, 2005:47).

The purposive approach on the other hand seeks to ascertain the purpose of the legislation in the interpretation of legislation. In *Bato Star Fishing (Pty) Ltd v Minister of Environmental Affairs*\(^43\), Ngcobo J intimated that the emerging trend in statutory interpretation is to have regard to the context in which the words occurs even if the words to be interpreted are clear and straightforward. In *Natal Joint Municipal Pension Fund v Endumeni Municipality*\(^44\), Wallis JA emphasized the importance of the purpose of the provision and its context in as far as statutory interpretation is concerned. The abovementioned cases have, it is suggested,

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\(^{41}\) A resident is a person who is ordinarily resident in South Africa. For further details on the definition of this term, refer to definition: “resident” in section 1 of the Income Tax Act.

\(^{42}\) Special inclusions are paragraphs (a) to (n) found under the gross income definition in section 1 of the Income Tax Act.

\(^{43}\) 2004 (4) SA 490 (CC).

\(^{44}\) 2012 (4) SA 593 (SCA).
endorsed a purposive approach to statutory interpretation and it is for this reason that the purposive approach to statutory interpretation has been adopted by this study.

3. 2 GROSS INCOME DEFINITION
In the framework for the calculation of taxable income the starting point is the determination of gross income, and the focus of this chapter is thus on breaking down and dissecting the gross income definition. Section 1 of the Income Tax Act, defines gross income (excluding the non-resident part of it) as follows:

Gross income, in relation to any year or period of assessment, means, in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, during such year or period of assessment, excluding receipts or accruals of a capital nature (Definition: “gross income” in section 1 of the Income Tax Act).

The key components of the gross income definition that are analysed in this chapter are the following:

- Total amount (in cash or otherwise);
- Received by or accrued to;
- In favour of; and
- Receipts or accruals of a capital nature.

The analysis of each of the gross income definition components will be dealt with seriatim\(^45\) as indicated above and will contribute to the “income part” of the checklist that is published in chapter 5.

3.2.1 Total amount (in cash or otherwise)
To establish “gross income” on which a taxpayer can be taxed, there must inter alia be an “amount” received by or accrued to the taxpayer. The understanding of the term “amount” in the context of gross income is therefore crucial in the determination of gross income.

\(^{45}\) It means “one after another”.

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The challenge regarding the amount to be included in gross income is not the cash amount but the “otherwise” amount. In *Lategan v CIR*, Watermeyer J stated:

> In my opinion, the word ‘amount’ must be given a wider meaning [than an amount of money] and must include not only money but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value.

In this case Watermeyer J, it is submitted, followed a purposive approach to statutory interpretation. He departed from the primary rule of interpretation when he stated that the word “amount” must be given a wider meaning. The judge applied the “reading-in” technique (thus tackling the *casus omissus*) in order to harmonise the gross income definition with the legislature’s intention.

Watermeyer J, it is submitted, correctly interpreted the term ‘otherwise’ in the gross income definition that it must include any form of property earned by the taxpayer as long as the property has a money value. This view has since become part of South Africa’s tax jurisprudence and was subsequently confirmed in *CIR v People’s Stores (Walvis Bay) (Pty) Ltd* when Hefer JA pointed out that an “amount” need not be an actual amount of money but may be every form of property earned by the taxpayer that has money value.

It then follows that if the amount is in cash the nominal value of the amount is included in gross income (Williams, 2009:94). However, if the amount is not in cash, the cash equivalent of the property received must be included in gross income.

This principle is very important when it comes to barter transactions. A barter transaction involves the exchange of goods or services for other goods or services without the use of money as a medium of exchange. Taxpayer SMEs, particularly at the start-up to early stage of their development, would engage in barter transactions as they do not sometimes have

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46 1926 CPD 203, 2 SATC 16.
47 *It is an omission in legislation, a matter that is not addressed by statute. As regards this term reference can be made to: Merriam – Webster. 2015. "Casus omissus". [Online]. Available at: http://www.merriam-webster.com/dictionary/casus%20omissus (Accessed: 10 November 2015)
48 1990 (2) SA 353 (A).
enough cash resources to finance certain transactions. If a taxpayer SME receives a property as a result of a service rendered (quid pro quo) to another business, the money value of such property must be included in the taxpayer SME’s gross income provided such amount is revenue in nature.\textsuperscript{49}

Previously, there used to be a view that if the property earned by the taxpayer cannot be converted into money it would not form part of gross income (\textit{Stander v CIR}\textsuperscript{50}; \textit{Tennant v Smith (Surveyor of Taxes)}\textsuperscript{51}; \textit{CIR v Delfos}\textsuperscript{52}). This view was termed the convertibility principle (Williams, 2009:171).

The convertibility principle was however invalidated in \textit{Brummeria Renaissance (Pty) Ltd v CSARS}\textsuperscript{53} when it was stated that the question of whether a property can be converted into money was actually one of the ways of determining the money value of the property. In other words, the ability of converting the property into money was not a criterion for the determination of whether the property earned should be included in gross income but one of the ways of establishing the money value of the said property.

In compiling financial information for tax purposes the taxpayer SME must therefore enquire whether there were any barter transactions not recorded in the books that have money value, and whether such barter transactions must be included in gross income. Any form of property received by the taxpayer SME in exchange for any service rendered or goods delivered (as a quid pro quo) by the taxpayer SME must be included in the taxpayer SME’s gross income.

Out of this analysis it emerges that a SARS auditor may look for barter transactions when auditing the taxpayer SME to ascertain whether such transactions have been accounted for and at the correct value. To be on the safe side, the taxpayer SME should compile financial information on an accrual basis (coincidentally, this is also one of the basic principles of accounting) to ensure that transactions that did not involve the exchange of cash are

\textsuperscript{49} Whether the amount is revenue or capital in nature is discussed later on in this chapter.  
\textsuperscript{50} 1997 (3) SA 617 (C) 59 SATC 212.  
\textsuperscript{51} 1892 AC 150 HL.  
\textsuperscript{52} 1933 AD 242 6 SATC 92.  
\textsuperscript{53} 2007 SCA 99 (RSA).
accounted for in the records. Sales invoices should therefore be accurately prepared (reflecting the correct date, correct description of goods or services), and the correct amount be reflected on the sales invoice (e.g. amount excluding VAT, the VAT amount and the amount inclusive of VAT). The foregoing analysis brings about the following checklist questions (refer to the checklist in chapter 5) and are numbered alphabetically throughout this dissertation:

a. Has all revenue from barter transactions been accounted for?

b. Have all amounts earned been included in gross income at nominal value or at market value for barter transactions?

3.2.2 Received by or accrued to

One of the requirements of the gross income definition is that for an amount to be included in gross income it must have either been received by or accrued to the taxpayer. If an amount has not been received by or accrued to the taxpayer it cannot be included in gross income. Any enquiry must therefore be made in respect of the meaning of “received by” or “accrued to”.

The phrase “received by or accrued to” received judicial interpretation in SIR v Silverglen Investments (Pty) Ltd\(^{54}\) to mean “the earlier of receipt or accrual”. The taxpayer does not have an option to decide when the amount should be declared in the tax return. The amount must be declared in the period in which it accrues to or is received by the taxpayer; whichever occurs first. This statement may seem to be straightforward; however there are instances where it is not so straightforward whether an amount received should be included in gross income. If the taxpayer receives a revenue amount in advance (deferred income - Afrikaans: Inkomste Vooruit Ontvang) before the services are rendered to a customer, can the full amount be included in gross income?

In ITC 702\(^ {55}\) Shaw AJ effectively held that if the amount is revenue in nature and has been received by the taxpayer it must be included in gross income even if the services for the

\(^{54}\) 1969 (1) SA 365 (A) 30 SATC 199.

