A comparative study of the understatement penalties levied.

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Declaration

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce in 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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Abstract

The Tax Administration Act 28 of 2011 is the most recent complete tax act to guide tax administration in South Africa and came into operation on 1 October 2012. The changes in the penalty regime in South Africa was that the understatement penalties, in sections 222 and 223 of the Tax Administration Act, replaced the additional tax that was previously levied in terms of section 76 of the Income Tax Act 58 of 1962. Understatement penalties are levied when a taxpayer understates his tax payable for a particular tax period. The understatement penalties are jointly determined by the behaviour of the taxpayer and other objective criteria that are listed in a table contained in section 223(1) of the Tax Administration Act.

The report will focus on comparing the understatement penalties levied in South Africa and comparing it with understatement penalties levied in the United States of America (USA), Australia (AUS) and the United Kingdom (UK). The comparison will be used to determine how the understatement penalties are imposed in different cases and to determine if there are improvements that can be made to the current understatement penalties levied in South Africa.

Keywords

understatement penalty; understatement; behaviour; conduct; penalty; Tax Administration Act, United States of America (USA); United Kingdom (UK); Australia (AUS); South Africa (SA)

Table of Contents

Chapter 1 - Introduction

1. Introduction

In the previous additional tax regime, being section 76 of the Income Tax Act 58 of 1962 (IT Act), SARS had an open-ended discretion to impose additional tax of up to 200% of the amount of the tax defaulted on. Understatement penalties as per Chapter 16 of the Tax Administration Act 28 of 2011 (TA Act) came into effect on 1 October 2012 and this has replaced section 76 of the IT Act. Chapter 16 of the Tax Administration Act introduced a penalty regime that aims to penalize taxpayers in similar tax circumstances with similar and consistent penalties.

The fiscus is prejudiced when the actions of a taxpayer causes a shortfall in the tax payable to the South African Revenue Service (SARS) in a particular tax period. SARS can levy an understatement penalty in terms of section 222(1) read with section 223 (1) of the Tax Administration Act if the fiscus is prejudiced.

In terms of section 222(3) of the Tax Administration Act, the following is stated:

> 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 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).

If an understatement of tax has occurred, an understatement penalty is imposed by using different percentages that are based on the behaviour and conduct of the taxpayer. In order to determine the penalty that should be imposed the understatement penalty percentage table contained in section 223(1) of the Tax Administration Act is used.

The table in section 223(1) of the TA Act (see below) contains, among other things, the type of behaviours that are applicable to a taxpayer in terms of the understatement penalties and the relevant conducts that are applicable.

Table: Understatement penalty percentage table:

Source: South Africa Tax Administration Act, section 223(1)

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%	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%

Section 222(2) of the Tax Administration Act states the following:

> 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.

This means that SARS will start at the highest penalty namely intentional tax evasion and will then move upwards in the table considering the facts of the case.

When the applicable 'behaviour' is identified from the table in section 223(1) of the Tax Administration Act, then the conduct of the taxpayer must be determined:

- Did the taxpayer make a voluntary disclosure before the notification of an audit or investigation?
- Did the taxpayer make a voluntary disclosure after the notification of an audit or investigation?
- Was the taxpayer obstructive when engaging with SARS officials?
- Is this a repeat case?

In terms of the *SARS's Short guide to the Tax Administration Act* (SARS guide), if none of the above conducts are applicable, the conduct of the taxpayer is assumed to be a 'standard case' in terms of the table.

The *SARS's Short guide to the Tax Administration Act* on page 78 also indicates that if numerous behaviours, as identified in the table, are applicable to a taxpayer, the understatement penalty percentage is based on the highest percentage per the table. For example, if in the column behaviour, substantial understatement and gross negligence are applicable to the taxpayer, the understatement penalty percentage of gross negligence will be imposed, being the higher of the two.

2. Research Problem

2.1 Statement of problem

Understatement penalties are imposed in terms of sections 222(1) and 223(1) of the Tax Administration Act. The understatement penalty regime came into operation on 1 October 2012. Being relative new legislation, problems have been identified by professionals, namely:

The research problem is to determine possible improvements to the current penalty regime as the current provisions in the TA Act lack definitions and guidance when each penalty is levied. In order to recommend improvements to the current penalties that are imposed, a comparative study will be done by comparing understatement penalties levied in South Africa with similar penalties that are levied in the United Kingdom, Australia and the United States of America.

In terms of section 233 of the South African Constitution, the judiciary must take international law into account when interpreting any legislation. The United Kingdom and United States of America were chosen as they are leading tax jurisdictions according to Broomberg (2007) in 'Tax avoidance Then and now'. Australia was used as it has a similar penalty regime to South Africa.

Section 233 of the South African Constitution reads as follows -

> Application of international law - When interpreting any legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.

2.2 Sub-problems

2.2.1 Interpretation of behaviours and conducts used to impose understatement penalties in South Africa

The terminology that is used in sections 222(1) and 223(1) of the Tax Administration Act to determine the understatement penalty imposed are not defined in the Tax Administration Act except for ‘repeat case’, ‘substantial understatement’, ‘tax’, ‘tax position’ and ‘understatement’ are defined in section 221 of the Tax Administration Act. The problem relating to terminology was highlighted by Somaya Khaki, a chartered accountant, in the article ‘The problem with SARS’ new behavioural penalties’ published on 20 December 2012 on the South African Institute of Tax Professional’s website and is stated as follows:

> If the substantial understatement came to SARS’ attention because of a voluntary disclosure by the taxpayer, then the penalties are significantly reduced. Taxpayers would be able to identify quite clearly whether something is substantially understated or not—and so would SARS — but the other behaviours have not been defined. There is some guidance in SARS’ Short Guide to the Tax Administration Act, but those types of behaviour or penalties raised in respect of those behaviours are still very subjective.

There is currently no South African case law to rely on to interpret the terminology relating to the understatement penalties that are imposed by the South African Revenue Service.

The onus to prove the understatement penalty is on SARS in terms of section 102(2) of the Tax Administration Act. As there is a lack of definitions in the Tax Administration Act, it is difficult for the taxpayer to contest the behaviour and conduct that was chosen by the South African Revenue Service.

The problems with the new understatement penalty regime are mainly because of the Tax Administration Act’s lack of definitions of important terminology and the limited guidance by the South African Revenue Service in this regard. The SARS Short Guide of the Tax Administration Act deals with understatement penalties but does not give extensive guidance of what each behaviour means. Furthermore, the SARS Short Guide of the Tax Administration Act is SARS’s opinion only and is not law.

Chapter 2 will look at the understatement penalties currently levied in South Africa by using *SARS’s Short guide to the Tax Administration Act,* articles published by tax commentators and local case law. Situations in which penalties are reduced or remitted will also be discussed. The research will aid in interpreting the behaviours and conducts currently used in South Africa in order to compare it to understatement penalties levied in the United Kingdom, Australia and the United States of America and recommend improvements to the current understatement penalties levied.

2.2.2 A comparison between the current penalties that are being imposed in South Africa with similar penalties imposed by other countries.

Understatement penalties levied and situations in which the penalties are reduced or remitted will be discussed and analysed per country in separate chapters. Thereafter a comparison will be done between understatement penalties levied in the different jurisdictions being the United Kingdom, Australia and the United States of America to identify differences in understatement penalties levied in each country and reducing or remittance of understatement penalties.

3. Research methodology

The research method adopted is a literature review of the understatement penalties that are imposed in South Africa and other countries.

The extensive literature review includes the following sources -

- Articles.
- Binding rulings.
- Books.
- Court cases.
- Electronic resources – internet.
- Journals.
- Statutes.

4. Scope and limitations

This study will be limited to Chapter 16 of the Tax Administration Act in South Africa that deals with penalties imposed on the understatement of tax. A comparison will be done between understatement penalties levied in South Africa and other countries. This will be done by specifically looking at what penalties are levied in different circumstances and what improvements South Africa can make, if any, to the current penalty regime.

The other countries are limited to the United States of America (USA), Australia and the United Kingdom (UK). Broomberg (2007) indicated in 'Tax avoidance Then and now' that the USA and the UK are leading countries in the taxation regimes and therefore they were selected. Australia was selected as South Africa's understatement penalty regime is similar to that of Australia.

The penalties discussed in this report will be limited to those penalties that are imposed in the event of the understatement of tax.

