

STRATEGIC TAX RISK MANAGEMENT FOR SOUTH AFRICAN FARMERS: AN EVALUATION OF AN INDUSTRY LEADER

by

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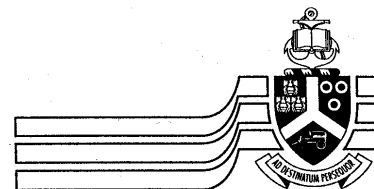
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ABSTRACT

STRATEGIC TAX RISK MANAGEMENT FOR SOUTH AFRICAN FARMERS: AN EVALUATION OF AN INDUSTRY LEADER

by

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DEPARTMENT: TAXATION

DEGREE: MAGISTER COMMERCII

With the current heightened awareness of corporate governance, tax risk management is becoming increasingly important. This is largely on account of developments in the regulations of the Sarbanes Oxley Act, which was promulgated partly in reaction to the scandalous events surrounding corporate collapses like that of Enron (Du Plessis & Molyneux, 2007:22). The results of international surveys have shown that 80% of total tax risks are not under the control of taxation departments, and that these risks go beyond normal compliance issues (Du Plessis & Molyneux, 2007:22).

Formal and effective tax risk management strategies that identify both the risks and the actions to address them are recommended (Du Plessis & Molyneux, 2007:22), and general habitual tax mistakes have been identified (Scott, Ross & Louw, 2007:16). However, little attention has been paid either to research identifying industry-specific and high-risk focus areas or to formulating what an effective tax risk management strategy should entail, one that is tailored to the specified needs of individual industries.

The aim of this study is to determine what an effective tax risk management strategy for South African farmers should entail.

A literature review was conducted to investigate the principles underlying effective tax risk management strategies in general. It has been deduced from the literature review that the tax risk management process forms a good framework for an effective strategy.

South African taxation legislation and case law were reviewed to determine farmers' exposure to tax risk in South Africa, and to identify their specific tax risks. Definitions of certain terms were identified as possible tax risks, as these are not properly defined in legislation. Forty five (45) specific tax risks relating to the legislation are discussed.

Drawing on the information obtained in the literature review and the review of tax legislation and case law, a proposed tax risk management strategy for the South African farmer was outlined. This was in turn used as criteria by which to evaluate the tax risk management strategy of a leader in the farming industry in South Africa, in order to identify possible weaknesses in South African farmers' tax risk management strategies in general.

The tax risk management strategy of the industry leader was summarised and evaluated according to the abovementioned criteria. The study concluded that some weaknesses do exist in the industry leader's tax risk management strategy, and that the proposed tax risk management strategy used as evaluation criteria gave an indication of what an effective tax risk management strategy for the South African farmer should entail.

OPSOMMING

STRATEGIESE BELASTINGRISIKOBESTUUR VIR SUID-AFRIKAANSE BOERE: 'N EVALUASIE VAN 'N INDUSTRIELEIER

deur

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Belastingrisikobestuur is besig om al hoe belangriker te word, as gevolg van die verhoogde bewuswording van goeie maatskappybestuur. Dit is hoofsaaklik as gevolg van die ontwikkelinge in die regulasies van die Sarbanes Oxley Wet, wat gepromulgeer is as reaksie op die gebeure rondom die ineenstorting van maatskappye soos Enron (Du Plessis & Molyneux, 2007:22). Die resultate van internasionale opnames het getoon dat 80% van alle belastingrisikos nie onder beheer van belastingdepartemente is nie, en dat die risikos meer is as bloot normale nakomingsprobleme (Du Plessis & Molyneux, 2007:22).

Alhoewel formele en effektiewe belastingrisikobestuurstrategieë, wat riskos identifiseer en, kontroles om die risikos teen te werk, voorgestel word (Du Plessis & Molyneux, 2007:22) en algemene gewoonte-belastingfoute geïdentifiseer word (Scott, Ross & Louw, 2007:16), word min navorsing gedoen om hoë-risiko areas te identifiseer wat uniek is aan spesifieke industrieë en om te formuleer wat 'n effektiewe belastingrisikobestuurstrategie vir daardie spesifieke industrie behels.

Die doel van hierdie studie is om te bepaal wat 'n effektiewe belastingrisikobestuurstrategie vir die Suid-Afrikaanse boer behoort te behels.

'n Literatuurstudie is gedoen om die beginsels wat effektiewe belastingrisikobestuurstrategieë onderskryf, te bepaal. Uit die literatuurstudie wat gedoen

is, is afgelei dat die belastingrisikobestuursproses 'n goeie raamwerk vorm vir 'n effektiewe strategie.

Suid-Afrikaanse belastingwetgewing en hofbeslissings is ondersoek om te bepaal wat die Suid-Afrikaanse boer se blootstelling aan belastingrisiko is en om die spesifieke belastingrisikos te identifiseer. Definisies van sekere terme is geïdentifiseer as moontlike risikos, aangesien dit nie behoorlik omskryf is in die wetgewing nie. Asook 45 spesifieke belastingrisikos wat verband hou met die wetgewing.

Die inligting wat ingesamel is deur die literatuurstudie en die ondersoek van belastingwetgewing en hofbeslissings is gebruik om 'n voorgestelde belastingrisikobestuurstrategie vir Suid-Afrikaanse boere op te stel. Die voorgestelde strategie is gebruik as kriteria om die belastingrisikobestuurstrategie van 'n leier in die boerderyindustrie te evalueer, met die doel om moontlike swakhede in die belastingrisikobestuurstrategie van boere in Suid-Afrika te identifiseer.

Die belastingrisikobestuurstrategie van die industrieleier is opgesom en met die bogenoemde kriteria vergelyk. Die gevolgtrekking was dat die belastingrisikobestuurstrategie van die industrieleier wel sekere swakhede bevat, en dat die voorgestelde belastingrisikobestuurstrategie wat gebruik is as evaluasiekriteria, 'n goeie aanduiding is van wat 'n effektiewe belastingrisikobestuurstrategie vir die Suid-Afrikaanse boer behoort te behels.

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STRATEGIC TAX RISK MANAGEMENT FOR SOUTH AFRICAN FARMERS: AN EVALUATION OF AN INDUSTRY LEADER

CHAPTER 1

BACKGROUND AND PROBLEM STATEMENT

1.1 BACKGROUND

It has been said that “[i]f you are not living on the edge, you are taking up too much space” (Anonymous). This might be a very exciting approach to life, but it could be very dangerous in the taxation environment, where the winds of change are blowing furiously. It could become even more dangerous if you were in it with your eyes shut, like so many taxpayers who adopt an informal, intuitive approach to tax risk management.

With the current heightened awareness of corporate governance, tax risk management is becoming increasingly important. This is largely on account of developments in the regulations of the Sarbanes Oxley Act, which was promulgated partly in reaction to the scandalous events surrounding corporate collapses like that of Enron (Du Plessis & Molyneux, 2007:22). The results of international surveys have shown that 80% of total tax risks are not under the control of taxation departments, and that these risks go beyond normal compliance issues (Du Plessis & Molyneux, 2007:22).

Formal and effective tax risk management strategies that identify both the risks and the actions to address them are recommended (Du Plessis & Molyneux, 2007:22), while general habitual tax mistakes have also been identified (Scott, Ross & Louw, 2007:16). However, little attention has been paid to research that identifies industry-specific and high-risk focus areas and to formulate what an effective tax risk management strategy should entail, one that is tailored to the specified needs of individual industries.

Previous research has addressed a few aspects of tax risk management:

- risks surrounding transfer-pricing (Sijmonbergen, Carey & Schmid, 2007);
- risks of transfer-pricing for financial-service companies (Mace, Faiferlick & Levy, 2007);

- the need for formal tax risk strategies (Du Plessis & Molyneux, 2007:22; Fourie, 2006); and
- how to combat the explosion of tax risk and what should be included in a strategy (Johnston, 2006).

While existing research focuses on overall actions that can be taken to address tax risk, such as developing good skills and processes (Johnston, 2006), little attention is paid to industry-specific high-risk focus areas, where risks are not controlled. Specific industries, such as the South African farming industry, will have to face unique challenges in a tax risk environment differing from other industries in the country, which is the result of specific tax legislation directed at farmers. An entire schedule of the South African Income Tax Act 58 of 1962 is devoted to farmers, in which they are clearly taxed differently from other taxpayers.

1.2 PROBLEM STATEMENT

The purpose of this study is to determine what an effective tax risk management strategy for farmers in South Africa should entail.

1.3 RESEARCH OBJECTIVES

The proposed study will be guided by the following specific research objectives:

- to identify effective tax risk management principles by reviewing literature on effective risk management strategies in general;
- to identify tax risks specifically applicable to farming operations by reviewing tax legislation and case law; and
- to identify possible weaknesses in existing tax risk management strategies used by South African commercial farmers by analysing the tax risk strategy of an industry leader.

1.4 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

From a theoretical perspective, the proposed study will make the following contributions to the extant body of knowledge on taxation risk management. While previous studies have focused on taxpayers' general taxation errors (Scott, Ross & Louw, 2007:16), this study will include industry-specific focus areas of tax risk for the South African commercial farming industry, and will tailor the general requirements of an effective tax risk management strategy to the specific needs of the farming industry.

This study should assist farmers in effectively managing tax risk. It should be a matter of great concern to farmers, as tax is a major expense item on their income statements, while the legislation governing tax for farmers is complicated. Farmers enter into complex transactions, like capital expansion, exporting goods and managing a significant workforce with a wide variety of different remuneration packages. All these elements add up to significant taxation considerations which influence farmers in a variety of ways. Farmers generally do not have taxation departments, and think about taxation only when their tax returns are due. The relevant information is handed over to a tax professional, for instance an auditor, who completes the return. At this stage all transactions are usually finalised for the specific year and little can be done to rectify tax errors. Farmers could therefore benefit significantly from taxation risk management.

1.5 DELIMITATIONS

This study will focus on farming operations as defined in taxation legislation (refer to the Income Tax Act of 1962) and will therefore not include the following:

- other agricultural operations;
- risks for farmers other than tax risk;
- legislation other than South African taxation legislation;
- tax risk management strategies for businesses other than farming operations.

1.6 ASSUMPTIONS

The following assumptions were made:

- South African farmers will continue to be liable for taxation under South African taxation legislation;
- farming will continue to be viable in South Africa;
- South African taxation legislation applicable to farmers will not change drastically in the near future; and
- The industry leader under review is a good representative of the farming industry in South Africa.

1.7 DEFINITION OF KEY TERMS

The following key terms are used in the study:

Tax risk: refers to all uncertainties relating to non-compliance with tax legislation, inaccurate tax reporting and ineffective management of tax as a cost that can have adverse consequences for the organisation, on a monetary or reputational level (Du Plessis & Molyneux, 2007: 21-23; Erasmus, 2007: dictionary xxi).

Tax risk management: refers to avoiding surprises related to taxation by proactively identifying upside tax opportunities and exploiting them, proactively identifying downside exposures and addressing and managing them, as well as proactively identifying weaknesses in tax reporting processes and improving on them (Du Plessis & Molyneux, 2007:22; Johnston, 2006:1).

Tax avoidance: is defined as “[a]n attempt to minimise a tax liability using legal means, i.e. to regulate one’s affairs in such a way that one pays the minimum tax imposed by the Act rather the maximum” (Huxham & Haupt, 2008:416).

Tax evasion: refers to “[t]he use of illegal means to reduce a tax liability, e.g. falsification of books, suppression of income, fraudulent non-disclosure of income, overstatement of deductions” (Huxham & Haupt, 2008:416).

Farming operation: “Farming operations” is a comprehensive term which includes any activity on land, but excludes hobbies (ITC 586 (1948) 14 SATC 123; Pearson (1993:1135)).

Tax risk management strategy: A plan relating to the management of tax risk, which has an objective. The strategy should include processes to identify tax-related risks that could prevent the objective from being achieved, and then identify the actions to address these risks (Erasmus, 2007:25-26; Du Plessis & Molyneux, 2007:23).

1.8 ABBREVIATIONS

The following abbreviations are used in the study:

Table 1: Abbreviations used in this document

Abbreviation	Meaning
Adv	Advocate
PAYE	Pay-as-you-earn
SA	South African
SARS	South African Revenue Service
SOX	Sarbanes-Oxley Act
USA	United States of America
VAT	Value-added tax

1.9 RESEARCH DESIGN AND METHODS

An empirical study in the form of a case study was conducted. A literature review was necessary to review principles laid down in the discipline of risk management; it was specifically applicable to tax risk, as well as to identifying high-risk taxation areas for farmers. This was so that the principles and high-risk areas could be used as a basis for evaluating the tax risk strategy of an industry leader in the farming industry.

Robinson (2002:178) describes case study research as follows: “[a] strategy for doing research which involves an empirical investigation of a particular contemporary”.

As this study is qualitative, qualitative analysis will be used to analyse data. The approach will be inductive; an analytical framework will be developed from existing theory and literature about effective tax risk management principles, which will then be used to evaluate a case study's tax risk strategy in order to determine what an effective tax risk management strategy should entail (Saunders, Lewis & Thornhill, 2007:489).

The techniques used to analyse data were the following:

- **summaries:** literature on tax risk management; the formal tax risk strategy document will be summarised before being analysed. The summary contains a list of the key points in the documents and describes the purpose, of the document in relation to the study as well as highlighting its significance (Saunders *et al.*, 2007: 486); and
- **self memos:** these memos will be used to record ideas as they occur to the researcher during any point of the research, so that the ideas are not lost, but can be used to direct the research or to incorporate significant avenues of thought or exploration (Saunders *et al.*, 2007:486).

1.10 BROAD FRAMEWORK OF STUDY

Chapter 1: Background and problem statement

This chapter presents the background to the study, indicating the importance of the study; the delimitations and assumptions made; the definition of key terms; and an overview of the research design and methods that will be used.

Chapter 2: An overview of tax risk management

The chapter aims at defining the terms “tax risk” and “tax risk management”, and at making a comparison between “tax planning”, “tax avoidance” and “tax evasion”. The importance of tax risk management is discussed.

Chapter 3: The guiding principles of effective tax risk management

This chapter is devoted to explaining the principles underlying effective tax risk management strategies as defined in available literature.

Chapter 4: The compilation of a tax risk management strategy

This chapter discusses the compilation of a tax risk management strategy by using the tax risk management process as a framework. Root causes and countermeasures for tax risk, as well as the different types of tax risks which should be mitigated by an effective tax risk management strategy will be discussed.

Chapter 5: The exposure of farming operations to tax risk

In this chapter, the terms “farming operation” and “farming income” are defined. Legislation applicable to farming operations and the farmer’s exposure to tax risk are discussed.

Chapter 6: Specific tax risks applicable to farming operations

In this chapter the particular tax risks that may pose a threat to farming operations are detailed, with specific reference to the risks associated with the First Schedule of the Act.

Chapter 7: A proposed Tax Risk Management Strategy for farming operations

This chapter attempts to draft a framework for what a typical tax risk management strategy for a farming operation should entail. This framework will be based on the findings and information gained in the previous chapters. The framework will be used as criteria by which to evaluate the tax risk management strategy of the case study, an industry leader in the farming sector.

