AN ANALYSIS OF THE COMPLIANCE APPROACH USED BY REVENUE AUTHORITIES WITH SPECIFIC REFERENCE TO CASE SELECTION AND RISK PROFILING

A thesis submitted in the partial fulfilment of the requirements for the degree of

MASTERS IN COMMERCE (TAXATION)

by

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ABSTRACT

The vision of probably all revenue authorities is to promote compliance with the provisions of the taxation laws and to ensure responsible enforcement by the revenue authorities, thereby contributing to the economic well being of the country. As with virtually all revenue authorities the South African Revenue Services has to a large extent implemented the self-assessment approach to tax assessments. Because this system depends on this process of self-assessment, an effective risk-based audit approach is required to ensure that tax compliance and responsible enforcement is adhered to. An effective case selection methodology is required for revenue authorities to make informed choices on how best to direct their activities in order to address areas of greatest risk.

Given these imperatives, the purpose of this study is to examine the case selection methodologies used by certain revenue authorities, including the South African Revenue Services, and to focus on the key elements of case selection: the use of computerised database systems, industry profiles, third party data and the role of the risk profiler.

The results of the study indicate that the case selection methodology of the South African Revenue Services is lacking in some areas. Computerised risk analysis is limited to a certain classes of taxpayers and other aspects of concern are also highlighted in this study.
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Finally, none of this would have been possible without the blessing of my Creator.
1.1 Background

During the past ten years of democracy in South Africa the South African government was committed to a reconstruction and development programme with the aim of meeting the basic needs of all South Africans (Manuel: 2004a). During this period the government has delivered, amongst various other projects, the following:

- 1.6 million houses have been built;
- 700 new primary health clinics have been constructed;
- potable water supplies have been extended to some 9 million people;
- about 4.5 million children have benefited from the primary school nutrition programme;
- 56 000 school classrooms have been constructed; and
- the renewal of further education has begun with the consolidation of technical colleges and universities into 50 new institutions.

The funds required for these projects are mainly generated by taxes. Taxes are imposed in South Africa by the Income Tax Act, No 58 of 1962, the Value-Added Tax Act, Act 89 of 1991, the Stamp Duties Act, No 77 of 1968, the Estate Duty Act, No 45 of 1955, the Tax on Retirement Funds Act, No 38 of 1996, the Customs and Excise Act, No 91 of 1964, and the Transfer Duty Act, No 40 of 1949. The taxes imposed by the Income Tax Act are normal tax (commonly known as income tax), secondary tax on companies and donations tax. For the 2003/04 financial years the revenue budget was estimated at R300.3 billion and for the 2004/05 fiscal year it is estimated at R327 billion of which the total tax revenue is estimated at R320 billion (Manuel: 2004a). Annexure I contains full details of the estimated revenue budget for the financial year ending 31 March 2005.
The South African Revenue Service Act, No 34 of 1997, grants the South African Revenue Services (hereafter referred to as SARS) the mandate to perform the following tasks:

- collect all revenues that are due;
- ensure maximum compliance with the legislation; and
- provide a customs service that will maximise revenue collection, protect our borders as well as facilitate trade.

The SARS collected a total of R302,5 billion during the 2003/04 financial year, according to its annual report (Pressly: 2004). The total tax revenue collected during this period is summarised in the following Table 1.1 below:

<table>
<thead>
<tr>
<th>Source</th>
<th>Actual Result (R million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax</td>
<td>171 963</td>
</tr>
<tr>
<td>Value-added tax</td>
<td>80 682</td>
</tr>
<tr>
<td>Customs duties</td>
<td>8 479</td>
</tr>
<tr>
<td>Fuel levy</td>
<td>16 652</td>
</tr>
<tr>
<td>Excise duties</td>
<td>12 381</td>
</tr>
<tr>
<td>Skills development levy</td>
<td>3 896</td>
</tr>
<tr>
<td>Other taxes and duties</td>
<td>8 457</td>
</tr>
<tr>
<td><strong>Total tax revenue</strong></td>
<td><strong>302 510</strong></td>
</tr>
</tbody>
</table>

Table 1.1: Revenue performance 2003/04

It is clear from the abovementioned table that income tax made the greatest contribution towards the total revenue budget. The following chart indicates the contribution expressed as a percentage of the total revenue:
The dependence of the revenue of the State on a sound tax system is demonstrated by these statistics. The core business of any tax administration organization is the levying, collection and control of taxes imposed by the government. The SARS has played a positive role in the South African economy and the Commissioner of the SARS has stated that the success is mainly due to the transformation process of the SARS in the last five years (Gordhan: 2003a). Some of the facts that he outlined as being responsible for this contribution to the economy were:

- SARS had exceeded their revenue target for the last five years;
- the Minister of Finance has given back to the South African taxpayers over R40 billion in tax cuts;
- the individual tax rates have been substantially reduced;
- corporates are beginning to pay a fairer share of the overall tax burden; and
- SARS’s approach to inducing better compliance has made a significant and growing impact on taxpayers in South Africa.

