

EXPLORING KEY CONSIDERATIONS WHEN DETERMINING BONA FIDE INADVERTENT ERRORS RESULTING IN UNDERSTATEMENTS

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Abstract

Chapter 16 of the Tax Administration Act (28 of 2011) (the TA Act) deals with understatement penalties. In the event of an 'understatement', in terms of Section 222 of the TA Act, a taxpayer must pay an understatement penalty, unless the understatement results from a *bona fide* inadvertent error. The determining of a *bona fide* inadvertent error on taxpayers' returns is a totally new concept in the tax fraternity. It is of utmost importance that this section is applied correctly based on sound evaluation principles and not on professional judgement when determining if the error was indeed the result of a *bona fide* inadvertent error. This research study focuses on exploring key considerations when determining *bona fide* inadvertent errors resulting in understatements. The role and importance of tax penalty provisions is explored and the meaning of the different components in the term '*bona fide* inadvertent error' critically analysed with the purpose to find a possible definition for the term '*bona fide* inadvertent error'. The study also compares the provisions of other tax jurisdictions with regards to errors made resulting in tax understatements in order to find possible guidelines on the application of *bona fide* inadvertent errors as contained in Section 222 of the TA Act. The findings of the research study revealed that the term '*bona fide* inadvertent error' contained in Section 222 of the TA Act should be defined urgently and that guidelines must be provided by SARS on the application of the new amendment. SARS should also clarify the application of a *bona fide* inadvertent error in light of the behaviours contained in Section 223 of the TA Act to avoid any confusion.

Keywords: Bona Fide Inadvertent Error, Tax Administration Act, Tax Administration Laws Amendment Bill, Understatement, Understatement Penalties

1. INTRODUCTION

The Tax Administration Laws Amendment Act (39 of 2013) (the 2013 Amendment Act) was promulgated on 16 January 2014 and one of the fundamental changes, amongst others, to the TA Act was that taxpayers, especially those who complete their tax returns themselves, would not be penalised for *bona fide* mistakes made on submitted tax returns.

The amendments to the understatement penalty provisions contained in Chapter 16 of the TA Act now provide relief to taxpayers in more than one way. Firstly, it executed the announcement that no penalty would be charged if the understatement had resulted from a *bona fide* inadvertent error (National Treasury, 2013a:63). Secondly, it refined the understatement penalty percentages as contained in the table under section 223 of the TA Act. This is in line with the Memorandum on Objects of the Taxation Administration Laws Amendment Bill (2013) (Memorandum) which stated that the new percentages were more in line with comparative tax jurisdictions where largely similar penalty regimes apply (SARS, 2013b:40).

The current area of concern is that there appears to be no specific guidelines and/or guidance from the South African Revenue Service (SARS) regarding the definition and application of the phrase *bona fide* inadvertent error. This could be

attributed to the fact that the provision in the TA Act is still a very new act. What adds to the problem is that, according to the Memorandum, it would be backdated and enforced from 1 October 2012 (SARS, 2013b:40). As stated by the Memorandum, SARS now has the responsibility to develop and implement a set of guidelines and evaluation factors so that the 2013 Amendment Act can be implemented and executed in the most effective and efficient manner (SARS, 2013b:40).

As is evident from above, the problem statement is that no definition or guidelines currently exist on how to classify or treat a *bona fide* inadvertent error for purposes of Section 222 of the TA Act.

The purpose of this study was therefore to explore key considerations as to what should be taken into account by SARS when classifying particular tax understatements as *bona fide* inadvertent errors.

2. RESEARCH METHODOLOGY

A literature review was performed to gain an in-depth understanding of the role and importance of tax penalty provisions in the tax system. Doctrinal research was also carried out to perform a critical analysis on the meaning of the different components in the term '*bona fide* inadvertent error'.

A comparative analysis was also performed between different countries regarding errors being made when dealing with understatements. Australia, New Zealand and the United Kingdom were used due to the fact that they are part of the Organization for Economic Cooperation and Development (OECD) English speaking countries. The levying of understatement (shortfall) penalties has already been successfully rolled out and implemented by the above-mentioned countries. The levying of understatement penalties in all of these countries is comparable to the legislative framework brought about by the TA Act. The penalty procedures of these countries also specifically provide for greater fairness in penalty percentages as compared to the maximum 200 per cent penalty that could have been levied in terms of Section 76 of the Income Tax Act (58 of 1962) (Feuth, 2013:49).

3. INTERPRETATION

When fiscal legislation is considered, one of the cornerstones on which revenue authorities can determine and receive taxes is interpretation. This will also be the starting point on which a taxpayer will build his or her rights (Goldswain, 2008:107). When interpreting fiscal legislation, the key rule is to apply the normal grammatical meaning to words (R Koster & Son (Pty) Ltd & Another, 1985; Goldswain, 2008:111).