Chapter 8: A summary of the tax risk management strategy of an industry leader

This chapter gives an analysis of the tax risk management strategy of an industry leader in the farming sector, summarising the contents of the document.

Chapter 9: Evaluation of the tax risk management strategy of the industry leader

In this chapter, the tax risk management strategy of the entity under review will be evaluated against the criteria discussed in Chapter 7. Diagram 3 of Chapter 7 illustrates the framework used as the criteria.

Chapter 10: Conclusion

The final chapter reaches a conclusion on what an effective tax risk management strategy for South African farmers should entail, based on the literature review and

an evaluation of the tax risk management strategy document of the industry leader will be carried out.

1.11 SUMMARY

This chapter provided a broad background on the subject of the study, which is “tax risk management”, indicating how important tax risk management is in the current changing tax environment. The research design and methods to be used were discussed, and a broad framework of the study was provided.

Chapter 2 will discuss a literature review on the definitions of “tax risk” and “tax risk management”. There will also be a comparison of “tax planning”, “tax avoidance” and “tax evasion”. The importance of tax risk management will be included.

CHAPTER 2

AN OVERVIEW OF TAX RISK MANAGEMENT

2.1 INTRODUCTION

In the previous chapter, the background; the problem statement; the research objectives; the importance and benefits; the delimitations; and the assumptions of the study were stated. Definitions of key terms; abbreviations; the research design; and the methods used in the study were provided. A broad framework of the study was included.

This chapter gives a comprehensive overview of what tax risk management entails. The terms “tax risk” and “tax risk management” will be defined, and there will be a comparison between the controversial issues of “tax planning”, “tax avoidance” and “tax evasion”. The importance of tax risk management will be discussed.

2.2 TAX RISK DEFINED

It is not easy to define tax risk; it could even be controversial. When scanning the list of journal articles during a search on the “Proquest” or “EbscoHost” databases, it was found that very few formal definitions of “tax risk” exist. Authors usually refer in the body of their articles to what they perceive to be the “problem” or “risk” when dealing with taxation legislation. However, there are numerous different opinions on what the “risk” actually entails. In most instances, the authors’ perceptions of “risk” have to be deduced from their suggested solutions to managing the risk.

Erasmus (2007: dictionary xxi) and Du Plessis and Molyneux (2007: 21-23) are two of the sources that formally define tax risk.

Erasmus (2007: definitions) defines “tax risk” by first defining “risk” as “[e]xposure to hazard; endanger; to expose to chance of injury or loss; to take the chances of...”. He goes on to say that for the purposes of his book “tax risk” is “[i]dentifying those areas in the business that give rise to potential financial loss when tax principles are applied to them...

. Primarily it is a cautionary measure to avoid possibly serious adverse financial consequences. It can be divided into two broad areas: internal and external tax risk”.

Du Plessis and Molyneux (2007: 22) state that: “[t]ax risk could perhaps best be described as ‘those uncertainties relating to tax that have potential for adverse consequences’.”

Du Plessis and Molyneux (2007: 22) give a more accurate definition, as the word “uncertainties” is more descriptive of risk than the phrase “areas of business”. Further, the statement by Erasmus that tax risk is a “cautionary measure” does not describe risk at all. The *management* of tax risk can be a cautionary measure, but not the risk itself. Although Erasmus did not word his definition with particular accuracy, it nevertheless contains certain important principles which are helpful in defining tax risk, such as the idea of a “potential financial loss when tax principles are applied...”.

To best understand what tax risk actually entails, it is necessary to investigate what is meant by “adverse consequences” or “financial loss”. Do these refer to a financial loss due to penalties of non-compliance to legislation? Or to a lower profit because of a too-high tax expense? And what “adverse consequences” are meant as far as tax is concerned?

Du Plessis and Molyneux (2007:22) describe these “adverse consequences” as “monetary in the form of tax, interest and penalties, but they may also include damage to reputation, for example with SARS, investors, shareholders, or the general public...”. It is clear from this description that these authors view the adverse consequences as resulting from the risk of non-compliance with tax legislation and they are on a monetary or reputational level. However, later on, they discuss potential objectives for a tax risk strategy, and in that context they give an additional objective as the principle of “paying the least amount of tax possible within legal limits”. Informally, then, they view “tax risk” as arising also from an additional source, namely paying more tax than is legally necessary; in other words, managing tax as a cost.

Erasmus maintains that these financial losses come primarily from differing opinions on the interpretation of tax laws and regulatory changes due to this ever-changing environment. This clearly refers to the risk of non-compliance with legislation. Further, he discusses “internal risks” that are the result of processes in certain areas of business that

result in management and reputational risk. This refers to the risk of a bad reputation in that area of governance (non-compliance risk) and the risk of not managing tax effectively. It is unclear whether he is referring to “managing tax” in the sense of managing tax as a cost, meaning tax planning, or whether he is again referring to non-compliance or tax-reporting issues. The reference is probably to all of these risks, as he mentions the business areas from which the risks result as transactional (tax management risk), operational (tax management risk), compliance (compliance risk) and financial accounting (tax reporting risk).

Du Toit (*TAXTalk*, 2007:4-5) describes tax risk in more informal terms. He explains that the board of directors of a company has a fiduciary duty. As part of this fiduciary duty, the board ought to be driving an organisational culture of “uncompromising tax legality and compliance”. At the same time, though, the board ought to be driving a culture of “active but legal management of the corporate burden in all taxes”. Du Toit explains that these two cultures “are not in conflict, they are complementary”. One can deduce from his explanation that there is a risk to the board of directors in any organisation as far as tax risk is concerned; that would be the risk of non-compliance with legislation, as well as the risk that tax, as a cost burden, is not managed effectively.

Angus Johnston (2006:1), a tax partner at PriceWaterhouseCoopers in London, describes the areas of tax risk to be compliance with legislation, tax reporting and managing tax as a cost.

For the purposes of this study, tax risk will be defined as all uncertainties relating to non-compliance with tax legislation, inaccurate tax reporting and ineffective management of tax as a cost, all of which have adverse consequences for the organisation on both the financial and reputational levels.

To further explain the tax risk definition, the following table shows the relationship between the tax risks and their effect on stakeholders.

Table 2: The definition of tax risk and its effect on stakeholders

TAX RISK	RISK LEVEL	STAKEHOLDERS AFFECTED
Non-compliance with legislation	Monetary: tax, penalties, interest	Shareholders, directors, employees
	Reputational: bad governance	Shareholders, SARS, general public
Ineffective tax management as a cost	Monetary: reduced profit	Shareholders, directors, employees
	Reputational: reduced share-price	Shareholders, general public
Inaccurate tax reporting	Monetary: inaccurate profit	Shareholders, directors, employees
	Reputational: inaccurate financial statements	Shareholders, SARS, users of financial statements

2.3 TAX RISK MANAGEMENT DEFINED

The definition of tax risk management is significantly influenced by the definition of tax risk, as people tend to manage only what they perceive to be the risk. For the purposes of this study, the definition of risk stated in Chapter 2.2 will be used.

There appears to have been a change in the approach to and definitions of tax risk management following the American and European corporate failures of the early 2000s (Johnston, 2006:1). Prior to this, tax risk management meant making sure that all the figures added up, in the sense that returns were completed accurately from management reports and calculations were made correctly in accordance with legislation (Johnston 2006:1). As long as no tax audit was on the horizon and no penalties were charged, no extra resources were spent on the tax front (Du Plessis & Molyneux, 2007:22). Tax risk management has evolved into a much more complex issue that no longer takes cognisance of simply the familiar obvious compliance processes (Du Plessis & Molyneux, 2007:22), but instead blends technical assurance, processes, controls, governance and stakeholder management together (Johnston, 2006:1).

There are therefore not many formal tax risk management definitions available. The best definition available on “tax risk management” is provided by Du Plessis and Molyneux

(2007:22). It is not a formal definition, but is rather a description of what tax risk management currently entails. This description states that tax risk management "...is also about facilitating a culture of tax risk management and risk ownership that is practised as everyone's responsibility, avoiding surprises and ensuring that upside tax opportunities are identified and exploited, while downside exposures are addressed and managed".

This description covers the tax risks of non-compliance and managing tax as a cost. It does not cover the risk of tax reporting.

For the purposes of this study, tax risk management will be defined as avoiding surprises related to taxation by pro-actively identifying upside tax opportunities and exploiting them; proactively identifying downside exposures and addressing and managing them; as well as proactively identifying weaknesses in tax reporting processes and improving them.

2.4 A COMPARISON BETWEEN TAX PLANNING, TAX AVOIDANCE AND TAX EVASION

In Chapter 2.2, tax risk was defined. Included in tax risk was the effective management of tax as a cost. Tax planning in the sense of managing tax as cost may have a reputational impact, as stakeholders could view any tax planning, legal or otherwise, in a negative light. However, according to Johnston (2006:1), recent reports by Henderson Investors and Citigroup highlight the idea that a stable decrease in taxes should be welcomed by the general public, just like any cost reduction, because share price generally reflects the market's perception of sustainable earnings.

As Du Toit (2007:5) points out, directors have, under company law, the fiduciary responsibility of effective management, including expenses related to taxation. Tax planning is therefore vital, even though the tax authorities may not be very positive about it and governments have tried to politicise corporate tax behaviour (Johnston, 2006:1).

Tax planning generally consists of tax avoidance. Huxham and Haupt (2008:416) define tax avoidance as "[a]n attempt to minimise a tax liability using legal means, i.e. to regulate your affairs in such a way that you pay the minimum tax imposed by the Act rather the

maximum”. Tax avoidance is, therefore, minimisation of tax within the boundaries of the legislation. The same authors define tax evasion as basically a misrepresentation or omission of the truth.

Tax avoidance, as opposed to tax evasion, is perfectly legal and acceptable. This was confirmed by case law in the judgement of Lord Tomkin in *Duke of Westminster v IRC* (1953: 52), when it was said that “[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure his result, then, however unappreciative the Commissioner of Inland Revenue or his fellow-taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax”.

2.5 THE IMPORTANCE OF TAX RISK MANAGEMENT

Du Toit (2007:5) gave a good explanation of the general importance of tax risk management when he insisted that directors of companies contribute to the wealth, know-how, economic and business opportunities of the country by managing their companies effectively, including the area of taxation management.

This is and has always been true, but events in America and Europe during the early 2000s, particularly corporate failures like that of Enron, had brought risk management to a new level of importance on the board room agenda (Du Plessis & Molyneux, 2007:22; Johnston, 2006:1).

The Sarbanes-Oxley Act was promulgated in the United States of America in response to the corporate failures. This legislation effectively pointed out that tax risk management was generally a great weakness in a company’s internal controls (Johnston, 2006:1). This legislation is applicable only to United States listed companies with a market capitalisation of more than \$75 million. This falls outside the context of this study, so this legislation will not be cited as the main reason for the importance of “tax risk management”.

There are, however, other reasons, why tax risk management has become a focus point for all taxpayers, especially in the South African context. The following reasons are stated by different authors:

- tax has become by far the largest expense on the income statement (Kader, 2007:29);
- anti-avoidance rules have grown in volume and complexity (Kader, 2007:290);
- SARS has changed its focus to enforcement, that means making sure taxpayers comply with legislation (Kader, 2007:29);
- the complexity of legislation has increased and there are frequently changes to existing regulation (Erasmus, 2007:xxi; Kader, 2007:29; West & Cramer, 2008:18);
- tax departments only manage 25-30% of tax risk, while 70-75% of tax risk exists in other areas of business where no tax skills are present (Du Plessis & Molyneux, 2007:22; Erasmus, 2007: 50);
- tax directors believed that tax risk management is critical in preserving the organisation's overall reputation (Law, 2005:9); and
- around two-thirds of companies at a tax seminar in London did not have a formally approved tax risk management strategy (*International Tax Review*, 2006:1).

A recent survey distributed by the website www.7taxrisks.com to tax practitioners, revealed the following:

- 15 % are certain they are 100% tax compliant;
- 79% had no tax risk strategy;
- 50%-60% did not have monthly meetings with the transactions and operational division of their organisations;
- 40% had tax returns that were not up-to-date;
- 66%-80% had not had VAT or payroll audits in two years; and
- only 16% discuss tax issues, like tax planning, at their board meetings (Erasmus, 2007:30).

Although not all of these authors give enough detail to determine whether the surveys were proper empirical studies, the results, together with all the other facts, give a good indication of the prevailing problem that risk management is not approached effectively.

The fact that tax legislation is becoming ever more complex and SARS is casting its net wider and focussing on enforcement, is sufficient reason to conclude that tax risk has become a serious business that needs to be managed to avoid potential adverse consequences

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2.6 CONCLUSION

In this chapter an overview of tax risk management was given by defining the terms “tax risk” and “tax risk management”; explaining the terms “tax evasion” and “tax avoidance”; and discussing the importance of tax risk management in general.

In Chapter 3, the guiding principles for an effective tax risk management strategy will be discussed.

CHAPTER 3

THE GUIDING PRICIPLES OF EFFECTIVE TAX RISK MANAGEMENT

3.1 INTRODUCTION

In the previous chapter an overview of tax risk management was given by defining the terms “tax risk” and “tax risk management”; explaining the terms “tax evasion” and “tax avoidance”; and discussing the importance of tax risk management in general.

This chapter will explain the principles underlying effective tax risk management as contained in available literature.

3.2 DEFINING TAX RISK MANAGEMENT STRATEGIES

In Chapter 2.2 to 2.5 what tax risk entails and why it is important to manage tax risk was discussed, especially in the context of farming operations. Because the objective of this study is to determine what an effective tax risk management strategy will entail, particularly in the context of farming, it is necessary to investigate and review current literature on the principles of effective tax risk management.

First, it is necessary to determine the definition of a tax risk management strategy. Erasmus (2007:25-26) and Du Plessis and Molyneux (2007:23) agree that a tax risk management strategy is a plan that should have as its objective managing tax risk. The strategy should include processes for identifying risks relating to taxation that could prevent the objective from being achieved, and should then identify the actions for addressing these risks.

Du Plessis and Molyneux (2007:23) are of the opinion that you can have any objective for this strategy, which may include being tax compliant or to paying the least amount of tax legally. Erasmus (2007:29) focuses more on compliance as an objective in his diagrammatical illustration of a strategy.

In order to achieve completeness, the three tax risks included in the definition of tax risk should make out the objectives of any strategy to cover tax risk as a whole. The objectives will then be: to be fully tax compliant, to effectively manage tax as a cost and to have accurate and complete tax reporting. Erasmus (2007:26) concurs by including managing the effective tax rate when assessing strengths and weaknesses. This is confirmed by du Toit (2007:50) in his discussion on the fiduciary responsibilities of a company's directors.

3.3 PRINCIPLES GUIDING EFFECTIVE TAX RISK MANAGEMENT

Ross (2007:18) and Erasmus (2007:26) agree that a good tax risk strategy, like any strategic plan, should start with a SWOT analysis (strengths, weaknesses, opportunities and threats). They agree that the focus should be on the weaknesses and threats and that two broad types of issues must be identified: "on-the-radar screen" issues and "off-the-radar screen" issues. "On-the-radar screen" issues are current, unresolved issues of which SARS and the taxpayer are aware, like a disagreement with SARS on an assessment already filed by SARS. "Off-the-radar screen" issues are current issues of which SARS, or even the taxpayer, may be unaware, but which do exist and may pose a threat, such as non-compliance with new tax legislation. Strengths and opportunities must nevertheless not be ignored. This will definitely be a good starting point for compiling a strategy.

