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A review of the understatement penalty provisions of the Tax Administration Act 28 of 2011

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Abstract

The research reviews the legislation pertaining to the understatement penalty provisions of the Tax Administration Act 28 of 2011. The problems associated with the levying of understatement penalties in the previous legislation are determined. A detailed evaluation is made of the understatement penalty provisions, with an emphasis on the determinants for the 'behaviour' and 'case' types, and the penalty percentages derived therefrom. The fiscus's stated goals and intentions in respect of the understatement penalties are identified and reviewed to determine if they are aligned with those considered to be international best practice. The requirements of the Constitution of the Republic of South Africa of 1996 are reviewed with respect to the understatement penalties. A comparative analysis of South Africa's understatement penalties and those of tax authorities identified as having similar tax administration regimes is presented. The research suggests that while a more systematic and uniform approach, to understatement penalties, has been established under the new legislation, the subjective nature of the 'behaviour' and 'case' determinants applied is likely to result in disputes between the South African Revenue Service (SARS) and the taxpayer. The research indicates that while the categories and nature of understatement penalties levied are broadly aligned with those of comparable countries' regimes, the penalty percentages applied in South Africa, are relatively high.

Key words and terms: understatement penalties, international best practice, goals, uniform, systematic, 'behaviour', 'case', subjective, similar tax administration regimes, penalty percentages.

DECLARATION

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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II: List of abbreviations and acronyms

Abbreviation/Acronym	Description
Australian Tax Act	Tax Administration Act 1953 (Australia)
ATO	Australian Taxation Office (Australia)
CC	Close Corporation
Canadian Income Tax Act	Income Tax Act R.S.C. 1985, c. 1 (5th Supp.) (Canada)
CRA	Canada Revenue Agency (Canada)
CIR	duly appointed Commissioner for Inland Revenue
Commissioner	duly appointed Commissioner for the South African Revenue Service
Constitution	The Constitution of the Republic of South Africa of 1996
Finance Act	Finance Act 2007 (UK)
HMRC	Her Majesty's Revenue and Customs (United Kingdom)
Income Tax Act	Income Tax Act 58 of 1962
IRS	Internal Revenue Service (United States of America)
KBI	Kommissaris van Binnelandse Inkomste
OECD	Organisation for Economic Co-operation and Development
PAIA	Promotion of Access to Information Act, 2 of 2000
PAJA	Promotion of Administrative Justice Act, 3 of 2000
RSA	Republic of South Africa
SAIT	South African Institute of Tax Professionals
SARS	South African Revenue Service
South Africa	Republic of South Africa
SAIT	South African Institute of Tax Professionals
Tax Administration Act	Tax Administration Act 28 of 2011
The Act	Tax Administration Act 28 of 2011
Tax Administration Bill	Tax Administration Bill
UK	United Kingdom
Penalty table	Understatement penalty percentage table
United States	United States of America
USA	United States of America
Revenue code	Title 26, Subtitle F, Chapter 68 Subchapter A, Part II, Revenue code (USA)

Chapter 1

Introduction

1.1 Context of the report

The levying of taxes has been a contentious issue since ancient times, such as when the Egyptian authorities imposed tithes and unpaid labour, in the service of the state, as an early form of taxation (Burg 2005). Burg explains that, 'governments have always struggled with tax compliance and resistance' because 'taxation is often perceived as oppressive' (Burg 2005). The further levying of penalties on taxpayers, over and above taxes, can only exacerbate such opposition, especially if the underlying tax itself is perceived as manifestly unfair, or the penalty is considered excessive in nature or amount. The need for punitive measures to be applied to errant taxpayers who do not comply with the taxing statutes is, nevertheless, undeniable (Burg 2005). If there were no such punitive measures, it is highly unlikely that many would comply with the taxing statutes and voluntarily pay the taxes due (Burg 2005).

In his tome *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith lays down four maxims in regard to taxes in general. In the fourth maxim Smith prefigures Burg's opinion when he specifies the need for each tax to be, '... as little as possible,' and states that:

'... [a tax should not] take out or keep out of the pockets of the people a great deal more than it brings into the publik (sic) treasury...' (1776).

The Tax Administration Act 28 of 2011 (the Tax Administration Act) was assented to in July 2012 and commenced on 1 October 2012, with the primary objectives of seeking:

'... to promote a better balance between the powers and duties of the South African Revenue Service (SARS) and the rights and obligations of taxpayers and to make this relationship more transparent. This balance will greatly contribute to the equity and fairness of tax administration. International experience has demonstrated that if taxpayers perceive and experience the tax system as fair and equitable, they will be more inclined to fully and voluntarily comply with it [and]...in order to replace the previous punitive legislation which was considered to be too wide in its interpretation and not uniform in its application especially over the varied and differing taxing legislature for which SARS is responsible for...' (SARS 2013b:4).

It would appear that, based on the above mentioned objectives, South African Revenue Service (SARS) admits that the balance between its powers and duties needed to be changed as they were, in certain instances, neither fair nor equitable, that the penalty system was open to interpretation, and that it was not always uniformly applied.¹

¹ This view assumes that SARS was not of the unlikely opinion that the balance of its powers and duties, as opposed to taxpayer rights and obligations, were unduly skewed in favour of the taxpayer.

These are considered significant admissions especially in the context of the sensitive nature of understatement penalties and the requirements of fairness and equality in terms of the Constitution of the Republic of South Africa Act 106 of 1996 (the Constitution).²

The passing into law of the Tax Administration Act is a milestone in the evolution of tax administration in the Republic of South Africa (South Africa). For the first time in the country's history it has a specific Act governing the administration of all taxes collected by SARS on behalf of the National Revenue Fund (SARS 2011:178). One of the primary purposes of the Tax Administration Act is, according to the long title of the Act, to ensure the effective and efficient collection of tax and the alignment of the administrative provisions of the various taxes into one consolidated piece of legislation (Tax Administration Act).

Non-compliance penalties for administrative requirements, understatement of taxes penalties, and criminal offences, are covered in the Tax Administration Act in Chapters 15, 16 and 17 respectively. Chapter 16, Part A of the Tax Administration Act, entitled *Imposition of Understatement Penalty*, incorporates four sections, numbering ss. 221- 224, which deal with the definitions, imposition criteria, calculation and objections to the understatement penalties. Understatement penalties have been incorporated into the legislation utilising both quantitative³ and qualitative⁴ penalty determinants, with the aim of achieving effective and appropriate sanctions (SARS 2011:179). The Tax Administration Act understatement penalties replaced the 'additional taxes' levied in terms of s. 76 of the Income Tax Act 58 of 1962 (the Income Tax Act).⁵

A further objective of penalties, as stated in the *SARS Short Guide to the Tax Administration Act, 2011 (Act no. 28 of 2011)* (the *SARS Short Guide to the Tax Administration Act*) is that:

'... the threat of punishment (imposition and effective collection of monetary administrative sanctions) deters unwanted behaviour (non-compliance and tax evasion)' (SARS 2013b:73).

The inferential corollary to this stated objective is that the penalties imposed also reward the fiscus with a welcome fillip to its coffers that it would not otherwise enjoy. The alacrity with which SARS raised, and pursued, the understatement penalties levied in terms of the legislation prior to the Tax Administration Act, namely s. 76 of the Income Tax Act, may be considered less than appropriate in light of the many criticisms, of SARS, by the courts. In a number of cases SARS was rebuked by the courts for the magnitude of the penalties imposed. Two notable examples are where the penalties raised by SARS were considered to be '... severe and out of proportion to the wrong committed' (Lewis, JA in *C: SARS v NWK* 2011 SA 347 (SCA), 73 SATC 55 at 79) and '... on the harsh side' (Friedman, J in *ITC 1295* (1979) 42 SATC 19 (N) at 33).

The previous legislation appeared to be subjective and highly unpredictable, so that the imposition and subsequent remission of penalties sometimes turned into a lottery for taxpayers (Cliffe Dekker Hofmeyr 2011). This contention is supported by the reported legal disputes between taxpayers and

² Section 9, Chapter 2 – Bill of Rights, The Constitution of the Republic of South Africa requires, inter alia, equality before the law and that the state not discriminate unfairly against any person.

³ For example a 200% penalty for the 'intentional tax evasion' 'behaviour' type (See Sub-Chapter 4.2, below)

⁴ For example a 'standard case' type (See Sub-Chapter 3.3.1, below)

⁵ The legislation relating to the equivalent of the Tax Administration Act's understatement penalties in the previous legislation was termed 'additional tax' in s. 76 of the Income Tax Act.

SARS, in the past, in respect of additional taxes, as supported by the cases law mentioned in the previous paragraph. It was evident that there was a need for an equitable, demonstrably transparent and uniform penalty system (SARS 2011:179). This report provides an analysis of the quantitative and qualitative elements determining the understatement penalty as measured against the stated objectives of SARS, the constitutional requirements of the Republic of South Africa, and international best practice.

SARS has shown that it is acutely aware of the need to follow international best practices and consistently refers to such practices.⁶ There is no universally accepted, single, international best practice benchmark for tax administration by which countries set standards and against which they measure themselves (Hasseldine 2007:2). Nevertheless the Organisation for Economic Co-operation and Development (OECD), issues various guides which are generally considered useful in the context of determining broad fiscal policies and applying general tax practices (Hasseldine 2010:13). SARS has stated that taxpayers' perception of equity and fairness is key to compliance (2013b:4) and that adopting international best practice is fundamental to effective compliance (2011:179). The legislators purportedly structured Chapter 16 of the Tax Administration Act accordingly and this is supported in the memorandum to the bill, published by SARS, which states that, in drafting the Tax Administration Bill (TAB), due regard was given to the following principles of international best practice in tax administration: equity and fairness, certainty and simplicity, efficiency and effectiveness (SARS 2011:179). It goes on to state that:

'[t]he drafting of the TAB was informed by international best practice and a comparative evaluation of the tax administration laws of other countries with practical experience with tax administrative laws over long periods, such as Australia, Botswana, Canada, New Zealand, the United Kingdom and the USA' (SARS 2011:179).

This report reviews four of the tax jurisdictions identified by SARS, in there comparative evaluation of countries with long standing tax administration laws, and which understatement penalty clauses appear similar to those of South Africa, to establish if the South African legislators have succeeded in attaining alignment with international best practices. A comparative analysis of the South African understatement penalties and those of the United States of America (USA), Canada, the United Kingdom (UK) and Australia is presented. These countries were selected for comparative evaluation purposes due to SARS' own statement that their policies 'informed' its fiscal policies (SARS 2011:179).⁷ Information about each country's understatement penalties comes primarily from their own legislation and relevant memoranda issued by the tax authorities of that tax jurisdiction. In respect of Australia these include, inter alia, the *Practice Statement Law Administration PS LA 2012/4* (ATO 2013), the *Practice Statement Law Administration PS LA 2012/5* (ATO 2014), and the

⁶ 'Best practice' and 'international best practice' are referred to in numerous SARS guides, for example, in the *Guide for VAT e-filing* on page 3, the *Step-by-Step Guide to Employee Reconciliation* on page 3, and the *Memorandum on the Objects of the Tax Administration Bill, 2011* at page 179. However, just what specific international best practice is being referred to, is not stated, and it must, therefore, be regarded as an unsubstantiated generalised description.

⁷ Note that while New Zealand and Botswana were also included in the SARS evaluation (SARS 2011:179), they have not been included in this research because the specific countries selected were considered to represent the more significant economies, in a worldwide context. These countries are consequently more likely to have better developed tax penalty regimes, which more accurately reflect what could be considered international best practice. Additionally, the independent perception of Australia is that it has 'one of the leading tax agencies in the world' (Hasseldine 2007:5).

Tax Administration Act 1953. The sources consulted for Canada include *False Statements or Omissions Penalty* (CRA n.d.(a)) and the Income Tax Act, RSC 1985, c. 1, (5th Supp.). Understatement penalty data for the UK was obtained from manuals issued by HMRC for example: CH71520 (HMRC n.d.(m)) and CH82487 (HMRC n.d.(l)), as well as the Finance Act 2007. The understatement penalty data for the USA was primarily obtained from legislation, namely the USA's Internal Revenue Code Title 26 Chapter 68 Subchapter A Part II.

The Tax Administration Act would appear, at first glance, to have achieved SARS's objective of ensuring certainty and equality in the application of the quantum of the understatement penalty (SARS 2013b:78). The understatement penalty determination table, in s. 223 of the Tax Administration Act, consists of five different 'behaviour' rows, for example 'Gross negligence' and 'Substantial understatement', and four different 'case' columns including, for example, 'Standard case'. These 'behaviour' and 'case' types intersect at pre-determined penalty percentages within the table. Once the 'behaviour' and 'case' types have been determined, the need for judgment in the quantum of the penalty percentage to be applied is eliminated (SARS 2013b:73). However, it is submitted that the evaluation of what constitutes the various behaviours is subjective by nature and, even with the assistance of SARS's brief descriptions, together with a lack of substantive clarity about the 'case' types can therefore be considered anything but certain or equal.

1.2 The Statement of the Problem

How effective will the Tax Administration Act be in remedying the problems inherent in the levying of understatement penalties under the previous legislation, whilst meeting the fiscus's objectives, which include, inter alia, the alignment of such penalties with international best practice?

1.2.1 The first sub-problem

The first sub-problem is to identify what the problems were, prior to the Tax Administration Act, in the determination and imposition of understatement penalties, and examine any other factors that contributed to the formulation of the understatement penalty legislation included in the Tax Administration Act.

1.2.2 The second sub-problem

The second sub-problem is to analyse the determinants, and the application, of understatement penalties included in the Tax Administration Act, and evaluate whether they are likely to be effective in meeting the goals and objectives of the legislators whilst remedying the problems associated with the preceding understatement penalty legislation. This sub-problem includes a review of the constitutional issues pertaining to the understatement penalty provisions of the Tax Administration Act.

1.2.3 The third sub-problem

The third sub-problem is to identify what the objectives and goals of the legislators were in the formulation of the understatement penalty provisions in the Tax Administration Act.

1.2.4 The fourth sub-problem

The fourth sub-problem is to determine what international best practice for tax administrations is considered to be and whether South Africa generally follows these identified norms and practices. This sub-problem includes a review of the understatement penalties of four of the countries that were identified by SARS as having comparable practical, long running, tax administration regimes, to determine how closely aligned the South African understatement penalties, as indicated by the fiscus, are with those countries' penalty regimes.

1.2.5 The fifth sub-problem

The fifth sub-problem is to determine how effective the understatement penalty provisions of the Tax Administration Act are likely to be and draw conclusions about the likelihood of achieving the goals set by the fiscus.

1.3 Delimitation of the report

The report is supported by both objective and subjective data. The origin of the supporting data for the information supplied is clearly identified, as are the sources for the views and opinions expressed, some of which are supported by studies and research, and some of which are not. Views expressed often relate to a specific context or set of circumstances and their wider application may therefore be limited – references to case law relating to the imposition, or reduction, of penalties are a case in point. In this respect, this report attempts to identify related trends and principles, within these points of view, which transcend specific circumstances.

The Tax Administration Act was specifically enacted to cover the administration of all taxes administered by SARS where practically possible.⁸ This research report limits the scope of its review, of the understatement penalties in the Tax Administration Act, to that of understatement penalties applicable to understated income tax derived from a South African source (not foreign source) and similarly to those foreign jurisdictions selected for review to those of understatement penalties applicable to their local income taxing statutes. This scope limitation is necessary because the Tax Administration Act applies to all nine fiscal legislations under the administration of SARS (Clegg 2014:3) and the foreign jurisdictions have, in some cases, extensive understatement penalty provisions relating to foreign income and other tax types.

SARS currently, and historically, does not release quantitative data relating specifically to understatement penalties charged or recovered, so the extent thereof, and the benefits, if any, of the introduction of the Tax Administration Act, cannot be quantitatively determined in this regard.

1.4 Research Methodology

The research reviews the problems identified in the understatement penalty legislation, and its application, prior to the passing into law of the Tax Administration Act. The research then identifies the policies and goals stated by the government of South Africa in respect of understatement penalties payable on understatements related to income tax. International best practices are

⁸ Extracted from the long title of the Tax Administration Act 28 of 2011.

ascertained, where possible, and compared to South African policies and goals. An analysis is made of the methodology applied in determining understatement penalties, in terms of the Tax Administration Act, to establish if the fiscus's stated policies and identified goals are generally met. The analysis is limited to understatements associated with income tax, for brevity's sake, even though the Tax Administration Act is applicable to other taxing statutes. The analysis compares South African understatement penalties with the understatement penalties levied by the tax authorities of Australia, Canada, the UK and the USA, on local income based taxes, to determine if they align with proven tax administration regimes and general international best practices.

This research has been carried out using a primarily qualitative approach by reviewing extensive literature, governmental websites and independent organisations' publications.

1.5 Report outline

Chapter 1: Introduction

This chapter presents the background to the research problem. The understatement penalty legislation is introduced. The research material, primarily books, e-books and the World Wide Web, includes publications from selected revenue authorities, information offered by universities for research purposes, and articles published by institutions and various publishers of tax periodicals. The scope and limitations of the research report are also put forward in this chapter.

Chapter 2: A critique of the understatement penalties prior to the Tax Administration Act

In this chapter the historical determinants used to quantify understatement penalties immediately prior to the Tax Administration Act are reviewed. A comparative analysis of the understatement penalties, as per Chapter 16, Part A of the Tax Administration Act, and the 'additional tax' levied in terms of the previous legislation, s. 76 of the Income Tax Act, which it replaced, are presented. The problems identified with the previous legislation in respect of understatement penalties are highlighted.

Chapter 3: 'Behaviour' and 'case' aspects of the understatement penalties in the Tax Administration Act

In Chapter 3 the 'behaviour' and 'case' type aspects of the understatement penalties, as detailed in the Tax Administration Act, are reviewed. The understatement penalty definitions and clauses (sections 221 to 224) included in Chapter 16 of the Tax Administration Act, entitled *Understatement Penalty*, are examined in light of the memoranda issued by SARS and the explanations and examples provided therein. An analysis of the circumstances in which an understatement penalty is applicable, the definitions of behaviours, the case determinants, and their application, which determines the penalty percentage reflected in the penalty table, is made. The likely efficacy of the understatement provisions in comparison to the prior legislation is presented.

Chapter 4: Quantification of understatement penalties in terms of the Tax Administration Act

Once the qualitative aspects of the understatement penalty have been determined, the table incorporated in the Tax Administration Act at s. 223, which specifies the quantum of the penalty to

be applied, is utilised. Chapter 4 introduces the various quantitative penalties detailed therein and also reviews the remission of penalties, as provided for in terms of s. 223(3) of the Tax Administration Act.

Chapter 5: Understatement penalty policies of the fiscus and international best practice

Chapter 5 reviews the stated policies, goals and objectives of the fiscus in respect of understatement penalties provided for in the Tax Administration Act, to determine if they are aligned. International best practice in respect of understatement penalties is identified and compared to those indicated by the fiscus, and incorporated in the Tax Administration Act, to determine if the Act is aligned with these practices and policies. This chapter also briefly reviews the requirements of fairness and equity, as required by the 'Bill of Rights' in Chapter 2 of the Constitution of the Republic of South Africa (the Constitution), and the Tax Administration Act's compliance therewith.

Chapter 6: A comparison of South African understatement penalties with those of Australia, Canada, the UK and the USA

Australia, Canada, the UK and the USA all have understatement penalties leviable on taxpayers for understatements, on income tax, included in their legislation. This chapter gives a brief overview of the nature and extent of each country's understatement penalty regime in respect of understatements relating to income tax. The review investigates how countries with long-standing tax administration laws, identified by SARS for comparative purposes, are determining, and applying, their equivalent of understatement penalties. These are then compared to the current South African understatement penalties.

Chapter 7: Conclusion

The final chapter summarises the outcomes of the research. The chapter presents conclusions about whether the Tax Administration Act is likely to be effective in remedying the shortcomings of the previous understatement penalty legislation. The identified objectives of the fiscus are measured against the provisions pertaining to South African understatement penalties to determine if these goals are likely to be achieved. Identified international best practice is compared to the practices implemented by SARS through the understatement penalty system to determine how closely aligned South Africa is with those practices. The proximity of South African understatement penalties to those of the countries selected, for comparative purposes, is summarised to establish whether the knowledge inherent in these foreign jurisdictions' tax administrations has been recognised in the South African understatement penalty provisions, and thus the likely effectiveness of those provisions, is presented.

Chapter 2

A critique of the understatement penalties prior to the Tax Administration Act

2.1 Introduction

This chapter reviews the understatement penalties based on a retributive justice system. The quantitative and qualitative measures previously utilised in South Africa to determine the quantum of understatement penalties, were contained in terms of s. 76 of the Income Tax Act and the resulting 'penalty' referred to as 'additional tax'. A general review of the problems identified with this legislation, its application and the case law pertaining to this 'additional tax' is presented. The need for revised legislation, relating to understatement penalties, is discussed.

2.2 A brief history of penalties

The levying of taxes has been a contentious issue since the ancient Egyptian authorities introduced tithes and imposed unpaid labour for the benefit of the state, known as corvee, the first known forms of taxation (Burgs 2005). Burgs states that:

'... because taxation is often perceived as oppressive, governments have always struggled with tax compliance and resistance...' (2005:vi-viii).

As taxation has often been onerous, excessive and cruel, reaction to its enforcement has often been heated and violent, resulting in revolts and protests (Burgs 2005). Recorded tax revolts date back to the Han Dynasty (CE 25–CE 220) and continue throughout history, originating or contributing to many major historical upheavals such as, the signing of the Magna Carta in 1215, the American Revolution of 1777, and the French Revolution of 1789 (Burgs 2005). Historically, penalties for non-compliance often included imprisonment, corporal punishment, torture and even death of the defaulting taxpayer (Burgs 2005). In the not so distant past, when a taxpayer defaulted, family, neighbours, communities and even the debt collectors themselves, may have been held liable for payment of the taxes due (Burgs 2005). The levying of penalties over and above these taxes, whether through pecuniary levies, incarceration, or physical punishment, would clearly have done little to abate such resistance to these taxes at the time. As civilisations and societies evolved and their government systems became more administratively efficient, legislators turned to a combination of pecuniary penalties and, to a lesser degree, incarceration as their preferred, and somewhat more humane, methods of retributive justice.

The first comprehensive income tax was introduced in the United Kingdom in 1799 by the then British Prime Minister William Pitt the Younger (Vivian 2006:81). Income tax and the penalties levied thereon, for non-compliance, are therefore relatively recent innovations in the evolutionary stage of taxation, across the world.

In his tome *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith laid out four maxims of taxation, the fourth of which is specifically relevant to this report. It states, inter alia, that:

‘... by the forfeitures and other penalties which those unfortunate individuals incur, who attempt to evade tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capitals....’ (1776).

Smith indicates, in the passage quoted above, that the imposition of taxes needs to be carefully considered and applied, as does the imposition of penalties for non-compliance with the taxing statutes, with respect to their broader economic ramifications (1776). Smith emphasizes the need for such penalties, but that authorities who impose ‘ill-considered or excessive taxes [or penalties] are more likely to encourage avoidance and evasion rather than compliance’ and stresses that the penalties should be tempered, proportionately, to the nature of the non-compliance (1776). In the same maxim he states that:

‘An injudicious tax offers a great temptation to smuggling. But the penalties of smuggling must arise in proportion to the temptation.’ (1776).

The application of these fundamentals in a South African context must be balanced on the one hand with a person’s fundamental rights, including constitutional rights to fairness and equity, and on the other hand with the government’s need to generate revenue through a fair and proportionate levying of taxes on all. In his treatise *Principles of Political Economy*, John Stuart Mill states that if:

‘... any one bears less than his fair share of the burthen (sic), some other person must suffer more than his share. And the alleviation to the one is not, caeteris paribus, so great a good to him, as the increased pressure upon the other is an evil’ (1885).

In the context of modern day tax systems, both Smith and Mill caution all tax levying jurisdictions about the necessary balance between the need for penalties, in order to encourage compliance, and excessive penalties, which could harm the economy and the entrepreneurs which drive it.

2.3 The retributive justice system

Retributive justice is described as a theory of justice that considers a proportionately reasonable punishment as morally good, and its corollary, that it is morally impermissible to intentionally punish the innocent (Walen 2014). The concept is commonly found in cultures across the world and is not a recent innovation, the concept is evidenced in the Bible, at Deuteronomy 19:17-21 and Exodus 21:23-21, and the older code of Hammurabi⁹ (Ushistory.org 2004). Although in historical contexts retributive justice was generally considered the most appropriate system, some scholars do not agree entirely with its application in isolation. Mr E J James suggests that a system of indirect compulsion (reward for compliance) as opposed to direct compulsion (penalties, for example,) might be very effective at achieving compliance (James, ed. Lalor 1899: para II.7.23). This method has been tried under various circumstances, always with marked success (James, ed. Lalor 1899: para II.7.23). A system of reward is considered more powerful than one of punishment, and such a system is economical, politically more acceptable, and in harmony with many cultural traditions and institutions – a claim which James says no recent system of successful direct compulsion can make (James, ed. Lalor 1899: para II.7.23). Whilst this approach is of interest, the methodology and merits of such a system are outside the ambit of this research report. Despite the evidence in favour of the alternative, the retributive justice system of penalising non-compliance has generally become the

⁹ A Babylonian code dating back to 1795 BC which reflected the retributive justice system.

norm and, more specifically, is evident in the tax systems reviewed in this report (SARS 2013b:73 & refer Chapter 6, below) .

The OECD has also highlighted the shortcomings of a retributive penalty system. In November 2010, the Centre for Tax Policy and Administration, a division of the OECD, issued a report on taxpayer compliance behaviour which was based on findings from surveys carried out in member countries coupled with an extensive review of available scientific literature (2010:5). When asked how a taxing jurisdiction promotes compliance, the general public identified deterrence¹⁰ as the key factor (OECD 2010:5). However, studies on whether such strategies have the desired behaviour influence on compliant and non-compliant taxpayers produce conflicting results – in some instances jurisdictions found that deterrence caused errant taxpayers to adopt non-compliant behaviour in subsequent years (OECD 2010:5). Studies indicate that the perception of retributive fairness in the application of punishment when a taxpayer is non-compliant is linked to, or gives justification for, future non-compliance (2010:5). The existence of a maximum amount that the taxpayer will bear in taxes is directly related to the extent of illegal, or illicit, business operations that may occur, no matter how drastic the penalty (James, ed. Lalor 1899: para I.375.7). This maximum is crisply presented in the example of taxes levied on distilled spirits in the United States of America, in 1868. The government reduced the tax on the distilled spirits from \$2 to 50 US cents whereupon tax revenues, from this source, increased from \$14 000 000 to \$34 000 000, within one year (James, ed. Lalor 1899: para I.375.7). It is self-evident that the tax benefit derived from being non-compliant, in this instance, had become economically unviable.

Bird and de Jantscher state that the ability of any jurisdiction to ensure that its tax base is tax compliant, and remains so, requires an efficient tax administration system and an effective and enforceable punitive measures regime (Bird & de Jantscher 1992). Significantly their research led them to conclude that:

‘[t]he “best” tax administration is not simply one that collects the most revenue. How that revenue is raised – that is, the effect of the revenue-generation effort on equity, on the political fortunes of governments, and on the level of economic welfare – may be equally important’ (1992).

They state further that the literature researched suggests that revenue needs to be collected via a tax administration system that is simple to understand (for both taxpayer and tax administrator), comprehensively planned, and driven by strong commitment from government (1992).

The need for punitive measures to be applied for non-compliance with taxing statutes would seem to be undeniable. If there were no such measures it is highly unlikely that many people would comply with the taxing statutes and voluntarily pay the taxes due (Burg 2005). Based on the practices of the taxing jurisdictions of the world, it appears that a retributive penalty system is the regimen most favoured (Burg 2005). The need for significant penalties was also succinctly stated in the case *Israelsohn v CIR* 1952 (3) SA 529(A), 18 SATC 247, by Centlivres CJ, at 257, where referral was made to *Federal Commissioner of Taxes v Trautwein* 4 A.T.D 92 at 96, in which Evatt J stated that:

¹⁰ Deterrence, in this context, encompasses audits, the risk of detection, and severe punishment.

‘[t]he object of the section is to impose a heavy penalty so as to ensure the accuracy of returns, upon which the whole income tax system of the Commonwealth is based. The penalty is imposed “by way of additional tax” but as I endeavoured to point out in *Richardson’s* case, although the penalty is collected via the machinery of assessment, the section is definitely a penal provision’.