This key rule, however, may be deviated from if the normal grammatical meaning will result in uncertainty or absurdity, in which case the court must establish the "intention of the legislature" (Glen Anil Development Corporation Ltd v SIR, 1975; Goldswain, 2008:112).

Due to the fact that the term '*bona fide* inadvertent error' has not been defined by SARS, the normal grammatical meaning will be explored in this study.

4. LITERATURE REVIEW

What motivates taxpayers to comply with tax laws? Is it the fear of being penalised when not complying or is it personal and social morals that drive taxpayers to comply? How harsh should tax penalties be in order to maximise compliance to tax laws? And under which circumstances would taxpayers choose not to comply?

The starting point is to gain an understanding of the provisions of Section 222 in the TA Act, as amended in 2013, and specifically the definition and meaning of a *bona fide* inadvertent error in order to ascertain the role and importance of tax penalty provisions in the tax system.

5. VIEWS ON THE ROLE AND IMPORTANCE OF TAX PENALTIES

In the Strategic Plan of 2013/2014 - 2017/2018 SARS established four core outcomes, increased tax compliance being one of them. SARS states that it operates on the basis of voluntary compliance and a ground rule is that balance must exist between education, service and enforcement. Enforcement is a critical component to establish objective and fair treatment of all taxpayers and to simplify the process for all taxpayers willing to comply

voluntarily (SARS, 2013a:42). The aspiration of SARS "to consistently increase voluntary compliance across a broader taxpayer base through targeted and informed outreach, superior service and enforcement interventions" will be accomplished by a couple of initiatives. One such initiative already implemented is the SARS Compliance Programme which contain strategies to systematically improve compliance over a multi-year period (SARS, 2013a:42).

5.1. Voluntary compliance

Compliance with all tax laws by taxpayers will ensure an effective tax system. Tax penalties and appropriate guidelines, therefore, should be in place to encourage amongst taxpayers a habit of compliance. Tax penalty provisions should be crafted and administered in such a way that it will ensure that tax penalties discourage bad practice without discouraging good practice or taking punitive measures against innocent taxpayers. Clearly defined penalties that will correspond to certain standards of behaviour and will be fairly administered encourage voluntary compliance to tax laws. The other side of the coin will be that unreasonable, vaguely defined penalties will result in a negative paradigm where taxpayers will feel being treated unfairly and might undermine voluntary compliance. This can specifically be the case where there are no safeguards built into the provisions or where the tax system automatically imposes tax penalties (AICPA, 2013:1).

The main aim for the provisions of tax penalties is therefore voluntary compliance and all the measures taken should be taken to the accomplishment of this as penalties are a vital part of tax administration.

In America, Congress enacted comprehensive penalty reform legislation in 1989. The Subcommittee on Oversight made the following statements regarding penalties:

- The purpose of tax penalties should be to encourage voluntary compliance with tax laws.
- The main purpose of tax penalties should not be the raising of revenue.
- Tax penalties and the required standard of behaviour should be clear and easily understood by all taxpayers.
- Tax penalties should only be targeted toward culpable conduct by taxpayers.
- Multiple tax penalties should not apply to the same misconduct.
- Tax penalties should be proportionate to the degree of misconduct.
- Tax penalties should not treat taxpayers who make an honest effort to comply as harshly as those taxpayers who deliberately violate the tax laws (AICPA, 2009:3).

Administrative procedures for imposing tax penalties should ensure that all taxpayers are treated in a fair and reasonable manner (AICPA, 2009:3).

Doran (2009:131-133) also refers to the norms model where taxpayers comply with tax laws through adherence to personal as well as social standards. This model accepts that there will be non-compliant taxpayers, and therefore acknowledge that tax penalties remain imperative to punish those

taxpayers in order to prevent tax compliance from weakening. Too much dependence on tax penalties, on the other hand, might have a negative impact on norms and therefore a fine balance should exist.

The same approach should be taken when drafting South African penalty legislation to ensure voluntary compliance to the South African tax laws by all taxpayers.

5.2. Audit lottery

Another view on the role that tax penalties play in the tax system is that taxpayers are expected to violate tax laws if the benefits gained from the violation of the law will exceed the expected punishment and by that playing the so-called "audit lottery" (Keinan, 2006:388). If taxpayers only comply with tax laws when the punishment of non-compliance exceeds the benefits gained from not complying, the accurate crafting and administering of the tax penalty provisions are crucial.

Robert Cooter, the Herman F. Selvin Professor of Law at the University of California, Berkeley, School of Law and a pioneer in the field of law and economics refers to Justice Holmes's "bad man" theory in the context of economic analysis of deterrence and explains that a rational bad man will decide to break the law when his own benefit will be greater than the risk of being punished. For the "bad man" the law is outside of his personal values (Cooter, 2000:1591).

Another important aspect to consider is the fact that penalties should not be too harsh or disproportionate, because this might discourage economic activity. Only tax-motivated transactions without economic substance need to be reduced (Keinan, 2006:397). The balance should therefore be found between rigid penalties to deter non-compliance, but at the same time avoiding over-deterrence.

