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South African Revenue Service
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BY E-MAIL: aveary@sars.gov.za

Dear Adrian

COMMENTS ON THE DRAFT GUIDE TO UNDERSTATEMENT PENALTIES

1. We herewith present our comments in Annexure A on behalf of the South African Institute of Chartered Accountants (SAICA) National Tax Committee on the draft Guide on understatement penalties (the draft Guide) as levied in terms of the Tax Administration Act 28 of 2011 (TAA).

2. We have attempted to expand on our concerns as clearly as possible but acknowledge that some submissions may require further explanation due to the complexity of the matters. We accordingly request that a workshop be hosted to discuss the draft Guide.

We however would like to thank SARS for providing an opportunity to us to participate in developing the tax law and practice in South Africa.

Yours sincerely

Tarryn Atkinson

Chairperson: SAICA TAA subcommittee

Christel van Wyk

SAICA Project Director: Tax

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ANNEXURE A

1. We firstly set out our general comments and secondly our comments, concerns and submissions with references to the specific sections used in the draft Guide.

General comments

Statutory interpretation rules

We note that the draft Guide makes reference to 'the ordinary meaning of the word in context' and then goes into some detail explaining the particular law of interpretation applicable to tax and the TAA.

2. Submission: Considering that a new *locus classicus* on statutory interpretation law exists as to the concept of the ordinary meaning of the word used in context, it is submitted that the relevant case law of *Natal Joint Municipal Fund v Endumeni Municipality*[1] and the relevant paragraph be cited in the footnote.

Interrelation with other penalties

3. In paragraph 2.70 of the Memorandum on the objects of the Tax Administration Laws Amendment Bill, 2012 (the 2012 EM) the interrelation between USP and other penalties is addressed and explains the proposed amendment to avoid double jeopardy:

   2.70 Tax Administration Act, 2011: Amendment of section 210

   The proposed amendments seek to avoid administrative 'double jeopardy' by providing that a fixed amount administrative penalty may not be imposed for non-compliance which is subject to a percentage based penalty, in respect of which an understatement penalty has been imposed or constitutes failure to disclose information subject to a reportable arrangement penalty.

4. The opportunity for confusion and double jeopardy is quite clear given that paragraph (a) of the definition of 'understatement' in section 221 of the TAA includes a default in rendering a return, which is usually the purvey of fixed amount penalties.

5. Furthermore, the wide definition of 'return' in section 1 of the TAA includes relevant material required under section 25, 26 & 27 or such document of thing on which an assessment by SARS is based upon. In this context, disputes on the accuracy of valuations that determine a specific tax liability come to mind.

6. Submission: We submit that the draft Guide addresses the interrelation between the various penalties and provide practical examples

[1] Natal Joint Municipal Pension Fund v Endumeni Municipality 2012 (4) SA 593 (SCA)

Onus shifting in applying USP provisions

7. SARS bears the onus in terms of section 102 of the TAA to prove the facts on which the understatement penalties, which SARS seeks to impose, are based upon.

8. A routine practice has seemingly developed, whereby SARS issues a letter to the taxpayer instructing that the taxpayer first justify in detail certain amounts claimed as deductions, and then secondly, as a 'generic' question, asks for the taxpayer to justify why understatement penalties should not be imposed.

9. No detail is provided as to the basis that SARS would consider imposing possible USP and there is usually no evidence that SARS considered the detail contained in the return which would show the basis on which the deductions were claimed. These situations often end up in time consuming and costly tax disputes process that seek to undermine the USP regime.

10. It is submitted that by requiring a taxpayer in this context to provide SARS with a detailed factual basis why USP should not be imposed, without SARS first stating that factual basis for each behaviour it believes applies, creates a reverse onus situation.

11. In effect SARS is 'fishing' for the taxpayer to provide the factual basis of a USP, which duty is by law upon SARS, under the guise that it is offering the taxpayer an opportunity to respond to SARS' findings of fact on a USP..,

12. Submission: We submit that this practice by SARS of shifting the onus to the taxpayer must be specifically addressed in the draft Guide and clarify that this onus is upon SARS to determine factual basis for each behaviour applicable to an understatement. It is submitted that only once the relevant facts have been provided to the taxpayer and the relevant USP behaviours identified, can SARS truly afford a proper administratively fair opportunity to the taxpayer to respond.