In summary South Africa has previously, and under the Tax Administration Act, adopted the retributive system in respect of the application of understatement penalties which is succinctly stated by SARS:

‘The principle goal of sanctions is based on a simple premise – the threat of punishment (imposition and effective collection of monetary administrative sanctions) deters unwanted behaviour (non-compliance and tax evasion)...’ (SARS 2013b:73).

In declaring this ‘principle goal’, SARS has reaffirmed its belief that a retributive penalty system is the most appropriate method to ensure, and encourage, compliance with taxing statutes.

2.4 The penalty system prior to the Tax Administration Act of 2011

Prior to the Tax Administration Act, SARS utilised s. 76 of the Income Tax Act¹¹ to determine and apply the quantum of a penalty on an identified understatement. Section 76(1)(a) required SARS to levy an additional tax of twice the tax chargeable, or alternatively stated as 200% of the tax chargeable, on the taxable income for that specific year in the event of a default in the rendering of a taxpayer’s return. In the event of an omission from the taxpayer’s return, s. 76(1)(b) required an additional amount, equal to twice the amount of tax due on the omitted amount, to be paid. Similarly, for an incorrect statement made on a taxpayer’s return, s. 76(1)(c) applied additional tax of twice the difference between the tax so assessed and the tax which should have been assessed if the incorrect statement had not been made. The Commissioner for Inland Revenue, and subsequently the Commissioner for the South African Revenue Service (the Commissioner) had, in terms of s. 76(2) of the Income Tax Act, a discretion to remit, in whole or in part, the additional tax determined in terms of s. 76(1). This remission was subject to the proviso in s. 76(2)(a) that the Commissioner was not allowed to remit such additional tax if he was satisfied that any act or omission was done with the intention to evade taxation, unless there was extenuating circumstances. The taxpayer was only able to avail him or herself of the right to objection and appeal in the event of the Commissioner not remitting the whole of the additional tax according to s. 76(2)(b). Sections 76(5) and 76(6) included provisions which ‘deemed’ certain amounts to be omitted from a taxpayer’s return. Finally s. 76(7) dealt with the case of assessed losses brought forward, and reductions thereto due to deemed omissions, when determining current year assessed profits. To facilitate understanding within this report, this ‘additional tax’ may in future be regarded as an understatement penalty.

The legal firm Cliffe Dekker and Hofmeyr published an article in the tax journal *Integritax*¹² stating that s. 76 of the Income Tax Act was:

‘lacking objective differentiation in that the legislation was a case of one size fits all’ (2011).

¹¹ Refer to Appendix A for the full text of s.76. of the Income Tax Act.

¹² *Integritax* is a tax journal published by the South African Institute of Chartered Accountants.

The author of the article went on to suggest that, based on the firm's experience, the maximum penalty of 200% was invariably imposed, and SARS was not particularly receptive to considering extenuating circumstances (2011). This resulted in taxpayers having to argue the merits of a remittance of the 200% penalty, based on a process that appears to be highly subjective and unpredictable (Cliffe, Dekker and Hofmeyr 2011). The reason for SARS's intransigence, they surmise, is SARS's emphasis on the penal nature, and deterrent effect, of the penalty imposition, rather than being open to the merits of the case and any extenuating circumstances (2011). The author of the above article is presumably only referring to taxpayers who, in SARS opinion, had the intention to evade taxation, as extenuating circumstances are only a requirement to be considered when this intent was present (s. 76(2)(a) of the income Tax Act). All other instances fall in the general case scenario where the Commissioner may have remitted 'the additional charge...or any part thereof as he may think fit...' (s. 76(2)(a) of the Income Tax Act).

In an article published in *Opinion*,¹³ Dr B Croome of the legal firm Edward Nathan Sonnenbergs was quoted as saying that that the application of s. 76 of the Income Tax Act:

'... was subject to the discretion of the official handling the return with different outcomes for similar defaults...' (Visser 2013).

In his lecture notes Dr Croome states that, in the past, certain SARS officials may have used the imposition of penalties as a bargaining tool to bring a tax dispute to finality (2013a:7). This was done by means of SARS indicating that if the taxpayer accepted the adjustments under consideration, no interest or penalties would be imposed, whereas if the taxpayer sought to challenge SARS's view on the law, then penalties and interest would be considered seriously, and possibly imposed. Dr Croome does admit, however, that these situations may have been the exception rather than the rule (2013a:7). Nevertheless the point is that a SARS official could, on behalf of the Commissioner and in terms of s. 76(2)(a) of the income Tax Act, be empowered to make such decisions.

2.5 The extent of the monetary value of penalties to SARS

Little quantitative data is available publicly in respect of the number of taxpayers who were assessed for additional taxes in the past under the provisions of s. 76 of the Income Tax Act, or as to the quantum of the additional taxes so levied. Similarly, no such data is made available to the general public on understatement penalties levied under the Tax Administration Act.

In the explanatory memorandum entitled *Compliance programme 2012/2013 to 2016/2017*, SARS indicated that 230 taxpayers were successfully prosecuted from April 2011 to April 2012 for various offences involving those who would 'cheat the fiscus', incurring 370 years of jail sentences and fines of almost R5 000 000 (SARS 2012:5). This, unfortunately, does not indicate the extent of the understatement penalties levied on these taxpayers. In the SARS annual report for 2004 it was stated that audits were carried out on 5.5% of VAT registered vendors were conducted, 0.55% of registered PAYE taxpayers, and 0.5% of registered income taxpayers (2004:34). The value of additional tax assessments raised as a result of these audits was R20 407 222 000 of which R14 883 172 000 was for income tax (2004:34). The 'additional' assessment figures were not further analysed by SARS, so no extrapolation of the constituent parts of the 'additional' tax assessments

¹³ *Opinion* is an online tax journal published by the South African Institute of Tax Practitioners (SAIT).

can be made (SARS 2004:77). SARS ceased reporting the audit and related assessment figures after 2004.

Considering the number of registered income taxpayers (individuals and corporations) in the 2014 annual report of 19 787 304 (SARS 2014b:28), as compared to 5 563 284 in 2004 (SARS 2004:24), and coupled with income tax revenues in 2014 having reached R490 449 000 000 (SARS 2014b:16) while in 2004 it was R 171 962 773 000 (SARS 2004:77), it would be surprising if the 'additional' assessment figures are not significantly higher, both in absolute and percentage terms, than those in 2004. The lack of available data in respect of understatement penalties incurred by taxpayers is regrettable, especially in light of the fact that one of the main reasons for such a penalty regime is to encourage taxpayers to be compliant. If taxpayers were made more aware of SARS's ability to identify and follow-up on understatements, they might be more inclined to be fully compliant so as to avoid the understatement penalties that could be levied in terms of the Tax Administration Act.¹⁴

In a paper published in the United States on the estimated tax gap, determined to be difference between tax reported and estimated actual tax, it was estimated that between 18% and 19% of total reportable income is not properly reported, which equated to \$ 500 billion in 2008, and that tax evasion is increasing (Feige & Cebula 2011).

A journalist, L Steyn, reported in 2014 that SARS estimates the tax gap in South Africa to be between 15% and 30% of tax revenues, which could amount to R 300 billion (2014).

2.6 The litigious landscape in respect of South African understatement penalties prior to the Tax Administration Act.

As indicated in the previous chapter, little official or anecdotal evidence is available about the number of taxpayers who have had understatement penalties levied or the quantum, and the nature, thereof. Publicly available reported case law has therefore been identified as a reliable source of information to obtain an insight into the type, and nature, of the issues raised by taxpayers relating to the levying of understatement penalties in respect of the Income Tax Act. The cases presented below were selected based on their academic merit, related to this report, but are considered to reflect the major portion of the Southern African cases which were adjudicated on due to objections to the quantum of additional tax raised by SARS. Disputes ending up in a court of law, by their very nature, represent taxpayer dissatisfaction with the treatment meted out by SARS. The antithesis is that there are likely to be instances, where the findings by SARS were incorrect, or the penalty was excessive, but taxpayers did not take the matter to court after weighing up the financial or personal considerations. These personal considerations may involve, inter alia, whether the embarking on a possibly costly, uncertain, and in all likelihood, stressful legal route is worthwhile (Croome 2013:21 and 71). Nevertheless the general conclusions reached in this chapter of the research report are based on the available facts, even if they are not necessarily statistically representative.

¹⁴ This position is supported by the judiciary as evidenced in ITC 1430 (1987) 50 SATC 51 (E) at 54 where the presiding judge, Mullin, J, indicated that the deterrent factor was one of the factors to be considered in applying penalties but inferred that without public disclosure it is hardly likely to come to the notice of many other taxpayers.

In the relatively recent case of *C: SARS v NWK* 2011 SA 347 (SCA), 73 SATC 55 at 79, Lewis JA stated that the penalty was 'severe and out of proportion to the wrong committed by NWK...' when referring to a 200% penalty levied by SARS on the taxpayer. The full bench of the Supreme Court of Appeal concurred with this judgment in *C: SARS v NWK* 2011 SA 347 (SCA). In her judgment, in *C: SARS v NWK* 2011 SA 347 (SCA), Lewis JA, at 79, explained that even though SARS argued the taxpayer had deliberately made incorrect statements in returns, this did not mean that there were no extenuating circumstances and, at 78, that such circumstances should allow SARS to reduce the additional tax in spite of the taxpayer having been dishonest. It is clear that, according to the Supreme Court of Appeal, SARS had erred in not exercising their discretion in terms of s. 76(2)(a) of the Income Tax Act. The fact that counsel for SARS accepted the reduction of the penalty by 100% as being appropriate (*C: SARS v NWK* 2011 SA 347 (SCA), 73 SATC 55 at 79) also indicates some culpability by SARS in not taking extenuating circumstances into account properly.

Another case, ITC 1331(1980) 43 SATC 76(T) is relevant to this report for two reasons: Firstly, the Commissioner, did not furnish the basis on which he exercised his discretion to remit, in part, the additional tax prescribed by legislation (ITC 1331(1980) 43 SATC 76 (T) at 83). The court was, therefore, not informed as to whether the Commissioner found that the appellant had made the incorrect statements in his submitted returns with intent to evade taxation, and consequently there were extenuating circumstances, or whether the appellant was merely negligent in the rendition or supervision of the returns rendered on his behalf (ITC 1331(1980) 43 SATC 76 (T) at 83). Secondly, the Commissioner contended that there were no extenuating circumstances relating to the case, whilst the court found that there were in fact extenuating circumstances which, in its view, justified a remission of the prescribed additional tax to some extent (ITC 1331(1980) 43 SATC 76 (T) at 86). The views of the Commissioner in arriving at the penalty raised appear confusing in the judgment handed down. Penalties were raised, by the Commissioner, at rates of 50% to 150% over the different tax periods at issue, thereby indicating that a remission of penalties by the Commissioner was applied (ITC 1331(1980) 43 SATC 76 (T) at 78). The Commissioner contended that the taxpayer:

'... wilfully and knowingly colluded with his bookkeeper in making such incorrect statements to the Receiver of Revenue ...'(ITC 1331(1980) 43 SATC 76 (T) at 86),

in which case the full 200% penalty would then be required to be levied as there were no extenuating circumstances. Melamet J, did however ultimately determine a similar penalty, to that of the Commissioner, and therefore confirmed the assessments (ITC 1331(1980) 43 SATC 76 (T) at 87). It is germane that Melamet, J noted that a factor to be considered in determining the additional tax was:

'the loss of interest, which would have been paid if there had been a proper and timeous assessment, by virtue of the delayed payment of tax...' ITC 1331(1980) 43 SATC 76 (T) at 87,

but made no mention of the deterrence factor which was indicated as a factor in ITC 1430 (1987) 50 SATC 51 (E) at 54. Although no actual adjustment to the additional tax levied was required in this case it would seem that there was no transparency in respect of how the Commissioner determined the amount of additional tax, either to the taxpayer or the court (ITC 1331(1980) 43 SATC 76 (T) at 83). Whilst not applicable at the time this case was heard, it is doubtful whether the constitutional

requirement of fair administrative justice¹⁵ would be met by these actions. The Commissioner stated that there were no extenuating circumstances to be taken into account, whilst the court was of the opinion that there was and that the Commissioner took too narrow a view of what constitutes extenuating circumstances (ITC 1331(1980) 43 SATC 76 (T) at 86). The requirement of equality and fairness required under the Constitution¹⁶ would probably not have been met by the Commissioner when considering what might be regarded as 'extenuating circumstances' and to whom, and how, it was applied.

In an appeal heard by the Appellate Division, *CIR v Da Costa* 1985 (3) SA 768(A), 47 SATC 87 at 96, Van Heerden JA found, with the full bench concurring, that the court a quo (The Cape Income Tax Special Court) had reached a conclusion that any reasonable court would have reached, and, quoting from the court a quo's judgment said:

'It seems to this court ... that the penalty fixed by the committee in Pretoria ... was excessively severe, was – having regard to the relationship it bore to the maximum penalty imposable – arbitrary and unreasonable and that taking all the circumstances into account ... [w]ill certainly bring home to him the lesson which the legislature sought to teach errant taxpayers by providing for a penalty in circumstances such as are present here. A lesser penalty would not serve the legislature's purpose. On the other hand, one as heavy as that deemed proper by the "penalty fixing committee" is out of all proportion to the wrong committed. The punishment must fit the crime, in tax matters no less than elsewhere'(*CIR v Da Costa* 1985 (3) SA 768(A), 47 SATC 87 at 96-97),

The admonishment of the Commissioner by the lower court, and the Supreme Court of Appeal's agreement therewith, indicates that the taxpayer was treated unnecessarily harshly in respect of penalties which were, apparently, 'arbitrarily' and 'unreasonably' applied.

The judgment in ITC 1489 53 SATC 99(c) also determined that the penalty, levied at 100% was '... too severe...' (ITC 1489 53 SATC 99(C) at 108) and proceeded to reduce the penalty by 50%. An additional defence by the taxpayer was raised citing culpability of the taxpayer's accountant, who was responsible for the determination of certain figures submitted in the return, (ITC 1489 53 SATC 99(C) at 100) but this defence was rejected by the presiding judge (ITC 1489 53 SATC 99(C) at 106), Conradie J, on the grounds that no particular *mens rea*¹⁷ was required, by the taxpayer, for the contravention of s. 76 of the Income Tax Act, citing a Transvaal Provincial Division case *CIR v Di Ciccio* 1985 (3) SA 989(T), 47 SATC 199 at 106.

The Appellate Division was called upon to review the additional tax levied by the Commissioner on the wife of a taxpayer, the husband being responsible for not including certain of his wife's taxable income in their joint return in the case, *CIR v Israelsohn* 18 SATC 247. Centlivres, CJ stated, in his judgment, that the Commissioner could not levy additional tax on the wife because of her husband's failure to include such income in their joint return (*Israelsohn v CIR* 1952 (3) SA 529(A), 18 SATC 247 at 248). Although this part of the case was determined on the interpretation of the legislation where

¹⁵ Section 33, Chapter 2 – Bill of Rights, The Constitution of the Republic of South Africa requires, inter alia, just administrative action.

¹⁶ Section 9, Chapter 2 – Bill of Rights, The Constitution of the Republic of South Africa requires, inter alia, equality before the law and that the state not discriminate unfairly against any person.

¹⁷ *Mens rea* is defined, in this context, as a 'guilty knowledge' and wilfulness or wrongful purpose (West's, 2008).

it was found to have two constructs (*Israelsohn v CIR* 1952 (3) SA 529(A), 18 SATC 247 at 248) and, coupled with a lack of culpability in respect of a person not rendering the return, this case again represents an example of the revenue authorities unseemly eagerness in raising and pursuing additional taxes.

In the case of a motor dealer, ITC 1430 (1987) 50 SATC 51 (E) at 51, who had passed away before the appeal against the additional 100% tax levied was heard, the court received no information about the Commissioner's determination of the reduction from the prescribed 200% additional tax raised. In delivering his judgment, Mullins J, stated that there were three factors in determining the imposition of additional taxes and the amount to remit: punishment of the taxpayer, the deterrent effect upon him, and the deterrent effect upon other taxpayers (ITC 1430 (1987) 50 SATC 51 (E) at 54). The learned judge went on to say that the additional charges are not monies to which the fiscus lays claim as part of its budgeted state revenue, but are rather a fortuitous additional amount (ITC 1430 (1987) 50 SATC 51 (E) at 54). Mullins J further stated that, with regards to the deterrent factor, the remission of additional charges by the court is hardly likely to come to the notice of many other taxpayers (ITC 1430 (1987) 50 SATC 51 (E) at 58), and went on to negate the additional charges save for the computed loss of the imputed interest to the fiscus (ITC 1430 (1987) 50 SATC 51 (E) at 59). Mullins J, also stated that there was no guidance as to the clause 'extenuating circumstances' (ITC 1430 (1987) 50 SATC 51 (E) at 55), and was of the view that factors other than the moral guilt of the wrongdoer (as determined in criminal law) could be considered (ITC 1430 (1987) 50 SATC 51 (E) at 55). It is pertinent that firstly Mullins J noted that the Commissioner did not forward any information in respect of the remission and that it would have been useful to the court had he done so (ITC 1430 (1987) 50 SATC 51 (E) at 55), and secondly, that the court needed to exercise its discretion in respect of the quantum of additional charges as its view differed from that of the Commissioner (ITC 1430 (1987) 50 SATC 51 (E) at 58). It is also significant that according to the court, the remission of penalties, or otherwise, by a court, did not affect the deterrent value of tax penalties due to the limited public awareness of court proceedings (ITC 1430 (1987) 50 SATC 51 (E) at 58). The lack of transparency shown by the Commissioner, noted in the case above, would be unlikely to meet the requirements of fair administrative justice as required by the Constitution (see Sub-Chapter 5.3, below).

The case of ITC 1486 53 SATC 39(T) at 48, although relating to penalties on sales tax, is relevant to this report in that it shows the Commissioner's apparent reluctance to examine the relevant circumstances properly (ITC 1486 53 SATC 39(T) at 48), especially those in extenuation. In this case, a fraud was perpetrated by certain employees, without the knowledge of management, which caused an understatement of sales tax declared to the Commissioner (ITC 1486 53 SATC 39(T) at 41). The presiding judge, Melamet J, stated that the Commissioner erred in his interpretation of the legislation in that he (the Commissioner) was precluded from remitting the penalty payable in whole, or part, and additionally, that the penalty, and the amount of penalty determined, is directly connected to the 'blameworthiness' of the taxpayer and only indirectly to the extent of the taxpayers income (ITC 1486 (1990) 53 SATC 39 (T) at 48, with specific reference to *Commissioner for Inland Revenue v McNeil* 1959(1) SA 481(A) at 487 with the footnote 22 SATC 374 at 382). This judgment suggested that the Commissioner should take cognisance of the intent of the taxpayer, and the nature of his transgression, in addition to the rand value of the understated taxes (ITC 1486 53 SATC 39(T) at 41).

In *CIR v Di Ciccio* 1985 (3) SA 989(T), 47 SATC 199 at 307, the presiding judge, Conradie J, whilst upholding the Commissioner's levy of additional tax, considered that the taxpayer had perhaps failed himself by not arguing extenuating circumstances in the late submission of his correct returns.

In ITC 1518 54 SATC 113(T) at 121, the court reduced the penalties raised by the Commissioner from 200% to 60% because, even though the court found that the taxpayer's actions were careless, or thoughtless, there were, according to the court, extenuating circumstances which warranted the reduction.

Davis AJ, in his judgment in ITC 1758 65 SATC 396 at 397, determined, inter alia, that while a penalty should have a deterrent value, it should not burden the taxpayer to the extent that the taxpayer would no longer be an economically effective member of the community (ITC 1758 65 SATC 396 at 399). The court determined that the penalty levied, of 100%, be reduced to 50% (ITC 1758 65 SATC 396 at 399). There was no requirement for SARS to acknowledge agreement with the court's decision, however, in this instance, counsel for SARS conceded that the amount was appropriate (ITC 1758 65 SATC 396 at 399).

A further case indicating error by SARS is ITC 1377 (1981) 45 SATC 221(T) at 229, where the presiding judge found that the Commissioner had erred in the imposition of the additional tax and reduced it to nil.

On an appeal by the Commissioner in the case *KBI v Mabotsa* 55 SATC 98, the court found that the reduction of a penalty from R43 133 to R4 000 by the lower court was, even given the extenuating circumstances, too much, but that the 100% penalty originally applied by the Commissioner had been excessively high (*KBI v Mabotsa* 55 SATC 98 at 99). On the one hand the personal financial capacity of the taxpayer was stated as a mitigating factor but, on the other hand, the loss of interest to the fiscus was also a consideration (*KBI v Mabotsa* 55 SATC 98 at 98). The opportunity cost to the taxpayer, resulting from a loss of interest, and the interest incurred by the taxpayer, on borrowed funds, due to the freezing of the taxpayers' bank account by the Commissioner, were not considered mitigating factors in the application of the penalty by the Appeal Court. (*KBI v Mabotsa* 55 SATC 98 at 98). According to the Appeal Court the Special Tax Court erred in its consideration of the opportunity costs and loss of interest to the taxpayer (*KBI v Mabotsa* 55 SATC 98 at 99). It was ultimately determined that a penalty of R20 000 was appropriate (*KBI v Mabotsa* 55 SATC 98 at 99).

2.7 Summary

Due to the avarice of some taxpayers and the indifference of others understatement penalties are required to encourage compliance and discourage non-compliance. Books have been written in respect of the varied approaches to interpretations and interpellations of the English language as it pertains to legislation.¹⁸ Based on the current and previous legislation relating to understatement penalties the retributive justice system is the generally preferred regime for encouraging compliance and punishing non-compliant taxpayers in South Africa (refer Sub-Chapter 2.3, above). Efficient tax systems are characterised by simplicity, strategic excellence and a determined government (Bird &

¹⁸ For example refer Botha, C., 2012, *Statutory interpretation an introduction for students*, 5th edn., Juta & Co Ltd, Cape Town.

de Jantscher 1992). The nature and extent of the taxes, the manner in which such taxes are collected, and the socio-economic state of the country and its people, all have a bearing on what size, and to what extent, penalties are needed to induce taxpayers to meet their tax obligations, willingly or under duress (Bird & de Jantscher 1992). There are alternatives to the historic methods of pecuniary penalties and incarceration but, to deter the repeat offender who is intent on evading taxes, such penalties are considered a necessary weapon in the fiscus's armoury (Bird & de Jantscher 1992).

It would seem evident, from the 12 cases referred to in this chapter, the courts have generally reduced the quantum of the penalties originally imposed by SARS (nine out of the twelve cases), and, in some instances, openly criticised SARS for levying unreasonably high penalties (seven of the twelve cases). Reinforcing this view is the agreement by SARS's legal counsel, on one occasion, that the resulting reduced penalty was more appropriate. The frequency of the courts' interventions, and the concessions by SARS counsel with respect to reduced penalties, indicates that SARS could have been considered to be vexatious and excessive in its penalty determinations, and been unsuccessful, or perhaps less than willing, in applying the concept of 'extenuating circumstances'

In respect of the additional taxes imposed in terms of s. 76 of the Income Tax Act and based on the research undertaken in this chapter it is submitted that the following inferences can be drawn:

- There was little transparency, by the Commissioner, in respect of the reasons for the determination of the quantum of the additional tax levied in terms of s. 76 of the Income Tax Act.
- The reasons for the remission of additional tax, or not, in terms of s. 76(2)(a) and s. 76(2)(b) of the Income Tax Act, was generally not communicated to the taxpayers who then had to decide whether to object or appeal against such penalties or not. The courts were seemingly also not advised of the reasons for the Commissioner's determinations.
- The Commissioner did not seem to consider the application of extenuating circumstances widely enough, or did not appreciate what the nature of the different types of 'extenuating circumstances' might be in the determination of remittance of penalties (Cliffe, Dekker and Hofmeyr 2011).
- The additional tax charged was initially excessive, as determined by SARS, based on the fact it was reduced in nine of the twelve cases reviewed.
- The additional tax was not uniformly applied in similar circumstances by the Commissioner and it also varied between the different revenue offices (Cliffe, Dekker and Hofmeyr 2011).
- Whilst the deterrent factor of a 'heavy' penalty was put forward by SARS, and was confirmed by the courts on occasion,¹⁹ information about understatement penalties was invariably not made public, with the exception of some high profile cases.²⁰ The monthly SARS Enforcement and Customs Operations publication²¹ covers current fraud and

¹⁹ ITC 1430 (1987) 50 SATC 51 (E) at 54

²⁰ Refer, for example, to the joint media statement from *Settlement between the SARS and King* 13 June 2013 and unreported cases such as Case No.: 54768/2008 and Case No.: 24997/2011.

²¹ Refer, for example, to [www.sars.gov.za/Media/MediaReleases/Pages/13-June-2014-SARS Enforcement and customs operations for May 2014](http://www.sars.gov.za/Media/MediaReleases/Pages/13-June-2014-SARS%20Enforcement%20and%20customs%20operations%20for%20May%202014.aspx).

corruption cases and discloses fines and prison sentences, but does not disclose understatement penalty issues, amounts or statistics.

It is evident from the above that there was a need for a revision of the legislation pertaining to understatement penalties. The transparency of the process of identifying and determining the understatement penalty, and any remission thereof by SARS, needed to be revisited especially in light of the constitutional issues it raised (SARS 2011: 178). These factors led to the introduction of the Tax Administration Act.

Chapter 3

The Tax Administration Act understatement penalties and their 'Behaviour' and 'case' aspects

3.1 Introduction

The Parliament of South Africa introduced into law the Tax Administration Act of 2011, which was subsequently published in the *Government Gazette*, on the 4 July 2012. The Tax Administration Act contains four sections in Part A of Chapter 16 which include specific definitions relating to pecuniary sanctions to be imposed on taxpayers who make an understatement that prejudices SARS or the fiscus.

3.2 General review of understatement penalties and definitions in the Tax Administration Act

An understatement penalty is initiated by an 'understatement' determined in terms of s. 222(1) of the Tax Administration Act which states that:

'in the event of an "understatement" ... the taxpayer must pay....the understatement penalty...'

An 'understatement' occurs when a taxpayer causes 'prejudice to SARS or the fiscus' due to any one of four events, as defined in definition of 'understatement', s. 221 of the Tax Administration Act. Once an understatement is identified, s. 223(3) of the Tax Administration Act requires the 'shortfall' to be computed by deducting from the amount properly chargeable under the taxing provisions of the appropriate Act (specifically the Income Tax Act in respect of this report), that which would be charged if the understatement was accepted. The tax rate applicable to the amounts properly chargeable is required, in terms of s. 222(5) of the Tax Administration Act, to be the maximum tax rate applicable to the taxpayer type excluding assessed losses or any other benefit brought forward from a preceding tax period. The computed 'shortfall' is then multiplied by the percentage obtained from the understatement penalty percentage table²² (the penalty table) in s. 223(1) of the Tax Administration Act. The understatement penalty percentage table has five different 'behaviour' type rows and four different 'case' type columns (see Table 1 in Sub-Chapter 4.2, below). These 'behaviour' and 'case' types intersect at various pre-determined penalty percentages specified in the penalty table. The highest understatement percentage relevant to the taxpayer's 'behaviour' and 'case' type is determined and applied to the 'shortfall' in terms of s. 222(2) of the Tax Administration Act. Once the 'behaviour' and 'case' types have been determined, the need for judgment in the quantum of the penalty percentage to be applied is eliminated (SARS 2013b:73). SARS has an obligation to remit a penalty imposed in the event of a the 'behaviour' type specified as a 'substantial understatement' which remission is subject to certain requirements as specified in s. 223(3) of the Tax Administration Act. SARS has no discretion to remit a penalty otherwise (SARS 2013b:73). The imposition of an understatement penalty and its non-remittance, where applicable, are subject to objection and appeal procedures in accordance with s. 224 of the Tax Administration Act.

²² Section 222(2) of the Tax Administration Act states, inter alia, the 'understatement penalty is the amount resulting from applying... the... penalty percentage... to each shortfall determined...'

3.2.1 The definition of understatement

‘Understatement’ is defined in s. 221, ‘Definitions’ of the Tax Administration Act as ‘... any prejudice to SARS or the fiscus as a result of...’ one or more of the following: a default in rendering a return, an omission from a return, an incorrect statement in a return, or if no return is required, the failure to pay the correct amount of tax.

