

**INTERPRETATION NOTE 129**

DATE: 24 May 2023

**ACT : TAX ADMINISTRATION ACT 28 OF 2011**  
**SECTION : SECTION 222(5)**  
**SUBJECT : UNDERSTATEMENT PENALTY: MEANING OF “MAXIMUM TAX RATE APPLICABLE TO THE TAXPAYER”**

**Contents**

Preamble ..... 1

1. Purpose..... 2

2. Background ..... 2

3. The law..... 2

4. Interpretation and application of the law ..... 2

4.1 “Shortfall” in tax [section 222(3)] ..... 3

4.1.1 Shortfall when a taxpayer is in a tax payable position [section 222(3)(a)] ..... 3

4.1.2 Shortfall when the taxpayer is in a refund position [section 222(3)(b)] ..... 6

4.1.3 Shortfall when the taxpayer is in an assessed loss position [section 222(3)(c)] ..... 7

4.2 Meaning of “maximum tax rate applicable to the taxpayer” ..... 7

4.2.1 Flat rate of tax ..... 9

4.2.2 Progressive rate of tax..... 10

5. Conclusion ..... 16

Annexure – The law ..... 17

***Preamble***

In this Note unless the context indicates otherwise –

- “**SBC**” means a small business corporation” as defined in section 12E of the Act;
- “**section**” means a section of the TA Act;
- “**TA Act**” means the Tax Administration Act 28 of 2011;
- “**tax**” means tax as defined in section 221;
- “**tax period**” means a “tax period” as defined in section 1;
- “**the Act**” means the Income Tax Act 58 of 1962;
- “**taxpayer**” means a “taxpayer” as defined in section 151;
- “**understatement**” means an “understatement” as defined in section 221;

- “**understatement penalty**” means the understatement penalty imposed by SARS in accordance with Part A of Chapter 16 of the TA Act; and
- any other word or expression bears the meaning ascribed to it in the TA Act.

## 1. Purpose

This Note provides clarity on the interpretation and application of the phrase “maximum tax rate applicable to the taxpayer” used in section 222(5) when the tax rate applicable to the shortfall determined under subsections (3) and (4) is applied.

## 2. Background

The TA Act provides for an understatement penalty to be imposed where a taxpayer has made an understatement.<sup>1</sup> The main purpose of the understatement penalty regime is to deter behaviours that result in non-compliant reporting, and the understatement penalty framework aims at ensuring consistent and equal treatment of taxpayers in comparable circumstances.<sup>2</sup>

Section 222(2) stipulates that the highest understatement penalty percentage must be applied to each shortfall determined under subsections (3) and (4). Section 222(5) provides that the tax rate applicable to the shortfall determined under these subsections 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”.

There is uncertainty as to how the “maximum tax rate applicable to the taxpayer” may be applied to a taxpayer that has made an understatement and is in an assessed loss position. This Note provides clarity on the rate to be applied in circumstances where the taxpayer is in an assessed loss position after the understatement is corrected.

## 3. The law

Sections 222 and 223 of the TA Act are quoted in the **Annexure**.

## 4. Interpretation and application of the law

Section 222(1) provides that in the event of an understatement by a taxpayer, an understatement penalty determined under subsection (2) must be paid in addition to the tax payable for the tax period, unless the understatement is as a result of a *bona fide* inadvertent error.<sup>3</sup>

An “understatement” is defined in section 221 and means any prejudice to SARS or the *fiscus* as a result of –

- (a) failure to submit a return required under a tax Act or by the Commissioner;
- (b) an omission from a return;
- (c) an incorrect statement in a return;
- (d) if no return is required, the failure to pay the correct amount of “tax”; or

<sup>1</sup> Chapter 16 Part A of the TA Act.

<sup>2</sup> *SARS Short Guide to the Tax Administration Act, 2011*: Chapter 16: Understatement Penalties at 16.1 and 16.2, available on the **SARS website**.

<sup>3</sup> Section 222(1).

(e) an “impermissible avoidance arrangement”.

In accordance with section 222(2), the understatement penalty is determined in relation to each understatement by applying the highest applicable understatement penalty percentage<sup>4</sup> to each shortfall determined under subsections (3) and (4).

Section 222(3) provides that the shortfall is the sum of –

- (i) 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;
- (ii) 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
- (iii) 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).

The different components of the calculation to determine the shortfall under section 222(3) are considered below.

#### **4.1 “Shortfall” in tax [section 222(3)]**

The first step in calculating the understatement penalty is to determine the “shortfall”. The shortfall is essentially the sum of the difference between the correct amount of tax and the tax based on the information that was disclosed by the taxpayer for that period.