The South African Minister of Finance, Trevor Manuel, acknowledged the contribution by the SARS in his medium term policy statement to Parliament. He stated the following: “However, Madam Speaker, it is not our borrowing but our revenue capacity that is the foundation of our fiscal position. After a decade of fundamental reforms of our tax
structure and improvements in revenue administration, these foundations are firm” (Manuel: 2004b:11).

At the same time, the relevant tax administration should strive to prevent or reduce non-compliance with taxation legislation by taxpayers. It is in the interest of any revenue authority to protect the tax base as this forms the main source of income of any government.

1.2 Importance of protecting the tax base

What is referred to as the “tax gap” is the difference between the amount of tax that is collected by the revenue authority and the amount that is theoretically collectable under existing tax law. The SARS have estimated the tax gap in South Africa at R30 billion (Gordhan: 2003). The tax gap is continuously being analysed with the purpose of reducing it. The factors giving rise to the tax gap have been analysed by the SARS as follows (South African Revenue Services: 2004):

- illegal activities;
- tax avoidance;
- potential uncollected tax;
- tax evasion;
- debt caused by operational inefficiency; and
- tax collected (the gap exists due to individuals and businesses understating income or overstating deductions).

Tax evasion is the illegal way of reducing the tax owing (the difference between tax evasion and tax avoidance is discussed later in this chapter). Various factors contribute to the incidence of tax evasion, including the rate at which tax is levied. The higher the tax rate, the greater the risk of evasion impacting on the tax base. In addition, Caragata (1998:90) stated that the following factors contribute to tax evasion:
• the taxpaying behaviour of others;
• perceptions of whether the government offers value for money in its service;
• the compliance costs of paying tax; and
• how taxpayers are treated by the tax authority.

Risk profiling was conducted in New Zealand to determine which corporate firms reduced their taxes illegally. The profiles of tax evaders as compared to tax compliers indicated that larger firms tend to be significantly more compliant that smaller ones (Caragata:1998). Allingham and Sandmo (1972) modeled an individual’s choice regarding tax evasion and stated that an individual regards tax evasion as a choice or a sort of gamble in which there is a trade-off between a gain if the evasion is undetected and a loss if the evasion is detected and penalised. It is submitted that taxpayers are neither honest nor dishonest, but merely rational decision-makers in calculating what is in their best interest.

According to Slemrod (2003) the most comprehensive data on tax compliance for any country at any time was collected by the United States revenue department. This was done by means of its tax compliance measurement program which measured the total estimated amount of under-reported income and overstated subtractions using a sample of returns filed for six tax years. The following table summarises the results (Slemrod, 2003:34)
Voluntary Reporting Percentage (VRP), Net Misreporting Percentage (NMP) and Gross Tax Gap Estimates by Underreporting Gap Component for Tax Years 1987 and 1988, According to Two Different IRS Studies

<table>
<thead>
<tr>
<th>Underreporting Gap Component</th>
<th>TY 1987</th>
<th>TY 1988</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>VRP (%)</td>
<td>Gap $ billions</td>
</tr>
<tr>
<td>Non-Business Income</td>
<td>15.7</td>
<td>15.7</td>
</tr>
<tr>
<td>Wages and Salaries</td>
<td>99.5</td>
<td>1.4</td>
</tr>
<tr>
<td>Interest Income</td>
<td>94.6</td>
<td>3.2</td>
</tr>
<tr>
<td>Dividends</td>
<td>a</td>
<td>a</td>
</tr>
<tr>
<td>State Income Tax Refunds</td>
<td>95.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Alimony Income</td>
<td>71.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Pensions and Annuities</td>
<td>98.4</td>
<td>0.1</td>
</tr>
<tr>
<td>Unemployment Compensation</td>
<td>89.1</td>
<td>0.3</td>
</tr>
<tr>
<td>Social Security Benefits</td>
<td>96.7</td>
<td>a</td>
</tr>
<tr>
<td>Capital Gains</td>
<td>88.3</td>
<td>6.7</td>
</tr>
<tr>
<td>Income from Sales of Bus. Property</td>
<td>b</td>
<td>28.0</td>
</tr>
<tr>
<td>Other Income</td>
<td>b</td>
<td>3.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Business Income</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-farm Proprietor Income</td>
<td>32.6</td>
<td>31.3</td>
</tr>
<tr>
<td>Informal Supplier Income</td>
<td>50.9(^c)</td>
<td>16.6</td>
</tr>
<tr>
<td>Farm Income</td>
<td>13.1(^c)</td>
<td>7.7</td>
</tr>
<tr>
<td>Rents and Royalties</td>
<td>b</td>
<td>3.1</td>
</tr>
<tr>
<td>Partnership and S Corporation Income</td>
<td>42.1(^c)</td>
<td>3.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Offsets to Income</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjustments</td>
<td>6.1</td>
<td>7.2</td>
</tr>
<tr>
<td>Deductions</td>
<td>106.3</td>
<td>0.5</td>
</tr>
<tr>
<td>Exemptions</td>
<td>104.4</td>
<td>3.5</td>
</tr>
<tr>
<td>Tax Credits</td>
<td>b</td>
<td>0.9</td>
</tr>
</tbody>
</table>

Notes: The VRP is the ratio of the total amount of income or other related items that are voluntarily reported to the corresponding correct amount, expressed in percentage terms. The NMP for a given tax return line item is defined as the ratio of the net misreported amount in the taxpayer’s favour to the sum of the absolute values of what should have been reported, expressed in percentage terms. For income items the NMP value corresponds approximately to 100 minus the VRP. For offsets, the NMP corresponds approximately to theVRP minus 100.