To ‘prejudice’ is defined in the Oxford English Dictionary (OED) as to be detrimental to, or to disadvantage, compromise, hinder or undermine (n.d.). As the word is neither defined in the Tax Administration Act nor in the Income Tax Act, it would seem that the common interpretation of the word applies (Botha 2012: 93) and thus ‘to prejudice’ relates broadly to any fiscal disadvantage to which either SARS, or the fiscus, may be exposed. It is interesting that the legislators deem it necessary to include both SARS and the fiscus as parties which may be prejudiced. SARS’s mandate in respect of the Income Tax Act, as per the long title of the Income Tax Act and read with s. 5(1) of the Income Tax Act, is to recover taxes for payment into the National Revenue Fund. Similarly the long title of the Tax Administration Act is to ‘make provision of the payment of tax’ and, inter alia, recover taxes, interest and understatement penalties for the benefit of the National Revenue Fund. The Tax Administration Act at s. 2 states further that the purpose of the Act is ‘... to ensure the effective and efficient collection of tax ...’. It is therefore not very clear as to where or how SARS, other than as an agent of the National Revenue Fund, may be so prejudiced. The definition of ‘understatement’ in s. 221 of the Tax Administration Act requires the prejudice to SARS or the fiscus to be as a result of a default, omission or incorrect statement in respect of a return or the failure to pay the correct amount of tax (where no return is required). The South Africa Revenue Service Act of 1997 in s. 2 states that SARS is an organ of the state within the public administration and in s. 3 of that Act that SARS stated objective is to collect revenue (which is defined in s.1 of the Act and includes penalties) efficiently and effectively. It is conceivable that because fiscus is not defined in either the Tax Administration Act or the Income Tax Act, the legislators deemed it prudent to extend the description of those who may be prejudiced to both SARS, in its capacity as an agent of the State, and therefore the National Revenue Fund, and the fiscus. As described in the *Merriam-webster dictionary* fiscus is ‘the treasury responsible for collecting taxes’(n.d.)²³ but it is considered that a wider more holistic definition of fiscus would likely apply in the context of s. 221 of the Tax Administration Act.

The ‘prejudice’ occurs as a result of any one of four possible events (s. 221 of the Tax Administration Act). Firstly in terms of s. 221, the definition of ‘understatement’, para (a) of the Tax Administration Act, produce ‘a default in rendering a return’. A default occurs in the event that a taxpayer neglects to render a return, as and when required by the Tax Administration Act in terms of ss. 25, 26 & 27. A ‘return’ is defined in broad terms in the Tax Administration Act, s.1 as:

‘[a] form, declaration, document or other manner of submitting information to SARS that incorporates a self-assessment or is a basis on which an assessment is to be made by SARS...’.

The absence of such a return could result in an estimated assessment being raised by SARS, in terms of s. 95 of the Tax Administration Act, such that a ‘shortfall’ may be determined and an understatement penalty computed in terms of s.222 of the Act. Secondly ‘an omission from a

²³ ‘Fiscus’ – as defined in the *Merriam-webster dictionary* at merriam-webster.com/dictionary/fiscus.

return', in terms of para(b) of the definition of 'understatement' in s. 221 of the Act. An 'omission' from a return occurs when any information that is conceivably relevant to the determination of tax from a return is not included with the return (per Nedstadt J, *CIR v Di Ciccio* 1985 (3) SA 989(T), 47 SATC 199 at 205).²⁴ In this context, if, in the process of calculating the tax payable by a taxpayer, the absence of any information results in the taxation of the taxpayer's income being lower than it would have been if such information was included, it is regarded as an 'omission' (*CIR v Di Ciccio* 1985 (3) SA 989(T), 47 SATC 199 at 205). As in s. 76(1)(c) of the Income Tax Act, the intent behind such an 'omission' is of no consequence in the determination of an 'understatement', due to its determination being an objective factual one, and as such no particular *mens rea* is required (*CIR v Di Ciccio* 1985 (3) SA 989(T), 47 SATC 199 at 205). As stated earlier in this paragraph 'return' is defined very broadly in s. 1 of the Tax Administration Act and could conceivably refer to any information conveyed to SARS, where the taxpayer is cognisant that such information could be utilised for assessment purposes. The corollary of this is that any such information not included in a return could be regarded as an 'omission', which may therefore result in a 'shortfall' and a subsequent understatement penalty determined in terms of s. 222 of the Tax Administration Act. Thirdly, in para(c) of the definition of 'understatement' in s. 221 of the Act, 'an incorrect statement in a return' is information declared which is inaccurate, based on the factual evidence (*CIR v Di Ciccio* 1985 (3) SA 989(T), 47 SATC 199 at 205 where Nedstadt J states '...it [the incorrect statement] relates specifically to facts (which should be disclosed)...'. Similar to an 'omission', discussed above, the intent behind an 'incorrect statement' is immaterial in determining an understatement due to its factually based determination. In the case of *CIR v Di Ciccio* 1985 (3) SA 989(T), 47 SATC 199, at 205, Nestadt J stated that, as the information in the return was culpably and palpably wrong, it was an incorrect statement. Finally, the fourth possible event which may prejudice SARS or the fiscus, as per para(d) of the definition of 'understatement' in s. 221 of the Act is – 'if no return is required, the failure to pay the correct amount of tax' – this would occur where an amount is paid, or meant to be paid, to SARS but where no return is required to be submitted with the payment. It is suggested that while payments can be made to SARS without some form of accompanying documentation (anyone can pay a cheque into SARS bank account), it is not a normal occurrence. The inclusion of this event would seem to cater for the wider range of legislation to which the Tax Administration Act extends as determined in s. 3 of the Tax Administration Act. The determination of the correct amount of tax due is likely based on the factual evidence supporting the requirement for any such payment. Any amount paid which is less than the correctly determined amount of tax as defined in s. 1 of the Tax Administration Act will be regarded as a 'shortfall' and an understatement penalty may be incurred in terms of s. 222 of that Act.

It is significant that, while under the previous legislation the taxpayer carried the burden of proof as to the validity of the 'additional tax' (2011: 199), the onus of proof of an understatement now rests with SARS, in terms of s. 102(2) of the Tax Administration Act. This means that SARS would need to accumulate evidence to substantiate the understatement penalty so determined, while the taxpayer would only need to respond to SARS's determinations (Khaki 2012). This evidential requirement of SARS extends, it is submitted, to the determination of whether 'a *bona fide* inadvertent error' was not '*bona fide*' or an 'inadvertent error'.

²⁴ Nedstadt J stated that 'the question is simply whether, objectively considered, there was an omission of an amount which ought to have been included or an incorrect statement', *CIR v Di Ciccio* 1985 (3) SA 989(T), 47 SATC 199 at 205.

3.2.2 The meaning of the understatement penalty

In its *Explanatory Memorandum on the objects of the Tax Administration Bill, 2011*, SARS states that the rationale for replacing the concept of ‘additional tax’ with the term ‘understatement penalty’ was twofold, firstly, to remove any uncertainty as to its status in respect of s. 77 of the Constitution, which restricts taxes being imposed unless legislated under a money bill, and secondly, so that this additional tax is regarded by the courts as a penalty, and not a tax, as the name clearly states (SARS 2011: 198).

Section 222(1) of the Tax Administration Act details what is regarded as an ‘Understatement penalty’ and states that:

‘(1) In the event of an “understatement” by a taxpayer, the taxpayer must pay, in addition to the “tax” payable for the relevant tax period, the understatement penalty determined under subsection (2) unless the “understatement” results from a *bona fide* inadvertent error.’

An ‘understatement’, as defined, is the catalyst for the required payment of an understatement penalty (see Sub-Chapter 3.2.1, above). The ‘taxpayer’ is broadly defined in s. 151 of the Tax Administration Act,²⁵ and this definition incorporates all the possible taxpayer types, including representatives, agents and responsible third parties in an attempt to ensure the widest possible ambit of the application of the provisions of this Act. The term ‘must pay’ is seemingly more in the present tense and has certainty, as it implies no refrain or abatement (OED n.d.) unlike the previous legislation, which, at s. 76(1) of the Income Tax Act, stated ‘... shall be required to pay...’, which connotes a reference to a future event (OED n.d.) inferring a requirement for subsequent action, such as SARS discretion to remit penalties (s. 76(2)(a)). It should, however, be noted that the limited possibility for remission still exists, as stated in s. 223(3) of the Act. This possibility is of limited application, however (it applies only to a ‘substantial understatement’), and is therefore generally not available to most taxpayers (Edward Nathan Sonnenbergs 2013). The term ‘in addition to the “tax” payable’ would seem to clarify that the understatement penalty is an additional amount to be paid, and is not part of the normal tax payable otherwise. Due to the understatement penalty being called an additional tax in the past, the courts deemed it necessary to clarify it as ‘penal’ in nature (*CIR v McNeil* 1958 (3) SA 375(N), 22 SATC 374 at 180). ‘Tax’ is also defined in s. 1 of the Tax Administration Act²⁶ and it includes all the tax types which may conceivably fall foul of the Tax Administration Act’s understatement penalty regime. The term ‘relevant tax period’ clarifies that the understatement penalty relates to the specific tax period in which the ‘shortfall’ occurred and not just to when the prejudice to SARS or the fiscus occurred in respect of an ‘understatement’ which could conceivably occur on two different dates (SARS 2013a:40). The provision that an understatement resulting from ‘a *bona fide* inadvertent error’ is not subject to payment of an understatement penalty is particularly relevant to any taxpayer who submits a return containing

²⁵ Taxpayer is defined in this Act as ‘(a) a person chargeable to tax; (b) a representative taxpayer; (c) a withholding agent; (d) a responsible third party; (e) a person who is the subject of a request to provide assistance under an international tax agreement.’ All of the aforementioned, with the exception of (e), are also further defined in ss. 152, 153, 156 and 158 of the Tax Administration Act but these definitions are not considered relevant in the context of this report.

²⁶ Tax is defined ‘for purposes of administration under this Act’ as including ‘a tax, duty, levy, royalty, fee, contribution, penalty, interest and any other monies imposed under a Tax act.’ Note that ‘tax Act’ is also defined and includes the Tax Administration Act or an Act, or portion thereof, as defined in s.4 of the South African Revenue Service Act 1997, with the exception of the Customs and Excise Act.

one, or more, errors. That SARS is required to prove the error was ‘not inadvertent’ or not ‘*bona fide*’ is undoubtedly of benefit to the taxpayer (Williams 2014:9). Section 222(1) of the Tax Administration Act specifically excludes the levy of an understatement penalty on such an error even when it is a default, omission, incorrect statement or failure to pay the correct amount. SARS included this clause via an amendment to the original Tax Administration Act²⁷ and explained in its *Memorandum on the objects of the Tax Administration Laws Amendment Bill 2013* that, due to the broad range of possible errors that may occur, no definition of a ‘*bona fide* inadvertent error’ is included in the Tax Administration Act because such a definition might inadvertently exclude deserving cases or alternatively include undeserving cases (2013a: 41). SARS stated that guidance on what constitutes a ‘*bona fide* inadvertent error’ would be developed for both taxpayers and SARS officials in time, but as at the time of writing, none is yet available (SARS 2013a: 41). In its *Draft Memorandum on the Objects of the Taxation Act Amendment Bill, 2013*, SARS states that due regard would be shown to ‘the circumstances in which the error was made’ when determining whether the understatement was a result of a ‘*bona fide* inadvertent error’ (SARS 2013e: 13), and it would also consider other factors such as:

- the taxpayer’s knowledge, education and skill and the care a reasonable person in the same circumstances would have exercised,
- the quantum, nature and frequency of the error,
- the taxpayer’s previous return history,
- in the case of an arithmetic error, what procedures the taxpayer had in place in respect of arithmetical errors, and
- in respect of legal interpretive errors, the legal provisions’ complexity, the taxpayer’s attempt at understanding, or the reliance on information from a reputable source (SARS 2013e: 13).

The term *bona fide* is defined in the OED as, inter alia, ‘without intention to deceive, genuine, legitimate, valid and with good faith...’ (n.d.). In this context, the interpretation of ‘*bona fide*’ weighs up the taxpayers stated (subjective) intention with the associated facts and circumstances based on the balance of probability (Williams 2014:10), and is therefore inherently subjective. In ITC 1423 (1986) 49 SATC 85(Z) at 94, the meaning of ‘good faith’ was examined where, in delivering judgment Smith J, quoted from another judgment, *R v Nyakuwa & another* 1980 ZLR 19 at 22-3, saying that the ‘question of whether the [errors] were done “in good faith” occasions greater difficulty.... to establish on a balance of probabilityThe result, however, more often than not will be circumstantial evidence of the [cause of the error]....’ It would seem that, in the current available legal interpretation, the determination of what constitutes ‘*bona fide*’ is to be based on the circumstantial evidence available and the balance of probability. It is likely that the subjectivity inherent in this term will lead to significant disagreement between the taxpayer and SARS about the determination of an error as ‘*bona fide*’ or its antithesis *mala fide* (Williams 2014:10).

The meaning of ‘inadvertent error’ is not a defined tax term (Williams 2014:10). Inadvertent and error are respectively defined in the OED as ‘unintentional, unintended, unplanned, unthinking and innocent...’ (n.d.) and ‘a mistake, inaccuracy, erratum, misprint and miscalculation...’ (n.d.). In order to determine what constitutes an ‘inadvertent error’ SARS would logically, firstly, be required to establish that an error has occurred. An error is identified as information presented to SARS that is

²⁷ Substituted by s.75(a) of the Tax Administration Laws Amendment Act of 2013.

objectively incorrect (in some manner or form) when compared to the supporting, factually correct, information (Williams 2014:10). The results required to meet the definition of an 'understatement' in terms of s. 221 of the Tax Administration Act are defaults, omissions, incorrect statements and failure to pay could, depending on the circumstances, all be considered as 'errors'. The nature and cause of the error would then have to be determined in order to determine if it was 'inadvertent'. Guidance from SARS on the meaning of 'inadvertent' would likely indicate its proposed application, in the context of either a narrow or a wide interpretation, but this guidance is not, as yet, forthcoming. The issues as to what may constitute 'inadvertent', and what SARS need to address, in this context are likely to be wide ranging, and may, for example, include:

- If a taxpayer could conceivably have envisaged an understatement error occurring in a specific scenario, could it still be regarded as 'inadvertent'?
- Could an entity with strong internal controls designed to identify errors ever claim that an unidentified error is 'inadvertent'?
- If there are no controls in place, could an error always be considered 'inadvertent' or would it depend on the nature of the error?
- While it is trite that ignorance of the law is no excuse for contravening the law, could a taxpayer still claim an error as 'inadvertent' if it was due to the taxpayers relative circumstances (for example illiteracy), or if the error occurred due to the taxpayer's relative lack of specific knowledge of a particular law could the error still be 'inadvertent'?
- Can a lack of knowledge of specific laws, as opposed to the general application of the law, ever be determined as an 'inadvertent' error?

In the case, *Cheek v United States*, 498 U.S. 192, 111 S. Ct.604, 112L Ed.2d 617(1991), a taxpayer was charged with tax evasion and wilfully failing to file tax returns. The taxpayer's defence was that, while attending certain seminars, he had heard the speakers say that the IRS's application of the laws was unconstitutional, and the taxpayer sincerely believed that to be the case (Casebriefs, n.d.). White, J in his judgment held that an unreasonable belief, even if claimed in all honesty and good faith, cannot negate the USA Internal Revenue codes criminal provisions requirement for wilfulness to comply, and further, significantly, that ignorance of the law may be a defence against wilfulness if the taxpayer's misunderstanding is in good faith (*Cheek v United States* 498 U.S. 192, 111 S. Ct.604, 112L Ed.2d 617(1991) at 199-200).

As the determination of both '*bona fide*' and 'inadvertent' will ultimately be based on the intent of the taxpayer, and the circumstantial evidence surrounding the nature of the error, this can only be regarded as subjective (Williams, 2014:10). Due to this subjectivity, it is likely that, even in the event of SARS issuing some informative guidance to their interpretation, the courts will be called upon to adjudicate, in this matter, in the future. The advantage for the taxpayer is that the onus will be on SARS to prove that it was not a 'bona fide inadvertent error', made in good faith (Williams 2014:10). From a practical perspective, taxpayers should, of course, ensure that submissions to SARS are properly managed to ensure that SARS reaches the correct conclusion (Williams 2014:10). An article in *TaxTalk*²⁸ suggests that the taxpayer can make it extremely difficult for SARS to dismiss the burden of proof by, for example, implementing certain processes and actions in respect of tax submissions

²⁸ *TaxTalk* is a journal issued by the South African Institute of Tax Practitioners.

and obtaining tax opinions timeously in respect of substantial understatements, thus limiting their exposure to possible understatement penalties (van der Zwan 2013).

Where more than one 'shortfall' has been determined s. 222(2) of the Tax Administration Act requires that the understatement penalty be determined utilising each shortfall's highest applicable understatement penalty percentage, as reflected in the understatement penalty percentage table of s. 223(1) of the Tax Administration Act. Section 222(2) of the tax Administration Act states that:

'[t]he understatement penalty is the amount resulting from applying the highest applicable understatement penalty percentage in accordance with the table in section 223 to each shortfall determined under subsection (3) and (4) in relation to each understatement in a return.'

Applying different penalties to each 'shortfall' is confirmed by SARS in its *Memorandum on the Objects of the Tax Administration Laws Amendment Bill, 2013* which explains that the use of 'each' and 'in relation to each understatement in a return' is to avoid an unnecessarily onerous penalty resulting from the overall highest possible penalty percentage being applied indiscriminately to every understatement (2013a: 40). SARS states that each understatement must be separately, or individually, determined and the appropriate 'behaviour' type applied (2013a: 40) according to the specific merits related specifically to the understatement, the case and the taxpayer due, for example, to a 'shortfall' being capable of transgressing both 'gross negligence' and 'no reasonable grounds for "tax position" taken'.

3.2.3 The shortfall analysed

The 'shortfall' is determined in accordance with s. 222(3) of the Tax Administration Act by adding three possible 'shortfall' scenarios as follows:

'(3) The shortfall is the sum of:

(a) the difference between the amount of 'tax' properly chargeable for the tax period and the amount of 'tax' that would have been chargeable for the tax period if the 'understatement' were accepted;

(b) the difference between the amount properly refundable for the tax period and the amount that would have been refundable if the 'understatement' were accepted; and

(c) the difference between the amount of an assessed loss or any other benefit to the taxpayer properly carried forward from the tax period to a succeeding tax period and the amount that would have been carried forward if the 'understatement' were accepted, multiplied by the tax rate determined under subsection (5).

Section 222(4) of the Tax Administration Act includes an additional situation where two of the above mentioned 'shortfall' scenarios overlap:

'(4) If there is a difference under both paragraph (a) and (b) of subsection (3), the shortfall must be reduced by the amount of any duplication between the paragraphs.'

Section 222(5) of the Tax administration Act states:

‘(5) The tax rate applicable to the shortfall determined under subsections (3) and (4) is the maximum tax rate applicable to the taxpayer, ignoring an assessed loss or any other benefit brought forward from a preceding tax period to the tax period.’

In s. 222(3)(a) of the Act, the ‘shortfall’ is envisaged as the difference between the tax that which should have been charged in the tax period, and the amount of tax that would have been charged if the understatement had been accepted, related to each ‘shortfall’ individually identified. This would apply to scenarios involving under-declared income or over-stated expenditures, allowances or deductions for example. Section 222(3)(b) caters for the situation where a taxpayer has overpaid taxes and is due a refund of tax but, due to the understatement, receives a higher refund than the taxpayer was otherwise entitled to. The difference between the refund initially determined and the amount subsequently properly determined would be regarded as the ‘shortfall’. The third scenario described in s. 222(3)(c) relates to taxpayers who find themselves in an assessed loss situation wherein the loss, properly determined, is subtracted from the loss that would have been determined had the understatement been accepted. Section 222(4) of the Tax Administration Act caters for the scenario where s. 222(3)(a) and s. 222(3)(b) are duplicated and apply at the same time. This subsection therefore allows for the reduction of amounts which may be duplicated in determining each identified ‘shortfall’ on which the understatement penalty would be charged.

Once the ‘shortfall’ is determined for each possible difference identified above its then added together and multiplied by the maximum tax rate applicable to the taxpayer as required by s. 222(5) of the Tax Administration Act. The maximum tax rate applicable to each taxpayer is determined by the nature of the taxpayer (that is, whether the taxpayer is a corporate, individual, trust, estate et cetera) and the legislated relevant tax rate applicable to the specific taxpayer in terms of the Income Tax Act (SARS 2013b: 78). The applicable may also vary on an annual basis for example if a company becomes a small business corporation. Similarly an individual has a progressive tax rate based on the individual’s taxable income and as such the applicable tax rates may vary due to different levels of taxable income. Each year should therefore be viewed independently and only the rate applicable to the person/entity for that year will apply. This is supported by s. 222(1) of the Act where it states that the understatement penalty payable is determined in addition to the “tax” payable for the relevant tax period’. While not specifically stated it is presumed that the maximum tax rate to be determined is after taxable income has been adjusted by the ‘shortfall’, and properly charged, and not prior thereto (Clegg 2014: at 102). Section 222(5) of the Tax Administration Act states that assessed losses and ‘any other benefit brought forward’ from preceding tax periods are ignored in determining the tax rate to be applied.

3.3 The ‘behaviour’ and ‘case’ types included in the understatement penalty percentage table

The understatement penalty determination table presented in s. 223(1) of the Tax Administration Act has five different ‘behaviour’ rows and four different ‘case’ columns. These ‘behaviour’ and ‘case’ types intersect at pre-determined penalty percentages, thus, once the ‘behaviour’ and ‘case’ types have been determined, the need for judgment in the quantum of the penalty percentage to be applied is eliminated (SARS 2013b:73). SARS’s stated objective is that non-compliance penalties are to be applied impartially and proportionally to the seriousness, and duration, of the incidence of the non-compliance, and further, that a discretionary judgment in imposing sanctions is only required where non-compliance is based on negligence or intent (2013b:73).

3.3.1 Understatement penalty definitions listed in the Tax Administration Act

Certain of the 'behaviour' and 'case' types listed in the table are defined in the Tax Administration Act at s. 221, under the heading 'Definitions'. Included in this section is the definition of a 'repeat case' type, which is defined as follows:

“repeat case” means a second or further case of any of the behaviours listed under items (i) to (v) of the understatement penalty percentage table reflected in section 223 within five years of the previous case’.

There is a significant increase in the penalty percentage applicable to the 'repeat case' type from that of a 'standard case' type for example the percentage doubles for the 'behaviour' type 'reasonable care not taken' whilst the 'gross negligence' type incurs a relatively smaller 25% increase in the penalty percentage (Clegg 2014:103). This does not appear to be appropriate in light of the nature of the different 'behaviour' types. The rand value of double the penalty on a 'substantial understatement' would be, by definition, materially significant to the taxpayer. It is considered that the doubling of the penalty is unlikely to be considered fair, when compared to the intentional repeat tax evaders 33.3% increase, even though they are then paying twice the tax otherwise chargeable.

The meaning of the words '... any of the behaviours listed ...' in s. 221's definition of a 'repeat case' is not patently clear as to what the 'repeat' refers to for example it could be construed as meaning a second instance of the same behaviour, or alternatively, the second instance of any of the behaviours (Clegg 2014: 103).

The definition of a 'substantial understatement' in s. 221 of the Act is as follows:

“substantial understatement” means a case where the prejudice to SARS or the *fiscus* exceeds the greater of five per cent of the amount of “tax” properly chargeable or refundable under a tax Act for the relevant tax period, or R1 000 000.’

The inclusion of a substantial understatement definition is to discourage taxpayers from taking 'aggressive' tax positions²⁹, that are considered significant in value, both in absolute and relative terms, to the taxpayer (SCOF 2013:59), and that do not fit into any of the other 'behaviour' types (SARS 2013b:79). To achieve this, a rand value, based on materiality, in relation to the taxes payable, by a taxpayer, was determined as the appropriate basis (SCOF 2013:59). The determination of the greater of 5% of the tax properly charged, and R1 000 000, is calculated objectively, the percentage being derived from the 'lower bound(sic) of the materiality threshold that is commonly used in audit practice when applied to net income....' (SCOF,2013: 59) and the R1 000 000, as a fair indicator, based on the context of the taxpayer to which this substantial understatement may apply, in terms of its own materiality levels and, presumably, relative to the resources required by SARS to investigate and adjudicate in these matters.

The definition of 'tax' in s. 221 in the Tax Administration Act is as follows:

²⁹ No indication of what is considered 'aggressive positions' is given in the memorandum but in its context it is presumed to be taxpayers entering into a 'tax position', as identified in s. 221 of the Tax Administration Act, which may not meet the requirements of s.223(3)(b)(iii), of the Tax Administration Act, in respect of a 'position', 'more likely than not to be upheld... [in]... court...'.

‘**“tax”** means tax as defined in section 1, excluding a penalty and interest.’

The definition of tax in s. 1 of the Tax Administration Act includes:

‘... tax, duty, levy, royalty, fee, contribution, penalty, interest, and any other moneys imposed under a tax Act...’,

but for the purposes of this report, ‘tax’ relates to taxes imposed under the Income Tax Act.

The definition of ‘tax position’ in s. 221 of the Tax Administration Act is as follows:

‘**“tax position”** means an assumption underlying one or more aspects of a tax return, including whether or not:

- (a) an amount, transaction, event or item is taxable;
- (b) an amount or item is deductible or may be set-off;
- (c) a lower rate of tax than the maximum applicable to that class of taxpayer, transaction, event or item applies; or
- (d) an amount qualifies as a reduction of tax payable.’

The ‘assumption’ of a tax position, and presumably the possibility of more than one ‘assumption’ in a tax return, means, according to the Oxford English Dictionary, and in the context of this definition, ‘accepted as true, without proof’ (n.d.). The intent of the legislators, based on the use of the term ‘including whether or not’, thereby encompassing both positive and negative connotations, would appear to convey a very wide context with respect to any such ‘tax position’ assumed. The first specific inclusion, in s. 221 para (a) in the ‘tax position’ definition of the Tax Administration Act, appears to relate to gross income (both defined in s. 1 of the Income Tax Act) as the amount, ‘transaction’, ‘event’ or ‘item’ are required to be taxable, or not. It is not made clear what an ‘event’, or ‘item’, may entail that is not covered by an ‘amount’ or ‘transaction’, but based on their absence from the second inclusion type, they only relate to gross income in some form. The second inclusion, s. 221 para (b) in the ‘tax position’ definition of the Tax Administration Act, relates to the deductibility or off-set potential of an ‘amount’ or ‘item’ (for example an expense or allowance, respectively), but interestingly, not of a ‘transaction’ or ‘event’. The third inclusion in s. 221 para (c), in the ‘tax position’ definition of the Tax Administration Act, relates to the utilisation, or not, of a ‘lower tax rate’ than the maximum applicable to the class of taxpayer, in respect of the taxpayer’s assumed tax position would appear to be directed at the contrived use of taxpayers’ with lower tax rates, than would otherwise be applicable to the taxpayer, for example a taxpayer incorrectly claiming it is a small business corporation. Finally the fourth event in s. 221 para (d) in the ‘tax position’ definition of the Tax Administration Act only relates to an ‘amount’, refers to a possible ‘reduced tax payable’, or not which would seem to include amounts that may, or may not, reduce tax that is otherwise payable such as rebates, assessed losses and tax credits.

3.3.2 ‘Substantial understatement’ behaviour analysed

SARS suggests that a ‘behaviour’ type should be identified first, and then a ‘case’ type should be determined (SARS 2013b: at 79). However, this sequence of determination is of no real consequence. The ‘behaviour’ column of the penalty table, in s. 223(1) of the Tax Administration Act, includes five ‘behaviour’ types:

- ‘Substantial understatement’
- Reasonable care not taken in completing a return
- No reasonable grounds for ‘tax position’ taken

- Gross negligence
- Intentional tax evasion

The identification of a 'substantial understatement' behaviour type, as defined in the Tax Administration Act at s. 221 (see Sub-Chapter 3.3.1, above), acts as a disincentive to large taxpayers and high net worth individuals, who may otherwise take aggressive tax positions (SCOF 2013: 59). Large taxpayers are expected to incorporate the principles of tax risk management in their governance structures but, even with full implementation of such tax risk management, disagreements with SARS will inevitably arise (SCOF 2013: 60). The Standing Committee on Finance noted that, if no substantial understatement penalty was incorporated into the Tax Administration Act, then taxpayers who adopt aggressive tax positions would, even if detected, only incur the tax that should have been charged plus interest thereon (2013:59). The 'substantial underpayment' is the only behaviour type for which an understatement penalty may be remitted by SARS (Section 223(3) of the Tax Administration Act). A 'rigorous test' was therefore introduced, and is required by s. 223(3) of the Act, for cases where an understatement penalty remission might need to be determined (SCOF 2013: 60).