5. Proposed chapter outline

5.1 Chapter 1 – Introduction

This introductory chapter will explain the understatement penalties that are being imposed by the South African Revenue Service. This chapter will also include the research problem, research sub-problems; research methodology and the scope and limitations of the report.

5.2 Chapter 2 – Interpretation of behaviours and conducts used to impose understatement penalties in South Africa.

This chapter will discuss what the behaviours and conducts means as per the interpretation by tax commentators and SARS by utilising numerous articles and guides that were published. Appropriate websites (tax/accounting/legal) will be used as the source for numerous articles that were published relating to understatement penalties, tax court cases and the *SARS's Short guide to the Tax Administration Act*. It will also further discuss in what instances the understatement penalty will be remitted.

5.3 Chapter 3 – Penalties that are imposed by Australia.

This chapter will discuss the penalties imposed by Australia and in what situations the penalties will be reduced or remitted.

5.4 Chapter 4 –Penalties that are imposed by the United States of America.

This chapter will discuss the penalties imposed by of the United States of America and in what situations the penalties will be reduced or remitted.

5.5 Chapter 5 – Penalties that are imposed by the United Kingdom.

This chapter will discuss the penalties imposed by the United Kingdom and in what situations the penalties will be reduced or remitted.

5.6 Chapter 6 – Comparison of penalties levied by South Africa and the other countries and recommending improvements to the penalties regime in South Africa*.*

This chapter will compare the penalties imposed by South Africa with the penalties imposed by Australia, the United Kingdom and the United States of America. Possible improvements to the South African tax system will be discussed.

5.7 Chapter 7 – Conclusion

This chapter will summarise the findings of the research, conclude and make recommendations.

Chapter 2 – Interpretation of behaviours and conducts of taxpayers used to impose understatement penalties in South Africa and the remittance of penalties.

1. Introduction

There are behaviours and conducts that are used to levy the understatement penalties that are not defined in the Tax Administration Act. Regarding the understatement penalties, various articles, court cases and other sources, have been published aiding in the interpretation of these behaviours and conducts. In order to compare the current penalty regime to other countries it is important to discuss the understatement penalties currently levied in detail. This will also aid to identify possible improvements that can be implemented by SARS.

The following will be discussed in this chapter:

- Substantial understatement
- Reasonable care taken in completing a return
- No reasonable grounds for ‘tax position’ taken
- Gross Negligence
- Intentional tax evasion
- Conducts not defined in the Act
- Situations in which understatement penalties will not be levied or will be reduced.

1.1 Substantial understatement

Substantial understatement is the only behaviour that is defined in the Tax Administration Act. Section 221 defines substantial understatement as the following:

> 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 R1000 000

The above means that if the understatement exceeds the 5% or R1 000 000 of the tax that is payable or refundable, it will be seen as substantial understatement.

To calculate the substantial understatement the threshold of 5% will be calculated on the tax payable/ refundable and this will be compared to the R1 000 000. The higher of the two will be compared to the understatement. If the understatement exceeds R1 000 000 or 5% of the tax payable or refundable it will be seen as the behaviour substantial understatement is applicable.

1.2 Reasonable care taken in completing a return

In the article *'Reasonable care in completing tax returns'* authored by Danielle Botha (2014) she indicates the following:

> "Reasonable care" implies that the taxpayer knew or should reasonably have known that the given outcome could occur.

The word reasonably known that the given outcome could occur might mean that the taxpayer would have been able to prevent the outcome. This means that the taxpayer could have had certain controls in place to prevent the understatement of tax.

In the case *Kruger v Coetzee* (1966) a reasonable person test was laid down. The conduct of the taxpayer will be that reasonable care was not taken in completing a return if it is not in line with what a reasonable person in a similar situation would have done. For example this means that if an error was made on an Annual Tax Return and that could have been prevented by taking more precaution in the completion of the return it could be seen that no reasonable care was taken in completing the return.

In the SAICA Integritax newsletter, Piet Nel (2013), indicated the following:

> Although the standard of care is measured objectively, it takes into account the circumstances of the taxpayer. The effort required is one commensurate with all the taxpayer's circumstances, including the taxpayer's knowledge, education, experience and skill.

This means that there are certain criteria that should be take into account when determining if a taxpayer acted reasonable or not. For example a taxpayer that is elderly with no tax knowledge will be treated differently from a taxpayer that is a qualified tax professional. In order to determine if a person did not take reasonable care a test should be done to determine if the person's behaviour is the same as a reasonable person with the same competence level.

The *SARS Short Guide of Tax Administration Act* on page 80, section 16.5.3 states the following:

> Reasonable care means that a taxpayer is required to take the degree of care that a reasonable, ordinary person in the circumstances of the taxpayer would take to fulfil his or her tax obligations

From the above quotation it can be seen that according to SARS, reasonable care means that a person should take care to fulfil his or her obligations like a reasonable, ordinary taxpayer would do. The guide further states that reasonable care does not mean perfection but a person should to the same as a reasonable taxpayer would have done.

1.3 No reasonable grounds for tax position taken

A judgment was handed down in the Tax Court on 18 November 2014 in the case of *Z v Commissioner for the South African Revenue Service*. In this judgment the SARS levied an understatement penalty with the following behaviours 'no reasonable grounds for tax position taken' and 'reasonable care not taken' by the taxpayer. The Commissioner based their conclusion on the following: 'the legislation and the facts are clear'. The court determined that the behaviour of no reasonable grounds for the tax position is not applicable. The court indicated in paragraph 40 the following:

> I am of the view that having received advice, there were reasonable grounds for the appellant to take the tax position which he did. Nor can it be said that he did not take reasonable care – he did so by consulting the experts.

The court based its decision on United States of America case: *Estate Spruill v Commissioner,* in this case the following was said:

> When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require a taxpayer to challenge the attorney, to seek a "second opinion", would nullify the very purpose of seeking the advice of a presumed expert in the first place….

After the abovementioned facts were taken into account it could be contended that it is not necessarily that if the act is clear that the behaviour attributed to the taxpayer is that of no reasonable grounds for the tax position taken. Other factors such as that the taxpayer obtained professional advice could be regarded as reasonable grounds for tax position taken.

The Tax Administration Act defines a tax position as the following:

> tax position
>
> means an assumption underlying one or more aspects of a tax return, including whether or not—
> (a) qualifies as a reduction of tax payable; and
> (b) an amount, transaction, event or item is taxable;
> (c) an amount or item is deductible or may be set-off;
> (d) a lower rate of tax than the maximum applicable to that class of taxpayer, transaction, event or item applies; or
> (e) an amount

Tax position means that the taxpayer makes an assumption on aspects on his/her tax return such as if an amount is taxable, deductible or a lower tax rate is applicable.

The SARS guide gives guidance on the behaviour of reasonable grounds for a tax position taken. The guide indicates on page 80, the following:

> The purpose is not to levy a penalty when SARS disagrees with a position adopted by a taxpayer but to attach a penalty where a taxpayer assumes a position unreasonably. As there is an inherent risk in assuming a tax position, taxpayers are expected to adopt a sensible approach in the process of adopting a tax position and to also have considered the integrity of the tax position taken.

This approach followed in the SARS guide is concerning as it does not define what will be seen as an unreasonable position. This could lead to more disputes of understatement penalties with SARS as what is reasonable for a taxpayer and for SARS could be different. SARS guide however indicate that it should be a sensible approach and should consider the integrity of the tax position taken.

1.4 Gross Negligence

The behaviour 'gross negligence' was explained by P Van der Swan (2013) in the article *'A taxpayer's right to manage its exposure'* as the following:

> A person's conduct in relation to a risk that a person is conscious of could however be so completely different from the standard of a reasonable person that it can amount to gross negligence. In the case of taxation, a taxpayer is likely to be aware of the risk of not complying with the requirements of the relevant tax legislation. It was suggested in another court case that where gross negligence is considered in relation to a person consciously taking a risk, the conduct in question must involve a departure from the standard of a reasonable person to such an extent that it may be categorised as extreme; a complete lack of intellect must therefore be demonstrated.

This means that the behaviour of gross negligence can be attributed to a taxpayer if the taxpayer has scant regards to the consequences. For example a taxpayer received revenue and declared only part of the revenue for tax purposes due to lack of accounting records.
In the case *Kruger v Coetzee* (1966) it was stated that a person's conduct will be classified as negligent if a reasonable person would have acted differently under the same circumstances.
A taxpayer will unlikely be regarded as being grossly negligent if he/she has implemented controls to ensure that transactions are recorded accurately for tax purposes.

