

**GENERALLY RECOGNISED ACCOUNTING PRACTICE: A CRITICAL
EVALUATION OF THE IMPACT OF GRAP 23 ON ADMINISTRATIVE TAX
LEGISLATION AND RECOMMENDATIONS**

Mini dissertation by

G.J. De Vos
(97237109)

Submitted in partial fulfilment of the requirements for the degree

MAGISTER COMMERCII (TAXATION)

in the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES

at the

UNIVERSITY OF PRETORIA

Supervisor: Prof M Cronje

April 2009

ABSTRACT

GENERALLY RECOGNISED ACCOUNTING PRACTICE: A CRITICAL EVALUATION OF THE IMPACT OF GRAP 23 ON ADMINISTRATIVE TAX LEGISLATION AND RECOMMENDATIONS

by

G.J. De Vos

SUPERVISOR: PROF M CRONJE

DEPARTMENT: TAXATION

DEGREE: MAGISTER COMMERCII

The application of accrual accounting principles is a challenge for public sectors internationally and increases the level of transparency and accountability of management. Taxation authorities are governed by legislation and have to be supported by a sound legislative framework to enable effective administration of taxes and the proper application of the accrual accounting principles. The recent issuing of the accounting standard for taxes and developments relating to the subsequent measurement of tax receivables highlights the ineffectiveness of current administrative tax legislation relating to penalties and interest which does not allow SARS to effectively apply accrual accounting principles. The receipt of taxpayer returns and payments as required by legislation are critical in order to allow the recording of taxes owed in the financial records of SARS. These taxpayer actions can only be effectively influenced by an effective penalty regime. Similarly, the current interest regimes on tax receivables and payables need to be adjusted in order to allow efficiencies and be comparative to market rates and calculation methods. International comparisons of penalty and interest regimes did not indicate a specific standard regime that should be applied, but the United Kingdom identified sound design principles for penalty and interest regimes. A simple standardised penalty and interest regime for all taxes administered by SARS is recommended which meets the identified design principles and supports the accrual accounting principles. The move to accrual accounting is an additional driver for administrative legislative reform which supports the effective management of taxation authorities.

OPSOMMING

ALGEMENE ERKENDE REKENINGKUNDIGE PRAKTYK: 'N KRITIESE ONDERSOEK NA DIE IMPAK VAN GRAP 23 OP ADMINISTRATIEWE BELASTINGWETGEWING EN AANBEVELINGS

deur

G.J. De Vos

STUDIE LEIER: PROF M CRONJE

DEPARTEMENT: BELASTING

GRAAD: MAGISTER COMMERCII

Die toepassing van die toevallingsbasis van rekeningkunde is 'n internasionale uitdaging vir die openbare sektor en vereis verhoogde vlakke van deursigtigheid en verantwoordelikheid deur bestuur. Belastingowerhede word deur wetgewing beheer en moet daarom ondersteun word deur weldeurdagte wetgewing wat effektiewe administrasie van belastings en die toepassing van die toevallingsbasis van rekeningkunde toelaat. Die onlangse uitgawe van die rekeningkundige standaard insake belastingtransaksies en die ontwikkelings op die gebied van die waardasie van belastingdebiteure beklemtoon die oneffektiwiteit in die huidige administratiewe belastingwetgewing ten opsigte van boetes en rentes, wat nie die effektiewe toepassing van die toevallingsbasis van rekeningkunde deur SARS toelaat nie. Die ontvangs van belastingpligtiges se opgawes en betalings soos deur die wet vereis is belangrik vir SARS om die verskuldigde belastings te boek te stel. Hierdie handeling van belastingpligtiges kan slegs effektief beïnvloed word deur effektiewe wetgewing ten opsigte van boetes. Wetgewing ten opsigte van rente op belastingdebiteure en belastingkrediteure vereis ook verandering om meer effektief te kan wees deur markverwante rentekoerse en berekeningsmetodes te vereis. Internasionale vergelykings van wetgewing ten opsigte van boetes en rente het geen standaard opgelewer nie, maar die Verenigde Koninkryk het die fundamentele beginsels waaraan wetgewing ten opsigte van boetes en rente moet voldoen geïdentifiseer. Eenvoudige wetgewing ten opsigte van boetes en rente wat op al die belastings wat deur SARS geadministreer word van toepassing sal wees, is aanbeveel. Die verandering na die toevallingsbasis van rekeningkunde dien as 'n addisionele motivering vir die verandering

van administratiewe wetgewing sodat die effektiewe bestuur van belastingowerhede
ondersteun word.

TABLE OF CONTENTS

| | |
|--|----|
| CHAPTER 1 | 3 |
| BACKGROUND AND PROBLEM STATEMENT | 3 |
| 1.1 BACKGROUND..... | 3 |
| 1.2 PROBLEM STATEMENT | 5 |
| 1.3 RESEARCH OBJECTIVES | 5 |
| 1.4 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY | 5 |
| 1.5 DELIMITATIONS | 6 |
| 1.6 DEFINITION OF KEY TERMS | 6 |
| 1.7 LITERATURE REVIEW..... | 8 |
| 1.8 RESEARCH DESIGN AND METHODS | 9 |
| 1.9 CONCLUSION | 9 |
| CHAPTER 2 | 10 |
| CONCEPTUALISING AND APPLICATION OF ACCRUAL ACCOUNTING IN THE PUBLIC SECTOR | 10 |
| 2.1 INTRODUCTION | 10 |
| 2.2 THE CURRENT SOUTH AFRICAN PUBLIC SECTOR ACCOUNTING SCENE | 11 |
| 2.2.1 Background | 11 |
| 2.2.2 Application of GRAP | 12 |
| 2.2.3 Should an accounting standard dictate taxation legislation? | 18 |
| 2.2.4 Conceptualising the impact of accrual accounting to support administrative tax legislation reform | 19 |
| 2.3 INTERNATIONAL LESSONS LEARNT ABOUT ACCRUAL ACCOUNTING IN THE PUBLIC SECTOR | 20 |
| 2.4 THE STATUS OF THE SOUTH AFRICAN PUBLIC SECTOR | 21 |
| 2.5 CONCLUSION | 21 |
| CHAPTER 3 | 23 |
| ADMINISTRATIVE TAX LEGISLATION REFORM TO SUPPORT GRAP | 23 |
| 3.1 INTRODUCTION..... | 23 |
| 3.2 PENALTIES AND INTEREST REGIME REFORM IN SOUTH AFRICA..... | 25 |
| 3.3 INTERNATIONAL COMPARISONS OF PENALTIES AND INTEREST REGIMES..... | 28 |
| 3.3.1 United Kingdom..... | 28 |
| 3.3.2 Australia | 39 |
| 3.3.3 Canada..... | 40 |

| | | |
|--|---|----|
| 3.3.4 | Ireland | 40 |
| 3.3.5 | New Zealand | 41 |
| 3.3.6 | United States..... | 41 |
| 3.4 | CONCLUSION | 42 |
| CHAPTER 4 | | 44 |
| RECOMMENDATIONS PERTAINING TO PENALTY AND INTEREST LEGISLATION IN SOUTH AFRICA..... | | 44 |
| 4.1 | INTRODUCTION | 44 |
| 4.2 | PROPOSED PENALTY REGIME FOR SOUTH AFRICA..... | 46 |
| 4.3 | PROPOSED INTEREST REGIME REFORM FOR SOUTH AFRICA..... | 51 |
| 4.4 | CONCLUSION | 53 |
| CHAPTER 5 | | 56 |
| FINAL CONCLUSIONS AND RECOMMENDATIONS..... | | 56 |
| 5.1 | INTRODUCTION..... | 56 |
| 5.2 | THE APPLICATION OF GRAP 23 AND THE SUBSEQUENT MEASUREMENT OF TAX RECEIVABLES AND PAYABLES BY SARS | 56 |
| 5.3 | GUIDELINES FROM INTERNATIONAL TAX REFORM PROCESSES AND EXISTING LOCAL LEGISLATION RELATING TO INTEREST AND PENALTIES..... | 58 |
| 5.4 | CONCLUSIONS AND RECOMMENDATIONS OF LEGISLATIVE REFORM TO MEET ACCOUNTING AND LEGISLATIVE GOALS..... | 62 |
| CHAPTER 6 | | 65 |
| SUMMARY | | 65 |
| 6.1 | INTRODUCTION AND PROBLEM STATEMENT | 65 |
| 6.2 | THE RESEARCH OBJECTIVES AND FINDINGS | 65 |
| 6.3 | FINAL CONCLUSION | 67 |
| LIST OF REFERENCES..... | | 68 |

LIST OF FIGURES

| | |
|--|----|
| Figure 1: The proposed penalty regime decision tree..... | 50 |
|--|----|

CHAPTER 1

BACKGROUND AND PROBLEM STATEMENT

1.1 BACKGROUND

The general international government and South African public sector drive towards transparency and accountability has resulted in the move towards accrual accounting based financial reporting frameworks necessary for effective and efficient management of government (Public Sector Committee – IFAC, 1996:1-4; Van der Hoek, 2005:33,41).

In South Africa, the Public Finance Management Act, 1 of 1999 (PFMA), introduced the initiation of a similar process to adhere to international trends and reporting requirements. The South African Accounting Standards Board (ASB) was created by the PFMA and tasked to define accrual accounting standards for the local public sector. These generally recognised accounting practice (GRAP) standards are based on accrual accounting principles and require a high level of administrative efficiency in order to ensure that financial statements and annual reports are an accurate reflection of a public sector entity or department's financial position. (www.asb.co.za, Not dated.)

The last 5 years have seen the issue of a new international accounting standard by the International Federation of Accountants (IFAC) for the treatment of taxation by taxation authorities and agencies. The international standard underwent a process of 'Invitation to Comment', whereby international stakeholders including the South African Accounting Standard Board (ASB) and relevant local stakeholders provided comments on the proposed accounting standard.

In February 2008 the ASB adopted the international standard with minor changes as the standard on Revenue from Non-exchange transactions (Taxes and Transfers) (GRAP 23). The accounting standard requires SARS to record taxes based on accrual accounting principles through the application of specific recognition criteria. The accounting standard attempts to ensure that a taxation authority can prepare financial reports that reflect the true financial position of the authority at any given time. The revenue recognition rules are therefore based on academic principles that should effectively ensure that financial reports

of taxation authorities are not only a true reflection of the financial results and position of the authority, but also enable comparative analysis between the taxation authorities world wide. The accounting standard changes the manner of recognition of tax transactions for accounting purposes. (ASB, 2008:19-22.) The effect thereof will ultimately have an impact on the taxpayer account and can be seen as an additional driver behind administrative tax legislation reform within the management of taxes by taxation authorities.

The application of accrual accounting principles by taxation authorities poses a number of challenges, since it has been designed to function within the private sector and taxation transactions are in principle far removed from general private sector transactions. This is supported by the fact that a specific accounting standard (GRAP 23) was developed in order to provide rules for the accounting of tax transactions. The application of accrual accounting within the taxation highlights certain specific challenges within the administration of taxes relating to the identification, valuation and timely recording of taxation transactions. (ASB, 2008:19-22.)

These challenges are directly linked to the availability of information from taxpayers relating to the existence of taxable events. Taxation authorities need to ensure that information (returns and declarations) are received and processed timeously as required by taxation legislation and that existing tax liabilities are accurately valued. A high level of compliance is therefore required in order to increase the administrative effectiveness required by accrual accounting principles.

This study focuses only on the critical evaluation of the impact of GRAP 23 on administrative taxation reform required within the compliance domain (interest and penalties), in order for SARS to apply the standard effectively and efficiently.

1.2 PROBLEM STATEMENT

Administrative tax legislation in regard to interest and penalties does not allow SARS to effectively apply GRAP 23 and the accurate valuation of recorded tax receivables and payables. The various tax legislation managed by SARS are furthermore ineffective, complex and too fragmented to ensure consistent high levels of taxpayer compliance, which reduces the ability of SARS to effectively and efficiently manage taxes and apply accrual accounting principles.

1.3 RESEARCH OBJECTIVES

The study was guided by the following objectives:

- evaluate and explain the concept and application of GRAP 23 within a taxation authority and the subsequent measurement of tax receivables and payables;
- identify and evaluate international tax reform processes and existing administrative tax legislation relating to interest and penalties as guideline for recommendations; and
- recommend changes to present tax legislation in regard to interest and penalties that will enable the effective application of GRAP 23 and the accurate valuation of recorded tax receivables and payables, reduce complexities in legislation and allow SARS to effectively and efficiently manage taxes.

1.4 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

This study makes a valuable contribution to the taxation authority tax reform initiatives through the critical evaluation of the impact of accounting standards within the realm of tax authorities. GRAP 23 directly reflects the principles within IPSAS 23, which will be utilised as an international accounting standard. The application challenges of an accounting standard based on accrual accounting principles and legislative tax reform proposals in the areas of interest and penalties to enable the application of GRAP 23 principles and accurate valuation of tax receivables and payables, will be a valuable addition to public

sector accounting and related tax reform. Furthermore, the study will in principle be of use to other tax authorities and will stimulate thinking around the practical application of IPSAS 23 and the subsequent measurement of tax receivables and payables world wide along with the impact on necessary legislative adjustments for the effective management of taxes.

1.5 DELIMITATIONS

The impact of GRAP 23 on administrative tax legislation is limited to interest and penalties, which directly affect the taxpayer account:

- penalties are limited to late filing of returns and declarations and late payment of tax liabilities. Penalties based on under declaration or other compliance failures are not addressed in this study; and
- interest is limited to interest charged on late payment of tax liabilities and interest earned on overpayment of taxes. Interest is viewed as a manner to recompense the rightful owner of money for the time that monies are held by another party and is not deemed as a punitive measure.

1.6 DEFINITION OF KEY TERMS

This study involves a number of key terms, namely accrual accounting, cash accounting, taxpayer account, non-exchange transactions, administrative tax legislation, taxation reform, subsequent measurement, inflation and time value of money. These terms are defined as follows for purposes of this study:

Accrual accounting is the recording of all financial transactions relevant to a specific financial period of an entity, inclusive of receivables, payables and provisions. A transaction is therefore recorded at the time that the tax liability is created (OECD, 2007:293)

Cash accounting is the recording of financial transactions at the time when the actual payment is received or made. A transaction is therefore recorded at the time that the cash is received in the bank or an expense paid out of the bank. Taxes may therefore be due in

one financial period but only paid in the next period and according to cash accounting recorded only on receipt. Similarly, an overpayment of taxes may be made in one year and the refund paid in the following year and according to cash accounting recorded only in the year of paying the refund. (OECD, 2007:294)

Taxpayer account is the account for a specific tax type administered by SARS.