With this in mind, it is important to consider whether the amendments to Sections 222 and 223 of the TA Act, specifically the inclusion of the term '*bona fide* inadvertent error', will be successful in finding the balance between voluntary compliance on the one side, and preventing the benefits from non-compliance to exceed the punishment on the other.

6. UNDERSTATEMENT PENALTY UNDER SECTIONS 222 AND 223 OF THE TA ACT

Under the previous Section 76 of the IT Act (58 of 1962) and Section 60 of the VAT Act (89 of 1991), additional tax and penalties were charged to taxpayers, but too much discretion were given to SARS officials. No rules or guidelines stipulated how the Commissioner should exercise his powers. Previously under Section 76 a taxpayer had to prove the existence of mitigating conditions and motivate the downward remission from the 200% maximum penalty percentage, which turned into somewhat of a lottery for taxpayers as well as advisers (Hofmeyr, 2011:1).

The introduction of an understatement penalty contained in Chapter 16 of the TA Act seeks to rectify some of these shortcomings. According to the TA Act 'understatement' means any prejudice to SARS or the *fiscus* as a result of

- (a) a default in rendering a return;
- (b) an omission from a return;
- (c) an incorrect statement in a return; or
- (d) if no return is required, the failure to pay the correct amount of 'tax'.

The provisions in the TA Act on understatement penalties will hopefully result in more transparency, objectivity and predictability. In terms of the TA Act, the onus to prove the grounds for the charging of an understatement penalty and the applicable percentage will now be on SARS, and the imposition of an understatement penalty will be subject to the normal objection, appeal and dispute resolution procedures (Hofmeyr, 2011:1).

6.1. Sections 222 and 223 of the ta Act before the amendment in the 2013

6.1.1. Amendment act

Before the amendment in 2013, Sections 222 and 223 of the TA Act read as follows:

222. (1) In the event of an 'understatement' by a taxpayer, the taxpayer must pay, in addition to the 'tax' payable for the relevant tax period, the understatement penalty determined under subsection (2).

(2) The understatement penalty is the amount resulting from applying the highest applicable understatement penalty percentage in accordance with the table in section 223 to the shortfall determined under subsections (3) and (4).

(3) The shortfall is the sum of

(a) the difference between the amount of 'tax' properly chargeable for the tax period and the amount of 'tax' that would have been chargeable if the 'understatement' were accepted;

(b) the difference between the amount properly refundable for the tax period and the amount that would have been refundable if the 'understatement' were accepted; and

(c) the difference between the amount of an assessed loss or any other benefit to the taxpayer properly carried forward from the tax period to a succeeding tax period and the amount that would have been carried forward if the 'understatement' were accepted, multiplied by the tax rate determined under subsection (5).

(4) If an 'understatement' results in a difference under both paragraphs (a) and (b) of subsection (3), the shortfall must be reduced by the amount of any duplication between the paragraphs.

(5) The tax rate is the maximum tax rate applicable to the taxpayer, ignoring an assessed loss or any other benefit brought forward from a preceding tax period to the tax period.

223. *Understatement penalty percentage.*

(1) The understatement penalty percentage table is shown below.

(2) An understatement penalty for which provision is made under this Chapter is also chargeable in cases where

(a) an assessment based on an estimation under section 95 is made; or

(b) an assessment agreed upon with the taxpayer under section 95 (3) is issued.

(3) SARS must remit a 'penalty' imposed for a 'substantial understatement' if SARS is satisfied that the taxpayer

(a) made full disclosure of the arrangement, as defined in section 34, that gave rise to the prejudice to SARS or the fiscus by no later than the date that the relevant return was due; and

(b) was in possession of an opinion by a registered tax practitioner that

(i) was issued by no later than the date that the relevant return was due;

(ii) took account of the specific facts and circumstances of the arrangement; and

(iii) confirmed that the taxpayer's position is more likely than not to be upheld if the matter proceeds to court.

Table 1. The understatement penalty percentage

| Item | Behaviour | Standard case | If obstructive, or if it is a 'repeat case' | Voluntary disclosure after notification of audit or investigation | Voluntary disclosure before notification of audit or investigation |
|-------|--|---------------|---|---|--|
| (i) | 'Substantial understatement' | 25% | 50% | 5% | 0% |
| (ii) | Reasonable care not taken in completing return | 50% | 75% | 25% | 0% |
| (iii) | No reasonable grounds for 'tax position' taken | 75% | 100% | 35% | 0% |
| (iv) | Gross negligence | 100% | 125% | 50% | 5% |
| (v) | Intentional tax evasion | 150% | 200% | 75% | 10% |

6.2. Sections 222 and 223 of the ta Act after the amendment in the 2013

6.2.1. Amendment Act

After the amendment in 2013, Sections 222 and 223 of the TA Act read as follows:

222. (1) In the event of an 'understatement' by a taxpayer, the taxpayer must pay, in addition to the 'tax' payable for the relevant tax period, the understatement penalty determined under subsection (2) unless the 'understatement' results from a *bona fide* inadvertent error.