\(^{55}\) (1950) 17 SATC 14.
amount received are still to be rendered. It is therefore clear that the gross income definition
does not recognise deferred income as a liability as is done in financial accounting. However,
the taxpayer SME, where applicable, may qualify for a section 24C allowance of the Income
Tax Act in reducing the tax liability.

As regards deferred income, a SARS auditor may scrutinise the taxpayer’s bank statements to
confirm that all amounts received by the taxpayer have been included in gross income.\textsuperscript{56} Once the SARS auditor has identified all receipts from the taxpayer’s bank statements and
cashbook the burden of proof will shift to the taxpayer SME to prove that the received amounts are not taxable.\textsuperscript{57} In order for the amount to fall outside the ambit of the gross
income definition the taxpayer will have to prove that the amounts are capital in nature (i.e.
subject only to capital gains tax) or are borrowed moneys received (not income) and so forth.
The taxpayer SME should ensure that deferred income is included in gross income even
though for accounting purposes it is excluded from income (as it is recorded as a liability).

The receipt of loan amounts should be properly designated in the accounting records so that
they are not included in gross income by mistake. In \textit{CIR v Genn \& Co (Pty) Ltd},\textsuperscript{58} Schreiner
JA stated that borrowed money is not received nor does it accrue within the meaning of gross
income definition. Williams (2009:185) for the same reason argues that moneys received on
loan do not have the character of income and thus should be excluded from gross income.
Borrowed moneys should thus not be taxed and the taxpayer SME should take great care that
bank deposits of borrowed moneys do not find their way to the revenue account i.e. they are
appropriately recorded in the general ledger as a liability. The foregoing analysis brings about
the following checklist questions (refer to the checklist in chapter 5):

\begin{enumerate}
\item[c.] Have all amounts received by the taxpayer (with the exception of borrowed moneys)
been included in gross income?
\item[d.] Has all deferred income in respect of ordinary operations of the business been included in
gross income?
\end{enumerate}

\textsuperscript{56} As indicated in paragraph 1.8 of chapter 1, the SARS audit procedures are inferred from general auditing principles.
\textsuperscript{57} In terms of section 102 of the Tax Administration Act, 28 of 2011, the burden of proof shifts to the taxpayer to prove that an amount or
item is exempt or otherwise not taxable.
\textsuperscript{58} 1955 (3) SA 293 (A) 20 SATC 113.
As stated before, the taxpayer does not only have to include amounts received in gross income but also amounts accrued to, whichever occurs first. There may be instances where the accrual of an amount takes place before the receipt thereof; in such an instance the amount is included in gross income upon accrual. The other principle that emerged from *Lategan v CIR* (supra) was that an amount accrues to the taxpayer once the taxpayer becomes entitled to it. The entitlement takes place once the taxpayer has fulfilled the obligations of the sales contract e.g. the delivery of goods has occurred or the service has been rendered. In *Mooi v SIR*\(^9\) the abovementioned principle was taken further to say an amount accrues to the taxpayer once the taxpayer becomes unconditionally entitled to the amount- in other words, once all the conditions of sale have been fulfilled.

The SARS auditor may not only scrutinise receipts but may also search for accruals that have not been included in gross income for the tax period under review. The SARS auditor may perform cut-off procedures\(^60\) and scrutinise business contracts\(^61\) the taxpayer SME has entered into with customers to ensure that accruals have been accounted for in the tax period under review. Income Tax and VAT turnover reconciliations are useful in detecting amounts that were erroneously omitted from gross income.

To void pitfalls as regards the incomplete recording of revenue, it is important for the taxpayer SME to compile financial information on an accrual basis (as stated earlier on) to be on the safe side when it comes to tax compliance. In most instances, accrual normally occurs first, so it is always prudent to prepare information on an accrual basis. Coincidently, the accrual basis is also an accounting principle. It was stated earlier on that although accounting principles are not relevant in a tax computation, there may be instances whereby the accounting and taxation principles converge. The accrual basis is one example of such convergence. The analysis beforehand brings about the following checklist questions (refer to the checklist in chapter 5):

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\(^9\) 1972 (1) SA 675 (A) 34 SATC 1.

\(^60\) Cut-off procedures ensure that transactions occurring near year end or shortly after year end are recorded in the correct year.

\(^61\) Examining contracts that a business has entered into is one of the ways of confirming the completeness of the recording of transactions relating to the contract. For example to confirm the completeness of recorded revenue, one may examine the contract to confirm whether the revenue is recorded in accordance with the contract.
e. Has the income not yet received in respect of services rendered or goods delivered been included in gross income?
f. Is the date on the sales invoice a true reflection of the accrual date of the amount to be received?
g. Are sales invoices issued sequentially numbered?
h. Has the general ledger or sales journal been inspected to confirm the sequence of sales invoice (and credit note) numbers?
i. Have cut-off procedures been performed to ensure that sales invoices are recorded in the correct tax period?
j. Has the reconciliation between IT and VAT turnovers been conducted, and discrepancies appropriately accounted for?

3.2.3 In favour of

The amount may have been received by or accrued to the taxpayer, but if such amount was not in favour of the taxpayer it cannot be included in the taxpayer’s gross income. In other words, if the taxpayer does not receive an amount for his or her own benefit, it cannot be included in his or her gross income. This issue came under the spotlight in *Geldenhuys v CIR*, in which the judiciary stated that the words ‘received by’ must mean received by the taxpayer on his or her own behalf for his or her own benefit. It is suggested that the judicial interpretation in this case followed a purposive approach in that Steyn J did not apply the ordinary meaning of the word, but sought to reconcile the meaning of the word with the purpose of the legislation.

The same issue arises under the common law in the agent-principal relationship. The principal makes use of an agent as a middleman in entering into a transaction with a customer. The customer will make payment to an agent and the agent will hand over the payment to the principal. The question that arises in this scenario is whether the payment received by the agent is taxable in its hands or that of the principal. The answer seems to be similar to the judgment in *Geldenhuys v CIR* (supra). The agent does not receive the payment for its own benefit, but for the benefit of the principal. This means that the payment is technically received by the principal and is thus taxable in the principal’s hands - in the context of gross income.

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62 1947 (3) SA 256 (C) 14 SATC 419.
In a scenario where an agent-principal relationship exists, and the taxpayer SME is an agent, the SARS auditor may look for ways to confirm that the amount is included in the agent’s gross income if the evidence is weak as to the existence of an agent-principal relationship. The taxpayer SME must ensure that there is a contract between the parties that clearly outlines that the receipts and accruals are for the benefit of the principal.

Failure to produce a contract with such evidence the taxpayer SME may fail to discharge the onus of proving the non-taxability of such receipts and accruals earmarked for the principal. A simulated contract may not necessarily be effective as SARS and the judiciary tend to follow the principle of substance over form. In addition, the Income Tax Act is filled with specific anti-tax avoidance provisions and general anti-tax avoidance rules (GAAR). The agent-principal relationship should therefore be a bona fide contract entered into for business purposes.

