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AN ANALYSIS OF THE EFFECTIVENESS OF THE UNDERSTATEMENT PENALTY

by

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ABSTRACT

With the enactment of the understatement penalty in the Tax Administration Act 28 of 2011, in October 2012, a new era dawned on compliance penalties for the taxpayers of South Africa. It brought about changes to the legislative provisions regulating compliance penalties and introduced behavioural penalties, a foreign concept which was met with fear and scepticism. The subjective imposition of the former penalty regime, the additional taxes, which was scattered all over the different tax Acts, contributed to the perception of the taxpaying public that the understatement penalty would follow suit.

The main objective in this study was to determine if the understatement penalty was effectively applied and aligned with its foreign counterparts. To achieve this objective, it was essential to conduct a comparative study of the understatement penalty with the behavioural penalties of Australia and New Zealand. These countries were selected due to the strong English influence in terms of the legal systems and legislative framework applied in each of these countries and the similarities that these countries show in terms of the processes applied by the Revenue Authorities. It was essential to define and explain, on the basis of a literature review, the construct of the understatement penalty and the behavioural penalty regimes of the foreign jurisdictions selected for this study.

It was further essential to define and explain the administrative requirements as provided for in the Constitution together with the legislation regulating just administrative action, to ensure that the understatement penalty is effectively applied. Finally the purpose for the analysis of domestic and foreign case law applicable to the imposition of behavioural penalties was to assess the validity of the theoretical constructs underpinning the efficacy of the understatement penalty.

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LIST OF ABBREVIATIONS USED

Abbreviation /Acronym	**Meaning**
ADR	Alternative Dispute Resolution
ATO	Australian Taxation Office
ATR	Advance Tax Ruling
BEPS	Base Erosion and Profit Shifting action plans
CFI	Committee on Fiscal Affairs
Constitution 1996	The Constitution of the Republic of South Africa, 1996
CPA	Criminal Procedure Act, 51 of 1977
FIC	Financial Intelligence Service
FICA	Financial Intelligence Centre Act 38 of 2001
FSB	Financial Services Board
FTA	Forum on Tax Administration
GFI	Global Financial Integrity
IR	Inland Revenue of New Zealand
ITA	Income Tax Act, 58 of 1962
ITAA	Income Tax Administration Act
MT2008/2	Miscellaneous Taxation Ruling MT 2008/2
NPA	National Prosecuting Authority
OECD	Organisation for Economic Co-operation and Development
PAIA	Promotion of Access to Information Act,2 of 2000 (PAIA)
PAJA	Promotion of Administrative Justice Act, 3 of 2000 (PAJA)
PFMA	Public Finance Management Act, 1 of 1999
POCA	Prevention of Organised Crime Act 121 of 1998
PSLA 2012/5	Practice Statement Law Administration 2012/5
RSA	Republic of South Africa
SAPS	South African Police Service
SARS Act	South African Revenue Service Act, 34 of 1997

SARS	South African Revenue Service
SCA	Supreme Court of Appeal
Administration Act	Tax Administration Act 1953 (Australia)
TAA	Tax Administration Act 1994 (New Zealand)
TA Act	Tax Administration Act, 28 of 2011
TAB	Tax Administration Bill, 11B of 2011
TIB	Tax Information Bulletin
VAT Act	Value-Added Tax Act, 89 of 1991

CHAPTER 1

BACKGROUND AND INTRODUCTION TO THE RESEARCH

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1.1 BACKGROUND AND INTRODUCTION

Historically the fear of the tax collector was echoed in the proverb 'you can have a Lord, you can have a King, but the man to fear is the tax collector'.[1] Taxation and the requirement for tax compliance started as early as 3000 BCE–2800 BCE in Ancient Egypt

[1] Goldswain G K 'The personal circumstances of the taxpayer as a defence or as a plea of "extenuating circumstances" for the purposes of remission of penalties in income tax matters' (2003) *Meditari Accountancy Research Journal* 11 at 68. Goldswain referred to this proverb and the history of it, as a source in his article from Adams C 'For Good and Evil -The impact of Taxes on the course of Civilisation' (1999) 2nd edition, Madison Books, Lanham, Maryland.

developing throughout the centuries.[2] The gradual transition to international cross border trading societies, led to the adoption of independent revenue authorities who act as tax collectors for the various states. South Africa's tax collector is known as the South African Revenue Service (SARS) which was established as an organ of state in terms of the South African Revenue Service Act,[3] (SARS Act).

The democracy of South Africa is relatively new since it was signed into law in terms of the Constitution of the Republic of South Africa.[4] With the re-introduction of South Africa into the international world of trade after 1994, South Africa was exposed to the global markets and the world of transnational organised crime and all of its facets which gradually had a major impact on South Africa's gross domestic product.[5] Evans[6], referred to statistics published by the international monitoring organisation Global Financial Integrity (GFI), for 2012, in which it is estimated that South Africa loses R147 billion per year to the illegal movement of money from South Africa. Quoting the president of GFI,[7] Raymond Baker, South Africa was ranked 9th highest of 151 countries on losing money through illicit financial outflows in 2012.

The South African taxation laws were clearly outdated as it only focused on the non-compliance with its domestic tax Acts. The previous South African penalty dispensation lacked a meaningful and objective differentiation, in that no proper distinction was made between serious and non-serious tax acts when penalties were imposed, and lacked

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[2] Muller E 'A Framework for Wealth Transfer Taxation in South Africa' (2010) (Unpublished LLD thesis) University of Pretoria at 1.

[3] In 1997 the South African Revenue Service was established as an organ of state in terms of the South African Revenue Service Act 34 of 1997, primarily responsible for the administration of fiscal legislation and efficient and effective collection of revenue.

[4] Constitution of the Republic of South Africa, 1996.

[5] Hartley W 'SA loses 10% of GDP to illicit economy' (2011) *Business day* http://bit.ly/2mzbUDt (Accessed 2 March 2017).

[6] Evans S 'R147 billion lost through money illegally leaving SA' (2014) *Mail & Guardian.* http://bit.ly/2myf7Sc. (Accessed 8 March 2017).

[7] The Global Financial Integrity Organisation is an advisory international organisation based in Washington DC who collects information from the International Monetary Fund (IMF).

consistency in terms of the imposition of additional taxes and penalties which were scattered all over the tax Acts.[8] The section 76[9] additional taxes were subjectively imposed up to 200% on the tax debt owing by the taxpayer with no or little guidance in an attempt to deter the wrongful behaviour of the taxpayer.

South Africa identified the need for specific strategies, to properly administer the fiscal legislation and ensure efficient and effective collection of revenue, in an attempt to deal effectively with these elements of organised crime. Accordingly, four important pieces of domestic legislation was enacted, between 1997 and 2011, to give effect to these strategies namely:

i) The SARS Act,[10] which established the organ of state known as SARS to ensure proper administration of fiscal legislation and efficient and effective collection of revenue. The extensive fiscal legislative powers of SARS enable it to exercise these duties within the ambit of the provisions of the Constitution of the Republic of South Africa.[11]

ii) The Prevention of Organised Crime Act[12] (POCA) which effectively deals with organised crime such as money laundering and tax evasion;

iii) The Financial Intelligence Centre Act[13] (FICA) which imposes a duty on organisations dealing in, receiving and managing money and finances, to report and disclose

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8 Feuth J A ‘Refining the understatement penalty in terms of the Tax Administration Act’ (2013) (Unpublished MCom dissertation) North West University at 9.

9 Section 76 of the Income Tax Act 58 of 1962.

10 Section 2 and 4 of Act 34 of 1997.

11 Section 4(2) of the SARS Act read with section 44 of the Constitution, 1996.

12 Act 121 of 1998.

13 Act 38 of 2001.

suspicious and unusual transactions of a person or persons belonging to these organisations;[14] and

iv) The Tax Administration Act[15] (TA Act) which enables SARS to amongst others, implement, impose and enforce the understatement penalty (USP) as a punitive measure to improve the overall behaviour of the taxpayer in terms of tax compliance;[16]

South Africa sought to align the tax penalty regime with its foreign counterparts and accordingly, introduced a penalty regime that attempted to contribute to the equity and fairness of tax administration, which would lead to a balance between the powers and duties of the Commissioner, and the rights and obligations of the taxpayers.[17] This penalty regime is reliant on the behaviour of taxpayers, which behaviours determine the severity of the penalty that should be imposed, if an act or omission leads to an understatement of income which prejudices SARS or the *fiscus*.

Accordingly, these four pieces of legislation encourages co-operation between the various governmental agencies to close the loopholes or tax gaps, and to identify and curb the spiralling effect that each of these tax crimes have in various areas of our tax law.

Of importance to this paper, is SARS' duty to administer the TA Act[18] under the control and discretion of the Commissioner.[19] To administer the Act, according to Silke,[20] SARS is

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14 Section 29 of FICA.

15 The TA Act was promulgated in Government Gazette No.35491 on 4 July 2012 and came into effect on 1 October 2012.

16 Section 222 read with section 223 of the TA Act.

17 This is in accordance with the purpose of the TA Act as outlined in section 2 of the Act.

18 In terms of section 2(2) of the TA Act.

19 In terms of section 3(1) of the TA Act.

20 Arendse et all 'Silke on Tax Administration' (2016) Lexis Nexis On-line at 18.2. http://bit.ly/2mPwGNB (Accessed 9 March 2017).

required to obtain full information in relation to the tax liability and tax compliance of a taxpayer regarding a previous, current or future tax period. SARS is required to establish the identity of the taxpayer to collect tax and pay out any refunds due. It is within the power of SARS to investigate and assist in the prosecution of tax offences committed and to ensure that any obligation imposed by a tax Act is enforced and complied with.

Gcabo and Robinson,[21] suggested that the unprecedented success by SARS to consistently surpass the collection of revenue targets, had the effect of improving tax morale and ensuring an improved tax administration. It emphasised the element of trust that the taxpayers had in the taxing authority, which had a direct impact on the tax-compliance behaviour of the taxpayers. Unfortunately the days of surpassing collection targets might not be a tangible concept for future collection years to come, due to the economic recession and unstable political climate that South Africa is currently facing. [22] Obtaining knowledge and an understanding of the taxpayers' reasons for non-compliance, is a challenge for any revenue collecting authority.[23]

When a revenue authority decides to impose penalties in instances of non-compliance with tax Acts, the aim is to ultimately rectify the behaviour of the taxpayer. But in order to succeed in this aim, the revenue authorities need to understand the taxpayers' behaviour. In examining the behavioural attitudes of taxpayers, as opposed to compliance traits, Devos[24] is of the view that a revenue authority will be better equipped to improve their

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21 Gcabo R, Robinson Z 'Tax compliance and behavioural response in South Africa: An alternative investigation' (2007) *SAJEMS* at 357.

22 On 3 April 2017, the ratings agency Standards and Poors, downgraded South Africa to sub-investment grade, stating that it was due to the massive Cabinet re-shuffle and put policy continuity at risk. It lowered the long-term foreign currency sovereign credit rating on the Republic of South Africa to BB+ and lowered the short term foreign currency rating to 'B'. On 9 June 2017, rating agency Moody's 'downgraded the country's long-term foreign and local currency debt ratings by one notch from Baa2 to Baa3, with a negative outlook, keeping it at investment grade,' due to the weakening of South Africa's institutional framework, slow economic growth and continued erosion of the country's fiscal strength. http://bit.ly/2rmBM4M. (Accessed 12 June 2017)

23 Devos K Tax Evasion Behaviour and Demographic Factors: An Exploratory Study in Australia (2008) *Revenue Law Journal* at 1.

24 Devos K (2008) at 2.

audit strategies in an attempt to close the tax gaps, if it understands what the effect of taxpayers' behavioural attitudes have, on tax compliance.

Certain types of inappropriate behaviour such as conflict of interest and bribery often lead to the design of codes of conduct or behaviour to anticipate and prevent these types of behaviour.[25] Codes that focus on behaviour are important tools to promote an ethical and professional public service. By conducting a comparative study on the elements that make codes work and elements that make codes fail, Gilman[26] found that codes of conduct or ethics, are recognised internationally, as it provides a framework for public servants in terms of the political and civil service responsibilities that they need to deliver. This ultimately induces monetary reform, improves economic programs and creates productive democratic institutions.[27]

Taxing authorities need to present a clear vision on what behaviours the authority wants to encourage and what behaviour it wants to discourage, as the demand for respect and truthfulness both from the public servants and the public will ensure an honest and respectful system.

It is of further importance that a code is supported by a viable legal system, which has laws to deal with corruption and provides for proper investigations, administrative adjudication and a judiciary with a certain level of independence.[28]

This paper examines the evolution of the understatement penalty, since its enactment in 2012 and how effectively it is imposed. In briefing Parliament's Standing Committee on

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[25] Gilman S C Ethics Codes and Codes of Conduct as Tools for Promoting an Ethical and Professional Public Service: Comparative Successes and Lessons (2005) Paper prepared for the PREM World Bank OECD Governance Forum at 16. http://bit.ly/2pk0Hsa (Accessed 18 March 2017).

[26] Gilman S C (2005) at 4. http://bit.ly/2pk0Hsa (Accessed 18 March 2017).

[27] Gilman S C (2005) at 6. http://bit.ly/2pk0Hsa (Accessed 18 March 2017).

[28] Gilman S C (2005) at 65-66. http://bit.ly/2pk0Hsa. (Accessed 18 March 2017).

Finance,[29] SARS indicated that the implementation of advanced compliance measures such as the understatement penalty regime was necessary to combat the ever-increasing incidents of tax fraud and tax evasion.

However, with the imposition of an advanced compliance measure such as the understatement penalty, SARS has a legislative duty to ensure that the administrative action it administers, complies with the requirements of the provisions in terms of the Promotion of Administrative Justice Act (PAJA).[30] Hoexter was of the view that the requirements of fairness and legality should be applied in a similar fashion as it will ensure that procedural fairness is appropriately applied.[31]

Consequently, apart from comparing the understatement penalty regime with its foreign counterparts so identified for this study, this paper determines if the South African understatement penalty complies with the administrative principles as identified by Hoexter,[32] in terms of PAJA.

The understatement penalty regime as introduced in Chapter 16 of the TA Act, provides a limited structure whereby the percentage of the penalty, to be imposed as a result of the understatement of income, is determined by the taxpayer's behaviour and objective criteria. This penalty regime effectively repealed the open-ended discretion that the Commissioner previously had in terms of section 76 of the Income Tax Act.[33] The understatement penalty predominantly targets the more serious non-compliance conduct, which includes elements of tax evasion, gross negligence and instances where the taxpayer takes a tax position that is not reasonably arguable in an attempt to combat the continuous erosion of the fiscal strength and revenue base.

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29 Gordan P and Magashula O 'SARS' Strategic Compliance Programme 2012/13 – 2016/17' (2012) at 5.

30 Section 3(1) pf Act 3 of 2000.

31 Hoexter C 'The New Constitutional and Administrative Law' (2002) Juta & Co at 214.

32 Hoexter C (2002) at 214.

33 Act 58 of 1962.

Due to the severe restrictions in the understatement penalty regime, specifically pertaining to the limited grounds upon which the understatement penalty can be remitted or reduced, the question has been posed whether SARS could be viewed as the playground bully.[34] The process undertaken to impose the understatement penalty and the administrative avenues available to challenge these impositions are discussed to provide some insight on alternative remedies for the taxpayers to have the penalties reduced or remitted.

1.2 COMPARATIVE STUDY – COUNTRIES SELECTED

Having regard to the recent Tax Court matters, where the imposition of the understatement penalty was adjudicated, the comparative study undertaken in this paper aims to compare the understatement penalty with its foreign counterparts in an attempt to determine whether the penalty regime is internationally aligned. The appropriate choice of countries for the comparative study for purposes of this dissertation is Australia and New Zealand. The choices in selecting these countries are supported by the following reasons:

i) South African law is based partly on Roman-Dutch law and English law.[35] The South African and Australian tax Acts are similar in certain respects due to the fact that the Australian tax law originated from the New South Wales Act of 1895.[36] The strong English influence in both Australian and South African Income Tax Acts is as a result of the fact that these countries were previous British colonies;[37]

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34 Kanamugire J C A 'Critical Analysis of Tax Avoidance in the South African Income Tax Act, 58 of 1962 as Amended' (2013) *Mediterranean Journal of Social Sciences* at 357.