Non-exchange transactions are transactions that are defined in GRAP 23 as: “an entity receives value from another entity without giving approximately equal value in exchange” i.e. taxes are paid to SARS without receiving an equal value in exchange

Administrative tax legislation relates directly to the ability of a tax authority to manage a taxpayer’s account and ensure all returns and declarations are recorded as required, payments processed and interest calculated on tax liabilities or refund situations.

Taxation reform is the initiatives of taxation authorities to address specific needs through additional tax legislation or simplification and standardisation of current legislation.

Subsequent measurement is the valuation of existing tax receivables and payables administered by SARS, which are recorded in taxpayer accounts.

Inflation is the continues increase of consumer prices over time or continues decline in purchasing power of money, due to the increase of demand over supply (Answers.com, Not dated b).

Simple interest is the interest that is calculated by using the interest rate per annum applied on the capital amount only and not on the interest (Answers.com, Not dated c).

Compounded interest is the interest calculated that is calculated by using the interest rate per annum applied on the capital amount and also the accumulated interest on the capital amount (Answers.com, Not dated a).

The following abbreviations are used in this document:

Table 1: Abbreviations used in this document

| Abbreviation | Meaning |
|---------------------|--|
| ASB | Accounting Standards Board |
| ATO | Australian Taxation Office |
| DP | Discussion Paper |
| CPI | Consumer Price Index |
| GAAP | Generally accepted accounting practice |
| GRAP | Generally recognised accounting practice |
| HMRC | Her Majesties Revenue and Customs |
| IAS | International accounting standard |
| IFAC | International Federation of Accountants |
| IPSAS | International public sector accounting standard |
| IPSASB | International public sector accounting standards board |
| OECD | Organisation for Economic Co-operation and Development |
| PSC | Public Sector Committee of IFAC |
| SARS | South African Revenue Service |

1.7 LITERATURE REVIEW

Relevant literature on the topics of accrual accounting, legislation, compliance and international comparatives were critically evaluated in order to support conclusions and recommendations. The literature included:

- generally recognised accounting practice standards issued by the Accounting Standards Board on the application of accrual accounting principles for tax authorities and discussion papers issued relating to subsequent valuation of tax receivables and payables. The international accounting standard IPSAS 23 was also reviewed in order to include additional information relating to the allowed transitional period for tax authorities;
- South African taxation legislation, regulations and annual reports issued by SARS;

- available documentation relating to South African public sector accrual accounting issues and experiences and also international experiences documented by the International Federation of Accountants; and
- international documentation and information relating to taxation authorities and compliance issued by the Australian Tax Office, Her Majesty's Revenue and Customs and the Organisation for Economic Co-operation and Development.

1.8 RESEARCH DESIGN AND METHODS

A critical evaluation as a conceptual research method based on a review of available literature was followed. The study was researched through the reviewing of relevant literature and the application of information gathered on the proposed topic in order to enable supported recommendations of required legislative changes relating to interest and penalties.

1.9 CONCLUSION

The need for reform in administrative areas of penalties and interest in South Africa will enable SARS to effectively and efficiently manage taxpayer accounts through increased levels of taxpayer compliance and the accurate financial valuation of tax receivables and payables. The impact of GRAP and accrual accounting requirements does not really change the responsibility of SARS to manage taxpayer accounts and to be able to report on the true financial position of taxes under administration, but can be seen as an additional driver to enable administrative tax legislation reform to be implemented.

CHAPTER 2

CONCEPTUALISING AND APPLICATION OF ACCRUAL ACCOUNTING IN THE PUBLIC SECTOR

2.1 INTRODUCTION

IFAC initiated the necessity for an accounting standard in respect of non-exchange transactions relating to taxes and transfers. The international standard on Revenue from Non-exchange Transactions (Taxes and Transfers) (IPSAS 23) was issued in December 2006 and has a 5 year transition period for taxation authorities with financial periods beginning on or after 30 June 2008 (IFAC, 2006:31). The issue of the standard placed a renewed emphasis on the ability of taxation authorities to apply accrual accounting principles.

The lengthy transition period clearly indicates that the standard and the application are not expected to be straight forward. The global move towards modernising and aligning of public sector accounting standards which are based on accrual accounting principles is relatively new and numerous countries are still applying the cash basis of accounting within the public sector. This is supported by Van der Hoek's (2005:33) findings that governments traditionally employed cash based accounting systems as well as the OECD's Revenue Statistics 1965-2006 (2007:293) where it was found that data from earlier years were predominantly based on cash accounting and more recent data were based on accrual accounting. A transition from a cash basis to an accrual basis requires a number of internal controls and system changes to be implemented.

The 5 year transition period allowed by IPSAS 23 takes the following into consideration (IPSASB, 2006:27-30):

- the disclosure of the classes of revenue which are recognised in accordance to the standard in the financial statements;

- the disclosure of classes of revenue not recognised in accordance with the standard and the entity's progress towards full compliance in the financial statements; and
- the development of detailed models for the measurement of non-exchange revenue, where necessary.

The complexity of applying such an accounting standard is only completely understood when the principles are applied in practice. Taxation authorities rely on legislation to provide a sound framework to enable the effective administration of taxes. Accrual accounting requires a much higher level of effectiveness than required in a cash accounting environment and therefore needs to be supported by the legislative framework.

2.2 THE CURRENT SOUTH AFRICAN PUBLIC SECTOR ACCOUNTING SCENE

2.2.1 Background

The ASB is tasked to define generally recognised accounting standards for all aspects of the South African public sector and has strict deadlines for finalising the required standards. IFAC as the international leader in standard setting for the public sector is therefore used as the main provider of input into the local public sector standards. The ASB works closely with IFAC in the drafting of public sector accounting standards, which enables the ASB to adopt IFAC standards with little or no changes for South African specific circumstances.

GRAP 23 adopted the key principles set out in IPSAS 23 and focussed on the initial recognition of non-exchange transactions. The ASB identified that the subsequent measurement of non-exchange transactions was specifically not addressed in an accounting standard. Because the subsequent measurement of receivables and payables is currently classified as financial instruments, the application of the IAS 32 and IAS 39 were reviewed by the ASB for application to the subsequent measurement of non-exchange transactions (ASB, 2007b:11). Since no international financial instrument accounting standard presently exists for the public sector the subsequent measurement of financial instruments i.e. tax debtors and tax creditors was investigated by the ASB and a discussion paper (Discussion Paper 3) was issued in September 2007 in order to invite comments on the proposed methods of the subsequent measurement of financial instruments within the

public sector. Since the issue of Discussion Paper 3, the ASB has convinced IFAC for the need of a financial instruments accounting standard for the public sector. IFAC has placed such a standard on their delivery schedule and the ASB will participate in the drafting of the international standard. Discussion Paper 3, comments received and the ASB's research to date will be valuable input into the ultimate formulation of this standard.

The issues identified in by the ASB in Discussion Paper 3 relate mostly to the limited application of IAS39 within the public sector and more specifically to the manner of classification and valuation method of certain financial instruments.

2.2.2 Application of GRAP

Generally Recognised Accounting Practice (GRAP) is mostly based on Generally Accepted Accounting Practice (GAAP) therefore accrual accounting principles are used as the basis of recognition and measurement of all financial transactions or transactions with a financial influence. GAAP has in the recent past been defined within the international accounting standards and the term therefore refers to accounting standards with the prefix IAS (International Accounting Standard).

2.2.2.1 The requirements of GRAP 23

GRAP 23 defines the accounting guidelines for when tax revenues should be recorded in the financial records of the collection agency. In order to record the tax transaction, certain criteria have to be met. The criteria are referred to as the recognition requirements. Basic accounting principles require the principle of double entry to apply; this entails that for each debit transaction a corresponding credit transaction will be recorded in the financial records. In the event where the cash basis of accounting is applied, the debit transaction will be recorded on the receipt of cash in the bank and the corresponding credit transaction is recorded in tax revenue. GRAP 23, however is based on the accrual basis of accounting and therefore would record a debit on the recording of a tax return on the taxpayer account and a corresponding credit in tax revenue, the transaction is therefore not linked to the actual receipt of the cash. In this accrual accounting example, the debit leg of the transaction creates an asset in the form of a tax receivable and the credit leg represents tax revenue generated.

This highlights the importance of the requirement for recognition of taxes, which determines the point in time when taxes can be recorded in the financial records. The recognition requirements according to GRAP 23, relate to the ability to indicate that tax revenues are owed to government and that the receivable created in the financial records will be collectable. In order to recognise a tax transaction in the financial records, the following criteria are to be satisfied:

- the occurrence of a taxable event. This is an event is defined in GRAP 23 as the event that government, legislature or other authority has determined to be subject to taxation (ASB, 2008:7); and
- the recording of an asset is allowed. GRAP 23 requires that an asset will only be recorded where it is probable that the asset will be collectable (lead to an inflow of future economic benefits i.e. cash receipts) and the value can be reliably measured in order to record the transaction in the financial records (ASB, 2008:14,19).

Taxes are in essence an inflow of cash to government and therefore should seldom translate into a liability other than where overpayments of taxes were made by the taxpayer. Revenue from non-exchange transactions are recognised to the extent that an asset was recognised, except to the extent that a liability is also recognised in respect of the same inflow. (ASB, 2008:19-22.)

The taxable event in South Africa is determined by taxation laws to be either the earning of taxable income during a tax period, the undertaking of taxable activities, the movement of dutiable goods across customs boundaries or any other taxable activity defined in taxation legislation. The identification of a taxable event (or numerous taxable events for a legislated tax period) by SARS in most instances is only recorded on the receipt of a return or declaration from the taxpayer by SARS. (ASB, 2008:19-22.)

The measurement of assets is based on fair value on the date of acquisition (ASB, 2008:16). In most instances there is a separation between the timing of taxable events and the collection of the taxes. It is proposed that statistical models may be developed to record tax revenues and assets whilst taking into consideration the timing of taxable events, filing of returns and declarations as well as other economic factors impacting on taxation revenues. The models may take into account the following:

- taxation law requirements, which allow a time difference between the taxable event and the declaration of the taxes to the taxation authority;
- complexities in tax legislation requiring extended periods for assessing taxes i.e. taxation law allows the netting of taxable events over a certain time period as allowed in VAT legislation where input and output VAT are netted off during the month for which a return must be submitted to SARS;
- taxpayers failure to file returns and declarations as required by law;
- valuing non-monetary assets for tax assessment purposes;
- benefits of rigorous enforcement of tax legislation to government may be outweighed by the financial or political costs;
- taxation laws permitting taxpayers to defer payment of some taxes; and
- a variety of circumstances required by tax legislation or jurisdictions.

(ASB, 2008:19-22.)

These models are not expected to be accurate to the point where the actual tax revenues determined in subsequent periods need no adjustment. It is therefore emphasised in the standard that the requirement to reliably measure assets can only be met some time after the taxable event occurs (ASB, 2008:21-22). In some instances the recognition criteria will only be satisfied when the payment is received. The standard provides for specific examples per tax type which are deemed to allow reliable measurement and can be summarised as:

- the submission of a tax return or declaration; and/or
- the receipt of payment by the taxpayer or liable party.

(ASB, 2008:19-22.)

The ability to reliably measure the tax amount due to the taxation authority is therefore in most instances based on the availability of information provided mainly by the taxpayer. In the absence of information from the taxpayer, actual amounts paid by the taxpayer will be viewed as a method for reliable measurement. (ASB, 2008:19-22.)

The importance of receiving returns and declarations as determined in taxation legislation from taxpayers is therefore a key requirement to apply GRAP 23 effectively. The timely

receipt of taxpayer returns, declarations and payments are compliance issues and need to be dealt with within the areas in taxation legislation where provisions are made to ensure compliance.

The 5 year transition period as determined in IPSAS 23 is effective for taxation authorities with financial periods beginning on or after 30 June 2008 (IFAC, 2006:31). The international community has not formally accepted the application, but numerous taxation authorities have embarked on a general move from a cash accounting basis to an accrual accounting basis. GRAP 23 (ASB, 2008:30) determines that the effective date is to be determined by the Minister of Finance in a regulation and that transitional provisions will be prescribed in directives. It is assumed that the IPSAS 23 guidelines will be followed locally and adjusted in order to allow the local public sector to comply within a reasonable timeframe. Exposure Draft 57 was issued by the ASB in March 2009, where the proposed transition provisions for SARS are detailed. SARS has already received approval by the Minister of Finance to apply the cash basis of accounting until 2012 according to the SARS Annual Report 2007-2008 (2008:104). It is therefore expected to require full application of GRAP 23 after this approval lapses.

2.2.2.2 The requirements of financial instruments per Discussion Paper 3 and IAS 39 in relation to taxation legislation

The key items within the area of financial instruments and non-exchange transactions relate to the subsequent measurement of tax receivables and payables. The subsequent measurement of an asset or liability determines the method by which the accounting value is determined.

Discussion Paper 3 (ASB, 2007) in essence debates all the possible methods of making IAS 39 principles relevant for public sector. The main decisions are within the categorisation and definition areas in order to include non-exchange transactions, which are not based on contractual arrangements requiring consent by both parties. The initial measurement of non-exchange transactions need to be retained in GRAP 23 and not repeated in a standard for financial instruments, but the actual subsequent measurement method should be determined in the financial instrument standard. The subsequent

measurement methods of IAS 39 will basically apply to assets and liabilities that arose from taxes.

Although the new standard will be issued only in the future, the principles in IAS 39 are deemed to already be relevant and will not be changed for non-exchange transactions. IAS 39 requires that financial instruments be valued in such a manner that the recorded value reflects the theoretical accounting value of an asset at a specific point in time (IASB, 2006). This implies that a tax debtor, as an amount determined in Rand, should reflect the value of the asset as calculated at its amortised net present value utilising a market related interest rate (IASB, 2006). The value of the debtor will therefore reflect the true worth thereof on a given reporting date, taking the period in which it will be paid, interest accruing on the amount as well as market related interest on such a debt, into account. This principle is also referred to as the effect of time value of money.

An example to explain the effect of time value of money:

An amount of R100 is owed by Mr A, simple interest of 5% per annum is levied on the amount and a market related simple interest of 10% on similar debts is charged. Repayment must be done in 12 months.

Repayment will result in the receipt of R105 (R100 capital and R5 interest), in the instance where a market related interest rate was used the repayment would have totalled R110 (R100 capital and R10 interest). It is therefore clear that due to the usage of an interest rate below the market related interest rates effectively reduced the total value of the repayment.