More than one author refers to specific principles viewed as effective tax risk management principles that should guide or be included in a strategy. The table below is comprised of the principles proposed by these authors. This is followed by a discussion on relevant points added to shed more light on these principles.

Table 3: Principles of effective tax risk management by author

Principle	Erasmus (2007)	<i>TAXtalk</i> – various authors (2007)	Lourens (2007:12)	Johnston (2006:1)
Compile a strategy document, and have it approved by the Board	Yes	Yes	Yes	Yes
Obtain professional assistance	Yes	Yes	Yes	No
Be pro-active	Yes	Yes	No	No



Principle	Erasmus (2007)	TAXtalk – various authors (2007)	Lourens (2007:12)	Johnston (2006:1)
Assemble a tax team	Yes	Yes	Yes	Yes
Ensure accurate financial accounting	Yes	Yes	Yes	No
Build communication lines between tax department and business units	Yes	Yes	Yes	Yes
Ensure complete documentation and filing of relevant evidence of facts.	Yes	Yes	Yes	No
Stay up-to-date with regulatory changes	Yes	No	No	Yes
List all stakeholders affected by tax risk and the specific impact on each	Yes	No	No	Yes
Understand overall risk management	Yes	Yes	No	No
Review tax strategy annually	Yes	Yes	No	Yes
Communicate with Board and Audit Committee about tax strategy and risks	Yes	No	No	No
Ensure processes and controls are in place to mitigate tax risk	Yes	No	No	No
Cultivate a culture of tax awareness at entity-level.	Yes	Yes	No	No
Review of important transactions and processes with reference to tax	Yes	Yes	Yes	Yes
Focus on all taxes	Yes	No	Yes	Yes
Create a technical tax training curriculum to avoid deficiency in technical knowledge	No	No	Yes	No
Reconcile tax accounts regularly	Yes	No	Yes	Yes
Build good relationships with SARS	Yes	Yes	No	No
Follow the correct procedures when objecting to an assessment	No	Yes	No	No

Principle	Erasmus (2007)	<i>TAXtalk</i> – various authors (2007)	Lourens (2007:12)	Johnston (2006:1)
Follow the correct procedures when answering a query received from SARS	Yes	No	No	No

Source: (*TAXtalk* authors: Goërtz, Faber & Watkin, 2007: 16-18 and Scott, Ross & Louw, 2007: 16-18)

Some of the principles listed above are explained in further detail below:

- **compiling a strategy:** a strategy is seen as a plan, with objectives and identification of weaknesses that are a threat to the objectives, as well as identification of controls to address the risks;
- **obtaining professional assistance:** expert knowledge on the part of tax professionals is needed when planning and conducting transactions, not just when tax returns are due and it is too late to change anything;
- **being pro-active:** do not act only when things go wrong, for instance when SARS gives penalties for non-compliance. Have a plan to identify instances of non-compliance in your organisation, or implement controls to prevent non-compliance;
- **assembling a tax team:** a tax team should consist of internal tax staff, external advisors like legal and auditing/accounting professionals and the Chief Financial Officer (CFO). Tax staff should be experienced and skilled and there should be no vacancies in these positions beyond a reasonable period. External professionals should be chosen carefully for their skill and technical training. The legal team should provide legal privilege, under which professional opinions can be obtained protected from unnecessary scrutiny by SARS. The tax team should have a charter that provides a definition of an effective tax team, which can be used to measure the performance and effectiveness of the team, and can provide guidance to the proper conduct of meetings and set measurable goals for the team;
- **ensuring accurate financial accounting:** accounting staff should be skilled, experienced and no vacancies should exist for lengthy periods. IT systems should function properly; internal control should be well designed and monitored; internal audit should function properly; not all entities are big enough to justify an internal audit function, but, in that case, management should fulfil these functions;

- **creating communication lines between the tax department and other business units:** technical tax skills should be available at all levels of business, including transactional and operational, when needed. Tax staff should sign off on important planning of transactions, and the tax department should frequently circulate tax questionnaires to other operational divisions to determine potential current tax risks;
- **ensuring complete documentation and filing of relevant evidence of facts for all transactions:** files should be ready for third-party review. The tax return should be completed to disclose all material facts of transactions with tax consequences. Incomplete disclosure may lead to serious and unnecessary tax consequences;
- **staying up-to-date with regulatory changes:** be aware of how peers are approaching these changes. This will be especially helpful with the issue of transfer-pricing and other complex tax principles. Staff training on the tax impact of regulatory changes will create tax awareness in the organisation;
- **focusing on all taxes:** focus should be not only on income tax but also on indirect taxes like VAT and high-risk taxes like PAYE;
- **following the correct procedures when objecting to an assessment:** make sure that an objection is filed within 30 days of the assessment date and on the correct forms (ADR1) and that it is sent to the correct address; and
- **handling queries received from SARS with much caution and in the right manner:** it is particularly important for taxpayers to know their rights when it comes to SARS' query process; for instance, the taxpayer has the right to request a query in writing, to request details on the tax periods and types of taxes involved, as well as the legislative basis for the query. It is also important to mark all information supplied to SARS in response to a query as "supplied under compulsion". This information would then be inadmissible evidence in a criminal investigation against the taxpayer, because it would be self-incriminating evidence which could not be used against the taxpayer.

The above table shows that a combination of the views of a few authors on effective tax risk management principles gives a better, more complete list of guiding principles for a tax risk strategy. Some principles would not be practical for farming operations. The size and specific risks that an entity is facing also vary, which means that some principles are more important than others.

3.4 CONCLUSION

In this chapter available literature has been reviewed on the principles guiding effective tax risk management strategies. The term “tax risk management strategy” was defined, and the principles of effective tax risk management were given in Table 3, along with a detailed explanation of some of these principles. Not all of the principles may seem applicable to a typical South African farming operation, but this will be contextualised in the discussion on the ideal tax risk strategy for the farming operation in Chapter 7.

In Chapter 4, the compilation of a tax risk management strategy is discussed, as well as the tax risk management process, and what it entails in general.

CHAPTER 4

THE COMPILATION OF A TAX RISK MANAGEMENT STRATEGY

4.1 INTRODUCTION

In the previous chapter, the principles that guide effective tax risk management were discussed. According to Erasmus (2008: 6), tax risk management consists, in effect, of a process, and if a strategy or a plan is to be compiled, this process should form the framework for the “planning, implementation and execution” of the strategy.

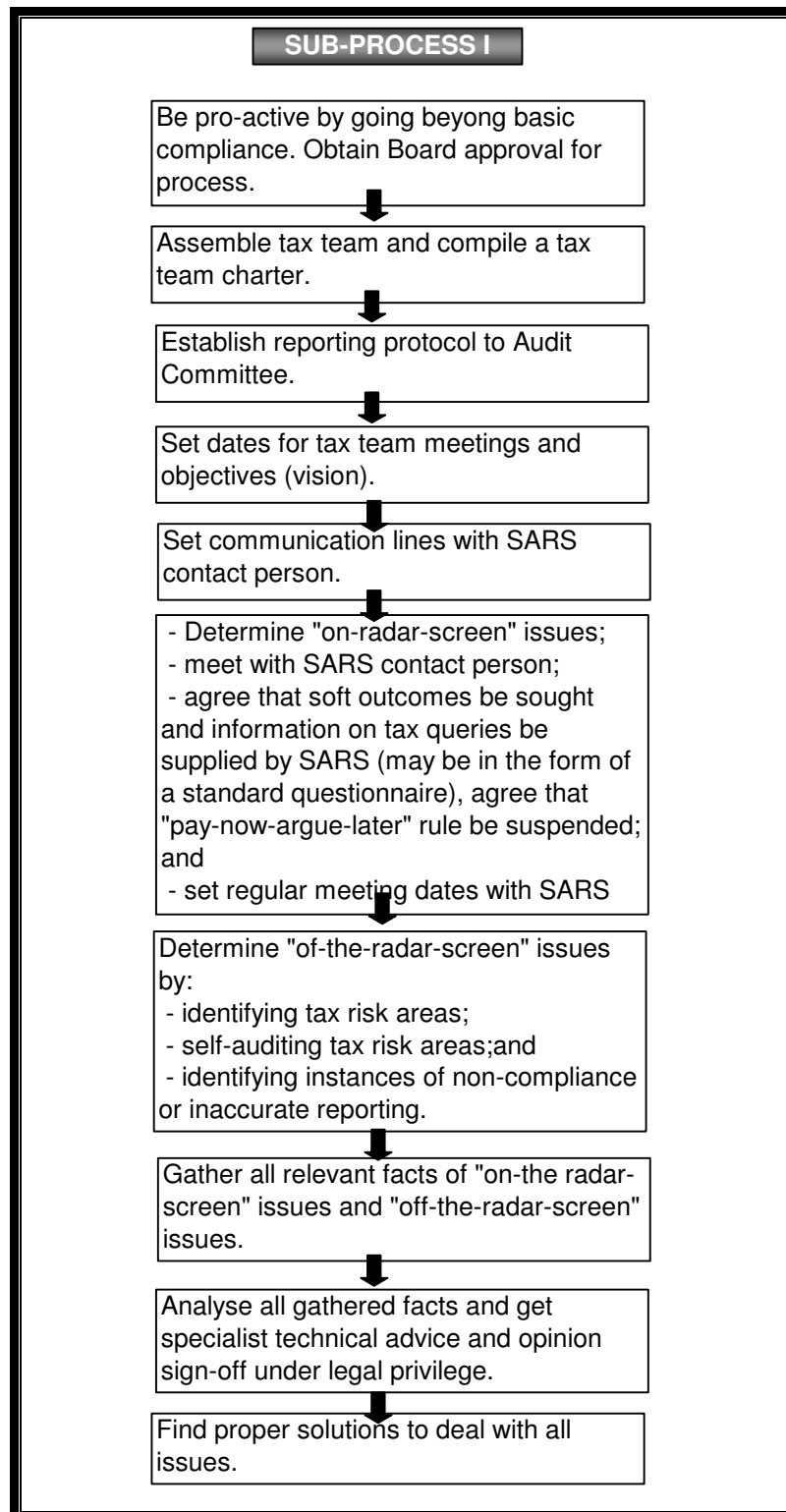
In this chapter, the compilation of a tax risk management strategy by using the tax risk management process given by Erasmus (2008: 9) will be discussed. Root causes of tax risk and the countermeasures, as well as different types of tax risk that should be mitigated by an effective Tax Risk Management strategy, will be discussed.

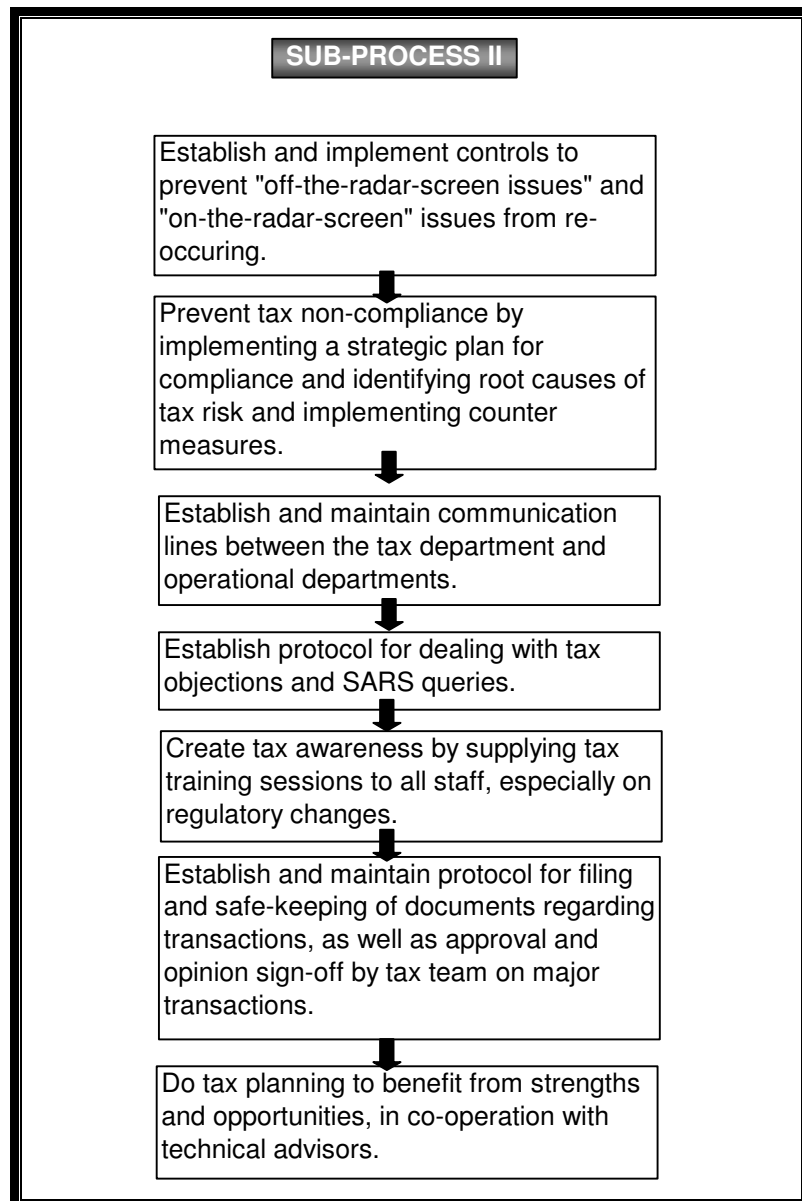
4.2 THE TAX RISK MANAGEMENT PROCESS AS A FRAMEWORK FOR A TAX RISK MANAGEMENT STRATEGY

The tax risk management process consists broadly of two different sub-processes. The first sub-process involves the initial establishment of the overall process and deals with the different tax threats and weaknesses on hand; the second sub-process involves the maintenance of actions implemented in the first sub-process, and the prevention of further issues, as well as addressing strengths and opportunities through tax planning.

The following diagram sets out the actions of the tax risk management process, which will form the framework for the strategy. Most of the actions in the process are principles discussed in the previous chapter, so further detail will be given only when necessary.