However, not all taxpayers are in a tax payable position as some taxpayers may, after the correction of the understatement, have an assessed loss for the tax period resulting in no tax being payable (see **4.1.3**). In such cases, the shortfall is determined with reference to the specific position of a taxpayer in the tax period in which an understatement is made.

##### **4.1.1 Shortfall when a taxpayer is in a tax payable position [section 222(3)(a)]**

Section 222(3)(a) applies when a taxpayer is in a tax payable position after the understatement is corrected. A taxpayer may, however, be in a loss position before the understatement is corrected, in which case section 222(3)(c) also applies as in accordance with section 222(3), the shortfall is the sum of paragraphs (a), (b) and (c) (see **4.1.3**). As it pertains to the tax payable position, the “shortfall” is 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 by SARS. The amount of “tax properly chargeable” is the correct amount of tax determined under a tax Act after correcting the understatement.

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<sup>4</sup> See Annexure – The law: “Understatement penalty percentage table” as contained in section 223(1).

As this calculation determines the tax payable portion of the shortfall, the revised taxable income or taxable turnover will be subject to either a flat or progressive rate of tax in accordance with the applicable legislation. Since the shortfall associated with the understatement is expressed in an amount of tax, section 222(5) is not applicable.

**Example 1 – Company - Shortfall in tax and the understatement penalty where the taxpayer is in a tax payable position before and after the understatement is corrected [section 222(3)(a)]**

*Facts:*

ABD (Pty) Ltd (ABD) declared taxable income of R20 000 for the tax period ending 31 December 2022. ABD, being a company is taxed at a flat tax rate of 28%, which resulted in an income tax liability of R5 600. SARS conducted an audit for the tax period and found that ABD's taxable income was understated. The understatement occurred as a result of expenses being overstated to the amount of R5 000. The understatement did not result from a *bona fide* inadvertent error and it was concluded that the error arose as a result of gross negligence. This resulted in taxable income being revised to R25 000 (R20 000 + R5 000), hence an additional income tax liability of R1 400 (R5 000 × 28%) being payable. The highest understatement percentage as determined by the behaviour will be applied to determine the understatement penalty. Accordingly, an understatement penalty of 100% for gross negligence is levied under section 223(1) on the shortfall in tax.

*Result:*

**Step 1: Determine the shortfall in tax**

	R
Tax properly chargeable	7 000
Less: Tax chargeable if the understatement were accepted	<u>(5 600)</u>
Shortfall in tax [section 222(3)(a)]	<u>1 400</u>

The shortfall in income tax of R1 400 is the difference between the amount of tax properly chargeable and the amount of tax that would have been chargeable (R7 000 – R5 600) if the understatement were accepted.<sup>5</sup> The highest applicable penalty percentage, in this scenario, namely, 100%, must be applied to each shortfall in tax to determine the understatement penalty.

**Step 2: Determine the understatement penalty**

$$\begin{aligned} \text{Understatement penalty} &= \text{Shortfall in tax} \times \text{understatement penalty percentage levied} \\ &= \text{R1 400} \times 100\% \\ &= \text{R1 400} \end{aligned}$$

In addition to the shortfall in tax of R1 400, ABD also has to pay an understatement penalty of R1 400.

<sup>5</sup> Section 222(3)(a).

**Example 2 – SBC – Shortfall in tax and the understatement penalty where the taxpayer is in a tax payable position before and after the understatement is corrected [section 222(3)(a)]**

*Facts:*

NMR (Pty) Ltd (NMR) declared taxable income of R365 000 for the tax period ending 31 December 2021. NMR, being an SBC is taxed at a progressive tax rate (7% of the amount by which taxable income exceeds R83 100 but not R365 000), which resulted in an income tax liability of R19 733 [(R365 000 – R83 100) × 7%]. SARS conducted an audit for the tax period and found that NMR's taxable income was understated. The understatement occurred as a result of expenses being overstated to the amount of R20 000. The understatement did not result from a *bona fide* inadvertent error, and it was concluded that the error arose as a result of gross negligence. This resulted in taxable income being revised to R385 000 (R365 000 + R20 000), hence a revised income tax liability of R23 933 [(R365 000 – R83 100) × 7% + (R385 000 – R365 000) × 21%] being payable. The highest understatement percentage as determined by the behaviour was applied to determine the understatement penalty. Accordingly, an understatement penalty of 100% for gross negligence is levied under section 223(1) on the shortfall in tax.

*Result:*

**Step 1: Determine the shortfall in tax**

	R
Tax properly chargeable	23 933
Less: Tax chargeable if the understatement were accepted	<u>(19 733)</u>
Shortfall in tax [section 222(3)(a)]	<u>4 200</u>

The shortfall in income tax of R4 200 is the difference between the amount of tax properly chargeable and the amount of tax that would have been chargeable (R23 933 – R19 733) if the understatement were accepted.<sup>6</sup> The highest applicable penalty percentage, in this scenario, namely, 100%, must be applied to each shortfall in tax to determine the understatement penalty.