\(a\) denotes that the item is combined with item above.

\(b\) denotes not reported.

\(c\) denotes that the figure was not reported in IRS\((1988a)\), but was calculated by the author from other information reported there.

Table 1.2: Tax compliance measurement
The study clearly indicates a contrast between the relatively low income tax compliance rates of small businesses and a much higher compliance rate for other sources of income, such as wages and salaries. It is the opinion of the writer that the higher compliance rate for income from wages and salaries can be attributed to the fact that revenue authorities have implemented the “pay as you earn” system. In terms of this system income tax (employees’ tax) is required to be withheld from remuneration paid by an employer to an employee. The employer is under the obligation to pay over the tax withheld to the revenue authority. The reasons for the higher non-compliance rate by small businesses are twofold. The first reason may be the lack of a withholding tax and the fact that most tax systems rely on remittance of taxes by the individuals who own the businesses. Unlike employees of an employer, who will in most cases issue an income tax certificate which will indicate the amount of income earned, the information provided to the tax authority by an individual who owns a business is based on the self-declaration by the individual. It is difficult for the tax authority to obtain corroborating information and is not possible to audit each and every sole proprietor. Moreover, the sole proprietor is entitled to various tax deductions. The risk of law interpretation issues, private use of business assets and the deduction of domestic and private expenses are some of the factors that allow the business owner to overstate deductions for tax purposes.

In a presentation to the Standing Committee on Public Accounts, the SARS indicated that an analysis of the tax gap is required to determine the real tax gap, as the gap of R30 billion is only an estimation (South African Revenue Services: 2003b). The following flowchart is adapted from this presentation to indicate the exhaustive set of areas that require data to estimate the tax gap, based on where the decision rights are held. The “decision rights” refers to the choices which a taxpayer has, to either file or not to file a return and if filed, whether to declare all the income or to overstate tax deductions. This flowchart is based on data required only in respect of personal income tax evasion.
Personal income tax evasion

The Auditor-General expressed his concern in respect of the tax gap in the SARS 2001/2002 annual report (South African Revenue Services: 2002b). In the financial report of the SARS, the accounting policy acknowledges that incidences of tax evasion and other breaches of taxation laws affect the SARS ability to carry out its fiduciary responsibilities (South African Revenue Services: 2002b). The Auditor-General’s concern was that the report does not include a review of measures put in place by the SARS to address this matter. The SARS responded to the Standing Committee on Public Accounts as follows (South African Revenue Services: 2003a:12):

Every country has a tax gap that is very difficult to quantify. SARS has developed various initiatives and revenue activation strategies to address the tax gap. Specific industries are being identified for enforcement action and form an integral part of the business plan for enforcement for the 2003/2004 financial year. An integral part of closing the gap is to focus on high-risk areas and to perform risk profiling. The following progress has been made on risk profiling:
SARS has undertaken a comprehensive study to obtain a greater understanding of the tax gap. In this regard, particular attention was paid to the manner in which the gap manifests itself, the areas of risk posed in respect of the respective taxes administered by SARS and the prevalence of tax evasion in various industries. . .

It is evident that the SARS is acting on the concerns raised in the report of the Auditor-General, as one of the SARS compliance strategies for the 2003/2004 financial year is to reduce the tax gap. These strategies were published in the latest annual report of the SARS (South African Revenue Services, 2004:31):

- greater media interest in customs and tax matters, raising the profile of SARS’s actions, but also serving the important purposes of raising the level of awareness in respect of taxpayer obligations;
- larger organisations are increasingly aware of their obligations, with senior management taking a personal interest in tax and customs matters. This facilitates both proactive compliance as well as the quicker resolutions of disputes in instances where non-compliance has been detected;
- indications of proactive actions by taxpayers to rectify non-compliance; and
- an increase in both the quantity and quality of suspicious activities reported to SARS by citizens (the nature of these reports is discussed in Chapter 5 of this study).

As it is the vision or mission of various revenue authorities to promote compliance with tax and to ensure responsible enforcement, the importance of reducing the tax gap should not be under-estimated in adhering to these goals. Pravin Gordhan, Commissioner of the SARS, said the following in his address to the University of South Africa:

It is our hope that over time there will be more compliant tax payers than non-compliant ones, it is our hope that over time, the tax gap, which is the gap between what we collect and what we should be collecting, is narrowed in a significant way, and it is our hope that
at the end of the day we will have an administration on the southern tip of Africa of which all of us can be proud (Gordhan, 2003a:6).