Furthermore, it is important that the receipts and accruals that belong to the principal are placed in a separate bank account so that the principal’s amounts are demarcated from the agent’s amounts and thus eliminate any possible confusion that may arise. The separate account may also be the source of evidence that the principal’s amounts have not been appropriated by the agent for its own benefit. The agent should only include in its gross income amounts earned as a result of facilitating transactions between the principal and customers. The income earned by the agent in the agent-principal relationship is normally called “commission”. The commission is revenue in nature and it accrues to the agent for its own benefits. There should thus be detailed records that show a distinction between

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63 Erf 3183/1 Ladysmith (Pty) Ltd v CIR 1996 93) SA 942 (A), 58 SATC 229
64 Substance over form doctrine means that a judgment is not based on the form of the contract but on the effects the contract is giving. This doctrine was upheld in Erf 3183/1 Ladysmith (Pty) Ltd v CIR (supra), when the contracts the taxpayer had entered into were ignored and taxpayer was eventually taxed on the amounts that would have been diverted by the contracts.
65 Section 7 of the Income Tax Act, 58 of 1962, is an example of a specific anti-tax avoidance provision. Specific anti-tax avoidance provisions are colloquially referred to as a sniper approach.
66 Section 80A to 80L covers the general anti-tax avoidance rules and section 103 of the Income Tax Act. GAAR is sometimes referred to as a shotgun approach.
67 In Greases (SA) Ltd v CIR 1951 (3) SA 518, 17 SATC 358 it was effectively held that the deposit moneys received by a taxpayer would have escaped taxability if such depot moneys were held in a trust account.
commission earned by the agent and the proceeds that belongs to the principal so that there is no confusion between the two types of amounts.

If there is no separate bank account used to receive moneys that belong to the principal and the principal’s money is mixed up with that of the agent in the bank account, and there is no audit trail to identify the principal’s moneys, the SARS auditor is likely to include all the moneys received by the agent in its gross income regardless of whether a portion of those moneys should be taxed in the hands of the principal (section 102 of the Tax Administration Act, the burden of proof shifts to the taxpayer to prove the non-taxability of amounts). A taxpayer SME that operates as an agent should thus ensure the existence of the separate bank account for the principal’s moneys under its stewardship. The foregoing principles are equally applicable to deposits in general.68

The SARS auditor is thus likely to scrutinise “trade and other payables”, bank statements and cashbook to examine the nature of the amounts received but recorded as a liability. As SARS makes use of Computer Assisted Audit Techniques (CAATS)69, a SARS auditor can possibly search the whole general ledger for description of items such as the words “deposit” or “advance”.70 The onus of discharging the non-taxability of liability amounts received is on the taxpayer SME. The taxpayer SME should thus ensure that there are adequate records that clearly determine amounts received as liabilities from normal revenue. The taxpayer SME should, for example, place deposits in a trust account which must be clearly indicated they are to be refunded to customers.

The abovementioned analysis brings about the following checklist questions (refer to the checklist in chapter 5):

k. Have all the amounts received for the benefit of the taxpayer been included in gross income?

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68 For further details on deposits see Brookes Lemos Ltd v CIR 1947 (2) SA 976 (A) 14 SATC 295.
69 According to the 2012/13 Annual report at page 32.
70 CAATS is a reference to computer applications that are used to aid the auditing process. There are various brand names of computer applications that are available in the markets.
1. Have the amounts received as liabilities in respect of ordinary operations been included in gross income?

3.2.4 Receipts of a capital nature

Arguable, receipts of a capital nature, can be construed as one of the most problematic areas in terms of the application of the gross income definition. The amount may meet all the requirements of the gross income definition but if it is “not of a capital nature”, it will be included in gross income. On the contrary, amounts that are revenue in nature, are included in gross income.

A considerable amount of work has been written about the meaning of capital and revenue amounts (e.g. Silke, 2015 and case law). As the phrase “capital in nature” is not defined in the Income Tax Act, its ordinary grammatical meaning must be ascertained through the decisions held by the judiciary (CIR v George Forest Timber Company Ltd)\(^{71}\). Case law provides an example that there is no halfway house in the debate of “revenue vs capital”\(^ {72}\) i.e. an amount is either capital or revenue in nature. Williams (2009:169) argues the existence of a third category of income which is neither capital nor revenue exists. However, this view is yet to be confirmed by the judiciary and it is beyond the scope of this study to argue the point of the halfway house. It is however possible for an amount to be divided into revenue and capital amounts (Tuck v CIR).\(^ {73}\)

In CIR v George Forest Timber Company Ltd\(^ {74}\), de Villers JA stated:

“Whatever a person receives in the way of trade, business or profession is income...”

According to the learned judge, it may be implied that any amount derived by the taxpayer as a result of his wits and energy or by applying fixed capital will fall within the meaning of gross income. However the above statement requires some further clarification as a result of

\(^{71}\) 1924 AD 516 1 SATC 20.

\(^{72}\) See remarks in Pyott v CIR 1945 AD 128 13 SATC 121.

\(^{73}\) 1988 (3) SA 819 (A) 50 SATC 98.

\(^{74}\) 1955 (3) SA 293 (A) 20 SATC 113.
the judgement in *CIR v Pick n Pay Employee Share Purchase Trust*.\(^7^5\) In this case the court indicated that the carrying on of a business must still be distinguished from carrying on a scheme without the aim of making a profit. It is receipts and accruals that are derived in the scheme of profit-making that must fall within the meaning of gross income.

In *CIR v Visser*\(^7^6\) an analogy of the tree and its fruits was made wherein a tree was equated to capital and the fruit to revenue – the tree produces fruits. This analogy may be useful in trying to locate the nature of the amount. This analogy can be situated in the context of a business environment. The assets that are used to run the business are capital in nature and the income that is produced by virtue of running the business is revenue in nature. The proceeds from the disposal of assets are also of a capital nature just as the assets themselves are capital. The assets may further be broken down between fixed assets and floating assets (e.g. trading stock). A floating asset is excluded from the definition of assets\(^7^7\) that are of a capital nature (*CIR v George Forest Timber Company Ltd*) (supra). The foregoing analogy may seem to have clarified the principle, but in practice, it is not always easy to apply it effectively as the facts of each case may be complex in such a way that it becomes difficult to tell whether the amount should be revenue or capital in nature.

In *CIR v Lunnon*,\(^7^8\) the taxpayer had resigned as a company director and later the company decided to grant the taxpayer a gratuity in recognition of his past contribution to the company. The issue was whether the gratuity paid to the taxpayer should form part of his gross income or not. It was held by the court that the gratuity was a gift and thus of capital nature. In this case the taxpayer had no claim against the company so the payment could only have been a gift. This decision has been criticised for failing to recognise the principle that the amount in respect of services rendered is inherently revenue in nature (Williams, 2009:174; Goldswain, 2012:30) as the judge failed to recognise the link between the payment and the past services rendered by the taxpayer.

\(^7^5\) 1992 (4) SA 39 (A).
\(^7^6\) 1937 TPD 77 8 SATC 271.
\(^7^7\) An asset is any property or right that is used by the taxpayer in its ordinary operations.
\(^7^8\) 1924 AD 94 1 SATC 7.
The *nexus*\(^{79}\) among the cases dealing with the “revenue vs capital” debate as discussed, is the principle of “ordinary operations”. The ordinary operations principle generally implies it is the intention of the taxpayer to make profit. All the amounts that are deemed to be of a revenue nature have the quality of being derived in the ordinary course of business. It is thus reasonable to assert that receipts and accruals derived by reason of ordinary operations of the business are likely to be of a revenue nature. It is only under exceptional circumstances that amounts deemed not to be from ordinary operations, are included in gross income (*Stephan v CIR*).\(^{80}\)

There are furthermore instances of the taxpayer’s change of intention. For example, an asset could be held by the taxpayer for investment purposes and later be used for making profit. In some instances, there is uncertainty whether the change of intention has occurred or not. In *CIR v Richmond Estates (Pty) Ltd*\(^{81}\) the taxpayer had acquired land and held it as trading stock. However, the taxpayer argued that there had been a change of intention to the effect that the land was subsequently held as capital. The issue was whether the amounts received from the sale of the land was capital or revenue in nature. The court confirmed the taxpayer’s change of intention and held that the proceeds were capital in nature. However, the dissenting judgement by Schreiner JA effectively held that establishing the change of intention was not enough, something more was required, i.e. the actions of the taxpayer giving effect to the change of intention had to be ascertained. This dissenting judgment by Schreiner JA became influential in subsequent court rulings (*CIR v Stratohmore Consolidated Investments Ltd* 1959 (1) SA 469 (A) 478-C; *John Bell and Co (Pty) Ltd v SIR* 1976 (4) SA 415 (A) 426F; *Elandsheuwel Farming (Edms) Bpk v SBI* 1978 (1) SA 101 (A) 118B) on matters of change of intention (Williams, 2009:318).