The R100 is therefore discounted to reflect the actual net present value of such a debt. The fact that 5% interest is charged, whilst 10% is an acceptable market related rate will have the effect that the buying power of R100 in 12 months time will effectively reduce. The net present value of the debt is therefore only R95, which has to be reflected in the financial statements as the true value of the debt.

In the instance where the debt was accruing interest equal to the market related rate of 10% per annum, the net present value of the debt would have been R100. This would therefore ensure that the buying power of the debt does not reduce over time.

The application of the subsequent measurement in the taxation environment is mainly affected by the interest rate used by the taxation authority as well as the method of calculation of the interest. The simple example above utilised simple interest only, commercial practice is to apply compounded interest on amounts outstanding. The difference in value between compounded interest and simple interest will result in an even greater difference in value.

In taxation legislation in South Africa different rates in calculating interest on different taxes are used, whilst applying simple interest. For example the calculation of simple interest defined in terms of section 89(2) of the Income Tax Act (58 of 1962), determines that interest is calculated on the outstanding balance of tax only. The disparate manner of calculating interest on different rates reduce administrative effectiveness, while the method of calculating the interest is not market related and therefore reduces the actual value of outstanding taxes.

The importance of calculating interest based on both market related interest and method of calculation is a key requirement within an accrual accounting reporting environment. The subsequent measurement of tax receivables, attracting simple interest and at a interest rate which is below a comparable market rate, will require a net present value calculation utilising compounded interest and a market rate. The effect of the calculation will display that the tax receivable true accounting value is lower than the value currently recorded in the financial records. The value in the financial records will therefore have to be adjusted to reflect the true accounting value. The taxes receivables by taxation authorities have extremely high values and therefore even a small difference between the legislated interest rate and calculation method to a comparative market related interest rate and calculation method will effectively require a large adjustment of the tax receivables value in the financial records when the required subsequent measurement calculation is performed. This adjustment is expected to be of such a high value, that the financial statements will be materially misstated for auditing purposes and an adjustment in the financial records will be required. In order to avoid the necessity to continuously restate tax receivables:

- the legislated interest rate has to reflect market related i.e. prime lending rate; and

- the legislated calculation method has to be similar to the calculation method used in the market, being the compounded interest calculation method.

The interest regime in South African taxation legislation will therefore require reform in order to ensure that the tax receivables effectively retain their buying power. The same principle will apply in the instance of fixed penalties, which should allow for annual inflationary increases in order to retain its relevance in comparison to the South African economy.

The subsequent measurement of taxation debts will also be impacted by the impairment of the asset. Impairment is the reduction of an asset value due to specific identified events or circumstances (IASB, 2006). This means in simple terms, that debts become uncollectible or partially uncollectible. The value of the asset has to be reduced to display the actual value that will still meet the recognition criteria of an asset. An example of such an impairment event is when a tax debtor is liquidated and chances of recovery is low, the debt will need to be reduced to display the actual expected value which will be recovered. The taxation environment is of such a nature that amounts written off can always be reinstated at a later date. Impairment testing is an added complexity of accrual accounting, but will not be investigated in this study.

2.2.3 Should an accounting standard dictate taxation legislation?

Effective management of taxpayer accounts can only be achieved in an accrual accounting environment since cash accounting does not require the retention of receivables or payables (At this point SARS is not required to have audited receivable and payables included in the annual report (SARS, 2008b:144-146)). Therefore, it follows that the proposed accounting standard will allow transparency for the areas within a taxation authority, which are not being managed effectively. An example of such a situation will be displayed in a taxpayer's account where the taxpayer has not filed his return on the required legislated date and the taxation authority does not have the means to identify the failure to comply and remedy the failure through the raising of an estimated assessment within a short timeframe. Until such time as the estimated assessment is raised or the taxpayer is contacted through a costly process and informed that a legal process will be implemented in

order to ensure compliance to file his return and the return is then filed, the taxpayer's account will be either understated or overstated (HMRC, 2008d:8). Taxation authorities manage large numbers of taxpayers for a variety of different tax types, each requiring specific declarations or returns and filing dates, which impact financial reporting directly. Most taxation authorities have the power to estimate assessments, but due to the fact that manual intervention is required it is costly and time consuming.

The subsequent measurement based on accrual accounting requirements will require material restatement of taxation receivables and payables where legislated interest rates and calculation methods are not comparable to those utilised in the market. The restatement will in essence communicate a negative message to citizens, since non-compliant taxpayers appear to be advantaged through low interest rates and outdated calculation methods applied per legislation.

The implementation of accrual accounting will increase the level of accountability and transparency within the management of a taxation authority and display inefficiencies to all readers of financial statements and annual reports (Public Sector Committee – IFAC, 1996). The application of accrual accounting can therefore be seen as a positive move for any government. The transitional period that is expected to be allowed for taxation authorities will provide sufficient time to adjust and align taxation legislation to support the application of accrual accounting.

2.2.4 Conceptualising the impact of accrual accounting to support administrative tax legislation reform

This study displays the impact of accrual accounting requirements (GRAP) as an additional motivation for an effective penalty regime and interest regime, which will ensure increased taxpayer compliance in the most cost effective manner (HMRC, 2008d:8). The administrative legislation reform relating to penalties and interest required are applicable to all taxes administered by SARS and should therefore be standardised across tax types.

2.3 INTERNATIONAL LESSONS LEARNT ABOUT ACCRUAL ACCOUNTING IN THE PUBLIC SECTOR

Countries such as the Netherlands (Van der Hoek, 2005), New Zealand, Canada, Spain, Sweden, the United Kingdom, the United States and Australia have already made significant strides toward government and public sector adoption of accrual accounting principles (Public Sector Committee - IFAC, 2006). Numerous documents on the experiences of these countries attempt to provide a glimpse of the difficulties and challenges that they were confronted with when moving from cash accounting to accrual accounting.

It is however necessary to review some of the lessons, even only to provide additional reasons for South Africa to embrace the advantages of accrual accounting principles.

In the Occasional Paper 1 of the PSC, the experiences of New Zealand in moving to accrual accounting are detailed (IFAC, 1994). The lessons learnt in the process are that the transition is much greater than expected and long term commitment is required from all stakeholders. Accrual accounting provides the ability to enable better decisions to be taken, but requires management's ability to evaluate information provided correctly. IFAC subsequently issued the Occasional Paper 3, Perspectives on Accrual Accounting, wherein the experiences of a number of countries are described (IFAC, 1996). The benefits from the application of accrual accounting are emphasized and the fact that the reporting on the true financial position has led to the identification of previously unknown liabilities and therefore provide the opportunity to improve the management of assets and liabilities. The transparency in reporting on the financial position of government allows for increased public confidence. The accrual accounting basis can however also be to the detriment of public confidence, especially in cases where true financial results continue to display misadministration. The necessity to gain support of legislators is a key requirement for the successful implementation of accrual accounting at government level.

The benefits of accrual accounting is seldom disputed, although proving the actual benefit within an environment based on supporting cash accounting may prove to be difficult.

2.4 THE STATUS OF THE SOUTH AFRICAN PUBLIC SECTOR

South Africa is still in the process of migrating from cash to accrual accounting. According to Maranya (2007:25) many of the GRAP standards will become effective and once applied will advance accounting reform within the public sector. The move to accrual accounting is seen to be an opportunity for accountants in South Africa, since the need for qualified accountants in the public sector is expected to increase. The basis of accounting for government remains mostly 'modified cash' for the 2007/2008 financial period ending 31 March, which requires a margin of accrual accounting principles to be applied (Maranya, 2007:25). Public entities apply GRAP where a relevant standard exists or otherwise revert to the application of SA GAAP, whilst SARS is still allowed to remain on the cash basis (SARS, 2008b:104). SARS therefore does not have audited taxation receivables or payables. Receivables and payables schedules included in the annual financial reports are excluded from the audit performed by the Auditor General. Once GRAP 23 is applied, SARS will have to report on taxes on the accrual accounting basis.

2.5 CONCLUSION

The requirements of accrual accounting are not only a South African challenge, but a challenge for the public sectors internationally. Taxation authorities have to be supported by a sound legislative framework to enable effective administration of taxes through the application of the accrual accounting principles.

The ASB introduced the need for the application of accrual accounting principles by SARS by the formal issuing of the local standard (GRAP 23) in 2007. Additionally the ASB has also initiated the process of defining the subsequent valuation of tax receivables and payables in Discussion Paper 3 (ASB, 2007). The application of GRAP 23 and the subsequent measurement of tax receivables place an additional focus on the ability of SARS to apply the accounting standard within the current legislative environment.

GRAP 23 prescribes the accounting criteria identifying when tax revenues have to be recorded in the financial records of SARS. The criteria relate to the ability to identify tax revenues owed to government and the reliable valuation of the legally collectable tax

receivable. GRAP 23 recognises the practical difficulties of a taxation authority in reliably measuring the value of taxes and confirms that the receipt of taxpayer returns and payments as determined by legislation is a key requirement to the effective application of GRAP 23. The timely receipt of taxpayer returns, declarations and payments are compliance issues and have to be supported by taxation legislation.

Principles applicable for the subsequent measurement of the tax receivables according to Discussion Paper 3 (ASB, 2007) and IAS 39 (IASB, 2006) require that the value of the receivable reflects the true worth thereof on a given financial reporting date. This emphasises the importance of utilising a market related interest rate and method of calculation. The interest regime in South African taxation legislation will require reform in order to align legislated interest rates to be comparable to market related rates and utilise the compounded interest calculation method.

The implementation of accrual accounting will increase the level of accountability and transparency within the management of SARS and display inefficiencies to all readers of financial statements and annual reports (Public Sector Committee – IFAC, 1996). Accrual accounting can therefore be seen as an additional motivation for an effective penalty regime and interest regime, which will ensure increased taxpayer compliance in the most cost effective manner (HMRC, 2008d:8). This legislative reform will increase the ability of SARS to effectively manage taxes and taxpayer accounts and can therefore be seen as a positive move for the South African government.

The effect of non-compliance relating to late filing and late payment of taxes directly impacts SARS' ability to reliably measure taxes owed and an interest regime which is not market related indicates the necessity for change to the penalty and interest regimes.

The local and international scene relating to penalty and interest regimes and reform processes are reviewed and evaluated in the following chapter, confirming that effective application of accrual accounting have to be supported by effective penalty and interest regimes.

CHAPTER 3

ADMINISTRATIVE TAX LEGISLATION REFORM TO SUPPORT GRAP

3.1 INTRODUCTION

In order to effectively manage a taxation authority, the legislation has to provide a basic level of support to ensure that the taxpayer is compliant. The focus in this chapter is placed on the minimum requirements to allow accrual accounting to be effectively implemented and is therefore limited to the areas of penalties on taxpayer failure to file returns as required, penalties on failure to pay tax as required and interest on late payment of tax.

The need for administrative penalties is clearly identified by the South African historic experiences of non-compliance (late filing of returns and late payment of taxes) and SARS recently issued regulation on administrative penalties in terms of section 75B of the Act (SARS, 2008a). This is also supported by international documented trends as dealt with by the OECD in the *Tax Administration in OECD and selected Non-OECD Countries: Comparative Information Series 2006* (2006:94) and the same report for 2004 (2004:60). The OECD reports focuses on 3 areas for penalties and interest, namely

- a penalty for the failure to file returns on time (late filing):
- a penalty and/or interest for the failure to pay tax on time (late payment): and
- a penalty for the failure to correctly report tax liability (under declaration)

Interest payable for the failure to pay tax on time in some instances can be defined as punitive measures, while in other cases interest is payable in order to recompense the taxation authority for receiving payment late (HMRC, 2008a:35). Interest payable is dependant on the method of application of the calculation thereof, as summarised in the OECD reports.

Penalties relating to under declaration are excluded from this study, since taxpayer behaviour relating to under declaration is normally not administrative in nature and can also not be detected within the confines of administering a taxpayer's account.

The rationale for the OECD to only focus on these 3 areas is proof that they define the basic requirements for any taxation authority to allow for the effective management of taxes. It is also a simple penalty regime that is easily understood by taxpayers, whilst in principle applicable to all taxes administered by most taxation authorities. Late filing and payment can easily be identified and levied systematically based on simplistic rules, which allow for cost effective management and reduced manual intervention on taxpayer accounts. Although excluded from this study, it is important to note that under-declaration of income and other subjectively identified transgressions are costly to administer due to the fact that they are mostly manually identified and penalised through a process of identification of the facts and application of the suitable penalty as part of an assessment process.

Although the OECD report is focusses on income tax, the requirements for penalties and interest for non-compliance are deemed to be relevant for all taxes administered by taxation authorities (OECD, 2006:94).

Accrual accounting requires the prompt recording of taxpayer declarations and returns. Although the taxation authority has the power to estimate taxpayer tax obligations where no declaration or return was submitted, the legal requirements for estimation and manual intervention required is time consuming and do not allow for time relevant reports and materially accurate financial reports.

The current legislative reform in SA is reviewed in this study in order to place the focus areas into perspective and allow for comparisons with international trends in these areas along with identified reasons for proposed reform. International trends and principles concentrates on the recent focus by the HMRC in the UK on penalties and interest, since the research and proposals put forward in the UK can be used as a basis for proposed reform in SA. The HMRC has researched numerous identified aspects impacting on the design of an interest regime separate from a penalty regime that will achieve compliance across taxes. The HMRC documents were therefore analysed during this study in order to identify principles and reasons taken into account in an interest and penalty reform process and ensure that proposed principles for administrative legislation reform are in line with international guidelines.

3.2 PENALTIES AND INTEREST REGIME REFORM IN SOUTH AFRICA

The necessity for information from taxpayers in the form of the filing of declarations, returns and payments are paramount in the application of GRAP. In order to meet the GRAP revenue recognition rules, the tax debt has to be reliably measured (valued). This measurement requirement can only be achieved with the lowest level of effort where the taxpayer complies with filing declarations, returns and makes payments as required by legislation. Penalties have to ensure that taxpayer behaviour is effectively influenced to comply with the legislative requirements of filing returns, declarations and making payments. An effective penalty regime will allow SARS to effectively administer taxpayer accounts.