1.3 **Self Assessment**

The tax system of most Western tax administration authorities, including Australia, New Zealand, Canada, Netherlands and, to a great extent, South Africa is based on a self-assessment system. These systems rely mainly on voluntary compliance and on taxpayers declaring their tax obligations under the respective laws.

Verifying that the correct amount of tax has been paid is an important component of improving compliance. Limited resources restrict the ability of revenue authorities to audit each and every tax return submitted. Increased focus on areas of greater revenue risk would form a major part of the strategy of any revenue authority, which relies on a self-assessment system. At the 38th General Assembly of the Inter-American Centre of Tax Administrations held in Bolivia during March 2004, the Canadian Revenue Agency (hereafter referred to as CRA) reported that the allocation of its human resources is based on three primary criteria, of which one is the risk management and risk assessment division. The following statement was made by the CRA (Author unknown, 2004:5):

> In Canada, the objective is to ensure compliance across a full spectrum of taxpayers and industry sectors with a limited amount of resources. To do so, we need to identify strategies and priorities to target limited resources to problem areas and ensure that the compliance burden for compliant taxpayers is minimized. Our objective is to identify the most serious cases of non-compliance through the application of sound risk assessment principles and systems and take appropriate measures to correct and deter non-compliance with the aim of encouraging future compliant behaviour.

The SARS made the following statement about the importance of case selection and risk profiling in their annual report of 2003: “Risk profiling was introduced as a case selection methodology to improve overall audit effectiveness” (South African Revenue
One of the factors mentioned in the annual report of SARS that contributed to improved audit results was the fact that there was an improvement in the quality of cases selected for audit, resulting in a considerable improvement in yield per audit case (South African Revenue Services: 2003a).

The New Zealand Revenue Department stated the following about risk profiling in their annual report for 2003:

> We have changed the focus of our audit activity over the last few years to place a greater focus on areas that present significant compliance or revenue risks, namely corporate taxpayers, aggressive tax issues and tax evasion (New Zealand Government Publications, 2003:8).

The Australian Revenue Services also operate on a self-assessment basis. It is for this reason that risk profiling and case selection is of utmost importance. In their compliance program for 2003/2004 the following was said in this regard: “In the context of Australia’s system of self-assessment, our compliance program for large business is based on understanding the business environment so we can identify and address major tax risks and assist revenue forecasting” (Australian Government Publications, 2003:25). The writer of this thesis is of the opinion that the process of self-assessment could encourage taxpayers to evade tax as the number of cases which are selected for audit is small (refer to chapter two for further discussion on this matter).

1.4 The distinction between tax avoidance and tax evasion

Both tax avoidance and tax evasion on the part of taxpayers contribute to the existence of a tax gap. The distinction between tax evasion and tax avoidance is a well-recognised concept in the tax environment. Tax evasion refers to illegal activities deliberately undertaken by a taxpayer in order to reduce or limited his tax burden. Tax evasion has also been described as fraud, deceit, misrepresentation and non-disclosure (Vorster: 1984). A simple example of tax evasion is where a taxpayer omits income from his annual tax return.
On the other hand tax avoidance is the legitimate means of reducing or minimising taxes. There is no obligation upon any taxpayer to pay more tax than what is legally due under the Income Tax Act, and a taxpayer may enter into normal business transactions, which have the effect of reducing his liability for tax. However, this may only be done if there is no provision in the law designed to prevent the avoidance or reduction of such tax. This principle was clearly explained by the following extract from the judgment of Lord Tomlin in Duke of Westminster V IRC (1953), 520:

> Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow-taxpayers may be of this ingenuity, he cannot be compelled to pay an increased tax.

There is often a very fine line between tax evasion and tax avoidance. Taxpayers who structure their revenue-producing activities in order to pay the minimum amount of tax, do so legally and submit the returns and information required to substantiate their self-assessment. The revenue authorities, based on these disclosures, are thus able to identify tax avoidance schemes or transactions and have a range of general (known as “shotgun”) and specific (known as “sniper) anti-avoidance measures enacted in legislation to combat aggressive tax avoidance schemes (including section 103 of the Income Tax Act, 58 of 1962). The courts, too, apply the doctrine of “substance versus form” to identify transactions or schemes which aim to avoid tax by disguising the true nature of a transaction or set of transactions. In ERF 3183/1 LADYSMITH (PTY) LTD and ANOTHER v CIR (1996) (3) SA 942 (A), 58 SATC 229, the question was whether the taxpayer had obtained a right, the value of which was taxable in terms of paragraph (h) of the definition of “gross income” in section 1 of the Income Tax Act. The scheme was designed on the basis that the landlord owned property on which a valuable building was erected, without the accrual to the landlord of the right to have that building erected. The parties tried to prepare the relevant agreements in such a way that the accrual of the taxable right to the landlord would be avoided. The court acknowledges
the principle that the taxpayers could arrange their affairs in such a way as to fall outside the ambit of a certain provision of the Act, but the court made its decision by considering the true intention of the parties based on the substance of the transaction. As the parties were involved in a disguised transaction, the court further investigated the agreements and surrounding circumstances. The court found that the true intention of the parties was that a right to have improvements made to the land had accrued to the landlord and that it was liable to tax on the value of the improvements. These anti-avoidance measures are of no use to revenue authorities in combating tax evasion, however, as these practices rest on non-disclosure or fraudulent disclosure. The discussion of tax avoidance is beyond the scope of this dissertation. What is relevant is the fact that risk profiling is aimed at identifying cases where possible evasion has taken place.