SARS states that if no other stated behaviour defines the facts of the case, then, subject to the measurement criteria of a substantial understatement, the 'substantial understatement' behaviour will apply (SARS 2013b:79).

3.3.3 'Reasonable care not taken in completing return' behaviour analysed

The term 'reasonable care' is not defined in the Tax Administration Act. SARS states in its explanatory memorandum that 'reasonable care' means:

'... the degree of care that a reasonable, ordinary person in the circumstances of the taxpayer would take to fulfil his or her tax obligations..... If a taxpayer uses an adviser ... [who] does not exercise reasonable care, the taxpayer is liable...' (SARS 2013b:80).

This 'behaviour' type would appear to refer to the taxpayer who makes a '*bona fide*' error on a return, as there is then an apparent lack of intent, but who is unable to convince SARS that the error was 'inadvertent'.

In an article in *Integritax*, the authors cite the definition laid down in *Kruger v Coetzee* [1996] (2) SA 428 that conduct will be regarded as negligent, or that reasonable care will be considered to have not been taken, if a 'reasonable person' would have acted differently under the same circumstances and could have reasonably foreseen the consequences of his actions, and taken steps to avoid them (Cliffe Dekker Hofmeyr 2014).

The Australian Tax Office (ATO) states that 'reasonable care', is one of the four 'behaviour' types that it uses to determine culpability in terms of its understatement penalty regime (ATO n.d.(a)). The ATO issued a Miscellaneous Taxation Ruling in respect of, inter alia, the meaning of 'reasonable care', which in the context of making a statement to the Commissioner, the ATO understands 'reasonable care' to mean:

‘... giving appropriately serious attention to complying with the obligations imposed under a taxation law’ (2008: para 27).

The ruling goes on to state that the effort required to reasonably attempt to comply with the Tax Act is commensurate with the taxpayer’s circumstances, which include the taxpayer’s knowledge, education, experience and skill (ATO 2008: para 28). The ATO states that the proving of negligence in Australian common law is benchmarked against what a reasonable person of ordinary prudence would, or would not, have done in response to a situation, this involves the application of an objective test, which differs from the assessment of ‘reasonable care’, which is more subjective in nature as it takes the taxpayer’s circumstances into consideration (ATO 2008: para 31). The intention to act with ‘reasonable care’ is not relevant, only the acts relevant to what constitutes ‘reasonable care’ are taken into consideration (ATO 2008: para 34). This appears to correspond with the historical approach in South Africa, as indicated by the Kruger case, above.

In its tax ruling, the ATO also indicates that ‘reasonable care’ does not connote the highest level of care or perfection (2008: para 35). In this regard the ATO refers to *Maloney v. Commissioner for Railways (NSW)* (1978) 52 ALJR 292 at 292; (1978) 18 ALR 147 at 148, where Barwick CJ observed, inter alia, that:

‘[p]erfection or the use of increased knowledge or experience embraced in hindsight after the event should form no part of the components of what is reasonable in all the circumstances. That matter must be judged in prospect and not in retrospect’.

Similarly, SARS has stated that ‘reasonable care’ does not necessarily mean perfection, and cites the interpretation of reasonable care used in the United Kingdom as support (van der Zwan 2013). In another case quoted in the ATO tax ruling, *Reeders v. Federal Commissioner of Taxation* [2001] AATA 933; 2001 ATC 2334; (2001) 48 ATR 1170, the courts found that the ATO did not identify and consider evidence relating to care in relation to a claim made to deduct self-education expenses, and had merely presumed the lack of care. The ATO’s decision-making process was therefore considered flawed (ATO 2008: para 43).

In its *Practice Statement Law Administration*, the ATO lists items for consideration when assessing reasonable care, and what it regards as ‘personal circumstances’, including whether:

- ‘there was an inadvertent mistake,
- reasonable enquiries were made, which may be indicated by whether:
 - the entity just assumed the statement was correct
 - the degree of enquiry exhibited by the entity was commensurate with the risk associated with the decision and their resources,
- the entity was aware, or should have been aware, of the correct treatment of the law or of the facts:
 - an entity should not rely on advice they have received where a reasonable person would be expected to know the advice is not worthy of such reliance
 - an entity is not obliged or entitled to blithely accept assurance by his or her professional advisor,
- any factors prevented them from reporting, reporting correctly, seeking advice or understanding the requirements of the tax law, and
- the entity’s level of knowledge or understanding of the tax system impacted their compliance, with reference to:
 - whether a registered tax agent or BAS agent was used

- the entity's level of education, expertise and sophistication relating to tax matters, or
- the entity's age, health and background' (ATO 2013: para 73).

Unfortunately the list does not go further in its explanation of what might be regarded as an 'inadvertent error', which might otherwise have assisted in the determination of such an error under the South African tax regime.

It is noteworthy that in Australia, as in South Africa, the existence of a 'shortfall' caused by a 'false or misleading statement' (the Australian version of an understatement) is not presumed to mean that there was an automatic failure to take 'reasonable care' (ATO 2008: at para 42). The evidence must support the conclusion that the standard of care that could reasonably be expected, was absent in the circumstances (ATO 2008: at para 42). In the case of *Hart v. Federal Commissioner of Taxation* (2003) 131 FCR 203; [2003] FCAFC 105; 2003 ATC 4665; (2003) 53 ATR 371 at paragraph 44, Hill and Hely JJ note that 'in the ordinary case, the mere fact that a tax return includes a deduction which is not allowable is not of itself sufficient to expose the taxpayer to a penalty. Negligence, at least must be established...' (ATO 2008: para 42).

The United Kingdom tax authority imposes an understatement penalty for being careless in a return, which is defined as 'a failure to take reasonable care' (van der Zwan 2013). An *Integritax* article by Cliffe Dekker Hofmeyr included a case from the United Kingdom, *Harding v Revenue and Customs Commissioners* [2013] UKUT 575 (TCC), where it was decided that an omission of income from a taxpayer's return was regarded as careless, as the taxpayer could, or should, have known the income was subject to tax, and he therefore failed to take reasonable care (2014). This decision was relevant in respect of the application of an understatement penalty (Cliffe Dekker Hofmeyr 2014). The author of the article went on to hypothesise if the same facts as in Harding's case were tested against the Tax Administration Act in South Africa, and the 'reasonable person' test was to be applied, the South African Tax Court would likely come to the same conclusion that the United Kingdom's Upper Tribunal did (2014). In its published manual CH 81130, Her Majesty's Revenue & Customs (HMRC) discusses 'reasonable care', and states that even if an inaccuracy (the United Kingdom's equivalent of an understatement) occurs, it may be waived if reasonable care has been taken in completing the return (HMRC n.d.(a)). In a 2011 case in the United Kingdom, *Leachman V HMRC* [2011] UKFTT 261, the tribunal overturned a penalty levied by HMRC based on the fact that a genuine mistake could constitute a 'reasonable excuse'. The manual goes on to state that a person will be treated as having taken 'reasonable care' if:

- 'arrangements or systems exist that, if followed, could reasonably be expected to produce an accurate basis for the calculation of tax due either internally or through an external agent and
- despite such a system, properly utilised, an inaccuracy resulted in a misstatement of tax liability and
- the effect of the inaccuracies is not significant in relation to the taxpayer's overall tax liability in that tax period' (HMRC n.d.(a)).

The last point above is of interest in that it brings the concept of materiality into play. While it is understandable that the utilisation of HMRC's resources is limited, it would seem difficult to justify the fairness of determining whether a taxpayer has taken reasonable care or not, based on the value of an understatement, even when such inaccuracy is considered in proportion to the taxpayer's tax liability.

3.3.4 'No reasonable grounds for "tax position" taken' behaviour analysed

The 'no reasonable grounds for a "tax" position taken' behaviour refers to taxpayers who assume a particular view in respect of the tax treatment of an amount, item, transaction or event, which, in SARS's frame of reference, is untenable (2013b: 80). The definition of 'tax position' was reviewed earlier in this report (see Sub-Chapter 3.3.1, above). If a 'shortfall' arises due to a substantive disagreement between SARS and the taxpayer concerning the application of a taxation provision, an understatement penalty will be imposed if the taxpayer's position is not based on reasonable grounds (SARS 2013b: 80). The purpose is not to levy a penalty every time SARS disagrees with a position adopted by a taxpayer, but to attach a penalty where a taxpayer assumes a position unreasonably (SARS 2013b: 80). SARS states that, as there is an inherent risk in assuming a tax position, taxpayers are expected to take a sensible approach in the process of adopting such a position, and also to have considered the integrity of the tax position taken (2013b: 80). An assumption of a 'tax position' is considered 'reasonably arguable' by SARS if it was assumed with regard to relevant authority, for example income tax law, a court decision or a document issued by SARS, and is considered more likely than not, correct (SARS 2013b: 80). South African legislators appear to have followed the New Zealand tax authorities in respect of determining an unacceptable 'tax position' as one that fails to meet the standard of being, as likely as not, correct (IRD: n.d.).

The ATO states, in a published ruling, that a reasonably arguable position focuses solely on the merits of the position taken, and is therefore a purely objective standard involving an analysis and application of the law to the relevant facts (2008: para 35). The ATO regards a reasonably arguable position as being more onerous to achieve than reasonable care due to the process involved in establishing a reasonable position (2008: para 40). The ATO is of the opinion that an entity that adopts a tax treatment that is inconsistent with that of the Commissioner has still exercised reasonable care if a genuine effort has been made to research the issue which supports the basis for the position taken (2008: para 61).

In its manual on 'inaccuracy despite taking reasonable care', HMRC states that when an inaccuracy in a document occurs, despite the taxpayer's having taken reasonable care, no penalty will be levied if a 'reasonably arguable view' of the situation exists, even if the 'reasonable arguable view' is subsequently not upheld (HMRC n.d.(a)). The manual goes on to state that if a taxpayer acts on advice from a competent adviser (who was accurately given all the facts), or accepts information from another person that is not verifiably accurate or complete, then no penalty is levied (HMRC n.d.(a)).

In an Internal Revenue Bulletin,³⁰ issued by the IRS in the USA, it was indicated that 'reasonable belief' based on good faith, in respect of a position that would 'more likely than not be sustained on the merits of the position [taken]', would likely meet the penalty exemption requirements (2008: paras D, E and F).

3.3.5 'Gross negligence' behaviour analysed

The 'gross negligence' behaviour refers to those taxpayers who have submitted a return but not taken reasonable care in the submission to the extent that a high level of disregard for the

³⁰ IRS, 2008, Internal Revenue Bulletin, Notice 2008-13. Although this bulletin was directed at tax preparers it is considered equally applicable to the taxpayers themselves.

consequences is suggested or implied by the lack of care taken in the return's completion and the resulting understatement (SARS 2013b:80). The test for negligence is objectively oriented and based on what a reasonable person would regard as conduct that creates a high risk of a tax 'shortfall' (SARS 2013b: 80). 'Gross negligence' involves 'recklessness' and is differentiated from evasion by the fact that it does not require an element of *mens rea* or intent to breach a tax obligation (2013b: 80).

In an article in *TaxTalk*, van der Zwan states that the courts have determined that 'gross negligence' is distinguished from ordinary negligence by the lack of consciousness of risk-taking (2013). The author suggests that a taxpayer is unlikely to be regarded as grossly negligent if he or she instituted processes and controls that take into account the tax consequences of transactions or events (2013).

'Recklessness' was discussed in a South African case, *Philotex (Pty) Ltd and Others v Snyman and Others; Braitex (Pty) Ltd and Others v Snyman and Others* 1998 (2) SA 138 (SCA)³¹ in respect of the culpability of directors. The presiding judge, Howie JA, determined that 'the ordinary meaning of "recklessly" included gross negligence' and quoted the concept of gross negligence described in *S v Dhlamini* 1988 (2) SA 302 (A) at 308D–E as including an attitude or state of mind characterised by:

'an entire failure to give consideration to the consequences of one's actions, in other words, an attitude of reckless disregard of such consequences'. (*Philotex (Pty) Ltd and Others v Snyman and Others; Braitex (Pty) Ltd and Others v Snyman and Others* 1998 (2) SA 138 (SCA) at 8).

The judge was of the opinion that this position was objective insofar as the person's actions were concerned when measured against 'the notional reasonable person...' in the *Philotex (Pty) Ltd and Others* case, at 8, but was:

'subjective insofar as one had to postulate that notional being as belonging to the same group or class of the [person being judged], moving in the same spheres and having the same knowledge or means to knowledge.' (*Philotex (Pty) Ltd and Others* case, at 8)

The learned judge continued, stating that:

'[i]t remained, as far as subjectivity was concerned, to be pointed out that risk-consciousness in the realm of recklessness did not amount to or include that foresight of the consequences ...which was necessary for *dolus eventualis* (that is, intention imputed because of an awareness of possibility – since the result, though not intended, was foreseen as a possibility)' (*Philotex (Pty) Ltd and Others* case, at 8).

In the Australian penalty regime, the equivalent of what South African tax law regards as gross negligence is 'recklessness' (Cliffe Dekker Hofmeyr, 2013). Recklessness is not defined in Australian legislation but it connotes conduct that is more culpable than a failure to take reasonable care in complying with the taxing statutes, but less than an intentional disregard (ATO 2008: para 99). The determination of 'recklessness' is regarded as an objective test, based on specific circumstances and intention, and dishonest intent is not relevant in establishing 'recklessness' (ATO, 2008: para 100). The ATO cites the *Shawingian Ltd v. Vokins & Co Ltd* [1961] 2 Lloyd's Rep 153 at 162; [1961] 1 WLR

³¹ *v Snyman and Others; Braitex (Pty) Ltd and Others v Snyman and Others* 1998 (2) SA 138 (SCA). [Online], 30 November 2014, from <http://www.saflii.org/za/cases/ZASCA/1997/92.html>.

1206 at 1214; [1961] 3 All ER 396 at 403, case in respect of the meaning of recklessness where Megaw J states that:

‘[r]ecklessness is gross carelessness – the doing of something which in fact involves a risk, whether the doer realises it or not; and the risk being such having regard to all the circumstances, that the taking of that risk would be described as ‘reckless’. The likelihood or otherwise that damage will follow is one element to be considered, not whether the doer of the act actually realised the likelihood. The extent of the damage which is likely to follow is another element...’ (ATO 2008: para 103).

Megaw J further states in the *Shawingon Ltd v. Vokins & Co Ltd*, at 403, that:

‘[i]f the risk is slight and the damage which will follow if things go wrong is small, it may not be reckless, however unjustified the doing of the act may be. If the risk is great, and the probable damage great, recklessness may readily be a fair description, however much the doer may regard the action as justified and reasonable. Each case has to be viewed on its own particular facts and not by reference to any formula’ (ATO 2008: para 104).

It would appear that the learned judge is of the opinion that the degree of the risk and the gravity of the consequences, are influential in determining whether the conduct is regarded as reckless, or not (ATO 2008: para 104).

In the United States legal codes, the definition of negligence ‘includes any failure to make a reasonable attempt to comply with the provisions of [the Act]...’ (U.S.Code Title 26, Subtitle F, Chapter 68, Subchapter A, Part II, § 6662(c)), the meaning of ‘reasonable attempt’ in this context has been discussed previously in this report (see Sub-Chapter 3.3.3, above).

3.3.6 ‘Intentional tax evasion’ behaviour analysed

The category of this behaviour type refers to those taxpayers who wilfully and knowingly, with intent, attempt to evade taxes (2013b:81). SARS regards evasion as including the reduction or concealment of an amount required to be paid, and the inflation of a refund (2013b:81). Intention to evade tax is difficult to differentiate from a grossly negligent act, but nevertheless, SARS would have to make a determination based on the specific circumstances of the taxpayer and the actions that brought about the understatement (SARS 2013b:81).

The type of actions and specific circumstances relating to a taxpayer in the determination of intentional tax evasion were highlighted in a case concerning the purchase of a vehicle where, on certain allowances claimed by the taxpayer, the revenue authorities had levied a 200% penalty (ITC No 1334 (1981) 43 SATC 98(Z)). In his judgment, Squires J stated that the taxpayer did not satisfy the court that he (the taxpayer) did not make the claim or incorrect statement without the intention of evading tax (ITC No 1334 (1981) 43 SATC 98(Z) at 107). The reasons put forward by the judge were based on the taxpayer not being a credible witness (due to inconsistencies, contradictions and improbabilities), his ‘unlikely’ motive for the purchase of the vehicle, the taxpayers evidence being vague and inconsistent, his knowledge that an allowance could be claimed, and various facts relating to ownership of the vehicle, such as insurance (ITC 1334 (1981) 43 SATC 98(Z) at 102- 108). The judgment also commented on the fact that the understatement could not have been ‘inadvertent or

as a result of inefficiency' as the taxpayer had instructed the accountant to make entries into the books of account in respect of the vehicle (ITC 1334 (1981) 43 SATC 98(Z) at 107).

In a Transvaal Special Court case, Melamet J came to the conclusion that the taxpayer overstated his purchases with 'the intention to evade (pay less) tax' (ITC 1331(1980) 43 SATC 76(T) at 86). The learned judge arrived at this conclusion based on:

'... the probabilities that the appellant knew the system... in the compilation of his expenses for purposes of his income tax and the effect thereof... whereby incorrect statements were made in the returns to the Receiver of Revenue...' (ITC 1331(1980) 43 SATC 76(T) at 86).

In ITC 1351(1981) 44 SATC 58(N), at 61, Friedman J specifically identified two reasons for establishing that the [SARS] inspector had not erred in finding the taxpayer guilty of understating his income. Firstly, 'contradictory' and 'unsubstantiated evidence' as to the source of the income was given, and secondly the taxpayer's living expenses 'weighed up' against his declared income (ITC 1351(1981) 44 SATC 58(N) at 61).

In all three cases discussed above, the court reached its conclusion based on the circumstantial nature of the case and the balance of probability, or improbability, of the evidence presented.

In an ATO Miscellaneous Tax Ruling, the test for intentional disregard (the Australian equivalent of intentional tax evasion) in respect of a statement is purely subjective in nature and the actual intention is the key element (2008: para 111). The ruling states that there must be actual knowledge that the statement made is false (which requires an understanding by the taxpayer of the legislative operation), and that the taxpayer made a deliberate choice to ignore the law (2008: para 112). This 'knowledgeable choice' equates to dishonesty and is a prerequisite for 'intentional disregard', which differentiates it from reasonable care or recklessness (ATO 2008: para 113). The evidence relating to intention is supported either by direct evidence or by inference from the surrounding circumstances (ATO 2008: para 114). In its ruling, the ATO refers to *Weyers v. Federal Commissioner of Taxation* [2006] FCA 818; 2006 ATC 4523; (2006) 63 ATR 268 at para 168, in which circumstances describing inferred 'intentional disregard' were identified. The case dealt with a tax agent who prepared tax returns for taxpayers. The court indicated that the agent's actions inferred the agent knew that income reflected as loans was in fact income attributable to beneficiaries, as the loans were not levied with interest, no terms of repayment were set, and the agent stated to the taxpayers that the amounts were for the beneficiaries sole and unfettered use (2008: para 116).

The penalty regime in the United Kingdom describes two intentional tax evasion type case scenarios: 'deliberate but not concealed' and 'deliberate and concealed' (HMRC n.d.(h)). The first type of evasion occurs when a taxpayer submits to HMRC a document which the taxpayer knows contains an inaccuracy, immaterial of whether he or she knows what the actual amount reported should have been or not (HMRC n.d.(b)). In the second instance, not only is a deliberate inaccuracy included in a document submitted by a taxpayer to HMRC, but the taxpayer then actively attempts to conceal the inaccuracy either prior to the submission or subsequently (HMRC 2014 n.d.(c)). According to an article by Accounting Web UK in the United Kingdom, the HMRC has escalated its investigations into tax fraud such that, for the year ended March 2012, it had increased prosecutions by 53% over the prior year, and was 'more willing to opt for criminal – as opposed to civil – investigative weapons in

its arsenal' (Accounting web 2013), which indicates a more aggressive tax compliance stance by HMRC.

The United States penalty regime aligns specific penalties with understatements that result from fraud (IRS n.d. (b)). In a memorandum from Chief Counsel for the IRS (USA), fraud is evidenced by proof that the taxpayer intended (the *mens rea* or mental element of willfulness) to conceal, mislead (the *actus reus* or guilty conduct) or otherwise prevent the collection of taxes, and there is an underpayment of taxes (Hall 2009).

The Canadian revenue authorities do not have a specific category of penalty for intentional tax evasion, thus such non-compliance is, by default, included in the 'omission and false statement penalty' type, which includes either knowledge of the act, or gross negligence. This is evidenced in the Canadian case *O'Leary v. The Queen* 2008 TCC 406 at para 24, with reference to Strayer J. in *Lucien Venne v. Her Majesty the Queen*, 84 D.T.C 6247 at page 6256, where a taxpayer falsely claimed personal expenses as a business expense. Favreau J, in his judgment, stated that:

"Gross negligence" must be taken to involve greater neglect than simply a failure to use reasonable care. It must involve a high degree of negligence tantamount to intentional acting, an indifference as to whether the law is complied with or not...'

Favreau J goes on to include the concept of 'wilful blindness' in gross negligence along with wrongful intent, and its being an intentional act ((*O'Leary v. The Queen* 2008 TCC 406 at para 25). The link between intentional evasion and gross negligence in the Canadian context is further supported in *Thill v The Queen*, *O'Leary v. The Queen* 2008 TCC 406 at para 33 where a taxpayer did not disclose certain revenues received, and D'Arcy J, in his judgment stated:

'[t]he court accepted that the nature of the omission of the amounts from the taxpayer's returns was a false statement due to the taxpayer either intentionally failing to report the amounts or was completely indifferent to their lack of inclusion, knowingly or through gross negligence'.

In, South Africa, the recent Tax Administration Laws Amendment Bill, 2013, to s. 213 of the Tax Administration Act the legislation was updated in order to allow the tax court, when considering an appeal in respect of an understatement penalty levied by SARS, to determine if a different 'behaviour' category is more appropriate, or alternatively, to reduce, or increase, the penalty as the court deems fit, based on the evidence presented (SARS 2013a: 36).

Intentional tax evasion in South Africa is assessed by the facts and circumstances relevant to the taxpayer's actions, conduct and testimony, in respect of an understatement (2013b:81). In the South African context, the classification of the behaviour type may be managed to some extent by distinguishing between the wrongful application of legislation, and intentional tax planning designed to reduce tax otherwise payable, through the procuring of documentary evidence, which must indicate that the planning was completed within the confines of the law (van der Zwan 2013).

3.3.7 'Standard case' type analysed

The rows on the understatement penalty percentage table (refer Table 1 at Sub-Chapter 4.2, below), reflect the following 'case' types:

- standard case,

- if obstructive, or if it is a 'repeat case',
- voluntary disclosure after notification of audit or investigation, and
- voluntary disclosure before notification of an audit or investigation (s. 223(1) of the Tax Administration Act).

A 'standard case' is not defined in the Tax Administration Act but its meaning is clarified in a report issued by The Standing Committee on Finance where it is defined as a 'case' that does not meet any of the criteria of the other cases (2011: 61). A review of the other three 'case' types would therefore be required and, if none of the case type criteria applying to any of those types is met, by default, the 'standard case' type will apply.

3.3.8 'Obstructive case' or 'Repeat case' types analysed

The Tax Administration Act does not give any enlightenment as to what constitutes an 'obstructive case' and SARS has not issued any explanatory information relating thereto. Obstructive, as defined in the Oxford English Dictionary and used in this context, means to be 'causing or tending to cause deliberate difficulties and delays' (n.d.).³² Thus the 'obstructive case' would seem to include 'deliberate acts' or 'deliberate omissions' by the taxpayer which may, or are intended to, cause difficulty for SARS in both obtaining information pertaining to, and in the determination of, an understatement. 'Repeat case' was discussed earlier and the point made that there is a significant increase in the penalty percentage when an 'obstructive' or 'repeat case' type is invoked from that of a standard case type (see Sub-Chapter 3.3.1, above).

The ATO also increases the penalty percentage applied in the event of 'obstructive' or 'repeat' case types (ATO 2014: para 119). The ATO, in a practice statement, informs the taxpayer that it will adjust the 'base penalty' amount upwards if it is of the opinion that the taxpayer:

- prevents or obstructs the Commissioner from finding out about the false or misleading nature of the statement,
- becomes aware of the false or misleading nature of the statement after the statement is made and does not tell the Commissioner about it within a reasonable time, or
- has incurred this type of penalty previously (2014: para 119).

In its explanatory memorandum, the ATO indicates that obstructive behaviour will be determined based on the available evidence in each case, but generally, such behaviour is characterised as:

- repeated failure or deferral by the entity to supply information without an acceptable reason,
- repeated failure by the entity to respond adequately to reasonable requests for information including:
 - excessive or repeated delays in responding,
 - giving information that is not relevant or does not address all the issues in the request, or
 - supplying inadequate information,
- failure to respond to a request for information pursuant to formal information notices,

³² 'obstructive' obtained from the Oxford dictionary, <<http://www.oxforddictionaries.com/definition/English/obstructive?>> retrieved 22 November 2014.

- providing false or misleading information or documents,
- destroying records, or
- a combination of the factors above (2014: para 122).

In the penalty regime in the United Kingdom, taxpayers are afforded the chance to reduce the penalty they might otherwise incur through ‘quality of disclosure’ reductions (HMRC n.d.(d)). A taxpayer may obtain a reduction of the maximum penalty to the minimum penalty, or somewhere in between, for a particular behaviour type by co-operating with HMRC and ‘Telling’, ‘Helping’ and ‘Giving’ information in respect of the inaccuracy (in the United Kingdom, the equivalent of an understatement) (HMRC n.d. (d)). The ‘Telling’ element is similar to the South African ‘voluntary disclosure’ case type (see Sub-Chapter 3.3.9, below), where the taxpayer advises the revenue authorities of the nature and amount of the inaccuracy, and this may then result in a reduction of up to 30% of the ‘discretionary’ part of the penalty. The ‘Helping’ and ‘Giving’ elements may reduce the discretionary part of the penalty by up to 40% and 30% respectively (HMRC n.d.(e)). If a taxpayer does not disclose, assist or give up the necessary documents to enable the revenue authorities to determine the quantum of the inaccuracy, the taxpayer could be construed as being obstructive and no reduction in the maximum penalty would be given by HMRC (HMRC n.d.(e)).

The revenue codes in the USA do not have a specific ‘obstructive’ case type penalty but does have a specific set penalty for a frivolous tax submission, in addition to any other penalties that may be levied (IRS 2013). A frivolous tax submission is a return that does not contain sufficient information to determine the correct tax payable or contains additional information which indicates that the taxable income reported is substantially incorrect (IRS 2013). This indicates the likelihood of obstructive behaviour.

3.3.9 ‘Voluntary disclosure after notification of audit or investigation’ case type analysed

In order to encourage offending taxpayers to come forward voluntarily and comply with the taxing statutes and assist SARS in the best use and management of its resources, the Tax Administration Act, Chapter 16, Part B entitled ‘*Voluntary Disclosure Programme*’ offers taxpayer’s the ability to disclose an ‘understatement’ (SARS 2013b:81). The option is available to a taxpayer who has been culpable of some understatement, but who then voluntarily declares, in full, the nature and amount of the transgressions of the ‘tax Act’ (SARS 2013b:82). The ‘Voluntary Disclosure Programme’ enables taxpayers to take advantage of the significantly reduced penalty percentages included in the understatement penalty table, which are then applied to the ‘shortfall’ identified (SARS 2013b:82). The taxpayer may, by making use of this program, reduce the quantum of understatement penalties he or she may otherwise have incurred, to nil, except in the case of gross negligence or intentional tax evasion (SARS 2013b:81). The Voluntary Disclosure Programme may not be used by a taxpayer if a refund from SARS to the taxpayer would eventuate (SARS 2013b:82).