Penalties for the late submission of returns and the late payment of taxes by taxpayers currently differ for the various taxes. The past ineffectiveness of the penalty regime is displayed in the SARS annual report for 2007-2008 (SARS, 2008b:57), where outstanding returns for 2007/2008 for income tax, PAYE and VAT totalled 5,38 million returns. Therefore the penalty regimes for late filing of returns are not effectively impacting the compliance culture of South African taxpayers. Declarations and returns filed on the due dates, as required by legislation, are required in order to cost effectively calculate the taxpayers' tax liability. Estimates performed by a tax authority require costly manual intervention in most instances and can seldom be performed within a reasonable timeframe (HMRC, 2008d:8). An effective penalty regime will therefore be the only cost effective manner to ensure compliance and SARS' ability to meet GRAP requirements for the reliable measurement of a taxpayer's tax liability.

Interest payable on late payment of tax liabilities have to ensure that SARS as the mandated collection and management agency for taxation is recompensed at a market related rate for the time that taxes were unpaid. As previously mentioned, interest rates currently differ for the various taxes as well as the calculation methods and the manner of applying the calculation to the taxpayer's account. Examples of differing interest calculation methods can be found in the Act where:

- interest on outstanding assessed income tax in terms of section 89(2) is calculated for each completed month that outstanding tax amounts are not paid according to the prescribed rate and interest is thus not calculated on penalties and interest. This effectively means that interest is calculated only on the amount of tax outstanding at the end of each month and based on the simple interest calculation method; and
- interest on outstanding employee's tax and provisional tax in terms of section 89bis is calculated from the date that payment was required to the date of payment. This effectively means that interest accrues daily on the simple interest calculation method.

The fact that interest on outstanding taxes, based on distinctions between income tax, employee's tax and provisional tax, is calculated on different methods increases the complexity of administering different taxes (HMRC, 2008a:11). This creates disparate interest amounts calculated where the same tax value is owed to SARS for the same period, based on distinctions in the taxation legislation between income tax, employee's tax and provisional tax owing to SARS. Further differences are found between the other taxation legislation administered by SARS. SARS recently indicated in the 2009 Budget Review (National Treasury, 2009:70) the direction of the future interest regime and stated that a single interest rate for underpayments and overpayments and the compounded interest calculation method will be part of the modernisation of the tax system for accounting purposes. Furthermore, the reference to a single taxpayer account supports a process of standardisation of the interest regime for all taxes administered by SARS. SARS has therefore confirmed that legislative reform is motivated by accounting requirements.

Legislative reform and standardisation is required in order to ensure that GRAP can be applied effectively within the South African environment and also allow SARS to manage taxpayer accounts more cost effectively (HMRC, 2008a:8). Penalties are imposed to ensure that taxpayers provide SARS with the required information and payments on time, whilst a standardised interest regime ensures that SARS (and government) is recompensed at market related rates and calculation methods for delayed payment of all taxes.

There has been a focus on administrative penalties in South Africa in recent years in order to assist SARS' ability to manage taxpayers by increasing taxpayer awareness on compliance requirements. This has led to legislative reform through providing SARS the

ability to raise administrative penalties in terms of section 75B of the Act during 2007. The section allows an administrative regime to be enacted through the issue of a regulation in the Government Gazette. In December 2008 the final regulation was issued and includes numerous instances of non-compliance by taxpayers, which negatively affect SARS' ability to manage its mandate (SARS, 2008a). The final regulation has the following penalty calculation methods:

- fixed value penalties based on the relative size of the taxpayer through the stipulation of penalty categories of penalties as identified by the preceding year of assessment's taxable income and the time of non-compliance is also taken into account since penalties repeat monthly whilst the instance of non-compliance has not been remedied by the taxpayer; and
- penalties based on a 10% percentage of the underlying value relating to the non-compliance relating to employee's tax and provisional tax (this paragraph will only become effective with the specific sections of the Revenue Laws Second Amendment Act of 2008 (which has not become effective at the date of this study)).

Paragraph 2 of the regulation explains that the purpose of the regulation is to ensure taxpayer compliance in order for the effective administration of the tax system and the penalties raised are equitable in relation to the seriousness of the non-compliance (SARS, 2008a:5). The requirement of taxpayers to be compliant in order for the tax authority to effectively manage taxpayers is therefore specifically substantiated in the regulation.

Fixed penalties are listed in paragraph 4 (SARS, 2008a:6-7) for numerous instances where taxpayer information, declarations or actions are required for income tax, employee's tax and provisional tax. Failure to submit returns or declarations are only some of the identified instances of non-compliance. Geared penalties for late payment of employee's or provisional taxes as well as penalties for failure to submit an annual employee's tax return are listed in paragraph 6 (SARS, 2008a:9). The regulation therefore attempts to ensure the taxpayer's adherence to the Act through identifying non-compliance in a broad fashion, with specific stringent provisions on taxes that employers are managing on behalf of SARS.

The ability of the taxpayer to request the penalties to be waived has been effectively narrowed to reasonable reasons relating to the taxpayer's first offence or where the penalty

value is nominal, thereafter specific exceptional circumstances had to exist in order for SARS to consider waiving of the penalties imposed (SARS, 2008a:11-12). The waiving of penalties should be an exceptional process within SARS and the limited acceptable waiving criteria will therefore reduce the number of penalty remittance requests from taxpayers.

Although this regulation is limited to income tax there is a clear move from SARS to attempt to ensure that penalties on administrative compliance matters are enhanced to enable the effective management of all taxes administered. The regulation on administrative penalties will assist SARS in performing its mandated task through increased taxpayer compliance.

In addition to the above reform, the redrafting of the SARS Act 34 of 1997 is also underway and will in future enable standardisation of all administrative provisions across all taxes administered by SARS. Due to the uncertainty of the actual finalisation of this Act, standardisation and increased measures on penalties and interest need to be applied within the individual tax acts as soon as possible.

3.3 INTERNATIONAL COMPARISONS OF PENALTIES AND INTEREST REGIMES

3.3.1 United Kingdom

The UK recently started a focussed effort to modernise taxation legislation. A process of consultation is followed whereby principles proposed for the future direction of taxation legislation is put forward and comments from the public and other stakeholders are requested. Since the start of 2008 a number of such consultation documents relating to compliance, penalties and interest have been issued. The documents debate all aspects of each matter, propose possible solutions and furthermore close by including international comparisons.

3.3.1.1 Penalties for late and non filing and payment

3.3.1.1.1 Penalty regime design principles

The need for penalties through structuring a penalty regime that will ensure that taxpayers recognise the seriousness of non-compliance is necessary to show to taxpayers that payment of taxes and filing of returns are not only voluntary, but will be punished (HMRC, 2008g:5). Specific design principles applicable to a sound penalty regime were identified by the HMRC in the consultation document: *Penalty reform: The next stage* (2008g:5), namely:

- to influence taxpayer behaviour. This is achieved through the reinforcement of taxpayer legal obligations, encouragement of taxpayers to comply with taxation legislation, clear deterrence from non-compliance and action taken by the taxation authority to achieve the required taxpayer behaviour;
- to be effective. This is achieved through clearly legislating the penalty regime, ensuring that the penalty regime is simple to understand by taxpayers as well as simple to administer and therefore can be cost effectively administered, is clearly separated from interest regimes, applied consistently for similar instances of non-compliance and collection action is taken by the taxation authority to collect penalties and ensure the taxpayer remedies the instances of non-compliance; and
- to be fair. This is achieved through ensuring that the penalty is proportionate in value to the instance of non-compliance as well as the time that the non-compliance is not remedied by the taxpayer, taking the differences between taxpayers into account, allowing the taxpayer to appeal against the penalty and conform to legislated human rights.

These principles should be applied within any penalty regime and can be used as key requirement in assessing a penalty regime (HMRC, 2008d:21). The ability to have a unified penalty regime appears to be a key factor in order to achieve increased levels of compliance for all taxes administered.

In order to ensure fairness, taxpayer safeguards have to be included in the design of a penalty regime (HMRC, 2008d:17). The taxpayer should be able to appeal against penalties where reasonable excuses (attributable to circumstances outside the taxpayer's control) can be provided for the non-compliance and also if non-compliance is due to an error by the HMRC (HMRC, 2008d:18-19).

3.3.1.1.2 The need for reform – current situation

The HMRC consultation document *Meeting the obligation to file returns and pay tax on time* (HMRC,2008d), details requirements for an effective penalty regime. The HMRC's ability to administer taxpayer affairs efficiently and cost effectively is dependant on taxpayers meeting their obligations to file returns and pay tax on time (HMRC,2008d:8). In most cases, the reasons why taxpayers do not comply are due to the fact that taxation affairs are left to the last minute and then other more pressing priorities arise (HMRC, 2008d:11). The taxpayers will generally still attempt to comply within a short timeframe after the actual legislated due date for filing returns or paying taxes has passed (HMRC, 2008d:38).

The ineffective current penalty regime does not ensure that taxpayer's behaviour is sufficiently adjusted to ensure compliance. The main reason for ineffectiveness is due to the fact that penalty regimes differ significantly for the various tax types, whilst many taxpayers have interactions with the HMRC across a number of tax types (HRMC, 2008d:22). The different regimes can be attributed to the piecemeal way whereby tax legislation evolved over time and these differences may lead to confusion amongst taxpayers in order to understand the specific requirements for different taxes (HRMC, 2008d:22).

The current penalty regimes in the UK were reviewed in light of the penalty design principles and it was found that:

- the influence of the regime on taxpayer behaviour was difficult to determine and taxpayer behaviour appeared to correlate to HMRC actions such as advertising campaigns around filing requirements;
- the effectiveness of the regimes are reduced due to the taxpayer confusion caused by the differences in penalty regimes in different tax legislation; and
- the fairness of the regimes is reduced because similar late filing and payment offences are not consistently penalised in different tax legislation. (HRMC, 2008d:25-27.)

The issues experienced relating to late filing of returns by the HMRC can be compared to the SARS's issues where comparable statistics exist. Statistics of 2006/2007 (HMRC,

2008d:7) indicate that 13% of all returns across all taxes are not filed or filed late totalling to 3 million returns whilst in the SARS annual report for 2007-2008 (SARS, 2008b:57) outstanding returns for 2006/2007 across all reported taxes totalled 5,76 million returns. The absence of a return makes it very difficult for the HMRC to identify if the right tax was paid and manual intervention to get the required information is costly and may even be intrusive for the taxpayer (HMRC, 2008d:8). This also applies in South Africa. The fact that no tax may be payable does not remove the taxpayer's obligation to file, since the HMRC needs to be informed through a return which allows the HMRC to perform the necessary review of the return information in order to ensure that the tax calculation was in fact done correctly (HMRC, 2008d:31). The necessity to pay tax on time is similarly important, since taxpayers who fail to pay or pay their taxes late should not be advantaged above compliant taxpayers. Enforcement actions to collect payments are also expensive to administer and intrusive to taxpayers (HMRC, 2008d:28). Robust action from the HMRC is therefore necessary for both late filing and late payment, through an effective penalty regime which influences taxpayer behaviour and reduces the need for expensive administrative processes (HMRC, 2008d:28).

3.3.1.1.3 The options for reform

The HMRC has identified that a distinction can be made between annual obligations and frequent obligations (HMRC, 2008d:28). Taxpayers with frequent filing obligations are normally taxpayers registered for numerous taxes and are businesses in most cases, whilst annual filing obligations are in general for individual taxpayers. Penalties on frequent obligations take into account the ability to identify repeated failures by taxpayers and provide for additional escalations and measures to address these repeat offenders (HMRC, 2008d:44). The HMRC has stated that a difference between the obligation to file a return and the obligation to make payment exists, since the non-compliance does not always arise at the same point in time (HMRC, 2008d:32).

In order to determine a possible penalty regime, the different tools or building blocks need to be reviewed taking the design principles into account:

- determination of assessments (HMRC, 2008d:31, 40):

- estimated assessments can be utilised in the instance where the taxpayer fails to submit returns. Where the taxpayer also fails to make payment, the estimated assessment will allow the HMRC to identify if the taxpayer owes taxes;
 - estimated assessments require costly manual intervention and the exercise of judgement; and
 - the estimated assessment method may not have the correct effect on taxpayer behaviour especially where self assessments are used, the high administrative cost lowers its effectiveness and the fact that many estimated assessments are too high and overturned by taxpayers displays that the method may not be fair to taxpayers;
- fixed penalties (HMRC, 2008d:31, 40):
 - this is a simple and understandable penalty regime and offers options of charging the penalty shortly after the incident of non-compliance or at periodic intervals;
 - fixed penalties can therefore be once off or repeated during the period of non-compliance;
 - the value of fixed penalties can be adjusted in order to increase severity where a taxpayer continues to fail to remedy his non-compliance; and
 - this is an understandable regime which assists in influencing taxpayer behaviour and can be seen to be effective in communicating consequences of non-compliance to taxpayers, but the fairness of the value is questionable since it will probably be too high or too low in comparison a specific taxpayer;
 - geared penalties (HMRC, 2008d:32, 40):
 - the penalty is calculated as a percentage of the tax obligation;
 - similar to fixed penalties, the geared penalty can repeat and/or the percentage increased during the period of non-compliance;
 - the geared penalty can not be calculated in isolation and therefore requires an estimated assessment where the taxpayer has not provided any information; and

- geared penalties is likely to influence behaviour, but the fairness is questionable since the penalty will be low where little tax is payable. The fact that geared penalties can not exist without estimated assessments, increases costs and is therefore less effective;
- daily penalties (HMRC, 2008d:32,40):
 - fixed value daily penalties can be applied for each day that the taxpayer has not remedied the offence;
 - the threat of daily penalties will influence behaviour, but due to the costly administrative requirements it is not very effective. The use of these penalties may be unfair as it is disproportionate to the offence; And
- enforcement action (HMRC, 2008d:32):
 - this requires formal collection steps to be implemented against a taxpayer and is the strongest manner of ensuring taxpayer compliance. Although this option is noted by the HMRC, it is assumed to fall outside a penalty regime which attempts to influence taxpayer behaviour at the broadest level without costly manual interventions.

The tools can be used separately or in combination. By comparing the design principles, it can be deduced that each method has both positive and negative aspects, which have to be taken into account in structuring a penalty regime.

3.3.1.1.4 The proposed reform

The HMRC followed the initial process of consultation up with a further document *Meeting the obligation to file returns and pay tax on time: Consultation responses and refined models* (HMRC, 2008e). Inputs from all stakeholders on the first documents were incorporated in order to propose actual penalty regimes based on these principles and the draft legislation was released in December 2008. The HMRC utilised the design principles and the available tools in order to propose an effective regime utilising a combination of tools.