35 Schreiner O D (Hon) 'The contribution of English Law to South African Law: And the Rule of Law in South Africa' (1967) Juta & Company Ltd at 5.

36 The New South Wales Act of 1895 which is a British Act, conferred a Constitution on the Colony of New South Wales and established the democracy in Australia. http://bit.ly/2mVVG8E (Accessed 8 March 2017).

37 Brink S M, Viviers H A 'Inkomstebelastinghantering van Kliënte lojaliteitsprgram transaksies in Suid-Afrika' (2012) *Journal of Economics & Financial Services* at 439,

ii) The legal systems of the countries such as Australia,[38] and New Zealand[39] are based on English law, who applies similar processes, system and penalty regimes as in South Africa;

iii) As with the foreign counterparts such as Australia and New Zealand, South Africa introduced the TA Act to consolidate the administrative provisions of all the different tax Acts into one piece of legislation.[40]

iv) Although South Africa is not a member country of the Organisation for Economic Co-Operation and Development (OECD),[41] it actively participates in the Forum on Tax Administration (FTA) together with Australia and New Zealand.[42]

The penalty regimes of the selected countries display similarities with the understatement penalty of the TA Act, as the behaviour of a taxpayer leads to an understatement of income or a shortfall of income.

In all instances the revenue authority is compensated for the prejudice caused by the understated income or shortfall in income, through the imposition of a determined percentage penalty on the tax amount so understated. The similarities and differences between the identified penalty regimes pertaining to subject specific issues are highlighted throughout the chapters in this paper.

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[38] Brink S M, Viviers H A (2012) at 439.

[39] Wells R 'Dispute Resolution process commenced by the Commissioner of Inland Revenue' (2010) Standard Practice Statement ED0126. http://bit.ly/2mz6Wqz (Accessed 8 March 2017).

[40] Explanatory Memorandum on the objects of the Tax Administration Bill, (2011) Lexis Nexis at 1. See also section 2 of the TA Act.

[41] The OECD is an organisation of the thirty-five major countries across the world, with its headquarters in Paris. South Africa became a key partner to contribute to the OECD's work in May 2007. http://bit.ly/2mVZC9p (Accessed 8 March 2017).

[42] The Forum on Tax Administration was created by the OECD's Committee on Fiscal Affairs. The Committee on Fiscal Affairs was established by the OECD to set international standards for tax. The Committee oversees the creation and maintenance of OECD publications such as the OECD Model Tax Convention, Transfer Pricing Guidelines and publishes global Revenue statistics. http://bit.ly/2meqTiV (Accessed 8 March 2017).

1.3 RATIONALE, OBJECTIVE AND METHODOLGY FOR THE STUDY

The consequence of penalties imposed on taxpayers with regard to non-compliant behaviour with the tax Acts, and the attitudes of taxpayers towards these penalties, provided an insight on the measures to be used as deterrence by the revenue authorities.[43]

Levy,[44] who reviewed the international evidence that exists on the impact of civil and criminal sanctions upon serious tax non-compliance by individuals, concluded that as administrative penalties are confidential in nature, as opposed to the public nature of prosecutions, it encourages tax offenders who are caught, to willingly pay the heavy penalties in order to avoid publicity, a criminal record and imprisonment.

During the introductory phase of the penalty regime, SARS failed to apply these measuring tools, according to Mazansky[45] who questioned SARS' understanding of the understatement penalty scheme and the policy behind it. Mazansky[46] further levels criticism towards SARS' inability to recognise the *de minimis*[47] threshold, established in section 222 and 223 of the TA Act, creating a situation that a taxpayer can be accused of a more egregious behaviour despite not even meeting the *de minimis* threshold. Mazansky's article highlights the purpose of this study, and indirectly poses the main research question identified herein, as to whether the understatement penalty is effectively applied by SARS.

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43 Grasmick H G and Scott W J 'Tax Evasion and Mechanics of Social Control: A Comparison of Grand and Petty Theft' (1982) 2 *Journal of Economic Psychology* at 213. See also Devos K 'Tax Evasion Behaviour and Demographic Factors: An Exploratory Study in Australia' (2008) *Revenue Law Journal* at 1.

44 Levy M 'Serious tax fraud and noncompliance: A review of evidence' (2010) *Criminology and Public Policy* 9 at 493.

45 Mazansky E 'Understatement Penalties: SARS need to provide clarity' (2016) *Business Tax & Company Law Quarterly* at 1 and 2.

46 Mazansky E (2016) at 2.

47 Section 222(1) determines that for a substantial understatement to incur, prejudice to SARS or the *fiscus* must exceed a *de minimis* threshold of 5% of the tax or R1 million.

The theoretical study of the domestic penalty regime, in comparison with its foreign counterparts identified for this study, analyses its effectiveness and compliance taking into account the rules of administrative fairness. To achieve the main objective, the theoretical construct of the understatement penalty regime as it relates to this study, is clarified within the ambit of administrative fairness and compared with the foreign counterparts.

The methodology for this study is particularly based on a literature review of peer reviewed journal articles, case law and qualitative historical research of the governmental concept documents, relevant to the topic of this study. In applying and discussing the various statutory provisions of the domestic and foreign jurisdictions for this study, an insight is provided into the adequacy of the understatement penalty.

1.4 EXPOSITION

1.4.1 Chapter 1

This chapter provides a background to the research problem in terms of the former penalty regime that was applied in relation to the non-compliance with various tax Acts. As a result of the increasing incidents of tax avoidance, tax evasion and base erosion of state revenues, the chapter sets out to lay a basis for the identification of the research objectives to assist in finding an answer for the research questions. The methodology to achieve these objectives is explained and a tabled list of the abbreviations used throughout this study is provided. The study has a limited scope which is outlined at the end of the chapter.

1.4.2 Chapter 2

Chapter two details the history leading up to the enactment of the new understatement penalty regime as contained in the TA Act. It provides a bird's eye view of the evolution of

the understatement penalty since its enactment and the current status in terms of recent amendments to the legislative provisions of the understatement penalty. The construct of the understatement penalty is analysed to lay the foundation blocks for the comparative study in chapter four. It describes the types of behavioural penalties that are applied in terms of the understatement penalty within the ambit of the relevant legislation and guides available for the interpretation thereof.

1.4.3 Chapter 3

To ensure that the actions to impose an understatement penalty complies with the requirements of administrative fairness, Chapter three briefly highlights the administrative requirements for a fair administrative decision in terms of section 33 of the Constitution, 1996, read with the statutory provisions contained in PAJA.

1.4.4 Chapter 4

The factors relating to tax compliance that has an impact on tax behaviour, is outlined in chapter four as a basis for the discussion of the legislative provisions of the foreign penalty regimes, of the countries identified for comparative study. The focus will only be on the behavioural penalties in terms if these foreign jurisdictions, as it is compared with the behavioural penalty regime of the South African understatement penalty.

The purpose is to establish if the understatement penalty is internationally aligned with the penalty regimes of these foreign jurisdictions, and if it is effectively applied to reach its goals in preventing and curbing tax evasion, fraud and tax avoidance.

The behavioural penalties of each foreign jurisdiction is discussed and compared to the South African understatement behavioural penalties. Reference is made to respective case law, both local and foreign, to establish if the understatement penalty is judicially effective.

1.4.5 Chapter 5

The concluding chapter summarises the findings of the previous chapters and makes a determination if the research objectives that were identified for this study, were achieved. The limitations and contributions for this study is highlighted to finally establish if the research problem that was identified produced a positive or negative outcome.

1.5 LIMITATION OF SCOPE

This study focuses on the current practices and procedures applied by SARS in terms of the imposition of the understatement penalty. Other practices and procedures are specifically excluded from this dissertation, such as the additional taxes imposed prior to the enactment of the understatement penalty. Each country identified for this study, inclusive of South Africa, has various types of non-compliance penalties. For purposes of this study, only the behavioural penalties of each foreign jurisdiction relating to the understatement or shortfall of income will be the focus of this study.

It must furthermore be noted, that the practices and procedures identified may also *prima facie* infringe on the taxpayer’s constitutional rights as noted in pending Constitutional challenges filed in the High Courts of South Africa, at the time of writing the dissertation.

For purposes of this dissertation reference to a taxpayer as a man or woman must be construed to include the other gender. In addition, actions taken by SARS in terms of legislation will be referred to as procedures whilst actions taken by SARS as an everyday occurrence will be referred to as a practice.

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CHAPTER 2

THE CONSTRUCT OF THE UNDERSTATEMENT PENALTY

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2.1 INTRODUCTION

The use and abuse of inconsistencies in global and domestic tax rules is a modern-day phenomenon that revenue authorities are dealing with on a continuing basis.[1] Kruger, found that the acts of multinational corporations and high net worth individuals defrauding the *fiscus* by entering into tax avoidance schemes and committing tax evasion, fall within the realm of organised crime, which pose a very serious threat to the security and stability of any country and its revenue base.[2]

The starting point in terms of this study is to analyse the construct of the domestic tax rules, more specifically the provisions relating to the understatement penalty, which these multinational corporations and high nett worth individuals tend to abuse.

This Chapter outlines the history relating to the former penalty regime that was applied, and why it was considered ineffective. The chapter then unpacks the enactment and construction of the understatement penalty provisions by providing a detailed discussion regarding the contents of Chapter 16 of the TA Act.

The imposition of the understatement penalty is determined in accordance with the behaviour of the taxpayer, which establishes the measuring tool for the level and severity of the imposition of the understatement penalty. By analysing the five underlying behaviours of the understatement penalty, a better understanding for the need to introduce the understatement penalty develops.

The understatement penalty matrix as provided for in section 223 of the TA Act, forms the base of this chapter to describe the legislative provisions of each of these behaviours, their meaning and interpretation as found in case law and in terms of their ordinary dictionary meaning.

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1 Gordan P ‘Budget Speech 2017 National Treasury’ at 12.

2 Kruger A ‘Organised Crime and Proceeds of Crime Law in South Africa’ (2008) Lexis Nexis at v.

2.2 HISTORICAL OVERVIEW OF THE ADDITIONAL TAX PENALTY REGIME PRIOR TO THE ENACTMENT OF THE UNDERSTATEMENT PENALTY

2.2.1 Additional Tax Penalties

Prior to the introduction and enactment of the understatement penalties in the TA Act, penalties to address administrative non-compliance with tax Acts, understatements of income and incidents of tax evasion was imposed in terms of various legislative provisions in the different tax Acts.

Section 60 of the VAT Act[3] provided for the imposition of additional taxes in VAT assessments and section 76(1) of the Income Tax Act[4] was applied in income tax matters. In these circumstances the Commissioner could impose additional tax equalling 200% of the tax properly chargeable.[5] Additional tax is not considered a tax for the purposes of establishing a taxpayer's tax liability on assessment, but rather a penalty for certain tax offences committed in terms of Income tax or Value Added Tax.

2.2.2 Remission of Additional Tax Penalties

The remission of additional tax was governed in terms of section 39(2) of the VAT Act and section 76(2)(*a*) of the Income Tax Act respectively. The Commissioner had a discretion in terms of these provisions, to remit the additional charge on condition that extenuating circumstances existed and that there was no act or omission with the intent to evade taxation. Goldswain,[6] in examining the meaning of extenuating circumstances, briefly listed

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3 Act 89 of 1991.

4 Act 58 of 1962.

5 Goldswain G K 'The personal circumstances of the taxpayer as a defence or as a plea of "extenuating circumstances' for the purpose of remission of penalties in income tax matters' (2003) *Meditari Accountancy Research journal* at 68. See also Goldswain G K 'Extenuating circumstances II' (2002) 16 2 *Tax Planning Corporate and Personal* at 1-3.

6 Goldswain G K (2003) *Meditari Accountancy Research journal* at 68. See also Goldswain, G K 'The General Meaning of "Extenuating Circumstances" for the Purposes of section 76(2)(a) of the Income Tax Act' (2001) *Meditari Accountancy Research* 123–135, and Goldswain G K 'Reliance on

the circumstances that influenced the discretion of the Commissioner, which included but was not limited to reliance on a tax advisor, bookkeeper, accountant or member of staff, personal circumstances of the taxpayer including his financial means and behaviour and the taxpayer's ignorance of the law. If any of these circumstances were substantiated by the taxpayer in their request for the remission of the additional taxes, the Commissioner in terms of section 76(2) of the Income Tax Act, had the discretion to remit or reduce these additional taxes.

2.2.3 Inconsistent application of additional tax penalties

There was a perception amongst tax practitioners and the general public that SARS placed more emphasis on the deterrent effect and penal nature that section 76 had, rather than the extenuating circumstances that existed, which lead to the understatement of income to occur.[7]

In *CSARS v NWK* [8] the taxpayer, who traded in maize entered into a structured finance loan agreement with one of the banks that he had an account with. The loan had to be repaid over a period of five years. During this period the taxpayer claimed deductions in terms of section 11(a) of the Income Tax Act based on the interest that he had to pay on this loan. The Commissioner raised an additional assessment,[9] disallowing these deductions claimed, on the basis that the loan was not a genuine contract but a series of transactions, intended to disguise the intention of the taxpayer to avoid paying his taxes. Despite SARS persisting with a penalty of 200%, as it argued that there were no extenuating circumstances prevailing, the 200% penalty was reduced to 100% as the SCA held that the 200% penalty was severe and out of proportion to the wrong committed by

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Professional and Non-Professional Advisors or Staff as a Defence to the Imposition of Penalties in Income Tax Matters' (2001) *Meditari Accountancy Research* 137–154.

[7] Anon 'Understatement penalty' (2011) *The South African Institute for Chartered Accountants* at 147. http://bit.ly/2mOAiBH (Accessed 27 February 2017).

[8] *CSARS v NWK* [2011] 2 All SA 347 (SCA) at 369.

[9] The additional assessment was raised in terms of section 79 of the Income Tax Act.

the taxpayer.[10] There were several other examples of instances in which the imposition of additional taxes lacked consistency, such as *ITC 1576,*[11] where the Commissioner imposed an additional tax penalty of 125% and refused to afford the taxpayer the opportunity to apply for a remission of this penalty. The Court consequently reduced the penalty to 50%. In *CIR v BP Miller*[12] SARS imposed a 200% additional tax penalty. Upon exercising its discretion, the Commissioner reduced the penalty to 100%. The decision was referred to the Special Court where Fagan DJP reduced the additional tax amount with a further 75%, finding that the amount of the penalty depended directly on the size of the delinquent taxpayer's default, his blameworthiness.

2.3 THE ENACTMENT AND CONSTRUCT OF THE UNDERSTATEMENT PENALTY

2.3.1 The enactment of the Understatement Penalty

With the enactment of the TA Act, the legislator sought to introduce the range of administrative penalties that were formally scattered over the various tax Acts,[13] as a combined penalty regime, in Chapters 15 to 17 of the TA Act. These penalty regimes mainly dealt with the non-compliance acts and omissions that were encountered in terms of the Income Tax Act and the VAT Act.[14] There are three main penalty sections that are provided for in the TA Act which are reflected in the figure below:

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10 *NWK* at 371.

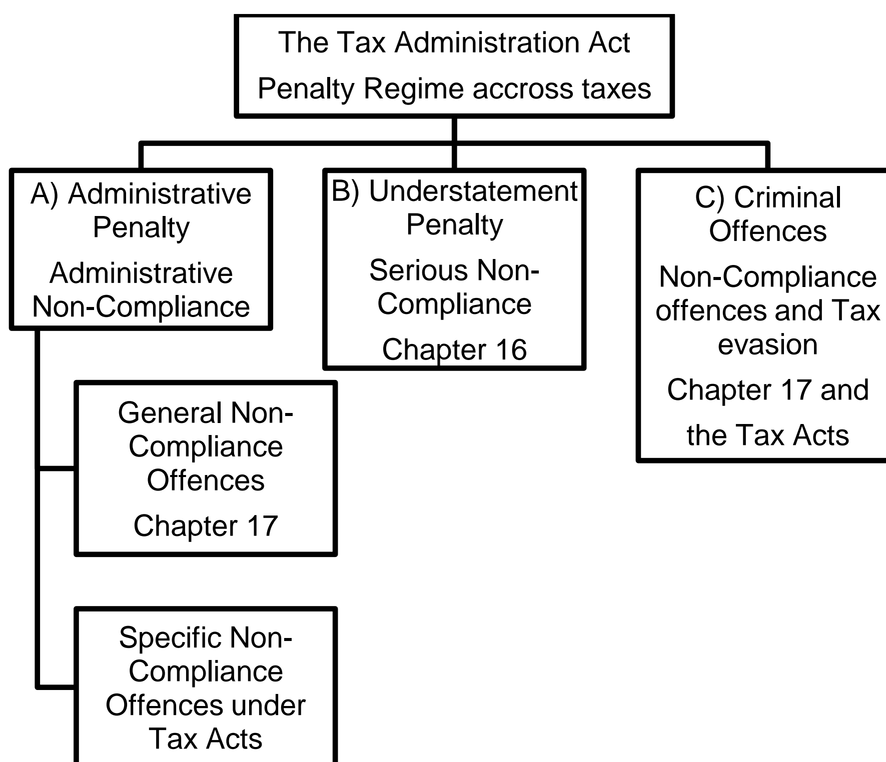
11 *ITC 1576* (56 SATC 225) at 236.