13. The principles and basic thought processes that a SARS official would have to apply in determining the facts and the relevant behaviours, should also be addressed in the draft Guide.

Penalty committee

14. We understand the current process for the imposition and mitigation of USP to be as follows:

    14.1 SARS requests the taxpayer to make representations and provide reasons why USP must not be imposed;

    14.2 The SARS official concerned presents the taxpayer response to a penalty committee;

    14.3 The penalty committee debates the matter and makes a decision with regards to the imposition as well as the category of USP;

15. The current shortcomings of the process is that there is insufficient transparency on the process followed, as taxpayers are not afforded the opportunity to make representations to the committee in an attempt to mitigate the facts concluded upon in imposing the USP.

16. The draft Guide also does not set out the legislative authority for, the internal policies of and the mechanisms employed for the use of internal SARS committees that deal with the USP, in considering the final facts upon which the USP is based.

17. There is no guidance on what these committees would take into account in terms of determining the relevant and most objectionable behaviour in the section 223 table.

18. Submission: We propose that the committee process is detailed in the draft Guide and that a process is introduced whereby taxpayers may make representations to the committee to mitigate the USP.

Powers of Tax Court

19. In paragraph 2.52 of the Memorandum on the objects of the Tax Administration Laws Amendment Bill, 2013 (the 2013 EM) an amendment to section 129 of the TAA is explained as follows:

    2.52 Tax Administration Act, 2011: Amendment of section 129

    Paragraph (b): The proposed amendment clarifies that the tax court, in dealing with an appeal against the imposition of an understatement penalty, is not limited to the behavioural category in the Understatement Penalty Table initially chosen by SARS. The tax court may decide, based on the evidence, that another behavioural category in the Table is more appropriate and reduce or increase the penalty accordingly.

20. This power of the Court to apply a specific category of USP was the subject of a recent Tax Court case[2]. This case raises important principles regarding the application of the Court's power to make an adjustment to the penalty category.

21. We note that this in only mentioned in passing on page 24 of the draft Guide.

22. Submission: We propose that the draft Guide is expanded to include a section on the powers of the Tax Court as contemplated in section 129 of the TAA to hear anew the facts for imposing a USP and adjusting it accordingly. Importantly, this also in effect means that taxpayers cannot just contest the behavioural requirements of the behaviour determined by SARS, but will have to satisfy a court that their behaviour is also not subject to any other objectionable behaviour.

More likely than not opinions

23. We note that the draft Guide currently excludes a section dealing with 'more likely than not' opinions, and the role this plays in mitigating USP, as contemplated in section 223 of the TAA. Given the importance of this in the context of taxpayers obtaining advice in

[2] XYC CC v CSARS 20 November 2017

sophisticated transactions, we consider that this would be an invaluable addition to the draft Guide.

24. It is submitted that much guidance can be given as to what constitutes and should be considered or plainly apparent from such opinion, and even more importantly, what would not in SARS' view constitutes an opinion that falls within this scope.

25. We also believe that it is important to also remind tax practitioners and clarify to them in the guide that when they issue such opinions, section 241(1) and (2)(c) should be duly considered and what the basis would be of such considerations in relation to section 231(3).

26. Submission: We submit that the draft Guide must include a detailed analysis and guidance on the 'more-likely than not'process as also the considerations for tax practitioners issuing such opinions and the consequences of not fully applying their minds.

Linguistic corrections

27. Throughout the document, the expression '…in their return…' is used when referring to a single taxpayer.

28. Submission: Grammatically the reference should be to 'his' or 'her' or 'its' return…'. Possibly for simplicity refer either to 'his' or 'her' return as appropriate throughout the Draft Guide. See for instance the introductory paragraph in example 4.6 on page 9.

