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No-shows, cancellations, and deductibility for tax purposes

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The law allows a business to deduct the expenses that it has incurred towards its business operations against the revenue that it has generated so that it can determine the amount that is subject to tax. On the revenue side of the equation, there are the sales that the business will make, while on the expenses side there are the inputs that the business will purchase in order to carry out its day-to-day operations. The negative impact of COVID-19 has brought to the fore unique scenarios which may not have been contemplated under the current tax rules and the tax authority and taxpayers have found themselves groping for solutions.

Due to restrictions imposed by governments, there was a significant increase in no-shows as well as the cancellations of contracts. In some instances where clients had already paid deposits for the supplies that they wanted or even where they had paid the entire sum for the consideration, most businesses found themselves, either through choice or circumstances, in a position where they had to refund the amounts paid. Though driven by commercially justified reasons which were aimed at ensuring that the business remains a going concern, the taxman could have a different view, especially now that 2020 is under the spotlight.

The law treats the receipt of a deposit as a tax trigger and requires businesses that receive monetary deposits or up-front payment in relation to supplies to account for VAT due at this point. The law also requires that businesses record that supply through its electronic fiscal device. A refund of the amount paid automatically means a cancellation of the sale, resulting in potential compliance challenges for the business. For example, administratively, credit notes have to be first endorsed by the TRA, with the turnover reported on filed VAT returns having to be reconciled with the turnover reported through the electronic fiscal device.

Wholly and exclusive in the production of income

There is also the question of bad debts which arises where a supply was made, an invoice was issued but, due to factors beyond its control, the client is unable to pay, and how the business should treat these for tax purposes. The bad debt eligibility criteria for both VAT and income tax are different and the business needs to ensure that the amounts in question fulfil the criteria in relation to each – a bad debt for VAT purposes is not necessarily a bad debt for income tax purposes.

The flip side of the coin relates to the deduction of expenditure that was incurred by the business towards revenue-generating activities and which either resulted in the revenue above and or is yet to result in revenue in the financial year under consideration. Just to clarify, I am not referring to capital expenditure which should be depreciated over a period of time; I am referring to expenditure that is incurred *wholly and exclusively in the production of income from the business or investment* and which is deductible for income tax purposes. While a business might have incurred expenditure that is wholly and exclusively in the production of income, the question that is emerging from this phrase is whether such expenditure ought to yield income for it to be deductible?

There is a school of thought that answers this question in the affirmative and argues that expenditure is only deductible for income tax purposes if it yields income. However, adopting such an interpretation means that businesses should be taxed on the amount of debt or equity that they inject into their business. Take, for example, a hotel that had to scale down its operations because of COVID-19 restrictions but its owners decided to continue paying its employees and injecting money into the hotel's infrastructure to make sure that it did not fall into disrepair. Or an airline company that had to continue making lease payments to the aircraft's lessor and also pay for the maintenance of the aircraft, the civil aviation authority and the pilots and crew all the while the aircraft were grounded.

Prudent businesses often take a long-term view of their business ventures; they invest now with the hope that it will result in profit down the line which timeframe depends on the nature of the business and the investor's patience and appetite for risk. It is for this reason that the operators of the hotel above will choose to keep the hotel's infrastructure up and running while the hotel is shut down because it would cost more to completely shut down the hotel, send all employees home during this period and then spruce up the hotel and get everything running once a guest makes a booking. It would also not be prudent for the airline company to terminate the lease, deregister the aircraft with the civil aviation authority, return the aircraft to the lessor, send the pilots home and then reverse all these and start all over again once it gets a paying passenger. Indeed it is for such commercial reasons that businesses will decide whether or not to impose a no-show or cancellation fee or waive it.

Case law precedents on deductibility

The tax dispute in ***Bulyanhulu Gold Mine Ltd v. Commissioner General (TRA)****, Consolidated Civil Appeals No. 89 & 90 of 2015* revolved around the deductibility of various capital and ordinary expenditure amounts that had been incurred. In its decision, the Court of Appeal said that "wholly" refers to quantum of the expenditure in that the whole amount sought to be deducted should have been incurred for the trade and not only part of it; and that 'exclusively' means that the expenditure must have been incurred solely for the purpose of the trade. In accepting that the nature of a business venture requires accepting the fact it could result in either a profit or a loss, the court went ahead to set out seven principles that should be used to determine whether expenditure has been incurred "wholly and exclusively" for the purpose of producing income and indicated that the generation of income or profit is not a prerequisite to deduction of expenditure that is wholly and exclusively incurred towards a business's operations.

The phrase *wholly and exclusively in the production of income* has its roots in English law; however, it is not only there but also in other Commonwealth countries where a number of court decisions have sought to define this phrase. The High Court in Kenya has adopted a position similar to the position of the Court of Appeal of Tanzania. In ***Mars Logistics Limited v. The Commissioner of Domestic Taxes****, Income Tax Appeal No 6 of 2018*, the High Court said that the criterium for determining whether expenditure was incurred in the production of income should be whether the expenditure was connected to the taxpayer's income-earning operations, rather than whether the expenditure actually produced income or was directly linked to income.

Often, those going into business fund their venture through either debt or equity and they do so with the full knowledge of the inherent risk that comes with it. The debt or equity that is injected into the business venture is used to procure assets and at the same time will also purchase inputs and incur expenses which are necessary for the business to make its own supplies and generate revenue. If it is successful, it might make enough profit to pay off its debt and provide a return on investment to its shareholders. If on the other hand it is unsuccessful, it will end up owing the banks and its shareholders would have made a loss on their investment.

Since tax audits by the revenue authorities are often retrospective in relation to the periods that they examine, deductibility is likely to come up when they start looking at 2020 and the spotlight will be on businesses that had to scale down operations or shut down altogether but continued to incur expenses during this period.

If you have any questions regarding this or if you would like to get in touch, please contact ***Joseph Thogo*** *(joseph.thogo@dentons.co.tz) or your usual contact at Dentons EALC.*

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