**Step 2: Determine the understatement penalty**

$$\begin{aligned} \text{Understatement penalty} &= \text{Shortfall in tax} \times \text{understatement penalty percentage levied} \\ &= R4\,200 \times 100\% \\ &= R4\,200 \end{aligned}$$

In addition to the shortfall in tax of R4 200, NMR must also pay an understatement penalty of R4 200.

<sup>6</sup> Section 222(3)(a).

#### 4.1.2 Shortfall when the taxpayer is in a refund position [section 222(3)(b)]

Section 222(3)(b) applies when the amount properly refundable for the tax period reduces the amount that would have been refundable if the understatement were accepted. As the refund before and after the correction of the understatement is stated in an amount in tax, section 222(5) is not applicable.

##### **Example 3 – Shortfall in tax and the understatement penalty where the taxpayer is in a refundable position before and after the understatement is corrected [section 222(3)(b)]**

*Facts:*

PAT (Pty) Ltd (PAT) is registered as a VAT (value-added tax) vendor and submitted a VAT201 return for a tax period, resulting in a VAT refund of R50 000. The refund was withheld as a result of an audit by SARS and the audit finding was that certain input tax deductions claimed on the VAT201 return could not be substantiated by the vendor. The VAT refund was subsequently reduced to R30 000 due to the disallowance of R20 000 input tax deduction. The understatement did not result from a *bona fide* inadvertent error and it was determined that there was no reasonable grounds for the tax position taken. The highest understatement percentage as determined by the behaviour will be applied to determine the understatement penalty. Accordingly, an understatement penalty of 50% is levied in accordance with section 223(1) on the shortfall.

*Result:*

**Step 1: Determine the shortfall in tax**

	R
Amount of tax (VAT) properly refundable	(30 000)
Less: Amount of tax (VAT) refundable if the understatement were accepted	<u>(50 000)</u>
Shortfall in tax (VAT) [section 222(3)(b)]	<u>20 000</u>

The shortfall in tax (VAT) of R20 000 is the difference between the amount of tax properly refundable (R30 000) and the amount of tax (VAT) that would have been refundable if the understatement was accepted (R50 000).<sup>7</sup> The highest applicable penalty percentage, in this scenario, namely, 50%, must be applied to the shortfall in tax to determine the understatement penalty.

**Step 2: Determine the understatement penalty**

$$\begin{aligned}
 \text{Understatement penalty} &= \text{Shortfall in tax} \times \text{understatement penalty percentage levied} \\
 &= \text{R20 000} \times 50\% \\
 &= \text{R10 000}
 \end{aligned}$$

As the refund was withheld, PAT is liable for an understatement penalty of R10 000, thus leading to a reduced refund of R20 000 (R30 000 less the understatement penalty).

<sup>7</sup> Section 222(3)(b).

### 4.1.3 Shortfall when the taxpayer is in an assessed loss position [section 222(3)(c)]

Section 222(3)(c) applies when a taxpayer is in a loss position before the understatement is corrected. A taxpayer may, however, be in a tax payable position after the understatement is corrected, in which case section 222(3)(a) also applies as in accordance with section 222(3), the shortfall is the sum of paragraphs (a), (b) and (c). As it pertains to the loss position, the shortfall is the difference between the amount of an assessed loss or any other benefit to the taxpayer properly carried forward from the tax period in which the understatement occurs 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).

Since the calculation in the scenario under section 222(3)(c), determines the loss position, there is no tax properly chargeable. Therefore, to determine the shortfall in tax, the tax rate to be applied to the aforementioned difference as provided in section 222(5), is the “maximum tax rate applicable to the taxpayer”. This tax rate is determined by ignoring any assessed loss or any other benefit, for example, an unredeemed balance of capital expenditure under section 36 of the Act or an unused farming capital expenditure under the First Schedule to the Act, brought forward from the preceding tax period to the tax period concerned (see 4.2).

### 4.2 Meaning of “maximum tax rate applicable to the taxpayer”

The phrase “maximum tax rate applicable to the taxpayer” used in section 222(5) for purposes of levying the understatement penalty under circumstances envisaged in section 222(3)(c) requires scrutiny based on the ordinary principles of interpretation.