The following penalty models for non or late filing were proposed without specific values or percentages indicated:

- penalties for late filing for annual and once off returns (HMRC, 2008e:31):
 - a fixed penalty immediately after the offence;
 - daily penalties from month 3 to 6 where the offence had not been remedied;
 - a geared penalty in month 7 where the offence had not been remedied; and
 - either a geared penalty in month 12 where the offence had not been remedied, with additional powers where evidence exists of deliberate failure to file;

- penalties for late filing for quarterly return obligations (HMRC, 2008e:34):
 - a fixed penalty immediately after the offence (the penalty value increases where repeated failures to file exist);
 - a geared penalty in month 6 where the offence had not been remedied; and
 - either a geared penalty in month 12 where the offence had not been remedied, with additional powers where evidence exists of deliberate failure to file; and

- penalties for late filing for monthly return obligations (HMRC, 2008e:36):
 - a fixed penalty immediately after the offence (the penalty value increases after each 3 consecutive repeated failures to file exist);
 - a geared penalty in month 6 where the offence had not been remedied; and
 - either a geared penalty in month 12 where the offence had not been remedied, with additional powers where evidence exists of deliberate failure to file.

The following penalty models for late payment were proposed without specific percentages indicated:

- penalties for late payment for annual and once off obligations (HMRC, 2008e:37):
 - a geared penalty on tax unpaid 1 month after the offence;

- an increased geared penalty on tax unpaid on month 6 where the offence had not been remedied; and
 - a further increased geared penalty on tax unpaid in month 12 where the offence had not been remedied;
- penalties for late payment of quarterly obligations (HMRC, 2008e:39):
 - a geared penalty on tax unpaid immediately after the offence (the geared penalty percentage increases where repeated failures to pay exist, starting with 0% in the first month);
 - a geared penalty on tax unpaid in month 6 where the offence had not been remedied; and
 - a geared penalty on tax unpaid in month 12 where the offence had not been remedied; And
 - penalties for late payment for monthly obligations (HMRC, 2008e:46):
 - a geared penalty on tax unpaid immediately after the offence (the geared penalty percentage increases after each 3 consecutive repeated failures to pay exist, starting with 0% in the first month);
 - a geared penalty on tax unpaid in month 6 where the offence had not been remedied; and
 - a geared penalty on tax unpaid in month 12 where the offence had not been remedied.

The HMRC has designed penalties for non/late filing to commence with a fixed penalty and adjusted the severity of the penalty over the time that the offence had not been remedied through the institution of a geared penalty (HMRC, 2008e:31,34,36). The complexity increases for frequent (quarterly and monthly) filing obligations where repeat offenders are identified and the value of fixed penalties increase with each new instance of non-compliance (limited to a specified maximum fixed penalty) (HMRC, 2008e:34,36). The penalty regime on late payment is based on geared penalties and therefore requires either a return from the taxpayer or an estimated assessment to be performed. Since penalties on late filing and late payment were discussed separately, the effect on a taxpayer where no return was filed or payment made was not discussed by the HMRC, although the fixed

penalties for non-filing can be instituted without manual intervention. The high administration cost associated with estimated assessments reduces the effectiveness of the proposed penalty regime, as meeting all design principles seems very difficult. A balance between the design principles is therefore required, since tensions exist between some of the design principles (HMRC, 2008d:21). The HMRC had clearly gone through a very detailed process in order to make the penalty regime proposals.

3.3.1.2 Interest

The HMRC (2008a:3) has also investigated the principles required for the effective application of interest rates as a method to increased harmonisation across all tax types administered. In HMRC consultation document *Interest: Working towards a harmonised regime* the principle to utilise interest as a method to recompense a person for the time that the money is not in the rightful owner's hands is used as the foundation of their research. Interest is therefore not seen as a penalty or a punitive measure (HMRC, 2008a:6). Methods of calculation and standardisation are put forward and will be included in the proposals for South African legislative reform.

3.3.1.2.1 Interest regime design principles

The specific design principles applicable to a sound interest regime have been identified by the HMRC in the consultation document (HMRC, 2008a:8), namely:

- interest is to recompense the legal owner of the money for the loss of use of the money during the time which the money was not in the owner's hands. Interest is paid to the HMRC where tax is paid late, but also to the taxpayer where a refund is due to the taxpayer. Interest rates have to take market rates and movements into account and needs to adjust accordingly;
- interest have to be applied with fairness. This will ensure that taxpayers who pay their taxes on time or overpay will be fairly recompensed. Additionally there should be no financial advantage for taxpayers to pay taxes late and deter taxpayers from delaying tax payments; and

- interest need to be simple to understand, transparent in the application and accessibility as well as cost effective to administer. This will enable the ability to harmonise the interest regime for different taxes.

These principles should be applied within any interest regime and can be used as key requirement in assessing an interest regime. The HMRC (2008a:8) clarifies that Government is neither lending nor taking deposits and therefore only require due taxes to be paid by taxpayers. Taxpayers should not be placed in the position where it is more cost effective to pay other creditors than the HMRC (HMRC, 2008a:9). This taxpayer attitude was reviewed in the Ipsos MORI report: *Late payment of tax: Motivations and Sanctions* compiled on instruction by the HMRC, where taxpayer priorities were researched and it was found that paying tax is the lowest priority for businesses which are taxpayers and a medium priority for taxpayers who are natural persons (2008:19).

3.3.1.2.2 The need for reform – current situation

The HMRC currently has a number of differences in the interest provisions administered across all taxes. This includes different starting dates for the charging of interest and also seven different rates for charging and paying interest (HMRC, 2008a:13-14). This lack in simplicity places an administrative burden on both the taxpayer and the HMRC (HMRC, 2008a:15). The current interest provisions in various tax legislation, fail the design principles in the following ways (HMRC, 2008a:18):

- interest is not always charged, or consistently paid;
- imposition of interest is not always automatic;
- the interest does not always run from the same date;
- different formulae and rates are used for different taxes;
- interest may be charged and paid at the same or different rates;
- interest rates changes irregularly and unpredictably;
- interest is not always tax deductible; and
- the legislation uses inconsistent language in different tax acts.

Reform is clearly required in order to simplify and standardise the interest regimes on all tax types administered by the HMRC.

3.3.1.2.3 The options for reform

The HMRC reviewed different aspects of a future interest regime, in order to ensure that the identified design principles are met and current issues are addressed. The interest rate used need to rightfully recompense the lender for the loss of the use of funds, through ensuring that inflation, the loan period, administration costs and risk of not recovering are taken into account (HMRC, 2008a:8). The rate that is used has to reflect commercial practices in order to avoid arbitrage (HMRC, 2008a:29), whilst there should only be one rate for late payment and one rate for repayment of interest applying to all taxes (HMRC, 2008a:22). Mirrored interest rates for late payment and repayment are not proposed since it does not support commercial practices. Similarly, the compounded method of interest calculation is in line with commercial practice and simple interest does not fully meet the recompense principle (HMRC, 2008a:25,28). The HMRC still proposed a simple interest calculation method since it is deemed to be easier to understand and calculate (HMRC, 2008a:27).

3.3.1.2.4 The proposed reform

The HMRC (2008a:26-27) proposed an interest regime where the following principles are included:

- interest is charged across all taxes and paid on all overpaid taxes;
- interest is charged automatically and on the same basis;
- interest is calculated by reference to a single external interest rate;
- interest is calculated using a single rate for late payments and a single rate for overpayments; and
- interest is charged on the simple interest calculation method.

Draft legislation was released by the HMRC in December 2008, where these principles were included.

3.3.2 Australia

The ATO receivables policy explains the ATO's approach to penalties and interest and their focus on streamlining their regime through enabling the application thereof on all administered taxation legislation to allow simplicity of administration and understandability by taxpayers (<http://law.ato.gov.au>, 2008). The ATO is viewed as one of the most modern taxation authorities and a world leader in simplification of taxation legislation and administration, since reforms addressed by the UK and SA relating to similar issues only commenced recently. Penalties and interest reform have been built on the failure to file declarations on time and interest on late payment of taxes, which are applied uniformly across all taxation legislation administered by the ATO. The ATO applied similar penalties for failure to meet the filing obligations for all administered tax types, regardless of the taxpayer's reason for failure to file (HMRC, 2008a:36). The actual penalty is based on a unit system with Aus \$110 payable per unit (HMRC, 2008d:58). Units are allocated per tax type and size of the taxpayer with certain maximum amounts payable per offence. Penalties for late payment of taxes were replaced by the general interest charge and therefore no penalties for the late payment exist (HMRC, 2008a:36).

A general interest charge is applied to all late payment of taxes using the compounded interest method and although it was seen as a second phase of the penalty reform process is not a punitive charge, but to recompense the ATO for not having the funds in hand (<http://law.ato.gov.au>, 2008 and HMRC, 2008a:35-36). The rate is however designed to be linked to the monthly average yield of Bank Accepted Bills plus 7% and is adjusted quarterly. The effect is that the interest rate is on average 4% higher than commercial secured loan rate and effectively reduces the risk of the taxpayer prioritising debts (arbitrage), since the high rate makes it uneconomical to pay taxes late (HMRC, 2008a:36). In a broader context, the interest rate closely resembles the rate charged by financial institutions on unsecured loans, which is normally associated with higher rates due to the

lack of security (HMRC, 2008d:59). The taxpayer behaviour is therefore also influenced through the interest regime, although it can not be deemed as punitive.

According to the ATO receivables policy, delayed refund interest on overpaid taxes is calculated on the simple interest method and allows for 14 days for the ATO to institute the repayment, after which interest accrues in favour of the taxpayer (<http://law.ato.gov.au>, 2008).

3.3.3 Canada

Comparative information is included in HMRC's consultation documentation and reviewed principles applied within Canada. Penalty regimes for late filing and late payment differ per tax type.

Late filing penalties is based on penalties geared by the tax amount owed, with immediate geared penalties of 5% and monthly penalties of 1% for a maximum of 12 months. Where a previous instance of non-compliance existed within the past 3 years, the geared penalties increase to a 10% initial penalty and a 2% monthly penalty for a maximum of 20 months (HMRC, 2008d:59). The fact that geared penalties require estimated assessments was not included in the comparative research done by the HMRC. The penalties for late filing is therefore based on geared penalties, with a monthly component where the non-compliance still exist, linked to a maximum period.

Late payment penalties differ per tax type. In some tax legislation no penalties are charged for late payment but interest is calculated on the compounded calculation method where in other tax legislation geared penalties are applied for late payment.

Interest is calculated on the compounded method and penalties are also interest bearing. (HMRC, 2008d:59).

3.3.4 Ireland

Penalties for late filing also differ for the various taxes, with geared penalties which increase if the non-compliance is not remedied over a number of months. The geared penalty is however capped to specified maximum monetary values (HMRC, 2008d:60). This capping of the penalty value limits the geared penalties to a maximum monetary value and therefore effectively changes the geared penalty to a fixed maximum penalty if the underlying non-compliance value exceeds a certain value. This reduces the proportionate effect of geared penalties, since the link to the value of the offence is removed.

In the case of late filing of VAT, no penalty is applied, but an estimated assessment is performed by the tax office, which allows interest to accrue on the estimate. The estimate does not remove the taxpayer's obligation to file his return (HMRC, 2008d:60).

3.3.5 New Zealand

Late filing penalties differ for the various taxes, while penalties for the late payment are applied across all taxes and are also applied on late payment of penalties. Late filing penalties for individuals and company returns are based on a range of fixed penalties, which are proportionate to the net income of the previous year's return (HMRC, 2008d:61-62).

Late payment penalties are geared with a 1% penalty on the day after the due date, and a further 4% penalty is charged if the amount is still unpaid 7 days after the due date. The 1% penalty will be charged each month that the amount remains unpaid (HMRC, 2008d:62).

In the instance where the taxpayer contacts the tax authority to make a payment arrangement, further penalties are not charged if the taxpayer keeps to the agreed payment plan (HMRC, 2008d:62).

3.3.6 United States

A geared penalty of 4,5% is levied on late filing and a penalty of 0,5% on the late payment of taxes on a monthly basis for failure to file or failure to pay up to a maximum of 25% respectively (HMRC, 2008d:62).

Interest is charged on the compounded basis (HMRC, 2008a:37).

3.4 CONCLUSION

A taxation authority has to be supported by an effective legislative framework in order to enable the effective management of taxes. This is confirmed by offences identified by the OECD (2006:94), which require effective legislation to minimise non-compliance relating to late filing of returns, late payment of taxes and interest on late payment.

SARS has experienced ineffectiveness of the current different penalty regimes and interest regimes for various taxes because the penalty regimes for late filing of returns do not effectively impact on the compliance culture of South African taxpayers and require costly manual interventions (HMRC, 2008d:8). Furthermore, the different interest regimes for various taxes increase the complexity of the administration for SARS (HMRC, 2008a:11). Effective penalty and interest regimes will therefore be the only cost effective methods to ensure compliance and SARS' ability to meet GRAP requirements for the reliable measurement of a taxpayer's tax liability and subsequent valuation of tax receivables.

Legislative reform and standardisation are required in order to ensure that GRAP can be applied effectively within the South African environment and also allow SARS to manage taxpayer accounts more cost effectively (HMRC, 2008d:8). In order to address these issues SARS issued a regulation on administrative penalties focussing on numerous administrative offences which allow for fixed penalties for specific offences, while geared penalties apply to more serious offences (SARS; 2008a).

The 2009 Budget Review (National Treasury, 2009:70) provided insight into changes expected to the interest regime relating to the usage of a single interest rate for underpayments and overpayments and the compounded interest calculation method as part of the modernisation of legislation for accounting purposes.

Internationally, the UK has started a focussed effort for the modernisation of taxation legislation in 2008, which includes areas of penalties and interest. The HMRC has identified specific design principles identified for both penalty and interest regimes. The design principles were used to evaluate the current penalty and interest regimes in the UK and propose draft legislation, which adequately meet the principles.

The design principles for a sound penalty regime have to influence taxpayer behaviour, to be effective and to be fair (HMRC, 2008g:5). A sound penalty regime would reduce the expensive administrative processes (HMRC, 2008d:28). The HMRC proposed draft penalty regimes which utilised a balanced application of the design principles and a combination of available tools (HMRC, 2008d:21). Similarly, the proposed draft interest legislation was also based on the design principles for a sound interest regime, which require the regime to recompense the legal owner of monies, to be fair to all parties, and to be simple to understand and applicable to all administered taxes (HMRC, 2008a:8).

The penalties and interest regimes for Australia, Canada, Ireland, New Zealand and the United States were reviewed and displayed a variety of regimes and applications but did not provide consistent international requirements which could be directly applied in South Africa. The different international applications can be used as additional input in determining proposed penalty and interest reform for South Africa. The design principles used by the HMRC provides sound and clear requirements for reform and was therefore utilised in the next chapter to propose a penalty and interest regime for South Africa.