Diagram 1: The tax risk management process

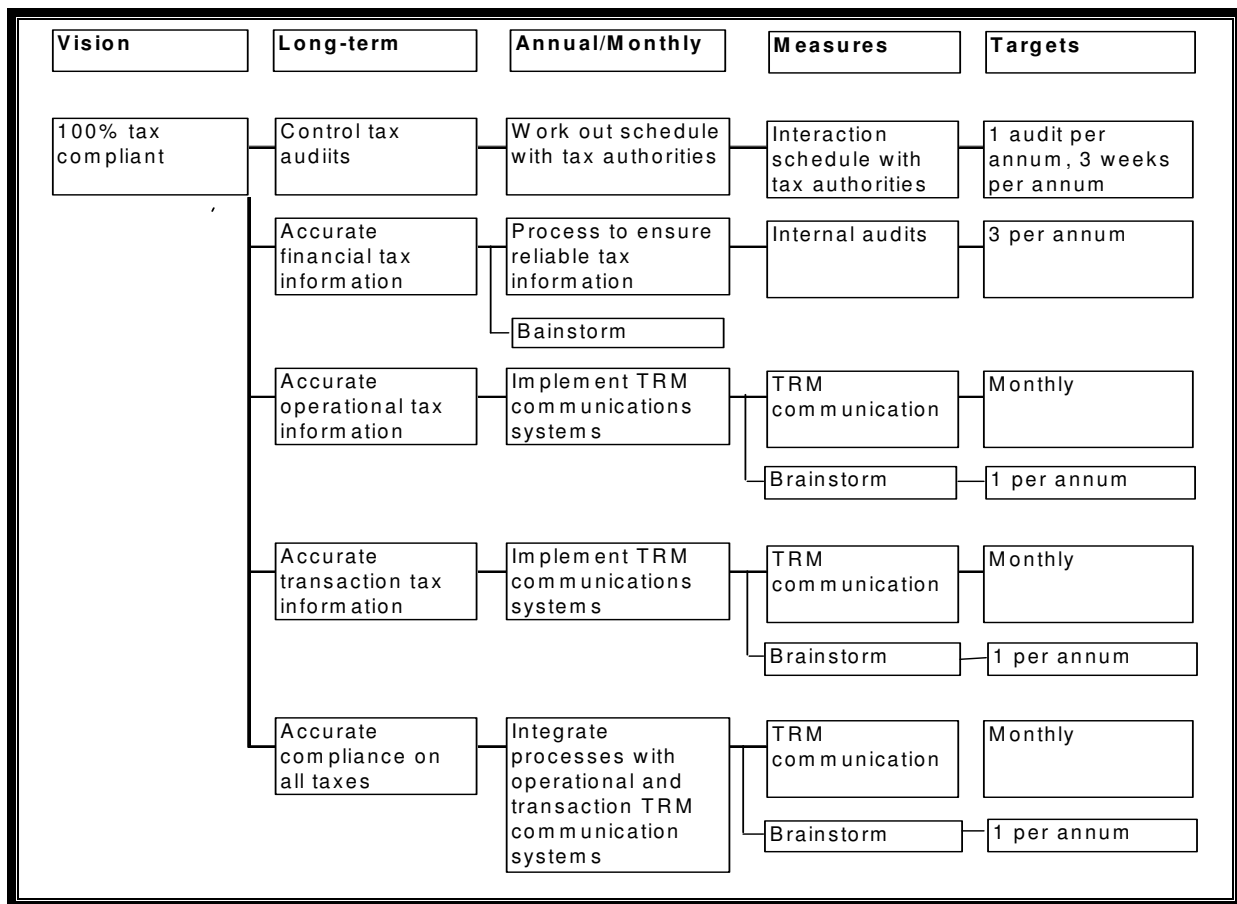




Most of the actions in the diagram above are self-explanatory. However, the strategic plan for tax compliance, and the root causes of tax risks and countermeasures to combat these merit further discussion.

A strategic plan should consist of long-term goals, measures, and targets for effective implementation. The following diagram, set out by Erasmus (2008: 29), will serve as an example of what a strategic plan for 100% tax compliance could entail.

Diagram 2: Compliance strategy



Source: Erasmus, 2008: 29

The above diagram is an example of how a strategic plan for tax compliance could be compiled.

4.3 ROOT CAUSES OF TAX RISK AND COUNTERMEASURES TO MITIGATE THE RISK

In compiling a tax risk management strategy, it is important to address and identify all root causes of tax risk, and to implement countermeasures for mitigating the risk.

Erasmus (2008: 31) gives the following main root causes of tax risk and proposes countermeasures for each:

- The continuous need for funds by government:
 - countermeasure 1: lobbying;
 - countermeasure 2: voting for different state leaders; and

- countermeasure 3: registering in a different tax jurisdiction by transferring the entity.
- SARS' negative view of taxpayers:
 - countermeasure 1: establish communication lines with a SARS contact person;
 - countermeasure 2: clear up all "on-the-radar-screen" issues; and
 - countermeasure 3: improve visible compliance by submitting returns on time, paying accurately-calculated provisional payments on time.
- Inaccurate financial information:
 - countermeasure 1: control over the accurate transfer of data from accounting records to the tax return;
 - countermeasure 2: regular self-auditing to identify inaccuracy or non-compliance, under supervision of technical consultants; and
 - countermeasure 3: improve visible compliance by submitting returns on time, paying accurately-calculated provisional payments on time.
- Inaccurate operational information
 - countermeasure 1: establish communication lines between the tax department and operational departments via e-mails and meetings;
 - countermeasure 2: provide training on regulatory changes and the tax impact on transactions relevant to operations; and
 - countermeasure 3: self-auditing of tax reporting by operations.
- Inaccurate transactional information
 - countermeasure 1: establish communication line between the tax department and operational departments, through the use of tax-compliance questionnaires;
 - countermeasure 2: provide tax support and training on complex transactions;
 - countermeasure 3: legal and tax review of major transactions; and
 - countermeasure 4: establish and maintain an effective filing and storage system for all facts and evidence relating to important transactions.

When the root causes of tax risks have been identified, it is important to consider all the different types of tax risk. Erasmus (2008: 39) provides the following table to illustrate the different types of tax risk, namely transactional, operational, compliance, financial accounting, management and reputational tax risk, along with the circumstances or events that could cause the different types of tax risk.

Table 4: Typical events giving rise to tax risk

Type of tax risk	Typical events giving rise to tax risk
Transactional	Acquisitions
	Disposals
	Mergers
	Financing transactions
	Tax-driven cross-border transactions
	Internal reorganisation
	Stock options
Operational	New business ventures
	New operational models
	Operating in new locations
	New operating structures (e.g. JVs or partnerships)
	Impact of technological developments (e.g. internet trading)
	Lack of communication
Compliance	Lack of proper management
	Weak accounting records and controls
	Data integrity issues
	Insufficient resources
	Systems changes
	Legislative changes
	Revenue investigations
Financial accounting	Specific local in-country customs, approaches and focuses on compliance
	Changes in legislation
	Changes in accounting systems
Management	Changes in accounting policies and GAAP
	Changes in personnel – both tax and in business
	Experienced tax people leaving –information being retained in memory and not properly documented
Reputational	New and inexperienced resources
	Revenue Service raid or investigation
	Court hearing and legal action
	Political developments

Source: Erasmus, 2008: 39-40

The above table shows the different types of possible tax risks and the events that could cause the risk. It is important in compiling a tax risk management strategy to aim at mitigating and managing all types of tax risk successfully.

4.4 CONCLUSION

In this chapter, the tax risk management process was discussed as a framework for the compilation of a tax risk management strategy. Root causes of tax risk and the countermeasures to combat them, as well as different types of tax risks, namely operational, compliance, financial accounting, management and reputational tax risk; and the circumstances or events that could cause the different types of tax risk were discussed. Mitigating these tax risks should be the goal of an effective tax risk management strategy.

Chapter 5 investigates the farming operations' exposure to tax risk by reviewing tax legislation applicable to farming operations.

CHAPTER 5

THE EXPOSURE OF FARMING OPERATIONS TO TAX RISK

5.1 INTRODUCTION

In the previous chapter the tax risk management process was discussed as a framework for the compilation of a tax risk management strategy. The root causes of tax risk and the countermeasures to combat them were discussed, as well as different types of tax risks, namely: operational, compliance, financial accounting, management and reputational tax risk; and the circumstances or events that could be the cause of the different types of tax risk. Mitigating these tax risks should be the goal of an effective tax risk management strategy.

In this chapter, the terms “farming operations” and “farming income” are defined; taxation legislation applicable to farming operations, as well as the farmer’s exposure to tax risk will be discussed.

5.2 FARMING OPERATIONS DEFINED

This study focuses on the risks associated with the taxation of farming operations. It would therefore be prudent to determine the definition of farming operations for taxation purposes.

The Income Tax Act, Act 58 of 1962 (hereafter referred to as “the Act”) gives no formal definition of farming or farming operations. There are, however, particular case laws that have established certain principles in defining what farming is.

Smalberger stated in *ITC 1319* (42 SATC 263: 264)) that “ [i]t seems ... that before a person can be said to carry on farming operations there must be a genuine intention to farm, coupled with a reasonable prospect that an ultimate profit will be derived...”.

Jordaan, Koekemoer, Stiglingh, Van Schalkwyk, Wasserman and Wilcocks (2008:537) maintain that “[t]he wording ‘farming operations’ includes only activities connected with what a farmer derives from his land. He need not be the owner of the land, but he must enjoy a right to it and its yield. Only then is he a farmer for the purposes of the First Schedule”.

The definition of farming seems very broad, but there is also an ongoing worldwide controversy as to what constitutes an actual farming operation and what constitutes a hobby. In the USA, Burns and Groomer (1982:11) maintain that, if a farming operation makes no profit, it is a hobby. In Canada, Pearson (1993:1135) says that when farming is a hobby expenses are not deductible.

In *H v COT*, Zimbabwe Appellate Division (ITC 1324) (43 SATC 22), the principle was laid down that “[a] farmer does not include a person who indulges in a country pursuit merely as an interest or as an enjoyable way of life. Pastoral activities signify more than grazing a couple of goats and growing a patch of vegetables”.

Bobbert (2001:37) quotes Ingram, CJ, in the case *ITC 586* (14 SATC 123), saying that the term “farmer” includes most activities performed on land and is a comprehensive term.

It is, however, important to note that a profit intention is necessary for an activity on land to qualify as a farming operation, as determined in *ITC 1424*, Zimbabwe Special Court (49 SATC 99). In this case the judge declared that the “hope of ultimate profit” should exist, and this hope should be based on reasonable grounds; such as the property size, viability of the land and the intensity with which this operation is pursued.

For the purposes of this study, the principles laid down by case law will be accepted, as this dissertation deals with taxation legislation. The principles are, however, very broad, except for the fact that it is clearly stated that farming operations do not include a hobby, and that a profit intention based on reasonable grounds will be a qualifying factor in considering whether a farming operation exists or not.

5.3 WHAT CONSTITUTES FARMING INCOME?

In Chapter 5.2 it is stated that the definition of a farming operation is determined by case law. Now the definition of farming income will be considered.

Jordaan *et al.* (2008: 537) state that revenue received must be directly linked to the farming operation if it is to be considered farming income. A few court cases have laid down principles concerning this issue, and will now be discussed.

In *ITC 740* (18 SATC 219) it was held that, although water, gravel or a mineral found on a farm can be viewed as a product of the farm, it does not necessarily constitute income from a farming operation. Therefore, not all income from products harvested from a farm will necessarily be viewed as farming income for tax purposes (Jordaan *et al.*, 2008: 536).

In *ITC 586* (14 SATC 123), the mere speculation with livestock was not viewed as a farming operation, but if the livestock is purchased, allowed to graze from a period of six weeks to six months or longer, and afterwards marketed and sold, the revenue from the transaction will be viewed as farming income. It should be noted that in practice SARS treats income received from grazing fees as farming income (Jordaan *et al.*, 2008:536).

The question of whether letting a farm constitutes farming income (Jordaan *et al.*, 2008:537) is controversial. In the Special Court case *ITC 166* (5 SATC 85), it was determined that, if the rental payment is in the form of cash, it is not farming income, but, if it takes the form of a percentage of the proceeds from the farming operation, it is considered farming income.

In *ITC 1548* (55 SATC 26) it was decided that a farmer who delivered certain services to his fellow farmers, in the form of transportation, shearing and harvesting, was not engaging in a farming operation. It is interesting to note that the court declared in this case that, although the activities may fall under the term “farming operations”, it does not fall under the term “boerdery”, as stipulated in the Afrikaans version of the Act (Jordaan *et al.*, 2008: 537).

In *CIR v D & N Promotions (Pty) Ltd*, 1993 (3) SA 33 (N) (55 SATC 89), certain principles concerning interest earned on amounts related to farming activities were laid down. Interest on a lump sum paid by the SA Sugar Association for the loss of freedom of delivery of products was not permitted inclusion as part of farming income. However, interest on the purchase price of sugar paid by a sugar mill was considered to be farming income.

Jordaan *et al.* (2008:537) give a list of items that are considered farming income, as well as a list of those that are not. The following table is a summary of the items listed by the authors:

Table 5: Farming and non-farming income

Farming income	Non-farming income
Income from the sale of livestock and produce.	Revenue received from letting farming assets, owing to ownership of assets.
Deemed recoupments of par 12 (1C).	Revenue received from letting livestock.
Income from manufacturing activities by the farmer, where only own produce is used for inputs.	Revenue earned from a manufacturing enterprise which is distinct from farming operations.
The value and proceeds of disposal of livestock and produce under a sheep lease or similar agreement.	
The value of livestock or produce retained from a discontinued farming operation, but let to another farmer.	

It is clear from case law that determining even whether income is farming income is not a simple matter and can become complicated. Farmers who have more than one source of income from a farm have to ascertain whether all the income constitutes farming income.

When one considers the definitions of farming operations and farming income, it becomes evident that a farmer could be exposed to a certain amount of tax risk, owing to the fact that these terms are not clearly defined, and guidance on certain types of farming comes largely from case law. A farmer who breeds thoroughbred horses and races them may think that both these related activities constitute farming income, while SARS views them as two distinct operations, of which only breeding the horses constitutes farming (Jordaan *et al.*, 2008:537).

Consequently, the basic definitions relating to farming definitely have the potential to expose the farmer to tax risk, which could pose a serious threat to his reputation with SARS, business activities and cash-flow budget.

5.4 LEGISLATION APPLICABLE TO FARMING OPERATIONS

In South Africa, section 26 of the Act states that the taxable income of farming operations will be determined in terms of the provisions of the Act, but will be subject to the special provisions of the First Schedule. The First Schedule includes provisions that deal mainly with livestock, produce and farming capital development expenditure (Huxham & Haupt, 2008:§13.1.3).

Certain special provisions are included under the First Schedule, and these must be applicable to normal taxpayers as their effect is different from the provisions. Huxham & Haupt (2008:257) give a summary of these provisions as follows:

- The normal section on trading stock, section 22(1) on closing stock and section 22 (2) on opening stock are not applicable to farmers. However, section 22 (8), which deals with deemed income, is applicable to stock other than livestock or produce, like consumables or spare parts.
- Only livestock and produce are considered farming stock and have to be accounted for; other stock purchases, such as fertiliser, are allowed as a full deduction under section 11(a).
- Capital expenditure that may be deducted in full when incurred is listed; most of these expenditures are, however, limited to taxable income. Examples are the

following: building or erecting roads, dams, fences, irrigation schemes, planting certain trees.

- Fluctuations in taxable income from year to year are dealt with under a special rating concession that has the effect of equalising income.
- Sales in times of drought, fire damage of sugar cane and other forced sales are dealt with under various special concession provisions.