In *C: SARS v Terraplas SA (Pty) Ltd*, Navsa JA said –

“Any one of a number of dictionary meanings of a word is not necessarily conclusive in the interpretation of words and phrases in statutes and documents. Meanings have to be determined contextually.”<sup>8</sup>

Therefore, a dictionary meaning of a word cannot be conclusive on its interpretation. It can only afford a starting point, and where a word has more than one meaning, as the dictionary does not prescribe priorities of meaning, the applicable meaning must be discerned from the context of the particular section under consideration.

In *Natal Joint Municipal Pension Fund v Endumeni Municipality*, Wallis JA stated the following relating to the interpretation of words or phrases:<sup>9</sup>

“The inevitable point of departure is the language of the provision itself, read in context and having regard to the purpose of the provision and the background to the preparation and production of the document.”

<sup>8</sup> [2014] 3 All SA 11 (SCA), 76 SATC 377 at 385

<sup>9</sup> 2012 (4) SA 593 (SCA) at 604. See also *Capitec Bank Holdings Limited and another v Coral Lagoon Investments 194 (Pty) Ltd and others* [2021] 3 All SA 647 (SCA) at paragraph 25.

In *Fidelity Security Services (Pty) Ltd v Minister of Police and others*<sup>10</sup>, after stating that the Constitutional Court in *Cool Ideas 1186 CC v Stubbard*<sup>11</sup> approved the principles set in the *Endumeni* case, Petse AP held that –

“a court will interpret the relevant provision having regard to the underlying purpose of the Act and the broader statutory scheme of which it forms part. This then means that an interpretation that results in a sensible meaning is to be preferred over one that leads to unbusinesslike results or undermines the apparent purpose of the Act. This entails that the ordinary and clear meaning of the words, read purposefully and contextually, must not be unduly strained. That the text, context and purpose of the Act must always be considered at the same time when interpreting legislation has been affirmed in various decisions of the Constitutional Court”.

Therefore, in order to interpret the ordinary meaning of the phrase “maximum tax rate applicable to the taxpayer”, regard must be had to the context in which the phrase appears in section 222(5) and the purpose of the legislation.

As stated in point 2 above, the main purpose of the understatement penalty regime is to deter behaviours that result in non-compliant reporting. This is evident as the actions or inactions that give rise to an understatement all negatively affect the submission or content of a return.<sup>12</sup> Within this context, section 222 is predominantly concerned with the calculation of the understatement penalty, which the tax Court in ITC 1934 described as follows:

“The quantum of an understatement penalty is determined by the nature of the wrongdoing for which the taxpayer is responsible; expressed as a percentage, that factor is then applied to the amount of tax concerned. For a given amount of tax in effect withheld, the penalty will be higher or lower, depending not on the prejudice suffered by SARS or the *fiscus*, but on the level of blameworthiness attributed to the conduct.”<sup>13</sup>

The shortfall is the amount of “tax concerned” or “in effect withheld” as a result of the understatement, which is calculated as the sum of section 222(3)(a), (b) and (c). As set out above, the chargeable or refundable amounts under paragraphs (a) and (b), already constitute tax, and therefore the tax rate described in section 222(5) does not find application. It is consequently unsurprising that only section 222(3)(c) makes reference to the tax rate described in section 222(5), it having to be applied “to the difference between the amount of an assessed loss or 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”.

On application of section 20(1) of the Act, assessed losses are carried forward in returns for the purpose of determining the taxable income or turnover of the taxpayer. As such, an assessed loss is not tax, and when the return contains an understatement that affects the assessed loss position, the difference between the stated and properly carried forward amounts must be converted into tax to establish the shortfall. This is achieved by multiplying the difference “by the tax rate determined under subsection (5)”, and because this difference is taxable income or taxable turnover, it follows that the tax rate references those set by the Rates and Monetary Amounts and Amendment of Revenue Laws Act annually.

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<sup>10</sup> [2021] 3 All SA 67 (SCA) at paragraph 25.

<sup>11</sup> 2014 (4) SA 474 (CC).

<sup>12</sup> See definition of “understatement” in section 221.

<sup>13</sup> ITC 1934 (2018), 82 SATC 457 at 471.



Returning to the phrase “maximum tax rate applicable to the taxpayer”, the word “maximum” is used to describe the legislated tax rate to be applied to the shortfall. The ordinary meaning of the word “maximum” when used as an adjective is defined in the *Dictionary.com* as follows:<sup>14</sup>

“1 the greatest quantity or amount possible, assignable, allowable etc.”

It is thus clear that the highest possible or permitted tax rate, applicable to that taxpayer, must be applied to the difference between the stated and properly carried forward amount described in section 222(3)(c) to determine the shortfall in the amount of tax. This tax rate must, however, be applied to “the taxpayer” who has made the understatement and it must be determined by ignoring the assessed losses or any other benefits brought forward from a preceding tax period.