(2) The understatement penalty is the amount resulting from applying the highest applicable understatement penalty percentage in accordance with the table in section 223 to each shortfall determined under subsections (3) and (4) in relation to each understatement in a return.

(3) The shortfall is the sum of

(a) the difference between the amount of 'tax' properly chargeable for the tax period and the amount of 'tax' that would have been chargeable for the tax period if the 'understatement' were accepted;

(b) the difference between the amount properly refundable for the tax period and the amount that would have been refundable if the 'understatement' were accepted; and

(c) the difference between the amount of an assessed loss or any other benefit to the taxpayer properly carried forward from the tax period to a succeeding tax period and the amount that would have been carried forward if the 'understatement' were accepted, multiplied by the tax rate determined under subsection (5).

(4) If there is a difference under both paragraphs (a) and (b) of subsection (3), the shortfall must be reduced by the amount of any duplication between the paragraphs.

(5) The tax rate applicable to the shortfall determined under subsections (3) and (4) is the maximum tax rate applicable to the taxpayer, ignoring an assessed loss or any other benefit brought forward from a preceding tax period to the tax period.

223. *Understatement penalty percentage table.*

(1) The understatement penalty percentage table is shown below.

Table 2. The understatement penalty percentage

| Item | Behaviour | Standard case | If obstructive, or if it is a 'repeat case' | Voluntary disclosure after notification of audit or investigation | Voluntary disclosure before notification of audit or investigation |
|-------|--|---------------|---|---|--|
| (i) | 'Substantial understatement' | 10% | 20% | 5% | 0% |
| (ii) | Reasonable care not taken in completing return | 25% | 50% | 15% | 0% |
| (iii) | No reasonable grounds for 'tax position' taken | 50% | 75% | 25% | 0% |
| (iv) | Gross negligence | 100% | 125% | 50% | 5% |
| (v) | Intentional tax evasion | 150% | 200% | 75% | 10% |

(2) An understatement penalty for which provision is made under this Chapter is also chargeable in cases where

(a) an assessment based on an estimation under section 95 is made; or

(b) an assessment agreed upon with the taxpayer under section 95 (3) is issued.

(3) SARS must remit a 'penalty' imposed for a 'substantial understatement' if SARS is satisfied that the taxpayer

(a) made full disclosure of the arrangement, as defined in section 34, that gave rise to the prejudice

to SARS or the fiscus by no later than the date that the relevant return was due; and

(b) was in possession of an opinion by an independent registered tax practitioner that

(i) was issued by no later than the date that the relevant return was due;

(ii) was based upon full disclosure of the specific facts and circumstances of the arrangement and, in the case of any opinion regarding the applicability of the substance over form doctrine or the anti-avoidance provisions of a tax Act, this requirement cannot be met unless the taxpayer is

able to demonstrate that all of the steps in or parts of the arrangement were fully disclosed to the tax practitioner, whether or not the taxpayer was a direct party to the steps or parts in question; and

(iii) confirmed that the taxpayer's position is more likely than not to be upheld if the matter proceeds to court.

6.3. Reason for inclusion of the term 'bona fide inadvertent error'

Considering the above, the main differences between Sections 222 and 223 before and after the amendments in the 2013 Amendment Act are as follows:

- After the amendment in the 2013 Amendment Act a taxpayer will not pay an understatement penalty if the understatement results from a *bona fide* inadvertent error.
- The understatement penalty will be applied to each shortfall (instead of 'the' shortfall before the amendment) in relation to each understatement. If a return contains more than one understatement, the relevant behaviour in respect of each understatement must be determined individually.
- The percentages in the penalty percentage table contained in Section 223 of the TA Act were updated.

The amendments to the understatement penalty provisions contained in Sections 222 and 223 of Chapter 16 of the TA Act therefore provide relief to taxpayers in that it executed the announcement that no penalty would be charged if the understatement had resulted from a *bona fide* inadvertent error (National Treasury, 2013a:63). It appears that this amendment will encourage voluntary compliance with tax laws because taxpayers will feel that only culpable conduct will be punished and that all taxpayers will be treated in a fair and reasonable manner, which are two very important objectives according to the AICPA report in order to increase voluntary compliance to tax laws (AICPA, 2009:3).

The importance of the responsibility of SARS to provide guidelines when determining whether an understatement will be classified as a *bona fide* inadvertent error is also highlighted when the view is considered that taxpayers might only comply with tax laws when the cost of punishment exceeds the benefits of not complying. If any possibility exists that an understatement can wrongly be classified as a *bona fide* inadvertent error, the risk of being punished will decrease and this will have a definite impact on compliance with tax laws.

Due to the fact that the term '*bona fide* inadvertent error' has not yet been defined by SARS, the next step was to critically analyse the meaning of the different components in the term '*bona fide* inadvertent error'.