12 *CIR v BP Miller* (56 SATC 1) at 8.

13 In terms of section 76 of the Income Tax Act and section 60 of the VAT Act.

14 These penalty provisions exclude the existing penalty provisions still contained in the Customs and Excise Act 91 of 1964, the Estate Duty Act 45 of 1955, the Income Tax Act 58 of 1962, the Marketable Securities Act 32 of 1948, the Skills Development Levies Act 9 of 1999, the Transfer Duty Act 40 of 1949 and the Value-Added Tax Act 89 of 1991. See also Arendse J A et all 'Silke on Tax Administration' (2016) http://bit.ly/2mPwGNB (Accessed 9 March 2017).

Figure 1 : Penalty Regimes – Tax Administration Act 28 of 2011



Source: Section 208 to 220 in the Tax Administration Act 28 of 2011.

The penalties reflected in the figure above, are described as follows:

A) The administrative non-compliance penalties – These penalties consist of both the fixed-amount penalties and percentage-based penalties, which are contained in sections 208 to 220 of the TA Act. The full range of non-compliance type penalties as originally promulgated in terms of section 75B of the Income Tax Act was incorporated in section 210 of the TA Act;[15]

[15] Section 75B was repealed by section 271 read with paragraph 64 of Schedule 1 of the TA Act, and incorporated into section 210 by section 70 of Act 21 of 2012. See also Arendse J A et all 'Silke on Tax Administration' (2016) http://bit.ly/2mPwGNB (Accessed 9 March 2017).

B) The understatement penalty – these penalties were introduced in terms of section 221 to 223 of the TA Act, which is regulated in terms of the provisions in Chapter 16 of the TA Act;[16] and

C) The criminal offences penalties. These penalties are provided for in each separate tax Act due to non-compliance with these different tax Acts including tax evasion.

The understatement penalty regime is duly regulated in terms of a disciplinary matrix provided for in section 223 of the TA Act, which forms the basis of this study, as discussed below.

2.3.2 The disciplinary penalty matrix of the Understatement Penalty

The disciplinary penalty matrix which is considered a behavioural matrix for the imposition of understatement penalties, is a tool used to assign the consequences, for serious misbehaviour committed by taxpayers in relation to the non-compliance with the tax Acts. The Commissioner applies this disciplinary penalty matrix when a decision is made to impose understatement penalties.

Gilman,[17] evaluated the elements of an effective public administrative system and found that for the system to be taken seriously, that an administrative organ such as a revenue authority needed to add weight to it in the form of statutory and regulatory devices. The matrix should assist the code that is developed for the understatement penalty regime, which should display the ultimate consequences of the understatement penalty, clearly and concisely to ensure that it is enforceable.[18] This will enable the administration to interpret and enforce the code by applying these essential elements for a good legal foundation.[19]To prevent discretionary abuse by public servants as enforcers, the law is

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16 Surtees P, Ross E 'SARS Penalties at a glance' (2014) *Tax Professional Journal* at 24-25.

17 Gilman S C (2005) at 20. http://bit.ly/2meOqA3 (Accessed 12 March 2017).

18 Gilman S C (2005) at 20. http://bit.ly/2meOqA3 (Accessed 12 March 2017).

19 Gilman S C (2005) at 32. http://bit.ly/2meOqA3 (Accessed 12 March 2017).

designed to prevent certain behaviours by public servants. Gilman concluded that behavioural objectives need to be clear as it can result in unintended consequences.[20] Widen,[21] found that to craft rules governing conduct, a revenue authority had to align these rules with the general notion of right and wrong, as opposed to technical and complex rules.

The understatement penalty regime of the TA Act is formulated in a disciplinary matrix, contained in the section 223(1) penalty table. There are five behaviours listed in the decision matrix. The disciplinary matrix in section 223 includes the percentage penalty to be imposed where the taxpayer made a voluntary disclosure on an understatement that occurred before an audit was initiated.[22]

In an effort to assist the public in terms of the application of each behaviour, SARS issued a Guide to assist the general public in terms of the interpretation of each of these behaviours, which is briefly listed and described in this guide.[23] As PAJA[24] defines an administrative decision to mean any decision of an administrative nature to be made under an empowering provision, an unfair administrative purports to ignore the legislative requirements to which it is bound to, depriving the taxpayer of his constitutional rights.[25] The taxpayer is accordingly not afforded the fair right to mitigate the imposition of a lower penalty and is placed on the back foot, having to justify the highest penalty percentage applicable to his specific case. Although the intention of the Legislator was to construct a penalty matrix which provided for an objective consistent application,[26] the lack in

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20 Gilman S C (2005) at 61. http://bit.ly/2meOqA3 (Accessed 12 March 2017).

21 Widen W 'Enron at the Margin' (2003) *The Business Lawyer* at 1002. See also Gilman S C (2005) at 23. http://bit.ly/2meOqA3 (Accessed 12 March 2017)

22 Items (i) to (v) under columns 5 and 6 of the Understatement Penalty Table in section 223 of the TA Act. For purposes of this study voluntary disclosure will not be discussed.

23 SARS (2013) 'Short Guide to the Tax Administration Act, 2011' at 78. http://bit.ly/2AAf5TB

24 Section 1 of PAJA.

25 Section 33 of the Constitution, 1996. Also see Hoexter C (2002) at 221.

26 Explanatory Memorandum of the Tax Administration Bill 2011.

information ascribed to this table leaves it open to own interpretation. Each behaviour, listed in column two, is dependent on the circumstances that might exist as listed in columns three to six. The percentages displayed in each column assigned to a specific behaviour increases or decreases in percentage which is dependent on the severity or circumstances of each case.

The disciplinary matrix in section 223(1),[27] is portrayed in the TA Act as follows:

Table 1: The understatement penalty table as per section 223 of the TA Act

1	2	3	4	5	6
Item	**Behaviour**	**Standard Case**	**If obstructive, or if it is a 'repeat case'**	**Voluntary disclosures after notification of audit or investigation**	**Voluntary disclosures before notification of audit or investigation**
(i)	'Substantial understatement'	10%	20%	5%	0%
(ii)	Reasonable care not taken in completing return	25%	50%	15%	0%
(iii)	No reasonable grounds for 'tax position' taken	50%	75%	25%	0%
(iv)	Gross negligence	100%	152%	50%	5%
(v)	Intentional tax evasion	150%	200%	75%	10%

Source: Section 223(1) of the Tax Administration Act 28 of 2011.

[27] Section 223(1) of the TA Act as amended in terms of section 76(1)(a) of the Tax Law Amendment Act 39 of 2013.

2.3.3 The construct of the Understatement Penalty

An understatement penalty is imposed once an understatement of taxable income occurs, which cause prejudice to SARS or the *fiscus*. Section 221 of the TA Act lists the circumstances that is considered to cause prejudice to SARS or the *fiscus* namely a default in rendering a return, an omission from a return, an incorrect statement in a return, or if no return is required, the failure to pay the correct amount of tax.'[28]

The taxpayer pays in addition to the tax payable, the understatement penalty determined in terms of section 222 read with section 223 of the TA Act, once it is determined that an understatement occurred. The understatement penalties are levied on the amount of the shortfall to the *fiscus*, which is calculated as the difference between the tax that is properly chargeable, and the tax amount that would have been charged had the taxpayer's declaration been accepted.[29]

The open-ended discretion of the Commissioner to impose the additional taxes under the former section penalty regimes was found to be too broad and hence the proposal was made in the Draft Tax Administration Bill to fetter this wide discretion.[30]

In terms of the understatement penalty regime, the discretion of the Commissioner is now restricted to only two instances where the understatement penalty can be remitted, which is when it is found that a *bona fide* error[31] was committed or if a substantial understatement occurred as a result of the reliance by the taxpayer on the opinion of a tax practitioner to take the specific tax position that lead to the understatement to occur.

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28 Definition of 'understatement' in terms of section 221 of the TA Act.

29 Section 222 of the TA Act.

30 Draft Explanatory Memorandum on the Tax Administration Bill, 2009. http://bit.ly/2nbZO4H (Accessed 7 March 2017).

31 As described in section 222 of the TA Act.

i) Definitions in Chapter 16 relating to the understatement penalty

Section 221 of the TA Act[32] provides chapter specific definitions[33] of the terms and phrases to be applied when interpreting Chapter 16. Words, terms and phrases not defined in terms of Chapter 16 of the TA Act, which directly relate to the behaviour of a taxpayer, is interpreted in terms of the descriptions provided in the Guide to the Understatement Penalty[34] or in terms of common law principles enshrined in case law or in terms of the ordinary meanings assigned to it in dictionaries. The definitions pertaining to the understatement penalty is accordingly defined or explained as follows:

a) 'Standard case' as listed in the heading of column three, is regarded as a first offense.[35] The ordinary dictionary meaning assigned to the adjective 'standard' as applied to 'case' means 'used or accepted as normal,'[36]as it is not defined in Chapter 16 of the TA Act or in the other tax Acts;

b) 'Obstructive' as listed in heading four, is not defined in the tax Acts, therefore the ordinary meaning assigned to it in terms of the dictionary, is that of 'being in the way, stopping or hindering progress'.[37] This occurs in circumstances where taxpayers refuse to co-operate with an ongoing audit or refuse to provide certain documentation for purposes of an audit;

c) 'Repeat case' means 'a second or further case of any of the behaviours listed under items (i) to (v) of the understatement penalty percentage table reflected in section 223 of the TA Act, within five years of the previous case'. If a taxpayer commits any

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32 Chapter 16 consists of sections 221 to 233 of the TA Act.

33 Section 221 of the TA Act lists and describes the definitions applicable to Chapter 16 of the TA Act.

34 Anon 'SARS Short Guide to the Tax Administration Act 28 of 2011' (2013) at 80. http://bit.ly/2AAf5TB (Accessed 7 March 2017)

35 Anon (2013) at 80. http://bit.ly/2AAf5TB (Accessed 7 March 2017)

36 Buxton C (ed) 'standard' Oxford English Dictionary (2013) Oxford University Press at 550.

37 Buxton C (ed) 'obstructive' Oxford English Dictionary (2013) Oxford University Press at 386.

of the behaviours listed under column two of the understatement penalty table within five years of originally being penalised for the contravention of the offence, the case is regarded as a repeat case, for purposes of the understatement penalty. This will lead to an escalation in the percentage of the understatement penalty when the Commissioner decides to impose it;

d) 'Substantial understatement' means 'a case where the prejudice to SARS or the *fiscus* exceeds the greater of five per cent of the amount of "tax" properly chargeable or refundable under a tax Act for the relevant tax period, or R1,000 000';[38]

e) 'Understatement Penalty' means 'a penalty imposed by SARS in accordance with Part A of Chapter 16; Section 222(2) of the TA Act - The understatement penalty is the amount resulting from applying the highest applicable understatement penalty percentage in accordance with the table in section 223 to each shortfall determined under subsections (3) and (4) in relation to each understatement in a return.';

f) 'Tax position' means 'an assumption underlying one or more aspects of a tax return, including whether or not an amount, transaction, event or item is taxable; an amount or item is deductible or may be set-off; a lower rate of tax than the maximum applicable to that class of taxpayer, transaction, event or item applies; or an amount qualifies as a reduction of tax payable.' An amount included in a tax return, whether the amount or transaction is taxable, deductible or may be set-off, or a lower tax rate is applicable or the amount qualifies for a reduction, is regarded as the 'tax position' taken by the taxpayer upon which an assessment is raised.[39]

g) The definition of the word 'tax' in section 221 of the TA Act,[40] differs from the same definition thereof in section 1 of the TA Act [41] and section 1 of the Income Tax Act.[42]

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[38] In terms of section 221 of the TA Act.

[39] Definition of 'tax position' in section 221 of the TA Act.

[40] The word 'tax' in section 221 of the TA Act excludes a penalty and interest.

[41] The word 'tax' in section 1 of the TA Act for purposes of administration of the TA Act includes 'a tax, duty, levy, royalty, fee, contribution, penalty, interest and any other moneys imposed under a tax Act.

Different meanings are assigned to the word ‘tax’ which will inevitably lead to disputes on what exactly the tax liability of the taxpayer is, and if it includes the understatement penalty that was imposed. The confusion was partly rectified with the recent amendment of the definition of ‘tax debt’[43] which now includes an understatement penalty, recoverable under the provisions of the TA Act. It is unclear why the word ‘tax’ in each of these separate provisions were not amended accordingly and why the three different meanings are still assigned to the same word as it can lead to the exploitation of the word to escape liability of paying a tax penalty.

h) ‘Tax Avoidance’ means ‘the lawful arrangement or planning of one’s affairs so as to reduce liability to tax’;[44]

i) ‘Tax Evasion’ means ‘Any illegal action taken to avoid the lawful assessment of taxes’;[45]

j) ‘Reasonable care’ means ‘this behaviour can only be considered if the taxpayer did submit a return. In order to identify reasonable care not taken, the auditor must consider what the reasonable, ordinary person in the circumstances of the taxpayer would have done’;[46]

k) ‘Gross negligence’ is ‘where a person has scant regard for the consequences of his/her action(s). The taxpayer is aware that there is a possibility that the tax position

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42 The definition of ‘tax’ in section 1 of the Income Tax Act means tax or a penalty imposed in terms of the Income Tax Act.

43 Section 1 relating to ‘tax debt’ was amended in terms of the Tax Laws Amendment Act 39 of 2013 and another term – ‘outstanding tax debt’ was inserted to clarify what is regarded as a tax debt to include an understatement penalty.

44 Law J (ed) ‘tax avoidance’ The Oxford Dictionary of Law (2015) University Press at 611.

45 Law J (ed) ‘tax evasion’ The Oxford Dictionary of Law (2015) University Press at 612.

46 Anon ‘SARS Short Guide to the Tax Administration Act, 2011’ - http://bit.ly/2AAf5TB (Accessed 7 March 2017) at 93. *See Kruger v Coetzee* 1966 (2) SA 428 (A) and *First National Bank v Duvenhage* [2006] SCA 47 (RSA) at paragraph 1 of the judgement for definitions of reasonable care.

taken, disclosure or omission from a return, is incorrect, but nevertheless decides to take the chance';[47]

l) 'Intent' means 'the state of mind of one who aims to bring about a particular consequence. Intention is one of the main forms of *mens rea,*[48] in criminal cases.' The term 'tax evasion' is defined as – 'any illegal action to avoid the lawful assessment of taxes.'[49] 'Intent' is defined in the Oxford Dictionary of Law as: 'the state of mind of one who aims to bring about a particular consequence'. Intention is one of the main forms of *mens rea*.'[50] '*Mens rea*' is defined in the Oxford Dictionary of Law as 'the intention to bring about a particular consequence, recklessness as to whether such consequences may come about.'[51]

One of the recent additions to section 221 was the term 'impermissible avoidance arrangement'. It allows for the imposition of an understatement penalty in terms of any transaction, operation, scheme or agreement under any tax Act, relating to general anti-avoidance arrangements.[52] This amendment allows for an understatement penalty to be imposed in instances of tax avoidance.

ii) The *Bona fide* inadvertent error.

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[47] SARS (2013) 'Short Guide to the Tax Administration Act, 2011' - http://bit.ly/2AAf5TB (Accessed 7 March 2017) at 93.

[48] Law J (ed) "*mens rea*" Oxford Dictionary of Law (2015) Oxford Press at 396 referring to *R v Cunningham* [1975] 2 QB 396. '*Mens rea'* means a criminal intention or knowledge that an act is wrong.

[49] Law J (ed) 'tax evasion' (2015) at 612.