Given the complexity of the aforementioned analysis, the SARS auditor may be interested in auditing receipts and accruals that have been excluded from gross income on the basis that they are of a capital nature. There is a possibility that the SARS auditor may not agree with

\(^{79}\) Nexus means the connection or common features among the cases that had been discussed.

\(^{80}\) 1919 WLD 1, 32 SATC 54.

\(^{81}\) 1956 (1) SA 602 (A), 20 SATC 355.
the taxpayer regarding the treatment of some of the excluded receipts and accruals given the complexity of the theory surrounding this issue.

If there are any receipts and accruals that have been excluded from gross income on the basis that they are of a capital nature, the taxpayer SME should ensure that such amounts do not arise in the ordinary operations of the business or the intention of making a profit is absent. The taxpayer SME should make an educated determination of the character of those receipts and accruals whether they are capital or revenue in nature and keep sufficient and appropriate evidence thereof. If the taxpayer SME is audited, SARS will raise an audit finding that will result in the incurrence of penalties if there is no sufficient and appropriate evidence available to state otherwise. The foregoing analysis brings about the following checklist questions (refer to the checklist in chapter 5):

m. Have all amounts received by virtue of ordinary operations been included in gross income?

n. Have all amounts that are of a capital nature been excluded from gross income, and properly evaluated to be of a capital nature?

The fact that an amount is regarded as being of a capital nature does not mean it has escaped any possible inclusion into gross income altogether. The amount can still be included in gross income by virtue of special inclusions. The special inclusions consist of paragraphs (a) to (n) of gross income. Amounts covered by special inclusions must specifically be included in gross income regardless of whether they are capital or revenue in nature (gross income definition in section 1 of the Income Tax Act). Any further discussion of the special inclusions is beyond the scope of this study as indicated in the beginning of this chapter.

Before 1 October 2001, receipts and accruals of a capital nature (those not covered by special inclusions) were never subject to tax (as they fell outside the tax net). For this reason, case law is filled with cases arguing the capital nature vis-a-vis the revenue nature of amounts. Many of these cases were heard before 1 October 2001 (Bourke’s Estate v CIR 1991 (1) SA 661 (A), 53 SATC 86 at 94; New Estate Areas Ltd v CIR 1946 AD 610, 14 SATC 155; CIR v

82 Special inclusions are additional amounts that are specifically deemed to form part of gross income.
African Oxygen Ltd 1963 (1) SA 681 (A), 25 SATC 67; CIR v Stellenbosch Farmers’ Winery 1945 CPD 377, 13 SATC 381). On 1 October 2001, the capital gains tax legislation came into effect bringing into the tax net receipts and accruals of a capital nature (those not covered by special inclusions). The capital gain is brought in as taxable income by means of section 26A and paragraph (n) of the gross income definition of the Income Tax Act read in conjunction with the Eighth Schedule.

There is, however, still an advantage of categorising an amount as of a capital nature despite the promulgation of capital gains tax. The advantage to the taxpayer SME is that a lesser portion of the amount is subjected to tax if it is classified as capital gain as opposed to gross income.

3.3 CONCLUSION

The gross income definition was discussed in as far as it relates to sales revenue and various contentious issues were identified and addressed in the context of a taxpayer SME and the SARS auditor. The questions posed in this chapter have been grouped together to form the “income part” of the checklist that is located in chapter 5, and they represent indicators of possible income tax errors. Through proper application of the checklist the taxpayer SME can be alert of the “common mistakes”\(^\text{83}\) on which SARS can possibly raise an audit finding. The checklist is therefore a precautionary measure against possible tax errors. The next chapter discusses the problematic income tax issues pertaining to the general deduction formula.

\(^{83}\) Refer to chapter 2, under paragraph 2.3.
CHAPTER 4: INCOME TAX ISSUES RELATING TO GENERAL DEDUCTION FORMULA

4.1 INTRODUCTION

The aim of this chapter is to continue with the analysis of the previous chapter *albeit* in respect of the general deduction formula (purchases). Again the analysis in this chapter is underpinned by the purposive approach to statutory interpretation.\(^{84}\)

It was emphasised in chapter 2 that SMEs face a number of tax compliance challenges and impediments in that there is often a probability of tax errors which may trigger a SARS audit finding in the event the SME is audited. This chapter analyses possible tax errors made in respect of the general deduction formula by taxpayer SMEs. The method of analysis carried out in the previous chapter shall *mutatis mutandis* apply in this chapter.

Tax deductions are regulated by two tests, namely the positive test and negative test.\(^{85}\) An amount must however pass both the tests in order to be tax deductible. Failure to meet the requirements of one of the tests renders an amount not to be tax deductible. SARS may raise an audit finding if the taxpayer claims an amount that is not tax deductible. In analysing the income tax issues on the general deduction formula, reference will thus be made to section 23 of the Income Tax Act.

4.2 GENERAL DEDUCTION FORMULA

The opening words of section 11 of the Income Tax Act are as follows:

> For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived...

It is clear from the opening words of section 11 of the Income Tax Act that the starting point in the determination of the deductibility of expenditure is to establish whether the taxpayer is

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\(^{84}\) Refer to section 39 of the Constitution as regards the method of statutory interpretation in South Africa and the introduction part of the previous chapter.

\(^{85}\) The positive test and the negative test are a reference to sections 11 and 23 respectively of the Income Tax Act.
carrying on a trade. Accordingly, the first requirement for the deductibility of expenditure is that of carrying on a trade at the time the expenditure was incurred. The SARS auditor, especially when the business is new, may want to investigate the expenditure that was incurred before the taxpayer commenced trading (pre-trade expenditure). This will help the SARS auditor to identify the expenditure that cannot be claimed under section 11 of the Income Act. It must be noted that pre-trade expenditure can be deducted under section 11A of the Income Tax Act.86

The opening words of section 11 are followed by various paragraphs under the same section. The first one being paragraph (a) which is a reference to the general deduction formula and it reads as follows:

Expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature.

The opening words of section 11 and paragraph (a) of the same section must be read together to test the deductibility of a particular expenditure. The general deduction formula regulates the deductibility of expenditure which is not directly addressed by other paragraphs to section 11 or other sections of the Income Tax Act for that matter (section 23B(3) of the Income Tax Act). The discussion of the general deduction formula is thus broken down into the following components for discussion (‘carrying on trade’ is excluded).

- Expenditure or loss
- Actually incurred
- In the production of income
- Not of a capital nature

The discussion of each of the abovementioned components follows below.

### 4.2.1 Expenditure or loss

86 Section 11A of the Income Tax Act has its own elaborate requirements that must be met.
Once it has been established that the taxpayer carries on a trade, the next step is to establish the expenditure or loss. In the ordinary sense expenditure is the amount that has been willingly expended by the taxpayer for the purpose of carrying on the business; whereas the loss is the extraordinary cost that arise out of the extraordinary circumstances of the business or that arises out of a mishap.

In *Port Elizabeth Electric Tramway Co v CIR*\(^{87}\), Watermeyer AJP stated:

> “The word ‘losses’ in this section appears to mean losses of the floating capital employed in the trade which produces the income.”

Whereas the same judge in *Joffe & Co (Pty) Ltd v CIR*\(^{88}\), stated:

> “The word ‘loss’ has several meanings. In relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money.”

From the above statements, it can be ascertained that loss involves involuntary spending, whereas expenditure involves voluntary spending.