In the SARS guide on page 80, it states the following regarding gross negligence:

> The test for gross negligence is objective and is based on what a reasonable person would foresee as being conduct which creates a high risk of a tax shortfall occurring. Gross negligence involves

> recklessness but, unlike evasion, does not require an element of *mens rea*, meaning wrongful intent or "guilty mind", or intent to breach a tax obligation.

According to the guide the meaning of 'gross negligence' has a degree of recklessness but it does not require the element of wrongful intent to evade tax.

1.5 Intentional Tax Evasion

In the article **'Understatement penalty:** when can SARS allege 'gross negligence' or 'intentional tax evasion'?', the author Johan van der Walt (2013) indicated the following:

> Whereas an objective test applies to determine whether there has been a lack of 'reasonable care' or that 'recklessness' was present, the test for intentional disregard is purely subjective in nature. The actual intention of the taxpayer is therefore crucial.
>
> Intentional disregard requires actual knowledge on the taxpayer's part that the statement made is false. To establish this, the taxpayer must understand the effect of the relevant tax provision and how it applies to him/her/it and, furthermore, make a deliberate choice not to comply. It follows that dishonesty is a requirement of behaviour reflecting an intentional disregard for the operation of the law.

In this article it can be seen that the behaviour intentional tax evasion means that a taxpayer makes a false statement with intention to evade tax. For example if a taxpayer claims input tax on his VAT201 return whilst not trading as an enterprise in terms of the VAT Act could constitute intentional tax evasion as the taxpayer knowingly made a false statement on the VAT201 return.

In the article 'The onus of proof rule for the imposition of understatement penalties', the author Ruaan van Eeden (2015) indicates the following:

> A first level turnover/expenditure reconciliation enquiry by SARS can never, in our view, establish any intent to evade tax as it is merely a test of reasonability. Once the test of reasonability is complete, it is only actual source documentation, coupled with a host of other factors that could remotely bring into play 'intentional tax evasion'. Taxpayers should not merely provide reasons to defend an 'intentional tax evasion' allegation where no credible evidence has been put forward by SARS to discharge its (frankly difficult) onus pertaining to the imposition of understatement penalties under s 102(2) of the TAA.

This article indicates that SARS cannot establish intent based only on a test that was performed. SARS should have evidence that the taxpayer had intent to evade tax as the onus of proof relating to understatement penalties is on SARS.

The SARS guide on page 81 indicated the following regarding intention:

> Intention is a wilful act, that exists when a person's conduct is meant to disobey or wholly disregard a known legal obligation, and knowledge of illegality is crucial.

This statement in the guide is important as it indicates that intention to evade tax is a wilful act and the taxpayer knowingly disregarded an obligation and knew that his/her action was illegal.

1.6 The following conducts are not defined in the Tax Administration Act and will be discussed:

- Obstructive taxpayer;
- Voluntary disclosure before/after notification of an audit or investigation

Obstructive taxpayer

In the article 'Request by SARS for information from South African taxpayers regarding related parties abroad', the author Dr. Beric Croome (2016) indicated the following:

> In addition, the failure to provide information, particularly information held by a connected person abroad, could be construed as obstructive and result in an increase in the understatement penalty which SARS may seek to impose if SARS adjusts the taxable income of the taxpayer.

In the abovementioned article it is clear SARS could attribute the conduct of an obstructive taxpayer if a taxpayer fails to provide information that was requested by SARS.

Voluntary disclosure before/after notification of an audit or investigation

Chapter 16 Part B of the Tax Administration Act, regulates the voluntary disclosure program stating the requirements that should be adhered to in order to apply for relief of disclosure of tax defaults. If applicant is successful in his/her application of voluntary disclosure the taxpayer will enjoy relief of understatement penalties relating to his tax defaults.

After consideration of the table in section 223(1) of the Tax Administration Act, the difference in voluntary disclosure before notification of audit or investigation is that the understatement penalties only levied for the behaviours 'gross negligence' and 'intentional tax evasion'. In the case of voluntary disclosure of the notification of audit, SARS will be able to levy understatement penalties that are applicable for all behaviours, although these penalty percentages are significant lower than the penalties that are levied in the other cases without a voluntary disclosure.

For example, if the behaviour 'Intentional tax evasion' is applicable to a standard case, an understatement penalty of 150% applies, and if there was a voluntary disclosure after a notification of audit the understatement penalty will be 75% and 10% if the voluntary disclosure was granted before a notification of audit.

1.7 Situations in which understatement penalties will not be levied or will be reduced

- **Bona fide inadvertent error**

In terms of section 222(1) of the Tax Administration Act, the understatement penalty will not be levied if the understatement was because of a bona fide inadvertent error.
The issue in this regard is that a bona fide inadvertent error is not defined in the Tax Administration Act and therefore it is important to establish which error will constitute a bona fide inadvertent error.
The Draft Explanatory Memorandum on the objects of the Taxation Administration Laws Amendment Bill on page 12 states criteria that could determine if the error that was made was in fact bona fide inadvertent errors.
Factual errors

- The taxpayer knowledge, education, experience and skill needs to be considered to determine if the taxpayer took reasonable care in completing a return.
- The behaviour of the taxpayer is also measured against what a reasonable person would have done in the same circumstances.
- The nature of the error, frequency of the error and the quantum of the error.
- If it was a numeric error, did the taxpayer have control in place to prevent this error?

Legal interpretive error

- The provision in the act is complex and the taxpayer made effort to understand the act by using explanatory material or making enquiries regarding the provision to be able to understand the provision in the act.
- The taxpayer relied on information from trusted sources which was incorrect or misleading and a reasonable person in the same circumstances would also have found the information complex.

It is important that the above-mentioned factors should be determined by the SARS official and SARS should be able to prove that these circumstances were taken into account in levying understatement penalties in terms of section 102(2) of the Tax Administration Act.

- **Remittance in understatement penalty**

In terms of section 223(3) of the Tax Administration Act, SARS can remit an understatement penalty in the following situations:

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

It should be noted that a penalty can only be remitted if the understatement penalty levied relates to the behaviour 'substantial understatement'. If a taxpayer is aggrieved with the penalty levied he/she needs to lodge an objection in terms of section 224 of the Tax Administration Act.

Chapter 3 – Penalties that are imposed by Australia.

1. Introduction

Practice Statement Law Administration PS LA 2012/5 was issued by the Australian Commissioner to explain how the penalties are levied if a false or misleading statement was made on or after 1 April 2004.
According to the Practice Statement paragraph 9 the following principles should be taken into account:

- The main objective of the penalty regime is to encourage taxpayer to adhere to the laws and a taxpayer that made an effort to comply should not be penalised.
- The tax authority should be fair to entities that wants to comply and must be strict but fair with the taxpayers that chose not to comply and avoid there tax liabilities.
- The taxpayer will be treated to be honest unless information on hand suggest otherwise.
- The circumstances of the case will be considered by looking at the background and experience of the taxpayer.
- The decisions that are made in the case of penalties should be supported by evidence.
- The tax authority should be in contact with the taxpayer to give the taxpayer an opportunity to explain their actions before a decision regarding a penalty is made.

These principles indicate that all circumstances surrounding the shortfall will be taken into account when the penalty is being determined.

The following table at paragraph 99 of the Practice Statement is used to determine the base penalty amount (BPA) that is levied:

BPA Table

Source: Paragraph 99 of the Practice Statement

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

The Practice Statement Law Administration states that if there is more than one statement made by the taxpayer that resulted in the shortfalls of tax it should be examined separately as different levels of care can be applicable to each shortfall. The levels of care are the following:

- failure to take reasonable care.
- Recklessness. and
- intentional disregard.

The guidelines of determining the levels of care is set out in the Miscellaneous Tax Ruling MT2008/1 referred to as MT2008/1 ruling in rest of the research report.

In this chapter the following will be discussed:

1.1. failure to take reasonable care.

1.2. recklessness.

1.3. intentional disregard.

1.4. circumstances in which administrative penalties will not be levied or be reduced.