Comments on specific sections of the draft Guide

Section 3-Transition from additional tax

29. The use of the word 'lays' appears to be incorrect.

30. Submission: The word 'lays' in the second last sentence of the first paragraph on page 5 should change to 'lies'.

31. The third and fourth paragraphs on page 5 merely refers to '1 October' and '30 September' without specifying the specific year (namely 2012) relevant in this context.

32. Submission: The reference to '1 October' should change to '1 October 2012' since it refers to the date that the TAA commenced. In turn, all references to '30 September' should change to '30 September 2012' since it refers to the date that certain provisions of other Acts had been repealed.

Section 4-An understatement

Causal link between understatement and prejudice

33. On page 6 under the heading 'an understatement' the following paragraph appears:

The main purpose of the understatement penalty regime is to deter unwanted behaviour that causes non-compliant reporting. To reflect this purpose, all the actions or inactions that can trigger understatements are ones that negatively affect the submission or content of a return – a default in rendering, an omission from, or an incorrect statement in a return; the failure to pay the correct amount of tax when a return is not required; or an impermissible avoidance arrangement. In any given tax period there can be one or more of these actions or inactions and for each one that causes prejudice to SARS or the fiscus*, the resultant prejudice will be an understatement.*[28] *It follows that a person who 'fails to submit a return as required' or 'submits a return or information that is incorrect or inadequate' will incur an understatement penalty*[29] *when SARS makes an assessment based on an estimate*

34. As submitted above, the interrelation between USP and administrative penalty for non-submission of returns needs to be clarified.

35. Even if an estimated assessment is issued under section 95 of the TAA, it is unclear how SARS would calculate a shortfall without a taxpayer having submitted a return as the calculation invariably requires two amounts, the 'as is' with the understatement and the 'to be' without it. The estimate invariably is the "to be" amount without the accepted understatement but in such scenario there is no "as is" amount. There is therefore in our view no '*amount of tax that would be chargeable if the understatement had been accepted*' as required in section 222(3) of the TAA.

36. The prejudice suffered by the fiscus for the non-submission of returns should be correctly dealt with under section 210 and 211 of the TAA.

37. Submission: The double jeopardy and interrelation with administrative penalties for the non-submission of return should be clarified. Should SARS still hold the position, it should explain by way of example how the shortfall would be calculated.

Prejudice as financial loss

38. The second paragraph on pages 5 and 6 reads as follows:

The 'prejudice' that the action or inaction causes need not be actual financial loss.[31] *If this were so, an understatement would not occur if it was discovered before the tax or refund was payable. A non-compliant or dishonest person would get off scot-free and not be deterred from engaging in similar unwanted behaviour in future. The purpose of the regime would not be achieved. On the other hand, applying too broad a meaning to 'prejudice' would blur the distinction between the various financial sanctions under the Act.*

39. We cannot support the conclusion that the prejudice envisaged is something other than financial prejudice.

40. We agree that financial prejudice does not equate to actual financial loss having been suffered as precondition, as the section 223(3) shortfall envisages an amount which is the difference between the actual tax chargeable and that which would have been payable had the understatement been accepted, but there still needs to be financial prejudice.

41. This however does not mean that the prejudice relates to potential financial prejudice, but rather potential financial loss as quantified in context of the shortfall.

42. For example, the reallocation of mining expenses to reduce a mining loss and increase a redeemable CAPEX balance arguably does not result in financial prejudice to SARS. The same would apply where capital allowance amounts are reallocated on audit or otherwise to general or specific revenue deductions.

43. We therefore also agree that prejudice cannot have a too broad application and needs to be interpreted in context to the shortfall calculation specifically but also in relation to financial prejudice generally.

44. This again raises the problem regarding non-submission of a return as the 'understatement', namely the non-submission of the return, can technically and practically never be '*accepted*' by SARS i.e. non-submission does not equate to a Rnil submission as is the case for paragraph 19(6) of the Fourth Schedule in respect of provisional tax.