The distinction between expenditure and loss was better explained in *COT v Rendle*\(^{89}\), where the judge held that expenditure is “money voluntarily and designedly spent” and loss as “money that was involuntarily spent”.

From the case above, it can be ascertained that expenditure involves an element of awareness, which awareness constitutes a planned expenditure by the taxpayer. A loss would entail an element of unpreparedness, and it seems taxpayers do not have control over the events that lead to the incurrence of the loss. For ease of reference in this dissertation, the term “expenditure” will include the meaning of “loss”.

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\(^{87}\) 1936 CPD 241, 8 SATC 13.

\(^{88}\) 1946 AD 157 13 SATC 354.

\(^{89}\) 1965 (1) SA 59 (SRAD), 26 SATC 326.
Expenditure involves an amount. In *Lategan v CIR*\(^90\) the court indicated that an amount need not be in cash; it can take the form of any other asset, and the asset may be corporeal or incorporeal.\(^91\) Although this case dealt with gross income the constitution of the meaning of the word “amount” is, it is suggested, equally applicable to expenditure.

Barter transactions would fall into this category of an amount other than cash\(^92\). The value of the property\(^93\) that has been disposed of by the taxpayer in exchange for another property will be regarded as an expenditure incurred. Likewise, the expenditure must result in an outflow of an asset (e.g. cash) i.e. a reduction in the taxpayer’s net worth.

The SARS auditor may establish (vouch for) the reduction in the taxpayer’s net worth by scrutinising the supplier invoice to ensure its validity, and proof of payment to ensure the occurrence of the outflow of cash or some other form of asset. Establishing (vouching) whether an amount is really expenditure is, it is suggested, done simultaneously with the verification of the incurrence of the expenditure (actually incurred).

By scrutinising a supplier invoice, the SARS auditor may want to establish whether the taxpayer SME has incurred a legal obligation in respect of the expenditure (first factor) and will inspect proof of payment to confirm that the liability was settled by the taxpayer (second factor). These two factors will help establish the occurrence of expenditure. It is important to establish the identity of the person who settles the liability because if it is not settled by the taxpayer, then the whole scheme of the tax deduction collapses. In this regard the taxpayer cannot be said to have incurred the expenditure (Legwaila, 2013:324).

Paragraph 23(c) of the Income Tax Act prohibits the claiming of expenditure that is recoverable from another party. If for example the expenditure is claimable from an insurer, it is prohibited by this paragraph for a deduction – the same applies in the case where the taxpayer is a subsidiary and the expenditure is recovered from the holding company. If the

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\(^90\) 1926 CPD 203, 2 SATC 16.
\(^91\) For example, section 24B allows for the deductions of shares as expenditure under certain circumstances.
\(^92\) Barter transactions involve the exchange of goods or services for other goods or services without the use of money.
\(^93\) It will have to be objectively determined i.e. by reference to the market price.
expenditure has already been claimed, it must be included in the income of the taxpayer in the subsequent tax period (in which it is recovered) in terms of section 8(4)(a) of the Income Tax Act. The SARS auditor will not hesitate to reverse expenditure that was recovered by the taxpayer. The foregoing analysis brings about the following checklist questions (refer to the checklist in chapter 5):

- o. Has the expenditure claimed been paid by the taxpayer (not paid by another entity)?
- p. Will all accrued expenses be paid by the taxpayer in the following year (not by another entity)?
- q. Is the expenditure claimed not recoverable from another party?

### 4.2.2 Actually incurred

For expenditure to be deductible, it must *inter alia* meet the requirement of “actually incurred”. “Actually incurred” means the taxpayer has incurred an unconditional legal obligation to effect payment in respect of the expenditure (*Edgars Stores Ltd v CIR*). However, the phrase “actually incurred” does not mean “paid”, and for expenditure to be actually incurred it will be enough to incur a legal obligation to pay for the expenditure (*Edgars Stores Ltd v CIR*) (supra). The expenditure need not have been paid at the end of the tax period for it to be deductible for as long as the liability exists in respect of the expenditure.

This view may be misleading from a practical point of view in that the taxpayer SME may mistakenly think that producing proof of having incurred a liability is the final requirement of claiming the expenditure. Although, the unpaid expenditure may be deductible at the end of the tax year, the SARS auditor may want to see proof of payment subsequent to year end to ensure that the expenditure was actually paid by the taxpayer. If the liability is not settled by the taxpayer but by someone else (e.g. a holding company), the expenditure will, as discussed earlier on, not be deemed to have been incurred by the taxpayer. For example, if the outstanding electricity bill at the end of the financial year is subsequently settled by the shareholder and not by the business itself, the business cannot be said to have incurred the

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94 1988 (3) SA 876 (A) 50 SATC 81.
expenditure. The taxpayer will be deemed to have recouped the expenditure as it was recovered from the shareholder.\(^95\) The requirement that the expenditure need not be paid to be deductible is thus a temporary measure of relief.

To avoid any pitfalls, the shareholder should lend the money to the taxpayer SME instead of settling the liability directly on behalf of the taxpayer. The taxpayer will thus have received the money from the shareholder and subsequently record a liability in the books. Once this is done, the taxpayer can then take the very same money and use it to settle the debt. In this way the expenditure will be deductible in the hands of the taxpayer.\(^96\)

Expenditure in relation to a provision for leave (\(Pyott v CIR\))\(^97\) and contingent liabilities do not rank for a deduction (\(Nasionale Pers Bpk v KB\))\(^98\); Edgars Stores Ltd v CIR (supra)) as they do not represent an unconditional liability. These provisions and similar accounting entries should be reversed for the purposes of computing taxable income (if the starting point is net profit as per income statement)\(^99\). Reviewing the tax computation should logically be one of the first steps of a SARS auditor\(^100\); it is therefore important for the taxpayer SME to ensure that expenditure relating to provisions is reversed in the tax computation so that it is not claimed as a deduction.

Paragraph 23(e) prohibits the deduction of expenditure that is carried to a reserve fund or capitalised in any way\(^101\). Provision is an example of a reserve fund. Expenditure relating to the provision is not actually incurred as the existence of the liability is uncertain (\(Concentra (Pty) Ltd v CIR\))\(^102\); \(Pyott v CIR\) (supra)).

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\(^{95}\) Section 8(4)(a) of the Income Tax Act covers recoupment whereas section 23(c) prohibits the deduction of recoverable expenditure.

\(^{96}\) In terms of section 11 (a) (general deduction formula) of the Income Tax Act.

\(^{97}\) 1945 AD 128 13 SATC 121. The expenditure relating to provision for leave is now regulated by section 7B of the Income Tax Act.

\(^{98}\) 1986 (3) SA 549 (A).

\(^{99}\) This is based on common sense in that if the non-deductible amounts have been subtracted from revenue they should be added back when calculating taxable income.

\(^{100}\) Because in the tax computation, adjustments are made to the net profit in order to calculate taxable income. These adjustments should logically be verified before further audit procedures can be carried out. It follows the notion of understanding the bigger picture before delving in the detail.

\(^{101}\) Section 23(e) of the Income Tax Act states that “no deductions shall in any case be made in respect of the following matters, namely – income carried to any reserve fund or capitalised in any way.”

\(^{102}\) 1942 CPD 509, 12 SATC 95.
Furthermore, the expenditure cannot be claimed if the corresponding liability is still under dispute and such liability has not been established (CIR v Golden Dumps (Pty) Ltd).\textsuperscript{103} The taxpayer SME should ensure that expenditure that is still subject to a dispute or litigation is not claimed even if it is probable that it may be incurred. This will help to avert any possibility of a SARS audit finding.