1.1 Failure to take reasonable care

The MT2008/01 ruling states in paragraph 27 the following regarding reasonable care:

> The expression 'reasonable care' is not a defined term and accordingly takes its ordinary meaning. The Australian Oxford Dictionary, 1999, Oxford University Press Melbourne, defines 'care' as '... 3 serious

> attention; heed, caution, pains' and 'reasonable' as ' 3a within the limits of reason; not greatly less or more than might be expected'. Taking 'reasonable care' in the context of making a statement to the Commissioner or to an entity within the meaning of subsection 284 75(4) means giving appropriately serious attention to complying with the obligations imposed under a taxation law.

This indicates that the taxpayer should have made an effort when the returns were compiled to comply with the Act. The MT2008/1 ruling also makes reference to the reasonable man test as discussed in Chapter 2.

Barick, CJ indicated in the court case *Maloney v Commissioner for Railways (NSW)* (1978) that reasonable care does not mean the utmost perfection should have been exercised when a return was completed.

In paragraph 41 of the MT2008/1 ruling the reasonable arguable position is discussed:

> Although demonstrating a reasonably arguable position involves the application of a purely objective test, an entity will usually reach their position (at the time of making the statement) as a result of researching and considering the relevant authorities. In these circumstances, the efforts made by the entity to arrive at the correct taxation treatment will also demonstrate that reasonable care has been shown.

This indicates that if a taxpayer can demonstrate the process that was followed in the taxation treatment it could prove that the taxpayer took reasonable care when applying the tax laws.

Paragraph 47 of the MT2008/1 indicates that when the behaviour reasonable care is determined by the tax authority personal circumstances of the taxpayer should be taken into account to determine if a person in the same circumstances would have acted in the same way. The following example was made in paragraphs 48 and 49 of the MT2008/1 ruling:

> Helen has been diagnosed with cancer and has had emergency surgery and intensive chemotherapy treatment. In preparing her tax return she overlooked a relatively small amount of interest earned on one of her investment accounts. While recovering from surgery and during her treatment she misplaced the relevant statement from the financial institution.
>
> It is a reasonable conclusion that Helen's illness has contributed to her failure to correctly record interest earned during the income year. An appropriate conclusion is that a reasonable person in the same circumstances might not be as thorough or as organised in keeping records as a person who was not dealing with significant health issues. Taking her personal circumstances into account it is reasonable to conclude that Helen has exercised reasonable care.

It is further noted that in paragraph 52 of the MT2008/1 ruling that knowledge, education, experience and skill may have an impact on the level of care that is taken when completing a return.

In the *Administrative Appeals Tribunal case 34/95* in paragraph it can be seen that the court considered the level of knowledge of the taxpayer practitioner and compared this with what a similar taxpayer practitioner would have done in the same situation.

Paragraph 56 of the MT2008/1 ruling is to determine if a person acted with reasonable care having the particular person's competence and experience. This should be compared with a person having similar competence and experience.

Paragraph 59 of the MT2008/1 ruling indicates the following:

> In determining the standard of care that is reasonable and appropriate in the circumstances, factors such as the complexity of the law and whether the relevant law involves new measures are also relevant. These factors have the potential to affect an entity's capacity to understand their entitlements or obligations under the law.

In this paragraph it can be seen that when determining reasonable care, one must take into consideration the complexity of law.

In paragraph 68 of the MT2008/1 ruling it states that errors or oversights can indicate a lack of reasonable care. It further indicates the following examples of practices that promote reasonable care:

- frequent internal audits.
- sample verification of transactions.
- staff training. and
- preparing instruction manuals for staff of how to capture transactions.

It is therefore clear that reasonable care taken relates to the controls of the entity or individual that has been put in place to ensure that their tax obligation is accurate. It further states in paragraph 74 that you cannot prevent all errors but if the internal controls are designed and monitored to reduce the error rate to an acceptable level it will be regarded that reasonable care was taken.

1.2 Recklessness

Paragraph 99 of the MT2008/1 ruling indicates that the aim of the penalty regime is to impose a higher penalty in the cases where the conduct of the taxpayer demonstrates high level of carelessness.

In paragraph 101 of the MT2008/1 ruling it explains what the behaviour carelessness means:

> Behaviour will indicate recklessness where it falls significantly short of the standard of care expected of a reasonable person in the same circumstances as the entity. Although the test for determining whether recklessness is shown is the same as that applied for testing a want of reasonable care, it is the extent or degree to which the conduct of the entity falls below that required of a reasonable person that underscores a finding of recklessness.

The abovementioned means that a taxpayer will be found to be reckless if the conduct of the taxpayer significantly deviates from a reasonable person in the same circumstances.

In the court case *Hart v Federal Commissioner of Taxation* (2002), the deductibility of aircraft expenses were disallowed as it was found not to be business expenses. According to paragraph 105 of the MT2008/1 ruling the penalties were imposed by the Commissioner based on the behaviour of recklessness.

The following facts were considered:

- the tax return had been prepared by the accounting firm of the applicant's husband with full knowledge of the relevant circumstances surrounding the claim;
- evidence of a long history of very low income for very high outgoings; and
- the significant amount of the deduction in dispute – in the sum of $58,000.

Paragraph 106 and 107 of the MT2008/1 ruling stipulates the decisions that were made for Dowsett J and Hill and Hely JJ in *Hart v Federal Commissioner of Taxation (2002)*, the judges considered what a reasonable man would do in the same situation. In this case a reasonable man would not have disregarded the risk that the expenses were not be deductible for tax purposes. It can therefore be concluded that if a person disregards the risk that an amount is deductible or taxable for tax purposes, the behaviour of recklessness could be applicable.

In the case *BRK (Bris) Pty Ltd v Federal Commissioner of Taxation* (2001) a false claim that certain beneficiaries has entitlement to trust income. The tax agent did not make sure that it is a valid appointment in terms of the trust deed. Cooper J indicated the following in paragraph 80 of the case:

They took the risk that any existing trust deed may not have empowered the applicant to effectively pass the resolutions or appoint the income. They conducted themselves on that basis at all times thereafter in the conduct of the applicant to make sure that it is a valid appointment in terms of the trust deed. Cooper J indicated the fs or of income had been made in each relevant income year. I am satisfied that Steven Hart and Robert Adcock, when the income tax returns were prepared and lodged, were indifferent as to whether or not the statements as to the distribution of income contained in the returns were correct. It was reasonably foreseeable to a person in their position that to allow the preparation and lodgment of the tax returns on that basis would cause the Act to operate so as to bring the income of the Trust to account under s 97 of the Act rather than s 99A(4), when there was a real risk that that was not the correct basis on which the income ought to be assessed. In my judgment, to lodge the returns in the form in which they were lodged containing the statement as to the distribution to WCC was reckless.

In the above extract of the court case it was established that if there is a risk that the position that is taken by the taxpayer is incorrect and this risk was disregarded it could be seen as recklessness.

1.3 Intentional disregard of a taxation law

The penalty for intentional disregard is the highest penalty that is levied for severe failure to comply with tax legislation.

Paragraph 110 of the MT2008/1 ruling indicates the meaning of intentional as follows: ‘The adjective ‘intentional’ means that something more than reckless disregard of or indifference to a taxation law is required.’

This means that intentional is that you should have had intention to be reckless. This is further specified in paragraph 111 of the MT2008/1 ruling. In paragraph 112 of the MT2008/1 ruling indicates that the taxpayer must have known that the statement made is false and made a deliberate decision to disregard the law.

In the other two behaviours discussed above dishonesty was not part of behaviours and therefore this is a major difference from the behaviour intentional disregard.

It is important to note that evidence of intention, either should be found directly or from surrounding circumstances and the conduct of the taxpayer should also be taken in consideration as indicated in paragraph 114 of the MT2008/1 ruling.

In the court case *Weyers v Federal Commissioner of Taxation* (2006), it showed that intentional disregard of the law can be based on facts and surrounding circumstances. The tax agent in this case classified income of the trust as loan payments. Dowsett J concluded the following in paragraph 168 of the case:

I return to the requirement of the ITA Act that a taxpayer disclose trust income. It does not really matter whether the moneys distributed by the family trust went to Nommack Nominees as banker, as bare

> trustee or as trustee of the Sydney trust. To the extent that such moneys and other income of the Sydney trust was distributed to the Weyers, it was income derived from one or other of the two trusts and should have been returned as such. I cannot avoid the conclusion that Mr Steele must have known that. He intentionally disregarded the requirement for disclosure of such income. That caused the Weyers' tax shortfalls.