45. Submission: We submit that the USP provisions only deal with actual financial prejudice in a particular tax period, by way of financial prejudice, as quantified in terms of the shortfall, to the fiscus. Financial prejudice suffered from the time lost for the use of the money is compensated for in the interest provision and is in our view not a basis on which prejudice is suffered in itself in respect of the USP.

46. Furthermore, prejudice in context must be informed holistically and not in isolation as per the examples above and should at most relate to potential financial loss quantified in terms of the shortfall as being the prejudice, not potential financial prejudice which is a much broader concept.

47. We therefore request that SARS expand on the prejudice concept taking into consideration these principles.

Considering the shortfall

48. As noted above, the shortfall is the difference between the following, this is again not where the test ends:

    - the amount of tax properly chargeable and the amount of tax that was reported as chargeable, this is not where the test ends;

    - the difference between the amount properly refundable and the amount that was reported as refundable; and

    - the result of the maximum tax rate applied to the difference between the assessed loss or other benefit to the taxpayer properly carried forward from one tax period to the next and the assessed loss or benefit that was reported as carried forward. (The tax rate is the maximum one applicable to the taxpayer, ignoring any assessed loss or other benefit to the taxpayer carried forward from one tax period to the next).

49. Whilst the third 'category' namely the difference in the carry forward assessed loss leads to anomalies in practice (especially between difference types of loss balance transfers), we will not expand on this for present purposes. We emphasise submit that the difference is inextricably linked to the prejudice as a result of such difference. This aspect is often neglected in practice which results in significant problems in correctly applying the USP provisions.

50. Submission: We propose that the fact sets in the examples should ideally be expanded to in the context of explaining the casual link between the shortfall difference and the prejudice.

Section 5-Bona fide inadvertent error

Purpose of the USP regime

51. The following statement appears on page 10 of the draft Guide:

> *The understatement penalty regime is designed to sanction undesirable behaviour, not to punish involuntary mistakes. It consequently exempts an understatement from a penalty if it is caused by a bona fide inadvertent error.*
>
> *According to the Oxford Dictionary the origin of the word 'bona fide' is Latin and literally means 'with good faith'. The word is also defined as 'genuine'; 'real'; 'without intention to deceive'. 'Inadvertent' is defined as 'not resulting from' or 'achieved through deliberate planning'. The Merriam-Webster online dictionary gives the following as some of the synonyms for the word inadvertent: 'accidental' 'unintentional', 'unintended', 'unpremeditated', 'unplanned' and 'unwitting'.38*
>
> *Notwithstanding views to the contrary, in the phrase 'bona fide inadvertent error', 'bona fide' does not describe the word 'error', it describes the word 'inadvertent'. If both described the error, there would be a comma after 'bona fide'. The significance of this differentiation is illustrated below.*

52. Should SARS' construction of the grammar be correct, then a *mala fide* inadvertent error should be possible with *mala fide* qualifying inadvertent i.e. a 'with intention to deceive unintentional error' using SARS' own construction or at a minimum a *mala fide* advertent error, namely with intention to deceive intentional error. Neither of these constructions make sense.

53. A possible reason why SARS' example of red floral dress may make some sense (though it is highly questionable whether the example is in fact sensical) is because red and floral are two totally different concepts which *bona fide* and unintentional are not, they overlap.

Submission: The clear inability of SARS to properly explain this term is unfortunately not through a lack of construction, but because of the clumsy language used in the law to describe something which clearly was achieved through *bona fide* error because if an error is committed in good faith it is unintentional. The 'clarification' on page 11 therefore just creates more confusion than clarification and it is submitted it should be omitted.

Section 5-Bona fide inadvertent error – Third party reporting

We express much concern with the view given in the example on pg. 12 that in principle a *bona fide* inadvertent error can never occur in such circumstances and it extends to all third-party reporters such as banks, medical schemes, employers etc.

There is therefore clearly some overlap in principle between *bona fide* inadvertent error and reasonable care taken and SARS should explain the difference as relates to third party reporting reliance.

Submission: We furthermore request that wider guidance be given regarding the distinction between 'reasonable care not taken' and a '*bona fide* inadvertent error' as it appears that these expressions overlap, especially give SARS' example on pg. 12 relating to the charity statement.

