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TAX ALERT

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UNDERSTATEMENT PENALTY: WHAT DOES "REASONABLE CARE NOT TAKEN IN COMPLETING RETURN" ACTUALLY MEAN?

The Tax Administration Act, No 28 of 2011 (TAA) introduces the 'understatement penalty' in Chapter 16.

Section 223 contains an 'understatement penalty percentage table'. According to the SARS Short Guide on the TAA (Guide) the penalty will be determined by placing each case within the table which assigns a percentage by objective criteria. SARS carries the onus of proving that the grounds exist for imposing the understatement penalty.

One of the 'behaviours' contained in the TAA s223(1) table refers to "Reasonable care not taken in completing return." The Guide (at par 16.5.3) gives limited content to what exactly SARS expects of a taxpayer. It merely states that "reasonable care means that a taxpayer is required to take the degree of care that a reasonable, ordinary person in the circumstances of the taxpayer would take to fulfil his or her tax obligations." Furthermore, "the reasonable care standard does not mean perfection, but refers to the effort required commensurate with the reasonable person in the taxpayer's circumstances." This merely restates the well-known 'man on the Clapham bus' test.

Many South African tax cases have referred to the taxpayer's obligation to submit honest and accurate tax returns. Melamet J in *ITC 1331 43 SATC 76* held (with reference to the repealed 200% penalty): "The prescribed penalty is heavy – twice the difference between the tax charged and that which should have been charged – but it is so by design to ensure honest and accurate returns by taxpayers." (See also *CIR v De Ciccio 47 SATC 199*.)

But how much effort should actually go into the completion of a tax return before a taxpayer can be said to have met the 'reasonable care' yardstick?

SA taxpayers should perhaps consider the Australian Tax Office's (ATO) guidance in Miscellaneous Tax Ruling (MT 2008/1). This deals extensively with the meaning of "reasonable care, recklessness and intentional disregard." For this article we shall confine the discussion to the meaning of 'reasonable care' as set out in MT 2008/1.

Similar to the position in SA, the concept of 'reasonable care' has not been defined by the ATO. Hence, it takes its ordinary meaning.

The ATO points out that taking 'reasonable care' in the context of making a statement to the Commissioner means giving appropriately serious attention to complying with the obligations imposed under a taxation law. Reasonable care thus requires of a taxpayer to take the same care in fulfilling his tax obligations that could be expected of a reasonable ordinary person in the same position.

Although the standard of care is measured objectively, it takes into account the circumstances of the taxpayer. The effort required is one commensurate with all the taxpayer's circumstances, including the taxpayer's knowledge, education, experience and skill. The question is whether a reasonable person of ordinary prudence in the same circumstances would have exercised greater care, or not?

continued

IN THIS ISSUE

- **Understatement penalty: What does "reasonable care not taken in completing return" actually mean?**
- **Paying SARS by cheque**

There is no 'one size fits all' standard of 'reasonable care'. A professional person with specialist tax knowledge will be subject to a higher standard of care reflecting the level of knowledge and experience that a reasonable person in such circumstances would possess. The objective standard of reasonableness that applies is commensurately lower for a new entrant to the tax system who has little tax knowledge or experience in interacting with the tax system. This ensures that a person's behaviour is only penalised if it fails to measure up to the standard of a reasonable person with the same level of knowledge and experience.

The ATO emphasises that the fact that the person has tried to act with reasonable care is not the test. The issue is whether, on an objective analysis, reasonable care has been shown. It consequently follows that, because an objective test applies to determine whether reasonable care has been taken in making a statement to the Commissioner, the actual intention of the taxpayer is irrelevant.

According to the ATO, 'reasonable care' does not connote the highest possible level of care or perfection. For example in *Maloney v Commissioner for Railways (NSW) (1978) 52 ALJR 292 at 292; (1978) 18 ALR 147* at 148 it was held: "Perfection or the use of increased knowledge or experience embraced in hindsight after the event should form no part of the components of what is reasonable in all the circumstances. That matter must be judged in prospect and not in retrospect."

The ATO does not intend the 'reasonable care' test to be overly onerous for taxpayers. An earnest effort to follow the Tax Pack instructions would normally be sufficient to pass said test.