In this conclusion of Dowsett J it can be seen that the tax agent had knowledge that the money distributed was not loans and that he intentional disregarded the requirement to disclose income. Although there was no direct evidence of intent the surrounding facts indicated that the tax agent intentional disregarded the tax law.

1.4 Circumstances in which administrative penalties will not be levied or be reduced

According to subsection 284-75(6) of Schedule 1 to the Taxation Administration Act 1953, the penalties are waived or reduced in certain circumstances.

Paragraph 12B of the MT2008/1 ruling stipulates the requirements that need to be met in order for a penalty to be reduced or waived:

(a) the taxpayer engaged a registered agent.

(b) all relevant material was given to the registered agent.

(c) a statement was made by the registered agent.

(d) the statement that is false or misleading did not result from:

- (i) intentional disregard by the registered agent. or
- (ii) recklessness caused by the registered agent.

From the above it can be interpreted that a penalty is reduced if the taxpayer consulted and gave all the information to the registered representative and the representative made the statement. This is only applicable if the behaviours of intentional disregard or recklessness of the representative were not present.

Chapter 4 –Penalties that are imposed by the United States of America.

1. Introduction

As stated in the scope and limitations of this report there are various penalties that can be imposed by the Internal Revenue Service (IRS). In this report focus will be on the penalties that relates to accuracy-related penalties that are imposed if there is an understatement of tax.

An accuracy penalty is only imposed if the taxpayer failed to demonstrate a reasonable basis of the tax position that was taken.

A penalty of 20% of the understatement of tax will be levied in terms of section 6662 of the Internal Revenue Code of 1986 in certain circumstances:

In this chapter the following circumstances in which penalties is levied will be discussed:

- Negligence or disregard of rules or regulations.
- Any substantial understatement of income tax.
- Any substantial valuation misstatement under chapter 1.
- Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.)
- Circumstances in which administrative penalties will not be levied or be reduced.

1.1 Negligence or disregard of rules or regulations.

Negligence is defined in section 6662(c) of the Internal Revenue code as the following:

For purposes of this section, the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless, or intentional disregard.

In the article The Accuracy-Related Penalty (Part I) by Cook and Ocheltree (2010) the following was stated:

> Nevertheless, courts have generally applied the common law tort definition of the term, holding that negligence means failing to do what a reasonable and ordinarily prudent person would do under the same or similar circumstances. In addition, the regulations, while not defining negligence, do provide examples of negligent behavior. These examples include failing to keep adequate books and records and failing to substantiate items properly.

The above statement is in agreement with what was stated in the previous 2 chapters regarding 'negligence' that is an objective test. Cook and Ocheltree (2010) also states that this could be seen as a 'two edged sword'. The meaning of this is that a taxpayer with less education and experience will be measured at an inferior level than a taxpayer that has the relevant knowledge and experience.

In the court case *Magnon v Commissioner* (1980), it is evident that if the taxpayer did not keep adequate records it could constitute negligence.

1.2 Any substantial understatement of income tax

Section 6662(d)(1) of the Internal Revenue Code indicates that substantial understatement of tax means the following:

> 1) Substantial understatement
>
> (A) **In general** For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of— —
>
> (i) 10 percent of the tax required to be shown on the return for the taxable year, or
>
> (ii) $5,000.
>
> (B) **Special rule for corporations** In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of—
>
> (i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or
>
> (ii) $10,000,000.

This penalty will only apply when the taxpayer substantially understates his/her tax by using the above mentioned criteria.

In the article The Accuracy-Related Penalty (Part I) by Cook and Ocheltree (2010) the following was said regarding substantial understatement of tax penalty trigger:

> The third Sec. 6662 penalty trigger is the existence of a substantial understatement of tax. This is the first mechanical trigger. This penalty applies, logically, only if the taxpayer's return contains an understatement and that understatement is substantial.

In the above statement it can be seen that in the instance of levying substantial understatement penalty it does not take into account the taxpayer's behaviour and conduct.

SARS levies a similar penalty namely substantial understatement. The only difference is that South Africa does not differentiate between companies/corporations and individuals.

1.3 Any substantial valuation misstatement under chapter 1.

In terms of section 6662(e)(1) of Internal Revenue Code this penalty is levied in the following instances:

> For purposes of this section, there is a substantial valuation misstatement under chapter 1 if-
>
> (A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or
>
> (B)(i) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or
>
> (ii) the net section 482 transfer price adjustment for the taxable year exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

The abovementioned penalties are levied in instances when taxpayer values assets incorrectly.

SARS is not currently levying this type of penalty. This type of penalty can be helpful in instances of capital gains tax for example: if taxpayer understates the value of property when sold or overstates the value of the base cost of the property. This will be further discussed in chapter 6.

1.4 Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance

In terms of section 6662(i)(1) of Internal Revenue Code this penalty is levied in the following instances:

> (1) In general
>
> In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting “40 percent” for “20 percent”.
>
> In this instance penalties is levied by the IRS if a transaction lacks economic substance and the percentage of 20% is substituted by the percentage of the 40%.

SARS is not currently levying this type of penalty. This type of penalty can be helpful in instances of schemes of tax avoidances in terms of section 80A to 80L of the South African Income Tax Act. This will further be discussed in chapter 6.

1.5 Circumstances in which administrative penalties will not be levied or be reduced

In the following instances in terms of section 6662(2)(B), the penalties that are levied by the IRS as discussed above are reduced:

- if the taxpayer proves that there was substantial authority for that treatment or
- the tax treatment of a transaction was adequately disclosed and there was a reasonable basis for the tax treatment.

McLaughlin (2014), McLaughlin Legal, San Diego tax law firm indicated that in order to remit a penalty in terms of substantial authority an analysis should be done together with application of the law to the applicable facts of the taxpayer. Substantial authority will only exist if a substantial amount of authorities is in support of the tax treatment by the taxpayer.

In the *Taxpayer Advocate Service – 2013 Annual report to Congress – Volume 1,* the indicated that reasonable cause consideration is determined mainly:

- by considering the facts and circumstances of the case.
- the effort that was taken by the taxpayer to ensure that the tax liability is correct.

In the article, '*Avoiding an IRS Imposed Accuracy Related Penalty'* by Podraza the following was indicated regarding advice taken by taxpayer from a tax adviser to show reasonable cause:

> Probably the most common defense for a taxpayer's non-compliant conduct is the taxpayer's reliance on the advice of a tax professional. The reliance on advice will only demonstrate reasonable cause and good faith if the advice is based on all facts and circumstances and does not rely on any unreasonable assumptions. This minimum requirement is not met if the taxpayer fails to disclose to the adviser a fact that the taxpayer knows, or should have known, that is relevant to the proper tax treatment of the item.
>
> The regulations state that in order for the taxpayer's reliance on advice to constitute reasonable cause and good faith, the reliance itself must be reasonable. Here, again, the taxpayer's education, sophistication and business experience are relevant factors.

In the above, it is noted that to be able to prove reasonable cause the following should be taken into account:

- advice should be based on all the facts and circumstances
- the taxpayer should disclose all the facts that could affect a tax treatment on which advice is provided
- The taxpayer reliance on advice could also show reasonable cause. This will take into account the taxpayer's education, sophistication and business experience.

If the income of the corporation was not properly disclosed the above remittances are not applicable for transactions that relate to multiple financings transactions in terms of section 6662(2)(B).

Chapter 5 –Penalties that are imposed by the United Kingdom.

1.1 Introduction

Penalties are levied in three situations namely in terms of the schedule 24 of the Finance Act, 2007:

1. Error in taxpayer’s document;
2. Error in taxpayer’s document attributable to another person; and
3. Under-assessment by HMRC.