CHAPTER 4

RECOMMENDATIONS PERTAINING TO PENALTY AND INTEREST LEGISLATION IN SOUTH AFRICA

4.1 INTRODUCTION

The principles identified in this study have to be taken into account for proposing an effective penalty and interest regime in South Africa. These principles are indicative of a well rounded regime focussed on changing taxpayer behaviour and ensuring that SARS and the taxpayer are equitably recompensed for the time that moneys were not held by the rightful party. The proposals are focused on the following areas:

- penalty for the failure to file returns on time and failure to pay tax on time; and
- interest for failure to pay tax on time or refund taxpayers on time.

A key focus for the proposed regimes is to allow standardisation across all tax types administered by SARS and therefore increase operating efficiencies and allow for the effective application of accrual accounting. This requires a broad application of the regime and a renewed focus by the taxpayer on voluntary compliance.

The fact that current penalty and interest regimes exist was taken into account in defining proposed changes, thereby attempting to utilise effective measures in current legislation as well as introducing additional measures. It is clear from international comparisons that numerous different regimes exist and each appears to address a key compliance issue, which may depend on the way that the legislation evolved within the specific country. There was no clear regime, which could be seen as the best and therefore have to be adopted within South Africa.

The fact that the compliance culture within South Africa is unique, as with each country, poses a challenge and has to be recognised in the proposal. South Africa is a young country in global terms and is seen as a developing country, the local compliance culture is therefore also in the process of developing. The fact that lessons learnt by international

countries as well as consultation documentation can be utilised, places South Africa in an advantageous position to attempt to ensure that the correct level of compliance is achieved.

The research done by the HMRC and their proposed regimes clearly indicate that penalty and interest regimes have to utilise a combination of a number of tools in order to reach most of the design principle goals. A similar approach will therefore be followed in the proposed regimes but with a clear focus on simplicity. Simplicity is deemed to be required in order for taxpayers to clearly understand the legislation and compliance requirements as well as the effect of non-compliance as a key requirement for ease of administration for SARS. The proposed penalty and interest reform have to ensure an alignment between all tax types can be accomplished. The proposed reform attempts to take the direction of SARS into account as indicated in the 2009 Budget Review (National Treasury, 2009:70) where it was stated that a single interest rate for underpayments and overpayments and the compounded interest calculation method will be part of the modernisation for accounting purposes.

The Administrative Penalty regulation has only been issued on 31 December 2008 and is therefore still new to South Africans. The effectiveness thereof has not been proven as yet and therefore an integrated penalty regime proposal is still put forward in this study.

The current penalty regime for late filing for income tax existed, whilst late filing for PAYE carried no penalty and VAT was a criminal offence (not practical and never really applied). Non-filing for PAYE alone has created an incorrect liability on taxpayer accounts of around R10billion (SARS, 2008b:145). The current penalty regime for late payment for income tax does not exist, whilst non/late payment on PAYE and VAT attracts a 10% penalty.

Interest is charged on all late payments, calculated differently between tax types. Penalties do not attract interest.

Detail research into each regime in existence is not the focus of this study, but only the identification of differences that exist between taxes and the lack of standardisation and ease of administration created by having to administer each tax type with specific rules.

4.2 PROPOSED PENALTY REGIME FOR SOUTH AFRICA

It is proposed to maximise current legislated powers relating to penalties and add thereto, rather than propose a regime where existing powers are relinquished. It is therefore proposed to combine the requirements of the current penalties, which can be applied to all tax types. The combining of fixed and geared penalties was also supported by the HMRC's draft legislation (HMRC, 2008e:31,34,36).

During a discussion with Mr. G. M. English of the Strategy and Modernisation business area of SARS, in January 2008, he expressed the opinion that in an attempt to propose a simple penalty regime, no distinction should be made between penalties arising from late filing and penalties arising from late payment.

This principle was used in the proposal for the simplified penalty regime recommended in this study, in terms of which a penalty for late filing as in the case of late payment will also attract a 10% penalty charge. This is applicable for where one or both the filing and payment requirements are not met. The application of a geared penalty ensures that the penalty is in all circumstances related to the offence and hedged against inflation. A minimum or fixed penalty is required in order to ensure that any penalty imposed is of a sufficient quantum to ensure that a taxpayer will be encouraged to comply with legislation and have a positive cost/benefit ratio for collection efforts. The minimum or fixed penalties will have to be increased on an annual basis in order to ensure that inflationary pressures do not reduce the charge to a nominal amount over time. Penalties on taxpayer accounts will accrue interest if paid late along with all other taxes and charges on the taxpayer account. (Refer to Figure 1.)

SARS' systems should be able to identify the offences of non/late filing and payment systematically and therefore does not require costly human intervention or subjective interpretation of facts. The penalty is imposed in a single transaction, since the act of non-compliance is also a single action. Non-compliance does not in essence increase over time – SARS is not placed in a position to effectively manage taxpayers if the basic requirements of filing and payment by taxpayers are not met. The focus on simplicity may in this instance lean toward a very rigid and harsh regime, since taxpayers may comply within a short period of time.

The simplistic application of the proposed penalty would for PAYE and VAT be either when a return is not filed or payment is not made on the legislated due dates. A 10% penalty will apply. Similarly for income tax the late or non filing will result in a 10% penalty as well as on late or non payment when an assessment liability is due.

In the instance where the taxpayer has not provided any information, an estimated assessment needs to be done in order to record a liability and apply the geared penalty. The fixed minimum penalty, however allows for a fixed penalty to be charged to the taxpayer's account during the timely process of manually raising an estimated assessment. The fixed minimum penalty will therefore be an effective tool in order to ensure taxpayer compliance at an early stage, the penalty can be adjusted subsequent to the finalisation of an estimated assessment and adjust in the event where a geared penalty based on the estimated assessment is of a higher value.

The fixed minimum penalties are increased in the event where the taxpayer repeatedly fails to comply with filing and payment obligations and aims to reduce repeat offenders.

Objections by taxpayers against penalties have to be controlled through legislating reasonable and exceptional circumstances which can be used by taxpayers to request the waiving of penalties. This will effectively limit acceptable grounds for waiving of penalties and ensure that the numbers of objections are limited. Waiving or reducing of penalties should be for exceptional circumstances only and ensure that taxpayer compliance is supported and not undermined by lenient powers to waive or reduce penalties imposed. Penalties imposed by SARS in error will be deemed to be exceptional circumstances.

The proposed regime is evaluated against the HMRC (2008g:5) penalty design principles in order to identify if the proposed regime meets the principles and resulted in the following:

- the regime needs to influence taxpayer behaviour and this principle is achieved by penalising both late filing as well as late payment which will ensure that taxpayer behaviour is adjusted effectively. The fact that a single interaction with SARS can

lead to two penalties increase taxpayer awareness to comply with tax legislation and therefore effectively influence taxpayer behaviour; and

- the regime needs to be effective and this principle is achieved as:
 - the penalty regime will be included in all tax legislation;
 - it is simple to understand by both taxpayers and SARS;
 - a single penalty will be incurred for an instance of non-compliance, the application of the regime is therefore simple;
 - the penalty regime is applicable for all taxes administered by SARS, this allows standardisation of administrative functions within SARS and reduces costs and complexities;
 - the instances of non-compliance can be identified systematically and therefore reduce costly manual intervention; and
 - penalties will be interest bearing; And
- the regime needs to be fair and this principle is achieved as:
 - it utilises a fixed minimum penalty as well as geared penalties and the higher calculated penalty will be imposed on the taxpayer. This will allow that penalties are proportionate to the offence, with specific minimum amounts;
 - the minimum fixed penalties are proposed as amounts which will impact small and large taxpayers, but may be viewed as unfair by the general public in comparison to their actual tax liability;
 - repeat offenders will incur higher fixed minimum penalties;
 - objections can be lodged against penalties, but restricted powers for waiving or reduction of penalties under specified circumstances will impact the ability of SARS to waive penalties easily and effectively undermine the penalty regime; and
 - it has aspects of fairness and unfairness, but attempts to support compliant taxpayers and not provide an unfair advantage to non-compliant taxpayers.
HMRC (2008d:21-22,25-27.)

The proposed regime appears to meet the HMRC (2008g:5) penalty design principles and can be seen to effectively influence taxpayer behaviour, be effective and be fair to compliant taxpayers. The proposed regime will also ensure that accrual accounting

requirements will be supported, since taxpayers will be influenced to file returns and make payments when required by legislation.

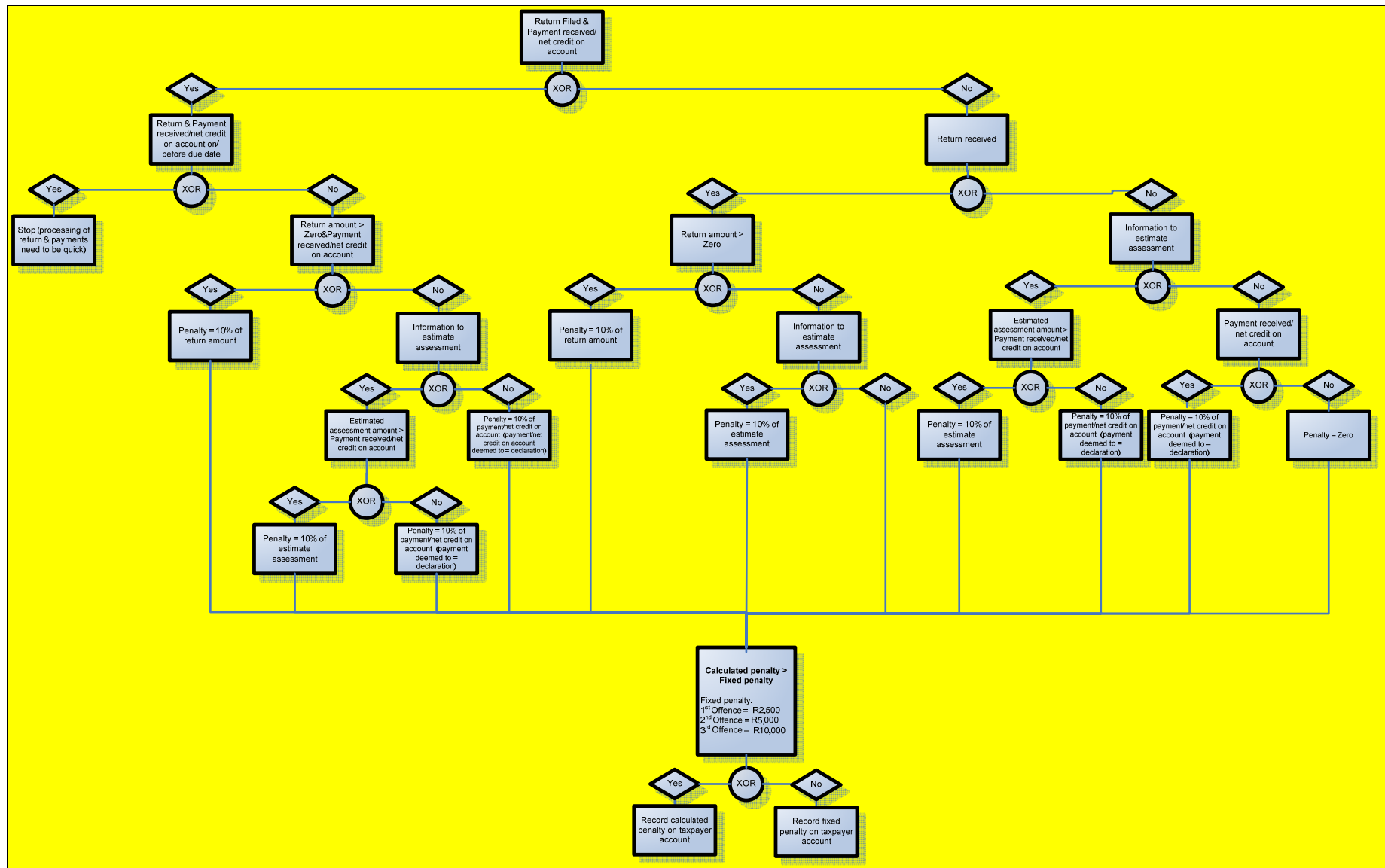


Figure 1: The proposed penalty regime decision tree

4.3 PROPOSED INTEREST REGIME REFORM FOR SOUTH AFRICA

It is proposed to maximise current legislated powers relating to penalties and add thereto, rather than propose a regime where existing powers are relinquished. It is therefore proposed to combine requirements of current interest free periods, which can be applied to all taxes. The interest free periods relate to a 21 day administrative period which SARS requires in order to ensure VAT refund claims are valid, in terms of section 45(1) of the VAT Act 89 of 1991. A similar administrative period is granted to taxpayers in the event where an assessment was raised by SARS to allow taxpayers time to receive the notice and arrange their affairs to make payment, the length of the period is not legislated but is defined as part of the Commissioner's discretion to determine the date payable for a tax assessment, which is in terms of section 89(1) of the Income Tax Act. . This administrative period is only relevant where the taxpayer is not required to do a self assessment i.e. VAT or PAYE.

Interest has to recompense the rightful owner for the time that the funds were in another party's possession. The recompense calculation and rate should therefore be market related and interest should therefore be calculated on the compounded method and at a rate indicative of the average market rate i.e. prime rate (HMRC, 2008a:29). Market rates tend to move and it is therefore proposed to utilise a rate that attempts to reflect market rates, but is not as volatile. The PFMA legislated rate for 'debts to the state' can be viewed to be best representative indicator of a market rate. Interest has to be calculated on all outstanding taxes, penalties and interest. This will also ensure that taxpayer account administration can be simplified; since payment allocation rules are currently determined in legislation to reduce non-interest bearing amounts first with payments from taxpayers before interest bearing amounts are effectively paid.

During the discussion with Mr. G. M. English of the Strategy and Modernisation business area of SARS, in January 2008, referred to above, he also expressed the opinion that in a simple interest regime the interest rate for outstanding debts and refunds should be a mirrored rate.