Huxham & Haupt (2008:257) give a full list of the provisions contained in the First Schedule, which is displayed in the following table:

Table 6: Provisions contained in the First Schedule of the Act

Paragraph number	Provision
Paragraph 3	Livestock and produce: opening and closing stock
Paragraph 4	Opening stock
Paragraph 4 (a) (ii)	Stock acquired by means other than normal farming activities
Paragraph 5	Closing stock
Paragraphs 6 & 7	Standard values
Paragraph 8	Purchases of stock
Paragraph 9	Produce: closing stock
Paragraph 11	Donations of stock
Paragraph 12	Capital expenditure
Paragraph 13 & 13A	Forced sales
Paragraph 14 to 16	Plantation farming
Paragraph 17	Sugar can damaged by fire
Paragraph 19	General rating formula
Paragraph 20	Expropriation

5.5 THE FARMER'S EXPOSURE TO TAX RISK

As discussed in Chapter 5.1 to 5.4, the regulations surrounding the taxation of farming operations are not straightforward, but can become rather complex.

As discussed in Chapter 5.2, the complexity of legislation can result in a greater risk of, inter alia, non-compliance. All other reasons discussed as to why tax risk management is becoming more important will be applicable to farmers, because farmers usually engage in a wide variety of activities, such as imports, exports, capital development, or marketing.

5.6 CONCLUSION

In this chapter, farmers' exposure to tax risk was discussed, by defining farming operations and farming income according to taxation legislation; and by identifying the income tax legalisation applicable to farmers and their exposure to tax risk.

In Chapter 6, an overview is given of specific tax risks applicable to farmers as a result of complex legislation and case law, as identified by certain authors.

CHAPTER 6

SPECIFIC TAX RISKS APPLICABLE TO FARMING OPERATIONS

6.1 INTRODUCTION

In Chapter 5, farmers' exposure to tax risk was discussed, and it was concluded that they could be exposed to significant tax risk on account of the complexity of legislation that applies exclusively to farmers. Even the basic definition of farming operations and farming income poses a tax risk, as it is not clearly defined.

In this chapter, the specific tax risks that may pose a threat to farming operations will be detailed. It must be noted that farming operations include many different types and sizes of farming activities. This means that all tax risks mentioned will not be relevant to all farming enterprises. The tax risks associated with each paragraph of the First Schedule to the Act will be discussed separately.

6.2 FIRST SCHEDULE: PARAGRAPHS 1 and 2

Paragraph 2 of the First Schedule states that only livestock and produce have to be accounted for as opening stock and closing stock for income tax purposes. This means that large purchases of consumables, such as fertilisers, pesticides, veterinary medicines and other stock items, can be deducted in full in the year of purchase. Financial statements for management purposes will account for other stock items such as stock, as it is beneficial for management and financing purposes to account for assets that are to hand. Tax records will therefore differ from financial accounting records, which can lead to inaccurate tax recording.

Tax Risk 1: Inaccurate recording of opening and closing stock, in that other stock items are included in these amounts, or other stock items can be added back but not deducted.

If the farmer purchased large quantities of, for instance, fertiliser, to reduce tax exposure for a certain year, and use the fertiliser in the next year, no deductions are allowed in the next year, unless additional fertiliser is purchased. In the next year, the farmer can expect higher taxable income than in previous years, as the fertiliser used in that year has already been claimed as an expense in the previous year. The planning surrounding the large purchases of stock items can become difficult to manage, and may negatively influence the farmer's expectation of taxable income.

Tax Risk 2: Inaccurate planning of taxable income owing to large purchases of stock items to reduce tax liability.

In *Farmer v COT*, 1944 SR 80 (13 SATC 158) and *R Koster and Son v CIR*, 1985 (2) SA 831 (A) (47 SATC 23), it was held that all livestock used in farming operations must be included as stock. This means that a dairy farmer has to include his whole dairy herd in opening and closing stock (Huxham & Haupt, 2008:258).

Tax Risk 3: Not all livestock used in farming operations is included in opening and closing stock, especially livestock not sold but used, such as a dairy herd, horses or donkeys.

6.3 FIRST SCHEDULE: PARAGRAPH 3

Paragraph 3 of the First Schedule deals with the treatment of opening and closing stock, livestock and produce. If a farmer discontinues his farming operation without disposing of the livestock, he still has to account for the stock under opening and closing stock (Huxham & Haupt, 2008:258). The farmer may fail to mention his previous farming endeavours to his new accountant or auditor.

Tax Risk 4: Farmers with discontinued farming operations do not account for stock not disposed of as opening and closing stock.

Livestock used for domestic or private purposes does not have to be accounted for as stock items (Jordaan *et al.*, 2008:538). A farmer does not have to add the horse he uses mainly for riding and the pigs he slaughters for his household to his stock figures.

Tax Risk 5: Included in opening and closing stock are animals used for domestic or private purposes.

Tax Risk 6: The farmer cannot effectively identify private and domestic stock from other stock to prove to SARS that it does not have to be accounted for as stock.

Paragraph 3(3) deals with a transaction called a sheep lease. A sheep lease is letting livestock to a lessee, with the understanding that on completion of the agreement period livestock of the same quality, number and age group will be returned to the lessor. For tax purposes, the lessor has to account for the stock, and the rental income constitutes farming income, while the lessee can deduct both the rental payment and the purchases to make up the number of livestock owed to the lessor at the end of the period.

Tax Risk 7: The lessor does not account for the stock, but the lessee does, or the lessor does not account for the rental income as farming income for tax purposes. The lessee does not deduct purchases of livestock to make up the owed quantity from his income, but regards it as capital expenditure.

Tax Risk 8: The sheep lease arrangement is not thoroughly documented and signed by both parties and documents safely filed, to prove that the agreement is, in fact, a sheep lease or similar arrangement and to identify the quantity owed at the end of the arrangement.

6.4 FIRST SCHEDULE: PARAGRAPH 4

Paragraph 4 of the First Schedule deals with the value of opening stock of livestock or produce. Huxham and Haupt (2008:258) state that the value of opening stock, according to paragraph 4, will be equal to

- the value of the previous year's closing stock: plus
- the market value of livestock or produce obtained by means other than normal farming operations: plus

- the market value of livestock or produce that was previously held for non-farming activities, but was used it for farming activities in the current year.

It is evident from the above provision that a number of risks may exist relating to the accuracy of the value used by the farmer as opening stock. The effect of stating livestock or produce acquired by donation, *in specie* dividend or inheritance at market value is that a deduction is allowed in the year the livestock or produce is obtained by this means, which is a considerable advantage.

Tax Risk 9: Livestock or produce acquired by means other than normal farming operations is valued at standard values, instead of market values.

Tax Risk 10: If he does not retain evidence of the transaction or of the market value, the taxpayer cannot prove that the livestock or produce was obtained by means other than normal farming operations.

Tax Risk 11: The farmer does not keep accurate records of the change of use of livestock, as well as the market value on date of change in use.

6.5 FIRST SCHEDULE: PARAGRAPHS 5 to 7

Paragraph 5 deals with the valuation of closing stock of livestock, and states that it should be valued at standard values, as fixed by the Government Gazette 5309 of 8 October 1976 (Huxham & Haupt, 2008:259).

Paragraphs 6 and 7 deal specifically with standard values. They state that where livestock has a standard value the farmer may use his own value, which may not diverge more than 20% from the gazetted value; and where no standard value exists, the farmer must negotiate a value with the Commissioner. Paragraph 7 states that, if a value was agreed upon, it could be changed only with the Commissioner's consent.

Tax Risk 12: Standard values are used which diverge more that 20% from the gazetted value or differ from the negotiated value, and have not been approved by the Commissioner.

6.6 FIRST SCHEDULE: PARAGRAPH 8

Paragraph 8 deals with the purchase of livestock, and sets certain provisions for ring-fencing the deduction in terms of section 11 (a) of this expenditure. Paragraph 8(3)(a) determines that the ring-fencing does not apply if livestock is bought and disposed of in the same year.

In terms of paragraph 8(1), the ring-fencing limits the deduction to income from farming, in that the deduction will be limited to an amount equal to farming income, less subsidies allowed in terms of section 10(1)(z), plus closing stock, less opening stock.

A further deduction is allowed in terms of paragraph 8(3) for the amount that is disallowed in terms of paragraph 8(1), if the disallowed amount and the opening stock at standard values are greater than the market value of the closing stock. This difference is the additional amount allowed for deduction.

Everything else that is disallowed can be carried forward to the next year, as stated in paragraph 8 (2).

Tax Risk 13: When livestock is disposed of in the same year as the purchase, the ring-fencing provision does not apply.

Tax Risk 14: The ring-fencing of the deduction of purchases is calculated incorrectly, either by the farmer or by a SARS official, owing to lack of technical knowledge.

Tax Risk 15: The further deduction allowances i.t.o. paragraph 8(3) are not utilised or are inaccurately calculated, either by the farmer or by a SARS official.

Tax Risk 16: Disallowed expenditure of previous years is not included in the current year's calculation.

Tax Risk 17: Supporting documentation for purchase transactions is not retained as proof for when a transaction is queried by SARS, particularly transactions carried out in previous periods.

6.7 FIRST SCHEDULE: PARAGRAPH 9

Paragraph 9 deals with the value of opening stock and closing stock of produce that the farmer should include in his calculation to determine income from farming.

According to the provisions of paragraph 4, produce acquired by any means other than normal farming operations or purchase must be included in opening stock at market value. According to Huxham and Haupt (2008:263), this produce must also be included at market value in closing stock that is not sold during the year. The risks associated with paragraph 4 have already been discussed in Chapter 5.5.

Paragraph 9 determines that produce must be included in opening and closing stock, at a value that is considered reasonable by the Commissioner. This value, according to Jordaan *et al.* (2008: 542), is normally determined in practice by using the lower of the cost of actual production or the market value.

In *Rex v Bade*, 1951 (3) SA218 (T) (17 SATC 438), it was held that “mealie meal” should fall within the definition of produce.

Tax Risk 18: Produce is included in opening stock at a value that the Commissioner does not deem reasonable, such as a value that is not equal to the lower of the actual cost to produce or the market value.

Tax Risk 19: The farmer cannot prove with accuracy what the actual costs of production are, or includes capital expenditure under the cost of production.

6.8 FIRST SCHEDULE: PARAGRAPH 11

Paragraph 11 is very similar to section 22(8), dealing with non-trade disposal of livestock and produce (Huxham & Haupt, 2008:263).

Paragraph 11 determines that produce used for domestic consumption must be included in farming income at cost price (or market value if cost cannot be determined). If produce is removed from the Republic, it must be included in the farmer's income at market value. Donations of produce, *in specie* dividends paid in the form of produce, or any non-trade disposals must be included under market value in the farmer's income.

If produce is disposed of at a consideration less than market value, the difference between the consideration and the market value must be added to farming income. Rations for employees must also be included in income at market value, but a deduction in terms of the provisions of section 11(a) is allowed, to the same value as a trading expense.

Tax Risk 20: Non-trade disposals are not included in farming income at market value.

Tax Risk 21: Disposals at less than market value added to farming income at the full value, resulting in the value of the consideration being included in income twice.

6.9 FIRST SCHEDULE: PARAGRAPH 12

Paragraph 12 deals with capital development expenditure of farmers, which is allowed as a deduction in full in the period incurred, subject to certain limitations. Expenditure allowed is listed in paragraph 12(a) to (i), including the eradication of noxious plants, the prevention of soil erosion, dipping tanks, dams, irrigation schemes, boreholes, pumps, fences, certain buildings, certain trees, roads, bridges and carrying infrastructure for electric power.

The deduction for expenditure to eradicate noxious plants and to prevent soil erosion may create a farming loss, while the other items may not. The disallowed portion may be carried forward to the next year. Paragraph 12(3B) states that recoupments on moveable assets must first be set off against amounts carried forward from the previous year before being brought into account in the current year.

Unredeemed expenditure when a farming operation and farm are disposed of may be added to the base cost of the farm, but may not create a capital loss, and if the market value on 1 October 2001 is used, only expenditure incurred after this date is allowed to be included as part of the base cost.

The deduction for buildings is allowed only for those relating to the farming operations and may not be domestic housing for people other than employees. This deduction is limited to R 6000 per employee, and is subject to recoupments when the building is inhabited by people other than employees. If the farmer is a company, the shareholders and their relatives are not considered employees in terms of this provision.

The recoupment provisions of section 8(4)(a) are not applicable to the recoupment of expenditure allowed in terms of paragraph 12. This has its own provision for recoupments, namely paragraph 12(3B), which limits the recoupments to the amount previously allowed.

When a farm is purchased, capital expenditure not actually incurred by the farmer who buys the property is not allowed, except for dipping tanks, dams, irrigation schemes, boreholes, pumps and fences. In practice, however, SARS still does not allow this expenditure as a deduction if it is not self-incurred (Jordaan *et al.*, 2008:549-550).

Tax Risk 22: Capital expenditure is claimed which is not part of the allowed expenditure in terms of paragraph 12(a) to (i).

Tax Risk 23: Expenditure which is deductible in terms of paragraph 12(c) to (i) which may create a farming loss; or the disallowed portion from the previous year is not carried forward to the next year; or recoupments of moveable assets are not subtracted from the amount previously disallowed before bringing it into account in the next year.

Tax Risk 24: Unredeemed expenditure is not added to the base cost of the farm land when the farm is disposed of, or expenditure before 1 October 2001 is added when the market value on that is used as base cost.

Tax Risk 25: Buildings inhabited by shareholders of a company farm or non-employees are added to the deduction of capital expenditure or the deduction is not limited to R6 000 per employee.

Tax Risk 26: Recoupments of capital expenditure on buildings are not brought into account when non-employees commence habitation of buildings for which costs were previously claimed as a deduction.

Tax Risk 27: Recoupments of expenditure previously claimed as a deduction in terms of paragraph 12 are not brought into account, or recoupments are brought into account when expenditure is not redeemed on the date when recoupments occur.

Tax Risk 28: Capital expenditure which was not incurred by the farmer is claimed as a deduction, particularly expenditure deductible in terms of paragraph 12 (c) to (e), where there is a difference between law and practice.

6.10 SECTION 12B

While section 12B is not part of the First Schedule, it is nevertheless also applicable only to farmers. It provides a wear-and-tear allowance, so that farmers can write off machinery, utensils, implements and articles brought into use by the farmers for the first time. The deduction of the cost is allowed as follows: 50% in the year in which the asset is brought into use, 30% in the second year and 20% in the third year. This deduction is subject to the recoupments provisions in terms of section 8(4)(a).

This deduction is not limited to taxable income, and need not be apportioned to part of a year in the year the asset is procured. The cost includes installation costs. The deduction is disallowed for: assets disposed of in previous years; assets under leases other than operating leases, unless the lessee earns trading income or the lease period is more than five years; or the acquisition is from a connected person.

Paragraph 12(1C) determines that moveable assets disposed of as a donation, at inadequate consideration or at no value must be included in income limited to the original cost.

Tax Risk 29: The allowance in terms of section 12B is not utilised for farming assets, or is apportioned in the first year without the full benefit being utilised.