Section 226(1)(a) and s. 226(1)(b) of the Tax Administration Act specifically exclude pending or incomplete audits and investigations from the ‘Voluntary Disclosure Programme’. Thus, once notified by SARS of an impending audit or investigation into their affairs, the taxpayers may not avail themselves of the ‘Voluntary Disclosure Programme’. Nevertheless an exception exists where a senior SARS official may decide that a taxpayer can still apply for the Voluntary Disclosure Programme, if, firstly, the default would not have been detected by SARS otherwise, and secondly, if

it is in the interest of the management, and use, of SARS's resources (s. 226(2) of the Tax Administration Act). The taxpayer would then fit the criteria for the case type 'voluntary disclosure after notification of audit or investigation' and enjoy a significantly reduced understatement penalty percentage (s. 223(1) of the Tax Administration Act).

The 'case' type of 'Voluntary disclosure after notification of audit or investigation' in column 5 in the penalty table, s. 223 of the Tax Administration Act, is neither defined in the Act nor referenced in any other section of the Act. The only specific reference to this 'case' type in the Tax Administration Act is in Part B of the Voluntary Disclosure Programme section at s. 229(b) where it specifies that the relief to be granted in terms of the voluntary disclosure must comply with that specified in column 5 or 6 of the understatement penalty percentage table in s. 223 of the Act. In the Tax Administration Act, Chapter 5, Part A, entitled '*Information Gathering*', 'inspection', 'verification', 'audit', 'field audit', and 'criminal investigation' are referred to at various points but the terms are not defined (Clegg 2014:85), the determination of what precisely an 'audit' or 'investigation' for the constitutes for the purpose of applying s. 223 of the Tax Administration Act therefore remains to be determined. SARS is required to produce a written authorisation, issued by a senior SARS official, to conduct a 'field audit' or 'criminal investigation', which is presumably presented on arrival at the taxpayer's premises or when arrangement to attend such premises is made (s. 48 of the Tax Administration Act). This may be regarded as notification of such an audit or investigation (Clegg 2014:85), however SARS is of the opinion that it merely has to determine that such a taxpayer has been selected for an audit or investigation and that notification of such an audit or investigation does not have to have been formally communicated to the taxpayer (SARS 2013b:82). This opinion, it is suggested, may be in conflict with the Promotion of Administrative Justice Act as it is a requirement that the administrative action be procedurally fair and include adequate notice, reasonable opportunity to make representation, a clear statement of the action, notice of review or appeal, and accommodate requests for reasons for the action (Croome 2013a: 3). A senior SARS official determines whether a disclosure made by a taxpayer was prior to the taxpayer's selection, and also if the disclosure was such that SARS was unlikely to have uncovered the underlying default, in which case the official may allow the disclosure (SARS 2013b:82). This circumstance may not lend itself to certainty or, possibly, fairness, but, in mitigation, the taxpayer has the ability to submit an anonymous declaration of an understatement, which involves SARS issuing a non-binding private opinion (SARS 2013b:82).

In the event of SARS accepting the taxpayer's request to follow the voluntary disclosure option, an agreement is entered into between SARS and the taxpayer (s. 230 of the Tax Administration Act), containing full details of the nature of the understatement and penalty amounts, and any undertakings and payment terms (SARS 2013b: 82-83). Subsequent to the agreement, an assessment is issued by SARS which is not subject to objection or appeal unless the relief is withdrawn by SARS due to non-disclosure of a material factor (SARS 2013b:83). Relief may not be obtained for a subsequent understatement that is similar in nature to the previous understatement (s. 227(b) of the Tax Administration Act).

The use of this 'case' type to manage a taxpayer's risk exposure to a SARS audit or investigation may be of significant value to the taxpayer due to the lower penalty percentages offered under this 'case' type (van der Zwan 2013).

3.3.10 'Voluntary disclosure before notification of audit or investigation' case type analysed

As indicated in the previous sub-chapter, the Voluntary Disclosure Programme is available to encourage taxpayers to be properly compliant (SARS 2013b:81). They may, at any time, elect to follow the voluntary disclosure framework introduced by the Tax Administration Act in ss. 225-233 (SARS 2013b:81). The need for an existing understatement, and the disclosure requirements and administrative procedures, are precisely the same for 'voluntary disclosure before notification of an audit or investigation' as they are for 'voluntary disclosure after notification of an audit or investigation' (see Sub-Chapter 3.3.9, above).

The distinguishing point between this 'Voluntary disclosure after notification of audit or investigation' type and the 'Voluntary disclosure before notification of audit or investigation' type is whether the valid voluntary disclosure application occurred before or after the notification of an audit or investigation was received or initiated. A senior SARS official determines whether a disclosure made by a taxpayer was prior to the taxpayer's selection, and also if the disclosure was such that SARS was unlikely to have uncovered the underlying default, in which case the official may allow the disclosure (SARS 2013b:82). As indicated in the preceding sub-chapter 3.3.9, above, the time of such 'notification' is not particularly clear in some circumstances, but where the taxpayer has actually received notification, in writing, of an audit or investigation they will not be able to apply for voluntary relief under the 'voluntary disclosure before notification of an audit or investigation' case type. The impact to the taxpayer in this instance is the significantly increased penalty percentages specified in the understatement penalty percentage table (s. 223(1) of the Tax Administration Act).

3.4 Summary

Once an understatement is identified which may cause prejudice to SARS or the fiscus the 'shortfall' is determined (s. 222(3) of the Tax Administration Act). The tax rate applicable to the amounts properly chargeable is the maximum tax rate applicable to the taxpayer type and must exclude assessed losses or any other benefit brought forward from a preceding tax period (s. 222(5) of the Tax Administration Act). The determined shortfall is then multiplied by the percentage obtained from the understatement penalty percentage table (s. 222(2) of the Tax Administration Act). The understatement penalty percentage table has five different 'behaviour' types and four different 'case' types (s. 223(1) of the Tax Administration Act). These 'behaviour' and 'case' types intersect at various pre-determined penalty percentages (s. 223(1) of the Tax Administration Act). The highest understatement percentage relevant to the taxpayer's 'behaviour' and 'case' types is determined and applied to the 'shortfall' (s. 222(2) of the Tax Administration Act). Once the 'behaviour' and 'case' types have been determined, the need for judgment in the quantum of the penalty percentage to be applied is eliminated (SARS 2013b:73). SARS only has an obligation to remit a penalty imposed in the event of a 'substantial understatement', subject to certain requirements in terms of s. 223(3) of the Tax Administration Act. SARS has no discretion to remit a penalty otherwise (SARS 2013b:73).

Chapter 4

Quantification of understatement penalties in terms of the Tax Administration Act

4.1 Introduction

When the understatement penalty percentage table (penalty table) was initially introduced, in SARS's *Memorandum on the objects of the Tax Administration Bill, 2011*, the memorandum stated that the understatement penalties were to '...target more serious non-compliance...' (SARS 2011: 199) and that the '... penalty percentages [would be] based on specified and defined (where required) behaviour ...' (SARS 2011: 199). The general lack of definitions and general guidance on the requirements for the different 'behaviour' and 'case' types is problematic (Khaki 2012). It is noteworthy that the original penalty table, included in the Tax Administration of Act when it was promulgated, contained significantly higher penalty percentages than the current understatement penalty percentage table (refer Table 1 at Sub-Chapter 4.2, below). Table 1 below (refer Sub-Chapter 4.2, below) includes both the current penalty percentages and the originally enacted penalty percentages (indicated in brackets). The penalty percentages in the understatement penalty percentage table were amended for the first time in January 2014 (Amendment of s. 223 of the Tax Administration Act, as amended by section 73 of Act 21 of 2012.(GG No.37236 at 46, 16 January 2014.). The *Memorandum on the Objects of the Tax Administration Laws Amendment Bill, 2013*, states that the understatement penalty percentage table was adjusted so that:

'the percentages are now more aligned with comparative tax jurisdictions where largely similar penalty regimes apply' (SARS 2013a: 41).

The relatively early adjustment of this understatement penalty percentage table, after promulgation, and the significant changes in the penalty percentages contained therein, might be considered surprising given the extensive research carried out in respect of the drafting of the Tax Administration Bill, and the fact that SARS stated that equity and fairness, to ensure a fair tax system both perceived and in reality, are required while following international best practice in tax administration (SARS 2011: 179).

4.2 The understatement penalty percentage table

The application of the penalty table, while seemingly obvious, is only referred to in the Tax Administration Act at s. 222(2) where it is stated that the penalty percentage is obtained:

'from applying the highest applicable understatement penalty percentage in accordance with the table in section 223 to each shortfall... '.

The rates are structured to escalate based on the culpability, obstructiveness or repeat offending of the taxpayer, with the provision that they may be reduced if a taxpayer voluntarily discloses the understatement (Clegg 2014:102). The Tax Administration Act at s. 223(2) specifically includes the application of the understatement penalty percentage table in respect of assessments that are estimated (s. 95 of the Tax Administration Act), and assessments that are mutually agreed with taxpayers (s. 95(3) of the Tax Administration Act), to understatement penalties levied in terms of the Tax Administration Act.

Table 1: Understatement penalty percentage table. (The previous penalty percentages applicable on inception of the Tax Administration Act are included in brackets behind the currently prevailing penalty percentages, for comparative purposes).

1	2	3	4	5	6
Item	Behaviour	Standard case	If obstructive, or if it is a repeat case	Voluntary disclosure after notification of audit or investigation	Voluntary disclosure before notification of audit or investigation
(i)	Substantial understatement	10% (25%)	20% (50%)	5%	0%
(ii)	Reasonable care not taken in completing return	25% (50%)	50% (75%)	15% (25%)	0%
(iii)	No reasonable grounds for tax position taken	50% (75%)	75% (100%)	25% (35%)	0%
(iv)	Gross negligence	100%	125%	50%	5%
(v)	Intentional tax evasion	150%	200%	75%	10%

As discussed in the previous chapter, the determination of the ‘behaviour’ and ‘case’ types can have a significant impact on the quantum of the understatement penalty percentage ultimately determined, which ranges from 0% to 200%. SARS has not offered any rationale as to why the penalty percentages included in Table 1, above, are set at the amounts so indicated, other than that they have now been:

‘more aligned with comparative tax jurisdictions where largely similar penalty regimes apply’ (SARS 2013a:41).

The maximum and minimum penalty percentages of 200% and 0%, in table 1 above, are precisely the same as in the legislation that existed prior to the Tax Administration Act³³ it appears therefore that SARS considers this range of percentages to meet their stated objectives of being fair, equitable, and appropriate in respect of the ‘understatement penalty’ to be applied (SARS 2011:179). In determining the penalty percentages SARS has stated that the penalty determined should ‘... deter unwanted behaviour...’ (SARS 2013b:73), as:

‘... If the likely punishment is sufficient to outweigh the prospect of gain, a rational person will not undertake the activity...’ (SARS 2013b:73),

and that the penalty ‘... is proportional to the seriousness and duration of the incidence of non-compliance.’ (SARS 2013b:73). As is evidenced by the table, whilst the percentages escalate with the increasing of culpability, obstructiveness and if a ‘repeat’ offence (Clegg 2014:102), there is no logical mathematical progression in the escalation of the penalty percentages in respect of either the ‘behaviour’ type or ‘case’ type (refer Table 1, above). For example, if a ‘standard case’ is determined

³³ Section 76(1) of the Income Tax Act specifies double (200%) the tax as an additional tax while s. 76(2)(a) of the Income Tax Act allows full remittance of the additional tax (0%).

for behaviour (ii), in Table 1, then a penalty percentage of 25% is levied, but if it is determined to be an 'obstructive case' the penalty percentage doubles to 50% (a 100% increase), whereas comparatively, in behaviour (iii) of Table 1, the penalty increases only by 50% when the case goes from 'standard' to 'obstructive'. Similarly if a 'standard case' migrates from 'no reasonable grounds' to 'intentional tax evasion' the penalty percentage escalates by 200% whilst in an 'obstructive case' the escalation increases by 167%. Based on the above evidence it is difficult to see the relative proportionality applied as being fair and equitable relative to the 'behaviour' and 'case' types, and thus it may be argued that without such logical mathematical progression then fairness, and just equitable treatment of taxpayers is not achieved, as required by the constitution.³⁴

In the fairly recent, widely reported, criminal case of J Arthur Brown, Mr Brown was convicted of two counts of fraud for which he was fined R75 000 for each count, of which one count related to a R69 000 000 fraudulent transfer of funds (Sapa 2013). While it is accepted that the nature and computation of criminal fines is not directly comparable to that of understatement penalties levied in terms of the Tax Administration Act, at 0.1% of the fraudulent amount determined such a fine does not seem in any way aligned with understatement penalties provided for within the Tax Administration Act. It would seem, on this evidence that SARS has elected to apply decidedly higher penalties than that which the criminal justice system deems appropriate, One might argue that criminal acts involving fraud should incur far harsher penalties than non-criminal acts such as 'reasonable care not taken' which result in an understatement penalty levied in terms of the Tax Administration Act for a 'standard' case of 25%. Botha, in his book on statutory interpretation, suggests that legislation must be construed within the total legal picture which includes the Constitution and all other relevant law (2012:129), from which it could be inferred, that penalties and fines, of whatever nature, should be harmonised within the Constitution, and non-compliance should be punished equitably and fairly.³⁵ While this apparent disparity is of interest, its further investigation is considered beyond the ambit of this report.

Under the previous penalty tax legislation, the Income Tax Act, guidelines for the determination of penalties were apparently issued to SARS staff, in a SARS circular, in an attempt to achieve a uniform practice (Lombard 2008). The Table (see Table 2, below) included in that circular was adapted from the Hong Kong Special Administrative Region, Inland Revenue Department (Lombard 2008).

³⁴ Section 9, Chapter 2 – Bill of Rights, The Constitution of the Republic of South Africa requires, inter alia, equality before the law and that the state not discriminate unfairly against any person and Section 33, Chapter 2 – Bill of Rights, The Constitution of the Republic of South Africa requires, inter alia, just administrative action.

³⁵ Section 9, Chapter 2 – Bill of Rights, The Constitution of the Republic of South Africa requires, inter alia, equality before the law and that the state not discriminate unfairly against any person

Table 2: Guide in respect of application of additional tax (Lombard 2008).

Percentage to be imposed or remain imposed:

	<u>1</u>		<u>2</u>		<u>3</u>		<u>4</u>	
	<u>Normal</u>	<u>Max</u>	<u>Normal</u>	<u>Max</u>	<u>Normal</u>	<u>Max</u>	<u>Normal</u>	<u>Max</u>
Group A	20	60	25	75	30	90	50	200
Group B	10	40	15	50	20	60	25	100
Group C	5	20	10	25	15	30	20	50

Categories of disclosure and cooperation:

Group A: Serious Intent

Cases where the taxpayer shows intentional disregard for the law and adopts deliberate cover-up tactics involving the preparation of false sets of books, fictitious entries, or multiple omissions, over a long period of time.

Group B: Intent and Gross Negligence

Cases with slightly less serious acts of omission or intentional overstatement, resulting from recklessness or gross negligence.

Group C: Negligence and Inadvertence

Cases where the taxpayer fails to exercise reasonable care, is ignorant of the law, has made inadvertent errors, or is at most merely negligent (and no finding of intentional conduct can be proven).

Once the group category was determined, the columns, numbered 1 through 4, are said to represent various levels of both aggravating, and mitigating, factors which include disclosure, co-operation with SARS, the nature of the understatement, and the length of the period of non-compliance (Lombard 2008). Although not clearly stated in the article it would seem that starting from the left side the tax officer would start at column 1 and move across to column 2 if no disclosure was forthcoming but back to column 1 if the taxpayer was cooperative and so on (Lombard 2008).

As can be seen in Table 2, the maximum understatement penalty for the most serious offender who neither disclosed information nor co-operated with SARS was 200%, the same as the penalty currently prevailing in the Tax Administration Act. At the lower end of the scale, inadvertent errors were punishable with at least a 5% penalty, compared to the current rate of 0% (refer Table 1, above). It seems that in the initial Tax Administration Act, prior to the increase in the penalty percentages (Amendment of s. 223 of the Tax Administration Act, as amended by section 73 of Act 21 of 2012.(GG No.37236 at 46, 16 January 2014) SARS may have made use of this guide in determining the penalty percentages to be included in the understatement penalty percentage table (see Table 1 above).

In 2014, the Tax Administration Act's understatement penalty percentage table was amended and eight of the penalty percentages were materially reduced, as can be seen in Table 1 above (Amendment of s. 223 of the Tax Administration Act , as amended by section 73 of Act 21 of

2012.(GG No.37236 at 46, 16 January 2014). The ‘comparative tax jurisdictions’ (SARS 2013a: 41) which provided comparative evaluation, and with which the understatement penalty percentages were apparently ‘aligned’, are presumed to include the same countries listed in SARS’s *Memorandum on the Objects of the Tax Administration Bill*, which were used due to their comparable tax administration laws (SARS 2011:179), namely Australia, the United Kingdom, the United States, New Zealand, Canada and Botswana (2011:179). Due to the penalty methodologies differing from country to country it is considered simplistic to directly compare the penalty percentages applied in Australia, the UK, the USA and Canada (the countries selected for inclusion in this reports review). For example, in the United Kingdom, a maximum penalty percentage is levied but can then be reduced based on certain criteria, whereas in Australia, a minimum (or base) percentage levied it initially determined and can be increased and decreased depending on certain specified factors.

In a recent, unreported case (*AD CC v C: SARS*, Unreported Case no: VAT 1069, Tax Court of South Africa, Durban), although relating to a penalty on value added tax (Vat) imposed in terms of s. 60(1) of the Value Added Tax Act (VAT Act), the taxpayer, a close corporation (CC), was found to have intentionally failed to pay over VAT which it had charged its clients (*AD CC v C: SARS*, at para 2) . A 200% penalty was imposed under the VAT Act but the appeal against the penalty imposed was heard in terms of the Tax Administration Act (*AD CC v C: SARS*, at para 5). Lopes J, indicated that the penalty under the Tax Administration Act would have been 150% (although, statutorily, it did not apply in this case), which is the penalty for ‘intentional tax evasion’ behaviour, based on a standard case (*AD CC v C: SARS*, at para 20). Nevertheless the judge found that a penalty of 100% was appropriate, given the particular circumstances of the case (*AD CC v C: SARS*, at para 20). This judgment is perhaps indicative that the new understatement penalty percentage table will not give SARS or taxpayer’s the certainty based on ‘objective criteria’ that the understatement penalty provisions were intended to (SARS 2013b:73).

The imposition of understatement penalties by SARS is subject to objection and appeal by the taxpayer under s. 224 of the Tax Administration Act (SARS 2013b:81). The tax court may reduce, confirm or increase the understatement penalty as it deems appropriate, on appeal, given that the burden of proof is on SARS as per s. 129(3) of the Act. However in terms of s. 224 of the Tax Administration Act, read in conjunction with s. 95(3) of the Act, understatement penalties, levied on estimated assessments which have been agreed upon, in writing, with the taxpayer, are not subject to objection or appeal.

4.3 The remission of an understatement penalty

Two of the primary objectives stated by SARS in respect to understatement penalties, imposed in terms of the Tax Administration Act, are to ensure the consistent treatment of taxpayers in comparable circumstances and to negate the open ended discretion of SARS to impose penalties up to 200% (SARS 2013b:78). To this end, the Tax Administration Act does not allowed SARS any discretion to remit understatement penalties except where the ‘behaviour’ type satisfies the definition of ‘substantial understatement’, as indicated in s. 223(3) of the Act. The section states that:

‘(3) SARS must remit a ‘penalty’ imposed for a ‘substantial understatement’ if SARS is satisfied that the taxpayer:

- (a) made full disclosure of the arrangement, as defined in section 34, that gave rise to the prejudice to SARS or the fiscus by no later than the date that the relevant return was due; and
- (b) was in possession of an opinion by an independent registered tax practitioner that:
 - (i) was issued by no later than the date that the relevant return was due;
 - (ii) was based upon full disclosure of the specific facts and circumstances of the arrangement and, in the case of any opinion regarding the applicability of the substance over form doctrine or the anti-avoidance provisions of a tax Act, this requirement cannot be met unless the taxpayer is able to demonstrate that all of the steps in or parts of the arrangement were fully disclosed to the tax practitioner, whether or not the taxpayer was a direct party to the steps or parts in question; and
 - (iii) confirmed that the taxpayer's position is more likely than not to be upheld if the matter proceeds to court.'

Consistent with the objectives of the Tax Administration Act's use of the word 'must' remit in s. 223(3) of the Tax Administration Act, removes any discretion in respect of the application of the remission of an understatement penalty for a substantial understatement by SARS. However, there are certain provisions required to apply the remission provision (s. 223(3) of the Tax Administration Act): firstly, the amount must be due to a 'substantial understatement', which definition requires the prejudice to SARS, or the fiscus, to be the greater of 5% of the tax properly payable, and R1 000 000 (s. 221, definitions, 'substantial understatement' of the Tax Administration Act), and the understatement must not have been as a result of any of the other four 'behaviour' types listed in s. 223(1) of the Tax Administration Act (SARS 2013b:79). Secondly, the 'reportable arrangement' disclosures specified in the Tax Administration Act at Part B of Chapter 4, must be met, and such disclosures must be delivered to SARS by no later than the required submission date of the return (s. 223(3)(a) of the Tax Administration Act). Section 223(3)(a) of the Tax Administration Act may be considered an onerous requirement as a 'substantial understatement' is not, by definition, the same as 'reportable arrangement', but for any penalty that is otherwise payable, to be remitted, the 'arrangement',³⁶ as defined, is required to be fully disclosed (s. 223(3)(a) of the Tax Administration Act). A 'substantial understatement' must therefore, although not necessarily a 'reportable arrangement', as defined, still be fully disclosed to SARS, by due date of the return as if it was a 'reportable arrangement', in order to be considered for remittance. Thirdly, the taxpayer is required to be in possession of an opinion, based on full disclosure of the facts and circumstances, issued by an independent tax practitioner, prior to the return due date, and, additionally, the taxpayer's position is required to be one that would 'more likely be upheld in a court of law than not' (s. 223(3)(b)(iii) of the Tax Administration Act). The inference from the above discourse is that SARS wishes to be appraised of possible tax avoidance schemes, prior to submission of returns, if the taxpayer wishes to avail him or herself of the understatement penalty remission section of the Act.

Certain tax specialists believe that the remission of penalty should be applicable to more of the 'behaviour' types than just the 'substantial understatement' (Brits 2014). SARS has attempted to structure the understatement penalty regime such that this is not the case. The penalty percentage for the 'substantial understatement' 'behaviour' type is only applicable when no other 'behaviour' types apply (SARS 2013b:79), *ipso facto*, all other taxpayers, having not met any other of the

³⁶ Defined in the Tax Administration Act in s. 34 as 'any transaction, operation, scheme, agreement, or understanding (whether enforceable or not)'.

'behaviour' types specified in s. 223(1) of the Tax Administration Act would have no penalty applied, thus negating a need for any remission. The taxpayers meeting the definition of a 'substantial understatement', on the other hand, require a 'remission of penalty' section in order to escape any understatement penalties, which carry a minimum 10% penalty percentage otherwise (refer Table 1 at Sub-Chapter 4.2, above). In the legislation that preceded the Tax Administration Act, SARS's ability to remit penalties extended even to dishonest taxpayers, as indicated in the case *C: SARS v NWK* 2011 SA 347 (SCA), 73 SATC 55 at 78 where Lewis JA, stated that SARS 'can remit the additional tax, even if there is a dishonest attempt to evade tax, where there are extenuating circumstances'. The issue of the absence of the power to remit the understatement penalties on a case by case basis, may well result in SARS imposing penalties that conform to the letter of the Tax Administration Act, even when, due to extenuating circumstances, a remission of the penalty may be more appropriate (Croome & Strydom 2013).

4.4 Summary

The understatement penalty percentage table (refer Table 1 in Sub-Chapter 4.2, above) incorporated in the Tax Administration Act under s. 223(1) coupled with the definitions specified under s.221 in the Act have, it is considered, given a large measure of clarity and support for the uniform application of the understatement penalty. The absence of a remission of understatement penalties, other than for 'substantial understatements', is considered a positive step forward by removing the unfettered discretion of SARS (SARS2011:179), but may have some unintended negative consequences for the taxpayer who, given their specific circumstances should have the understatement penalty remitted (refer Sub-Chapter 4.3, above). The effectiveness of the Tax Administration Act in achieving a uniform application to the interpretation of the 'behaviour' and 'case' types (discussed in Chapter 3, above) remains to be seen (Edward Nathan Sonnenbergs, 2013).

Chapter 5

Understatement penalty policies of the fiscus and international tax practice

5.1 Introduction

This chapter reviews the stated policies, goals and objectives of the fiscus in respect of understatement penalties provided for in the Tax Administration Act in order to determine if those goals and objectives are aligned with the Tax Administration Act. This chapter will also briefly review the requirements of fairness and equity, as required by the Bill of Rights in Chapter 2 of the Constitution of the Republic of South Africa (the Constitution), and the Tax Administration Act's compliance with these requirements. International best practice in respect of understatement penalties is identified and compared to those policies and objectives of the fiscus, and incorporated in the Tax Administration Act, to determine if the Act is aligned with these practices and policies.

5.2 SARS's stated policies

SARS's primary function is the efficient and effective collection of revenues (SARS 2013b:4). SARS is of the opinion, according to its guide on the Tax Administration Act, that simplified law enhances clarity, as, if the taxpayer understands the law, it is easier for the taxpayer to fully comply with the law (SARS 2013b:4). When the law is too technical and therefore more difficult to understand, it is more difficult to comply with it (SARS 2013b:4). When drafting the Tax Administration Act, the legislators recognise that the majority of taxpayers are compliant and it is only a minority who seek to evade tax or defraud government (SARS 2013b:4).

The legislators intend the Tax Administration Act to be aligned with modern approaches, business practices, accounting practices and constitutional rights, so as to provide a single, simplified body of law which outlines common procedures, rights and remedies, while balancing the rights and obligations of both SARS and the taxpayers in a transparent relationship (SARS 2011: 178). The *Memorandum on the Objects of the Tax Administration Bill, 2011*, states that regard to the following principles of 'international best practice'³⁷ in respect of tax administration have been given:

- (a) Equity and fairness to ensure that the tax system is fair and also perceived to be fair, which should, in turn, enhance compliance.
- (b) Certainty and simplicity so that tax administration is not seen as arbitrary but transparent, clear and as simple as the complexity of the system allows.
- (c) Efficiency, where compliance and administration costs are kept to a minimum and payment of tax is as easy as possible.
- (d) Effectiveness, so that the right amount of tax is collected, active or passive non-compliance is kept to a minimum, and the system remains flexible and dynamic to keep pace with technological and commercial development' (SARS 2011: 178).

In point (a), above, SARS aims at ensuring consistent treatment of taxpayers in comparable circumstances, thereby achieving greater equity and fairness in tax administration matters, and linking discretionary powers of SARS to objective criteria (SARS 2011:179). This point refers

³⁷ Comparative evaluations of the tax administration laws of Australia, Botswana, Canada, New Zealand, the United Kingdom and the United States were conducted, as these countries were considered to represent similar tax administration regimes and to have a long history of practical experience with respect to tax administrative laws.

unequivocally to the issues highlighted in the previous understatement penalty regime (refer Sub-Chapter 2.7, above) and its subsequent replacement with the Tax Administration Act. The memorandum indicates that open-ended discretions have also been fettered (2011:179).

SARS states that the main purposes of introducing the understatement penalty framework are to enhance voluntary compliance, and assist SARS in the use of its resources, which is ultimately in the interests of good management (SARS 2011: 199). The targeting of more serious non-compliance, including tax evasion, is a key requirement (SARS 2011:199). SARS, in its explanatory memorandum, states that the principle goal of sanctions stems from the simple premise 'the threat of punishment deters unwanted behaviour' (SARS 2013b: 73). The memorandum states that for effective administration of sanctions, the sanctions must be easily understood, there must be certainty as to the imposition and quantum of a penalty, and discretionary judgments must only eventuate where non-compliance is caused by negligence or intent (SARS 2013b:73).