7. DICTIONARY DEFINITIONS OF THE COMPONENTS IN THE TERM 'BONA FIDE INADVERTENT ERROR'

7.1. Introduction

As mentioned, the key rule when interpreting fiscal legislation is to apply the normal grammatical meaning to words (R Koster & Son (Pty) Ltd & Another, 1985; Goldswain, 2008:111). The normal

grammatical meaning will be explored next. The following dictionaries will be used: Black's Law Dictionary, Burton's Legal Thesaurus, The Merriam-Webster Dictionary, The Oxford Dictionary and The West's Encyclopaedia of American Law.

7.2. Bona fide

According to the West's Encyclopaedia of American Law the term '*bona fide*' is a Latin term and means "in good faith; honest; genuine; actual; authentic; acting without the intention of defrauding".

The Oxford Dictionary states that the origin is Latin, and literally means "with good faith". The term is also defined as "genuine; real; without intention to deceive".

Black's Law Dictionary defines '*bona fide*' as "in or with good faith; honestly, openly, and sincerely; without deceit or fraud. Truly; actually; without simulation or pretence. Innocently; in the attitude of trust and confidence; without notice of fraud".

7.3. Inadvertent

Burton's Legal Thesaurus defines 'inadvertent' as "accidental, blind, careless, disregarding, heedless, imprudent, inattentive, neglectful, negligent, oblivious, regardless, thoughtless, undersigned, undiscerning, unheeding, unheeding, unintended, unmean, unmindful, unnoticing, unobservant, unpremeditated, unseeing, unthinking". It also states that associated concepts are "neglect, negligence".

The Oxford Dictionary defines 'inadvertent' as "not resulting from or achieved through deliberate planning". It also gives the following synonyms: "unintentional, unintended, accidental, unpremeditated, unplanned, unmean, innocent, uncalculated, unconscious, unthinking, unwitting, involuntary, chance, coincidental, careless, thoughtless".

According to the Merriam-Webster dictionary 'inadvertent' means "not intended or planned". Synonyms given are: "casual, chance, fluky, fortuitous, accidental, incidental, unintended, unintentional, unplanned, unpremeditated, unwitting".

7.4. Error

Burton's Legal Thesaurus defines 'error' as "aberrance, aberrancy, aberration, delusion, deviation, distorted conception, erratum, erroneous statement, error, false conception, false impression, fault, flaw, inaccuracy, incorrect belief, injustice, lapse, malapropism, misbelief, miscarriage of justice, miscomputation, misconception, misconjecture, miscount, misguidance, misinterpretation, misjudgement, misprint, misreckoning, misstatement, mistaken belief, mistaken judgment, mistranslation, misunderstanding, misuse of words, oversight, peccatum, poor judgment, slip, untruthfulness, wrong course, wrong impression, wrongness".

The Oxford Dictionary defines 'error' as "a mistake". It also gives the following synonyms: "The state or condition of being wrong in conduct or judgement".

Black's Law Dictionary defines 'error' as "a mistaken judgment or incorrect belief as to the existence or effect of matters of fact, or a false or mistaken conception or application of the law".

From the research evidence, it can be concluded that the grammatical definition of a *bona fide* inadvertent error in the context of Section 222 of the TA Act is the innocent misstatement of a taxpayer on his return that led to an understatement, while the taxpayer acted in good faith and without the intention to deceive.

An area of concern will be the definition linked to the word 'inadvertent'. As seen from the Burton's Legal Thesaurus, included in the definition are the following words: "blind, careless, disregarding, heedless, imprudent, inattentive, neglectful, negligent, oblivious, regardless, thoughtless, undersigned, undiscerning, unheeding, unheeding, unmindful, unnoticing, unobservant, unseeing, unthinking." It also states that associated concepts are "neglect, negligence".

The synonyms given by the Oxford dictionary of "careless, thoughtless" also raise concern. Is it SARS' intention to include negligent behaviour under the definition of a *bona fide* inadvertent error? This might result in taxpayers, making errors on their tax returns due to careless, negligent behaviour, not paying any tax penalties when such errors are classified as *bona fide* inadvertent errors.

Also, as seen in Section 223 of the TA Act above, one of the behaviours is "reasonable care not taken in completing return" and another is "gross negligence". How will the definition and application of a *bona fide* inadvertent error fit into the tax penalty system without creating confusion when looking at the behaviours of Section 223 of the TA Act? For example, if an honest mistake was made by a taxpayer but the taxpayer did not take reasonable care and the mistake leads to an understatement, will the understatement be classified as a *bona fide* inadvertent error and not be penalised, or will the understatement be penalised under Section 223 of the TA Act?