[The TAA has behaviour "no reasonable grounds for 'tax position' taken." Its Australian equivalent is 'reasonably arguable position.']

The ATO makes the following differentiation between 'reasonable care' and 'reasonably arguable position'.

Whereas the reasonably arguable position test focuses solely on the merits of the position taken, the reasonable care test has regard to the taxpayer's efforts to comply with his tax obligations. The reasonably arguable position test applies a purely objective standard involving an analysis of the law and application of the law to the relevant facts. Consequently it excludes a consideration of the taxpayer's personal circumstances as part of the test. It follows that the reasonably arguable position test imposes a higher standard than that required to show reasonable care. A taxpayer may therefore not have a reasonably arguable position in relation to a matter, despite having satisfied the reasonable care test.

The ATO states that there is no presumption that the existence of a shortfall amount (in SA the 'understatement' amount) caused by a false or misleading statement necessarily or automatically points to a failure to take reasonable care. The evidence must support the conclusion that the standard of care shown has fallen short of what would be reasonably expected in the circumstances (refer to *Reeders v. Federal Commissioner of Taxation [2001] AATA 933; 2001 ATC 2334; (2001) 48 ATR 1170* where it was decided that the entity and its tax agent had demonstrated reasonable care in relation to a claim made to deduct self-education expenses.)

In determining whether 'reasonable care' has been taken the ATO considers the following factors, among others:

- Understanding of tax laws: To determine the standard of care that is reasonable and appropriate in the circumstances, factors such as the complexity of the law and whether it involves new measures are relevant. Where the taxpayer is uncertain about the correct tax treatment, reasonable care requires that appropriate enquiries be made to arrive at the correct tax treatment. An interpretative position that is frivolous might indicate a lack of reasonable care since it reflects that little or no effort was made to exercise sound judgment.

- Likelihood that a statement is false or misleading: The likelihood of the risk that a statement is false or misleading is a relevant factor in deciding whether reasonable care has been exercised in making a statement to the Commissioner. However, a failure to respond to every foreseeable risk will not necessarily mean that reasonable care is absent. In each case the seriousness of the risk must be weighed against the cost of guarding against it.

- Relevance of the size of a shortfall amount: The size of a shortfall or the proportion of a shortfall to the overall tax payable, arising from making a false or misleading statement, are indicators pointing to the magnitude of the risk involved in making the statement. A taxpayer dealing with a matter that involves a substantial amount of tax or involves a large proportion of the overall tax payable is required to exercise a higher standard of care because the consequences of error or misjudgement are greater.

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- Use of a tax agent/adviser: Using the services of a tax agent/adviser does not of itself mean that a taxpayer discharges the obligation to take reasonable care. It remains the taxpayer's primary responsibility to properly record matters relating to his tax affairs and to bring all of the relevant facts to the attention of the agent/adviser to show reasonable care.
- Relying on information provided by a third party: A statement may be false or misleading because it relies on incorrect information obtained from a third party. Whether such reliance indicates a failure by the taxpayer to exercise reasonable care depends on an examination of all facts. Where, for example a taxpayer returns interest income based on incorrect information provided by a bank, there will not be a failure to take reasonable care, that is unless the taxpayer knew or could reasonably be expected to have known that the information was wrong. Whether a tax agent/adviser shows reasonable care by relying on information provided by a client that is incorrect also depends on an examination of all the circumstances. The reasonable care standard is not so demanding as to require a tax agent to extensively audit, examine or review books and records or other source documents to independently verify the information provided by the taxpayer. Whilst it is not be possible or practical for an agent to scrutinise every item of information supplied, reasonable enquiries must be made should the information appear to be incorrect or incomplete.

The TAA penalty percentage table imposes a 50% penalty where reasonable care has not been taken in completing a return (that is with regard to a 'standard case').

SA taxpayers should appreciate what the 'reasonable care' standard requires of them when they prepare their tax returns.