#### 4.2.1 Flat rate of tax

The Act read with the Rates and Monetary Amounts and Amendment of Revenue Laws Act annually provides that some taxpayers are taxed at a single or a flat rate, including a company, a qualifying company in a special economic zone and a trust (other than a special trust). As only one rate applies, there can be no doubt that this is the maximum tax rate applicable to these taxpayers for purposes of section 222(5).

#### **Example 4 –Shortfall in tax and the understatement penalty when the taxpayer is in an assessed loss position before and after the understatement is corrected where a flat rate is applicable – [section 222(3)(c) read with section 222(5)]**

##### *Facts:*

APS (Pty) Ltd (APS) declared an assessed loss of R50 000 for the tax period ending 31 December 2022, thus incurring no tax liability for this tax period. SARS conducted an audit on the tax period and found that the taxpayer had understated taxable income by R30 000. The income tax assessment was subsequently revised to account for the understatement hence leading to a reduction of the assessed loss to R20 000 (R50 000 – R30 000). The understatement did not result from a *bona fide* inadvertent error, and it was determined that the omission of taxable income was as the result of intentional tax evasion. The relevant understatement percentage as determined by the behaviour will be applied to the shortfall to determine the understatement penalty. Accordingly, an understatement penalty of 150% for intentional tax evasion is levied under section 223(1) on the shortfall determined under section 222(3).

##### *Result:*

#### **Step 1: Determine the difference between the stated and properly carried forward amount**

	R
Stated assessed loss carried forward	(50 000)
Less: Properly carried forward assessed loss	<u>(20 000)</u>
Difference	<u>30 000</u>

<sup>14</sup> [www.dictionary.com/definition/maximum](http://www.dictionary.com/definition/maximum) [Accessed 24 May 2023].

**Step 2: Determine the shortfall in tax**

$$\begin{aligned}
 \text{Shortfall in tax} &= \text{difference} \times \text{maximum tax rate applicable to the taxpayer} \\
 &= R30\,000 \times 28\% \\
 &= R8\,400
 \end{aligned}$$

Although section 222(5) also requires that the determination of the applicable tax rate must ignore an assessed loss or any other benefits brought forward from a preceding tax period, because companies are subject to a flat tax rate of 28%, such an exercise will not alter the maximum tax rate that must be applied. Consequently, the tax rate of 28% must be applied to the difference of R30 000 in order to determine the shortfall in tax, where after the highest applicable penalty percentage for the behaviour must be applied to the shortfall in tax to determine the understatement penalty.<sup>15</sup>

**Step 3: Determine the understatement penalty**

$$\begin{aligned}
 \text{Understatement penalty} &= \text{Shortfall in tax} \times \text{understatement penalty percentage levied} \\
 &= R8\,400 \times 150\% \\
 &= R12\,600
 \end{aligned}$$

In addition, to the reduction of the assessed loss, APS must pay an understatement penalty of R12 600.

**4.2.2 Progressive rate of tax**

In relation to some income tax taxpayers, their taxable income or taxable turnover is divided into bands that are each taxed at a progressive rate of tax. This includes natural persons, special trusts, deceased estates, insolvent estates, an SBC or micro business. The highest or greatest permissible (in accordance with the definition of “maximum” discussed in 4.2 above) tax rate applicable to these taxpayers depends on the band in which the amount of their taxable income or taxable turnover for the year or period of assessment falls, even though they are effectively taxed at a lower rate. The maximum tax rate will consequently be the marginal tax rate applicable to the band within which the taxable income of the taxpayer falls for the year or period of assessment when the assessed loss or any other benefit brought forward from a preceding tax period to the period in which the understatement occurs is ignored.

The tax rate to be applied to the shortfall determined under section 222(3) and (4) is therefore the marginal tax rate, which will represent the maximum tax rate that is applicable to that specific taxpayer in a class of taxpayers, for the tax period. The facts and circumstances of each taxpayer must be considered to determine what tax rate will apply when establishing the “maximum tax rate” for purposes of determining the shortfall in the amount of tax under section 222(3)(c).

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<sup>15</sup> Section 223(1).

**Example 5 – A natural person in an assessed loss position before and after the understatement is corrected**

*Facts:*

A, a sole trader, declared an assessed loss of R200 000 for the tax period ending 28 February 2022, thus incurring no tax liability for this tax period. SARS conducted an audit on the said tax period and found that the taxpayer had understated his taxable income by R150 000. The income tax assessment was subsequently revised to account for the understatement hence leading to a reduction of the assessed loss to R50 000 (R200 000 – R150 000). The understatement did not result from a *bona fide* inadvertent error as it was determined that the omission of taxable income was as a result of reasonable care not taken in completing the return. Accordingly, an understatement penalty of 25% is levied under section 223(1) on the shortfall.