1.5 Measures employed to uncover tax evasion

Due to the self-assessment approach to process tax assessments, revenue authorities focus on tax compliance by introducing effective risk-based audits. In a media statement by the Australian Tax Commissioner he stated that his tax office will continue to expand risk profiling and field work activity across the large corporate sector (Canberra: 2003). The tax office of New Zealand also has a Taxpayer Audit Selections System, referred to as TASS, which is designed to provide an audit selection system that brings together all potential audit risks (New Zealand Government Publications: 2003). Risk profiling was only recently introduced as a case selection methodology by the SARS to improve overall effectiveness of their tax audits. South Africa is faced with an estimated tax gap of R30 billion (Kemp: 2002). The South African Revenue Services Commissioner has stated that better risk management and profiling would enable Revenue authorities to address ways of narrowing the tax gap (South African Revenue Services: 2003a).

Revenue authorities also make use of data base programs to assist with case selection. A data base is a research tool which combines data from various Revenue information systems and identifies areas of risk to be investigated by the audit section. External data base programs from other Government or non-Government agencies are also used, such as those of the Registrar of Companies, the Deeds Office, and others.
The in-depth understanding of specific industries forms yet another aspect of case selection and risk profiling. Elements external to the financial accounts of a taxpayer will contribute to effective risk profiling and case selection. It is for this reason that the creation of industry profiles plays an important role. These industry profiles enable the revenue authorities to identify companies whose financial statements reveal significant divergence from industry norms and therefore flag them for further audit investigation. Another method of ensuring compliance used by many tax authorities is the suspicious activities report that is submitted to the revenue authorities by members of the public. This report contains details of suspicious or non-compliant activities carried on by taxpayers. These reports assist the Revenue Authorities to identify taxpayers who are non-compliant and to ensure that these cases are scrutinized for possible selection for an audit.

One of the aspects of case selection is to perform a screening process of the financial statements submitted by taxpayers, with specific reference to tax risks. When reviewing information for risk areas the focus is on potential areas of non-compliance and on trying to identify what is missing or lacking in the information available. It is therefore important to interpret the financial statements from a tax perspective. A targeted ratio analysis assists with this interpretation. A capital reconciliation is another method used to determine risk. There is little documented information available on capital reconciliations in South Africa, although the SARS and other tax authorities use it. Certain taxpayers are obliged to submit a statement of assets and liabilities when submitting their income tax returns. A capital reconciliation attempts to establish an “opening net worth” of the taxpayer’s assets at the beginning of a given year and it then proves increases in the taxpayer’s net worth for each succeeding year. Any unexplained growth in assets is taxed in terms of section 78(1) of the Income Tax Act, Act No 58 of 1962, which deals with estimated assessments. Each of these measures is discussed in this thesis.

1.6 Goals and objectives of research

In view of the fact that the South African Revenue Services and those of other counties rely on self-assessment, it is important to adopt an effective compliance program with
specific reference to case selection and risk profiling. The success of any compliance division is an effective and successful case selection system. The objective of a case selection program should be to maximise the impact of voluntary compliance and to identify those taxpayers, or categories of taxpayers where the probability of substantial understatement of income is the highest. This risk analysis aims to identify those areas where there is risk of non-compliance and or fraud. The tax authorities need to make choices about how best to direct their activities to address areas of greatest risks.

The main objective of this research will be to analyse methods of case selection and risk profiling used by the revenue authorities of countries such as New Zealand and Australia, with a view to designing a model to be used in South Africa to identify cases of possible tax evasion. The SARS is in the developing stages of its case selection methodology and the research is directed mainly at comparable information from other countries such as New Zealand and Australia. The research will be approached from the broader goals of the preservation of the tax base and increasing revenue collection.

Very little has been written on case selection or the interpretation of financial statements from a tax perspective, and in view of the fact that it is not common practice to expose tax practitioners during their education and training to procedures applied by revenue authorities to detect tax fraud or to the interpretation of financial statements with specific reference to tax risks, it is submitted that the proposed area of research is of practical importance to both revenue services and tax practitioners.