In the case where the liability for the expenditure exists but the quantum cannot be established with certainty at the end of the tax period, the taxpayer is allowed to claim the deduction but will have to make a reasonable estimate of the amount based on the available information (Edgars Stores Ltd v CIR) supra. If the estimate is unreasonable, SARS can set it aside and present the taxpayer with an alternative calculation (section 95 of the Tax Administration Act). The estimate of expenditure does not apply in respect of acquisition of an asset.\textsuperscript{104}

In addition, expenditure must be claimed in the tax period in which it is actually incurred and consequently the taxpayer thus cannot choose the tax period in which to claim the expenditure (Concentra (Pty) Ltd v CIR) (supra). The expenditure from previous tax years claimed in the current year will accordingly be disallowed by the SARS auditor.

For tax purposes, the distinction between extravagant and cost-effective expenditure is not necessary. What is important is that the expenditure must be actually incurred (Port Elizabeth Electric Tramway Co v CIR) supra. In this regard, SARS does not have the authority to tell the taxpayer SME how to run its business. However, SARS can still disallow excessive expenditure but in respect of connected persons only (Tobacco Father v COT).\textsuperscript{105}

When dealing with connected persons, the taxpayer SME should ensure that transactions are entered into in a similar fashion as willing parties would do in an open market i.e. at arm’s

\textsuperscript{103} 1993 (4) SA 110 (A), 55 SATC 198.

\textsuperscript{104} Section 24M (2) of the Income Tax Act.

\textsuperscript{105} 1950 17 SATC 395 (SR).
length\(^{106}\). A market related interest must be charged if the inter-related party transaction is for example a loan. If this interest expense is excessive it may be perceived by a SARS auditor as unreasonably reducing the tax liability of the party claiming the deduction. There may however be dividends tax consequences for the taxpayer SME if the loan account is in a debit balance and no interest is charged. The foregoing analysis brings about the following checklist questions (refer to the checklist in chapter 5):

r. Is the expenditure claimed supported by a valid supplier invoice?
s. Does the supplier invoice reflect the name, address and VAT number (if applicable) of the taxpayer?
t. Did the taxpayer perform cut-off procedures to ensure that expenditure is recorded in the correct tax period?
u. Has expenditure relating to provisions or contingent liabilities been reversed in the tax computation?

4.2.3 In the production of income

The phrase in the ‘production of income’ is one of the important components of the general deduction formula. The phrase, put in other words, can be interpreted to mean “for the purposes of earning income”.

In carrying out a trade, the taxpayer SME incurs various types of expenditure. Some of the taxpayer’s expenditure for example may be incurred to generate sales revenue or the expenditure may consist of a gift to a person. The former mentioned expenditure may rank for a deduction as there is a close link between the expenditure and the generation of sales revenue, and the latter cannot rank for a deduction as there is no nexus between the gift expenditure and the earning of sales revenue.

This principle was illustrated in *Port Elizabeth Electric Tramway Co v CIR* supra, where Watermeyer AJP stated:

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\(^{106}\) Arm’s length implies that the buyer and seller are independent of each other and each would want to fulfil his or her interest as normal parties would do in an open market.
A little reflection will show that the two questions arise (a) whether the act, to which the expenditure is attached, is performed in the production of income, and (b) whether the expenditure is linked to it closely enough.

What Watermeyer AJP suggests is that it must first be established whether the act that has caused the expenditure is connected to the taxpayer’s ordinary operations. If such connection exists, the next step is to establish the nexus between the expenditure and the said act. If the act and the expenditure cannot be linked, the expenditure cannot be deducted. It is possible that the expenditure may be linked to the act but the act may not be connected to the taxpayer’s ordinary operations. In such a scenario, the expenditure may also not be deductible. Incidental expenses incurred bona fide by virtue of ordinary operations of the taxpayer are also in the production of income (CIR v Genn & Co (Pty) Ltd).\textsuperscript{107}

When inspecting a supplier’s invoice, the SARS auditor may scrutinise the description in the invoice to establish whether it is related to the nature of the business. The taxpayer SME should thus make sure that the descriptions reflected in supplier invoices highlight the SME’s ordinary operations.

The phrase “in the production of income” does not imply the requirement to produce income in the same year in which the expenditure is claimed. The expenditure may be incurred in the current tax year whilst income may be earned in subsequent tax years and in such a scenario, the expenditure may still be regarded as incurred in the production of income in the current year. The matching principle of accounting (of recognising expenditure only when the income relating to the expenditure is recognised) is not applicable in taxation. It is not a requirement that expenditure must be claimed in the year income is received or accrued\textsuperscript{108}. For as long as the expenditure is incurred in good faith with the aim of generating income in the near future, it can be claimed. This view is derived from the decision in Sub-Nigel Ltd v CIR, where Centlivres JA stated:

\textsuperscript{107} 1955 (3) SA 293 (A) 20 SATC 113.

\textsuperscript{108} Sub-Nigel Ltd v CIR 1948 (4) SA 580 (A) 15 SATC 381.

\textsuperscript{109} 1948 (4) SA 580 (A) 15 SATC 381.
“The mere fact that no income has actually resulted is, in my view, irrelevant: the purpose was to obtain income on the happening of a fire which would prevent the carrying on of income-producing operations”.

It is thus vital that the expenditure incurred match the taxpayer’s legitimate business purpose to derive income in the production of income. A new business that will take many years to earn income must have a sound business plan so that when presented to SARS, it can be accepted as a legitimate business purpose. For example, businesses involved in property development, mining exploration and farming are some of the types of businesses that may take more than one tax year to earn income.

Amounts paid to former employees in recognition of their past services are not deductible as no link can be established between the expenditure incurred and the earning income derived by the business (WF Johnstone & Co Ltd v CIR).\textsuperscript{110} There is no tax symmetry on this matter as the amount will be taxable in the hands of the recipient. The expenditure may however be deductible if it is the policy of the employer to pay former employees so as to motivate and boost the morale of current employees to remain in the employment of the taxpayer (Williams, 2009:451).

The taxpayer SME should always ensure that all expenditure is incurred in the ordinary operations of the business, so that transactions can be properly structured right from the outset.

Expenditure incurred for the maintenance of the taxpayer is not incurred in the production of income as it relates to the personal circumstances of the taxpayer (L v Commissioner of Taxes).\textsuperscript{111} Section 23(a) of the Income Tax Act also prohibits the claiming of such expenditure.

Similarly, private or domestic expenditure is also not incurred in the production of income. If the expenditure is mistakenly claimable in terms of the general deduction formula, it is still

\textsuperscript{110} 1951 (2) SA 283 (A) 17 SATC 23.
\textsuperscript{111} (1992) 54 SATC 91 (ZHC).
prohibited by section 23(b) of the Income Tax Act. The deduction of private expenditure was challenged by the revenue authority in *CIR v Hickson* but the taxpayer was successful in claiming the deduction. However, the taxpayer SME should be careful of claiming private expenditure, as it is unlikely that the facts may be similar to those in *CIR v Hickson* supra. It is submitted that the SARS auditor will not hesitate to reverse a deduction related to private expenditure. The taxpayer SME should only claim such expenditure if there is sufficient proof to convince the SARS auditor otherwise.

Section 23(f) of the Income Tax Act specifically prohibits the taxpayer SME claiming any expenditure that is incurred to earn income that will not be subject to tax (*CIR v Nemojim (Pty) Ltd*). If a taxpayer SME receives a loan to finance a dividend pay-out, the interest paid on the loan cannot be claimed as a deduction as the purpose of the loan was not to produce income (*Tickin Timbers CC v CIR*). The purpose of the loan and the effect of such loan are two important criteria in the determination of the deductibility of loan interest expense (*CSARS v Scribante Construction (Pty) Ltd*). The foregoing analysis brings about the following checklist questions (refer to the checklist in chapter 5):

- v. Is the description of goods or services adequately described in the supplier invoice?
- w. Does the description of goods or services received by the taxpayer relate to the nature of the taxpayer's business?
- x. Did the taxpayer claim not expenditure in respect of the maintenance of the taxpayer or his family?
- y. Did the taxpayer make not withdrawal from the company's bank account that will attract STC or dividends tax?
- z. Is all expenditure incurred for the generation of sales revenue?

