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Tax · IFRS

Tax Update

Dealing with and managing exposure to understatement penalties: Latest developments

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The sections of the Tax Administration Act (TAA) that are best known to taxpayers and advisors must probably be sections 221 to 223, which deal with understatement penalties. In brief terms, SARS may impose an understatement penalty if the *fiscus* has been prejudiced as a result of the following understatement events: (a) default in rendering a return, (b) an omission from a return or (c) an incorrect statement in a return. An incorrect statement, as contemplated in (c) above, would arise where SARS has a different view on the correct treatment of a transaction or item from that followed by the taxpayer. In my view, this is the most dangerous aspect of the understatement penalty regime for taxpayers who ensure that they submit accurately completed tax returns on time.

A number of amendments have been made to the understatement penalty regime. This newsletter considers a few of these new developments.

Objecting to or appealing against understatement penalties

Section 224 has been amended to clarify that a taxpayer may object to or appeal against the imposition of an understatement penalty. As with any objection or appeal, it is of critical importance to carefully draft the grounds of objection or appeal on a technically correct basis and to specify all grounds of objection that may be relevant, as failure to do so could limit the taxpayer's grounds of argument going forward in the dispute process.

Circumstances under which an understatement penalty may be imposed

As indicated earlier, the TAA requires that the *fiscus* be prejudiced by the understatement event before an understatement penalty may be imposed. This requirement has been clarified to not limit the prejudice to a specific tax period. In other words – as long as SARS can prove that it did not collect the correct amount of tax across all periods, this would give rise to an understatement. The penalty in respect of a specific tax period must however be determined with reference to the shortfall between tax properly chargeable and the tax chargeable if the understatement were accepted for that period. Where an understatement has been imposed and SARS has suffered a loss in tax during any period, it is submitted that objection should be made to the timing (i.e. calculation of the shortfall for a specific period) rather than the fact that a penalty has been imposed.

In addition, section 222 has been amended to state that an understatement penalty must be imposed, "unless the 'understatement' results from a bona fide inadvertent error". This amendment gives taxpayer respite in cases where the understatement was caused by an error of which the taxpayer was not aware, rather than an informed tax risk or position taken. It is submitted that a taxpayer would be in a good position to argue that an understatement arose from a bona fide inadvertent error in an instance where the taxpayer corrects a mistake before that mistake is detected by the Commissioner. It is expected that SARS is likely to consider a statement that an understatement was caused by a bona fide inadvertent error with some degree of critical scepticism.

Calculation of the understatement penalty

A further amendment to section 222 clarifies that the penalty imposed in respect of *each* understatement must be imposed at the highest rate applicable to *that* understatement. In drafting an objection to an understatement penalty, the objection should be done on an understatement-for-understatement basis, rather than the total penalty amount.

It should furthermore be noted that from 16 January 2014 (and therefore arguably in respect of penalties imposed or assessed from this date onwards) some of the penalty rates in the table in section 223 have been reduced.

Remittance of the understatement penalty

A taxpayer should be able to implement measures to prove that it is not guilty of the behaviours listed in items (ii) – (v) of the table in section 223 of the TAA. These include implementing tax related controls, developing a policy of documenting views on the application of tax law, especially transactions that involve contentious issues, and perhaps also making use of tax specialists where necessary.

If you require technical tax or IFRS assistance or an inhouse seminar please feel free to contact Pieter van der Zwan at **083 417 5904** or **pieter@pvdz.co.za** or to visit **www.pvdz.co.za** and submit a request on the relevant page.

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Section 223(3) provides a mechanism for remittance of a penalty arising from the behaviour in item (i) of the table. This includes making full disclosure about the transaction in the relevant returns and obtaining a tax opinion on the matter from a registered tax practitioner. From 16 January 2014, section 223(3) requires that the tax opinion must have been obtained from an *independent* registered tax practitioner for the Commissioner to remit such an understatement penalty. The memorandum on the objects of the amendment bill explains this to mean that opinions, for purposes of section 223(3)(b), may not be prepared by in-house tax practitioners employed by a taxpayer.

Penalties from returns submitted prior to the TAA

Numerous concerns have been raised in respect of the fact that the understatement penalty regime in the TAA also applies to understatements arising from returns submitted before the TAA was effective. As a result of these concerns, certain amendments were made that would affect understatement penalties in respect of such returns. The relevant transitional provisions are found in section 270(6) – (6D) of the TAA.

The first of these amendments relate to the overall application of the new understatement penalty regime. Section 270(6), read with section 270(6A), confirms that an understatement penalty will be imposed if the verification, audit or investigation necessary to determine the additional tax or penalty under the old system had not been completed before 1 October 2012. In other words, where understatements are identified in a verification, audit or investigation that is only completed on or after 1 October 2012, the understatement penalty regime would apply to understatements in pre-1 October 2012 returns.

The second aspect of the amendments relate to the mechanisms that can be used to manage or reduce the understatement penalty. As a taxpayer is, and has always been, required to not evade tax, not act grossly negligently, have reasonable grounds before taking a tax position and act with reasonable care in completing returns, the taxpayer should not be at a disadvantage in respect of these behaviours if the understatement penalty system is applied to a pre-1 October 2012 return. A taxpayer would however not have been able to obtain the tax opinion referred to earlier in respect of such a return as it was not yet aware of this requirement. Section 270(6B) now deems the taxpayer to have obtained such an opinion if the return was submitted before 1 October 2012. The taxpayer will therefore be able to claim remittance of a penalty based on 'substantial understatement' if full disclosure of the transaction was made in a pre-1 October 2012 return.

Lastly, the possible negative effects of the transition from an open-ended discretion under the previous legislation to the structured penalty approach under the current law have been addressed for taxpayers who submitted returns prior to 1 October 2012. Section 270(6D) states that where an understatement penalty is imposed in respect of a return submitted before 1 October 2012, the taxpayer may object to the penalty (irrespective of whether it previously object to it or not). Depending on the type of return, the following must be considered in reducing the penalty:

- ✓ Return submitted under the Income Tax Act: The SARS official must consider extenuating circumstances to remit the penalty partially or in whole (similar to the requirement under s 76 of the Income Tax Act); and
- ✓ Return submitted under the Value Added Tax Act: the SARS official must reduce the penalty in whole if the penalty was imposed under circumstances other than intentional tax evasion.

This effectively means that a taxpayer's objection to an understatement penalty must be considered on the structured grounds of the understatement penalty regime, but also the discretionary grounds that would have applied to reduce the penalties at the time when the return was submitted.

Concluding thoughts

The amendments to the understatement regime are in my view mostly favourable to the taxpayer. Making full use of the opportunities to manage exposure to and dealing with understatement penalties could however become quite a technical matter!

Should your company or firm require assistance in developing a policy to make optimal use of the structured penalty approach to reduce your exposure, obtaining a tax opinion on a matter as contemplated in section 223(3)*(b)* or drafting an objection to understatement penalties impose, you are welcome to contact me to assist.