[50] Law J (ed) 'intent' (2015) at 328.

[51] Law J (ed) '*mens rea*' (2015) at 396 referring to *R v Cunningham* [1975] 2 QB 396.

[52] The definition of 'impermissible avoidance arrangement' was inserted by section 61 (a) of the Tax Laws Amendment Act 16 of 2016. These terms are defined in Chapter 1 hereof, at paragraph 1.3.2.

The commission of a *bona fide* inadvertent error does not fall within the behavioural penalty matrix, but is dealt with as a valid reason to remit an understatement penalty.[53] If an understatement occurred as a result of a *bona fide* inadvertent error and it is found that there was a mistake in completing the return, or due to mistakes or calculation errors, the taxpayer will not be liable for an understatement penalty.[54] De Villiers,[55] explored the key considerations when determining *bona fide* inadvertent errors and concluded in terms of the grammatical definitions, that a *bona fide* inadvertent error can be the result of an understatement that occurred as a result of a taxpayer acting in good faith and having no intention to deceive SARS, erroneously states his affairs incorrectly on his return.

2.3.4 Definitions and concepts of the specific behaviour underpinning the understatement penalty

Items (i) to (v) of the understatement penalty table,[56] lists the five behaviours, which are assigned to a specific percentage, in the penalty matrix. The behaviour of taxpayers play an important role in determining which penalty should apply.

Through various studies conducted on the behaviour of taxpayers, concepts such as trust, economic approach, behavioural approach, fairness, attitudes and perceptions featured throughout. Bornman,[57] found that various behavioural themes and economic factors play a role in tax compliance but that the most important theme found to emerge throughout the studies was the requirement of trust. Cullis and Lewis,[58] found that the notion, that an

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53 In terms of section 222(2) of the TA Act.

54 Section 222(1) of the TA Act.

55 De Villiers C ‘Exploring key considerations when determining bona fide inadvertent errors resulting in understatements’ (2015) (Unpublished MCom dissertation) Northwest University at 22.

56 As per section 223 of the TA Act.

57 Bornman M ‘The determinants and measurement of trust in tax authorities as a factor influencing tax compliance behaviour’ (2015) *Journal of Economic and Financial Sciences* 772 - 789 at 775.

58 Cullis J G, Lewis ‘A "Why people pay taxes" From a conventional economic model to a model of social convention’ (1997) *Journal of Economic Psychology* at 305-321. See also Bornman M (2015) at 775.

individual's willingness to comply with or evade tax, was dependant on additional factors such as attitudes, values and economic perceptions.[59]

Wentzel,[60] expanded on these studies and found that the degree of fairness of interactions with society could be distinguished between four issues, which is of importance to the understatement penalty regime. These factors are the fairness in the manner which the tax authority treats the public, the degree of participation in the process by the taxpayers, the quality of information and feedback provided by the tax authorities and the administrative costs to ensure compliance with the tax Acts.

Allingham and Sandhimo,[61] discovered in their studies on tax compliance, that two categories existed to ensure tax compliance, being the economic approach and the behavioural approach. They developed the 'Allingham and Sandhimo (1972) standard economic model', which were found to be based on four parameters: the possibility to detect tax evasion, the ability to punish acts of tax evasion and the comparison of tax rates and the different income levels.

Kirchler,[62] however found that this model lacked the required substance and detail to make it an effective model, as what the neoclassical economists had intended, as it was a generalised model, which could not be applied on specific countries.

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59 This was confirmed in the study of Schmölders G 'Fiscal Psychology: A new Branch of Public Finance' (1959) *National Tax Journal* 340-345 and later in Vogel J 'Taxation and public opinion in Sweden: An interpretation of recent survey data' (1974) *National Tax Journal* 499-513.

60 Wenzel M 'Tax Compliance and the Psychology of Justice: Mapping the Field In V. Braithwaite, Taxing Democracy (2002) Aldershot: Ashgate (pp. 41-70) at 54. See also Bornman at 778.

61 Allingham M G, Sandhimo A 'Income Tax Evasion: A Theoretical Analysis' (1972) *Journal of Public Economics* at 323-338.

62 Kirchler E 'The Economic Psychology of Tax Behaviour' (2007) New York: Cambridge University Press at 107.

To determine if these concepts have an impact on the five behaviours listed in the penalty matrix, one need to understand the requirements for each of these behaviours and how it is described.

i) Substantial understatement.

Substantial understatement occurs where the prejudice to SARS or the *fiscus* exceeds the greater of five per cent of the amount of "tax" properly chargeable or refundable under a tax Act for the relevant tax period, or R1,000 000. A substantial understatement will be triggered if no other behaviour defines the facts of a case, and is normally applicable in instances where major companies have to pay great amounts of tax.[63] Provision is made for the remittance of this penalty if the taxpayer is in possession of an opinion by a registered tax practitioner regarding the arrangement or incorrect interpretation of the law that lead to the understatement penalty to be imposed, and the taxpayer made full disclosure of the arrangement that gave rise to the prejudice.[64] This should be done by no later than the date that the relevant return was due.

ii) Reasonable care not taken in completing a tax return.

This behaviour is only applicable if the taxpayer submitted a tax return, where certain deviations, understatements and omissions are detected. This will result in an understatement penalty being imposed. The test applied in this instance is the test for reasonable care, to consider what the reasonable, ordinary person in the circumstances of the taxpayer would have done.[65]

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[63] Anon (2013) at 79. http://bit.ly/2AAf5TB (Accessed 7 March 2017)

[64] Section 223(3) of the TA Act read with the Explanatory Memorandum to the Tax Administration Law Amendment Bill as published in the Government Gazette No. 36941 of 18 October 2013.

[65] SARS (2013) 'Short Guide to the Tax Administration Act, 2011' - http://bit.ly/2AAf5TB (Accessed 7 March 2017) at 93.

The test for reasonable care was described by Botha[66] as 'the knowledge of the consequences of the outcome if the taxpayer did not take reasonable care in completing a return'. In other words, the taxpayer knew or should reasonably have known what the given outcome could be and that it can occur if he should act in this fashion.

The test for both concepts of 'reasonableness' and 'negligence' was laid down in *Kruger v Coetzee*,[67] where Holmes J formulated the test for negligence by laying down two specific steps to follow to determine if liability *culpa* arises. *Culpa* for purposes of liability arises if a reasonable man would foresee the reasonable possibility of his conduct injuring another in his person or property, causing patrimonial loss and in taking reasonable steps to guard against such occurrence, fails to take such steps.[68] SARS amended the percentage assigned to this behaviour, downward from 50% to 25%.[69]

iii) No reasonable grounds for the tax position taken.

The term 'no reasonable grounds for the tax position taken', refers to the interpretation by a taxpayer of a provision in a tax Act, or in case law or in terms of a general ruling issued by SARS that is not based on reasonable grounds.[70] Having regard to the relevant authorities, the sources from which the taxpayer formulates his interpretation is deemed to be correct. In this instance the definition of 'tax position' is taken into account to consider

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66 Botha D 'Reasonable Care in Completing Tax Returns' (2014) *Tax Professional* 24-25 at 24.

67 *Kruger v Coetzee* 1966 (2) SA 428 (A) at 430E-F. In this matter the plaintiff whilst driving on the road at dawn collided with a horse which wandered onto the road. The plaintiff instituted an action for damages against the owner of the horse and the court had to determine what negligence constituted.

68 The test for reasonableness was confirmed by Nugent JA in *First National Bank v Duvenhage* [2006] SCA at 47, on the basis that it is necessary to consider whether the loss for damages is causally linked to the alleged unlawful conduct. Three elements were listed by Nugent to constitute a delict founded on negligence which were 'a legal duty in the circumstances to conform with the standard of the reasonable person, conduct that falls short of that standard, and loss consequent upon that conduct.'

69 Section 223(1) of the Tax Administration Act was amended in terms of section 76(1)(a) of the Tax Law Amendment Act 39 of 2013.

70 Anon (2013) at 80. http://bit.ly/2AAf5TB (Accessed 7 March 2017)

the thought process and rationale applied or the reasons provided by the taxpayer for the decision regarding the tax position taken.

The purpose of this penalty is for instances where a taxpayer is unable to explain why he adopted a certain tax position when it is clear that it is contrary to the provisions in the law, or contrary to principles adopted in case law or contrary to directions in terms of general rulings. A sensible approach should be adopted when a taxpayer decides on a certain tax position.[71]

iv) Gross negligence.

The behavioural penalty for gross negligence is applicable when a taxpayer has scant regard for the consequences of his/her actions.[72] Gross negligence occurs when a taxpayer, acts in a certain way, well aware of the negative consequences of his actions, that is to the detriment of another person or institution such as SARS. It is also defined to mean 'a high degree of negligence, manifested in behaviour substantially worse than that to be expected of the average reasonable man.'[73] Objective facts are required to establish that the taxpayer was aware of the consequences of his actions. Local and foreign case law provides an understanding of the judiciary's interpretation of what gross negligence constitutes in terms of tax cases.

In *Rosenthal v Marks*,[74] Murray J stated that gross negligence is equivalent to total recklessness which can be seen as a total disregard for the consequences of his actions or duty. Megaw J noted in *Shawinigan Ltd v. Vokins & Co Ltd*[75] that the degree of risk and

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71 Anon (2013) at 80. http://bit.ly/2AAf5TB (Accessed 7 March 2017)

72 SARS (2013) 'Short Guide to the Tax Administration Act, 2011' - http://bit.ly/2AAf5TB (Accessed 7 March 2017) at 93.

73 Law J (ed) 'gross negligence' (2015) at 287.

74 1944 TPD 172 at 180.

75 [1961] 1 WLR 1206 at 1214.

gravity of the consequences of the actions are the deciding factors whether the conduct is reckless. The distinction between negligence and gross negligence is also found in criminal law.

In *R v Bateman*,[76] Lord Hewart stated the following: 'in order to establish criminal liability the facts must be such that, in the opinion of the jury the negligence of the accused went beyond a mere matter of compensation between subjects and showed disregard for the life and safety of others as to amount to crime against the State and conduct deserving punishment.' It can accordingly be said that the judiciary considers gross negligence to be a reckless disregard of the consequences of the taxpayer's actions, which entails the imposition of a much heavier penalty.

v) Intentional tax evasion.

Tax evasion is a wilful act.[77] *General Council of the Bar of South Africa v Geach*; *Pillay v Pretoria Society of Advocates*; *Bezuidenhout v Pretoria Society of Advocates*,[78] highlights the seriousness of the act as Wallis J describes the act of the taxpayer as 'a sustained course of dishonesty for which he gave a dishonest explanation.' Evasion is distinguished from attempts to use interpretation of tax laws and/or imaginative accounting to reduce the amount of payable tax; or 'any act or omission which results in a person paying less tax than is legally due by, for example, concealing or understating a source of income, overstating expenses, making false claims to reliefs or failing to disclose chargeability.'[79]

Intent in terms of common law, more specifically as defined in the Appeal Court case of *Ramsay v Minister of Polisie*,[80] is regarded as a 'legally reprehensible state of mind or

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76 (1925) 19 Cr App R8.

77 *R v Harvey* 1927 TPD 878.

78 [2012] ZASCA 175 at [120].

79 Law J (ed) '*mens rea*' (2015) at 395.

80 1981 (4) SA 802 (A) at 807.

mental disposition encompassing the direction of the will to the attainment of a particular consequence and conscious of the fact that such result is being achieved in an unlawful or wrongful manner.' The actions of the taxpayer and the consequences as a result of these actions are pertinent in establishing intentional tax evasion.

2.3.5 Remission or reduction of the understatement penalties

The Commissioner only has discretion to remit an understatement penalty if it is imposed in terms of a substantial understatement[81] or if the understatement occurred as a result of a *bona fide* error.[82] The only other two situations that warrants the remission of an understatement penalty is when it was incurred in respect of tax defaults voluntarily disclosed under the Voluntary Disclosure Programme in terms of section 229(1)(b) of the TA Act, or in terms of a settlement agreement entered into between SARS and the taxpayer in terms of section 146 of the TA Act.[83] The Commissioner will be regarded as acting *ultra vires,*[84] if he remits any of the understatement penalties in terms of the other behaviour categories, as the Act does not provide for such a process. Innes CJ in *Johannesburg Consolidated Investment Co v Johannesburg Town Council* [85] described the power to review administrative decisions taken *ultra vires* as the disregard of a duty imposed on it by a statute.

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[81] In terms of section 223(3) of the TA Act. See also Van Eeden R and Botha D 'Remission of understatement penalties under the Tax Administration Act' (2013) *Tax Alert* at 2.

[82] In terms of section 222(2) of the TA Act.

[83] Section 146(1)(a) to (e) of the TA Act determines what circumstances are considered appropriate for the Commissioner to enter into a settlement with a taxpayer in terms of a pending dispute. It is a requirement that the settlement must be to the best advantage of the state to settle the dispute on a basis that is fair and equitable to both the taxpayer and SARS.

[84] '*Ultra vires*' is defined to mean 'beyond its powers, invalid acts or illegal acts.' Law J (ed) (2015) at 637.

[85] 1903 TS 111 AT 116. See also Hoexter C 'Administrative Law in South Africa' (2013) Juta & Co at 115.

2.3.6 Retrospective application of the understatement penalty and subsequent amendments to the Tax Administration Act 28 of 2011

With its initial enactment, the TA Act in terms of section 270 provided for the retrospective application of an understatement penalty to periods prior to the commencement date of the Tax Administration Act, being 1 October 2012. The Memorandum on the Objects of the Tax Administration Bill, 2011 stated that the aim of these transitional provisions was to ensure a smooth transition from the current law to the Tax Administration Act, when it comes into effect. Unfortunately, the practical application of these transitional provisions lead to numerous objections being filed by disgruntled taxpayers and tax advisers who were of the view that SARS was not entitled to levy the understatement penalty in these circumstances.[86] These provisions were amended and lead to the introduction of subsections (6A), (6B), (6C) and (6D)[87] into the TA Act with retrospective application as from 1 October 2012 which provides briefly as follows:

i) Section 270(6) enables the Commissioner to impose additional tax penalties in terms of section 76[88] in periods pre-1 October 2012 if but for the repeal it would have been capable of being imposed, levied, assessed or recovered by the commencement date of the TA Act and it had not been imposed as yet.

ii) In terms of section 270(6A) it became a requirement for section 270(6) that the concept ‘capable of being imposed’ meant that the verification, audit or investigation to determine the additional tax, penalty or interest had been completed before the commencement date of the TA Act. Any additional tax imposed as a result of verifications, audits or investigations that were completed after 1 October 2012, was regarded as invalid.

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86 Mandy K ‘SARS does about-turn on understatement penalties’ (2013) Price Waterhouse Coopers http://pwc.to/2my2bvF (Accessed 27 February 2017)

87 Subsection 270 (6A) - (6D) was inserted by section 86 of the Tax Laws Amendment Act 39 of 2013.

88 Section 76 of the Income Tax Act.

iii) Section 270(6B) determines that if a substantial understatement occurred in terms of a return that was due on 1 October 2012, that it could be remitted in terms of section 223(3)(b)(i) of the TA Act.

iv) Section 270(6C) provides for the granting of relief in terms of section 229(b) of the TA Act if the audit or investigation of the person's affairs who made a voluntary disclosure, has commenced before but only concluded after commencement date of the TA Act.

v) Section 270(6D) allows for the remission of an understatement penalty imposed as a result of an understatement made in a return in terms of the Income Tax Act or the VAT Act, submitted before 1 October 2012. Section 270(6)(b) was amended to stipulate that an understatement penalty may not be imposed if it relates to an understatement that occurred prior to the commencement date of the TA Act.

vi) Section 270(6E) was introduced in terms of the Tax Administration Laws Amendment Act, relating to the imposition of interest on understatement penalties in terms of section 187(3)(f) of the TA Act.[89] With the introduction of section 270(6E) read with section 187(3)(f), the accrual and payment of interest on an understatement penalty imposed under section 222, must be calculated in the manner that interest upon additional tax is calculated in terms of the interest provisions of the relevant tax Act, as from the effective date being the commencement date of the TA Act, being 1 October 2012.[90] This amendment is now under scrutiny as certain tax advisers are of the view that interest on understatement penalties cannot be imposed on periods prior to 1 October 2012.

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89 Act 16 of 2016.