This principle was used in the proposal for the simplified interest regime recommended in this study, in terms of which a mirrored interest rate, utilising the PFMA rate, is applied. This will simplify calculation of interest and allow for easier debt equalisation whereby refund positions in one tax type can be set off against taxes payable in another tax type. It will also promote equitable treatment of taxpayers (HMRC, 2008a:8). The misuse of interest on refund positions need to be addressed in order to ensure that taxpayers do not overpay taxes on purpose in order to receive interest at rates higher than those available on deposits in the open market. A 21 day interest free administrative period is therefore proposed, which is combined with the requirement that refund interest will only accrue interest from the latest of the legally due date for full payment and the receipt of a taxpayer return or declaration. Therefore the possible abuse of interest on refunds, through overpayment of PAYE or provisional tax, is mitigated by instituting an additional rule for the due date of interest on refunds. Interest on a net credit position will only be calculated from the latest of the 3rd provisional payment date or 21 days after the submission of the tax return. This will further ensure that the taxpayer has no additional incentive to overpay PAYE or provisional tax and additionally file his income tax return late or request extension for his filing obligation.

Interest will accrue from the date that taxes and penalties were legally required to be paid, where payment dates are legislated (i.e. VAT and PAYE) or 21 days after assessment by SARS where no legislated date exists.

The proposed regime is evaluated against the HMRC (2008a:8) interest design principles in order to identify if the proposed regime meets the principles and resulted in the following:

- the regime needs to recompense the rightful owner and this principle is achieved as:
 - interest will provide recompense for loss of use of money for both SARS and the taxpayer;
 - the PFMA rate for 'debt to state' is adjusted periodically and attempts to track changes in market rates, excluding the day-to-day volatility; and
 - it will effectively recompense the rightful owner of monies;
- the regime needs to be applied with fairness and this principle is achieved as:

- a taxpayer who pay late will not be advantaged by delaying payment of taxed to SARS and similarly taxpayer who pay on time or overpay will not be disadvantaged;
 - the purposeful overpayment of taxes is effectively removed through providing SARS with an adequate administrative period to ensure refund positions are valid;
 - assessments raised by SARS, where no final payment date is legislated, will allow the taxpayer with an adequate administrative period to ensure he can organise his affairs to make payment before interest accrues on the tax liability; and
 - it will be fair to both the taxpayer and SARS; And
- the regime needs to be characterised by simplicity and this principle is achieved by:
 - a single interest regime across all tax types will simplify administrative requirements of SARS and ensure cost effectiveness; and
 - a single interest rate on both taxes due and refunds due is easy to understand by taxpayers and to administer by SARS.

The proposed regime appears to meet the HMRC (2008a:8) interest design principles and can be seen to effectively recompensing the rightful owner, be fair to taxpayers and SARS and simple to understand and administer. The proposed regime will also ensure that accrual accounting requirements will be supported, since subsequent measurement of tax receivables and payables should not be required.

4.4 CONCLUSION

The principles identified in this study are indicative of a well rounded penalty and interest regimes focussed on changing taxpayer behaviour and ensuring SARS and the taxpayer are equitably recompensed for the time that moneys were not held by the rightful party. The proposed regimes should allow standardisation across all tax types administered by SARS and therefore increase operating efficiencies and allow for the effective application of accrual accounting. This requires a broad application of the regimes and a renewed focus by the taxpayer on voluntary compliance.

The research undertaken by the HMRC and their proposed regimes clearly indicate that penalty and interest regimes have to utilise a combination of a number of tools in order to reach the material design principle goals. The other international comparisons did not identify internationally accepted standard penalty and interest regimes, but only different applications of regimes. The HMRC guidance was therefore used as the main input and method for evaluation in the proposed regimes. The proposed regimes focussed on simplicity in order for taxpayers to clearly understand the legislation and compliance requirements along with increasing the effectiveness of the administration of the regimes by SARS. The proposed penalty and interest reform have to ensure an alignment between all tax types can be accomplished.

The proposed penalty and interest regimes attempted to retain current legislated powers and to build on it. The combining of fixed and geared penalties was supported by the HMRC's draft legislation, and was therefore included in the proposal (HMRC, 2008e:31,34,36). The proposed regime required a minimum fixed penalty for late filing and late payment, which will ensure that a penalty will be recorded on the taxpayer account in the event of non-compliance in these areas. The fixed penalty increases for each instance where the taxpayer failed to comply in order to have more stringent penalties for repeat offenders. The fixed minimum penalty ensures that a penalty is charged to the taxpayer account and may be adjusted at a later stage when an estimated assessment could be performed. The proposed regime appears to adequately meet the HMRC (2008g:5) penalty design principles.

The proposed interest regime attempts to recompense the rightful owner for the time that the funds were in another party's possession. It is proposed that interest is calculated on the compounded method and at a rate indicative of the average market rate. The PFMA legislated rate for 'debts to the state' is proposed to be used for both outstanding tax debts and refunds. Interest will be calculated on all outstanding taxes, penalties and interest in order to ensure that taxpayer account administration can be simplified. The proposed regime appears to meet the HMRC (2008a:8) interest design principles.

The proposed penalty and interest regimes will ensure that accrual accounting requirements are supported.

The requirement of having an effective penalty and interest regimes in place on SARS in order to apply accrual accounting principles will be discussed in the following chapter.

CHAPTER 5

FINAL CONCLUSIONS AND RECOMMENDATIONS

5.1 INTRODUCTION

The requirements of accrual accounting are not only a South African challenge, but a challenge for the public sector internationally. The move towards the modernising and aligning of public sector accounting standards is relatively new and numerous countries are still using the cash basis of accounting (Van der Hoek, 2005:33). Taxation authorities rely on legislation to provide a sound framework to enable the effective administration of taxes. The accrual accounting basis requires a much higher level of effectiveness than required in a cash accounting environment and therefore has to be supported by the legislative framework.

The implementation of accrual accounting will increase the level of accountability and transparency within the management of SARS and display inefficiencies to all readers of financial statements and annual reports (Public Sector Committee – IFAC, 1996). Accrual accounting can therefore be seen as an additional motivation for an effective penalty regime and interest regime, which will ensure increased taxpayer compliance in the most cost effective manner (HMRC, 2008d:8). This legislative reform will increase the ability of SARS to effectively manage taxes and taxpayer accounts and can therefore be seen as a positive move for the South African government.

Non-compliance relating to late filing and late payment of taxes directly impacts the ability of SARS to reliably measure taxes owed and allow the timely recording of the taxes on taxpayer accounts, which reduces the effectiveness SARS and therefore indicates the necessity for change to the penalty regime. Similarly, an interest regime which is not market related also requires change to the interest regimes.

5.2 THE APPLICATION OF GRAP 23 AND THE SUBSEQUENT MEASUREMENT OF TAX RECEIVABLES AND PAYABLES BY SARS

In 2007 the ASB introduced the requirement for the application of accrual accounting principles for SARS by the issuing of GRAP 23 and proposing the subsequent valuation of

tax receivables and payables in Discussion Paper 3 (ASB, 2007). The application of GRAP 23 and subsequent measurement of tax receivables places an additional focus on the ability of SARS to apply accrual accounting standards within the current legislative environment.

GRAP 23 sets down the accounting criteria identifying when tax revenues have to be recorded in the financial records of SARS. These recognition requirements relate to the ability to indicate that tax revenues are owed to government and the receivable may be created in the financial records and will be legally collectable. In order to recognise a tax transaction in the financial records, a taxable event has to have occurred, the value of the tax must be reliably measured and the receivable recorded must have a high probability of being collected from the taxpayer. The accounting standard recognises that reliable measurement in most instances can be achieved by:

- the submission of a tax return or declaration by the taxpayer; and/or
- the receipt of payment by the taxpayer.

The ability to reliably measure the tax amount due to the taxation authority is therefore in most instances based on the availability of information provided mainly by the taxpayer. In the absence of information from the taxpayer, actual amounts paid by the taxpayer will be viewed as a method for reliable measurement. (ASB, 2008:19-22.)

This confirms the importance of receiving returns, declarations and payments as determined in taxation legislation from taxpayers as a key requirement for SARS to apply GRAP 23 effectively. The timely receipt of taxpayer returns, declarations and payments are compliance issues and have to be dealt with within the areas in taxation legislation where provisions are made to ensure compliance. An effective penalty regime is therefore required for the effective application of GRAP 23.

The subsequent measurement of the tax receivables debated in Discussion Paper 3 (ASB, 2007) is based on the principles in IAS 39 (IASB, 2006), which require that tax receivable should reflect the rand value of the asset as calculated at its amortised net present value utilising a market related interest rate. The value of the debtor will therefore reflect the true worth thereof on a given financial reporting date, taking the period in which it will be paid, interest accruing on the amount as well as market related interest on such a debt, into

account. In South African taxation legislation different rates in calculating interest for different taxes are used, whilst applying simple interest. The disparate manner of calculating interest on different rates reduce administrative effectiveness, while the method of calculating the interest is not market related and therefore reduces the actual value of outstanding taxes.

The importance of calculating interest based on both a market related interest and method of calculation is highlighted as a key requirement within an accrual accounting reporting environment. The interest regime in South African taxation legislation will therefore require reform in order to align legislated interest rate to be comparable to market related rates and utilise the compounded interest calculation method. This will ensure that SARS and the taxpayer will retain the buying power of monies owed respectively through the accrual of interest on owed amounts based on market related interest rates and the market related method of calculation. Additionally it will also reduce administrative requirements on SARS because the value of tax receivables and payables will not have to be adjusted on accrual based financial reports to take differences between the legislated interest rate and calculation method and market related interest rates and calculation methods into account.

5.3 GUIDELINES FROM INTERNATIONAL TAX REFORM PROCESSES AND EXISTING LOCAL LEGISLATION RELATING TO INTEREST AND PENALTIES

A taxation authority has to be supported by an effective legislative framework in order to enable the effective management of taxes. The accrual accounting basis requires increased compliance in order to ensure that taxpayers file returns and make payments on time. The OECD (2006:94) identified 3 internationally comparative focus areas for penalties and interest, namely:

- a penalty for the failure to file returns on time (late filing):
- a penalty and/or interest for failure to pay tax on time (late payment): and
- a penalty for the failure to correctly report tax liability (under declaration)

This confirms that the basic requirement for the effective management of a taxation authority is supported by an effective penalty and interest regime.

In South Africa, SARS has experienced ineffectiveness of the current penalty regimes according to the SARS annual report for 2007-2008 (SARS, 2008b:57), which indicate that the penalty regimes for late filing of returns are not effectively impacting the compliance culture or South African taxpayers. The lack of returns forces SARS to perform estimations, which are costly manual interventions and can seldom be performed within a reasonable timeframe (HMRC, 2008d:8). An effective penalty regime will therefore be the only cost effective manner to ensure compliance and SARS' ability to meet GRAP requirements for the reliable measurement of a taxpayer's tax liability. Legislative reform and standardisation is required in order to ensure that GRAP can be applied effectively within the South African environment and also allow SARS to manage taxpayer accounts more cost effectively (HMRC, 2008d:8).

The interest regimes for South African taxes are currently different for the various taxes, which increases the complexity of the administration (HMRC, 2008a:11). SARS has recently indicated in the 2009 Budget Review (National Treasury, 2009:70) the direction of the future interest regime and that accounting requirements impact on legislative reform.

The recent focus on administrative penalties in South Africa has led to legislative reform which provided SARS with the ability to raise administrative penalties in terms of section 75B of the Act during 2007. In December 2008 the final regulation was issued and includes punitive measures against numerous instances of non-compliance by taxpayers, which negatively affect SARS' ability to manage its mandate (SARS, 2008a). The regulation attempts to ensure the taxpayer's adherence to the Act through identifying non-compliance in a broad fashion, with specific stringent provisions on taxes that employers are managing on behalf of SARS (SARS, 2008a:6-7,9). The effectiveness of this penalty regime reform has not been proven, due to the short time that the regulation has been promulgated.

Internationally, the UK has started a focussed effort in the modernisation of taxation legislation, which includes areas of penalties and interest. The HMRC has issued consultation documents and issued draft legislation for public comment based on specific design principles identified for both penalty and interest regimes.

The design principles for a sound penalty regime are (HMRC, 2008g:5):

- to influence taxpayer behaviour;
- to be effective; and
- to be fair.

The HMRC reviewed the current penalty regimes in light of the design principles and found that them lacking (HMRC, 2008d:25-27). Robust action from the HMRC is therefore necessary for both late filing and late payment, through an effective and fair penalty regime which influences taxpayer behaviour and reduces the need for expensive administrative processes (HMRC, 2008d:28). In proposing the draft legislation the HMRC identified the possible tools that can be used separately or in combination in a penalty regime as the following (HMRC, 2008d:31):

- determination of assessments (estimations);
- fixed penalties;
- geared penalties;
- daily penalties; and
- enforcement action against a taxpayer to force compliance.

The HMRC utilised the design principles and the available tools in order to propose an effective regime utilising a combination of tools. Separate penalty models late filing and for late payments were proposed without specific values or percentages indicated.

The proposed penalty models for late filing were further segregated between annual or once off returns and frequently filed returns (quarterly or monthly) as follows:

- penalties for late filing for annual and once off returns, propose the utilisation of a fixed penalty, daily penalties and a geared penalties over specified periods of time where the offence has not been remedied, with additional powers where evidence exists of deliberate failure to file (HMRC, 2008e:31); and
- penalties for late filing for quarterly and monthly return obligations, propose the utilisation of a fixed penalty immediately which increases in value where repeated failures to file exist and geared penalties over specified periods of time where the

offence has not been remedied, with additional powers where evidence exists of deliberate failure to file (HMRC, 2008e:34,36).

The proposed penalty models for late payment were further segregated between annual or once off payments and frequent payment obligations (quarterly or monthly) as follows:

- penalties for late payment for annual and once off obligations utilises geared penalties which increase over specified periods of time where the offence has not been remedied (HMRC, 2008e:37); and
- penalties for late payment of quarterly or monthly obligations, utilises geared penalties which increase over specified periods of time (the geared penalty percentage increases where repeated failures to pay exist) where the offence has not been remedied (HMRC, 2008e:39,46).

The HMRC has designed penalty regimes which are combinations of the tools available and attempts to ensure that the penalty value is proportionate to the offence and time it takes the taxpayer to become compliant. Geared penalties require estimated assessments in order to place a value on the offence and manage the collection thereof. The high administration cost associated with estimated assessments will reduce the effectiveness of the proposed penalty regime. A balance between the design principles is therefore required and tools available, since tensions exist between some of the design principles (HMRC, 2008d:21).

The design principles for a sound interest regime require the regime (HMRC, 2008a:8):

- to recompense the legal owner of monies;
- to be fair to all parties; and
- to be simplistic to understand and applicable to all administered taxes.