8. COMPARATIVE ANALYSIS

A comparison was drawn between the tax penalty provisions contained in Sections 222 and 223 of the TA Act and the tax penalty provisions in Australia, New Zealand and the United Kingdom in order to find a possible definition and guidelines on the application of *bona fide* inadvertent errors as contained in Section 222 of the TA Act. These tax jurisdictions are used as they are part of the OECD English speaking countries. Another reason is the fact that the measures regarding penalty provisions of all these countries are comparable to the understatement penalty provisions contained in the TA Act (28 of 2011) (Feuth, 2013:49).

8.1. Australian penalty provisions relating to errors

Practice Statement Law Administration 2012/5 (PSLA 2012/5) explains under which conditions a taxpayer will be liable for a tax penalty in making a false or misleading statement which results in an understatement and how the tax penalty will be assessed (ATO, 2012:1).

PSLA 2012/5 states that, in terms of Subsection 284-75 of the Australian Taxation Administration Act (1 of 1953) (the AU TAA), a taxpayer is liable to an administrative penalty if:

- The taxpayer or his agent makes a statement to the Commissioner or another entity applying powers or performing duties under a taxation law which results in a shortfall amount, and

- The statement is misleading or false in a significant particular, whether because of things included in it or excluded from it.

A taxpayer is also liable to an administrative penalty if:

- The taxpayer or his agent makes a statement to an entity other than the Commissioner and an entity applying powers or performing duties under a taxation law which results in a shortfall amount, and

- The statement is, or has the intention to be, one required by a taxation law, and

- The statement is misleading or false in a significant particular, whether because of things included in it or excluded from it (ATO, 2012:5).

PSLA 2012/5 further explains that subsection 284-75 of the AU TAA contains three exceptions to a shortfall penalty which will avoid or decrease liability for statements made on or after 4 June 2010, namely:

- The taxpayer and his agent (if relevant), took reasonable care in connection with making the statement

- 'safe harbour' applies to the statement, or

- The taxpayer and his agent (if relevant), applied the law in an accepted way (ATO, 2012:8).

No penalty will therefore be charged if a taxpayer and its agent (if relevant) took reasonable care when making the statement as referred to above. The definition of the term 'reasonable care' is explained in Miscellaneous Taxation Ruling MT 2008/1: Penalty relating to statements: meaning of reasonable care, recklessness and intentional disregard (MT 2008/1) as making "a reasonable and genuine attempt to comply with obligations imposed under a taxation law" (ATO, 2008:8). It also states that a false or misleading statement does not automatically mean that reasonable care was not taken. Assessing whether reasonable care was taken, the personal circumstances of the taxpayer, level of skill and experience as well as the taxpayer's knowledge of tax laws must be taken into account and the evidence gathered must support the finding that reasonable care had not been taken. In determining whether reasonable care was taken, it should be considered what the taxpayer was supposed to do or not supposed to do in order to mitigate the risk of making a mistake. When dealing with transactions with large amounts, it would be expected that a higher degree of care will be exercised when making a statement (ATO, 2008:11-12, 29).

A genuine attempt means that a taxpayer indicates that he is dedicated by actively striving to comply with his tax obligations. An important criterion to determine whether a taxpayer is making a genuine attempt to comply is whether the taxpayer is making reasonable attempts to mitigate risks associated with his tax obligations and demonstrates this approach when submitting a tax return (ATO, 2012:9).

The following must be taken into account when considering the personal circumstances of the taxpayer to determine whether reasonable care was taken:

- Whether there was an inadvertent error such as an arithmetical error or an overlooked document.
- Whether realistic and sound enquiries were made, which may be indicated by whether:
 - The taxpayer just concluded the handling of the transaction was correct and signed a document without examining the content.
 - The degree of the enquiry carried out by the taxpayer was appropriate in relation to the risk associated with the decision and his resources, or
 - The effort and consideration was appropriate in relation to the size of the transaction.
- Whether the taxpayer was aware, or should have been aware, of the accurate treatment of the tax law.
 - A taxpayer should not put reliance on advice given where a reasonable person would be expected to know that the advice is not trustworthy.
 - A taxpayer is not compelled or allowed to just accept assurance by his or her professional advisor.
- Whether it was a new, uncommon or exceptional transaction – such transactions should have proportionally higher levels of care related to them.
- Whether reasonable efforts were made to keep records and to implement processes and systems, including staff-training.
- Whether anything hindered the taxpayer from reporting, reporting correctly, obtaining advice or understanding the requirements of the tax law, and
- The taxpayer's level of knowledge or understanding of the tax system, with reference to:
 - Whether a registered agent was used.
 - The taxpayer's level of education, knowledge and tax expertise, and
 - The taxpayer's age, health and background (ATO, 2012:9).

8.2. New Zealand penalty provisions relating to errors

Understatements (or tax shortfalls) are dealt with in Section 141 of the New Zealand Taxation Administration Act (166 of 1994) (the NZ TAA). The specific sections of interest regarding a *bona fide* inadvertent error are Sections 141A(1), 141A(3) and 141A(4) as well as Sections 141B(1) and 141B(1B).