90 Section 270(6E) was inserted by section 76(1) of the Tax Law Amendment Act 23 of 2015 which is deemed to have come into operation on 1 October 2012. Paragraph (f) of section 187 was amended by section 59(1)(b) of the Tax Law Amendment Act 23 of 2015 which was published in the Government Gazette 39586 dated 8 January 2016.

Amendments to the section 223 penalty table were also made to align the penalty regime with its comparative tax jurisdictions where similar penalty regimes apply.[91] The percentages initially assigned to the different behaviours were substituted with reduced percentages in terms of section 76(1)(a) of the Tax Law Amendment Act.[92] In 2016, the legislator made further amendments to provide for instances related to General Anti-Avoidance Regulations (GAAR) matters.[93] A new behavioural category was accordingly introduced into the understatement penalty table, to wit 'impermissible avoidance arrangement', under item (iii) thereof.

2.4 CONCLUSION

In Chapter One the secondary research objective identified was to clarify the theoretical construct of the Understatement Penalty regime as it relates to this study. As can be seen from this chapter, Chapter 16 of the Tax Administration Act has been amended three times to resolve interpretational disputes and problems that was encountered in interpreting the penalty regime. The legal construct of the understatement penalty seems hardly adequate to address such a major introduction of a new objective penalty regime.

During the unpacking of the provisions relating to the understatement penalty it became clear that there were still areas of improvement in terms of the legal construct. Definitions were not adequate, or in contrast with similar provisions in the Act and in other tax Acts. Taking into account the aim of combatting serious tax crimes, as identified as a priority in introducing the new penalty regime, the little information available to explain the working of the understatement penalty, create loopholes for innovative taxpayers to successfully avoid or even evade tax. Mazansky, concluded that there is no clarity on the

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[91] The Explanatory Memorandum to the Tax Law Amendment Bill for 2013, provides the reasons for the reduction in percentages of section 223 of the TA Act.

[92] Act 39 of 2013.

[93] Section 223 in terms of the TA Act as amended in terms of section 61(a) of the Tax Laws Amendment Act 16 of 2016.

understatement penalty as it creates a perception that certain bad behaviour is not sufficiently egregious to warrant punishment which will allow the taxpayer to escape liability.[94]

[94] Mazansky E 'SARS needs to provide clarity' (2016) *Business Tax & Company Law Quarterly* at 3.

CHAPTER 3

ADMINISTRATIVE REQUIREMENTS AND JUDICIAL ANALYSIS

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3.1 INTRODUCTION

Section 33(1) of the Constitution confers on everyone the right to administrative action that is lawful, reasonable and procedurally fair. Subsection 33(2) of the Constitution provides the right to written reasons, if a person whose rights have been adversely affected by an administrative action requires an explanation for the action taken. Effect to these rights must be enacted in terms of national legislation which provides for the review of these actions, and which provides for the promotion of an efficient administration.[1] The legislation enacting these rights, is PAJA. An 'administrative action' is defined as - 'any decision taken, or failure to take a decision by an organ of state when exercising its powers or performing a public function in terms of the Constitution or in terms of any legislation…which adversely affects the rights of any person and which has a direct external legal effect…'[2]

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1 Section 33(3) of the Constitution, 1996.

2 Section 1 of PAJA.

Section 3(1) of PAJA requires that an 'administrative action which materially and adversely affects the rights or legitimate expectations of any person, must be procedurally fair.' In exercising its administrative powers SARS performs these administrative functions by enforcing and implementing legislation, to wit the tax Acts.[3]

In *Pharmaceutical Manufacturers Association of SA and Another: In re ex parte President of the Republic of South Africa and Others,*[4] Chaskalson held that administrative law forms the core of public law, which overlaps with constitutional law. In this matter the rationality of SARS's decision making process, when exercising its discretion, had to be demonstrated to prove that it applied its mind properly in the exercising of its duties.[5] SARS is prohibited from acting arbitrary or irrational.[6] Administrative law as described by Chaskalson,[7] is the 'interface between the bureaucratic state and its subjects'.

To determine the efficacy of the understatement penalty, a determination needs to be made whether the taxpayer has a legitimate expectation to a fair, lawful and reasonable process during the imposition thereof and whether the penalty so imposed is done in a procedurally fair manner.[8] Accordingly, this chapter intends to evaluate how the construct and process in imposing an understatement penalty compares with the requirements for a fair, lawful reasonable administrative action in terms of administrative justice.

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3 *Metcash Trading Ltd v Commissioner, South African Revenue Service* 2001 (1) SA 1109 (CC) at 22 in paragraph 42.

4 2000 (2) SA 674 (CC) in paragraph 45 at 37.

5 *Pharmaceutical Manufacturers Association of SA and Another: In re ex parte President of the Republic of South Africa and Others* 2000 (2) SA 674 (CC) in paragraph 45 at 37. See also Erasmus D N (Prof) 'The Tax Administration Act, Taxpayer's rights and SARS Audits' (2013) *The South African Institute for Tax Professionals* (thesait) http://bit.ly/2okaXOd (Accessed 30 March 2017).

6 Sections 40, 46, 47 and 48 of the TA Act read with subsection 4(2) of the SARS Act, confirms the constitutional obligation that SARS has in performing its administrative duties in terms of section 33 of the Constitution,1996.

7 Chaskalson A 'The Past Ten Years: A Balance Sheet and Some Indicators for the Future' (1989) *South African Journal on Human Rights* at 293.

8 Hoexter C (2013) at 220.

Administrative justice comprises of various principles which were established in terms of common law confirmed in legislation, such as the *audi alteram partem* principle, the *nemo iudex in sua causa* principle and the doctrine of legitimate expectation. These principles are further founded in the legal consequences of an unlawful administrative action if the action so taken, was found to be *ultra vires.* As administrative action is ruled by law, any deviation from the requirements for a fair process will lead to an *ultra vires* action.[9] The TA Act does not provide for the ratification of an *ultra vires* decision in terms of the imposition of an understatement penalty.

Finally, this chapter evaluates how these administrative principles and requirements were applied and adjudicated, when analysing the recent Tax Court cases where understatement penalties were imposed.

3.2 THE LEGISLATIVE REQUIREMENTS FOR A LAWFUL, REASONABLE AND PROCEDURALLY FAIR PROCESS

3.2.1 The history and principles of administrative justice

One of the principles of administrative justice established in terms of common law, confirmed in legislation, is the *audi alteram partem,* which means that 'the other side must be heard'. A person being affected directly by a decision must be given the opportunity to state his case and know what the other side's case is.[10] Another principle, *nemo iudex in sua causa,* determines that any decision made, is invalid, if the decision-maker has a financial interest in the decision so made, or shows any bias that affected his impartiality.[11]

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[9] Freund D and Price 'A On the legal effects of unlawful administrative action' (2017) *South African Law Journal* at 184.

[10] Law J (ed) '*audi alteram partem'* (2015) at 411.

[11] Law J (ed) '*nemo iudex in sua causa* '(2015) 411.

Historically the validity of administrative decisions were challenged when the pre-existing rights of a party was affected on the basis that the person did not have the right to be heard prior to the decision being taken. The courts realised that in certain circumstances pre-existing rights might be absent, which left a void to challenge the validity of the administrative decision effectively.[12] As procedural fairness remained a requirement for a fair administrative action, the judiciary, in various cases found that the scope of these principles needed to be expanded.[13] Consequently, the courts held that the validity of a pre-decision depended on the circumstances of each case. Section 3(2)(a) of PAJA requires that a fair process be followed which depends on the circumstances of each case, whilst subsection 3(2)(b) provides for the opportunity to make representations. Accordingly both principles are therefore contained in PAJA[14] which ensures procedurally fair and reasonable administrative actions.[15]

In *Administrator of Transvaal v Traub and Others*[16] the right to be heard was extended as it recognised the doctrine of legitimate expectation. Corbet CJ in *Traub,* expressed the doctrine of legitimate expectation as a 'substantive benefit or advantage or privilege which the person concerned could reasonably expect to acquire or retain and which it would be unfair to deny such person without prior consultation or a prior hearing.'[17]The phrase 'adversely affects rights' defines the importance of an administrative action, the necessity of the doctrine of legitimate expectation in terms of procedural fairness of such an action was emphasised in the Constitutional Court matter of *Walele v City of Cape Town and Others*.[18] O'Regan ADCJ held that the requirements for a fair administrative action in the

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12 *Walele v City of Cape Town and Others* 2008 (6) SA 129 (CC) at 84.

13 *Janse van Rensburg NO and Another v Minister of Trade and Industry and Another NNO* [2000] ZACC 18; 2001 (1) SA 29 (CC); 2000 (11) BCLR 1235 (CC) at para 24; *Du Preez and Another v Truth and Reconciliation Commission* [1997] ZASCA 2; 1997 (3) SA 204 (A); 1997 (4) BCLR 531 (A) at paras 31-3.

14 In sections 3(2)(a) and 3(2)(b) of PAJA.

15 Section 3(2)(b) of PAJA incorporates the principle of *nemo iudex in sua causa*.

16 [1989] 4 All SA 924 (AD) at 53 and 72 of the judgement.

17 [1989] 4 All SA 924 (AD) at paragraph 758D.

18 2008 (6) SA 129 (CC).

context of section 3 of PAJA is not restricted to the definition of administrative action as per section 1 thereof, but that a legitimate expectation should be prevalent in terms of both the substantive and procedural fairness requirements.[19]

In instances where an understatement penalty is imposed, the taxpayer is afforded the right to provide reasons as to why the understatement penalty should not be imposed. The ultimate decision and reasons for this decision to impose this penalty, is what cause controversy in the legal fraternity. A taxpayer acquires the right to legitimately expect that the understatement penalty so imposed by SARS is done fairly, lawfully and reasonably. O'Reagan J determined in *Bato Star Fishing (Pty) Ltd v Minister of Environmental Affairs and Tourism and Others.*[20] That certain factors need to be considered when making a reasonable decision which includes the following, 'the nature of the decision, the identity and expertise of the decision-maker, the range of factors relevant to the decision, the reasons given for the decision, the nature of competing interests and the impact of the decision.'

The doctrine of legitimate expectation is clearly established in two judgments handed down in the Supreme Court of Appeal (hereafter referred to as the 'SCA'), to wit *Commissioner for the South African Revenue Service v Pretoria East Motors (Pty) Ltd*,[21] and *Commissioner for South African Revenue Service SARS v Sprigg Investment 117 t/a Global Investment CC.*[22] The issue relating to the provision of adequate reasons by SARS for raising additional assessments, became the reference point for SARS to measure what would be regarded as adequate reasons and what would not be regarded as adequate reasons.

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[19] 2008 (6) SA 129 (CC) in paragraph 124 and 125 at 80.

[20] 2004 (7) BCLR 687 (CC) in paragraph 10 at 7.

[21] [2014] 3 All SA 266 (SCA) paragraphs 54 to 57 at 288.

[22] 73 SATC 114 [2010] ZASCA 172.

In the case of *Pretoria East Motors*,[23] SARS was criticised by the judiciary throughout the judgment, for the manner in which the audit was conducted and the lack of substance it ascribed to the behaviour of the taxpayer to impose additional taxes of 200%. The SCA dismissed the grounds put forward by SARS relating to the imposition of the additional taxes, on the basis that the behaviour ascribed to justify the imposition of the high penalty was not aligned to the facts and findings of the auditors in raising the assessment.

In contrast to this, SARS was commended by the SCA in *Commissioner for South African Revenue Service SARS v Sprigg Investment*,[24] for the adequate reasons supplied in the "Letter of Findings" and response to the taxpayer's letter. Although these judgements dealt with the imposition of additional taxes under the former penalty regime, these judgments created a legitimate expectation for proper reasons in future penalty assessments.

It is therefore apparent from the extracts of the cases briefly discussed above, that the imposition of additional tax penalties, was either not effectively applied or the extenuating circumstances were not taken into account to remit or reduce these penalties.

3.2.2 <u>The scope and ambit of procedural fairness</u>

SARS has the legislative power to impose an understatement penalty on acts of non-compliance with the tax Acts, or in instances of tax avoidance, tax evasion and tax fraud.[25] The imposition of an understatement penalty is a punitive measure, which has a negative financial impact on the taxpayer. As discussed in Chapter Two, an understatement penalty is imposed based on the behaviour of the taxpayer that led to the understatement of income to occur. A taxpayer is therefore entitled to reasons by SARS, explaining the behaviour of the taxpayer that was taken into account when a certain understatement penalty was imposed.

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23 [2014] 3 All SA 266 (SCA) at 288.

24 73 SATC 114 [2010] ZASCA 172 at 116.

25 Section 4 of the SARS Act.

Section 3(2)(b) of PAJA details the requirements to give effect to a procedurally fair administrative action, being proper notice of the nature and purpose of the proposed administrative action, the opportunity to make representations, a clear statement of the administrative action, details of the right of review or internal appeal and the right to request reasons for the administrative action.

When an administrator such as SARS exercises its discretion in terms of an administrative decision (imposition of understatement penalty), section 3(3) requires the administrator to give the person the opportunity to obtain legal representation, the opportunity to state his case, question and dispute the information and arguments and the opportunity to appear in person.

Certain of these requirements are adhered to, however the taxpayer only appears in person if he selects to participate in the alternative dispute resolution process. Whether SARS provides adequate reasons for the decision to impose understatement penalties, is dealt with case by case. It appears from the criticism towards SARS in scholastic journals such as by Mazansky,[26] that SARS fall short in this regard. The judiciary however found that extensive replies as contained in letters of finalisation of audits as issued by SARS to the taxpayers, suffice to comply with the requirements as outlined above.[27]

To complete its procedural compliance, as required in terms of PAJA, section 102(2) read with section 129(3) of the TA Act, determines that the onus is on SARS to prove whether the facts upon which SARS based the imposition of the understatement penalty, under Chapter 16, is reasonable and fair.[28]

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[26] Mazansky E (2016) at 2.

[27] *CSARS v Sprigg Investment 117 CC t/a Global Investment* 2011 (4) SA 551 (SCA) in paragraphs 16 and 17 at 121.

[28] See *ITC 1882* 78 SATC 165 at 171.

3.3 ADJUDICATION OF THE UNDERSTATEMENT PENALTY IN SOUTH AFRICAN TAX COURTS

There are currently four cases that were adjudicated in the Tax Courts of South Africa on the imposition of the understatement penalty. Of the four cases, SARS only achieved success in one of these cases. These cases are briefly discussed below pertaining to the adjudication of the imposition of the understatement penalties.

i) In *ITC 1880*,[29] SARS imposed an understatement penalty in terms of section 223 of the TA Act of 75% on the basis that the appellant had no reasonable grounds for the tax position taken. The only reason supplied by SARS, for imposing the understatement penalty, were on the basis that 'the legislation and the facts were clear.' The assessment in which the understatement penalty was imposed did not sufficiently deal with the behaviour of the taxpayer to warrant the said imposition of the understatement penalty. Furthermore, SARS' application of two separate behaviours in one determination was completely incorrect.

Wepener J,[30] held that SARS reached this decision 'without a consideration of the full facts referred to in the TA Act, based on a penalty table that had been amended.' Therefore, the initial penalty of 75% that was imposed by SARS without even considering the merits of the matter was reduced to 50% to align it with the amended section 223 penalty matrix. The court held that SARS did not challenge the evidence presented by the taxpayer that he consulted experts to advise him on the said tax position taken.

ii) In *ITC 1890*,[31] an understatement penalty was imposed by SARS on the basis that a substantial understatement[32] occurred and accordingly levied a 10%

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29 78 SATC 103.

30 *ITC 1880* 78 SATC 103 at 107.

31 78 SATC 62.

penalty. The appellant was of the view that he was entitled to claim the section 24C future allowance but if the court find against him that it be excused on the basis that he committed a *bona fide* inadvertent error and acted on the strength of tax advice that he received. Attached to the notice of objection was a tax opinion from a Professor who assisted the appellant's accountants in this regard.

In relation to the imposition of the understatement penalty the court correctly referred to the attached tax opinion and indicated that SARS did not dispute this document during trial. Turning to the definitions in the Oxford dictionary of the words '*bona fide*', 'inadvertent' and 'error', Boqwana J[33] found that '*bona fide* inadvertent error has to be an innocent misstatement by a taxpayer on his or her return, resulting in an understatement, while acting in good faith and without the intention to deceive.' The court found that the appellant acted in good faith and had no intention to deceive SARS.[34] The complexity of the wording in section 24C possibly created the incorrect interpretation by the tax expert to believe that the two contracts were inextricably linked. The court therefore excused the taxpayer in light of the above circumstances and remitted the understatement penalty.

iii) In *IT 13935*[35] SARS imposed an understatement penalty of 75% on the basis that no reasonable grounds existed for the tax position taken. After the taxpayer adduced their evidence SARS applied to raise the understatement penalty to that of 150% on the basis of intentional tax evasion. In relation to the request by SARS to increase the understatement penalty from 75% to 150%, the court was

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32 In terms of s 222(1) of the TA Act.