According to The Standing Committee on Finance, the introduction of the understatement percentage table is, in general, welcomed, as it should provide certainty and consistency in the case of understatements on tax payable (2011: 58 and 59). The Tax Administration Act, in respect of understatement penalties, is apparently transparent in respect of the reasoning behind the determination of the understatement penalty and the procedures that SARS is required to follow (SARS 2013b:73). The transparent computation of the understatement penalty and the fact that taxpayers, when identified according to similar 'behaviour' and 'case' types, will be treated equally, is commendable and seemingly meets the requirements of fairness and equity. It is suggested, however, that until some guidance as to the factors it will use to determine the 'behaviour' types is issued by SARS,³⁸ it is unlikely that the levying of understatement penalties will be uniformly applied. This suggestion finds some support in a recent unreported case, *AD CC v C: SARS*, Unreported Case no: VAT 1069, Tax Court of South Africa, Durban, where the court's interpretation of the taxpayers case, by reference to the understatement penalty table, was determined to be 150% whilst SARS had levied 200%.³⁹

The application of the Voluntary Disclosure Programme may also prove to be problematic in that it requires senior SARS officials to exercise their discretion as to the merits of a taxpayer's application (Section 226(2) of the Tax Administration Act).⁴⁰ The legislators, by including comparatively high understatement penalty percentages (See Table 6 in Sub-Chapter 6.6, below) in the understatement penalty percentage table appear to have met the requirement of a significant deterrent to keep taxpayers from adopting 'unwanted behaviour' (SARS 2013b: 73).

In the manual issued in respect of its five-year compliance program, SARS states that its goals are:

- to understand what affects taxpayers' attitudes and their willingness to comply,

³⁸ SARS states in its *Memorandum and Objects on the Tax Laws Administration Bill of 2013* at 40, that guidance will be issued with regard to an 'inadvertent error' and, by inference, the other 'behaviour' types will also be addressed so as to assist in differentiating between the various 'behaviour' types.

³⁹ Note that the case related to additional tax raised in terms of the Vat Act at 200% thus pre-dating the Tax Administration Act. Lopes J, also determined that 150% (if determined under the Tax Administration Act) was not appropriate and reduced the penalty further to 100%.

⁴⁰ Section 226(2) of the Tax Administration Act states that 'A senior SARS official may direct that a person may apply for voluntary disclosure relief'.

- to know what their obligations to the taxpayers are,
- to educate taxpayers in respect of their obligations,
- to make compliance easy for taxpayers, and
- to ensure taxpayers understand the possible consequences of non-compliance (2012: 6).

SARS states further that monetary and other punitive measures, which escalate according to the context and severity of the non-compliance, are required to establish the perception of a credible threat of detection for non-compliance, and to maintain such a perception (2012: 6).

The overall objectives of SARS, in respect of the Tax Administration Act, was to be aligned with modern approaches, business practices, accounting practices and constitutional rights, so as to provide a single, simplified body of law which outlines common procedures, rights and remedies, while balancing the rights and obligations of both SARS and the taxpayers in a transparent relationship (SARS 2011: 178) are, it is suggested, theoretically sound and appropriate. The practical application of these objectives is deemed significantly more difficult to attain, especially in the light of the limited resources that the government has at its disposal (National Treasury n.d.) but due to the relatively recent introduction of the Tax Administration Act there is little evidence to support or deny SARS success in achieving their stated goals.

5.3 The Constitution of South Africa

The Constitution does not legislate specifically on understatement penalties. Parliament may effectively pass any legislation it deems necessary in this regard.⁴¹ However, any legislation may be set aside by the Constitutional Court if it is determined to be unconstitutional (Parliament: n.d.). Section 77 of the Constitution has specific Parliamentary requirements for any Money Bill (any Bill that appropriates money or imposes taxes, levies or duties) and s. 213 of the Constitution states that all such monies received by the government must be paid into the National Revenue Fund, unless specifically excluded by Parliament (s. 213 of The Constitution of the Republic of South Africa).

The Constitution of South Africa contains a Bill of Rights that ensures, inter alia, that every person has the right to: equality before the law, no unfair discrimination, privacy, not be deprived of property, just administrative action, and access to the courts (Chapter 2, Bill of Rights, The Constitution of the Republic of South Africa). These rights are not absolute, however, and may be limited in their application, subject to s. 36 of the Constitution which, in respect of laws of general application, may be limited to the extent that such limitation is reasonable and justifiable in an open democratic society, subject to all relevant factors (Croome 2013b: 7).

The *Memorandum on the objects of the Tax Administration Bill, 2011* states that one of the purposes of the bill is to uphold the constitutional rights of the taxpayer, especially in respect of administrative justice and fairness, but, as these are fact and context specific, they were not codified (2011: 178). Administrative fairness is to be effected through affording taxpayers more effective and overreaching support such as the Ombud's office, and procedural rights in respect of SARS's powers. In drafting the Tax Administration Act, SARS consulted domestic tax and constitutional law experts

⁴¹ The Constitution of the Republic of South Africa, 1996, s. 44(1)(a)(ii) states that parliament may 'pass legislation with regard to any matter ...'.

(SARS2011:201) so as to ensure that the Tax Administration Act does not violate the Bill of Rights contained in the Constitution (Croome 2013b: 16). However, Dr Croome cautions that:

‘[t]he Income Tax Act and other fiscal statutes confer certain powers upon the Commissioner: SARS. Many of these powers are, in my view, necessary in order to ensure the proper and efficient collection of taxation but certain of these powers may indeed be held to be unconstitutional’ (2013b: 10).

In his lecture notes Dr Croome hypothesises as to whether differential tax rates between taxpayers are a breach of the right to equality (2013b: 66), and taking this hypothesis further, could it then be argued that differential understatement penalty ‘case’ types may also then be regarded as breaching the constitutional equality requirement? It would seem that if all taxpayers are treated equally, based on similar actions and circumstances, which determine the tax bracket or understatement penalty category they fall into, then each person is, *ipso facto*, treated equally. They would not therefore be unfairly discriminated against but, the ‘if’ here is considered to contain some subjective determinations which might make equality difficult to ascertain. Dr Croome also makes the point that where a taxpayer makes an understatement, SARS will impose an understatement penalty (s. 222(1) of the Tax Administration Act), whereas when SARS makes an error, there is no requirement of SARS to apologise or compensate the taxpayer (Croome 2013b: 23), which cannot be considered equal in the eyes of the law (2013b: 23). As noted by Botha, an enactment does not apply to the state or other public bodies from which such enactment emanates (Botha 2012: 139). Nevertheless, it is possible for officers of SARS to be held personally responsible if they act negligently (Botha 2012: 141). In his lecture notes, Dr Croome states that while the Tax Administration Act introduces a number of provisions that enhance taxpayers’ rights in South Africa, it does not introduce a cost-effective remedy where SARS has abused its powers or has acted ‘badly’ (Croome 2013b: 21). Taxpayers can therefore only seek relief in the form of damages or costs awarded by the High Court, which is both a costly and a time consuming exercise (Croome 2013b: 21).

The Constitution requires that local courts consider both international and local law when interpreting any legislation (Croome 2013b: 11). Section 233 of the Constitution states that the courts may:

‘...prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is not consistent’.

As Botha points out in his book on statutory interpretation, the examination of comparative law must, however, be done with due regard to the unique domestic context of the Constitution (2012: 194).

The imposition of understatement penalties can be regarded as an ‘administrative action’ under the Promotion of Administrative Justice Act of 2000, with which SARS is required to comply (Croome 2013b: 28). Administrative action is required to be procedurally fair and include adequate notice, reasonable opportunity to make representation, a clear statement of the action, notice of review or appeal, and accommodate requests for reasons for the action (Croome 2013a:3). SARS indicated its consideration of the Promotion of Administrative Justice Act’s general application in its guide SARS’s *Short Guide to the Tax Administration Act* (2013b: 10). SARS’s believes its compliance with the requirements of the Tax Administration Act in regard to understatement penalties, meets the

Promotion of Administrative Justice Act requirements (SARS 2013b: 10), but due to the relatively recent introduction of the Tax Administration Act there is little evidence to support or deny this view.

SARS compliance with Promotion of Administrative Justice Act is uncertain as while SARS would appear to have expended time and effort in ensuring compliance (SARS 2013b: 10), the practical application of the necessary administrative procedures still needs to be tested over time.

The Promotion of Access to Information Act of 2000 also gives taxpayers rights according to which they are entitled to certain information held by SARS in respect of themselves (Croome 2013b: 29). The Tax Administration Act makes provision for taxpayers to have the right of access to certain of the documents in SARS's possession. For example, s. 65 of the Tax Administration Act allows a taxpayer access to documents seized by SARS, and s. 73 of the Tax Administration Act allows a taxpayer access to the information on which assessments are based, all information submitted to SARS by the taxpayer, and other information relating to the taxpayer's tax affairs. SARS has therefore appeared to have considered the requirements of the Promotion of Access to Information Act within the Tax Administration Act.

5.4 International best practice

According to Hasseldine's working paper on *The Administration of Tax Systems*, when:

'considering the scale of tax administration worldwide, there is a relatively small evidence base on what may be considered best practice in tax administration, and a dearth of scholarly literature' (2010:18).

The Organisation for Economic Co-operation and Development (OECD) issues documents as part of a tax guidance series, but gives a caveat in respect of each document which warns that:

'... each revenue authority faces a varied environment within which they administer their taxation system. Jurisdictions differ in respect of their policy and legislative environment and their administrative practices and culture. As such, a standard approach to tax administration may be neither practical nor desirable in a particular instance.' (OECD 2001:1).

In the practice note on *Principles of Good Tax Administration*, the OECD makes a statement with respect to the recommended goals and challenges of revenue authorities, which include:

- 'The main role of revenue authorities is to promote tax compliance and must review operating approaches and procedures regularly to ensure the promoting of voluntary compliance (2001:3).
- Taxpayers who are aware of their rights and expect, and in fact receive, a fair and efficient treatment are more willing to comply (2001:3).
- When compliance is not achieved on a voluntary basis, revenue authorities must identify and address the risks associated with non-compliance by developing strategies targeted at those risks (2001:3).
- Good revenue authorities are strategically focussed and responsive to changes in their environment and that of their taxpayers (2001:3).
- Authorities should apply tax laws in a fair, reliable and transparent manner (2001:4).
- Authorities should outline and communicate to taxpayers their rights and obligations as well as the available complaint procedures and redress mechanisms (2003: 4).

- The exercise of penalties and sanctions by a revenue authority should take into account any evidence as to the reasons for non-compliance. Errors can arise due from honest mistakes – particularly with complex tax requirements, from ignorance about tax obligations or, in some instances, from the taxpayer being prevented from complying by some event outside their control, such as a natural disaster’ (2003: 5).

In his book *The Concise Encyclopedia of Economics*, Minarik states that there are four accepted longstanding objectives of tax policy – simplicity, efficiency, fairness and revenue sufficiency (2008). The application or balance of these objectives can, however, cause conflict among economists as, in some instances, they are contradictory (Minarik 2008). Simplicity in this context means that compliance by the taxpayer and administration by the revenue authorities should be as easy as possible (Minarik 2008). Efficiency means that taxation should interfere as little as possible in the choices people make, for example, tax policy should discourage neither work nor investment, as opposed to leisure or consumption (Minarik 2008). Fairness requires that taxpayers of equal status pay equal taxes (this is called ‘horizontal equity’) and that better-off taxpayers pay more tax (‘vertical equity’) (Minarik 2008). Revenue sufficiency suggests, as the term indicates, that the government should tax no more than it requires to function efficiently. However, budget surpluses and deficits occur constantly due a myriad of factors (Minarik 2008).

The Australian Tax Office states in its practice statement that the purpose of a penalty regime is to encourage entities to take reasonable care in complying with their tax obligations and that, generally, taxpayers should not be penalised where they have made an honest and genuine attempt to comply (2014: para 9). The statement goes on to say that the ATO should be fair to those taxpayers wanting to do the right thing, and be firm but fair with those choosing to disengage and avoid their taxation obligations (2014: para 9). The taxpayer should always be presumed to be honest, unless information is given, or obtained, which suggests otherwise (2014: para 9).

International best practice is not able to be summarised in a paragraph, it comprises an holistic amalgamation of laws, policies, culture and administrative actions which are combined to achieve the specified objectives of a taxing jurisdiction, where no one solution fits all (OECD 2001:1). Nevertheless there are certain longstanding accepted objectives of tax policy, succinctly summarised by Minarik as – simplicity, efficiency, fairness and revenue sufficiency, which should be core to a jurisdictions tax administration system (2008).

5.5 Summary

The understatement penalty regime in South Africa has many similar policies, objectives and goals to those determined as tax best practice by the OECD (see Sub-Chapter 5.4, above). It would therefore appear that, SARS has generally included what could be regarded as international tax best practices within the Tax Administration Act as evidenced by the explanations and guidance in SARS’s *Memorandum on the objects of the Tax Administration Bill, 2011* (SARS 2011) and its *Short guide to the Tax Administration Act* (SARS 2013b). These guides and memoranda issued by SARS include many of the objectives and principles (see Sub-Chapter 5.4, above) proffered by the OECD and the authors indicated above.

The general procedural approaches applied to the determination of understatement penalties and the ‘behaviour’ categories of the countries, included in this research report, will be reviewed in the

following chapter in order to determine if the South African understatement penalties are aligned with their understatement penalty procedure methodologies. The Tax Administration Act appears to have been constructed in compliance with the rights guaranteed under the Constitution, and specifically with those outlined in Promotion of Administrative Justice Act and Promotion of Access to Information Act, subject to SARS's following the required procedural requirements as set out within the Tax Administration Act (see Sub-Chapter 5.3, above).

Chapter 6

A comparison of South African understatement penalties with those of the United Kingdom, the United States of America, Australia and Canada

6.1 Introduction

In this chapter Australia, Canada, the United Kingdom and the United States have been selected as all have understatement penalties leviable on taxpayers for understatements included in their legislation and have been identified by SARS for comparative purposes (SARS 2011:179). This chapter gives a brief overview of the type and application of each country's penalties, levied on understatements of income tax, charged on income from a local source in relation to that jurisdiction.⁴² The review investigates how the selected countries with long-standing tax administration laws (SARS 2011:179), are determining and applying such understatement penalties, and then compares them to current South African understatement penalties.

6.2 United Kingdom

Her Majesty's Revenue & Customs (HMRC) is, similar to SARS, a non-ministerial department established by the Commissioners for Revenue and Customs Act 2005, which gives the legal powers and responsibilities of the department to commissioners appointed by the Queen (HMRC n.d.(p)) in order to administer, inter alia, the Income Tax Act of 2007, Corporation Tax Act of 2010, Taxes Management Act of 1970, and the Finance Act of 2007. The penalties on inaccuracies (the United Kingdom's equivalent of understatement penalties) are legislated in terms of s. 97, and Schedule 24, of the Finance Act 2007 (the Finance Act) (HMRC n.d.(i)). Schedule 24 of the Finance Act 2007 contains provisions '... largely similar to those of the [South African] Tax Administration Act...' in respect of penalties levied on understatements of tax (Cliffe Dekker Hofmeyr 2014).

6.2.1 Penalties on inaccuracies

According to manuals issued by Her Majesty's Revenue & Customs (HMRC), penalties on inaccuracies are levied by HMRC (HMRC n.d.(f)). Schedule 24 s. 1(1) of the Finance Act states that a penalty is payable by a taxpayer where that taxpayer gives HMRC a document (as defined) and the document carries an inaccuracy which amounts to either, (a) an understatement of a liability of tax, or (b) a false or inflated statement of a loss, or (c) a false or inflated claim to repayment of tax, and the inaccuracy was careless or deliberate by the taxpayer. Careless is defined in the Finance Act at Schedule 24 s. 3(1)(a) as an inaccuracy in a document due to the failure of a taxpayer to take reasonable care. The definition of 'deliberate but not concealed' in the Finance Act at Schedule 24 s. 3(1)(b) is that the inaccuracy by the taxpayer is deliberate but that the taxpayer makes no arrangements to conceal it. The definition of 'deliberate and concealed', at Schedule 24 s. 3(1)(c) in the Finance Act, is defined as an inaccuracy deliberately made by a taxpayer which he or she then makes arrangements to conceal. The description given of 'deliberate and concealed' in HMRC's

⁴² In this context, and for this report, 'local income taxes' are taxes which originate from a local, as opposed to a foreign source, and are based on taxes triggered by the jurisdictions taxes on income as opposed to indirect taxes or other such taxing statutes, for example value added tax.

manual, is that of deliberately submitting false evidence in support of a deliberately inaccurate figure (HMRC n.d.(c)).

The amount of the penalty is based on the 'potential lost revenue' (PLR) which is the equivalent of the tax which should have been paid, less the tax actually paid (HMRC n.d.(q)) and is considered the equivalent of a 'shortfall' in the South Africa context. The taxpayer, if he or she discovers an under-assessment, has thirty days to advise HMRC (HMRC n.d.(h)). If the taxpayer fails to do so, they would be treated as careless, even if they were not initially careless (HMRC n.d.(h)). HMRC differentiates between unprompted and prompted disclosure of the 'shortfall'. If the taxpayer discloses to HMRC an under-assessment (unprompted disclosure), prior to HMRC identifying it, a lesser penalty will be levied (HMRC n.d.(g)). If the taxpayer discloses an under-assessment after HMRC finds out about it (prompted disclosure), a higher penalty will be levied than for unprompted (HMRC n.d.(g)). No penalty will be levied by HMRC on mistakes made by a taxpayer if the taxpayer has a reasonable excuse and they put right the failure without unreasonable delay (HMRC n.d.(m)).

Table 3: HMRC- standard maximum penalty table and prompted and unprompted disclosure penalty range (HMRC n.d.(g)).

1	2	3	4	5	6
<i>Item</i>	<i>Reason for penalty</i>	<i>Type of inaccuracy</i>	<i>Maximum penalty payable</i>	<i>Penalty range for unprompted disclosure</i>	<i>Penalty range for prompted disclosure</i>
(i)	Giving an inaccurate return or other document	Careless	30% of PLR	0%-30% of PLR	15%-30% of PLR
(ii)	Giving an inaccurate return or other document	Deliberate but not concealed	70% of PLR	20%-70% of PLR	35%-70% of PLR
(iii)	Giving an inaccurate return or other document	Deliberate and concealed	100% of PLR	30%-100% of PLR	50%-100% of PLR
(iv)	Inaccuracy discovered later but no reasonable steps taken to tell HMRC	Treated as careless	30% of PLR	0%-30% of PLR	15%-30% of PLR
(v)	Understated assessment not notified	N/A	30% of PLR	N/A	30% of PLR
(vi)	Inaccuracy due to deliberate behaviour of another person	N/A	100% of PLR	30%-100% of PLR	50%-100% of PLR

The determination of the penalty amount is made by determining the type of inaccuracy and the reason for the penalty and applying the maximum penalty as indicated in Table 3, column 4, above (HMRC n.d.(h)). The penalty may, if applicable, be reduced, based on the quality of the disclosure and whether the inaccuracy was determined through prompted or unprompted disclosure (HMRC n.d.(h)). The resulting penalty percentage is then multiplied by the 'potential lost revenue' (HMRC n.d.(h)).

A taxpayer may incur a penalty due to reliance on another person, either for inaccurate information received or information not received, that was used in or omitted from a document submitted to HMRC, if the taxpayer was either careless or deliberately included (or excluded) the information (HMRC n.d.(j)). In addition, the 'other person' may also be charged a penalty if the inaccurate information supplied (or accurate information not supplied) to the taxpayer caused an inaccuracy on a document submitted to HMRC by the taxpayer (HMRC n.d.(j)). The inaccuracy must have been deliberately supplied by the other person and such person must have known that the document submitted by the taxpayer would be inaccurate as a consequence thereof (HMRC n.d.(j)). A penalty may be levied on the other person supplying the information, whether or not a penalty is levied on the taxpayer (HMRC n.d.(j)).

There are higher penalty percentages for inaccuracies related to offshore matters (which only involve offshore income tax or capital gains tax), which are dependent on the country with whom the taxpayer is dealing (HMRC has two categories of countries which are designated in separate lists, based on their tax risk profile) (HMRC n.d.(h)). Category 2 offshore matters increase the standard penalty percentages by 1.5 times, up to 150%, while Category 3 offshore matters double the standard penalty percentages up to 200% (HMRC n.d.(k) & (l)). The unprompted and prompted disclosure and quality of disclosure rules apply for offshore penalties as well (HMRC n.d.(k) & (l)). Due to the fact that South Africa does not have a specific offshore understatement penalty system, unlike the United Kingdom (HMRC n.d.(o)), and this report is directed at South African local taxes and the understatement penalties thereon, these understatement penalties are considered to be outside the ambit of this report and are mentioned here only for completeness.

A taxpayer will not be liable for a penalty for a non-deliberate failure to notify HMRC if he or she has a reasonable excuse, and the taxpayer corrects the failure without unreasonable delay after the excuse has ended (HMRC n.d.(m)). The HMRC manual goes on to say that the onus of proof of 'a reasonable excuse', at the time of the failure, rests with the taxpayer and cannot apply if the failure is deliberate (n.d.(m)). No definition of 'reasonable excuse' is included in the statutes but HMRC has issued a guide in this respect. A 'reasonable excuse' will differ from taxpayer to taxpayer and each one is determined based on its own merits and the particular circumstances of the case (HMRC n.d.(n)).⁴³ It is interesting to note that in its guide HMRC states that certain excuses are, with some exceptions, not normally accepted. One of these unacceptable excuses is a 'shortage of funds'. However, in the case of *Kincaid v HMRC* [2011] UKFTT 225, the tribunal reversed the penalties as the taxpayer was found to be 'unable to pay on time because of cashflow difficulties' (Accounting WEB 2011). In another case in the United Kingdom, *Reachman v HMRC* [2011] UKFTT 261, the tribunal ruled that a taxpayer who mistakenly relied on his accountant to file a return, had made a genuine mistake which constituted a 'reasonable excuse' and it overturned the penalty raised by HMRC.

The culpability of a taxpayer based on a 'careless' type of inaccuracy is, according to an article by PwC, 'a cause for concern' as there is no definition of careless in the United Kingdom's taxing statutes (2014). PwC goes on to say that HMRC's view is that when a taxpayer can show that he has made an honest and reasonable attempt to comply with the legislation, no penalty will be imposed even if there is an under-assessment (2014). The author of the article states that the onus is usually on HMRC to show carelessness or deliberate carelessness on the part of the taxpayer (PwC 2014). The

⁴³ The HMRC manual refers in this regard to *Rowland v HMRC* [2006]STC (SCD) 536 at 18.

adoption by a taxpayer of a 'tax position', as defined in the Tax Administration Act (see Sub-Chapter 3.3.1, above), which differs from that of HMRC, is not specifically covered in the United Kingdom's inaccuracy types. It is submitted that in the event of such an inaccuracy, HMRC would categorise it as a deliberate inaccuracy, which may, or may not, be regarded as concealed, or attributable to another person, depending on the specific circumstances of the tax position assumed.

In serious tax evasion cases, HMRC provides evidence to the Crown Prosecution Service which will then determine if criminal charges should be initiated (Out-Law.com 2013). Criminal charges are considered outside the ambit of this report and no further research has been undertaken on these.

6.2.2 Comparison of the penalty regimes of the United Kingdom and South Africa

Based on the information provided in the above sub-chapter it may be said that the UK understatement penalty system is similar in many respects to that of South Africa. Both have escalating penalty percentages based on the nature of the transgression (s. 223(1) of the Tax Administration Act & HMRC n.d.(g)), both have an exemption from understatement penalties in the event of *bona fide* errors (s. 222(1) of the Tax Administration Act), subject to certain requirements (HMRC n.d.(m)), and both apply the penalty percentage, so determined, against the differential in taxes which should have been declared against that which was initially declared (s. 222(3) of the Tax Administration Act & HMRC n.d.(q)). The UK includes in its penalty regime, which South Africa does not, a penalty levied on people who assist or supply the taxpayer with information that leads to an inaccuracy in documents submitted to the tax authority by the taxpayer (HMRC n.d.(j)). Where the two systems differ noticeably is, firstly, in the type and number of understatement behaviours, where South Africa has five (s. 223(1) of the Tax Administration Act) as opposed to the UK's nature of the inaccuracies (the UK has three) (HMRC n.d.(g)). As a result, South Africa has a wider spread of pre-determined penalty percentages. Secondly, the UK still has a remission of penalty system which is based on HMRC's opinion of the quality of disclosure offered by the taxpayer (HMRC n.d.(m)), South Africa has no such remission system. Finally, the Tax Administration Act has a maximum penalty of 200% (s. 223(1) of the Tax Administration Act) whilst the UK's equivalent is a maximum of 100% (HMRC n.d.(g)). This maximum penalty percentage differential is material and represents a significant difference in what the United Kingdom's legislators deem an appropriate level of penalty, compared to those of South Africa.

6.3 United States of America

The United State of America (USA) has federal, state and local taxes (IRS n.d.(g)) but, for comparative purposes, this report will confine its review to understatement penalties levied in terms of the federal tax system. The Internal Revenue Service (IRS) was set up and tasked:

'to carry out the responsibilities of the secretary of the Treasury under section 7801 of the Internal Revenue Code. The secretary has full authority to administer and enforce the internal revenue laws and has the power to create an agency to enforce these laws. The IRS was created based on this legislative grant.' (IRS n.d.(g))

The understatement penalties levied by the IRS are legislated in terms of various U.S. Codes under Title 26, Subtitle F, Chapter 68 Subchapter A, Part II (IRS n.d.(g)) . For ease of reference the US Codes detailed below all fall under Title 26, Subtitle F, Chapter 68, unless otherwise stated.

6.3.1 Accuracy-related penalty and underpayments

U.S. Code §6662 ‘imposition of accuracy-related penalty on underpayments’ states the application of penalties on underpayments of tax (IRS n.d.(a)) and which include the equivalent of the South African understatement penalties (SARS 2013b: 78). An ‘underpayment’, is defined in U.S. Code §6664 as:

‘(1) the sum of –

- (A) The amount shown as the tax by the taxpayer on his return , plus
- (B) Amounts not so shown previously assessed)or collected without assessment), over

(2) the amount of rebates made. ...’ ((IRS n.d.(c)).

and, according to the U.S. Codes §6662(b)(1)-(7), is attributable to any of the following:

- ‘Negligence or disregard of rules or regulations.
- Any substantial understatement of income tax.
- Any substantial valuation misstatement under chapter 1.
- Any substantial overstatement of pension liabilities.
- Any substantial estate or gift valuation understatement.
- Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance ... or failing to meet the requirements of any similar rule of law.
- Any undisclosed foreign financial asset understatement.’(IRS n.d.(a))

As can be seen from the above list, the code has specific penalty rules, peculiar to the USA tax regime and its required administration and disclosures, and consequently only the ‘underpayments’ attributable to the first item ‘Negligence or disregard of rules or regulations’(IRS n.d.(a)), the second item, the ‘understatement of income tax’(IRS n.d.(a)), and the sixth item:

‘disallowance of claimed tax benefits by reason of a transaction lacking economic substance ... or failing to meet requirements of any similar rule of law.’ (IRS n.d.(a))

are deemed directly relevant to the context of this report as the other items are not considered comparable to the South African ‘understatement’ penalties. In addition, special understatement rules which apply to identified offshore ‘tax shelters’ (IRS n.d.(a)) will also not form part of the discussion in this report as South Africa has no such specific understatement penalty provisions, and this report is also constrained to ‘understatement’ penalties on local income taxes.

An ‘understatement’ in respect of the above is defined in U.S Code §6662(2)(A) as the excess of the:

‘... amount of the tax required to be shown on the return for the taxable year, over ... the amount of the tax imposed which is shown on the return , reduced by any rebate...’(IRS n.d.(a)).

The code stipulates that a general 20% ‘base penalty’ on any portion of an underpayment of tax will apply, and a 40% penalty will apply for disallowed tax benefits relating to understatements on transactions lacking economic substance, which will be added to tax otherwise payable (IRS n.d.(a)). The US penalty regime also differentiates reportable transactions for penalty purposes which are discussed below.

‘Negligence’ and ‘disregard’ mentioned in the list above are defined in terms of U.S code 6662(c) respectively as including ‘any failure to make a reasonable attempt to comply with the provisions of this title’ and ‘any careless, reckless, or intentional disregard’ (IRS n.d.(a)).