The relevant sections of the NZ TAA (166 of 1994) read as follows:

141A(1) A taxpayer is liable to pay a shortfall penalty if the taxpayer does not take reasonable care in taking a taxpayer's tax position (referred to as not taking reasonable care) and the taking of that tax position by that taxpayer results in a tax shortfall.

141A(3) A taxpayer who takes an acceptable tax position is also a taxpayer who has taken reasonable care in taking the taxpayer's tax position.

141A(4) Subsection (3) and section 141B(1B) do not exclude a taxpayer who makes a mistake in the calculation or recording of numbers in a return from being liable for a penalty for not taking reasonable care.

141B(1) A taxpayer takes an unacceptable tax position if, viewed objectively, the tax position fails

to meet the standard of being about as likely as not to be correct.

141B(1B) A taxpayer does not take an unacceptable tax position merely by making a mistake in the calculation or recording of numbers used in, or for use in preparing, a return.

Tax Information Bulletins (TIBs) are issued by the New Zealand Inland Revenue (NZIR) and contain details and particulars regarding changes to legislation related to tax, proposed legislation, judgments, rulings and other specialist tax topics. TIB Vol 15, No 5 explains the intention of Sections 141A(4) and 141B(1B) as follows: "... Sections 141A(4) and 141B(1B) clarify that a taxpayer has not taken an unacceptable tax position if a tax shortfall is the result of a calculation mistake or by mis-recording numbers in a return. It was never intended that the unacceptable tax position penalty apply to calculation or processing mistakes. Rather, this penalty applies when a tax shortfall arises because a tax position is not as likely as not to be correct, whether or not the taxpayer actually interpreted the law. If a mistake is of such a magnitude that the mistake breaches the reasonable care standard, that shortfall penalty applies" (IR, 2003:49).

Interpretation Statement (IS0055) of the NZIR clarifies that the relevant definition of a mistake for purposes of Section 141B(1B) is "something that is not correct" and the intention of the legislature is not to include "error of judgment" in this definition as an error of judgment that will lead to an understatement was in effect a tax position taken by choice. Where amounts have been transposed by mistake, the mistake was not intentional and not an error of judgment, the taxpayer will not be considered to have taken an unacceptable tax position. The taxpayer might still be liable for the penalty, however, for not taking reasonable care (IR, 2005:34-35).

The NZIR states that a tax statement is not required to be free from any mistake or error, but it will consider whether the same care was taken which is expected from a reasonable person under the same circumstances. An arithmetical error does not in all circumstances indicate that reasonable care was not taken. The following factors will be considered to determine whether reasonable care was taken by the taxpayer (IR, 2008:1):

- the difficulty of the transaction and the law, and the complexity of interpreting the law
- the amount and severity of the tax shortfall
- the complexity and cost to prevent a shortfall from occurring
- taxpayer's age, background and health condition

Other factors to consider for a taxpayer operating a business:

1. The nature and size of the business.
2. Internal controls implemented in the business.
3. How the business operates the record-keeping.
4. What happens in case of failure of the system, and the reason for the failure (IR, 2008:1).

8.3. United Kingdom penalty provisions relating to errors

Schedule 24 to the Finance Act 2007 introduced a single penalty regime for errors in documents. Schedule 40 of the Finance Act 2008 extended the list of taxes and duties to which Schedule 24 applies. For purposes of this study, the focus will be on Schedule 24, which reads as follows:

1. (1) A penalty is payable by a person (P) where
 - (a) P gives HMRC a document of a kind (listed in schedule 24), and
 - (b) Conditions 1 and 2 are satisfied.
- (2) Condition 1 is that the document contains an inaccuracy which amounts to, or leads to
 - (a) an understatement of a liability to tax,
 - (b) a false or inflated statement of a loss, or
 - (c) a false or inflated claim to repayment of tax.
- (3) Condition 2 is that the inaccuracy was careless (within the meaning of paragraph 3) or deliberate on P's part.
- (4) Where a document contains more than one inaccuracy, a penalty is payable for each inaccuracy.
3. (1) For the purposes of a penalty under paragraph 1, inaccuracy in a document given by P to HMRC is—
 - (a) "careless" if the inaccuracy is due to failure by P to take reasonable care,
 - (b) "deliberate but not concealed" if the inaccuracy is deliberate on P's part but P does not make arrangements to conceal it, and
 - (c) "deliberate and concealed" if the inaccuracy is deliberate on P's part and P makes arrangements to conceal it (for example, by submitting false evidence in support of an inaccurate figure).

Her Majesty Revenue & Customs (HMRC) provides technical as well as operational guidance to taxpayers on how to apply and understand the penalty provisions. This is done in a form of a manual called the Compliance Handbook (CH).

CH81120 states that HMRC will consider each taxpayer's circumstances and ability in order to determine whether reasonable care was taken. Not the same level of competence and understanding will be expected from a self-employed individual as from a multinational company (HMRC, 2014a:1).