33 In *ITC1890* 78 SATC 62. at paragraph 45 of the judgment.

34 The court referred to the matter of *Commissioner for South African Revenue Services v Foskor* [2010] 3 All SA 594 (SCA) at paragraphs 48 to 51.

35 *IT 13935 - M Family Trust v Commissioner of the South African Revenue Service* 14 December 2016.

very stern against the request, stating that SARS did not raise an understatement penalty in the initial assessment of 150% nor did it raise the increased penalty in the Statement of Grounds of Assessment.[36]

The court held further that 'a trial by ambush cannot be countenanced and SARS is not entitled to increase its claim for understatement penalty without due notice.'[37]The court however agreed that there was a discernible prejudice to the *fiscus* as a result of the inclusion of the alleged embezzled amount as a bad debt and the overstating of its losses incurred.

Allie J[38] referred to the lack in SARS' attempt to challenge the tax practitioners' *bona fides* as concerning and stated that it could have made an impact in terms of the alleged tax evasion. However due to the lack of SARS's attempts to discredit the taxpayer and his tax practitioner, the court concluded that there was no intentional tax evasion. The court held further that that taxpayer failed to take reasonable care in completing the tax returns and reduced the understatement penalty to 50%. On face value SARS was correct to impose the said understatement penalty it initially imposed being 75% on the basis that there was no reasonable tax position taken.

iv) In *IT 13686*[39] SARS imposed an understatement penalty of 25% on the basis that the taxpayer did not take reasonable care in completing its tax return. The taxpayer in its objection, stated that the TA Act is not applicable at all and that there was no substantial understatement of income. At the relevant time the taxpayer was in possession of an opinion by a tax practitioner (senior counsel) which took the view that a reasonable argument could be made out that a

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36 A Statement of Grounds of Assessment is a pleading drafted by SARS to start the process in the Tax Court in terms of Rule 31 of the Tax Court Rules promulgated in terms of s 104 of the TA Act.

37 *IT13935* at paragraph 64 of the Judgement.

38 *IT13935* at paragraph 74 of the Judgement.

39 *IT13686 – ABC (Pty) Ltd v Commissioner of the South African Revenue Service* 27 March 2017.

mining contractor who incurred capital expenditure and performed mining activities, would be entitled to the capital allowances under section 15 of the Act. Sutherland J stated that sections 223(3) and 270(6D) of the TA Act was applicable.[40] When SARS imposed the understatement penalty no mention of the reliance on a tax opinion was made by the taxpayer. It was only during the process of discovery of documents for purposes of trial, that the taxpayer alleged its reliance on this opinion.

During evidence lead at trial it became clear that the taxpayer was a wholly owned subsidiary of a holding company. The holding company obtained a tax opinion in relation to its other subsidiaries which the taxpayer relied on in terms of the tax position to taken. However, Sutherland held that the taxpayer gave no explanation as to why it only revealed the existence of the opinion at the stage of discovery. Sutherland was critical of the fact that the opinion suggested full disclosure with SARS yet despite this advice was not followed by the taxpayer.[41] In light of the above there could be no other decision but to confirm the imposition of the understatement penalty of 25%.

3.4 CONCLUSION

The PAJA requirements to ensure that a procedurally fair administrative action is applied by SARS, is clearly outlined in PAJA in terms of proper compliance.[42] The construct of the understatement penalty is however vague and lack detailed legislative substance to sufficiently comply with these requirements to enable the SARS officials to impose these penalties effectively. Accordingly, creative taxpayers and tax practitioners are exploiting the situation to legally avoid paying the level of penalties as expected in terms of the law.

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[40] *IT13686* in paragraph 53 at 34 of the judgment.

[41] *IT13686* in paragraph 60 at 37 of the judgment.

[42] In terms of sections 3 and 4 of PAJA.

Knowing these shortcomings, majority of the disputes in relation to the imposition of understatement penalties end up being settled in terms of section 146 of the TA Act.

To assess the judicial successes and failures is very difficult as case law on understatements and understatement penalties deal with the imposition of additional taxes,[43] in terms of the former penalty regime. It is expected that more judgments will be reported in the years to come but until such time, existing case law merely deals with technical issues such as the transitional arrangements relating to the imposition of understatement penalties, or whether decisions on interlocutory applications in the Tax Court can be appealed, and the establishment of the onus of proof. These are typical growing pains of a new piece of legislation that need to establish itself in the legal domain.

SARS need to ensure that the recent interpretational disputes that surfaced since the enactment of the understatement penalty, are dealt with constructively and that the understatement penalties are imposed in a procedurally fair consistent manner. Guidance should be sought from the international authorities available where similar penalties were imposed as it not only addresses the penalty and the behaviour related thereto, but provides guidance on issues such as the burden of proof, the procedural processes and evidence required for a revenue authority to prove the correctness of its decisions to impose the understatement penalty.

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[43] In terms of section 76 of the Income Tax Act.

CHAPTER 4

COMPARATIVE STUDY OF THE UNDERSTATEMENT PENALTY

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4.1 INTRODUCTION

The main objective of this study, as identified in Chapter One, is to analyse the efficacy of the understatement penalty. To achieve this objective the construct and application of the foreign behavioural penalties of the countries selected for the comparative study, is analysed and discussed. The foreign behavioural penalties of Australia and New Zealand are considered and compared in terms of the descriptive titles as applied in terms of the South African understatement penalty matrix.

4.2 THE FOREIGN PENALTY REGIMES OF AUSTRALIA AND NEW ZEALAND

4.2.1 Australia : The construct of the behavioural penalty regime

The Australian penalty regime refers to an understatement penalty as a penalty due to a shortfall amount. The shortfall amount is the amount by which the relevant liability is less than it would otherwise have been, or the payment or credit is greater than it would otherwise have been. The previous penalty framework was composed of disparate penalty provisions that were evident in the various taxation laws which led to differing sanctions and unrealistic penalties as a result of shortfall amounts.

Consequently, various concerns were raised by taxpayers, tax practitioners and representative bodies relating to the legislative framework of the Australian behavioural penalty regime. This prompted the review of the Australian Taxation Office's (ATO) administration of penalties, by the Inspector-General of Taxation. The inadequacy of guidance material, the inadequacy of the legislative provisions relating to the imposition of the penalties and the lack of understanding by both the ATO's office and taxpayers, were some of the concerns that were raised. The review lead to the re-design of the Australian tax system in 1999 by the Parliament of the Commonwealth of Australia, House of Representatives.[1]

Subsequent to the re-design of the new tax system, the New Tax System (Tax Administration) Bill,[2] was introduced to amend the Income Tax Act[3] and other tax Acts as

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1 Ralph J T 'Australia- Review of Business Taxation' A tax system re-designed: more certain, equitable and durable: Report / Review of Business Taxation Treasury (1999) http://bit.ly/2rniqAj (Accessed 30 May 2017).

2 Explanatory Memorandum, House of Representatives, A New Tax System (Tax Administration) Bill 2 of 2000, at para 1.2.

3 Income Tax Act of 1936.

well as subdivisions 284 and 286 of the Tax Administration Act[4] ('Administration Act'). In the New Tax System Act, the proposed amendments set out a uniform, simple and equitable penalty regime to support the New Tax System.[5] It introduced a uniform administrative penalty regime[6] that would impose penalties relating to statements and schemes, penalties for the late lodgement of returns and other documents, and penalties for failing to meet other taxation obligations.

The Inspector-General of Taxation,[7] through the ATO released a report on the review on the administration of penalties in which the ATO identified the strategies it applied to encourage voluntary taxpayer compliance. One of these strategies included the introduction of the ATO's Compliance Model and Taxpayers' Charter[8] which describes the manner in which the ATO will conduct itself including the application of penalties. As a result of the obligation to publicise internal information, publications and documents as used by the ATO and the Commissioner of Taxation, the ATO commenced to publish rulings in 1982.[9]

The rulings were issued as either Income Tax Rulings or as Miscellaneous Taxation Rulings, which although it does not have legislative backing, provides certainty and fairness to the taxpayers in terms of the implementation of the tax laws. These rulings assist the taxpayers and tax practitioners in interpreting the complexities of the tax laws.

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4 Act of 1953.

5 The New Tax System Act commenced on 30 June 2000.

6 The uniform penalty regime is contained in Part 4-25 of Schedule 1 of the Administration Act.

7 Noroozi A 'Review into the Australian Taxation Office's administration of penalties: A report to the Assistant Treasurer' (2014) Commonwealth of Australia at 33.

8 A suite of 9 Australian Taxation Office's documents, including, Australian Taxation Office, Taxpayers' Charter — what you need to know <http://www.ato.gov.au/Print-publications/Taxpayers--charter---what-you-need-to-know/?default=&page=3.

9 As created in terms of section 9 of the Freedom of Information Act 1982 (Cth). See also Scolaro D, Jaques M S 'Tax Rulings: Opinions or Law? The need for an independent "Rule-Maker"' (2006) *Revenue Law Journal* at 110.

Two of these Miscellaneous Taxation Rulings are of importance to this study which is known as the MT2008/01 and the MT2008/02.[10] These Miscellaneous Taxation Rulings specifically deals with the interpretation of certain behavioural concepts for purposes of the application of behavioural penalties. When making decisions on the imposition of false or misleading penalties, the ATO's officers are required to follow the relevant law which includes the following:

i) Miscellaneous Taxation Ruling (MT 2008/1) - Penalty relating to statements: meaning of reasonable care, recklessness and intentional disregard;

ii) Miscellaneous Taxation Ruling (MT 2012/3) — Administrative penalties: voluntary disclosures;

iii) Miscellaneous Taxation Ruling (MT 2008/2) — Shortfall penalties: administrative penalty for taking a position that is not reasonably arguable;

iv) Taxation Determination (TD 2011/19) — Tax administration: what is a general administrative practice for the purposes of protection from administrative penalties and interest charges;

v) PSLA 2012/4 Administration of penalties for making false or misleading statements that result in shortfall amounts;

vi) PSLA 2012/5 Administration of penalties for making false or misleading statements that do not result in shortfall amounts; and

vii) ATO website information on penalties and interest.

The Miscellaneous Taxation Ruling titled MT2008/01, provides the Commissioner's interpretation of the concepts of 'reasonable care', 'recklessness' and 'intentional disregard', whilst the Miscellaneous Taxation Ruling titled MT2008/02 sets out the position of the Commissioner on the behaviour of a taxpayer taking a 'tax position that is not

10 Australian Taxation Office – Public Ruling MT 2008/01 Miscellaneous Taxation Ruling Penalty relating to statements: meaning of reasonable care, recklessness and intentional disregard' 2008.

reasonably arguable.'[11] In addition to this, the Australian Taxation Office published a Law Administration Practice Statement in 2012 to offer further guidance on these behavioural penalties.[12]

The process to impose penalties in terms of Division 284 of Schedule 1, to the Administration Act, as a result of shortfall amount that occur, must be preceded by a formal assessment to which the taxpayer may object to. This distinguishes the shortfall penalties from the other tax penalties in that it provides for an enhanced review process.[13] As explained in the explanatory memorandum to the Tax Administration Bill,[14] the review process was created as a mechanism to safeguard fairness with respect to the determinations of behavioural elements in relation to administrative penalties.[15] Two categories of penalties exist in terms of Division 284, which is referred to as the 'statement penalties' and the 'taxpayer scheme penalty'. The statement penalties are the behavioural penalties applicable to this study which are imposed in the following circumstances:

i) If a taxpayer makes a false or misleading statement to the Commissioner;
ii) If a taxpayer, in his statement, applies the law in a way that is not reasonably arguable;
iii) If a taxpayer fails to supply documentation to determine his tax liability;
iv) If a taxpayer does not take reasonable care in completing his tax return;
v) If a shortfall result from a taxpayer being reckless with respect to the operation of the tax laws; and

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11 Miscellaneous Taxation Ruling Shortfall penalties: administrative penalty for taking a position that is not reasonably arguable MT 2008/2 Australian Taxation Office 1-20. This public ruling is for purposes of Division 358 of Schedule 1 to the Tax Administration Act 1 of 1953.

12 Australian Tax Office Practice Statement Law Administration PS LA 2012/5.

13 Black C M 'Tax avoidance scheme penalties and purpose' (2016) *Australian Tax Forum* at 1.

14 Revised Explanatory Memorandum to the New Tax System Bill 2 of 2000 at 1.

15 Bill 2 of 2000 at 1. See also Black C M (2016) at 31.

vi) If a shortfall result from a taxpayer intentionally disregarding the tax law.

In terms of the construction of Division 284, penalties are imposed where a person or entity makes a false or misleading statement to either the Commissioner or an entity other than the Commissioner, exercising the powers and functions assigned to him or it under a taxation law in terms of subsection 284-75(1) and (4). Subsection 284-75(2) applies to the position where a person or entity takes a position under a relevant tax law that is not reasonably arguable. Subsection 284-75(3) applies in instances where the person or entity fails to provide a return, notice or other document to the Commissioner that is necessary to determine a tax-related liability accurately. Subsection 284-145 applies where a person or entity disregards a private ruling or enters into a scheme to obtain a tax benefit. The behavioural penalty matrix as contained in section 284-90[16] of the Administration Act differs slightly from the South African penalty matrix but appears to apply the same rationale in determining the behaviour. The penalty matrix reflects as follows:

Table 2: Australian Base penalty amount percentage table

Shortfall amount	Base penalty amount
Shortfall amount caused by intentional disregard of a taxation law.	75%
Shortfall amount caused by recklessness.	50%
Shortfall amount caused by lack of reasonable care.	25%
Shortfall amount where an unarguable position is taken and threshold applies.	25%
Liability under subsection 284-75(3) for failing to provide a document to the Commissioner as required.	75%
Shortfall amount under subsection 284-75(4) where a private ruling is disregarded.	25%

Source: New Tax System (Tax Administration) Act 2 of 2000 Schedule 2 (item 41).

[16] Division 284 section 284-90 of the Administration Act.

The taxpayers can apply for the remission of the shortfall penalties in terms of the provisions of section 298-20 of the Administration Act. Apart from the provisions in section 298-20 the Commissioner, in determining whether there are grounds for the remission of the penalty, is required to apply the Practice Statement Law Administration[17] together with the principles of the Australian Taxation Office compliance model and the Taxpayer's Charter.

4.2.2 New Zealand : The construct of the behavioural penalty regime

Section 141 of Chapter Nine of the Tax Administration Act,[18] (TAA) regulates the position pertaining to the imposition of shortfall taxation penalties. The tax shortfall for a tax type is calculated by setting off the tax effects of the overstatements against the understatement, in the case of one tax shortfall and setting off the tax effects of the overstatements prorated against the understatements, in the case of more than one tax shortfall.[19] To provide a detailed interpretative explanation of the shortfall penalties, the New Zealand Revenue Authority issued various Interpretation Statements[20] with respect to each behavioural penalty that would be imposed if an act or omission resulted in a shortfall of income declared.

The TAA read with the Interpretation Statements[21] on each behavioural penalty in terms of section 141 defines a shortfall penalty to mean 'a penalty imposed under any of sections

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17 PSL 2012/5.

18 Act 1994.

19 Section 141(5)(c) and (d) of the TAA.

20 As a result of the enactment of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003.

21 Interpretation statements contains the Commissioner's view of the taxation laws in relation to a particular set of circumstances in cases when 'a binding public ruling cannot be issued or is considered to be inappropriate'.http://www.ird.govt.nz/technical-tax/interpretations/interpretations-new-index.html(Accessed 30 May 2017).

141A to 141K for taking an incorrect tax position or for doing or failing to do anything specified or described in those sections'. If a taxpayer is not convicted of a disqualifying offence or is not liable for another shortfall penalty, the taxpayer is in terms of section 141FB entitled to a reduction of 50% of the shortfall penalty that was imposed.