1.7 Research methodology

The research method adopted is of a qualitative, interpretive nature, based on a detailed analysis and interpretation of the relevant case selection programs used by various tax
authorities. A literature review and analysis of relevant provisions of various Acts forms part of the research. The researcher collected certain unpublished information from other revenue authorities via electronic mail. The scope of the research also includes the investigation of various methods that are used by the tax authorities to ensure tax compliance. A review is undertaken of the Australian, New Zealand, South African revenue authorities and others, with reference to the methodology used to enhance compliance, with specific emphasis on case selection. Where necessary, to obtain clarity on specific aspects or to obtain further undocumented information, use has been made of unstructured interviews. The writer has used his own practical experience as an employee of the SARS to illustrate how tax risks are identified from a set of financial statements or a tax return submitted by a taxpayer and has compiled an industry profile as a case study to illustrate the practical use thereof.

1.8 Conceptual clarification

With a view to clarifying certain terminology the following concepts are explained:

When referring to a “case” it refers to the taxpayer’s file and related documentation. The term “case selection” is used to describe the process for screening tax returns to determine those filed returns most in need of an audit to determine the accuracy of the reported tax liability. “Case allocation” is the allocation of a case to the tax auditor for investigation. “Self-assessment” is the process by which a taxpayer completes his own tax return and the tax assessment issued by the revenue authority is based on the information completed by the taxpayer. “Risk profiling” or ”risk assessment” is an examination process, which is aimed at identifying tax risks using internal revenue data as well as external data. The term “risk-based audits” refers to cases identified for audit in which risks have been determined.

1.9 Structure of the research

Chapter 2 analyses the case selection methodology used to maximise the impact of voluntary compliance. Key characteristics of the risk assessment programs used by
different revenue authorities are discussed. The case selection methodology for tax refunds is also discussed in this chapter. Chapter 3 considers the use of computerised risk programs used to analyse risks and the management of these programs. Chapter 4 assesses the role of industry profiles in the risk identification process. A practical example has been compiled to illustrate the use of an industry profile to identify risks in a specific industry. Chapter 5 indicates how successful third party data can be used to assist revenue authorities to identify non-compliance and to reduce the tax gap, using suspicious activity reports. Chapter 6 considers the role of the risk profiler. The final chapter, Chapter 7, concludes the study with the recommendation of a case selection methodology, for use by the SARS.

1.10 Conclusion

Clearly, an important aspect of the task of any revenue department is based on determining whether taxpayers are complying with their obligations and taking appropriate enforcement action if they are not. To seek maximum efficiency of resources, risk profiling and case selection is essential. Taxpayers and categories of taxpayers with the greatest likelihood of non-compliance, together with the need to maximise recovery of the debt, should be a selection criteria for audit. Having a better understanding of the risk selection process enables any revenue authority to develop and implement a strategy best suited to effectively address the issue of non-compliance. These strategies include the case selection methodologies applied by the revenue authorities, which are discussed in the following chapter.
CHAPTER 2
CASE SELECTION METHODOLOGY

2.1 Introduction

Revenue departments continuously seek to identify non-compliant taxpayers (non-filers and under reporters) amongst a vast number of taxpayers and potential taxpayers. With limited resources available to identify and investigate such cases, the methods to be employed for case identification remain a challenge for these departments. A successful audit programme relies on a successful case selection system.

Case selection and allocation is one of the elements of the overall risk management process. Risk management can be defined as a systematic process in the course of which people and resources are deployed, based on risk analysis, aiming to achieve an optimum tax revenue yield. Because the risk management process is continuous, the process must be effective within the environment in which the revenue authority is operating. As the environment changes, it will have an effect on risks and risk assessment. Risk analysis is a proactive process through which risks are identified, analysed and assessed. This process provides the basis for decisions regarding any action which the revenue authority would take in respect of any tax case to be investigated. The process requires the identification of theoretical risks and can also involve research into economic activities of an industry. Although revenue authorities focus on high risk, it is important for these authorities to maintain an audit presence across all industry sectors and types of taxpayers. Maintaining an adequate audit coverage will ensure that the integrity of the revenue authority is upheld. The objectives of an effective case selection process are:

- to maximise the impact on voluntary compliance; and
- to focus attention on taxpayers identified as having the greatest probability of substantial understatement of income.
2.2 Selection Methodology

Various countries base their case selection methodology on similar principles. Cases are identified using a number of sources of information, database systems, industry profiles and others. The tax office of Australia stated in their annual report of 2002/03 that they identify risks for each segment of the tax base (Australian Government Publications: 2003). Because of the size, nature and diversity of their tax system, the Australian tax office separates taxpayers into market segments. These market segments are:

- individual taxpayers;
- micro businesses (annual turnover less than $2 million);
- small to medium enterprises (annual turnover between $2 million and $100 million);
- large businesses (annual turnover more than $100 million); and
- non-profit organisations.

For each of these segments risks are determined and cases are selected for audits, based on the risks inherent to the segment. Businesses attract the tax office’s attention for audits where the tax performance of the business appears to be inconsistent with their level of economic activity, or their financial or tax performance is not in line with others in their industry. Industries are investigated where their performance against key indicators such as lodgement, debt and levels of tax paid are inconsistent with economic conditions and industry benchmarks. Taxpayers trading in such industries will then be subjected to audit.