The HMRC currently has a number of differences in the interest provisions of administered taxes. This lack in simplicity places an administrative burden on both the taxpayer and the HMRC (HMRC, 2008a:15). The current interest provisions in the various tax legislations were reviewed and failed the design principles (HMRC, 2008a:18). The reform proposed required the interest rate used needed to rightfully recompense the lender for the loss of

the use of funds, through ensuring that commercial practices, inflation, the loan period, administration costs and risk of not recovering are taken into account (HMRC, 2008a:8,29). A single rate for late payment and a single rate for repayment of interest need to be set down and applied to all taxes administered (HMRC, 2008a:22). The HMRC still proposed a simple interest calculation method since it is deemed to be easier to understand and calculate (HMRC, 2008a:27).

The HMRC proposed an interest regime which included the following principles (HMRC, 2008a:26-27):

- interest is charged across all taxes and paid on all overpaid taxes;
- interest is charged automatically and on the same basis;
- interest is calculated by reference to a single external interest rate;
- interest is calculated using a single rate for late payments and a single rate for overpayments; and
- interest is charged on the simple interest calculation method.

The penalties and interest regimes for Australia, Canada, Ireland, New Zealand and the United States were reviewed and displayed a variety of regimes and applications, but did not provide consistent international requirements which could be applied in South Africa. The different applications can be used as additional input in determining proposed penalty and interest reform for South Africa. The design principles used by the HMRC provides sound and clear requirements for reform and was therefore utilised to propose a penalty and interest regime for South Africa.

5.4 CONCLUSIONS AND RECOMMENDATIONS OF LEGISLATIVE REFORM TO MEET ACCOUNTING AND LEGISLATIVE GOALS

An effective penalty and interest regime for a taxation authority has been identified as a requirement for effective management. Accrual accounting can be seen as an additional motivation for an effective penalty regime and interest regime, which will ensure increased taxpayer compliance in the most cost effective manner (HMRC, 2008d:8). The indication

by SARS in the 2009 Budget Review (National Treasury, 2009:70) of the direction of the future interest regime displays that legislative reform is motivated and impacted by accounting requirements. The impact of GRAP requirements do not really change the responsibility of SARS to manage taxpayer accounts and its ability to report on the true financial position of taxes under administration, but can be seen as an additional driver for the implementation of administrative tax legislation reform.

It is therefore concluded that effective penalty and interest regimes are necessary to support SARS in applying GRAP 23 and the subsequent measurement of tax receivables and payables. Reform of penalty regimes and interest regimes in South Africa will enable SARS to effectively and efficiently manage taxpayer accounts through increased levels of taxpayer compliance and accurate financial valuation of tax receivables and payables.

Reform proposals were identified and it is recommended that the principles identified in this study should be used in the development of well rounded penalty and interest regimes. The proposed regimes will allow standardisation across all tax types administered by SARS and therefore increase operating efficiencies and allow for the effective application of accrual accounting. This requires a broad application of the regimes and a renewed focus by the taxpayer on voluntary compliance. The proposals are focused on the basic requirements to apply accrual accounting and included the following areas:

- penalty for the failure to file returns on time and failure to pay tax on time; and
- interest for failure to pay tax on time or refund taxpayers on time.

The proposed regimes focussed on simplicity in order for taxpayers to clearly understand the legislation and compliance requirements along with increasing the effectiveness of the administration of the regimes by SARS. These proposed regimes can be used in evaluating current and future penalty and interest regimes. The proposed penalty and interest reform need to ensure an alignment between all tax types can be accomplished and allows for the direction of SARS indicated in the 2009 Budget Review (National Treasury, 2009:70).

The proposed penalty regime appears to meet the HMRC (2008g:5) penalty design principles and can be seen to:

- effectively influence taxpayer behaviour and increase taxpayer awareness of offences and definite actions taken against non-compliance;
- be effective by ensuring it is simple to understand, administer and can be applied to all taxes administered by SARS; and
- be fair to compliant taxpayers by ensuring that a minimum penalty will be charged for all offences, is proportionate to the value of the offence and allow for waiver of penalties in exceptional circumstances. HMRC (2008d:21-22,25-27.)

The proposed interest regime appears to meet the HMRC (2008a:8) interest design principles and can be seen to:

- effectively recompense the rightful owner at a market related interest rate and calculation method;
- be fair to taxpayers and SARS, since interest will accrue to all amounts owed and refunds to taxpayers, but without the ability to misuse interest on refunds; and
- be simple to understand and administer as well as able to be applied to all taxes administered by SARS

The proposed penalty and interest regimes will ensure that accrual accounting requirements are supported. These regimes are not seen to be the only solution but can be viewed as a possible solution. The principles applied in defining the proposed regimes and methods of evaluation should be applied in actual legislative reform in order to meet both the requirements of sound penalty and interest regimes, whilst supporting accrual accounting requirements.

The move of the public sector to accrual accounting is a global trend and the need for transparency and high levels of accountability by governments towards citizens is not seen to be a passing phase and the necessary legislative frameworks have to be put in place to enable government to effectively apply accrual accounting.

CHAPTER 6

SUMMARY

6.1 INTRODUCTION AND PROBLEM STATEMENT

The general international government and South African public sector drive towards transparency and accountability has resulted in the move towards accrual accounting based financial reporting frameworks necessary for effective and efficient management of government (Public Sector Committee – IFAC, 1996:1-4; Van der Hoek, 2005:33,41). This emphasises the need for a supportive legislative framework for effective application of accrual accounting based accounting standards by international taxation authorities and locally by SARS. In South Africa, the administrative tax legislation in regard to interest and penalties does not allow SARS to effectively apply GRAP 23 and the accurate valuation of recorded tax receivables and payables. The various tax legislation managed by SARS are furthermore ineffective, complex and too fragmented to ensure consistent high levels of taxpayer compliance, which reduces the ability of SARS to effectively and efficiently manage taxes and apply accrual accounting principles.

6.2 THE RESEARCH OBJECTIVES AND FINDINGS

The accounting requirements and the application of GRAP 23 and the subsequent measurement of tax receivables and payables was conceptualised and evaluated in light of the ability of SARS to effectively apply these principles. GRAP 23 sets down the accounting criteria identifying when tax revenues have to be recorded in the financial records of SARS. The receipt of returns, declarations and payments as determined in taxation legislation from taxpayers are key requirements for SARS to reliably measure taxes due and apply GRAP 23 effectively. An effective penalty regime is therefore required for the effective application of GRAP 23. The subsequent measurement of the tax receivables per Discussion Paper 3 (ASB, 2007) requires that tax receivables and payables should reflect the true worth thereof on a given financial reporting date and market related interest rates and calculation methods must be applied. In South African

taxation legislation, the various interest rates and applications reduce administrative effectiveness. The interest regime in South African taxation legislation will therefore require reform in order to align legislated interest rate to be comparable to market related rates and utilise the compounded interest calculation method.

In order to recommend the required reform to South African legislation, existing local and international tax reform and reform processes relating to interest and penalties was identified and evaluated for use as guideline to recommendations. Locally, SARS recently issued a regulation on administrative penalties and includes punitive measures against numerous instances of non-compliance by taxpayers, which negatively affect the ability of SARS to manage its mandate (SARS, 2008a). The effectiveness of this penalty regime reform has not been proven, due to the short time that the regulation has been promulgated. Internationally, a variety of regimes and applications was identified, but did not provide consistent international requirements which could be applied in South Africa. However, design principles identified and used by the HMRC in penalty and interest reform processes provided sound and clear requirements for reform and was therefore utilised to propose a penalty and interest regime for South Africa.

Changes to the present tax legislation in regard to interest and penalties was recommended that will enable the effective application of GRAP 23 and the accurate valuation of recorded tax receivables and payables, reduce complexities in legislation and allow SARS to effectively and efficiently manage taxes. Simplistic penalty and interest regimes were recommended which will allow taxpayers to clearly understand the legislation and compliance requirements along with increasing the effectiveness of the administration by SARS. The proposed penalty and interest regimes met the HMRC's design principles and will also ensure that accrual accounting requirements are supported. These regimes are not seen to be the only solution but can be viewed as a possible solution. The principles applied in defining the proposed regimes and methods of evaluation should be applied in actual legislative reform in order to meet both the requirements of sound penalty and interest regimes, whilst supporting accrual accounting requirements.

6.3 FINAL CONCLUSION

The recommended legislative reform will increase the ability of SARS to effectively manage taxes and taxpayer accounts and such reforms would therefore be seen as a positive move for the South African government. Accrual accounting principles required by GRAP 23 and Discussion Paper 3 can be seen as additional motivation to recommend an effective penalty regime and interest regime, which will ensure increased taxpayer compliance in the most cost effective manner and allow for the accurate reporting of tax receivables and payables.

The move of the public sector to the accrual accounting basis is a global trend and the need for transparency and high levels of accountability by governments towards citizens is not seen to be a passing phase and the necessary legislative frameworks have to be put in place to enable government to effectively apply accrual accounting.

LIST OF REFERENCES

Accounting Standards Board. 2007a. DP 3; Executive summary – *Discussion paper on Financial Instruments*. Midrand. [Online] Available from: www.asb.co.za (downloaded 17 March 2008)

Accounting Standards Board. 2007b. DP 3; Invitation to comment on the *Discussion paper on Financial Instruments*. Midrand. [Online] Available from: www.asb.co.za (downloaded 17 March 2008)

Accounting Standards Board. 2008. *GRAP 23; Revenue from Non-exchange Transactions (Taxes and Transfers)*. Midrand. [Online] Available from: www.asb.co.za (downloaded 17 March 2008)

Answers.com. Not dated a. Compound interest. (n.d.). *Investopedia*. [Online] Available from: <http://www.answers.com/topic/compound-interest-2>. [Accessed 13 January 2009].

Answers.com. Not dated b. Inflation. (n.d.). *The American Heritage® Dictionary of the English Language, Fourth Edition*. [Online] Available from: <http://www.answers.com/topic/inflation>. [Accessed 13 January 2009].

Answers.com. Not dated c. Simple interest. (n.d.). *The American Heritage® Dictionary of the English Language, Fourth Edition*. [Online] Available from: <http://www.answers.com/topic/simple-interest>. [Accessed 13 January 2009].

Australian Tax Office. 2006. *ATO Receivables Policy. PART F. Penalties and Interest Relating to Receivables Activities, 91 Introduction to part F - penalties relating to receivables activities*. [Online] Available from: <http://law.ato.gov.au> (Accessed March, 2008)HRMC. 2008a. *Interest – Working towards a harmonised regime*. Liverpool. [Online]

Available from: <http://www.hmrc.gov.uk/consultations/index.htm> (downloaded 11 July 2008)

HRMC. 2008b. *Interest – Working towards a harmonised regime. Draft legislation and commentary.* Liverpool. [Online] Available from: <http://www.hmrc.gov.uk/consultations/index.htm> (downloaded 14 March 2009)

HRMC. 2008c. *Interest – Working towards a harmonised regime. Summary of responses and proposals.* Liverpool. [Online] Available from: <http://www.hmrc.gov.uk/consultations/index.htm> (downloaded 17 March 2009)

HRMC. 2008d. *Modernisation powers, deterrents and safeguards. Meeting the obligation to file returns and pay tax on time.* London. [Online] Available from: <http://www.hmrc.gov.uk/consultations/index.htm> (downloaded 11 July 2008)

HRMC. 2008e. *Modernisation powers, deterrents and safeguards. Meeting the obligation to file returns and pay tax on time: Consultation responses and refined models.* London. [Online] Available from: <http://www.hmrc.gov.uk/consultations/index.htm> (downloaded 14 March 2009)

HRMC. 2008f. *Modernisation powers, deterrents and safeguards. Meeting the obligation to file returns and pay tax on time. Draft legislation and commentary.* London. [Online] Available from: <http://www.hmrc.gov.uk/consultations/index.htm> (downloaded 14 March 2009)

HRMC. 2008g. *Modernisation powers, deterrents and safeguards. Penalties reform: The next stage.* London. [Online] Available from: <http://www.hmrc.gov.uk/consultations/index.htm> (downloaded 11 July 2008)

International Federation of Accountants. 2006. *IPSAS 23; Revenue from Non-exchange Transactions (Taxes and Transfers)*. New York. [Online] Available from: www.ifac.org (downloaded 17 March 2008)

Ipsos MORI. 2008. *Late payment of tax: Motivations and Sanctions. Final report for HM Revenue & Customs*. London: HMRC. [Online] Available from: <http://www.hmrc.gov.uk/consultations/index.htm> (downloaded 17 March 2009)

Maranya, P. 2007. Public sector accounting: are we getting there.... *Accountancy SA*, Dec 2007/Jan 2008: 24-25

National Treasury. 2009. *Budget Review*. Pretoria. [Online] Available from: www.treasury.gov.za (downloaded 6 April 2009)

Organisation for Economic Co-operation and Development. 2004. *Tax Administration of OECD and Selected Non-OECD Countries: Comparative Information Series (2004)*. [Online] Available from: <http://www.oecd.org> (Downloaded on February 26, 2008)

Organisation for Economic Co-operation and Development. 2006. *Tax Administration of OECD and Selected Non-OECD Countries: Comparative Information Series (2006)*. [Online] Available from: <http://www.oecd.org> (Downloaded on February 26, 2008)

Public Sector Committee – International Federation of Accountants. 1994. Occasional Paper 1, *Implementing Accrual Accounting in Government: The New Zealand Experience*. [Online] Available from: <http://www.ifac.org> (Downloaded on February 26, 2008)

Public Sector Committee – International Federation of Accountants. 1996. Occasional Paper 3, *Perspectives on Accrual Accounting*. [Online] Available from: <http://www.ifac.org/Store/Details.tmp?SID=9560059893073&Cart=12040080871776209> (Downloaded on February 26, 2008)

South Africa. 1962. *The Income Tax Act 58 of 1962*. Pretoria: Government Printer.

South Africa. 1991. *The Value Added Tax Act 89 of 1991*. Pretoria: Government Printer.

South African Revenue Service. 2008a. *Income Tax Act, 1962: Regulations issued under section 75B prescribing administrative penalties in respect of non-compliance. Government Gazette, 522(31764):1-14*. Pretoria: Government Printer.

South African Revenue Service. 2008b. *South African Revenue Service Annual Report 2007-2008*. Pretoria. [Online] Available from: www.sars.gov.za (downloaded 1 December 2008)

Van der Hoek, P. 2005. From Cash to Accrual Budgeting and Accounting in the Public Sector: The Dutch Experience. *Public Budgeting & Finance*, Spring 2005: 32-45.