The New Zealand Inland Revenue Authority, issues Tax Information Bulletins detailing legislation, judgments and tax topics and Interpretation Notes to explain the intention of the legislator. Various tax reforms[22] were held, dealing with issues such as voluntary compliance, impartial imposition of penalties and the seriousness of the breaches of the respective tax obligations.[23] The issues that were identified during these reforms further included unfairness towards the compliant taxpayers, costs to litigate and ill-fitted rules pertaining to self-assessments. The reforms also proposed a fairer and more effective enforcement of the Inland Revenue Acts that will enhance taxpayers' understanding of the legislative requirements and standards.[24] Accordingly, the Revenue Authority of New Zealand introduced new rules in terms of the Tax Administration Amendment Act,[25] to enhance the taxpayers' understanding of their tax obligations in terms of the various tax Acts.[26]

These new dispute resolution rules[27] pertaining to the behavioural penalties replaced the additional tax penalties.[28]The purpose of the behavioural penalties is best described, to

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[22] Section 139 of the Taxpayer Compliance, Penalties and Dispute Resolutions Bill of September 1995.

[23] Tax obligations are listed in section 15B of the TAA.

[24] In terms of the commentary on the Taxpayer Compliance, Penalties, and Disputes Resolution Bill of September of 1995.

[25] Act 2 of 1996 at 13.

[26] Section 17A was introduced to the TAA, in terms of the Tax Administration Amendment Act 2 of 1996.

[27] Anon IRD Tax Information Bulletin: Introduction to the new disputes resolution process (1996) https://www.ird.govt.nz/resources/c/6/c68f30f3-84b5-4a95-b84c-2bc23287237e/tib-vol08-no03.pdf (Accessed 30 May 2017). In terms of the Tax Administration Amendment Act 2 of 1996.

[28] Section 141 of the TAA.

encourage tax compliance taking into account consistent and impartial penalties that address the breach of tax obligations appropriately.[29] Reductions are also considered if a voluntary disclosure was made.[30].

There is no Shortfall Penalty Matrix, in the TAA, but should reflects as follows:

Table 3: New Zealand Shortfall Penalty Matrix

Penalty Behaviour	**Percentage of resulting tax shortfall**
Lack of reasonable care	20%
Unacceptable interpretation	20%
Gross carelessness	40%
Abusive tax position	100%
Tax evasion or similar acts	150%

Source: Own construct from the Tax Administration Act 1994.

The tax system of New Zealand is quite ‘robust’ by international standards, as several action plans have been implemented to meet the recommendations in the BEPS Action Plan.[31] When regard is had to the extensive provisions in the TAA relating to the penalty regime, there is no doubt that New Zealand is set to prevent and combat tax evasion and tax avoidance. The extent of the legislation and interpretational statements that were issued to assist in the determination of each of the behavioural penalties is very detailed.

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29 In terms of section 139 of the TAA.

30 In terms of sections 141G and 141I of the TAA.

31 Woodhouse M (Hon) ‘Base Erosion and Profit Shifting (BEPS) – Update on the New Zealand Work Programme.’ (2016) Office of the Minister of Revenue, New Zealand. http://bit.ly/2rzHKDL (Accessed 30 May 2017).

4.3 COMPARATIVE STUDY ON BEHAVIOURAL PENALTY REGIMES OF AUSTRALIA AND NEW ZEALAND

4.3.1 Introduction

The behavioural penalties that attract the imposition of a shortfall or understatement penalty of the three countries appear to be similar in terms of the description and meaning assigned to it in each instance. The Australian penalty regime consists of behavioural penalties totalling six (6), whilst New Zealand and South Africa boast five (5) behavioural penalties each. The behavioural penalties of Australia and New Zealand will briefly be discussed before a comparison is made.

4.3.2 The behavioural penalties of Australia

i) Shortfall amount caused by intentional disregard of a taxation law (75%)

Intentional disregard of a taxation law is the description Australia applies for tax evasion. Where a taxpayer or agent deliberately excludes from the taxpayer's assessable income an amount knowing it to be assessable, or deliberately claims a deduction, rebate, credit or offset knowing that it is not allowable is deemed as an intentional disregard of a taxation law. In this instance the test of intentional disregard is purely subjective where the intention is critical.

This behaviour relates to tax evasion where culpability and the principle of '*mens rea*'[32] are applied in case law. The miscellaneous Taxation Ruling MT2008/01 stipulates that the adjective 'intentional' points to something more than the indifference to a taxation law or the reckless disregard of the law. Intent must be present which requires proof that the taxpayer had knowledge of the false statement that he made. Regardless of the

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32 The relevant precedent in Australia dealing with *mens rea* is the matter of *Director of Public Prosecutions v Morgan* [1976] AC 182). See also Law J (ed) "*mens rea*" (2015) at 396 referring to *R v Cunningham* [1975] 2 QB 396.

knowledge that the taxpayer is making a false statement it should further be proved that the taxpayer acted on this knowledge.

The next shortfall penalty – recklessness includes the penalties imposed as a result of a failure to provide documents and where a private ruling is disregarded. Hence these three behavioural penalties are discussed under the heading of a shortfall caused by recklessness.

ii) Shortfall amount caused by recklessness (50%); [Liability under subsection 284-75(3) for failing to provide a document to the Commissioner as required (75%) and Shortfall amount under subsection 284-75(4) where a private ruling is disregarded (25%)]

Australia's approach to gross negligence does not include acts of dishonesty. If a taxpayer behaves recklessly and the taxpayer's conduct shows disregard of, or indifference to, consequences foreseeable by a reasonable person it will be regarded as a reckless act. The concept of recklessness for the purposes of this penalty covers behaviour that could be described as gross negligence. Division 284-75 of the Administration Act[33] determines that a taxpayer is liable for an administrative penalty if the statement made to the Commissioner is false or misleading and amounts to a shortfall. The shortfall amount is calculated in terms of Division 284-80, which describes how the shortfall amount is calculated. Six situations are listed in the table provided for in the Act, [34] which are as follows:

i) If a tax liability is less than it would be if there was no misleading statements;

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33 Administration Act.

34 Section 284-80 was amended in terms of A New Tax System (Tax Administration) Act 2 of 2000 – Schedule 1.

ii) If a tax refund payable to a taxpayer is more than it would have been if the statement was not false or misleading;

iii) If a tax related liability would have been less if the treatment of the income tax law was not applied in a reasonable arguable manner;

iv) If a tax refund is more than would have been paid if the income tax law was not applied in a reasonable arguable manner;

v) If a tax liability is less than what it would have been if the taxpayer adhered to a private ruling;

vi) If a tax refund is more than would have been paid if the taxpayer adhered to a private ruling;

Frost J in *Carioti & ORS v FC of T*,[35] described recklessness 'to include in a tax statement material upon which the [relevant] Act or regulations are to operate, knowing that there is a real, as opposed to a fanciful, risk that the material may be incorrect, or be grossly indifferent as to whether or not the material is true and correct, and that a reasonable person in the position of the statement-maker would see there was a real risk that the Act and regulations may not operate correctly to lead to the assessment of the proper tax payable because of the content of the tax statement.'

In *Carioti & ORS v FC of T*[36] the taxpayers were involved in property investment and development projects. They established a unit trust for each new project and incorporated a company to act as trustee for the project. The court had to determine whether the administrative penalty of 50% of the tax shortfall that was imposed by the Commissioner, resulted from the recklessness as to the operation of the taxation law. The penalty was imposed as a result of the disallowance of a $4.3 million capital loss that was incorrectly claimed by the taxpayers in relation to a unit trust known as the Percival Road Unit. As a

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[35] [2017] AATA 62 at 66.

[36] [2017] AATA 62 at 66.

result of the disallowance, the 'assessed loss' reverted to a distribution amongst the taxpayers resulting in a shortfall in income declared. Frost J upheld the penalties that were imposed and held that the taxpayers' conduct amounted to gross carelessness. Megaw J in *Shawinigan Ltd v Vokins & Co Ltd*[37] noted that the degree of the risk and the gravity of the consequences are deciding factors to determine if the conduct of a taxpayer amounts to recklessness.

iii) Shortfall amount caused by lack of reasonable care (25%)

The miscellaneous Taxation Ruling MT2008/02 describes the reasonable care test that must be applied in these circumstances. The ruling refers to the comment made in *Maloney v Commissioner for Railways*[38] by Barwick CJ, where increased knowledge and perfection or experience is not required to prove reasonable care. The highest possible level of care or perfection is therefore not a requirement in terms of the reasonable care test.[39]

In *6/2016,*[40] Fice J upheld the reduced shortfall penalties, as levied by the Commissioner at the rate of 25%, for failure to take reasonable care in completing the business activity statements (BASs) during the relevant period. Initially the Commissioner claimed that the taxpayer made statements to the Commissioner in activity statements which were false and misleading because they understated taxable supplies and overstated creditable acquisitions. The Commissioner applied section 284-75 read with section 284-90 to impose a penalty of 50%. However, upon receipt of the objection, the Commissioner reduced the penalty to 25% based on reasonable care not taken in completing the return.[41]

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37 [1961] 1 WLR 1206 at 1214.

38 (1978) 18 ALR 147 at 148.

39 MT2008/01 at paragraph 35.

40 [2016] AATA 810 at 5.

41 [2016] AATA 810 at 5 and 20.

Fice J, held that there were no facts to warrant a remission of the penalty and found that the Commissioner complied with the requirements of section 298-20, as it considered the relevant Practice Statement Law Administration 2012/5 as well as the principles of the Australian Taxation Office compliance model and the Taxpayer's Charter[42] when it reduced the penalty.

iv) Shortfall amount where an unarguable position is taken and threshold applies (25%)

No reasonable ground for the tax position taken will be considered as a behaviour to warrant a penalty, if the taxpayer applies the income tax law in a particular way that does not conform to the law. This behavioural penalty differs from the behavioural penalty imposed as a result of the lack of reasonable care.[43]

The Australian Taxation Office issued a second miscellaneous Taxation Ruling MT2008/2 (entitled Shortfall Penalties: administrative penalty for taking a position that is not reasonably arguable), which sets out the position of the Commissioner on the behaviour of a taxpayer taking a tax position that is not reasonably arguable. In this ruling the Commissioner must take into account the relevant law as applicable at the time when the taxpayer made the statement.[44] It details the authorities that need to be taken into account to establish if an entity has a reasonably arguable position, namely the tax law, case law and public rulings.

The leading cases, to demonstrate what a reasonably arguable tax position is, and what objective standards are involved, to analyse the application of the law to the relevant facts, are *Walters v. Federal Commissioner of Taxation*,[45] and *Cameron Brae Pty Ltd v. Federal*

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42 The Taxpayer's Charter is a question and answer sheet on the Australian Taxation Office's website.

43 *Commissioner of Taxation* v *Traviati* (2012) 205 FCR 136 at 150, [70]-[71].

44 MT2008/02 at paragraph 40.

45 2007 ATC 4973.

Commissioner of Taxation.[46]In the *Walters*[47] case Greenwood J referred to the *Walstern* v *Commissioner of Taxation*[48] matter where it was established that an argument by a taxpayer should be considered objectively and on rational grounds. The argument advanced by the taxpayer should be sufficiently finely balanced to consider a reasonable arguable position.[49] The findings of fact and proper evaluation of the context in which the taxpayer obtained a tax benefit should be taken into account, especially for purposes of section 177C(1)(a) and section 177D if regard is had to the exclusion provision which it applies.

In *Cameron Brae (Pty) Ltd v. Federal Commissioner of Taxation*,[50]Stone and Allsop JJ had to adjudicate the manner in which the taxpayer interpreted the IS and PL Superannuation fund as a superannuation fund for purposes of section 82AAE of the Income Tax Assessment Act.[51] Stone and Allsop JJ in applying the canon of statutory interpretation[52] held that in order to interpret a statutory provision, the statutory history, the terms and structure of the Act as well as the Explanatory Memorandum should be considered to determine what the intention and purpose of the provision was.[53]The primary judge considered the factual conclusions about section 82AAE and the nature and purpose of section 8-1(1) of the Act, as sufficient to state a reasonable arguable tax position, which Stone and Allsop JJ held, was not sufficient, as the question of construction and interpretation of section 82AAE had to be dealt with.

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46 2007 ATC 4936 at 4936.

47 2007 ATC 4973 at 4990.

48 2003 ATC 5076; (2003) 138 FCR 1 at 26 [108]).

49 *Walters v. Federal Commissioner of Taxation* 2007 ATC 4936 at 4990 [102].

50 2007 ATC 4936 at 4936.

51 Act 1936 (Cth).

52 In terms of section 15AA of the Interpretation Act 1901 (Cth).

53 2007 ATC 4936 at 4949 [48].

The shortfall penalty in terms of an unreasonably arguable threshold' is applicable where a shortfall amount is caused by taking a reasonable arguable tax position which is more than the greater of $10,000 or 1% of the income tax payable which is calculated on the basis of the taxpayer's return. Where the reasonably arguable position relates to partnership or a trust, the threshold is doubled to the greater of $20,000 or 2% of net income of the partnership or the trust calculated on the basis of the return.

In *Bezuidenhout v Commissioner of Taxation*,[54] the Commissioner imposed a shortfall penalty,[55] based on the substantial shortfall that resulted from the false statement that the taxpayer made for the 2008 year of assessment. It appears that the taxpayer, who is a pilot, delayed the filing of his tax returns in previous years as well, and repeatedly failed to declare his foreign income. The Commissioner imposed a 75% behavioural penalty[56] as the Commissioner was of the view that the taxpayer acted recklessly.

4.3.3 The behavioural penalties of New Zealand

i) Lack of reasonable care (20%)

Section 141A of the TAA in New Zealand, determines that a taxpayer will be liable to pay a shortfall penalty amount of 20% for not taking reasonable care in completing his tax return.[57] According to the Interpretation Statement[58] applicable on acts after 2003 as read with the Standard Practice Statement for tax positions taken before 1 April 2003,[59] a

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54 *Bezuidenhout v Commissioner of Taxation* [2012] AATA 799.

55 In terms of item 2 in section 280-90(1) of Schedule One to the Administration Act.

56 In terms of item 7 of section 284-90 of the Administration Act.

57 Section 141A(2) of the TAA.

58 Interpretation Statement IS0055.

59 Standard Practice Statement INV-200 Shortfall penalties – not taking reasonable care appearing in Tax (1998) Information Bulletin at 1.

shortfall penalty is imposed on taxpayers who do not meet the standard of reasonable care.

Baron Alderson laid down the concept of the 'reasonable person' in *Blyth v Birmingham Waterworks*,[60] when he stated that to omit to do something that a reasonable man would have done, can be described as acting negligently. In tort law,[61] four factors were considered to establish a standard for reasonable care namely the probability of the injury, the gravity of the risk, the burden of precautionary measures and the social value of the activity.[62]

In contrast to the above, Barber J in *Case W4*[63] took into account the circumstances of the taxpayer when he applied the test for reasonable care, but held that where the risk and its consequences would have been foreseen by a reasonable person and the taxpayer has a high level of disregard for the consequences, that it would rather be seen as gross carelessness, which could be regarded as tax evasion if *mens rea* is involved.[64]

The New Zealand Revenue Authority relies on the dictionary meaning of reasonable care: 'Reasonable' describes the 'level or standard of attention required' or to mean 'within the limits of reason, not greatly or less or more than might be thought likely or appropriate, moderate...'[65] 'Care' is defined to mean 'serious attention, heed, caution, pains, assembled with care, handle with care…'[66]The New Zealand Revenue Authority further relies on common law (domestic and international) to define the standard of care in negligence

60 (1856) 11 Ex 781 at 784.

61 Todd S (ed.) 'The Law of Torts in New Zealand' (2001) at 389-392.

62 Mason J confirmed these factors in *Wyong Shire Council v Shirt* (1980) 146 CLR 40 at 47-48.

63 (2003) 21 NZTC 11,034 at 44.

64 (2003) 21 NZTC 11,034 at 45.

65 Brown L (ed) 'reasonable' The New Shorter Oxford English Dictionary on Historical Principles (1993) Oxford University Press at 2496.

66 Brown L (ed) 'care' (1993) at 516.

cases.[67] The Interpretation Statement comprehensively explains the various factors taken into account when determining the shortfall penalty and compares the New Zealand concept of reasonable care with Australian and Canadian cases.