### 4.2.4 Not of a capital nature

The last component of the general deduction formula is “not of a capital nature”. For the expenditure to be acknowledged as a deduction (after having met all the previous
requirements\textsuperscript{116}), it must be regarded as expenditure not of a capital nature.\textsuperscript{117} There seems to be tax symmetry with regards to amounts of a capital nature: an amount of a capital nature is not included in gross income and the other hand it is also not deductible in terms of the general deduction formula.

Expenditure which is incurred through ordinary business activities can be divided into expenditure of a capital nature and that of a revenue nature. The expenditure incurred by the business may for example be intended to generate sales revenue, or it may be intended to increase the earning capacity of the business. The first type of expenditure is tax deductible whereas the latter is not, as it is capital in nature.

The phrase “capital in nature” is not defined in the Income Tax Act and therefore reference must be made to case law to determine how the judiciary has interpreted the phrase. In \textit{Sub-Nigel Ltd v CIR} supra, Centlivres JA remarked:

\begin{quote}
It is, in my view, impossible to give a definition of what is expenditure of a non-capital nature which will act as a touchstone in deciding all possible cases and it would be impracticable to attempt such a definition.
\end{quote}

From the remark made by the judge it can be established that there is no exact definition of the term “not of a capital nature” and therefore recourse must be had to case law to establish the meaning of the term. There are three tests that have been established by case law\textsuperscript{118} to test whether an amount is of a capital nature or not, and they are listed as follows:

\begin{itemize}
    \item A. The nexus between expenditure and ordinary operations or income earning structure\textsuperscript{119};
    \item B. Enduring benefit\textsuperscript{120}, and
    \item C. Distinction between fixed capital and floating capital\textsuperscript{121}.
\end{itemize}

\textsuperscript{116} These requirements are, “expenditure or loss”, “actually incurred” and “in the production of income”.
\textsuperscript{117} The opposite of a capital nature is of a revenue nature.
\textsuperscript{118} Refer to the case law here.
\textsuperscript{119} \textit{CASARS v BP South Africa (Pty) Ltd} 2006 (5) SA 559 (SCA), refer in this case to the part that deals with pe-paid rental.
\textsuperscript{120} \textit{British Insulated & Helsby Cables v Atherton} [1926] AC 205.
\textsuperscript{121} \textit{CIR v George Forest Timber Company Ltd} 1924 AD 516, 1 SATC 20.
The abovementioned tests are not exhaustive and can only serve as indicators of whether an amount is capital or revenue in nature. Each case needs to be evaluated based on its own merits taking into account a variety of factors as an expenditure “of a capital nature” in one business may be “of revenue nature” in another business. Below follows a discussion of the three tests.

4.2.4.1 The nexus between expenditure and ordinary operations or income earning structure

In establishing whether the expenditure is capital or revenue in nature, an analysis is normally carried out to establish whether the expenditure relates to the day-to-day operations of the business or to the income-earning structure of the business. The expenditure that would relate to the day-to-day operations is for example delivery costs, purchases, maintenance costs and other related expense. The expenses that relate to the income earning structure are for example fixed assets such as furniture and fittings, vehicles, licence, and copyrights. In this regard, Innes J in *CIR v George Forest Timber Company Ltd* supra, *inter alia* stated:

Now, money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield future profit; and while the outlay does not recur, the income does. There is a great difference between money spent in creating or acquiring a source of profit and money spent in working it. The one is capital expenditure, the other is not.

Innes J suggests that expenditure that relates to the ordinary operations of the business is revenue in nature and should be deductible under the general deduction formula, whereas expenditure that relates to the income earning structure is not deductible under the general deduction formula. The taxpayer SME should thus ensure that the expenditure claimed can be linked to the ordinary operations (generation of sales revenue) of the business.

The foregoing analysis brings about the following checklist question (refer to the checklist in chapter 5).

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122 For example, the nature of the business, the purpose of the expenditure and the nature of the expenditure.
123 This is in the context of general deduction formula.
aa. Is the expenditure closely connected to the ordinary operations of the business?

4.2.4.2 Enduring benefit
Another test that is used is to establish whether the expenditure is of a capital nature, is one which determines whether the expenditure gives rise to an “enduring benefit”. In other words, the enquiry is whether the expenditure creates a durable benefit that lasts for more than one tax period. The expenditure is of capital nature if it is established that the expenditure creates a lasting benefit. For example, the acquisition of a right to produce a particular product creates an enduring benefit in that the taxpayer will be allowed to produce the product over a prolonged period of time.

If the taxpayer SME incurs expenditure that creates a lasting benefit but does not result in the ownership of a fixed asset, the expenditure is revenue in nature (Palabora Mining Company Limited v SIR)124. The expenditure is thus deemed to be closely linked to the ordinary operations of the taxpayer. Although this view may be simplistic; each case should still be judged on its own merits. The expenditure should be classified as an asset if it produces an enduring benefit, otherwise the SARS auditor will raise an audit finding. The foregoing analysis brings about the following checklist question (refer to the checklist in chapter 5.

bb. Where expenditure creates an enduring benefit, has it not been claimed as a deduction?

4.2.4.3 Distinction between floating and fixed capital
It can sometimes be useful to distinguish between floating capital and fixed capital (CIR v George Forest Timber Company Ltd).125 On the one hand, floating capital is expenditure (e.g. purchase of trading stock) that is revenue in nature and is deductible in terms of the general deduction formula. On the other hand, fixed capital (e.g. motor vehicle in a supermarket that is used to collect trading stock from suppliers) on the other hand is expenditure that is capital in nature and does not rank for a deduction in terms of the general

124 1973 (3) SA 819 (A).
125 1924 AD 516 1 SATC 20.
deduction formula. The foregoing analysis brings about the following checklist questions (refer to the checklist in chapter 5):

cc. Has expenditure in respect of fixed assets not been claimed as a full deduction?

4.3 CONCLUSION

The general deduction formula, relevant provisions in respect of section 23 of the Income Tax Act and case law were analysed against the problematic income tax issues in order to raise an audit finding on tax errors. Suggestions were provided in how the taxpayer SME should address these problematic income tax issues which may lead to tax errors. The questions posed in respect of these problematic income tax issues represent the indicators for possible tax errors made by SME taxpayers and therefore constitute a “deductions” part of the checklist located in chapter 5.

By responding effectively to the questions posed in the checklist, the taxpayer SME is likely to address the common tax errors that have been discussed. Over and above the checklist, the taxpayer SMEs should bear in mind the specific anti-tax avoidance provisions and the general anti-tax avoidance rules especially when formulating tax strategies.
CHAPTER 5: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 INTRODUCTION
The aim of the chapter is to synthesize and summarize the analyses from the previous chapters, reach the necessary conclusions and to make recommendations. The aim of this dissertation as indicated in chapter 1 was to develop a checklist of indicators whose main purpose was to alert taxpayer SMEs of possible income tax errors which may trigger a SARS audit finding.

5.2 SUMMARY
Among other factors that have influenced the study is the fact that SMEs play a significant role in the economy. They employ a sizeable portion of the labour force and most importantly their contribution to the Gross Domestic Product (GDP) is noteworthy. If the SMEs are ignored and not assisted to grow and sustain themselves in the midst of challenges and impediments they face, they are likely to fail and as a result the economy may be negatively impacted.

SMEs do not only face challenges such as access to finance but also various challenges such as the regulatory environment, high compliance costs (which are regressive in nature), low levels of entrepreneurial skills. In this regard, the government has instituted various initiatives in a bid to promote and develop SMEs in the country.