A ‘substantial understatement’ is (for non-corporations) generally that which exceeds the greater of 10% of the tax required to be shown on the return or US \$5 000 (IRS n.d.(a)). For corporations (other than S corporations, as defined, and a personal holding company), a ‘substantial understatement’ occurs when the understatement of income tax is the lesser of 10% of the tax required to be shown or US \$10 000 000 (IRS n.d.(a)). A number of other substantial understatement and overstatement determinations (IRS n.d.(a)), specific to the nature of the underpayment as indicated in the list above, are provided in U.S. Code §6662 (IRS n.d.(a)) but are considered outside the ambit of this report as they do not refer directly to income tax based understatements.

If a fraud is perpetrated, a 75% penalty is attributable to all underpayments related to such fraud (IRS n.d.(b)). As mentioned previously (see Sub-Chapter 3.3.6, above) fraud is evidenced by proof that the taxpayer intended (the *mens rea* or mental element of willfulness) to conceal, mislead (the *actus reus* or guilty conduct) or otherwise prevent the collection of taxes, and that there is an underpayment of taxes (Hall 2009).

Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, and any undisclosed foreign financial assets understatements, attract a penalty of 40% on the portion of the tax relating to the understatement so determined (IRS, U.S. Code §6662 paragraph (i)(3)(1) and (j)(2)(1) respectively) (IRS n.d.(a)).

An understatement is reduced by any portion of an understatement that is attributable to ‘substantial authority’ for such treatment or adequate disclosure of the ‘item’s’ facts which are supported by a reasonable basis in accordance with U.S. Code §6662(2)(b)(i) & (ii) (IRS n.d.(a)). The remission of the penalty in this regard relates to taxpayers assuming a tax position which is supported by appropriate third party evidence or where there is adequate disclosure in the taxpayer’s return, and the basis for it is reasonable so as to not unduly punish the taxpayer (IRS n.d.(a)).

U.S Code §6664(b) stipulates that no penalty will be imposed on understatements in terms of Code §6662 or Code §6663 that do not result from a return being submitted (IRS n.d.(b)). This clarifies the requirement that a ‘return’, in some form, is required prior to the penalties relating to these codes being triggered (IRS n.d.(b)).

No penalty will be imposed on any portion of an underpayment from a non-reportable transaction if reasonable cause is shown and the taxpayer acted in good faith, with the exception of any underpayment resulting from a disallowance of claimed tax benefits by reason of a transaction lacking economic substance (IRS n.d.(a)). In the case *Cheek v United States* 498 U.S. 192, 111 S.Ct. 604, 112 L. Ed. 2d 617 (1991), the taxpayer argued that he had reasonable cause not to file his tax returns, based on advice he had received at various seminars that the tax system was unconstitutional (Casebriefs, n.d.). He therefore failed to file six tax returns with the IRS (Casebriefs, n.d.). The court, on remand, found the taxpayer guilty of not submitting his returns and of tax evasion (Casebriefs, n.d.).

6.3.2 Understatements on reportable transactions

U.S. Code §6662A differentiates between understatements on ‘reportable transactions’, as defined,⁴⁴ and all other understatements as indicated in U.S. Code §6662 (IRS n.d.(a)). The U.S. Code §6662A(c) imposes a penalty of 20% on an understatement of tax which originates from a reportable transaction and this escalates to 30% for understatements of tax on non-disclosed listed and other avoidance transactions (those cases not based on the facts and existing law and resting solely on whether the taxpayer may be audited and identified as lacking economic substance) (IRS n.d.(a)).

U.S. Code § 6694(a) stipulates a penalty of the greater of US \$1 000 or 50% of the income derived by a tax preparer, in respect of the return, on unreasonable positions on returns compiled by such tax preparer resulting in an underpayment (IRS n.d.(e)). In the event of wilful or reckless conduct understatements, the penalty is increased to the greater of US \$5 000 or 50% (IRS n.d.(e)).

No penalty will be imposed on any portion of an understatement from a reportable transaction if there was ‘reasonable belief’ shown and the taxpayer acted in good faith as per U.S. Code §6664(d)(3) & (4) (IRS n.d.(c)). The code states that in order for this exemption to apply there must be adequate disclosure of the facts relating to the tax treatment of the item, there must be ‘substantial authority’, and the taxpayer must reasonably have believed that such treatment was, more likely than not, the proper treatment (IRS n.d.(c)). Reasonable belief in this regard is defined in U.S. Code §6664(d)(4)(A) where a taxpayer’s belief is based on the facts and law at the time of the return and relates solely to the taxpayer’s chance of success on the merits of such tax treatment as opposed to the chances of the item being audited or resolved through settlement (IRS n.d.(c)). The relevant section of the U.S. Code §6664(d)(4)(B) specifies both certain tax advisors and certain opinions obtained from tax advisors, which may not be relied upon for reasonable belief purposes (IRS n.d.(c)).

Federal laws have a number of criminally-based laws which are specified in the statutes at Title 26, Subtitle F, Chapter 68 Code §7201 to §7217 inclusive, and include both prison sentences and fines for tax evasion. These criminal sanctions fall outside the ambit of this report and therefore no further research in this regard, has been undertaken.

6.3.3 Other penalties

The USA Revenue codes have a separate penalty system for failure to file any return. U.S. Code 6651(a)(1) states that the penalty applicable to not filing a return in time, unless due to reasonable cause (not due to wilful neglect), is 5% of the tax reflected on the return, per month or part thereof, up to a maximum 25% (IRS n.d.(f)). These penalty percentages increase to 15% per month and a maximum of 75% in the event that the failure to file a return is due to fraud as per U.S. Code §6651(f) (IRS n.d.(f)). If the return is filed more than 60 days after it was due, a minimum penalty, being the lesser of \$135 or 100% of the unpaid tax, is payable (IRS n.d.(f)).

⁴⁴ Title 26, Subtitle F, Chapter 68, Subchapter A, Part II Code §6707A (c)(1) states: ‘The term “reportable transaction” means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations ... such a transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion.’ A listed transaction is defined in U.S. Code §6707A(c)(2) as: ‘The term “listed transaction” means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.’

A separate penalty of US \$5 000 is levied if a taxpayer files a 'frivolous' return (IRS n.d.(h)). A frivolous return is a return that does not include sufficient information for the IRS to make a reasonable determination of the correctness of the tax due by the taxpayer, or that contains what appears to be substantially incorrect tax information (IRS n.d.(h)).

6.3.4 Comparison of the penalty regimes of the United States and South Africa

The USA understatement penalty system, specific to income tax, has elements which are similar to the South African understatement penalty system but the approach in determining the USA understatement penalties follows a more convoluted path. Both have escalating penalty percentages (s. 223(1) of the Tax Administration Act) based on the nature of the transgression which, once determined, are applied to the amount of the understated tax payable (IRS n.d.(a)). The USA, however, has different determinants, being, for this reports comparative purposes, either a general 'underpayment' for 'negligence or disregard of the rules and regulations' (IRS n.d.(a)), a 'substantial understatement' or a 'transaction lacking economic substance'. These causes of the 'underpayment' are then further disseminated into either fraudulent 'underpayment' (IRS n.d.(b)) reportable or not 'understatement' (IRS n.d.(a)), 'reasonable cause exception for underpayments' (IRS n.d.(c)) and 'reasonable cause exception for reportable transaction understatements' (IRS n.d.(c)) in order to determine if they might change the penalty percentage to be ultimately applied. This systematic approach of the IRS would appear to be aimed at streamlining the use of IRS resources, so that the IRS is able to direct its resources to higher value, and higher risk, transgressions, which is considered good administrative tax management. This is in contrast to its South African counterpart of five 'behaviour' types and four 'case' types (s. 223(1) of the Tax Administration Act).

Both countries have an exemption from understatement penalties in the event of '*bona fide*' type errors (s. 222(1) of the Tax Administration Act) subject to certain requirements (IRS n.d.(c)) and refer Sub-Chapter 6.3.1, above. The most significant difference noted is that the Tax Administration Act has a maximum penalty percentage of 200% (s. 223(1) of the Tax Administration Act), whilst the USA equivalent is a maximum of 75% (IRS n.d.(b)), and, generally, its other penalties tend to be lower (Refer Table 4, Sub-Chapter 6.4, below). This maximum penalty percentage differential is significant, and consequently, a large disparity exists between what the USA deems to be an appropriate level of penalty, compared to that of South Africa.

6.4 Australia

The Australian Tax Office (ATO) is the principal revenue collection agency of the Australian Government (ATO n.d.(c)). The ATO administers major aspects of Australia's superannuation system (ATO n.d.(c)).

The Australian penalty regime applicable to Australian taxpayers is contained in Division 284, Part 4-25, Chapter 4, Schedule 1 of the Tax Administration Act 1953. The division specifies five circumstances where an administrative penalty would apply:

- for making either false or misleading statements in a material particular,
- for taking a tax position which is not reasonably arguable or entering into schemes,
- for refusing to provide documents to the ATO commissioner,

- for disregarding a private ruling, and
- for entering into a scheme so as to derive a scheme benefit (ATO 2008).

The penalty applied is on the basis of either a penalty percentage, or in the form of multiples of a 'penalty unit', as specified in the legislation (s. 284-90(1), Part 4-25, Chapter 4, Schedule 1 of the Taxation Administration Act 1953). A penalty unit is presently determined to be the equivalent of \$170 (ATO n.d.(a)). The purpose of the penalty regime according to the ATO is to encourage entities to take reasonable care in complying with their tax obligations and, as a general rule, entities should not be penalised where they have made an honest and genuine attempt to comply (ATO 2014: para 9).

A 'statement' is regarded as having been made, whether in writing, orally, electronically or in any other way, and, either by inclusion or exclusion, included or excluded, to the ATO commissioner or any officer representing him (ATO 2014: paras 16,17,18, 19 and 20). A 'false' or 'misleading' statement in a 'material particular' is determined within the context of the purpose of the 'false' or 'misleading' statement relative to the nature of the information requested (by the ATO) and the materiality of the 'statement' (ATO 2013: paras 37 and 38). A 'material particular' is therefore an amount, or information, that will likely affect a decision regarding the calculation of a taxpayer's liability (ATO 2014: para 23).

Once a 'false' or 'misleading' statement in a 'material particular' is identified, a determination is made as to whether a 'shortfall' occurred or not (ATO 2014: para 79). A 'shortfall' is in essence the difference between the correct tax liability and that which was actually submitted to the ATO (ATO 2014: para 79). A 'false' and 'misleading' statement that results in a 'shortfall' will attract an administrative penalty (the equivalent of the South African understatement penalty) (ATO 2014: para 14). 'False' and 'misleading' statements that do not result in a 'shortfall' will still be penalised but will attract a penalty determined by 'penalty units'⁴⁵ (ATO 2013: paras 20 & 21). Identified shortfalls will be penalised by a percentage that is determined based on the nature of the 'statement' as defined (ATO 2014: paras 15 & 16). This penalty is regarded as the 'base' penalty (ATO 2014: para 99). which is then increased or decreased depending on the circumstances of the 'false' or 'misleading' statement and certain prescribed criteria (ATO 2014: para 39).

6.4.1 General administrative penalties – 'shortfall' incurred

In terms of the Taxation Administration Act 1953, Schedule 1, Chapter 4, Part 4-25, Subdivision 284-B, s. 284-75(1) a taxpayer will be liable for an 'administrative penalty' if the taxpayer carries out any one of four transgressions: the taxpayer makes a statement to the ATO Commissioner which is misleading due to the particulars included therein or omitted therefrom, or, in terms of s. 284-75(2) of the Act, makes a statement while applying an income tax law in a way that is not reasonably arguable, or, per s. 284-75(3), fails to give a notice, document or return when required and the ATO has to make a determination of tax without the document, or, in terms of s. 284-75(4), makes a statement to the ATO Commissioner which is misleading either due to the particulars included therein or omitted therefrom and purports this to be required or permitted by a taxation law.

⁴⁵ A penalty unit is determined as per s. 4AA(1) of the Crimes Act 1914.

A statement is 'false' if it is contrary to fact or wrong, whether through inclusion or omission, irrespective of whether it was made with the knowledge that it was false (ATO 2014: para 21). A statement is 'misleading' if it creates a false impression, whether through inclusion or omission, even if the statement is true (ATO 2014: para 22). A 'material particular' is something that is likely to affect a decision regarding the calculation of an entity's tax-related liability or entitlement to a credit or payment (ATO 2014: para 23). Each statement is determined individually, on its own merits, and due to these determinations attracts different penalty amounts (ATO 2014: para 90). A reduction in an assessed loss is not regarded as a 'shortfall' amount. However, penalties may still be levied as per the 'no shortfall' penalty section discussed in the next chapter (see Sub-Chapter 6.4.2, below).

The ATO in their explanatory memorandum on penalties lists three different levels of 'care' categorised for those statements which result in a shortfall, and each one has a prescribed base tax penalty percentage (ATO n.d. (a)):

- Failure to take reasonable care: the 'base penalty' for this behaviour is 25% of the 'shortfall'. A taxpayer is determined not to have taken reasonable care if the taxpayer did not do what a reasonable person in the same circumstances would have done (ATO n.d.(a)).
- Recklessness: the 'base penalty' for this behaviour is 50% of the 'shortfall'. A taxpayer is regarded as reckless if a reasonable person in the same circumstances would have been aware that there was a real risk of a 'shortfall' arising, and disregarded the risk, or failed to take steps to diminish it (ATO, n.d.(a)). This type of behaviour is considered to be gross carelessness (ATO 2014: para 107).
- Intentional disregard: the 'base penalty' for this behaviour is 75% of the 'shortfall'. A taxpayer shows intentional disregard if he or she is fully aware of a clear tax obligation and disregards it with the intention of achieving a specific result (ATO n.d.(a)).

This is represented in tabular form by the ATO as follows:

Table 4 : ATO 'Base penalty' amount for 'shortfall' incurred (ATO2014: para 99)

[Shortfall amount * relevant percentage = base penalty amount]

Base penalty amount		
Item	In this situation	The base penalty amount is:
1	You have a shortfall amount as a result of a statement described in subsection 284-75(1) or (4) and the amount, or part of the amount, resulted from intentional disregard of a taxation law by you or your agent	75% of your shortfall amount or part
2	You have a shortfall amount as a result of a statement described in subsection 284-75(1) or (4) and the amount, or part of the amount, resulted from recklessness by you or your agent as to the operation of a taxation law	50% of your shortfall amount or part
3	You have a shortfall amount as a result of a statement described in subsection 284-75(1) or (4) and the amount, or part of the amount, resulted from a failure by you or your agent to take reasonable care to comply with a taxation law	25% of your shortfall amount or part

(ATO 2014: para 99)

A further type of non-compliance occurs when a taxpayer fails to give a notice or document, when required, and the ATO has to make a determination of tax without the document: a 75% penalty on the shortfall is applied according to item 7 of the table at s. 284-90(1), Subdivision 284-B, Part 4-25, Chapter 4, Schedule 1, of the Taxation Administration Act 1953.

The base tax penalty percentages indicated above are increased by 20% if a taxpayer is found to be guilty of any one of the following actions (ATO n.d.(a)):

- Attempting to prevent or obstruct the ATO from finding out about the 'shortfall' (ATO n.d.(a)).
- Becoming aware of the 'shortfall' but not informing the ATO within a reasonable time (ATO n.d.(a)).
- Being previously liable for a false or misleading statement penalty or for taking an income tax position that is not reasonably arguable (ATO n.d.(a)).

The above base tax penalties will be reduced by 80% if a taxpayer discloses a 'shortfall' to the ATO, prior to an examination of the taxpayer's affairs is conducted, or prior to a request for voluntary disclosure in respect of a transaction (ATO n.d.(b)) and no penalty would be payable in this regard if the 'shortfall' is less than AUS \$1 000 (ATO n.d.(b)). If a voluntary disclosure is made after the

taxpayer is informed that an examination is to be conducted, the penalty will be reduced by 20%, but only if the disclosure will save the ATO time and resources (ATO n.d.(b)).

No penalty is payable if the taxpayer took 'reasonable care' in connection with making the statement, or the 'safe harbour'⁴⁶ rule applies, or the taxpayer applied the law in an accepted way (ATO 2014: para 39). The 'reasonable care test' requires a taxpayer to make a reasonable and genuine attempt to comply with tax obligations. The effort required is one commensurate with the taxpayer's circumstances, including the taxpayer's knowledge, education, experience and skill (ATO 2014: para 44). A genuine attempt means that a taxpayer actively attempts to fulfil his or her tax obligations (ATO 2014: para 45). This occurs when the taxpayer makes a reasonable attempt to effectively manage the risks associated with the taxpayer's position and in the taxpayer's returns submitted to the ATO (ATO 2014: para 48). To meet the requirement of 'applying the law in an accepted way' the taxpayer would be required to have followed a practice that is generally applied by the ATO Commissioner in the course of its normal administration (ATO 2014: para 116).

The penalty for a 'false' or 'misleading statement' that results in a 'shortfall' amount is imposed by statute (ATO 2014: para 155). The Commissioner of the ATO can, however, exercise discretion to remit all or part of the penalty (ATO 2014: para 155). This discretion is an unfettered discretion (ATO 2014: para 155). A remission decision may result in no remission, partial remission or total remission of the penalty, but the decision to remit, or not, is based on the objectives of the penalty regime in a fair and reasonable way, so as to not cause unintended or unjust results (ATO 2014: paras 156 & 157).

The ATO Commissioner is required to make the determination of the administration penalty and advise the taxpayer accordingly (ATO 2014: para 197). Additionally, any remission, or lack thereof, must be communicated to the taxpayer and reasons for its determination must be given (ATO 2014: para 197). The taxpayer may object to the ATO Commissioner's decision (ATO 2014: para 198).

6.4.2 General administrative penalties – no 'shortfall' incurred

A statement of a 'material particular' is false if it is contrary to fact, or wrong, whether through inclusion or omission, irrespective of whether it was made with the knowledge that it was false (ATO 2013: para 35). A statement of a material particular is misleading if it creates a false impression, whether through inclusion or omission, even if the statement is true (ATO 2013: para 36). A material particular is something that is likely to affect a decision regarding the calculation of an entity's tax-related liability, or entitlement to a credit, or payment (ATO 2013: para 39). Each statement is determined individually, on its own merits, and can therefore attract different penalty amounts (ATO 2013: para 136).

There are three different levels of care categories for those statements which do not result in a 'shortfall' in terms of the items included in the table at s. 284-90(1), Subdivision 284-B, Part 4-25,

⁴⁶ Safe harbour in respect of a statement occurs when a taxpayer incurs a penalty as a result of certain actions or omissions of their registered agent, where the taxpayer provided all relevant taxation information to the registered agent which was necessary for the correct preparation of the statement (ATO 2014: para 57). No remission will apply if the registered agent acted recklessly or with intentional disregard of the taxation law (ATO 2014: para 58).

Chapter 4, Schedule 1 of the Taxation Administration Act 1953 (ATO 2013: para 95) and are represented in tabular form by the ATO as follows:

Table 5 : ATO ‘Base penalty’ amount for ‘shortfall’ not incurred (ATO2013: para 95)

3A	A statement described in subsection 284-75(1) or (4) was false or misleading because of intentional disregard of a taxation law by you or your agent but did not result in you having a shortfall amount	60 penalty units
3B	A statement described in subsection 284-75(1) or (4) was false or misleading because of recklessness by you or your agent as to the operation of a taxation law but did not result in you having a shortfall amount	40 penalty units
3C	A statement described in subsection 284-75(1) or (4) was false or misleading because of a failure by you or your agent to take reasonable care to comply with a taxation law but did not result in you having a shortfall amount	20 penalty units

(ATO 2013: para 95)

- As per item 3A of the table, a statement made with intentional disregard of the ATO Commissioner, which is misleading either due to the particulars included therein or omitted therefrom, or a statement made to the ATO Commissioner which is misleading either due to the particulars included therein or omitted therefrom and which purports to be required or permitted by a taxation law. A penalty of 60 penalty units is applicable to this category (currently AUS \$10 200) (ATO 2013: para 95)
- In terms of item 3B, a reckless statement to the ATO Commissioner which is misleading either due to the particulars included therein or omitted therefrom, or a statement to the ATO Commissioner which is misleading either due to the particulars included therein or omitted therefrom and which purports to be required or permitted by a taxation law. A penalty of 40 penalty units (currently AUS \$6 800) is applicable to this category (ATO 2013: para 95).
- As per item 3C, a statement made without reasonable care to the ATO Commissioner which is misleading due to the particulars included therein or omitted therefrom, or a statement to the ATO Commissioner which is misleading due to the particulars included therein or omitted therefrom and which purports to be required or permitted by a taxation law. A penalty of 20 penalty units (currently AUS \$3 400) is applicable to this category (ATO 2013: para 95).

The ATO states in its practice statement that the ‘base penalty’ amounts indicated above are increased by 20% if a taxpayer is found to be guilty of any one of the following actions:

- Attempting to prevent or obstruct the ATO from finding out about the false or misleading statement (2013 para 111).
- Becoming aware of the false or misleading statement but not informing the ATO within a reasonable time (2013 para 111).

- Being previously liable for a false or misleading statement penalty (2013 para 111).

The above penalties will be reduced to 0% if a taxpayer discloses a false or misleading statement prior to the ATO conducting an examination of the taxpayer's affairs or prior to a request for voluntary disclosure in respect of a transaction (ATO 2013: para 120). If the false or misleading statement is disclosed and the 'shortfall' is less than AUS \$1 000, the penalty will also be 0% (ATO n.d.(b)). If a voluntary disclosure is made after the taxpayer is informed that an examination is to be conducted, the penalty will be reduced by 20%, but only if the disclosure will save the ATO time and resources (ATO 2013: para 123).

As in the 'shortfall' administration penalty, no penalty is payable if the taxpayer takes reasonable care in connection with making the statement, or if the 'safe harbour' rule applies (see Sub-Chapter 6.4.1, above), or if the taxpayer applied the law in an accepted way (ATO 2013: para 64). The same 'reasonable care' requirements that apply for exemptions to the 'no shortfall' administrative penalty, also apply to the 'shortfall' administrative penalty (see Sub-Chapter 6.4.1, above).

The penalty for a false or misleading statement amount is imposed by law. However, the Commissioner of the ATO has the discretion to remit all or part of the penalty (ATO 2013: para 130). This discretion is an unfettered discretion (ATO 2013: para 130).

6.4.3 General administrative penalties – 'tax schemes'

The Australian Taxation Administration Act 1953, Schedule 1, Chapter 4, Part 4-25, Subdivision 284-C, s. 284-150 includes administrative penalties if a taxpayer attempts to reduce his or her tax liability or attempts to obtain credits through the use of a 'schemes' as defined.⁴⁷ The amount of the 'scheme benefit' is determined to be the 'scheme benefit shortfall' (Taxation Administration Act 1953, Schedule 1, Chapter 4, Part 4-25, Subdivision 284-C, ss. 284-150(1)-(5)). The penalty percentages determined by the 'base penalty' amount table, are multiplied by the 'scheme benefit shortfall' (Taxation Administration Act 1953, Schedule 1, Chapter 4, Part 4-25, Subdivision 284-C, s. 284-155). The penalty percentages vary based on whether the scheme relates to a transfer pricing scheme (which is considered outside the ambit of this report as it relates to foreign source income and expenses), or not, and also whether the sole purpose of the scheme was to obtain a tax advantage, or not. The penalty is determined in accordance with the 'base penalty' table in Taxation Administration Act 1953, Schedule 1, Chapter 4, Part 4-25, Subdivision 284-C, s. 284-160, which base penalties are as follows:

- Where a scheme is entered into and the sole, or dominant, purpose is determined to be to obtain a tax benefit, and it is not transfer pricing related, then the 'base penalty' is 50% of the 'scheme shortfall amount' (Taxation Administration Act 1953, Schedule 1, Chapter 4, Part 4-25, Subdivision 284-C, s. 284-160(1)(a)) If it can be reasonably argued that the

⁴⁷ Tax scheme and scheme benefit are defined in section 995-1 of the Tax Assessment Act 1997, but for the purposes of this report it is sufficient that they generally refer to schemes entered into by the taxpayer involving the reduction of tax otherwise payable, which therefore results in a tax benefit to the taxpayer.), Division 284, Part 4-25, Chapter 4, Schedule 1 of the Taxation Administration Act 1953.

‘adjustment provision’⁴⁸ does not apply then a 25% ‘base penalty’ is applied (Taxation Administration Act 1953, Schedule 1, Chapter 4, Part 4-25, Subdivision 284-C, s. 284-160(1)(b)).

- Where a scheme is entered into and the sole, or dominant, purpose is not determined to be to obtain a tax benefit, and it is not transfer pricing related, then a ‘base penalty’ of 25% is incurred (Taxation Administration Act 1953, Schedule 1, Chapter 4, Part 4-25, Subdivision 284-C, s. 284-160(2)(a)). If it can be reasonably argued that the adjustment provision utilised does not apply then a 10% ‘base penalty’ is applied (Taxation Administration Act 1953, Schedule 1, Chapter 4, Part 4-25, Subdivision 284-C, s. 284-160(2)(b)).

The ATO indicates in its explanatory memoranda that the ‘base penalty’ amounts indicated above are increased by 20% if a taxpayer is found to be guilty of any one of the following:

- Attempting to prevent or obstructing the ATO from finding out about the ‘shortfall’ (n.d.(b)).
- Becoming aware of the ‘shortfall’ but not informing the ATO within a reasonable time (n.d.(b)).
- Being previously liable for a false or misleading statement penalty or for taking an income tax position that is not reasonably arguable (n.d.(b)).

The penalties may be reduced or cancelled if the law was applied by the taxpayer in way that is acceptable to the ATO (ATO, 2014). This includes following advice, or a statement given in writing by the Commissioner of the ATO, or general administrative practice under that law (ATO, 2014).

The above tax scheme penalties will be reduced by 80% if a taxpayer discloses a ‘shortfall’ to the ATO prior to the ATO conducting an examination into a taxpayer’s affairs, or prior to a request for voluntary disclosure in respect of a transaction by the ATO (ATO, n.d.(b)). No penalty will be payable if the penalty is disclosed, as indicated above, and the ‘shortfall’ is less than AUS \$1 000 (ATO, n.d.(b)). If a voluntary disclosure is made after the taxpayer is informed that an examination is to be conducted, the penalty will be reduced by 20% if the disclosure will save the ATO time and resources (ATO n.d.(b)).

6.4.4 Other administrative penalties

The Australian tax regime has an additional penalty system for ‘Withholding tax on pay-as-you-go’ on which it levies a 100% penalty on any the amount withheld and not paid over to the ATO (ATO n.d. (b)).

6.4.5 Comparison of the penalty regimes of Australia and South Africa

The Australian understatement penalty system has elements which are similar to the South African system for such as both have escalating penalty percentages based on the nature of the transgression which, once determined, are applied to the amount of the understated tax payable (ATO2014: para 99). The Australian penalty regime has a number of specific administration penalties

⁴⁸ The ‘adjustment provision’ relates to specific provisions of a taxation law or action which adjust items otherwise considered to be a ‘scheme benefit’ from a ‘scheme’. (Taxation Administration Act 1953, Schedule 1, Chapter 4, Part 4-25, Subdivision 284-C, s. 284-145(1)).

for specific circumstances which South Africa does not: such as the penalty on 'Withholding tax on pay-as-you-go' at 100% (ATO n.d. (b)) and 'General administrative penalties – tax schemes' (refer Sub-Chapter 6.4.3, above). The Australian penalty system has penalties levied where misleading or false statement are made even when there is no direct loss to the fiscus such as 'General administrative penalties – no 'shortfall' penalties (refer Sub-Chapter 6.4.2, above). South Africa has no such specific understatement penalties however South Africa does have separate criminal and administrative chapters which may cover this form of non-compliance (SARS 2013b: 73 & 84). The Australian model has a specific section for tax avoidance schemes whereas the South African regime does not in terms of the Taxation Administration Act 1953, Schedule 1, Chapter 4, Part 4-25, Subdivision 284-C, s. 284-150. Both the Australian and South African penalty (at s. 222(1) of the Tax Administration Act) regimes have an exemption from understatement penalties in the event of non-deliberate errors, subject to certain provisions (ATO 2013: para 64).