Section 6-An understatement penalty

54. Submission: In the example on page 12, the word 'from' should change to 'form' in the expression '… (the positive **[from]** form of item (ii))'.

Section 7-Criteria for the determination of the penalty percentage

Distinction prior regime

55. Whilst it is noted in the draft Guide that the approach of the previous penalty regime was relied on, it is important to note that there are more differences than similarities to the prior regime. It will therefore be of more value to explain the reasoning behind the change in regime and the specific differences in approach.

Section 8.2-Reasonableness

56. Whilst we note the broad discussion on reasonableness, we consider that it will add significant value to specifically refer to the most relevant case law on reasonableness, being the 'reasonable person' test as this will, by establishing the principles, set out the principles with the required level of clarity.

57. Submission: We propose that the most relevant case law in point is included in the analysis to clarify the principles.

Reasonableness - Section 8.2.1

58. On page 16 in the discussion under point 8.2.1 the following statement is made:

> *'For instance, when completing a return, eFilers can check their declaration against source documentation to ensure accuracy and can utilise the tax calculator provided on eFiling to verify that the recorded declarations match the disclosures made.* ***Considering the resources at their disposal, in the absence of other relevant factors, an eFiler who makes a mistake when completing a return could not be said to have exercised reasonable care.'***

59. This example is overly simplified generalisation and in our view inappropriate and inaccurate.

60. Reasonableness cannot be determined merely from the hypothetically resources available, but rather that within the context of the resources, whether a reasonable person would still have committed such an error.

61. Submission: We submit that the statement and example of the eFiler be updated with the above principle, namely that error will be tested against various factors including the tools at hand and not just make a blanket statement in respect of eFiling errors.

Section 8.2.3 –Gross negligence

62. On page 17 under heading 'Gross negligence', the following examples are quoted as examples of gross negligence:

- *The absence of reasonable grounds for a belief in information provided, such as reliance on dubious advice*
- *Making declarations based on insufficient grounds*

63. The examples provided in this section do not clearly indicate a difference between simple negligence and gross negligence in order to highlight the rationale for an increased penalty to be applicable in a situation of gross negligence.

64. Submission: We request that the draft Guide includes broader guidance on applying the gross negligence legal principles within the USP context.

Section 8.3-Tax avoidance and evasion

65. The draft Guide under the heading 'Tax avoidance and tax evasion' states the following:

> *Denis Healey said, (t)he difference between tax avoidance and tax evasion is the thickness of a prison wall.*

66. Though the above quote is included to be impactful, it would be even better served in our view to add to it by stating that though tax avoidance is legal, continually seeking tax avoidance positions can create position of high risk i.e. flying to close to sun or the proverbial thickness of a prison wall.

67. Submission: The sentence is too long and become confusing.

68. *Such a taxpayer cannot be said to lack experience in financial matters **[,]** and would, all things being equal, definitely have known that her action would result in an underpayment of tax. **[, and]** She can therefore not **[cannot]** claim that she completed her tax return with reasonable care.*

Section 8.3.1-Impermissible avoidance arrangement

69. We consider that it will add value to the guide if reference is made to and the discussion centres around the general anti-avoidance (GAAR) provisions contained in the Act and Guide issued by SARS which specifically deal with the distinctions between tax avoidance, tax evasion and impermissible avoidance.

70. Submission: We propose that the referencing and analysis in relation to the GAAR will obviate the need to develop a novel explanation of these concepts in the draft Guide.

71. We further propose that the underlined text is added and that the bold text in square brackets is removed in the following sentence on page 18:

72. Avoidance arrangements (item (iv)) fall somewhere between legitimate tax planning and tax evasion **[. However,]** when their sole or main purpose is to obtain a tax benefit **[they are prohibited by the]** and the other preconditions necessary for the anti-avoidance rules are met. In such cases, they are prohibited by the anti-avoidance rules…'

73. Add the underlined text to the following sentence on page 18: 'If it does, an understatement penalty for an impermissible avoidance arrangement must be imposed.'