*Result:*

**Step 1: Determine the difference between the stated and properly carried forward amount**

	R
Stated assessed loss carried forward	(200 000)
Less: Properly carried forward assessed loss	<u>(50 000)</u>
Difference	<u>150 000</u>

**Step 2: Determine the shortfall in tax**

$$\begin{aligned} \text{Shortfall in tax} &= \text{difference} \times \text{maximum tax rate applicable to the taxpayer} \\ &= \text{R150 000} \times 18\% \\ &= \text{R27 000} \end{aligned}$$

Although the maximum tax rate for natural persons is 45%, the maximum tax rate applicable to the band in which the taxable income of A for the tax period falls is 18%. Section 222(5) also requires that in the determination of the applicable tax rate any assessed loss or any other benefits brought forward from a preceding tax period must be ignored, therefore, the tax rate of 18% must be applied to the shortfall of R150 000. The highest applicable penalty percentage, assumed in this scenario to be 25%, must be applied to the shortfall in tax to determine the understatement penalty.<sup>16</sup>

**Step 3: Determine the understatement penalty**

$$\begin{aligned} \text{Understatement penalty} &= \text{Shortfall in tax} \times \text{understatement penalty percentage levied} \\ &= \text{R27 000} \times 25\% \\ &= \text{R6 750} \end{aligned}$$

In addition to the reduction of the assessed loss, A must pay an understatement penalty of R6 750.

<sup>16</sup> Section 223(1).

**Example 6 – A natural person who underdeclared income and expenses and is in an assessed loss position before and after the understatement is corrected**

*Facts:*

D, a sole trader, declared an assessed loss of R200 000 for the tax period ending 28 February 2022, thus incurring no tax liability for this tax period. SARS conducted an audit on the said tax period and found that the taxpayer had understated income from trade of R400 000 and also underdeclared deductible expenses by R250 000. The income tax assessment was subsequently revised to account for both understatements hence leading to a reduction of the assessed loss to R50 000 (R200 000 – (R400 000 – R250 000)). The understatement did not result from a *bona fide* inadvertent error as it was determined that the omission of taxable income was as a result of reasonable care not taken in completing the return. Accordingly, an understatement penalty of 25% is levied under section 223(1) on the shortfall.

*Result:*

**Step 1: Determine the difference between the stated and properly carried forward amount**

	R
Stated assessed loss carried forward	(200 000)
Less: Properly carried forward assessed loss	<u>(50 000)</u>
Difference	<u>150 000</u>

**Step 2: Determine the shortfall in tax**

$$\begin{aligned} \text{Shortfall in tax} &= \text{difference} \times \text{maximum tax rate applicable to the taxpayer} \\ &= R150\,000 \times 18\% \\ &= R\,27\,000 \end{aligned}$$

Although the maximum tax rate for natural persons is 45%, the maximum tax rate applicable to the band in which the taxable income underdeclared by D for the tax period is 18%. The maximum tax rate applicable to the taxpayer under section 222(5) must be applied to the nett shortfall of R150 000 (R400 000 – R250 000). The tax rate of 18% must be applied to the “nett” shortfall of R150 000.<sup>17</sup> The highest applicable penalty percentage, assumed in this scenario to be 25%, must be applied to the shortfall in tax to determine the understatement penalty.<sup>18</sup>

**Step 3: Determine the understatement penalty**

$$\begin{aligned} \text{Understatement penalty} &= \text{Shortfall in tax} \times \text{understatement penalty percentage levied} \\ &= R27\,000 \times 25\% \\ &= R\,6\,750 \end{aligned}$$

In addition to the reduction of the assessed loss, D must pay an understatement penalty of R6 750.

<sup>17</sup> Section 222(3)(c).

<sup>18</sup> Section 223(1).

**Example 7 – An SBC where an assessed loss position changed to taxable income position after correction of the understatement**

*Facts:*

Company A meets the requirements of section 12E(4)(a) of the Act and accordingly qualifies to be taxed as an SBC. The original income tax assessment of Company A for the tax period ending 30 November 2020 reflects an assessed loss of R80 000. SARS conducted an audit on the tax period and found income to have been understated by R400 000. A revised assessment was issued changing the tax position of Company A from an assessed loss to taxable income of R320 000 [(R80 000) + R400 000]. The understatement did not result from a *bona fide* inadvertent error. The relevant understatement percentage as determined by the behaviour will be applied to determine the understatement penalty. Accordingly, an understatement penalty percentage of 150% for intentional tax evasion is levied under section 223(1) on the shortfall.