Tax Risk 30: The recoupments provisions of section 8(4)(a) and paragraph 12(1C) are not taken into account for determining taxable income when farming assets are disposed of.

Tax Risk 31: A deduction is claimed in terms of section 12B (4) when one of the circumstances stated in section 12B (4), which disallows the deduction, exists.

6.11 FIRST SCHEDULE: PARAGRAPH 13 and 13A

Paragraph 13 deals with forced sales owing to drought, disease, plague or fire, and allows the farmer to deduct the cost of the replacement stock in the year that the forced sale takes place or in the year of purchase.

The stock has to be replaced within four years, and the Commissioner must be notified of the forced sale. The Commissioner will tax as normal, until proof of purchase of replacement stock is submitted, and then a revised assessment will be issued.

If the forced sale is due to a Government livestock reduction scheme, the same provisions are applicable, except that the farmer has nine years in which to replace the stock. If paragraph 19 is elected, this election in terms of paragraph 13 is not available.

Paragraph 13A is a drought-relief provision, in which the proceeds from the sale of livestock owing to drought, which are deposited into the Landbank of South Africa, are taxed when the cash is withdrawn. The provision is available only for six years and only if the cash is left in the bank for more than six months.

Tax Risk 32: When forced sales take place, the tax relief provided for in terms of paragraph 13 and paragraph 13A is not utilised,.

Tax Risk 33: The Commissioner is not notified of the forced sale, or after four years, when replacement stock is purchased; neither the Commissioner nor the farmer has retained a copy of the notification of the forced sale by the farmer.

6.12 FIRST SCHEDULE: PARAGRAPHS 14 -16

Paragraphs 14 -16 deal with the provision applicable to plantation farming. Paragraph 16 gives the definitions of “plantation” and “forest produce”.

A plantation is defined as an artificially-established tree, as ordinarily understood, and is not a tree as described in paragraph 12(1)(g), which deals with trees and shrubs associated with fruit, nuts, coffee, trees, grapes, sugar, vegetable oils and fibres.

Paragraph 14 states that, for tax purposes, a distinction is made between the plantation, which is regarded as being of a revenue nature, and the land, which is regarded as being of a capital nature. If the buyer and seller of a plantation do not apportion the sales price between the trees and the land, or if the value is fictitious or disproportionate, the Commissioner will do the apportionment.

Paragraph 15 provides that the expenditure related to the establishment, maintenance and acquisition of a plantation is allowed as a deduction from plantation income. The acquisition costs of a plantation are ring-fenced to the gross income of that specific plantation, and cannot be used against another plantation’s income. If the farmer establishes the plantation on his own, the full establishment expenditure is deductible at once. The portion of acquisition costs that has not yet been utilised on the death of a farmer is not transferable to the person inheriting the plantation.

Plantation losses may be set off against other farming income, and any excess losses may be carried forward to the next year. The cost of land may not be written off.

Paragraph 15(3) contains the rating formula for plantation farmers, and cannot be used together with the rating formula in the same year in terms of paragraph 19. The rating formula cannot be used if the farmer ceases farming, only if produce is sold. Excess

plantation income on account of expropriation will not be included in the current taxable income or annual average figures in the formula.

Tax Risk 34: The farmer regards his farming operation as plantation farming when it does not fall under the definition of plantation farming.

Tax Risk 35: The buyer and seller do not apportion the selling price between trees and land, but leave it for SARS to carry out; or they are not aware of the fact that the trees are regarded as revenue and land as capital, and do not review SARS' assessment for accuracy.

Tax Risk 36: Acquisition costs are not claimed as a deduction or are claimed inaccurately, in that the limit is not adhered to.

Tax Risk 37: The acquisition costs of a plantation are not fully redeemed at the date of death of the farmer.

Tax Risk 38: Disallowed expenditure was not carried forward from the previous year in order to utilise the allowed deduction in the current year.

Tax Risk 39: The plantation rating formula is used when the rating formula in terms of paragraph 19 was elected, or when farming stops.

Tax Risk 40: Excess produce on account of expropriation is added to taxable income or to the annual average when the formula is used.

6.13 FIRST SCHEDULE: PARAGRAPH 17

Paragraph 17 deals with income from sugar cane that has been destroyed by fire, and provides that the rating formula in terms of section 5(10) may be used, the difference being the "c" value in the formula. C will be equal to the income that would not have been derived in that year. The rating formulae of paragraphs 19 and 17 cannot be used in the same year.

Tax Risk 41: The inaccurate utilisation of the rating formula of paragraph 17.

6.14 FIRST SCHEDULE: PARAGRAPH 19

Paragraph 19 contains the general rating formula that framers may elect for the calculation of their tax liability. The rating formula is available only for individuals, the executors of deceased estates and the trustees of insolvent estates, as companies and trusts are taxed at a flat rate.

The election must be made within three months after the close of any year of assessment. The farmer electing the application of the formula in terms of paragraph 19 effectively pays tax on his average income, which is beneficial only when actual farming income exceeds average income. The farmer, however, cannot be taxed on more than his actual income, and can therefore only benefit from the rating formula. There is special provision on the value of average income if the farming operation is less than five years old.

Tax Risk 42: The inaccurate utilisation of the rating formula in paragraph 19.

6.15 FIRST SCHEDULE: PARAGRAPH 20

Paragraph 20 contains a concession available to farmers with the cessation of farming on the sale of land to the state. Excess farming profits on account of the cessation of the farming operation are taxed at 18%, and the rest of the farming profits are taxed at normal rates.

The concession is available in the year of the sale and two years afterwards, but the farmer must submit a written application to apply for this concession. The gross profit on the disposal of livestock may not be more than the average gross profit over the previous five years.

Tax Risk 43: Omitting to utilise the concession in the situation described in paragraph 20.

Tax Risk 44: Not applying for the concession in paragraph 20 or not retaining the original copy of the approval afterwards.

Tax Risk 45: Gross profit declared on the tax return on disposal of livestock equals a value in excess of the five-year average.

6.16 CONCLUSION

In this chapter, the particular tax risks associated with the First Schedule of the Act, which deals specifically with the taxation of farming operations, were discussed. Each paragraph of the First Schedule was discussed and related tax risks were identified for each paragraph. Overall, 45 tax risks that may be applicable to farming operations were identified. Also, some tax relief provisions in the First Schedule were highlighted as being available to the farmer in certain circumstances of forced sales.

In Chapter 7, a proposed tax risk management strategy for farming operations is discussed, based on the information obtained from the literature review and the review of legislation and case law.

CHAPTER 7

A PROPOSED TAX RISK MANAGEMENT STRATEGY FOR THE FARMER

7.1 INTRODUCTION

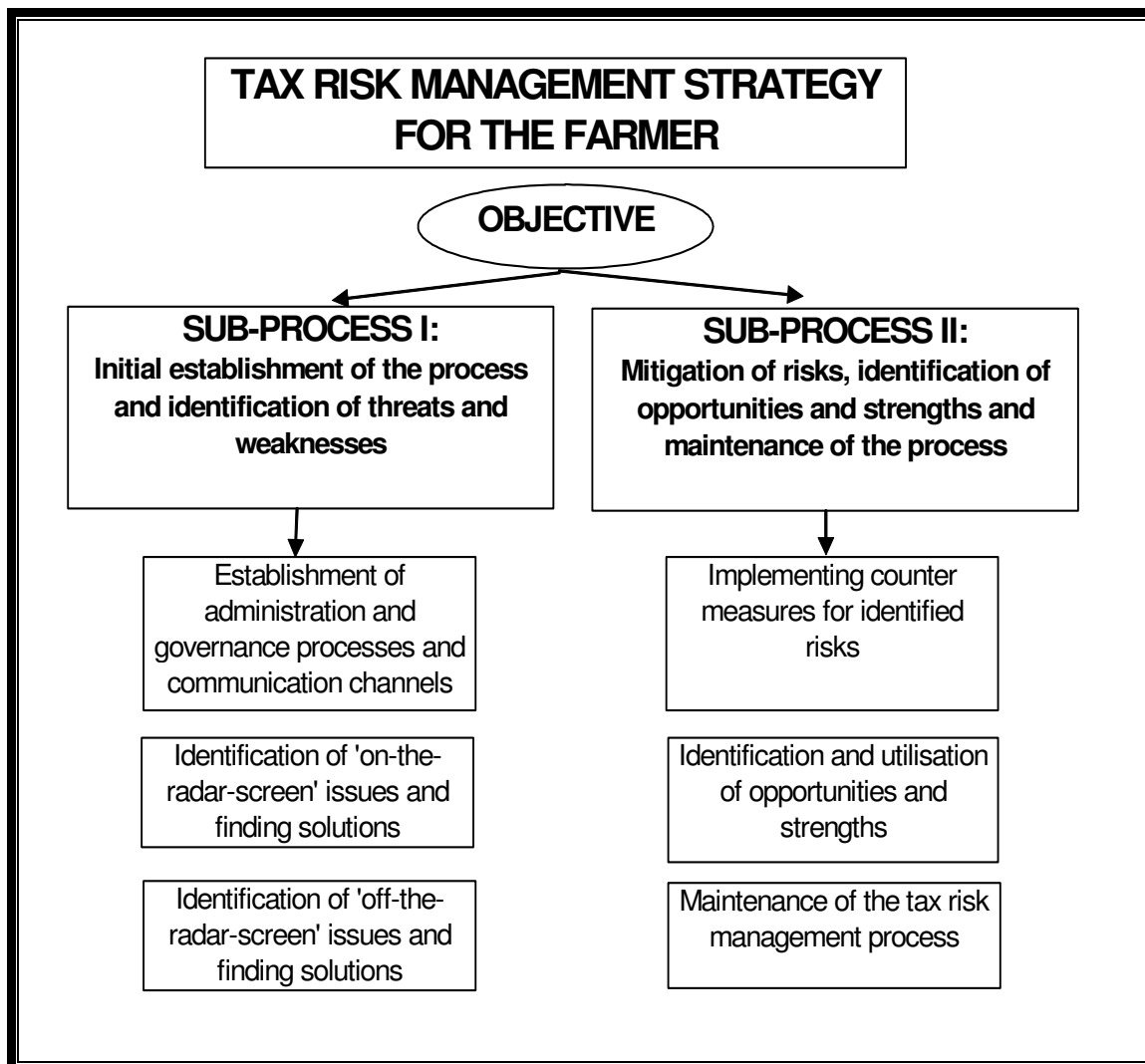
In the previous chapter, specific tax risks related to farming operations were identified, based on schedule 1 of the Act, which deals with the taxation of farmers; 45 tax risks were identified. It is important to note that these risks are related only to schedule 1, and additional risks can be identified that relate to other sections and schedules of the Act, which apply to all taxpayers, including farmers.

In this chapter, an attempt will be made to draft a framework for what a typical tax risk management strategy for a farming operation should entail. This framework will be based on the findings and information gained in the previous chapters. The framework will be used as criteria by which to evaluate the tax risk management strategy of a case study, who is an industry leader in the farming sector.

The guiding principles for effective tax risk management strategies discussed in Chapters 3 and 4 will be included in this strategy, as well as specific identified risks applicable to farming operations, as discussed in Chapters 5 and 6.

The following diagram gives an outline of the proposed tax risk management strategy. The rest of the chapter will be devoted to discussing the proposed strategy.

Diagram 3: Framework for a proposed Tax Risk Management strategy



7.2 OVERVIEW OF THE STRATEGY

As discussed in Chapter 3.3, an effective tax risk management strategy should involve a plan that includes an analysis of the strengths, weaknesses, opportunities and threats relating to tax risk that the farmer is facing. In Chapter 4.1, it was stated that the tax risk management process provides a framework for drafting a strategy. The proposed strategy is therefore based on the process outlined in Chapter 4.2

7.3 OBJECTIVE

As discussed in Chapter 3.2, the objective of an effective tax risk management strategy should be to manage tax risk in the form of non-compliance, inaccurate and incomplete tax reporting, and managing tax as a cost.

7.4 SUB-PROCESS I: ESTABLISHMENT OF ADMINISTRATIVE AND GOVERNANCE PROCESSES AND COMMUNICATION CHANNELS

Initially, basic administrative processes and reporting channels for governance and communication should be established. Board approval should be obtained for the strategy; communication and reporting channels to the Audit Committee should be set up; a tax team should be assembled; and communication channels with a SARS representative, as well as between the tax department and operational units, should be established.

A good understanding of tax risk management should be acquired by the whole tax team, as discussed in Chapter 3.3. Control processes must be put in place for the strategy to be reviewed annually, and all stakeholders must be listed, with the estimated impact that tax risk would have on each.

For the farmer, the extent of this establishment phase will depend largely on the size of the entity. Most farmers do not have extended governance structures, and the auditor would probably be the compliance officer. As far as the typical South African farmer is concerned, this process would consist of discussing tax risk management in principle with the auditor. Communication channels between the farmer, the auditor and the SARS representative would be established, which would encompass the pro-active management of tax risks. Meeting dates could be set and the rest of the process planned.

7.5 SUB-PROCESS I: IDENTIFICATION OF “ON-THE-RADAR-SCREEN” ISSUES AND FINDING SOLUTIONS

The process of identifying “on-the-radar-screen” issues would consist largely of a negotiation process with SARS on issues they would identify, as well as finding the best solutions, using a “soft approach”.

In this process, the principle of using a professional for assistance, one who understands how to lodge an objection and deal with queries from SARS, is vitally important, as was discussed in Chapter 3.3. The principle of gathering and analysing all the facts and evidence pertaining to resolving the issues would also come into play here. Obtaining regular tax clearance certificates may be useful in identifying these issues.

The farmer would definitely need the assistance of the auditor or external tax advisors in this regard.

7.6 SUB-PROCESS I: IDENTIFICATION OF “OFF-THE-RADAR-SCREEN” ISSUES AND FINDING SOLUTIONS

“Off-the-radar-screen” issues are those of non-compliance, inaccurate reporting or weakness, which have not yet identified by SARS, but which pose a threat to the farming operation in terms of tax risk (see Chapter 4.3). As discussed in Chapter 4.2, the most effective way of identifying these issues is through the self-auditing of tax risk focus areas under the supervision of a technical advisor.

Table 4 in Chapter 4.3 indicates typical events that can give rise to tax risk. This table can be used as a checklist to identify tax risk focus areas. The presence of the eventualities indicated in the table should indicate possible tax risk, including those for the farmer. Diagram 2 in Chapter 4.2 gives a typical strategic plan for tax compliance, which can be used as a guideline. The diagram indicates monthly tax risk management communication through established channels, as well as internal audits as measures of effective management of tax compliance.

Specific non-compliance tax risk focus areas must also be audited. These would be indirect taxes like PAYE, VAT and complex taxes like Capital Gains Tax (CGT). Typical tax risk areas are also transfer-pricing and classification of amounts as income or capital in nature.

This tax risk focus areas will also be applicable to the farmer, such as PAYE, as most farmers have complex employee structures, ranging from seasonal workers to contractors. VAT can also be a considerable risk area for the farmer, since zero-rated and exempt supplies, as well as valid tax invoices are always a focus are for inaccuracy when it comes to farming operations. Farmers who trade internationally should give attention to transfer-pricing and custom duties. Farmers who sell mining rights, sand or water from the farm should be especially cautious about classifying income on these transactions as income or capital of nature (De Koker 2008: §3.36,3.44,3.45). CGT is a complex tax that the farmer should review with the assistance of a technical expert.