Section 8.3.2-Intentional tax evasion

74. Submission: The second paragraph in the 'Take Note' block on page 19 should change as follows 'In both instances, should SARS meet the required onus of proof, it may impose the relevant penalty. **[; the onus will devolve upon the taxpayer to present proof to the contrary.]**

75. Submission: We propose that, in the first paragraph of this section on page 18, the reference to 'If they did…' should change to 'If he or she did…'

Section 8.4-Substantial understatement as understatement

76. The expression 'Substantial understatement is not an understatement…' does not appear to make sense.

77. We agree that it is not a behaviour per se (in the normal sense of the word) but it is still an 'understatement' as defined as it still arises from an omission or incorrect statement in a return, it just lacks some form of material culpability, though due to the prejudice suffered being substantial, is still penalised.

78. We also agree that this contradicts the inherent principle of the USP (as recognised in part 6) in that the fiscus will only seek to penalise material blameworthy conduct.

79. Submission: It is submitted that a substantial understatement is still an understatement by definition.

Section 8.4-Substantial understatement separate shortfalls

80. Example 8.4.3 involves separate 'shortfalls' from separate 'understatements', but implicit in SARS' conclusion that the 'capital expenses claimed incorrectly' gives rise to a USP for 'substantial understatement' (even though it, by itself, is patently below the R1 million threshold) is a conclusion that one should aggregate the separate 'shortfalls' from separate 'understatements'.

81. However, as a matter of legal construction, the legislation uses singular wording (e.g. 'a default', 'an omission', 'the understatement', 'each shortfall').

82. Paragraph 2.75 of the 2013 EM provides the following guidance:

Amendment of subsection (2): The purpose of the amendment is to avoid an unnecessarily onerous penalty. If more than one understatement is made in a return, the applicable behavioural category in respect of each understatement must be separately or individually determined as the behaviour may differ. For example, one understatement may result from reasonable care not taken while another may result from gross negligence. The amendment clarifies that the approach should not be to determine the net shortfall of the entire period and then apply the "highest applicable percentage". To follow the example above, this would mean that the higher percentage for gross negligence would apply in respect of both understatements.

83. SARS' construction that for all behaviours other than substantial understatement the shortfall is calculated per understatement is untenable.

84. As a listed behaviour, the same approach as for all other shortfalls should be applied and the cumulative understatements should in law and principle not be the measure of determining a substantial understatement threshold.

85. The increase in blameworthiness is reflected in the increase in % of the relevant and in principle it makes no policy sense to seek to penalise all other reasonable omissions as material blameworthy transgressions.

86. This in our view will also encourage a vindictive audit regime that seeks the one big amount just to penalise all the small amounts or conduct never ending audits on the same period in search of a total exceeding R1m or 5%.

87. Submission: We request clarity on this aspect.

Section 9-The prescribed circumstances

88. We note that the voluntary disclosure programme (VDP) is merely referred to in passing, yet a USP exposure plays a central role in accessibility to the VDP relief.

89. Submission: We propose that the draft Guide is expanded to include detailed guidance on USP in relation to the VDP.

Section 10-Interest

90. Whilst we agree that the interest provisions contained in Chapter 12 have not come into effect, the principles around interest and USP are nevertheless established.

91. Submission: We request that the draft Guide provides more detailed guidance on the principles.

Section 11-Objection and appeal

92. Submission: There is a grammatical error on page 24: '***[Excepting]*** *Except for a penalty imposed for an impermissible avoidance arrangement, a penalty may be reduced, or its*

imposition overturned if SARS cannot prove the facts upon which the penalty is based on a balance of probability.'

93. On page 24 the following statements are made:

> *In the event of a penalty for an impermissible avoidance arrangement, the correlation between the assessment and the penalty means that such a penalty stands or falls on the application of the anti-avoidance rules.*[88] *In other words, the only way to successfully object to or appeal against such a penalty is to prove that the arrangement underlying the understated tax did not contravene the anti-avoidance rules.*

94. Submission: We request that the principles are demonstrated at the hand of an example