1.2 The type of penalties levied can be summarised in a table:

Source: Authors table by utilising schedule 24

	Error in taxpayer’s document	Error in taxpayer’s document attributable to another person	Under-assessment by HMRC
Conditions for penalties to be levied	Person submits a document for example a VAT return or Company tax return as listed in paragraph 1 of the Table of documents in the schedule 24 of the Finance Act. This penalty is levied if the following criteria are apparent: Condition1 is the document contains an inaccuracy that causes: (a) an understatement of a tax; (b) a fabricated or increased statement of a loss; or (c) a fabricated or increased claim refund of tax. Condition 2 is that the inaccuracy was negligent	A representative or another person submits a document for example a VAT return or Company tax return as listed in paragraph 1 of the Table of documents in schedule 24 of the Finance Act on behalf of the responsible person. This penalty is levied if the following criteria are apparent: (a) the document contains a relevant inaccuracy, and (b) the inaccuracy was attributable to the responsible person for the document supplying fabricated information to (whether directly or indirectly) or consciously withholding information from the person that submits the document. The responsible person should have intent to misrepresent the document. The relevant inaccuracy should lead to: (a) an understatement of a tax; (b) a fabricated or increased statement of a loss; or (c) a fabricated or increased claim refund of tax.	This penalty is levied when an assessment is levied by the HMRC and the responsible person has neglected to take reasonable steps to notify the HMRC of the understatement within 30 days from the date of the assessment. (2) In deciding what steps (if any) were reasonable HMRC must consider— (a) whether a person knew, or should have known, about the underassessment, and (b) what steps would have been reasonable to take to notify HMRC.

1.3 Percentage of penalties levied

The penalties levied are measured with degrees of culpability. This is defined in schedule 24 of the Finance Act, 2007 as the following:

3 (1) For the purposes of a penalty under paragraph 1, inaccuracy in a document given by P to HMRC is—
(a) "careless" if the inaccuracy is due to failure by P to take reasonable care,
(b) "deliberate but not concealed" if the inaccuracy is deliberate on P's part but P does not make arrangements to conceal it, and
(c) "deliberate and concealed" if the inaccuracy is deliberate on P's part and P makes arrangements to conceal it (for example, by submitting false evidence in support of an inaccurate figure).

(2) An inaccuracy in a document given by P to HMRC, which was neither careless nor deliberate on P's part when the document was given, is to be treated as careless if P—
(a) discovered the inaccuracy at some later time, and
(b) did not take reasonable steps to inform HMRC.

In the above, it can be seen that the HMRC also consider the behaviour of the taxpayer when deciding the applicable penalty. These behaviours are defined in schedule 24 of the Finance Act, 2007. This could be an improvement to the penalties levied in South Africa as all penalties should be defined.

1.3.1 Table: Penalties percentages levied

The following table illustrates the penalties percentage levied for errors in a taxpayer's document:

Source: Authors table by utilising schedule 24

Culpability	**Penalties levied**		
	Category 1 As per schedule 24: (a)it involves a domestic matter, or (b) it involves an offshore matter and— (i) the territory in question is a category 1 territory, or (ii) the tax at stake is a tax other than income tax or capital gains tax.	**Category 2** As per schedule 24: (a) it involves an offshore matter, (b) the territory in question is a category 2 territory, and (c) the tax at stake is income tax or capital gains tax.	**Category 3** As per schedule 24: (a) it involves an offshore matter, (b) the territory in question is a category 3 territory, and (c) the tax at stake is income tax or capital gains tax.
Careless	30% of potential loss of revenue	45% of potential loss of revenue	60% of potential loss of revenue
Deliberate	70% of potential loss of revenue	105% of potential loss of revenue	140% of potential loss of revenue
Deliberate and concealed	100% of potential loss of revenue	150% of potential loss of revenue	200% of potential loss of revenue

Penalties levied for errors taxpayer's document attributable to another person is the 100% of the potential loss of revenue.

Penalties levied for under assessment by the HMRC are 30% of the potential loss of revenue.

1.4. Instances in which penalties are remitted or reduced.

In paragraph 9 indicates that if a person discloses the penalty to HMRC the penalty will be reduced if the taxpayer:

- gives assistance to the HMRC with the penalty. and
- allowing the HMRC access to records to verify the inaccuracy.

The HMRC also distinguish the disclosure between prompted and unprompted.

The disclosure is unprompted in the following instances in terms of schedule 24 paragraph 9(2):

- an inaccuracy that will be discovered by the HMRC.
- false information was supplied.
- information withheld. or
- under-assessment.

The following table illustrates the reduction of penalties (as discussed in the table in point 1.3.1) if disclosure of the inaccuracy was given by the taxpayer:

Source: Paragraph 10 of the schedule 24

Standard %	Minimum % for prompted disclosure	Minimum % for unprompted disclosure
30%	15%	0%
45%	22.5%	0%
60%	30%	0%
70%	35%	20%
105%	52.5%	30%
140%	70%	40%
100%	50%	30%
150%	75%	45%
200%	100%	60%

In should be noted that in South Africa there is not reduction in penalties if there was disclosure done by the taxpayer unless it was under the voluntary disclosure program and therefore this will be discussed further in chapter 6.

Chapter 6 – Comparison between the countries.

A comparison between the countries discussed in previous chapters and possible recommendations or improvements to the current penalty regime in South Africa will be made. The comparison will be in the following order:

1.1 Comparison between the penalties levied by Australia and South Africa
1.2 Comparison between the penalties levied by the United States of America and South Africa
1.3 Comparison between the penalties levied by the United Kingdom and South Africa
1.4 Possible recommendations and improvements to the current understatement penalties levied in South Africa

1.1 Comparison between the penalties levied by Australia and South Africa

During the research of penalties levied by Australia it was evident that certain behaviours used to levy penalties are similar to those of South Africa.

In Australia the level of care that is used to levy penalties are:

- failure to take reasonable care;
- recklessness; and
- intentional disregard.

The following behaviours are used to levy penalties in South Africa:

- Substantial understatement.
- Reasonable care taken in completing a return.
- No reasonable grounds for ‘tax position’ taken.
- Gross Negligence.
- Intentional tax evasion

The Australian levels of care are discussed in detail in the MT2008/1 ruling. This aids taxpayers and taxpayer representatives to know what penalties are levied under what circumstances.

The percentages of the penalties levied in the two countries are sometimes different. The same percentage is levied for reasonable care not taken of 25% in South Africa and Australia.

The percentage levied for recklessness or grossly negligent is 50% in Australia and 100% in South Africa for a standard case.

The percentage levied for intentional disregard is 75% in Australia and 100% in South Africa for a standard case.

Australia does not have a behaviour of ‘substantial understatement’ whereas South Africa does.

No penalties are levied in South Africa in the instance where there is a bona-fide error. In Australia, a bona-fide error is not considered as grounds not to levy a penalty.

A penalty levied in South Africa can only be remitted if the understatement penalty levied relates to the behaviour ‘substantial understatement’.

In terms of section 223(3) of the Tax Administration Act, SARS can remit an understatement penalty in the following situations:

The following should have been present at the due date of the return:

- disclosure was made regarding the arrangement
- the taxpayer obtained an opinion from the an tax practitioner that disclosed the facts and circumstances of the arrangements.
- The taxpayer’s position will be upheld if the matter proceeds to court.

Paragraph 12B of the MT2008/1 ruling stipulates the requirements that need to be met in order for a penalty to be reduced or waived:

(a) the taxpayer engaged a registered agent

(b) all relevant material was given to the registered agent

(c) a statement was made by the registered agent

(d) the statement that is false or misleading did not result from:

(i) intentional disregard by the registered agent or

(ii) recklessness caused by the registered agent

The Australia penalty regime does not take the conduct of the taxpayer into account when a penalty is levied, whereas South Africa does.

In Australia a penalty is remitted in the circumstance that a taxpayer representative gives a false or misleading statement on behalf of the taxpayer and the behaviours do not relate to intentional disregard or recklessness by the taxpayer representative, no penalty is levied. The means that the taxpayer is not penalised for errors that was made by the representative. This can be seen as an improvement to the current remittance of penalties in South Africa.

1.2 Comparison between the penalties levied by the United States of America (USA) and South Africa

The penalties levied by USA differ significantly from the penalties levied by South Africa.

The first difference is that the focus in the USA is mainly to quantify the misstatement and levy a penalty based on this. The USA only has one penalty that is levied for negligence.

This is different in South Africa as the focus is more on the behaviour of the taxpayer than on the quantity of the error made. South Africa has the behaviour 'substantial understatement' that relates to the quantity of the understatement.

The substantial understatement penalty that is levied by the USA also makes a distinction between corporations and individuals in the thresholds when calculating the substantial understatement penalty. Substantial understatement penalty levied by South Africa do not differentiate between corporation and individuals.

The following penalties discussed in chapter 4 are not levied by South Africa:

- Any substantial valuation misstatement

- Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance.