CH81130 goes further to state that no penalty will be charged to a taxpayer where an inaccuracy has been made despite the taxpayer having taken reasonable care to submit a correct return. One of the examples when a penalty will not be charged is "an arithmetical or transposition inaccuracy that is not so large either in absolute terms or relative to overall liability, as to produce an obviously odd result or be picked up by a quality check" (HMRC, 2014b:1).

A taxpayer will take reasonable care if:

- Policies and processes with specific reference to tax areas are in place that are expected to produce an accurate foundation for the calculation of tax liability, and
- Notwithstanding the above, inaccuracies arise through the accounting system of the taxpayer that leads to a misstatement of tax due, and
- The results of the inaccuracies are not material in relation to the taxpayer's overall tax liability (HMRC, 2014b:1).

8.4. Comparing South Africa to other tax jurisdictions

Considering the above information, it is clear from all three tax jurisdictions that a lot of emphasis is placed on whether the taxpayer took reasonable care concerning his tax affairs when determining whether an error will be subject to a shortfall penalty. In Australia it is evident from the PSLA 2012/5 that an inadvertent error does not mean that reasonable care was not taken. The personal circumstances of the taxpayer, level of skill and experience as well as the taxpayer's knowledge of tax laws must be taken into account.

The NZIR states that a tax statement is not required to be free from any mistake or error, but it will consider whether the same care was taken which is expected from a reasonable person under the same circumstances. An arithmetical error does not in all circumstances indicate that reasonable care was not taken. Again the personal circumstances of the taxpayer will be taken into account.

In the United Kingdom, CH81130 states that no penalty will be charged to a taxpayer where an inaccuracy has been made despite the taxpayer having taken reasonable care to submit a correct return.

When looking at the term '*bona fide* inadvertent error' contained in Section 222 of the TA Act, SARS should consider explaining in which circumstances an error will not lead to a shortfall penalty and in which circumstances an error will lead to a shortfall penalty. It should be taken into account whether the taxpayer took reasonable care when calculating his tax liability.

9. RECOMMENDATIONS

In order to address certain challenges that were identified in Section 222 and 223 of the TA Act, the following recommendations are put forward:

- It is imperative that the term '*bona fide* inadvertent error' contained in Section 222 of the TA Act will be defined urgently and that guidelines are provided to ensure an effective and efficient administration process and to prevent taxpayers trying to argue an understatement into being classified as a *bona fide* inadvertent error, even if it is not. The definition and guidelines should be simple and straightforward for the reasonable taxpayer to understand.

- SARS should also shed some light on what exactly is meant by the word 'inadvertent'. Is it SARS' intention to also include negligent behaviour under the definition of a *bona fide* inadvertent error?

- SARS should clarify whether an error of judgment will be considered a *bona fide* inadvertent error for purposes of Section 222 of the TA Act.

- SARS need to clarify whether a mistake, e.g. an arithmetical error made in a tax return, leading to a substantial understatement will be classified as a *bona fide* inadvertent error under Section 222 of the TA Act and consequently no penalty will apply, or whether it will fall under Section 223 of the TA Act in which case the taxpayer can be liable for an understatement penalty.

• SARS should clarify how a mistake or error will be dealt with when the taxpayer did not take reasonable care.

10. CONCLUSION

The amendment to the understatement penalty provisions contained in Section 222 of the TA Act that has the effect that no penalty will be charged if the understatement results from a *bona fide* inadvertent error are welcomed by taxpayers and will increase the fairness of the tax system. The 2013 Amendment Act is still a very new act and currently there are no guidelines regarding the definition and application of the term '*bona fide* inadvertent error'.

The focus of this study was to explore key considerations as to what should be taken into account by SARS when classifying particular tax understatements as *bona fide* inadvertent errors. It was found that the term '*bona fide* inadvertent error' contained in Section 222 of the TA Act should be defined urgently and that guidelines must be provided by SARS on the application of the new amendment to increase voluntary compliance. SARS should ensure that the expected gain from non-compliance to the new amendment do not exceed the cost of being punished.

A consideration to take into account might be to exclude the word 'inadvertent' from the term '*bona fide* inadvertent error' in order to avoid confusion. An error of judgement is another consideration SARS should take into account when defining the term '*bona fide* inadvertent error'. The correct definition and application will be imperative to ensure taxpayers will not try to argue an understatement into being a *bona fide* inadvertent error when in fact it is not.

SARS should also clarify the application of a *bona fide* inadvertent error in light of the behaviours contained in Section 223 of the TA Act to avoid any confusion. For example, how will an understatement be treated when the understatement was the result of a mistake, but the mistake was made due to the fact that the taxpayer did not take reasonable care when submitting the tax return? SARS should consider the personal circumstances of the taxpayer to determine whether reasonable care was taken by the taxpayer. Factors like the level of skill and experience, the taxpayer's knowledge of tax laws, age and health conditions of the taxpayer should be taken into account.

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