Johan van der Walt

PAYING SARS BY CHEQUE

Judgment was delivered on 6 March 2013 in the North Gauteng High Court in the matter between *Kirsten and Thomson CC t/a Nashua East London v The Commissioner of the South African Revenue Service.*

Fabricius J wrote an eloquent judgment dealing with the plaintiff's claim based on unjust enrichment against the South African Revenue Service (SARS). The case is interesting as it illustrates how making payment to SARS by cheque can go wrong, and how suing the wrong party can double up on your problems. The judgment also has a detailed exposition of the law on payments of cheques and unjust enrichment.

The plaintiff delivered a cheque to its bankers, being First National Bank (FNB) East London. The cheque was post-dated 25 April 2007, crossed, marked 'Not Transferable' and payable to SARS in the amount of R432,000. The cheque was hand delivered on behalf of the plaintiff and received by a SARS receptionist who signed as 'Nox' but whose full and further particulars are unknown. The cheque had been issued to discharge the plaintiff's liability to pay Value-added Tax (VAT) for February and March 2007. The plaintiff was therefore under the impression that it had discharged its obligations to SARS for the payment of said VAT.

In May 2007 the plaintiff, in the *bona fide* and reasonable belief that it was obliged to do so, made out a second cheque to SARS in the amount of R432,000, which cheque was paid to SARS. The plaintiff subsequently alleged that this second payment constituted a duplication of the first payment for which it was not liable in law. It thus sought to recover the first amount of R432,000 on the basis that it had been impoverished and that SARS had been unjustly enriched.

SARS denied that delivery of the first cheque discharged the plaintiff's obligation to pay the relevant VAT. SARS pleaded that the first cheque had not been collected by the ostensible collecting bank, namely Absa, that it had not been paid by FNB and that SARS had not received the proceeds of the first cheque. Accordingly SARS had not been paid in fact and in law. It did admit that the plaintiff had paid the outstanding VAT by means of the second cheque. It was clear that there was proper cause for this payment as it discharged the plaintiff's indebtedness to SARS in respect of the VAT. SARS pleaded that there had been no first payment as alleged by the plaintiff, and that there was no second payment, because there was only one payment – the payment by means of the second cheque on 18 May 2007. Accordingly SARS had not been enriched at all, and furthermore pleaded that the plaintiff had not been impoverished inasmuch as FNB had no right to debit the plaintiff's account with the amount of the first cheque.

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The plaintiff sought to rely on s79 of the Bills of Exchange Act, No 34 of 1964, and argued that payment by cheque is *prima facie* regarded as immediate payment subject to a condition. The question was whether the cheque had been honoured on presentation, and not on the process by which this had occurred. The plaintiff's argument was that the unjustified enrichment of SARS arose on the payment of the second cheque. The plaintiff called a witness, a Mr Ries, from FNB. He conceded that there was a discrepancy between the date of the cheque and the date of the stamp appearing thereon. Accordingly they argued that in the absence of any evidence suggesting the payment in these circumstances would have constituted negligence on the part of the drawee bank (FNB) the plaintiff had established its entitlement to rely on the provisions of s79.

SARS's argument was that the plaintiff had tried to rely on s79 and utilise it in two ways – to use the section to prove its own impoverishment. It had accordingly contended that FNB had debited its account with the amount of the first cheque in circumstances covered by the section. In the second place it had used the section as proof of a deemed enrichment on the part of SARS. SARS's counsel argued that the primary role of s79 is to regulate the contractual relationship between the drawer and the drawee bank where a crossed cheque is lost or stolen and collected by another bank. If a cheque is collected by a bank other than the drawee, the drawee bank has no means of establishing for whom the cheque was collected. The consequence of this is that the errant collection of a cheque (for someone other than the named payee) is a matter for which only the collecting bank can be answerable. Secondly, the drawee bank must nevertheless remain vigilant. SARS's counsel, Mr Louw SC, argued that the plaintiff was trying to transport the principles of delict applying to a collecting bank acting negligently into the realm of enrichment liability.

When the court analysed the question of the first cheque, the case became more complex. The original cheque had not been deposited by SARS and had probably been stolen by a person unknown to the plaintiff or to SARS. It appeared that a cloned cheque had been submitted and that the payee's name had been changed from SARS to Bihlongwa Construction CC. The plaintiff's authorised signatures were on the original cheque, with the name of the payee possibly the only difference between the original and the cloned cheque.