In 2005 the New Zealand Revenue Authority issued a revised Interpretation Statement (IS0053) detailing the interpretative explanation of the shortfall penalty on taxpayers who do not take reasonable care in terms of their tax obligations.

ii) Unacceptable interpretation (20%)

If a taxpayer takes an unacceptable tax position in relation to income tax, and the shortfall arising from the taxpayer's tax position is more than $50,000 or 1% of the taxpayer's total tax figure for the relevant return period, the taxpayer will be liable to pay a shortfall penalty of 20%.[68] The interpretative explanation for an unacceptable interpretation of a tax law in terms of section 141B, as contained in the Interpretation Statement,[69] describes in detail possible scenarios that would and would not be viewed as unacceptable tax positions taken so as to clarify any misunderstandings that might arise pertaining to interpretation of what an unacceptable tax position could be.

iii) Gross carelessness (40%)

New Zealand refers to gross negligence as gross carelessness in terms of section 141C. A taxpayer is liable to pay a shortfall penalty of 40% if the taxpayer is found to be grossly careless in taking a tax position. Section 141C(3) of the TAA defines 'gross carelessness'

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67 *Blyth v Birmingham Waterworks* (1856) 11 Ex 781 at 784; *Glasgow Corporation v Muir* [1943] AC 448 at 457; *Spiers v Gorman* [1966] NZLR 897 at 905 – 906; *Billy Higgs & Sons Ltd v Baddeley* [1950] NZLR 605 at 614; *Arland v Arland and Taylor* [1955] OR 131 at 142.

68 S 141B of the TAA.

69 Interpretation statement IS0055 in terms of section 141B of the TAA.

to mean 'the doing or not doing something in a way that in all the circumstances, suggest or implies complete or a high level of disregard for the consequences.'

iv) Abusive tax position (100%)

An abusive tax position occurs if a taxpayer, who initially took an unacceptable position to its tax position, entered into or acted in such a manner that reduced or removed tax liabilities or received undue tax benefits. In this instance the taxpayer will be liable to pay a shortfall penalty of 100%.[70] Section 141D (7) of the TAA, which describes what an abusive tax position is, falls within the purpose of tax avoidance whether directly or indirectly.

The abusive tax position as described in terms of section 141D(7) of the TAA means a tax position that,—

'(a) is an unacceptable tax position at the time at which the tax position is taken; and

(b) viewed objectively, the taxpayer takes—

(i) in respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly; or

(ii) where the tax position does not relate to an arrangement described in subparagraph (i), with a dominant purpose of avoiding tax, whether directly or indirectly.'

The New Zealand Revenue Authority published an Interpretation Statement to provide an interpretative explanation of a penalty imposed in terms of section 141D.[71]In terms of this Interpretation Statement a penalty of 100% is applied for a shortfall that occurs due to an abusive tax position taken.[72]The Interpretation Statement highlights the requirements that

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[70] Section 141D of the TAA.

[71] Interpretation statement IS0060 issued in terms of the TAA.

[72] In terms of section 141D(3) of the TAA read with the Interpretation statement IS0060 at 4.

are applicable to determine if an abusive tax position exist, provides relevant case law where abusive tax positions were adjudicated and gives a historical background to the development of the statement.

v) Tax evasion or similar acts (150%)

New Zealand imposes a shortfall penalty of 150% in terms of section 141E if a taxpayer is found guilty of tax evasion. Specific actions deemed to be intentional tax evasion is described in section 141E(1)(a) to (f) of the TAA. In 2006 the Revenue Authority for New Zealand issued the Interpretation Statement detailing the shortfall penalty relating to evasion.[73]

The Taxation Review Authority ("the Authority") stated in TRA 5/16,[74] that evasion requires intentional behaviour or subjective recklessness. Subjective recklessness requires actual awareness of the risk of breaching the obligation. The established principle in *Brent v Commissioner of Taxation*[75] that all amounts received for services rendered will be regarded as ordinary income, was confirmed in this decision. In *TRA010/14*,[76] the Authority held that to determine evasive intent requires a subjective test on the deliberate or reckless actions of the taxpayer and the taxpayer's states of mind.

4.4 CONCLUSION

In terms of section 14ZZK of the Australian penalty regime the burden of proof is on the taxpayer as opposed to its South African and New Zealand counterpart where the Commissioner needs to prove that the penalty so imposed was justified.[77]

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73 Interpretation statement IS0062 issued in terms of the TAA.

74 [2016] NZTRA 11.

75 (1971) 125 CLR 418 at 429.

76 Inland Revenue Technical Tax Areas - *TRA010/14* [2015] NZTRA 09. http://www.ird.govt.nz/technical-tax/case-notes/2015/cn-2015-06-08-tp-only-able-to-challenge.html. (Accessed 30 May 2017).

77 In terms of section 102(2) of the TA Act.

The behaviours identified in each foreign penalty regime are similar to the behaviours identified in terms of the understatement penalty regime. Prior to a penalty being imposed, the Australian and South African penalty regime provides for the situation where the taxpayer is afforded the opportunity to explain their actions. The countries identified for the comparison,[78] rely on a high level of trust in the taxing authorities to ensure tax compliance. Each one of these countries formulated a penalty regime based on the behaviour of the taxpayer pertaining to tax compliance. These countries consolidated their respective penalty regimes in one Act designed to administer the penalty provisions applicable to the tax Acts.

The successes and failures of each of these countries' penalty provisions are reliant on the taxpayers' trust in the respective revenue authorities. The prevalence of more serious acts of non-compliance in each of these countries is an indication of a downward trend in levels of compliance.[79]

The imposition of the different behavioural penalties in each of these countries are not sufficiently or adequately reported which makes a comparison in terms of the prevalence of these behavioural acts impossible to accurately determine. The New Zealand Inland Revenue Authority must prepare annual shortfall penalty reports pursuant to section 141L of the TAA.

These reports provide interesting insights into both taxpayer behaviour and the level and nature of Inland Revenue review activity in various areas. The different types of behaviour of taxpayers that lead to non-compliance with tax Acts, appear to be aligned in all four

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[78] The countries identified for comparison is South Africa, Australia and New Zealand. The reasons identified for the selection of these countries were due to the Roman-Dutch and English Law influences that applied in all of these countries; the application of the legal systems in each country which is based on English law; the consolidation of each country's penalties into one Act and the participation of South Africa in the OECD Forums, of which the three foreign countries are OECD members.

[79] Kirchler E 'The Economic Psychology of Tax Behaviour' (2007) New York: Cambridge University Press at 107.

countries, as evident from their penalty regimes. Though the percentage in penalties may differ slightly, it appears that the same criteria is applied in all four countries.

To highlight the similarities of the behavioural penalties between these regimes each penalty regime is summarised in table format as follow:

Table 4: Summary of behavioural penalties in South Africa, Australia and New Zealand

South Africa	**Australia**	**New Zealand**
Substantial Understatement	Reasonable Arguable threshold	No direct reference
Reasonable care not taken in completing a tax return	Lack of reasonable care / Failure to make a statement / Failure to follow a private ruling.	Not taking reasonable care
No Reasonable ground for the tax position taken	Reasonable arguable tax position	Abusive tax position / Unacceptable tax position
Gross Negligence	Recklessness	Gross Carelessness
Intentional Tax Evasion	Intentional disregard of taxation law	Tax Evasion

Source: Own summary of different behavioural penalties

In comparison to the South African penalty regime the first aspect that stands out is the amount of information available on these behavioural penalties. In each of the foreign jurisdictions, public rulings, interpretational statements and other forms of authority exist to explain the behavioural penalty regimes.

As was evident from the case law in South African, the main concern raised in this penalty review dealt with the ineffective application of the behavioural penalty. When the behaviours as identified in the understatement penalty regime of South Africa is compared to the behaviours as identified in the penalty regimes of Australia and New Zealand it is

clear that it addresses similar issues, identifying criteria, and rules of law. The behavioural penalties of each foreign jurisdiction was compared to one another in table format, to determine if it aligns according to the relevant behaviour and the percentage penalty assigned to the specific behaviours.

The table below therefore depicts this comparison which provides a basic overview of all of the behavioural penalty regimes that form part of this comparative study.

Table 5: Summary of Comparative Penalty Percentages

Description of Behaviour	Australia	New Zealand	South Africa
Substantial understatement/ Reasonable Arguable threshold	25%	20%	25%
Reasonable care not taken in completing a tax return/ Lack of reasonable care / Failure to make a statement / Failure to follow a private ruling	25%	20%	25% - 50%
No Reasonable ground for the tax position taken/ Reasonable arguable tax position/ Abusive tax position / Unacceptable tax position	50%	40%	100%
Gross Negligence/ Recklessness/ Carelessness/ Deliberate unconcealed act	75%	100%	75%
Tax Evasion / Intentional disregard of taxation law / Deliberate concealed act	75%	150%	150%

Source: Own construct of different penalty percentages

It is however clear from having studied the penalty regimes of the foreign jurisdictions, that the South African understatement penalty regime lack definition and substance. The volume of interpretational statements, guides and compliance handbooks issued on each respective behavioural penalty is vast in comparison to the little information and guide that is available on the South African understatement penalty. This might explain the incorrect interpretation of the law in the recent Tax Court cases that were adjudicated in terms of section 223 of the TA Act.

As is the case in terms of the South African legislation, there is a distinguishable link between tax evasion prosecutions and the punitive measures imposed in terms of the Proceeds of Crime Act,[80] (which is similar to the South African POCA).[81] To intensify its fight against tax evasion, South Africa penalises it in terms of the understatement penalty behaviour matrix, and prosecutes it as a criminal offence.[82]

The understatement penalty regime of South Africa requires a lot more interpretation, guidance and assistance from SARS to ensure that the penalties are imposed effectively. Not only will it stem non-compliance, but it will contribute to combat tax evasion and tax avoidance.

80 Act 2002.

81 Prevention of Organised Crime Act 121 of 1998.

82 Section 235 of the TA Act.

CHAPTER 5

CONCLUSION

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5.1 INTRODUCTION

With the introduction of the understatement penalty in terms of Chapter 16 of the Tax Administration Act, various scholars, authors and members of the tax profession expressed their concerns and fears pertaining to the effect of the understatement penalty.[1] The lack of detailed and substantive definitions of the behaviours identified in the penalty matrix, together with the perceived subjective imposition thereof,[2] prompted some of these fears. Kriel[3] was of the view that an understatement penalty will be imposed in each and every additional assessment raised and that SARS will not be able to provide proper reasons for the said imposition. In certain instances, the public was advised to object to each and every assessment and hope that SARS would be lenient in its approach,[4] whilst

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1 Van Zyl L (2014) at 905; Mazansky E (2016) at 1 and 2.

2 Khaki S 'The problem with SARS' new behavioural penalties: Taxpayers could be in for a shock' (2012) *Moneyweb Tax Breaks* at 7.

3 Kriel A 'Pitfalls within the Tax Administration Act – Mistakes to cost taxpayers dearly' (2013) *Moneyweb Tax Breaks* at 7.

4 Jones S 'SARS must provide reasons for its decisions…but how far is it required to go?' (2011) *Moneyweb Tax Breaks* at 5.

tax practitioners advised their clients to file objections in every instance where an understatement penalty is imposed.[5]

Having regard to the current international focus on tax evasion, tax fraud and tax avoidance schemes which seem to occur more frequently, South Africa need to implement a more aggressive attitude against these elements as it has the potential to deplete the country's revenue base. Tax evasion, corporate shelters and legal tax loopholes can become very problematic for a country that has a troubling economy and a budget deficit.[6]

The first step in the right direction has already begun with the introduction of the behavioural penalty regime, but SARS has a long road to walk before it can claim international alignment with the foreign jurisdictions that have similar penalty regimes.

5.2 SUMMARY OF THE FINDINGS AND CONCLUSIONS FROM THE CHAPTERS IN THIS STUDY

The main objective of this study was to analyse the efficacy of the understatement penalty. This was achieved in terms of the theoretical study of the construct and enactment of the understatement penalty,[7] which was then compared to the behavioural penalty regimes of the foreign jurisdictions of Australia and New Zealand.

The effectiveness of the imposition of the understatement penalty in light of the administrative requirements for a fair administrative decision was unpacked and compared to the Tax Court decisions that were recently adjudicated. On the construct of the understatement penalty in comparison to the foreign jurisdictions selected for the study, it became evident that the South African understatement penalty regime requires more

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5 Van der Zwan P 'Tax and Penalties – The perspective of a tax practitioner' (2014) *Tax Talk* 31 – 33 at 32.

6 Thomas K D 'The Psychic cost of tax evasion' (2015) *Boston College Law Review* at 618.

7 In terms of sections 221 to 224 of the TA Act.

detailed interpretation notes, guides and proper substance to be added to the relevant provisions in the TA Act.

The specific behaviours identified in the penalty regime were not adequately defined or were not defined at all. The resources to obtain guidance on the manner in which SARS interprets these behavioural penalties were restricted to the four sections in Chapter 16 and the general Guide on the Understatement Penalty published by SARS.

From the behavioural penalties defined in the foreign jurisdictions, it became evident that each revenue authority applies a different approach to the interpretation and application of these penalties. This is evident in the magnitude of resources published on each behavioural penalty in each jurisdiction.

It was further evident from the tax appeals adjudicated in the Tax Court, that a lack of proper training on the correct application of the penalty regime, be it the application of the law, or the provision of proper reasons for the decision to impose these penalties, lead to unsuccessful judgments. This is concerning, especially as these issues were raised in terms of the previous penalty regime in the decisions of *Commissioner for the South African Revenue Service v Pretoria East Motors (Pty) Ltd*,[8] and *Commissioner for South African Revenue Service SARS v Sprigg Investment 117 t/a Global Investment CC*.[9]

The challenges experienced by SARS and the taxpayer to apply the understatement penalty regime correctly, is still a cause for concern even though the legislator attempted to facilitate a smooth transition from the old penalty regime to the new understatement penalty regime.[10]

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8 *Commissioner for the South African Revenue Service v Pretoria East Motors (Pty) Ltd* [2014] 3 All SA 266 (SCA) paragraphs 54 to 57 at 288.

9 *Commissioner for South African Revenue Service SARS v Sprigg Investment 117 t/a Global Investment CC* 73 SATC 114 [2010] ZASCA 172.

10 In terms of s 270 of the TA Act.

On face value the South African penalty regime bears certain similarities with the penalty regimes of the foreign jurisdictions analysed in the comparative study. The types of behaviours and the percentages allocated to these behavioural penalties are more or less similar. The difference is noticeable in terms of the extensive guides, Interpretation Statements and Practice Notes published and issued by these foreign jurisdictions on each behavioural penalty. In answer to one of the research questions identified for this study, the South African understatement penalty compares poorly with the international standards of its foreign counterparts, as sections 221 to 224 of the TA Act do not nearly reflect the required detailed information, definitions and guides to introduce a new behavioural understatement penalty regime to the South African public.

From a domestic legislative point of view, the decisions and reasons to impose an understatement penalty will not be subject to a review application in the High Court, as the TA Act provides for an objection and appeal process to be followed in the Tax Court. Though this aspect has been challenged on several occasions in the High Court,[11] the judiciary concurs that once an assessment is raised, the dispute must be resolved in the Tax Court.

5.3 CONTRIBUTION AND LIMITATIONS OF THE PRESENT STUDY

The lack in case law on the imposition of the South African understatement penalty was identified as a major limitation in the present study. Of the four Tax Court cases available, certain conclusions as to the approach by SARS to these penalties, could be made, but in comparison to the array of foreign case law available, on the foreign behavioural penalty regimes, the question was left unanswered as to whether the understatement penalty is effectively applied or not.

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[11] *Commissioner for Inland Revenue v Taylor* 1934 AD 387 at 390; *Ackermans Ltd v Commissioner for South African Revenue Services* 77 SATC 191 at 194; *IT1866* (2012) 75 SATC 268; *Metcash Trading Ltd v Commissioner, SARS and Another* 2001 (1) SA 1109 (CC); *Rossi v Commissioner for South African Revenue Service* (2012) 8 SATC 387; *South Atlantic Jazz Festival (Pty) Ltd v Commissioner for the South African Revenue Service* [2015] ZAWCHC 8.

The wealth of sources available internationally on this topic contributed to the conclusions made in this study. Having regard to the extensive legislative provisions, guides and notes of the Australian and New Zealand behavioural penalty regimes, created the awareness of the potential to improve the South African understatement penalty. The focus on the effectiveness of the understatement penalty was restricted to the available legislation, guide and information published in journal articles.

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