

**ENFORCEMENT
AUDIT****Office**

Alberton Campus

Enquiries

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Date

1 April 2017

RJ Generators (Pty) Ltd

PO Box 4040

Cape Town

8000

South African Revenue Service

Gauteng South Enforcement

Centre

McKinnon Crescent, New

Redruth

Alberton

Website: www.sars.gov.za

Dear Taxpayer

TAXPAYER:

RJ Generators (Pty) Ltd

IT REFERENCE NO.:

1239874561

PERIOD UNDER AUDIT:

2016

TAX TYPE:

Income Tax

LETTER OF AUDIT FINDINGS

We have completed an audit of your tax affairs and would like to thank you for your time and co-operation.

This letter serves to inform you of our audit findings based on the work conducted. Your response is required within 21 business days from the date of this letter. Kindly note that this letter does not constitute an assessment.

Summary of Findings			
Tax Period	Provisions of the Income Tax Act No.58 of 1962 (IT Act)	Brief description of proposed adjustment	Amount
2016	Sections 11(a) and section 23(e) of the IT Act.	Provision for warranties	R4,829,645
Total			R4,829,645

Explanation of proposed adjustment(s):**1. Provision for warranties:****1.1. The facts (audit findings):**

The company claimed a deduction for provisions for warranties amounting to R4,829,645 in the 2016 income tax return. A warranty is an undertaking by the manufacturer to bear the cost of repairing certain parts of his product within a defined period subsequent to the sale of the product to the customer. The taxpayer provides the customer with a 9 month warranty upon conclusion of each sale. The warranty creates an obligation to effect repairs to (or replacement of) the generators within the 9 month period, if customers exercise their right to repair or replacement.

1.2. Statutory law:

- S11(a): Deduction is allowed in respect of 'expenditure and losses actually incurred in the production of income, during the year of assessment, provided such expenditure and losses are not of a capital nature'.
- Section 23(e): Prohibits the deduction of income carried to any reserve fund or capitalised in any way.

1.3. Applying the statutory law to the facts (conclusion):

- Since the expense in the amount of R4,829,645 is subject to a condition, namely the exercise of the customers right to have the product repaired or replaced if it is damaged or breaks within the defined period of the warranty, the expense cannot be said to be 'actually incurred' for purposes of s11(a) of the IT Act. Furthermore, a provision made to provide for a contingent liability will be denied as a deduction in terms of section 23(e).

Therefore the amount of R4,829,645 will be added back to your taxable income.

Underestimation Penalty

A underestimation penalty may be raised in terms of paragraph 20(1)(a) of the Fourth Schedule to the IT Act, due to the underestimation of the second provisional tax estimate.

Understatement Penalty

In terms of section 222 of the Tax Administration Act, where an 'understatement' was made by a taxpayer, the taxpayer must pay, in addition to the tax payable for the relevant period, an understatement penalty.

Therefore, an understatement penalty of 10% may be levied, which is determined in accordance with the table as set out in section 223 of the Tax Administration Act, and is based on the fact that there has been a 'substantial understatement' as defined in s221.

Finalisation of Audit

If you are not in agreement with the proposed adjustment, kindly respond in writing furnishing reasons and/or supply any relevant material within 21 business days from the date of this letter. Please submit your response via eFiling or by emailing the SARS official directly. Also provide reasons in writing as to why underestimation and understatement penalty should not be imposed.

Should you have any queries relating to the audit, please address them to the SARS official as per the contact details above.

Yours sincerely

C Mahala

Auditor - SARS