From the evidence given by an Absa teller in the matter, the probabilities were overwhelming that a cloned cheque had been created with Bihlongwa Construction CC as payee but with all of the other information on the original cheque remaining the same. Mr Louw informed the court that an amount of some R85 million had been involved in this scam. It appeared that the cheque had been deposited at Absa's Atteridgeville branch on 30 April 2007 crediting Bihlongwa Construction CC. In Mr Ries' testimony, it appears that Absa would have forwarded the cloned cheque to FNB for presentment and payment through the interbank collection process. However before the cloned cheque could reach FNB, it was probably removed from the cheque collection process and the original cheque substituted. The judge asked how else the original cheque would have come into the possession of the plaintiff and that the genuine cheque was then physically received by FNB on 30 April 2007. The genuine cheque was consequently paid, from FNB's point of view.

Mr Louw submitted that the probabilities were overwhelming that the teller at the Atteridgeville branch who took in the deposit slip with the cloned cheque did not act negligently. It thus did not matter who the true owner of the cheque was - the plaintiff or SARS - as neither would have had a viable delictual claim against Absa as the collecting bank. Absa simply did not deal with the lost or stolen first original cheque.

Mr Louw subsequently put it to the plaintiff that he should have taken action against FNB as the incongruent dates on the cheque should have raised queries. That is the cheque was dated 25 April 2007, the collecting bank's stamp was 20 April 2007 and that it had been presented for payment on 30 April 2007. Counsel for SARS argued that FNB was not entitled to the protection of s79, and so was not entitled to debit the plaintiff's account, in which case the plaintiff had not suffered any loss or prejudice. This went to the key element that the plaintiff had not been impoverished for the purposes of enrichment liability. As FNB was not joined in the matter, it was not for the judge to make a finding on this point. The judge did however find that on the objective evidence that Absa had collected payment of one document and FNB had paid another document did not constitute payment in our law. The Court quoted the case of *McCarthy Ltd v Absa Bank 2010 (2) SA 321* at paragraph 20 where it was held that the collection and payment functions of a cheque are the two sides of the same coin. There cannot be payment unless there is collection. Where there are two documents, a fraudulent document and a genuine cheque, what is paid is not what is collected. The Bills of Exchange Act did not contemplate a situation where a cheque is cloned so that there were two documents in the same context.

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On behalf of SARS, Mr Louw concluded that there was no payment in due course of the original cheque. This meant that the tax debt owing by the plaintiff to SARS had not been discharged. FNB did not pay the instrument which was collected by Absa and as a result the precondition for FNB to debit the account of the plaintiff with the amount of the cheque was not present. Accordingly when the judge looked at the question of liability under the principles of unjust enrichment, impoverishment had not been established on the facts of the case. With regard to enrichment, SARS had not received payment of the first cheque and accordingly it could not have cleared the plaintiff's VAT liability. The plaintiff had to either prove that SARS had received the payment of the first cheque or that it had an undefeatable claim against Absa for the value of this original cheque.

When the court looked at the question of the cause for paying, SARS clearly had a reason to retain payment of the second cheque. If it did not do so it would violate its statutory obligation to collect the VAT. Accordingly the second payment clearly had a proper cause. The plaintiff testified that he had made the second payment because he did not wish to incur penalties and because he required a tax clearance certificate for the purposes of his business. He alleged that SARS had exerted duress on him. The court found that the plaintiff could not have made the second payment in error when it was actually due as a matter of fact and law. The payment was made as a deliberate act for sound business reasons, and because of the law, it was done without duress. Accordingly, the plaintiff's claim was dismissed.

It is important for taxpayers to realise that payment by cheque is inherently risky. If a taxpayer pays SARS by cheque, and SARS loses the cheque (or someone at SARS steals the cheque), the taxpayer's tax liability may very well not be discharged, despite the fact that the cheque is cloned and presented for payment at a bank by a fraudster. To recover any monies lost in respect of such fraud, it is essential to carefully analyse the facts and the law and institute a claim against the correct party and on the correct basis.

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