Tax risk focus areas specific to the farmer were discussed in Chapters 5 and 6. In Chapter 5, the definitions of “farming operation” and “farming income” were identified as possible risk areas. For more detail on the specific risks, refer to Chapter 5.1. In Chapter 6, 45 possible tax risks relating to the First Schedule to the Act, dealing specifically with the taxation of farmers, were identified. These identified tax risks may be used as a checklist for identifying “off-the-radar-screen” issues relating specifically to the farmer.

Solutions for identified issues should be sought with the assistance of a technical professional.

7.7 SUB-PROCESS II: MITIGATION OF IDENTIFIED POTENTIAL RISKS

In Chapter 4.3, the root causes of tax risk and the counter-measures for mitigating the risks are discussed in detail. These counter-measures should be implemented and monitored regularly.

Most of the specific farming non-compliance risks discussed in Chapters 5 and 6 fall under the root cause of “inaccurate financial information”. The counter-measure for mitigating these risks will be regular self-auditing under the supervision of technical consultants (Chapter 4.3).

Transaction and operational tax risks, as discussed in Chapter 4.3, will also apply to the farmer, as many farmers carry out complex transactions without having the necessary

legal and tax knowledge. Filing important documentation is always a challenge in the typical farming environment, where trading and many other activities take place out of doors, far from any filing system.

The extent of these counter-measures will depend largely on the type and size of the farming operation, and an auditor or tax expert should be involved in assisting with this process.

7.8 SUB-PROCESS II: IDENTIFICATION AND UTILISATION OF OPPORTUNITIES AND STRENGTHS

As mentioned in Chapter 7.3, the objective of an effective strategy should include the management of tax as a cost. Opportunities for legal tax planning should be identified and utilised. The strengths of the tax risk management process should also be identified to ensure it is maintained properly.

As far as the farmer is concerned, certain provisions in the First Schedule were included for crisis situations, as well as a special rating formula which may benefit the farmer. Chapter 6 deals extensively with the First Schedule and can be referred to in identifying these special provisions, to ensure that those provisions that may be beneficial to the farmer are utilised, and utilised accurately.

7.9 SUB-PROCESS II: MAINTENANCE OF THE TAX RISK MANAGEMENT PROCESS

The tax risk management process as discussed in this chapter should be maintained, from the administrative processes to the mitigation of risks. “On-the-radar-screen” issues must be continually identified, as well as “off-the-radar-screen” issues. If the process is maintained effectively, sub-process I should become easier to manage on time.

Activities to comply with the principles discussed in Chapter 3.3, which should be maintained effectively during this phase, include:

- filing and safe-keeping of evidence of transactions or tax facts;

- creating tax awareness throughout the entity, by means of newsletters, e-mails, reporting, questionnaires and training;
- maintaining an extensive and up-to-date tax curriculum for regular training sessions;
- regular reconciliation and review of tax accounts and important transactions;
- regular tax-team meetings;
- regular communication through established tax-risk communication channels; and
- regular identification of “on-the-radar-screen” and “off-the-radar-screen” issues.

7.10 CONCLUSION

In this chapter, the framework for a proposed tax risk management strategy for the farmer was drafted, based on the principles, risks and processes of effective tax risk management discussed in previous chapters. This framework, illustrated by diagram 3 in Chapter 7.1, will be used as criteria for evaluating the tax risk management strategy of an industry leader in the farming sector.

In Chapter 8, the contents of the tax risk management strategy document of the industry leader will be summarised.

CHAPTER 8

A SUMMARY OF THE TAX RISK MANAGEMENT STRATEGY OF AN INDUSTRY LEADER

8.1 INTRODUCTION

In the previous chapter, an attempt was made to draft a framework for what a typical tax risk management strategy for a farming operation should entail. This framework is based on the findings and information gained in the previous chapters. The framework, as illustrated by diagram 3 in Chapter 7.1, will be used as criteria by which to evaluate the tax risk management strategy of an industry leader in the farming industry.

The chapter will provide an analysis of the tax risk management strategy of the industry leader by summarising the contents of the document.

8.2 OVERVIEW OF THE INDUSTRY LEADER

The industry leader under review is a multi-national group of companies (hereafter “the Group”) that has approximately 5900 employees in South Africa and undertakes the following farming activities:

- mango orchards;
- avocado pear orchards;
- soft-wood plantations;
- hard-wood plantations;
- cattle (not significant in size); and
- land with grazing potential.

The Group also processes mangoes into dried fruit and avocado pears into pulp. Wood from plantations is further processed by existing sawmills owned by the Group. Some products are exported, such as fresh mangoes, dried mangoes and avocado pear pulp. The Group owns companies that act as agents in selling some of the Group’s products in foreign countries.

This Group's strategy will be used to identify the weaknesses, and therefore the risk areas, in the approach to strategic tax risk management by the current farming industry in South Africa. Although the entity is fairly large in comparison with the general medium size of farming operations in South Africa, it is believed to be a good representative of the industry, since the extent of its activities covers many different types of farming operations in South Africa.

The following table gives an outline of the Tax Risk Management strategy document of the Group, which is called a *Tax Risk Policy Manual*:

Table 7: Outline of the Group's strategy

Sect\\\\ion	Description
	Glossary of terms
1	Preamble
2	Overview
3	The taxation process
4	The business transaction phase
5	Accounting and auditing phase
6	Dispute resolution
	Annexure A – D

Source: *Tax Risk Policy Manual*, 2008:3

8.3 GLOSSARY, PREAMBLE AND OVERVIEW

The glossary identifies the actions referred to in the document, as well as the terms "Board", "Group", "Manual", "SARS" and "The Tax Function". The "Tax Function" is defined as the "person or persons responsible for tax matters within the Group. Currently the Group Secretary." (*Tax Risk Policy Manual*, 2006: 4).

The preamble identifies the objective of the manual as tax compliance. The purpose of the document is stated to provide a framework for tax risk management, by recording identified tax risk and the controls implemented to mitigate the risks, as well as monitoring processes of these controls; and also to facilitate tax awareness within the entity (*Tax Risk Policy Manual*, 2006: 5).

The overview expounds on the responsibility of compliance, which is ultimately the Board's. The Board has delegated this responsibility to the Risk Committee, which in turn has appointed the Tax Function (the company secretary) to manage the tax risk. The company secretary has a broad knowledge of operations, as well as an understanding of the tax, legal and accounting implications of transactions. The Tax Function has to report to the Risk Committee and has to make the Board aware of tax risks and the controls implemented and monitored to mitigate the risks. The Tax Function is authorised to use experts when needed (*Tax Risk Policy Manual*, 2006: 6-7.)

The overview also gives a diagrammatical summary of the tax risk management process. Tax legislation relevant to the document is identified as the Income Tax Act, VAT Act and Stamp Duty Act. The following tax risks were identified and explained:

- tax technical risk (incorrect interpretation of legislation);
- legislative risk (non-compliance with changes in legislation) ;
- regulatory risk (SARS audit with adverse consequences);
- compliance risk (non-compliance by inaccurate or incomplete reporting);
- out-sourcing risk (non-compliance by sub-contractors);
- financial reporting risk (inaccurate tax disclosure in the financial statements) ; and
- tax litigation risk (disputes with SARS not dealt with in the proper manner) (*Tax Risk Policy Manual*, 2006: 8-11)

8.4 THE TAXATION PROCESS

The taxation process (or tax risk management process by the study's definition) is used as a framework for the management of tax risk. The process is sub-divided into four sub-processes, namely:

- the business transaction phase;
- the accounting and auditing phase;
- the payment phase; and
- the dispute resolution phase (*Tax Risk Policy Manual* 2006: 12-13).

Each sub-process is discussed separately.

8.5 THE BUSINESS TRANSACTION PHASE

The business transaction phase deals with all the transactions into which the Group enters, whether internal or external. Two types of transactions are distinguished, namely routine and non-routine transactions. Routine transactions pose an inherent risk on account of their repetitive nature, while non-routine transactions are normally qualitatively and quantitatively material, but are sufficiently planned to minimise tax obligation (*Tax Risk Policy Manual*, 2006: 14).

Tax risks identified for this process are tax technical risk, legislative risk and outsourcing risk. For each type of transaction, the tax type is identified, as well as the tax risk and the controls for mitigating the risk. The following table is a summary of these risks and controls identified for routine transactions in the document.

Table 8: Risks and controls for routine transactions

ROUTINE TRANSACTIONS			
Transaction type	Tax type	Tax risk	Control
Salaries and wages	PAYE	Tax legislative and tax technical risk	- Function outsourced to experts; - Regular training to staff involved; - Tax compliance questionnaire completed every 3 years - The Tax Function keeps up to date with legislative changes by attending seminars and reading newsletters;
		Outsourcing risk	- Sub-contractors are reviewed regularly;
Sales and purchases	VAT	Tax legislative and tax technical risk	- Review of each registered vendor in group with assistance by experts every three years; - After each review, road show is conducted to give feedback and training on findings; - The Tax Function keeps up to date with legislative

			changes by attending seminars and reading newsletters, and communicates relevant issues to the rest of the Group;
	Income tax and CGT	Tax legislative and tax technical risk	- Comprehensive tax packs are compiled to assist with tax calculations; - Tax packs amended annually with legislative changes and reviewed every two years by tax experts; - The Tax Function keeps up to date with legislative changes by attending seminars and reading newsletters, and communicates relevant issues;to the rest of the Group; - Transfer pricing document produced by tax experts is reviewed annually. Staff involved with cross-border transactions have basic understanding of transfer-pricing.

Source: *Tax Risk Policy Manual 2006: 15-21*

Non-routine transactions are identified but not limited to the following:

- dividend distributions;
- transfer of businesses/assets between Group companies;
- any restructuring within the Group;
- sale/purchase of material business assets to/from third parties; and
- introduction of new financial accounting systems within any of the Group's companies (*Tax Risk Policy Manual, 2006: 23*).

The following table is a summary of risks and controls identified for non-routine transactions in the document.

Table 9: Risks and controls for non-routine transactions

NON-ROUTINE TRANSACTIONS

Transaction type	Tax type	Tax risk	Control
All	All	Tax legislative and tax technical risk	- Creating awareness of the tax implications of all transactions; - The Tax Function review and sign-off of all material non-routine transactions. When needed expert opinion is sought. Accurate implementation is monitored; - The Tax Function keep up to date with legislative changes by attending seminars and reading newsletters, and communicates relevant issues to the rest of the Group.

Source: *Tax Risk Policy Manual 2006: 23-25*

8.6 ACCOUNTING AND AUDITING PHASE

The accounting and record-keeping phase focuses on recording transactions in the accounting system; internal controls are relied upon to ensure accuracy and completeness. This phase deals with normal accounting, as well as the completion and submission of tax returns. The risks and controls identified for normal accounting and record-keeping are indicated in the table below (*Tax Risk Policy Manual, 2006: 26*).

Table 10: Risks and controls for accounting and record keeping

ACCOUNTING AND RECORD KEEPING			
Focus area	Tax type	Tax risk	Control
Accounting and record keeping	All	Compliance risk	- Documents are safe-guarded for the period as required by SARS;
Financial statements	All	Financial reporting risk	- Review of tax pack, reviewed every 2 years by tax expert; - Deferred tax schedules reviewed by the Tax Function; - The Tax Function keeps up to date with legislative changes by attending seminars and reading newsletters, and communicates relevant issues to the rest of the Group; - Tax calculations are audited by external auditors;

			- The Tax Function reviews disclosure notes on tax in the Financial Statements.
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Source: *Tax Risk Policy Manual 2006: 27-29*

The risks and controls identified for the completion and submission of returns are indicated in the table below.

Table 11: Risks and controls for returns

COMPLETION AND SUBMISSION OF RETURNS			
Focus area	Tax type	Tax risk	Control
Returns	Income tax	Compliance risk	- Comprehensive tax packs are submitted to the Tax Function; - The Tax Function completes the returns and is centralised to ensure awareness of all transaction and their tax impact; - When needed expert advice is obtained; - Tax clearance certificates are obtained regularly.

Source: *Tax Risk Policy Manual 2006: 30-31*

8.7 DISPUTE RESOLUTION

The dispute resolution phase focuses on any disputes between SARS and the Group. This phase has three focus areas, namely SARS queries, assessments and disputes (*Tax Risk Policy Manual*, 2006: 32). The risks and controls for the dispute resolution phase are indicated in the table below.

Table 12: Risks and controls for dispute resolution

DISPUTE RESOLUTION			
Focus area	Tax type	Tax risk	Control
SARS queries/audits	All	Regulatory risk	- The Tax Function deals with all SARS queries; - When needed, expert advice is obtained

Assessments	All	Tax litigation risk	- The Tax Function reconciles all assessments with returns submitted; - All discrepancies in the review are subject to a decision by the Tax Function on whether to object or seek expert advice; - The Tax Function follows up all outstanding assessments;
Dispute resolution	All	Tax litigation risk	- Objections and disputes are dealt with by the Tax Function according to correct procedures, and expert advice is obtained when necessary.

Source: *Tax Risk Policy Manual 2006: 32-33*

8.8 PAYMENT PHASE

The payment phase focuses on the actual remittance of the outstanding tax obligation, and normal operational controls are relied upon to mitigate risks associated with this phase (*Tax Risk Policy Manual. 2006: 34*).

8.9 ANNEXURES

Annexure are included in the document to illustrate the process flow of the tax risk management process for each tax type. The following annexures are included:

- Annexure A: Income Tax and CGT;
- Annexure B: STC;
- Annexure C: VAT; and
- Annexure D: PAYE/SDL/UIF

8.10 CONCLUSION

In this chapter, the tax risk management strategy of an industry leader in the farming industry was analysed by summarising the contents of their tax document. An overview of the Group was given to allow a comprehensive perspective of the context of the strategy. The strategy was based on the taxation process, which consists of three phases, namely the business transaction phase, the accounting and auditing phase and the dispute resolution phase. Each phase was discussed separately.

In Chapter 9, the tax risk management strategy document of the Group is evaluated against the criteria determined in Chapter 7 to determine the strengths and weaknesses of the document as an effective tax risk management strategy for a farming operation.

CHAPTER 9

EVALUATION OF THE TAX RISK MANGEMENT STRATEGY OF THE INDUSTRY LEADER

9.1 INTRODUCTION

In the previous chapter, an analysis of the tax risk management strategy of the industry leader (the Group) was given in the form of a summary of the contents of the document.

In this chapter, the tax risk management strategy of the Group will be evaluated against the criteria discussed in Chapter 7. Diagram 3 of Chapter 7 illustrates the framework used as the criteria.

9.2 EVALUATION OF THE OVERALL STRATEGY

As discussed in Chapter 3.2, a tax risk management strategy should involve a plan that addresses the strengths, weaknesses and opportunities associated with tax risk, and identifies the controls required to mitigate those risks. In Chapter 7.2, it was concluded that the tax risk management process could be used as a framework for a tax risk management strategy.