One of these initiatives was the introduction of the structure called Small Enterprise Development Agency (SEDA) which is aimed at promoting and developing SMEs in the country. Although these initiatives should be commended, many challenges still remain that are a stumbling block to the growth of SMEs such as the complex regulatory environment which also contributes to high compliance costs. For example, the red tape that is associated with Companies and Intellectual Property Commission (CIPC) and VAT registration with SARS are a nightmare to small businesses.

In order to produce the checklist, the gross income definition and general deduction formula had to be analysed to identify income tax issues that may potentially lead to tax errors which
could trigger a SARS audit finding in the event of an audit. The gross income definition was analysed in chapter 3 and problematical tax issues relating to the general deduction formula, were analysed in chapter 4. Accordingly, chapters 3 and 4 represented the influence of the independent variable in tax matters and form the core of this dissertation. The checklist that is produced in this chapter represents the dependent variable which is the outcome of this research.

This checklist of indicators is not produced for every type of business but it is aimed at small and medium enterprises (SMEs). Some of the problematical tax issues identified in the analysis ranged from simple matters of tax compliance to complex grey areas of the law. Large businesses are able to deal much more efficiently with problematic tax issues as they are able to employ qualified professionals whereas SMEs may not have the financial backing to employ such professionals.

This study was confined to the tax compliance impediments and challenges facing SMEs in respect of and avoiding possible tax errors on the gross income definition and general deduction formula that are arguably relevant to SMEs. Its outcome was the contextualisation of indicators in the form of a checklist to assist SME’S in avoiding tax errors and is set out below.

5.3 CONCLUSION
The research question that was posed from the onset was: given the common tax errors committed by SMEs on gross income definition and general deduction formula what solution can be produced to reduce the probability of these tax errors?

The published checklist of indicators (as shown below) was part of the research objective and serves as a tool to be used by SMEs to help avoid possible tax errors that may lead to an audit finding.

This checklist of indicators should be considered before tax returns are completed and at the beginning of the financial year to help with their tax planning timeously.
As indicated in the problem statement, there are many previous research initiatives that have been carried out before on SMEs but none has dealt directly with tax errors in respect of the gross income definition and general deduction formula. The checklist of indicators for SMEs is published below in fulfilment of the research objective of this study.

**Figure 2: The checklist of indicators for SMEs.**

<table>
<thead>
<tr>
<th>ALPHABET</th>
<th>GROSS INCOME DEFINITION QUESTIONS</th>
<th>PAGE NUMBER</th>
<th>YES</th>
<th>NO</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>Has all revenue from barter transactions been accounted for?</td>
<td>26</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>Have all amounts earned been included in gross income at nominal value or at market value for barter transactions?</td>
<td>26</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>Have all amounts received by the taxpayer (with the exception of borrowed moneys) been included in gross income?</td>
<td>27</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d</td>
<td>Has all deferred income in respect of ordinary operations of the business been included in gross income?</td>
<td>27</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e</td>
<td>Has the income not yet received in respect of services rendered or goods delivered been included in gross income?</td>
<td>29</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f</td>
<td>Is the date on the sales invoice a true reflection of the accrual date of the amount to be received?</td>
<td>29</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>g</td>
<td>Are sales invoices issued sequentially numbered?</td>
<td>29</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>h</td>
<td>Has the general ledger or sales journal been inspected to confirm the sequence of sales invoice (and credit note) numbers?</td>
<td>29</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i</td>
<td>Have cut-off procedures been performed to ensure that sales invoices are recorded in the correct tax period?</td>
<td>29</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>j</td>
<td>Has the reconciliation between IT and VAT turnovers been conducted, and discrepancies appropriately accounted for?</td>
<td>29</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>k</td>
<td>Have all the amounts received for the benefit of the taxpayer been included in gross income.</td>
<td>31</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>l</td>
<td>Have the amounts received as liabilities in respect of ordinary operations been included in gross income?</td>
<td>32</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>m</td>
<td>Have all amounts received by virtue of ordinary operations been included from gross income?</td>
<td>35</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>n</td>
<td>Have all amounts that are of a capital nature been excluded in gross income, and properly evaluated to be of a capital nature?</td>
<td>35</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ALPHABET</th>
<th>GENERAL DEDUCTION FORMULA QUESTIONS</th>
<th>PAGE NUMBER</th>
<th>YES</th>
<th>NO</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>o</td>
<td>Has the expenditure claimed been paid by the taxpayer (not paid by another entity)?</td>
<td>41</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>p</td>
<td>Will all accrued expenses be paid by the taxpayer in the following year (not by another entity)?</td>
<td>41</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>q</td>
<td>Is the expenditure claimed not recoverable from another party?</td>
<td>41</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>r</td>
<td>Is the expenditure claimed supported by a valid supplier invoice?</td>
<td>44</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Continued:

<table>
<thead>
<tr>
<th>ALPHABET</th>
<th>GENERAL DEDUCTION FORMULA QUESTIONS</th>
<th>PAGE NUMBER</th>
<th>YES</th>
<th>NO</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>s</td>
<td>Does the supplier invoice reflect the name, address and VAT number (if applicable) of the taxpayer?</td>
<td>44</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>t</td>
<td>Did the taxpayer perform cut-off procedures to ensure that expenditure is recorded in the correct tax period?</td>
<td>44</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>u</td>
<td>Has expenditure relating to provisions or contingent liabilities been reversed in the tax computation?</td>
<td>44</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>v</td>
<td>Is the description of goods or services adequately described in the supplier invoice?</td>
<td>47</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>w</td>
<td>Does the description of goods or services received by the taxpayer relate to the nature of the taxpayer's business?</td>
<td>47</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>x</td>
<td>Did the taxpayer not claim expenditure in respect of the maintenance of the taxpayer or his family?</td>
<td>47</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>y</td>
<td>Did the taxpayer not make withdrawal from the company's bank account that will attract STC/dividends tax?</td>
<td>47</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>z</td>
<td>Is all expenditure incurred for the generation of sales revenue?</td>
<td>47</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>aa</td>
<td>Is the expenditure closely connected to the ordinary operations of the business?</td>
<td>50</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>bb</td>
<td>Where expenditure creates an enduring benefit, has it not been claimed as a deduction?</td>
<td>50</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>cc</td>
<td>Has expenditure in respect of fixed assets not been claimed as a full deduction?</td>
<td>51</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

5.3.1 Use of the checklist of indicators

The taxpayer SME should ask itself the questions in the checklist before the compilation of tax information is completed and sent to SARS.

If the answer to each of the above questions is the in the affirmative it means the taxpayer SME has addressed the problematic tax issues. However, if the answer is in the negative it means the taxpayer has not addressed the problematic tax issues.

The “not applicable” column may still be construed as a risk area and as a result, the taxpayer SME should perform verification procedures to ensure that the question is indeed not applicable.

The checklist of indicators is not foolproof in that after applying it, the revenue authorities will not detect a discrepancy, as human errors still occur.

55

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5.4 RECOMMENDATIONS

Taxpayers operate in a changing and dynamic environment. Income tax legislation is for example updated annually. Emerging trends may dictate change in the manner in which businesses must operate and SARS may respond to the changing environment by developing new techniques of dealing with errant taxpayer behaviour. It is therefore recommended that this checklist of indicators be treated as a living document as opposed to a static one. It must be reviewed and updated regularly to keep it abreast with latest developments, and future research efforts.

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DOI: http://dx.doi.org/10.4314/ldd.v14i1.14


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*Bourke’s Estate v CIR* 1991 (1) SA 661 (A), 53 SATC 86 at 94

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*Brookes Lemos Ltd v CIR* 1947 (2) SA 976 (A) 14 SATC 295

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