The Canada Revenue Agency (CRA) uses risk assessment programmes to guide the audit section by providing specific risks, patterns and trends within an industry (Canadian Government Publications: 2003). The Commissioner for the Canadian revenue authority (Alan Nymark) stated in his 2002/2003 annual report to parliament that to promote compliance, it is essential that they manage ongoing risks as well as
emerging risks associated with the changing nature of Canada’s socio-economic environment, globalisation and the growth of e-commerce. He further stated that the dynamic environment demands vigilance and increasingly strategic approaches for assessing, prioritising and addressing compliance risks (Canadian Government Publications: 2003). The risk assessment process identifies specific issues for the auditor’s attention whilst enabling effective use of their time and not restricting their ability to identify other issues for audit. As with many other revenue authorities the CRA is constantly refining their already sophisticated risk assessment tools to monitor trends and identify emerging issues, thereby increasing their revenue collection. The CRA has world-class risk assessment systems that enable them to focus on areas of high risk and to direct their enforcement action to these areas (Canada Revenue Agency (Author unknown): 2004). The methodology used by this agency to identify cases for audit is the following:

- using taxpayer compliance history;
- third party information;
- criteria established on the basis of analysis of non-compliant behaviour;
- national risk assessment systems; and
- segmentation of the tax base (for example, dividing taxpayers into criteria such as small, medium or large).

The United States revenue department (IRS) has an intelligent case identification and allocation system which automates the identification of under-reporters, ranks them according to selected criteria and assigns them to experienced investigators for further action (American Heuristics Corporation (Author unknown): 2004). The main modules of this system are the “case identifier” and “case allocator”. The case identifier receives input from three sources:

- the returns database – which contains all the returns that are to be evaluated;  
- case profiles – which stores profiles used to match and identify the returns which are candidates for future investigation; and
• identifier intelligence – which consists of data instructions and procedures which will be used by the case identifier to identify returns matching a specific profile.

This process will identify cases for further investigation. The case allocator receives input from the following sources:

• the list of cases received from the case identifier;
• an investigator skill profile;
• an investigator work schedule; and
• allocation intelligence (data instructions and procedures to be used by the allocator in assigning cases to individual investigators).

This case allocation methodology is illustrated in the following flowchart (adapted from Triage for Tax Audits, the American Heuristics Corporation).

**Figure 2:1 IRS case allocation methodology**

The case selection methodology of the New Zealand revenue office is based on their knowledge of a specific industry and on the information available in their database.
systems (Philp: 2004). The data warehouse is a research tool combining the data from the major revenue information systems of New Zealand. The data warehouse is mainly designed to evaluate areas of risk and to identify individual taxpayers for case selection. Information is extracted from returns submitted, supplemented by external data. This combination of internal and external data identifies potential high-risk cases for audit. The major benefit of this methodology is that all the data in respect of a single taxpayer is collated and used to identify risks.

The process is illustrated as follows (New Zealand Tax Office, Undated b):
The SARS introduced a research and analysis unit during 2001 which provides tactical and strategic intelligence to support enforcement strategies. Furthermore this unit will provide national risk analysis and sector specific industry analysis to the enforcement division (South African Revenue Services: 2002a). The unit will be responsible for the following:
• development of an organisation-wide risk management methodology;
• provision of a national risk analysis and sector specific industry analyses;
• establishment of key partnerships to ensure ongoing information collection;
• generation of taxpayer profiles to expedite investigations and audits;
• environmental scanning to proactively address emerging areas of high risk; and
• provision of tactical support to investigation units.

Another function of this unit is its intention to be more proactive in intelligence gathering whilst enhancing the process of case selection. The unit is still in a developing phase and is known as the SARS Business Intelligence Unit (hereafter referred to as BIU). A general understanding of the South African economy and industry segments is required at a national and regional level. This information is used to compile specific industry profiles, aimed at identifying role players within an industry. This process is aimed at identifying entities which are non-compliant whilst monitoring trends within the specific industry. This analysis can either be done on a national or regional basis. Industries are divided into sectors and segments (the real estate industry can be classified as a sector and the estate agent business as a segment within the real estate sector). An example of a high-risk industry profiled and audited by SARS during the 2002/03 tax year was the music industry (South African Revenue Services: 2003a). After investigation, this industry yielded more than R500 million in assessments of tax. The high-risk candidates are then subjected to in-depth analysis using various internal systems and external sources such as the Customer Credit Bureau, Registrar of Companies and others. Computer risk profiling tools such as SARAP (SARS Audit Risk Analysis Programme) are used to assist with risk profiling (Gordhan: 2001). External information received on candidates who are not complaint is also used in the process of case selection methodology. The SARS methodology therefore not only uses computer database programs to identify risks, but also in the application of intelligence sources in the case selection methodology.
The following diagram illustrates the basic case allocation process. This diagram has been compiled using the writer’s own knowledge of the case selection process in the SARS:

![Diagram](image)

**Figure 2.3: SARS case selection process**

### 2.3 Evaluation

Evaluation and feedback are essential elements of the risk management and case selection process. Evaluation is necessary in order to learn from the current process of risk identification and to increase the accuracy of this process. The feedback of any
results and conclusions from the evaluation process provides an important input for the revenue authority’s decision-making process. The feedback and evaluation feedback will provide information with regard to decisions on the audit and risk management strategy and the overall planning of operational activities within these units. Furthermore, the evaluation process will also be an essential tool for the allocation of human and technical resources. The effectiveness of the risk assessment and case selection methodology will rely on the evaluation process. If any revenue authority relies on a risk assessment programme to provide the audit section with cases to audit, it is of utmost importance to regularly evaluate the model and its outcome.