The Group calls its tax risk management strategy a *Tax Risk Policy Manual*, and states the purpose of the document to be the provision of a framework for tax risk management, by identifying tax risk and the controls required to mitigate these risks, as well as the process for monitoring the controls (*Tax Risk Policy Manual*, 2006: 5).

This document could be said to be a plan, since it identifies the controls for mitigating the identified risks. The threats and weaknesses endemic to tax are addressed, although strengths and opportunities are not identified. The document is based on the tax risk management process, as is illustrated on page 8 of the document.

9.3 EVALUATION OF THE OBJECTIVE

In Chapter 7.3 it was concluded that the objective of an effective strategy would be to manage tax risk as it is defined in Chapter 2, which would include non-compliance, inaccurate and incomplete tax reporting, and managing tax as a cost.

The Group's strategy states that its objective is tax compliance (*Tax Risk Policy Manual*, 2006: 5). Accurate and complete tax reporting is discussed under the Accounting and Auditing Phase (*Tax Risk Policy Manual*, 2006:23-25), although it is not explicitly stated as an objective.

An entity is free to adopt any approach or objective to tax risk management. However, omitting to focus on certain of these tax risks may lead to ineffective tax risk management. The Group's document omits as an objective tax management as a cost. As discussed in Chapter 2.2, complementary to the fiduciary duty of the company directors of ensuring compliance with legislation is the fiduciary duty of managing the cost burden associated with taxation.

9.4 EVALUATION OF SUB-PROCESS I: ESTABLISHMENT OF ADMINISTRATIVE AND GOVERNANCE PROCESSES AND COMMUNICATION CHANNELS

In Chapter 7.4, all the activities were discussed to establish the administrative and governance processes, as well as various communication channels for the tax risk management process. It was stated that the extent of these processes would depend on the size of the farming operation. Since this Group is a farming industry leader and fairly large in size, it will be evaluated as such, and all of the identified activities should be applicable.

The Board of the Group has delegated all the responsibilities of Tax Risk Management to the company secretary, through the Risk Committee. This one person represents the Tax Function of the entity, and has a broad knowledge of tax, legal and financial issues, and operations. The Tax Function reports to the Risk Committee, and has to make the Board aware of identified tax risks and the implementation and monitoring of controls to mitigate the identified risks (*Tax Risk Policy Manual*, 2006:6-7).

The document does not indicate whether the Board specifically approves the strategy at any point. The document is dated 2006, but no indication is given as to whether it is reviewed annually. The document does not seem to indicate whether the Audit Committee is involved in the tax risk management process, although the Tax Function reports to the Risk Committee.

In effect, the tax team of the Group consists of one person, the company secretary. Some external experts are consulted when needed. A tax team comprising a legal person, external tax experts, the CFO and the compliance officer, meeting regularly, would contribute more to a pro-active approach to tax risk management (Chapter 3.3). This would be more effective than making one person with a broad knowledge-base responsible for the whole tax risk management function.

It is also indicated in the document that a proactive approach is followed, as far as establishing communication channels and a good relationship with SARS or setting up regular communication between the Tax Function and the operational units is concerned.

9.5 EVALUATION OF SUB-PROCESS I: IDENTIFICATION OF “ON-THE-RADAR-SCREEN” ISSUES AND FINDING SOLUTIONS

The process of dealing with all “on- the-radar-screen” issues was discussed in Chapter 7.5, and largely involves a negotiation and fact-gathering process that should be performed with the assistance of experts who can ensure that the correct process is followed.

The Group’s strategy includes a Dispute Resolution Phase which deals with SARS queries/audits, assessments and disputes (*Tax Risk Policy Manual*, 2006: 30-33). In terms of the Accounting and Auditing Phase, regular tax clearance certificates are obtained to identify outstanding returns or payments (*Tax Risk Policy Manual*, 2006: 31).

It seems that enough is being done to ensure that disputes are handled effectively, although omitting to build pro-active relationships with a SARS representative may affect

this process negatively. Also, a protocol should be established for gathering facts and information that would serve as evidence in disputes and outstanding issues.

The process once again depends largely on the knowledge, skills and experience of the company secretary. Should this individual resign, or be absent from work owing to unforeseen circumstances, the dispute resolution process could become a disaster. Protocols should be established for the dispute resolution process, and a complete tax team, as discussed in Chapter 3.3, should oversee this process.

9.6 EVALUATION OF SUB-PROCESS I: IDENTIFICATION OF “OFF-THE-RADAR-SCREEN” ISSUES AND FINDING SOLUTIONS

The identification process for “off-the-radar screen” issues was discussed in paragraph 7.6. “Off-the-radar-screen” issues include largely non-compliance issues and areas of incomplete or inaccurate reporting. Diagram 3 in Chapter 4.2 illustrates that a plan that includes monthly communications (mainly through checklists) and 3 internal audits per annum is a good strategic plan for tax compliance. The plan would be effective in identifying “off-the-radar-screen” issues when executed under the supervision of experts. Table 5 in Chapter 4.3 may serve as a good checklist for identifying possible tax risks.

Areas for self-audit were identified as PAYE, VAT, CGT and income tax, specifically in the areas of classification of amounts as being income or capital of nature and transfer-pricing. Specific tax risk focus areas for farmers were identified the definition of certain terms, such as farming operations, and farming income; as well as the tax risks associated with the provisions of Schedule I of the Act (Chapter 7.6).

The strategy of the Group does address PAYE as a focus area of tax risk, but completes a compliance questionnaire every three years, which may not be adequate to identify and resolve “off-the-radar-screen” issues before they are identified by SARS. The function is outsourced and the sub-contractors are reviewed regularly, but there is no indication of the extent of the review or exactly how regularly the review takes place (*Tax Risk Policy Manual*, 2006:15-16).

VAT is also identified as a focus area of tax risk. Again, the focus area is reviewed every three years, which may not be often enough to be regarded as pro-active (*Tax Risk Policy Manual*, 2006:17-18).

The document does identify income tax and CGT as tax risk focus areas. No self-audit is performed here, although comprehensive tax packs are reviewed by experts every two years. Transfer-pricing is reviewed annually by experts (*Tax Risk Policy Manual*, 2006:18-19).

The Group has identified certain non-routine transactions as focus areas for tax risk (*Tax Risk Policy Manual*, 2006: 23). However, if one refers to Table 5 of Chapter 4.3, which indicates the eventualities that could give rise to tax risk, it should be noted that there exist many more possibilities that should be identified as focus areas. Although it is stated that the Tax Function reviews and signs-off on all material non-routine transactions, it should be noted that not all events that could give rise to tax risk are in the form of transactions, and these events should be specifically identified for special review.

The specific tax risks for farmers identified in Chapters 5 and 6 should be specifically addressed, because even though a comprehensive tax pack has been compiled it would be difficult to control the definition of farming operations and farming income by using a tax pack, as discussed in Chapter 5.

Further, the document does not indicate whether the specific tax risks of the First Schedule to the Act are included in the tax calculations of the tax pack. Some of these tax risks can be difficult to manage with a tax pack alone, and additional supervision may be needed, like the accounting for the farmer's stock items, which may become a complex exercise (see Chapter 6.2 - 6.8); and decisions on utilisation of the rating formulae (see Chapter 6.13-6.15). Documenting and preserving the evidence, along with information on agreements like sheep-leases and the sale of water or mining rights, is crucial for tax risk management purposes (Chapters 6.3 and 6.6). Protocols for the process of documenting, filing and storing these agreements should be established.

9.7 THE EVALUATION OF SUB-PROCESS II: MITIGATION OF IDENTIFIED POTENTIAL RISKS

The mitigation process of identified tax risks is discussed in Chapter 7.7, and the counter-measures for root causes of tax risks are discussed in Chapter 4.3. The main counter-measures for inaccurate financial, operational and transactional information are regular self-audits under the supervision of technical experts, reviewing and reconciliation of accounts and transactions (tax and normal accounting), regular communication between tax and operational functions, regular training and support on new legislation and the tax implication of complex transactions (Chapter 4.3).

Throughout the document, the Group's strategy identifies mitigating controls for all identified risks. Establishment of communication lines with a SARS representative is omitted and could result in SARS holding a negative view of the entity. There is no indication that data transferred from accounting records to tax reporting schedules is reviewed. Self-audits are performed every three years, which may not prove adequate for mitigation of risks. Communication lines between the tax and operational functions have not been established.

Although the Tax Function keeps up to date with regulatory changes and communicates changes to the rest of the organisation (*Tax Risk Policy Manual*, 2006: 16,18,20,25,28), it is not stated whether this communication is in the form of formal training with a comprehensive tax curriculum. No formal filing system for information and evidence pertaining to high tax risk areas and transactions has been established.

9.8 THE EVALUATION OF SUB-PROCESS II: IDENTIFICATION AND UTILISATION OF OPPORTUNITIES AND STRENGTHS

In Chapter 7.8, the identification and utilisation of opportunities and strengths related to tax risk management are discussed. Managing tax as a cost is a vital part of tax risk management, as was discussed in Chapter 2.2.

The Group's strategy holds that sufficient time exists to plan non-routine transactions, so that tax is "minimised" (*Tax Risk Policy Manual*, 2006: 22). However, the process of managing the cost burden of tax goes beyond "minimising" tax on non-routine transactions and should involve making use of special provisions in the Act, particularly in the First Schedule to the Act (see Chapter 7.8).

9.9 THE EVALUATION OF SUB-PROCESS II: MAINTENANCE OF THE TAX RISK MANAGEMENT PROCESS

The process of maintaining the tax risk management process is discussed in Chapter 7.9. Continual identification of "on-the radar-screen" and "off-the-radar-screen" issues; creating tax awareness in the organisation; regular training on complex tax areas and regulatory changes; maintaining effective filing systems of tax evidence; and regular review of tax accounts all form part of this process.

The Group's strategy does seem to include maintenance and monitoring of implemented controls and identification of threats by obtaining regular tax clearance certificates (*Tax Risk Policy Manual*, 2006: 31).

9.10 SUMMARY OF THE EVALUATION

Table 13: Summary of the evaluation of the Group's strategy

Evaluation focus area	Strengths	Weaknesses
Overall strategy and objective	Plan to mitigate tax risk, with the objective of compliance and accurate record-keeping.	The risks associated with managing tax as a cost are not identified.
Establishment of administration and governance processes and communication lines	Governance processes and some reporting exists.	The audit committee is not involved in the process, no tax team has been established, no

		communication lines with SARS or operational function. Not proactive.
Identification of “on-the-radar-screen” issues	Dispute resolution process exists, and identification of outstanding issues carried out.	Process heavily dependant on one person, no formal filing and fact -gathering system exists.
Identification of “off-the-radar-screen” issues	Reviews are done every three years.	Self-audit should include monthly communication in the form of checklists and three
Evaluation focus area	Strengths	Weaknesses
		annual internal audits. High risk events are not specifically identified. More focus should be placed on specific tax risks relating to farmers.
Mitigation of identified risks	Controls for identified risks are implemented and monitored	No communication line between tax and operational functions, no formal tax fact filing system, self-audit not adequate, review of transferring of information between accounting and tax schedules not done and no formal tax curriculum.
Identification and utilisation of opportunities and	Non-routine transactions are planned to minimise tax burden.	Other opportunities provided by the Act to manage tax as a cost

strengths.		are not identified
Maintenance of the tax risk management process	Maintenance and monitoring of implemented controls are performed.	None

9.11 CONCLUSION

In this chapter, the tax risk management strategy document of the industry leader (the Group) was evaluated and strengths and weaknesses were identified. Table 13 gives a summary of the findings of the evaluation.

In Chapter 10, the conclusion of the study will be presented, and it will be determined whether all the objectives of the study were met.

CHAPTER 10

CONCLUSION

10.1 INTRODUCTION

In the previous chapter, the tax risk management strategy of the Group, which is a leader in the farming industry, was evaluated against the criteria discussed in Chapter 7. Diagram 3 of Chapter 7 illustrates the framework used as the criteria. Table 13 in Chapter 9.10 gives a summary of the evaluation by highlighting the strengths and weaknesses of the Group under each evaluation criterion.

In this chapter, the study will conclude by addressing the outcome of the research and ensuring that all objectives have been met.

10.2 REVISITING THE PROBLEM STATEMENT AND RESEARCH OBJECTIVES

In Chapter 1.2 it was stated that aim of this study was to determine what an effective tax risk management strategy for South African farmers should entail. The research objectives given in Chapter 1.3 were:

- to identify effective tax risk management principles by reviewing literature on effective risk management strategies in general;
- to identify tax risks specifically applicable to farming operations by reviewing tax legislation and case law; and
- to investigate weaknesses in existing tax risk management strategies of commercial farmers in South Africa by analysing the tax risk strategy of an industry leader.

Chapters 2, 3 and 4 detail the literature review conducted to determine the principles underlying effective tax risk management strategies in general. Table 3 in Chapter 3.3 summarises the principles for effective tax risk management identified by various authors; and Chapter 4.2 outlines the tax risk management process as the proposed framework for an effective strategy.

In Chapters 5 and 6, the specific risks to farming operations relating to tax legislation and case law were discussed. The definitions of “farming” and “farming income” were identified as possible tax risk areas, as these are not properly defined in legislation; and 45 possible tax risk areas relating to the First Schedule of the Act were identified.

Chapter 7 presented a proposal for an effective tax risk management strategy for the farmer based on the information obtained in Chapters 2 through 6. This proposed strategy was used as criteria for evaluating the tax risk management strategy of an industry leader (the Group) in the farming sector, to identify the weaknesses in existing tax risk management strategies of commercial farmers in South Africa.

Chapter 8 summarised the existing tax risk management strategy of the Group and Chapter 9 detailed the evaluation performed on the strategy document by applying the evaluation criteria discussed in Chapter 7. The findings of the evaluation were summarised in Table 13 of Chapter 9.10.

10.3 THE PROPOSED TAX RISK MANAGEMENT STRATEGY

This study identified an effective tax risk management strategy for the South African farmer in Chapter 7, and the framework of this proposed strategy is outlined by Diagram 3 of Chapter 7.1. The industry-specific tax risks were identified in Chapters 5 and 6, and can be used as checklists to identify “off-the radar-screen” issues under sub-process I of the framework. This will address the specific tax risk exposure of the farmer.

During the evaluation of a current existing tax risk management strategy of an industry leader, which was used to represent the tax risk approach of the farming industry, the following were found:

- tax is not managed as a cost;
- communication lines between the tax function and operations have not been established;
- communication lines between the entity and SARS have not been established;
- a pro-active approach to tax risk management is not being followed;

- there is no tax team;
- there is no formal filing system for tax evidence and facts;
- self-audits are infrequent and specific tax risks relating to farmers are not identified as specific risk areas;
- tax training and awareness are insufficient; and
- tax planning is not a priority.

Although the Group has formulated a generic tax risk strategy, a proactive and industry-specific approach to tax risk management is not a priority.

10.4 CONCLUSION

For the farming industry to effectively ward off the winds of change emanating from the Receiver of Revenue's office, the current generic approach to tax risk management must be traded in for a proactive approach, with emphasis on the tax risks specific to the industry.

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