*Result:*

**Step 1: Shortfall under paragraph (a)**

	R
Tax properly chargeable	16 583
Less: Tax chargeable if understatement accepted	<u>0</u>
Shortfall in tax under paragraph (a)	<u>16 583</u>

The tax rates applicable to an SBC are used to determine the tax liability (shortfall in tax). The progressive rate of tax for an SBC with taxable income not exceeding R83 100 is at 0%, exceeding R83 100 but not exceeding R365 000 at 7%. The shortfall in tax of R16 583 is determined as follows [(R83 100 × 0%) + (R320 000 – R83 100) × 7%].

Although the maximum tax rate applicable to an SBC is 28%, the maximum tax rate applicable to Company A for the tax period is 7%, therefore the shortfall of R320 000 is subject to the actual progressive tax rates applicable to the revised taxable income as calculated above.

**Step 2: Shortfall under paragraph (c)**

	R
Stated assessed loss	80 000
Less: Properly carried forward assessed loss	<u>0</u>
Difference	<u>80 000</u>

**Step 3: Shortfall in tax under paragraph (c)**

$$\begin{aligned}
 &= \text{Difference} \times \text{Marginal rate of tax for an SBC in loss position} \\
 &= R80\,000 \times 0\% \\
 &= R0
 \end{aligned}$$

**Step 4: Total shortfall in tax**

$$\begin{aligned}
 &= \text{Paragraph (a)} + \text{Paragraph (c)} \\
 &= R16\,583 + R0 \\
 &= R16\,583
 \end{aligned}$$

**Step 5: Determine the understatement penalty**

$$\begin{aligned} \text{Understatement penalty} &= \text{Shortfall in tax} \times \text{understatement penalty percentage levied} \\ &= R\ 16\ 583 \times 150\% \\ &= R\ 24\ 874,50 \end{aligned}$$

In addition to the shortfall in tax of R16 583, Company A also has to pay an understatement penalty of R24 874,50.

**Example 8 – Micro Business taxed at a tax rate of zero percent***Facts:*

Company ZC (ZC) meets the requirements of a micro business as defined in paragraph 1 of the Sixth Schedule to the Act and accordingly qualifies to be taxed as a micro business. ZC declared taxable turnover of R250 000 for the tax period ending 28 February 2021. The progressive tax rate of 0% was applied to the taxable turnover declared and therefore there was no tax liability that was due and payable. SARS conducted an audit on the tax period and found that ZC omitted to include in its taxable turnover 50%<sup>19</sup> of the receipt from the sale of a delivery vehicle used for purposes of its trade. The proceeds from the disposal of the vehicle was R80 000, therefore, the taxable turnover of ZC was understated by R40 000 (R80 000 × 50%) resulting in taxable turnover being revised to R290 000 (R250 000 + R40 000). The understatement did not result from a *bona fide* inadvertent error. The relevant understatement percentage as determined by the behaviour will be applied to determine the understatement penalty. Accordingly, an understatement penalty percentage of 25% for reasonable care not taken in completing the return was levied under section 223(1) on the shortfall.

*Result:***Step 1: Determine the shortfall in tax**

Tax properly chargeable	R
	0
Less: Tax chargeable if understatement accepted	<u>0</u>
Shortfall in tax	<u>0</u>

The tax rates applicable to a micro business is used to determine the tax properly chargeable after the correction of the understatement by SARS. The tax properly chargeable of R0 is determined using the progressive tax rates for a micro-business as follows: (R290 000 × 0%).

**Step 2: Determine the understatement penalty**

$$\begin{aligned} \text{Understatement penalty} &= \text{Shortfall in tax} \times \text{understatement penalty percentage levied} \\ &= R0 \times 25\% \\ &= R0 \end{aligned}$$

<sup>19</sup> Paragraph 6(a)(ii) of the Sixth Schedule to the Act.

Although the intention was to levy an understatement penalty this is subject to there being a shortfall in tax after correction of the understatement by SARS. In this scenario as the shortfall in tax is R0 the understatement penalty which is determined on the shortfall in tax will also be R0.

**Example 9 – Micro Business taxed at a tax rate of zero percent before correction but taxable after correction**

*Facts:*

Company XY (XY) meets the requirements of a micro business as defined in paragraph 1 of the Sixth Schedule to the Act and accordingly qualifies to be taxed as a micro business. XY declared taxable turnover of R250 000 for the tax period ending 28 February 2021. The progressive tax rate of 0% is applied to the taxable turnover declared and therefore there is no tax liability that is due and payable. SARS conducted an audit on the tax period and found that XY omitted to include in its taxable turnover 50%<sup>20</sup> of the receipt from the sale of an immovable property used for purposes of its trade. The proceeds from the disposal of the immovable property was R500 000, therefore, the taxable turnover of XY was understated by R250 000 (R500 000 × 50%) resulting in taxable turnover being revised to R500 000 (R250 000 + R250 000). The understatement did not result from a *bona fide* inadvertent error. The relevant understatement percentage as determined by the behaviour will be applied to determine the understatement penalty. Accordingly, an understatement penalty percentage of 25% for reasonable care not taken in completing the return was levied under section 223(1) on the shortfall.