The other difference is that the USA only levy a 20% penalty for all instances except for a few special circumstances, the penalty is increased to 40%. For example ‘gross valuation misstatements’ is levied at 40%.
The penalties levied by South Africa range from 25% to 200%.

In South Africa penalties are reduced or remitted in the case of a ‘bona-fide error’ or if the criteria for substantial understatement as stated in section 223(3) is met.

This is different from the USA and Australia that they do limit the remittance of a penalty to the behaviour of substantial understatement.

The factors that are also considered by the USA is if the taxpayer disclosed the relevant items and there was substantial authority for such treatment or there was a reasonable basis for treating the transaction.

1.3 Comparison between the penalties levied by the United Kingdom and South Africa

The penalties levied by the United Kingdom are different from the penalties levied in South Africa. The United Kingdom also uses behaviours but it is categorised in three categories:

1. Error in taxpayer’s document
2. Error in taxpayer’s document attributable to another person
3. Under-assessment by HMRC

Each category has certain criteria that should be present to levy the penalty. The percentages are also then based on the behaviour of the taxpayer. These behaviours are defined in schedule 24 of the Finance Act namely:

- Careless
- Deliberate
- Deliberate and concealed

There is also a difference between South Africa’s penalties as only substantial understatement is defined in the Tax Administration Act.

The penalties levied also ranges from 30% to 200% for the UK whereas in South Africa it ranges from 5%-200%.

The conducts of the taxpayer in the understatement penalties levied by South Africa are divided into 4 categories namely:

- Obstructive taxpayer
- Voluntary disclosure before notification of an audit or investigation
- Voluntary disclosure after notification of an audit or investigation
- Standard case

The United Kingdom categorises the reduction or remittance of penalties between prompted and unprompted.
The word unprompted is defined in schedule 24 paragraph 9(2) of the Finance Act as the following:

- an inaccuracy that will be discovered by the HMRC;
- false information was supplied;
- information withheld; or
- under-assessment;
- in any other case it is seen as prompted.

The penalty levied by the United Kingdom is then reduced according as to whether the disclosure of the understatement was prompted or unprompted.

This is different with South Africa as SARS only specifies voluntary disclosure which is strictly monitored by the voluntary disclosure department of SARS.

The current penalty regime of South Africa for example excludes circumstances in which the taxpayer discloses information during an audit without a voluntary disclosure that could lead to an understatement.

1.4 Possible improvements to the current understatement penalties levied in South Africa

In the comparisons of penalties levied by South Africa with Australia, United States of America and the United Kingdom it was found that there are differences between how penalties are levied in each country.

In the comparison it was learnt that Australia, the United States of America and the United Kingdom all have guidance of how penalties are levied. This aids taxpayers in those jurisdictions to know what documentation or proof needs to be submitted to reduce or remit penalties. A similar type of guidance can be implemented by SARS will help SARS to levy the correct penalty that is applicable to a taxpayer and the taxpayer will know how the penalty that was levied was determined.

The recommendation of understatement penalties levied by SARS is not to recommend a new penalty regime but recommending improvements that can be made. These improvements should be made as part of the Tax Administration Act or a schedule to the Tax Administration Act.

Improvements that will be discussed below are the following:

- Behaviours used to levy understatement penalty
- Conducts used to levy understatement penalty
- Remittance of understatement penalty levied

1.4.1 Improvements to behaviours of taxpayers used to levy understatement penalty

1.4.1.1 Substantial understatement

Regarding the substantial understatement penalty there is currently no distinction between corporations and individuals in South Africa as is currently exercised by the USA. The recommendation is that a distinction should be made for individuals and companies/corporations and the threshold of R1 000 000 should be adjusted accordingly. This will make a difference as individuals will under normal circumstances not be penalised under the current substantial understatement penalty as the thresholds to calculate the substantial understatement is too high and will be penalised if applicable under the other behaviours which higher penalty percentages.

Substantial valuation misstatement is a penalty that is levied by the United States of America. This penalty is levied when there is a valuation error in a return. This penalty could be used in the following instances:

- incorrect valuation of base cost in capital gains tax
- incorrect valuation for transfer pricing

Incorrect valuation of base cost in capital gains tax

A new penalty for incorrect valuation of base cost for capital gains tax should be levied if the valuation that was stated in the return is more than a certain percentage. This is based on penalties that are levied by the United States if valuations are incorrect. The United States levy a penalty in situation where the valuation error is more than 200%. It is recommended that if the error in the valuation of base cost is more than 200% a penalty should be levied. The penalty levied should be the similiar as the penalty levied for substantial understatement.

Incorrect valuation for transfer pricing

A penalty to specifically address transfer pricing is important to ensure that pricing adjustments are not significant. The penalty levied for transfer pricing in the United States of America is based on $ 5 000 000 or 10% of the gross receipts of the taxpayer. It is proposed that the penalty should be levied with determined thresholds or percentage of the gross receipts of the taxpayer in South Africa. The thresholds or percentages as stated above should be determined by Treasury.

1.4.1.2 Reasonable care not taken in completing a return

As previously stated in the introduction chapter the behaviour of reasonable care is not defined. The recommendation is that a definition should be included in the Tax Administration Act or as part of a schedule to that Act as to what reasonable care means.

Interpretation of reasonable care is given in detail in the MT2008/1 ruling of Australia that can be used as a basis to define reasonable care in South Africa.

The following should be included in the definition of reasonable care:

- The taxpayer should be able to show the process followed in the tax treatment of a transaction.
- A reasonable person under the same circumstances as the taxpayer would have acted in the same way.
- The knowledge, skill, education and experience of the taxpayer should be taken into account.
- The taxpayer should have controls in place to prevent errors.

1.4.1.3 No reasonable grounds for tax position taken

The phrase 'tax position' is defined in the SA Tax Administration Act. There are improvements that can be made in this instance as the phrase 'no reasonable grounds' is not defined in the SA Tax Administration Act. A similar phrase as reasonable grounds was discussed in chapter 4 of the penalties of the USA namely:

- reasonable cause consideration
- substantial authority

The reasonable cause means that if the taxpayer can prove that effort was taken coming to the tax treatment of a transaction and that tax treatment was adequately disclosed. This improvement will provide evidence that the taxpayer has taken adequate steps to arrive at the tax treatment of a transaction.

Substantial authority means that a substantial amount of authorities supports the taxpayer's tax treatment of a transaction. This will aid in complex tax matters where there is a disagreement between SARS and the taxpayer of the tax treatment of a transaction.

1.4.1.4 Gross negligence

As previously stated in the introduction chapter, the behaviour 'gross negligence' is not defined in the SA Tax Administration Act. The recommendation is that a definition should be included in this Act or as part of a schedule to the act as to what gross negligence means.

Interpretation of this behaviour is given in detail in the MT2008/1 ruling of Australia and penalties levied by the United States can be used as a basis to define the behaviour.

The following should be included in the definition of gross negligence:

- The conduct of the taxpayer significantly differs from that of a reasonable person.
- There is a risk that the tax position taken by the taxpayer was incorrect and the taxpayer disregarded the risk.
- If the taxpayer did not keep adequate records of tax transactions.

1.4.1.4 Intentional tax evasion

As previously stated in the introduction chapter, the behaviour intentional tax evasion is not defined in the SA Tax Administration Act.

The recommendation is that a definition should be included in this act or as part of a schedule to this act as to what intentional tax evasion means.

Interpretation of this behaviour is given in detail in the MT2008/01 ruling of Australia. This can be used as a basis to define intentional tax evasion.

The following should be included in the definition of intentional tax evasion:

- It is a significant failure to comply with tax legislation.
- The taxpayer knowingly made a false statement.
- Taxpayer made a deliberate decision to disregard the tax legislation.
- The surrounding facts, circumstances and conduct of the taxpayer indicates that there was an intention to evade tax.

1.4.2 Improvements to conducts used to levy understatement penalty

The conduct of an obstructive taxpayer is not defined in the SA Tax Administration Act. The recommendation is that a definition to what is an obstructive taxpayer.

In the article 'Request by SARS for Information from South African Taxpayers Regarding Related Parties Abroad', the author Croome (2016) indicated the following:

> In addition, the failure to provide information, particularly information held by a connected person abroad, could be construed as obstructive and result in an increase in the understatement penalty which SARS may seek to impose if SARS adjusts the taxable income of the taxpayer.