The most significant difference in the understatement penalties is that the South African Tax Administration Act has a maximum penalty of 200% (Section 223(1) of the Tax Administration Act), whilst the Australian equivalent is a maximum of 75%. This maximum penalty percentage differential is significant and, generally, the South African system's behaviour types have higher penalty percentages than those in Australia. The Australian penalty system does have a 100% penalty in respect of withholding taxes not paid over to the ATO (ATO n.d.(d)). This penalty is not considered directly comparable to the South African understatement penalties as these type of events are covered in the South African Tax Administration Act at s. 234(p) under the 'criminal offences' provisions where if the taxpayer is guilty of an offence he may, upon conviction, be subject to a fine or to imprisonment not exceeding two years.

6.5 Canada

The Canada Revenue Agency (CRA) is responsible for the administration of tax programs, as well as the delivery of economic and social benefits. It also administers certain provincial and territorial tax programs (CRA n.d.(c)). The CRA is responsible for both federal and provincial/territorial taxes (CRA n.d.(c)). The CRA are tasked, inter alia, with the administration of the Canadian Income Tax Act R.S.C 1985 (Canadian Income Tax Act) (CRA n.d.(c)). The understatement penalty regime is found in s. 163 of the Canadian Income Tax Act. The CRA levies penalties on two different basis: firstly a flat rate on the repeated failure to report income (based on the gross income) in terms of s. 163(1) of the Canadian Income Tax Act (CRA 2014: 15), and secondly an understatement penalty on 'false statements and omissions' which is applied to the understated tax liability in terms of s. 163(2) of the Canadian Income Tax Act (CRA 2014: 15). The understated tax liability is determined in terms of s. 163(2)(a) of the Canadian Income Tax Act, as the amount of tax that would be payable by a taxpayer in terms of the Act as exceeds the taxable income so declared due by adding undeclared or deducting overstated expenditures income 'reasonably attributable' to such an 'false statement' or 'omission'. The CRA has the discretion to remit penalties in whole or part (CRA 2014: 15). A Voluntary Disclosure Program is in place under which no penalties would be levied on the taxpayer, subject to full disclosure (CRA 2014: 15).

6.5.1 Failure to report an 'income amount' penalty

Any 'income amount' which a taxpayer fails to report, which is otherwise required to be included in computing the taxpayer's income in any tax year, and an 'income amount' was also not reported in

any of the preceding three years, incurs a 'failure to report income' penalty (CRA 2014: 15). The penalty equates to 10% of the amount of income not reported in the current tax year, for federal tax purposes, and an additional 10% for provincial/territorial taxes, thus a 20% penalty in total according to s. 163(1) of the Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.) (CRA n.d. (a)). The 'income amount' not reported must relate to any of the three prior tax periods plus the current year's return as the nature of the penalty is one applying to a repeat offender (CRA 2014: 15). The important point in the application of the 'failure to report income' penalty is that the reason behind the omission plays no part in the determination of the quantum of the penalty amount: if the penalty is determined to apply it is levied at 10% on the income not reported in the current years return (CRA n.d. (a)).

To avoid duplication of penalties the 'failure to report income' penalty will not be levied if the taxpayer is penalised under s. 163(2) of the Canadian Tax Act (which is the penalty section for 'false statements or omissions') (CRA 2014: 15). The undeclared income resulting from a 'failure to report income' will therefore initially be reviewed in the light of the 'false statement and omissions' penalty regime so as to determine if that section is applicable, failing which a 'failure to report income' may then be applied, if applicable. This was evidenced in the case *Bernice Thill v Her Majesty the Queen* 2011 TCC 280 at para 1. Ms Thill had 'unreported income' for two tax years but the CRA imposed the penalties under s 163(2) of the Canadian Tax Act (false statement and omissions penalty). The court determined that the nature of the omission of the amounts from the taxpayers returns was a false statement due to the taxpayer either intentionally failing to report the amounts or being completely indifferent to their lack of inclusion, knowingly or through gross negligence (*Bernice Thill v Her Majesty the Queen* 2011 TCC 280 at para 33). The nature of this penalty, it would appear, is therefore directed at the understatement, through the accidental omission of income or other such taxable receipts (McFeat 2012). Once computed, this penalty, due to its being based on a flat rate on gross revenue, could conceivably result in a more onerous punishment than one calculated on an understated tax liability (McFeat 2012). A taxpayer could well have little or no taxable income but still have income which, if not reported, could cause a penalty to be incurred (McFeat 2012). The application of this penalty may therefore result in a significant, or alternatively insignificant, punishment depending on the financial status of the taxpayer and the size and nature of the gross, and taxable, incomes of the taxpayer.

A 'failure to report income' penalty may be waived, under common law, if a taxpayer took reasonable steps to comply with the tax rules, which would apply if the taxpayer can show he or she acted diligently (BDO 2012), or if any of the following factors occurred: a CRA error, a CRA delay, financial hardship, disasters both natural and man-made, serious illness, death, civil disturbance or other extraordinary circumstances (McFeat 2012). In a case, *Symonds and Her Majesty the Queen*, 2011 TCC 274, referred to in an article by BDO Accountants, a taxpayer successfully appealed an unreported revenue penalty by convincing the courts that the first incidence of omission of interest was a genuine mistake, and therefore did not form part of a 'failure to report income', this then resulted in the reason for the second incidence being irrelevant, as no two failures had occurred within the time frame required (BDO 2012).

A similar provincial/territorial tax penalty is also applied that would then double the penalty amount (CRA n.d. (a)). This is dependent on the taxpayer's residence and the prevailing legislation, relating to the province or territory (CRA n.d. (a)).

CBC news stated in an article, based on figures obtained from the CRA, that in 2011, 81 389 taxpayers were assessed for unreported income, resulting in federal penalties of Canadian \$39 300 000 (McFeat 2012).

6.5.2 False statement and omissions penalty

The understatement penalty, in s 163(2) of the Canadian Tax Act, is triggered if a taxpayer knowingly, or under circumstances amounting to gross negligence, makes a false statement or omission to the CRA (CRA 2014: 15).

The penalty for false statements or omissions is the greater of Canadian \$100 or 50% and is based on the understated amount of tax or overstated credits relating to the 'false statement' or 'omission' (CRA 2014:15). In accordance with s. 163(3) of the Act, the CRA has the responsibility of proving that a 'false statement' or 'omission' has occurred, and also that the taxpayer was either knowledgeable, or was grossly negligent, in respect of the submission or omission thereof.

The understatement penalty regime for Canadian taxpayers has a wide application in that 'every person', in terms of s. 163(2) of the Canadian Income Tax Act, who knowingly participated in, assented to, or acquiesced in the making of a false statement or omissions in a return that is filed with the CRA is liable to a penalty (Section 163(2) of the Income Tax Act R.S.C. 1985 c.1 (5th Supp.)). It is therefore conceivable that more than one person could be levied with this type of penalty for the same false statement or omission. Tax advisors have a specific penalty regime in place for any understatement penalties they may be party too which is considered outside of the ambit of this report.

The CRA may, in terms of s. 220(3.1) of the Act, nullify or reduce penalties for 'unreported income', 'false statements', or 'omissions', in the event that the taxpayer was prevented from fulfilling his or her tax obligations (CRA 2014: 9) due to:

- extraordinary circumstances,
- actions of the CRA,
- inability to pay or financial hardship, or
- other circumstances (CRA 2014: 9).

Additionally, in terms of a voluntary disclosure program, any correction of inaccurate information or omission prior to any enforcement action will not incur any penalty (CRA 2014: 15).

6.5.3 Other penalties

The Canadian Income Tax Act contains a number of penalty provisions for late, or non-filing, of returns based on the various categories of taxpayers (which have different penalty applications) (CRA 2014: 15). Misrepresentations made by third parties, with specific reference to tax schemes (designed to unfairly reduce taxpayers' tax obligations) are detailed in the Act, and also incur penalties (CRA 2014:15).

The Canadian penalty regime also has a separate penalty for 'late lodgement' (CRA n.d. (a)). This type of penalty is regarded as an 'absolute penalty' by the Canadian courts as there is no defence in its application – if the act, or omission, objectively occurred then the penalty applies (Rotfleisch &

Samulovitch 2010). The 'late lodgement' penalty levied is 5% of the unpaid tax plus 1% of the unpaid tax for each completed month it remains outstanding up to a maximum of 12 months (CRA 2014:9). A corporation will incur a more substantive penalty for 'late lodgement', 10% of the unpaid tax plus 2% per month, up to 20 months (CRA 2014:9). If the CRA has requested the return and the taxpayer has incurred a late filing penalty in the preceding three years, a 10% penalty will apply plus 2% per month up to 20 months (CRA 2014:14). Large corporate taxpayers⁴⁹ are penalised at 0.0005% of the taxpayer's taxable capital employed plus 0.25% of tax payable by the corporation per complete month, up to a maximum of 40 months for 'late lodgement' (CRA 2014:9).

6.5.4 Comparison of the penalty regimes of Canada and South Africa

The Canadian and South African penalty regimes generally have few similarities. The South African penalty system identifies understatements (Section 222 of the Tax Administration Act) on which understatement penalties are levied, as does the Canadian system (CRA 2014: 15). Both penalty regimes allow for inadvertent errors, the South African system at s. 222(1) of the tax Administration Act and the Canadian regime has a likely wider application in this regard (CRA 2014: 9) in that the South African context is only for errors that are 'inadvertent' (2013a:41), while the Canadian system allows more leeway, taking a greater degree of fault on the part of the taxpayer into account, even to the extent of negligence, but not gross negligence (Cyndee Todgham Cherniak, 2011). Both tax systems have a Voluntary Disclosure Program in place which reduces, or negates, penalties otherwise payable. The Canadian system has a specific penalty for repeated offences of 'undisclosed revenue' at a flat rate of 10% (effective rate may be 20% in most instances due to provincial/territorial tax penalty) (CRA 2014: 15). This system is not based on any specific loss to the Canadian fiscus and therefore differs, in principle, from the South African regime where the fiscus is required to be prejudiced (Section 221, definition of 'understatement' in the Tax Administration Act). The penalty system for 'false statements and omissions' carries a single, flat rate, for non-compliance of 50% and requires, as a minimum, the equivalent of 'gross negligence' in order to be applied (CRA 2014: 15). This 50% maximum compares to South Africa's maximum 200% penalty percentage for 'intentional tax evasion', while the equivalent for gross negligence in South Africa, for 'standard cases', is 100% (SARS 2013b:80). It is evident that the South African understatement penalty regime carries a significantly higher penalty percentage than its Canadian counterpart.

6.6 Summary

The understatement penalty regimes of the United States, the United Kingdom, Australia and Canada can, based on the potential maximum and minimum outcomes, be comparatively stated for the purposes of this report as follows:

⁴⁹ A large corporate taxpayer is defined as a corporation with total taxable capital employed of > Canadian \$10 000 000.

Table 6: Comparative ranges of understatement penalty percentages, by country and general behaviour type.

Country	Evasion	Negligence	Reasonable care not taken	Note	Reference
UK	30 % - 100 %	20 % - 70 %	0 % - 30 %	1	Table 3 at Sub-Chapter 6.2.1
USA	75 %	30 % - 40 %	0 % - 20 %	1	U.S. Code §6662 (refer Sub-Chapter 6.3.1
Australia	75 %	50 % - 70 %	0 % - 45 %	1	Table 4 at Sub-Chapter 6.4.1
Canada	50 %	0 % - 50 %	0 % - 43.5 %	1, 2	Refer Sub-Chapter 6.5.1 & Sub-Chapter 6.5.2
SA	75 % - 200 %	50 % - 150 %	0 % - 50 %	1	Table 1 at Sub-Chapter 4.2.

Notes to the Table:

Note 1: No substantial understatement comparison is included as not all jurisdictions have such a 'behaviour' classification.

Note 2: The 'unreported income' penalty in Canada is determined similarly to that of what is regarded in the South African understatement penalty regime as 'Reasonable care not taken in completing return' (Refer Sub-Chapter 3.2.7, above). Canada's 'unreported income' penalty is based on gross undeclared revenues, therefore to be comparable to a penalty rate based on tax payable, an appropriate adjusted rate is required to be determined. The total individual effective tax rate is determined to be 46%⁵⁰ and applied to the 20% of 'unreported income' results in an effective rate of 43.5% which is regarded as appropriate for this computation. Corporate tax rates vary based on business type and size but are lower than the individual rates (KPMG 2014) and therefore falls within the range specified in the table.

General note: Certain penalties of the non-South African jurisdictions have been excluded as they are either not directly comparable to the South African understatement penalty types or are not related to income tax based understatement penalties.

The above table 4 clearly shows that South Africa has higher absolute percentages on all 'behaviour' types and in many instances higher minimums. In a *TaxTalk* article the author suggests that the reason for the high understatement penalty percentages may be, in part, due to South Africa being a developing country, in which tax evasion is rife, and it is therefore appropriate that it should levy penalties such as 200% (Lombard 2008). The reference to tax evasion being 'rife' by Lombard, is debatable (Lombard offers no support for his statement) but the fact that South Africa is a developing country (Lombard 2008) does find some support from independent sources, when comparing the South African penalty regime to that of developed countries in that 'No single strategy is appropriate for all countries and under all circumstances' (Bird & de Jantscher 1992). 1992).

⁵⁰ As per the CRA the maximum federal individual tax rate for 2014 is 29% and the average maximum provincial/territorial rate (which differs by territory) is 17%, Therefore total tax rate is determined to approximate 46% for individuals (CRA n.d.(b)).

Chapter 7

Conclusion

7.1 Introduction

The understatement penalty system in the Tax Administration Act has been reviewed with specific reference to its application in respect of the Income Tax Act. The understatement penalty regimes of the United Kingdom, the United States, Canada and Australia have been reviewed and compared to that of South Africa. The objectives and goals of the South African government and as represented by SARS, relating to understatement penalties, have been identified and read in conjunction with those laws enacted, directly and indirectly, in respect of taxation. International best practice has been determined, subject to its inherent limitations, and the South African understatement penalty regime benchmarked against that. At the outset of this report the question was asked as to how effective the Tax Administration Act will be in remedying the problems experienced under the previous legislation whilst meeting the fiscus's objectives. The question of whether South African understatement penalty provisions aligned with those of specifically identified, comparable tax jurisdictions, and how it compared with international best practice, was asked.

7.2 Summary

The need for punitive measures to encourage compliance in tax matters, and discourage non-compliance, is a tried and tested necessity for all tax administrations. In his treatise *Principles of Political Economy*, Mill states that if:

‘any one bears less than his fair share of the burthen (sic), some other person must suffer more than his share. And the alleviation to the one is not, *caeteris paribus*, so great a good to him, as the increased pressure upon the other is an evil’ (Mill 1885).

History, as it is oft said, repeats itself, so while the requirement of a taxing authority to obtain the revenues required for the governance and management of a jurisdiction must be balanced with the needs, real and perceived, of taxpayers, revolts in various shapes and forms, and to greater or lesser extents, still persist in modern economies as evidenced by the ‘poll tax’ riots in the UK in 1990 where:

‘... at one point the situation turned violent: a major march in London in 1990 turned into a riot, with 340 arrested and 45 policemen injured, the worst riots in London for over a century....’ (Wilde n.d.)

The predecessor to the Tax Administration Act in respect of understatement penalties was fraught with subjective interpretations and decisions which SARS apparently handled administratively in a very poor manner (see Sub-Chapter 2.7, above) and as stated by the courts see in *CIR v Da Costa* 1985 (3) SA 768(A), 47 SATC 87 at 96 where the application of the additional tax was considered:

‘... that the penalty fixed by the committee in Pretoria ... was excessively severe, was – having regard to the relationship it bore to the maximum penalty imposable – arbitrary and unreasonable’.

The need for greater certainty and uniform application of understatement penalties was evident (SARS 2013b:4). The Tax Administration Act has seemingly achieved its objective of ensuring certainty and equality in the application of the quantum of the understatement penalty to each taxpayer once the 'behaviour' and 'case' types have been determined (SARS 2013b: 73). This eliminates the need for judgment as to the quantum of the penalty percentage to be applied (SARS 2013b: 73). SARS's stated objective is that a discretionary judgment in imposing sanctions must only be required where non-compliance is based on negligence or intent (SARS 2013b: 73) and that non-compliance penalties are impartial and proportional to the seriousness and duration of the incidence of non-compliance (SARS 2013b: 73). The use of a pre-determined understatement penalty percentage table (refer Sub-Chapter 4.2, above) allows greater clarity and certainty as to the amount of the penalty percentage to be levied. The SARS *Memorandum on the objects of the Tax Administration Laws Amendment Bill 2013* (2013a:80-81), gives brief descriptions of the penalty 'behaviour' types, but the descriptions are severely limited and are unlikely to give much certainty as to how they may be interpreted by SARS especially those of a subjective nature such as determining 'intentional disregard' (Cliffe Dekker Hofmeyr 2013). It is suggested that this uncertainty coupled with the subjective determinations required to establish the 'behaviour' types are likely, as not, to cause differences of opinion between taxpayers and SARS. The Tax Administration Act has defined 'substantial understatement' and 'repeat case' (s. 221, definitions of the Tax Administration Act) in the Act but none of the other 'behaviour' or 'case' descriptions are so defined.

The review of different countries' understatement penalties revealed that though all apply some form of understatement penalty system, the systems vary based on each country's risk assessment of the taxpayer, the revenue type, and the targeted areas of non-compliance identified by the tax jurisdiction (OECD 2001:1). All the tax jurisdictions reviewed attempt to balance the need to encourage compliance, which includes applying leniency in respect of taxpayers who make '*bona fide*' errors, against the punishment required to discourage tax evasion through deliberate acts, as evidenced in South Africa (s. 222(1) of the Tax Administration Act), in the UK where the HMRC manual advises no penalty will be levied by HMRC on mistakes made by a taxpayer if the taxpayer has a reasonable excuse and they put right the failure without unreasonable delay (HMRC n.d.(m)), in the USA no penalty will be imposed on any portion of an underpayment from a non-reportable transaction if reasonable cause is shown and the taxpayer acted in good faith, with the exception of any underpayment resulting from a disallowance of claimed tax benefits by reason of a transaction lacking economic substance (IRS n.d.(a)), the Australian penalty regime manual states that no penalty is payable if the taxpayer took 'reasonable care' in connection with making the statement, or the 'safe harbour' rule applies, or the taxpayer applied the law in an accepted way (ATO 2014: para 39), and in the Canadian understatement penalty provisions advise that the CRA may, in terms of s. 220(3.1) of the Canadian Tax Act, nullify or reduce penalties for 'unreported income', 'false statements', or 'omissions', in the event that the taxpayer was prevented from fulfilling his or her tax obligations (CRA 2014: 9) based on certain conditions.

This required balance requires that all the revenue authorities have some form of remission or non-charging system, based either on elective criteria or default provisions, which expose them to the vagaries of subjective determinations. The alignment of the revised South African understatement penalty percentages with those of comparative tax regimes has, based on this reports evidence, not being achieved and while there is some evidence to support generally higher penalty percentages needed in South Africa, as a third world economy (Bird & de Jantscher 1992) the general quantum of

the penalty is considerably higher (refer Table 6 in Sub-Chapter 6.6, above). This would appear to be in contrast to Smith's maxim that any taxes (and in the context of this report it is submitted applies equally to understatement penalties), must be:

'as nearly as possible in proportion to their respective abilities... neglect of this maxim consists what is called the equality or inequality of taxation' (1776).

In the interpretation of this statement it is evident that it is the individual taxpayer's ability to bear the burden of taxation (or penalties) that is of import and not the desire of the state for revenue, which is in any event insatiable (Vivian 2006: 84).

In drafting the Tax Administration Act, the legislators have clearly researched available comparative regimes tax administration systems and applied the principles put forward in respect of generally accepted international tax best practices as indicated by various writers and the OECD (See Sub-Chapter 5.4, above). The Tax Administration Act would also appear to have been constituted in order to comply with, the Constitutional requirements and tenets of the South African Constitution (See Sub-Chapter 5.3, above).

In summary, the Tax Administration Act is likely, based on the preponderance of evidence in this report, to assist SARS in implementing a more standardised approach to understatement penalty determinations, and it will broadly assist in uniformity of treatment for like cases with similar circumstances, especially when compared to the previous South African penalty regime. The Tax Administration Act appears aligned with the pertinent requirements of the Constitution of South Africa and is generally in line with the stated goals and objectives of the government and SARS, for example the inclusion of the provisions contained in the Tax Administration Act at Chapter 5, Part A, ss. 40-44, which lay down the rules and procedures for the carrying out of inspections by SARS. The correct and appropriate application, by SARS, of the Tax Administration Act remains to be seen due to the relatively short time the act has been in existence. The understatement penalty system is generally aligned in nature with comparable international regimes and general international best practice in that it identifies an 'understatement' and applies pre-determined penalty percentages to the 'understatements' (s. 222 of the Tax Administration Act). The determination of the 'behaviour' types still involves some element of subjective determination as does any remission for substantial understatements, but the differentiation and structuring of the 'behaviour' and 'case' types will assist broadly in treating like-for-like cases more uniformly (2013a: 40). It is suggested that the relatively high penalty percentages (refer Table 6 in Sub-Chapter 6.6, above), coupled with the subjective⁵¹ and elective⁵² provisions of the Tax Administration Act, will, undoubtedly, result in legal challenges in the near future.

⁵¹ Such as determining what is a '*bona fide* inadvertent error' (Williams 2014:10) and which 'behaviour' type may be applicable (SARS 2013b:73).

⁵² For example under s. 226(2) of the Tax Administration Act, where a senior SARS official may decide that a taxpayer can still apply for the Voluntary Disclosure Programme, if, firstly, the default would not have been detected by SARS otherwise, and secondly, if it is in the interest of the management, and use, of SARS's resources

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Appendices

Appendix A

Section 76 of the income Tax Act, 1962 states:

‘A taxpayer shall be required to pay in addition to the tax chargeable in respect of his taxable income

(1)(a) if he makes default in rendering a return in respect of any year of assessment, an amount equal to twice the tax chargeable in respect of his taxable income for that year of assessment; or

(b) if he omits from his return any amount which ought to have been included therein, an amount equal to twice the difference between the tax as calculated in respect of the taxable income returned by him and the tax properly chargeable in respect of his taxable income as determined after including the amount omitted;

(c) if he makes an incorrect statement in any return rendered by him which results or would if accepted result in the assessment of the normal tax at an amount which is less than the tax properly chargeable, an amount equal to twice the difference between the tax as assessed in accordance with the return made by him and the tax which would have been properly chargeable.

(2)(a) The Commissioner may remit the additional charge imposed under sub-section(1) or any part thereof as he may think fit: Provided that, unless he is of the opinion that there were extenuating circumstances, he shall not so remit if he is satisfied that any act or omission of the taxpayer referred to in paragraph(a), (b) or(c) of sub-section(1) was done with intent to evade taxation.

(b) In the event of the Commissioner deciding not to remit the whole of the additional charge imposed under sub-section (1), his decision shall be subject to objection and appeal.’

Appendix B

Section 221 of the Tax Administration Act 2012 states:

‘221. Definitions.—In this Chapter, unless the context indicates otherwise, the following terms, if in single quotation marks, have the following meanings—

‘repeat case’ means a second or further case of any of the behaviours listed under items (i) to (v) of the understatement penalty percentage table reflected in section 223 within five years of the previous case;

‘substantial understatement’ means a case where the prejudice to SARS or the fiscus exceeds the greater of five per cent of the amount of ‘tax’ properly chargeable or refundable under a tax Act for the relevant tax period, or R1 000 000;

‘tax’ means tax as defined in section 1, excluding a penalty and interest;

‘tax position’ means an assumption underlying one or more aspects of a tax return, including whether or not—

(a) an amount, transaction, event or item is taxable;

(b) an amount or item is deductible or may be set-off;

(c) a lower rate of tax than the maximum applicable to that class of taxpayer, transaction, event or item applies; or

(d) an amount qualifies as a reduction of tax payable; and

‘understatement’ means any prejudice to SARS or the fiscus as a result of—

(a) a default in rendering a return;

(b) an omission from a return;

(c) an incorrect statement in a return; or

(d) if no return is required, the failure to pay the correct amount of ‘tax’.

[Definition of ‘understatement’ amended by s. 74 of Act No. 39 of 2013 deemed to have come into operation on 1 October, 2012.]

Appendix C

Section 222 of the Tax Administration Act 2012 states:

‘222. Understatement penalty.—(1) In the event of an ‘understatement’ by a taxpayer, the taxpayer must pay, in addition to the ‘tax’ payable for the relevant tax period, the understatement penalty determined under subsection (2) unless the ‘understatement’ results from a *bona fide* inadvertent error. [Sub-s. (1) substituted by s. 75 (a) of Act No. 39 of 2013 deemed to have come into operation on 1 October, 2012.]

(2) The understatement penalty is the amount resulting from applying the highest applicable understatement penalty percentage in accordance with the table in section 223 to each shortfall determined under subsections (3) and (4) in relation to each understatement in a return. [Sub-s. (2) substituted by s. 75 (a) of Act No. 39 of 2013 deemed to have come into operation on 1 October, 2012.]

(3) The shortfall is the sum of—

(a) the difference between the amount of ‘tax’ properly chargeable for the tax period and the amount of ‘tax’ that would have been chargeable for the tax period if the ‘understatement’ were accepted; [Para. (a) substituted by s. 75 (b) of Act No. 39 of 2013 deemed to have come into operation on 1 October, 2012.]

(b) the difference between the amount properly refundable for the tax period and the amount that would have been refundable if the ‘understatement’ were accepted; and

(c) the difference between the amount of an assessed loss or any other benefit to the taxpayer properly carried forward from the tax period to a succeeding tax period and the amount that would have been carried forward if the ‘understatement’ were accepted, multiplied by the tax rate determined under subsection (5).

(4) If there is a difference under both paragraphs (a) and (b) of subsection (3), the shortfall must be reduced by the amount of any duplication between the paragraphs. [Sub-s. (4) substituted by s. 75 (c) of Act No. 39 of 2013 deemed to have come into operation on 1 October, 2012.]

(5) The tax rate applicable to the shortfall determined under subsections (3) and (4) is the maximum tax rate applicable to the taxpayer, ignoring an assessed loss or any other benefit brought forward from a preceding tax period to the tax period. [Sub-s. (5) substituted by s. 75 (c) of Act No. 39 of 2013 deemed to have come into operation on 1 October, 2012.]

Appendix D

Section 223 of the Tax Administration Act 2012 states:

‘223. Understatement penalty percentage table.—(1) The understatement penalty percentage table is as follows:

1	2	3	4	5	6
<i>Item</i>	<i>Behaviour</i>	<i>Standard case</i>	<i>If obstructive, or if it is a ‘repeat case’</i>	<i>Voluntary disclosure after notification of audit or investigation</i>	<i>Voluntary disclosure before notification of audit or investigation</i>
(i)	‘Substantial understatement’	10%	20%	5%	0%
(ii)	Reasonable care not taken in completing return	25%	50%	15%	0%
(iii)	No reasonable grounds for ‘tax position’ taken	50%	75%	25%	0%
(iv)	Gross negligence	100%	125%	50%	5%
(v)	Intentional tax evasion	150%	200%	75%	10%

[Sub-s. (1) substituted by s. 76 (1) (a) of Act No. 39 of 2013 with effect from the date of promulgation of that Act.]

(2) An understatement penalty for which provision is made under this Chapter is also chargeable in cases where—

(a) an assessment based on an estimation under section 95 is made; or

(b) an assessment agreed upon with the taxpayer under section 95 (3) is issued.

(3) SARS must remit a 'penalty' imposed for a 'substantial understatement' if SARS is satisfied that the taxpayer—

(a) made full disclosure of the arrangement, as defined in section 34, that gave rise to the prejudice to SARS or the fiscus by no later than the date that the relevant return was due; and

(b) was in possession of an opinion by an independent registered tax practitioner that—

(i) was issued by no later than the date that the relevant return was due;

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

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

[Para. (b) substituted by s. 73 of Act No. 21 of 2012 and amended by s. 76 (1) (b) of Act No. 39 of 2013 with effect from the date of promulgation of that Act.]'

Appendix E

Section 224 of the Tax Administration Act 2012 states:

'224. Objection and appeal against imposition of understatement penalty.—The imposition of an understatement penalty under section 222 or a decision by SARS not to remit an understatement penalty under section 223 (3), is subject to objection and appeal under Chapter 9.

[S. 224 substituted by s. 74 of Act No. 21 of 2012 and by s. 77 of Act No. 39 of 2013 deemed to have come into operation on 1 October, 2012.]'