*Result:*

**Step 1: Determine the shortfall in tax**

	R
Tax properly chargeable	1 650
Less: Tax chargeable if understatement accepted	<u>0</u>
Shortfall in tax	<u>1 650</u>

The tax rates applicable to a micro business is used to determine the tax properly chargeable after the correction of the understatement by SARS. The tax properly chargeable of R1 650 is determined using the progressive tax rates for a micro-business as follows: (R335 000 × 0%) + [(R500 000 – R335 000) × 1%].

**Step 2: Determine the understatement penalty**

$$\begin{aligned} \text{Understatement penalty} &= \text{Shortfall in tax} \times \text{understatement penalty percentage levied} \\ &= R1\ 650 \times 25\% \\ &= R412,50 \end{aligned}$$

In addition, to the shortfall in tax of R1 650, XY also has to pay an understatement penalty of R412,50.

<sup>20</sup> Paragraph 6(a)(ii) of the Sixth Schedule to the Act.

## 5. Conclusion

Section 222 imposes an understatement penalty in the event of an understatement by a taxpayer, except if the understatement is as a result of a *bona fide* inadvertent error.

The understatement penalty is determined by applying the highest applicable understatement penalty percentage in accordance with the table in section 223 to each shortfall. Each "shortfall" is determined under section 222(3) as the sum of paragraph (a), (b) and (c) depending on the specific facts of the taxpayer for the respective tax period to determine the shortfall in tax.

Section 222(3)(c) provides for the determination of the portion of the shortfall in tax where a taxpayer is in an assessed loss position after the understatement is corrected. Since an assessed loss is not a tax liability section 222(5) provides that under these instances, the "maximum tax rate applicable to the taxpayer", determined by ignoring an assessed loss or any other benefit brought forward from a preceding tax period to the tax period in which the understatement occurred, must be applied to determine the shortfall in tax.

Certain taxpayers are taxed either at a flat rate or a progressive rate of tax. The tax rate applicable to taxpayers subject to a flat rate of tax represents the "maximum rate applicable to that taxpayer" for purposes of section 222(5).

For taxpayers that are taxed at a progressive rate of tax, the maximum tax rate applicable to the shortfall envisaged under section 222(3)(c) is the marginal tax rate applicable to the taxable income or taxable turnover that is established by, ignoring the assessed losses or any other benefit brought forward from a preceding tax period to the tax period in question.

The facts and circumstances of each taxpayer must be considered to determine what tax rate will apply when determining the "maximum tax rate" for purposes of determining the shortfall in tax under section 222(3)(c).



## Annexure – The law

### Section 222 -- Understatement penalty

**222. Understatement penalty.**—(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’ result 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 subsection (3) and (4) in relation to each ‘understatement’.

(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) (a) 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.

(b) Where the ‘understatement’ is the failure to submit a return, the ‘tax’ resulted from the ‘understatement’ had the ‘understatement’ been accepted, for purposes of subsection (3), must be regarded as nil.

(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.

(6) Any penalty imposed under subsection (2) must be reduced by any penalty imposed under section 4(2) of the Employment Tax Incentive Act, 2013, in respect of the same employment tax incentive amount.

### Section 223(1) – Understatement penalty percentage table

1	2	3	4	5	6
<i>Item</i>	<i>Behaviour</i>	<i>Standard case</i>	<i>If obstructive, or if it is a ‘repeat case’</i>	<i>Voluntary disclosure after notification of audit or criminal investigation</i>	<i>Voluntary disclosure before notification of audit or criminal investigation</i>
(i)	‘Substantial understatement’	10%	20%	5%	0%
(ii)	Reasonable care not taken in completing return	25%	50%	15%	0%

1	2	3	4	5	6
<i>Item</i>	<i>Behaviour</i>	<i>Standard case</i>	<i>If obstructive, or if it is a 'repeat case'</i>	<i>Voluntary disclosure after notification of audit or criminal investigation</i>	<i>Voluntary disclosure before notification of audit or criminal investigation</i>
(iii)	No reasonable grounds for 'tax position' taken	50%	75%	25%	0%
(iv)	'Impermissible avoidance arrangement'	75%	100%	35%	0%
(v)	Gross negligence	100%	125%	50%	5%
(vi)	Intentional tax evasion	150%	200%	75%	10%