The definition of an obstructive taxpayer should be that if a taxpayer fails to provide information that was requested by SARS in the timeframes provided by SARS, the behaviour of an obstructive taxpayer will be attributed for understatement penalties purposes.

In the comparison between the penalties levied by South Africa and the United Kingdom, it was found that if there was prompted or unprompted disclosure by the taxpayer the penalty percentage that is levied was reduced in the United Kingdom. In South Africa penalties are less when voluntary disclosure was given by the taxpayer through the voluntary disclosure programme. This should be included in the conduct of the taxpayer as it will encourage taxpayers to disclose information to SARS without using the voluntary disclosure programme and in this way enhance compliance. A definition of unprompted disclosure should be include in the Tax Administration Act or schedule to the act.

The following should be included in the unprompted disclosure definition:

At the time the taxpayer made a disclosure to SARS there was no reason to believe that:

- errors will be discovered by SARS;

- false information or statements were provided;
- information was not submitted to SARS; or
- understatement of tax will occur.

In any other case of disclosure it is assumed to be prompted if any of the above-mentioned criteria are not met.

1.4.3 Remittance of understatement penalty levied

Understatement penalties levied by SARS are only reduced if it was a bona fide error or a taxpayer representative was consulted in the event of substantial understatement. In the comparison between the circumstances in which penalties are remitted per country, it was found that there are improvements that can be made.

In Australia, penalties are remitted when a taxpayer representative made a false statement or misleading statement if the behaviour of recklessness or intentional disregard is not present and all information was disclosed to the taxpayer representative.

The recommendation is that a similar provision is placed in the SA Tax Administration Act. The provision should include the following:
In the instance of a taxpayer that consulted with a taxpayer representative, no penalty will be levied in the following instance:

- All information was disclosed to the taxpayer representative;
- The taxpayer representative made a false or misleading statement; and
- The false or misleading statement did not cause gross negligence or intentional tax evasion.

In terms of section 222(1) of the Tax Administration Act, the understatement penalty will not be levied if the understatement was because of a bona fide inadvertent error. A bona fide inadvertent error is not defined in the Tax Administration Act.

The recommendation is that bona-fide inadvertent error is defined in the act.

The interpretation of a bona-fide inadvertent error as per the Draft Memorandum on the objects of the Tax Administration Laws Amendment Bill (2013) should be utilised in drafting the definition as discussed in detail in Chapter 2.

Chapter 7 – Conclusion.

1.1 Introduction

A comparative study was done by comparing understatement penalties levied in South Africa with similar penalties that are levied in the United Kingdom, Australia and the United States of America.

In Chapter 1 the following sub-problems were identified:

- Interpretation of behaviours and conducts used to impose understatement penalties in South Africa
- A comparison was done between the current penalties that are being imposed in South Africa with similar penalties imposed by other countries.
- Possible improvements to the understatement penalties levied in South Africa.

This chapter will give a brief summary of what was found during the research report.

The following was discussed in the research report:

1. Understatement penalties levied in South Africa.
2. Understatement penalties levied in Australia.
3. Understatement penalties levied in United States of America.
4. Understatement penalties levied in United Kingdom.
5. Comparison of penalties levied in Australia, United Kingdom and United States of America with penalties levied in South Africa and possible improvements to penalties levied by South Africa.

1.3 Understatement penalties levied in South Africa

In chapter 2 the following was discussed:

- Substantial understatement.
- Reasonable care not taken in completing a return.
- No reasonable grounds for ‘tax position’ taken.
- Gross Negligence.
- Intentional tax evasion.

- Conducts not defined in the Act.
- Situations in which understatement penalties will not be levied or will be reduced.

It was found that the SA Tax Administration Act lacks definitions and interpretation in the event that understatement penalties are levied. Interpretation of behaviours and conducts that are used to levy understatement penalties was discussed by utilising articles from tax commentators, cases and the SARS Short Tax Administration Guide.

1.4 Understatement penalties levied in Australia

In chapter 3 the penalties levied by Australia and the remittance thereof was discussed:

- failure to take reasonable care.
- recklessness.
- intentional disregard.
- circumstances in which administrative penalties will not be levied or be reduced.

It was found in the research that similar penalties in South Africa are levied by Australia, but the naming of the penalties differs. The Australia penalties however are interpreted by a MT2008/1 ruling and practice statement issued by the Australian Commissioner. Further cases and articles that relates to penalties was also utilised to interpret the penalties levied by the Australian tax authority.

1.5 Understatement penalties levied in the United States of America

In chapter 4 the following was discussed:

- Negligence or disregard of rules or regulations.
- Any substantial understatement of income tax.
- Any substantial valuation misstatement under chapter 1.
- Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.).
- Circumstances in which administrative penalties will not be levied or be reduced.

It was found in the research that the penalties of South Africa differs from the penalties levied by the United States of America. Similar penalties levied by the United States of America are those of negligence and substantial understatement. It was also noticed that section 6662 of Internal Revenue Code gives guidance on the penalties levied by the United States of America. Cases and articles were also utilised in order to obtain an interpretation of the penalties levied in the United States of America.

1.6 Understatement penalties levied in United Kingdom

In chapter 5 the following was discussed:

Penalties are levied in three situations namely in terms of the schedule 24 of the Finance Act, 2007:

- Error in taxpayer's document ;
- Error in taxpayer's document attributable to another person;
- Under-assessment by HMRC.

There are then certain situations that should be presented for a penalty to be levied. The culpability of the taxpayer is then taken into account when the penalty is levied and the penalties are divided into three categories that is stated in schedule 24 of the Finance Act. The penalties levied by the United Kingdom are totally different from the penalties that are levied by South Africa. It is the opinion of the researcher that the penalties levied by United Kingdom are very complex in comparison with penalties levied by South Africa. It was also noticed that schedule 24 of the Finance Act gives guidance on the penalties levied by the United Kingdom.

1.7 Comparison of penalties levied in Australia, the United Kingdom and the United States of America with penalties levied in South Africa and possible improvements to the penalties levied by South Africa

In chapter 6 the penalties levied by Australia, the United Kingdom and the United States of America were compared with penalties levied in South Africa.

It was noted that the penalties in some instances are the same as those in South Africa and more guidance is given by Australia, the United Kingdom and the United States of America in the event that a penalty is levied. This guidance aids taxpayers and the applicable tax authority to understand what penalties are levied in different circumstances. To give guidance to taxpayers regarding how the penalties levied work can enhance compliance. The officials of the tax authority will benefit from the guidance as the correct penalty will be levied in the appropriate circumstances and could reduce objections regarding penalties levied. Possible improvements that can be made to the penalties levied in South Africa were discussed.

The following improvements to the penalties levied by South Africa were summarised below:

- Substantial understatement - to make different thresholds for corporations and individuals.

- Reasonable care not taken in completing return - The MT2008/1 ruling of Australia can be used as a source to define reasonable care in South Africa.
- Gross negligence - The MT2008/1 ruling of Australia can be used as a source to define gross negligence in South Africa.
- Intentional tax evasion - The MT2008/1 ruling of Australia can be used as a source to define gross intentional tax evasion in South Africa.
- Obstructive taxpayer – to be defined in the SA Tax Administration Act.
- Bona-fide error – to be defined in the SA Tax Administration Act.
- No reasonable grounds for tax position taken - additional interpretation of the behaviour by using the substantial authority and reasonable cause terminology of the United States of America.
- Additional penalty to be introduced namely substantial valuation misstatement that can be levied in incorrect valuation of base cost in capital gains tax and incorrect valuation for transfer pricing.
- Extending the circumstances in which penalties are reduced or remitted by using prompted or unprompted disclosure terminology of the United Kingdom. In the instances in which the taxpayer consulted with a taxpayer representative, no penalty will be levied if all the information was disclosed to the taxpayer representative, the taxpayer representative made a false or misleading statement and the false or misleading statement did not cause gross negligence or intentional tax evasion as done by Australia.

Overall Conclusion

It was found that in comparison with the countries discussed in the research report, that penalties levied by Australia, the United Kingdom and the United States of America detailed guidance is given of how these penalties are levied and it what circumstances penalties can be remitted or reduced. It was therefore found in the research that improvements can be made to the penalties levied currently in South Africa. These improvements can be included within section 221 to section 223 of the SA Tax Administration Act or alternatively as part of a schedule to the Act.

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