- The SARS capture results on all cases referred to the audit section on a computer database program. However, there is currently no direct link between the audit result and the risk identified by the profiler (Schlenther: 2004). For example, if a profiler identified that the provision for obsolete stock and under-declaration of income are risks in a company, the case is forwarded to the auditors based on these risks identified. The auditors will conduct an audit and capture the monetary result on the database system after the audit has been completed. This result captured may not relate to stock provisions or non-declaration of income, but could relate to any other tax adjustment made while conducting the audit. It is therefore submitted that the risk management process must ensure that the feedback loop exists between the actual results achieved by the audit division and the relationship between these results and the actual risk determined.

The 2003 annual report of the SARS stated that the audit coverage has decreased (South African Revenue Services: 2003a). The audit coverage refers to the number of cases audited by the SARS as a percentage of the total cases on register with SARS. The following table indicates the audit coverage:
<table>
<thead>
<tr>
<th>2003 Fiscal Year</th>
<th>Number of audits</th>
<th>Coverage as % of the tax register</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax</td>
<td>76 151</td>
<td>1,4 %</td>
</tr>
<tr>
<td>PAYE</td>
<td>3 347</td>
<td>1,3%</td>
</tr>
<tr>
<td>Value Added Tax</td>
<td>52 071</td>
<td>10,2%</td>
</tr>
<tr>
<td>Other</td>
<td>3 966</td>
<td>Not known</td>
</tr>
</tbody>
</table>

Table 2.1: Audit coverage

The report indicated that the reason for the decrease in coverage was due to the risk profiling done on taxpayers, which increased the strike rate of the audit performed. What is referred to as the strike rate is the number of cases audited which yielded an audit result as a percentage of the total cases audited. The strike rate increased from 34% in 2001/02 to 52% in 2002/03 (South African Revenue Services: 2003a).

The latest annual report was released during September 2004. This report indicates a further drop in the audit percentage coverage (South African Revenue Services: 2004). The audit coverage compared to the previous year is illustrated in the following graph:

![Audit as % coverage of tax register](chart2.1.png)
The revenue yield per case has increased but the strike rate has remained the same from the 2003 to 2004 tax year. The report states that one of the factors that contributed towards the increase in the additional tax assessment per case, is due to an improvement in the risk profiling of cases. The strike rate and additional income per assessment is illustrated below:

**Strike rate and additional tax assessment per case**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strike rate</td>
<td>52%</td>
<td>52%</td>
</tr>
<tr>
<td>Average additional tax assessment per case</td>
<td>R351 321</td>
<td>R151 296</td>
</tr>
</tbody>
</table>

*Table 2.2: Strike rate and additional income*

The risk profiling of cases might have contributed towards the increase in the revenue yield per case, but if the risk profiling process was indeed more effective than the previous year, the strike rate should also have increased. The mere fact that the audit percentage coverage has once again reduced from 2003 to 2004 without an increase in the strike rate should be of concern to the SARS and the Auditor General. It would appear that the SARS are not concerned about the audit percentage coverage, but that their approach is one of a more effective audit process.

Having regard to the fact that results from the auditors are not directly linked to the risks determined by the profilers, it is questionable whether the increase in the strike rate can be attributed to the implementation and expansion of the business intelligence unit.

### 2.4 Tax Refunds

Although tax risks are to be found in taxpayer’s returns with or without a tax refund, tax authorities appear to have a separate case selection methodology when taxpayers are in a refund situation. The Australian tax office indicated in their annual report of 2002/03
that they check high-risk refunds and ensure that benefits are paid to those entitled to receive them (Australian Government Publications: 2003).

The New Zealand tax office utilises a system called the General Sales Tax Refund Audit Selection System (GRASS) to ensure that refunds are profiled before being paid to taxpayers (New Zealand Government Publications: 2003). The GRASS is an application built over the data warehouse that sources the majority of its information from taxpayers. The primary function of GRASS is to improve efficiency in the General Sales Tax (hereafter referred to as GST) refund screening process by targeting risk cases and eliminating the duplication of effort in compiling customer profiles. Details of all GST refunds, greater or less than the Approved Refund Level, are included in GRASS. Revenue authorities limit the number of refunds to be reviewed using the approved refund level. Due to the vast number of refunds it is not practical to review each and every case generated by the system.

The main features of GRASS are (New Zealand Tax Office (Author unknown): undated b):

- GST refund details are available within one working day after the returns have been captured on the main computer system;
- a multi option selection screen is available for use by screeners to target risk cases either greater or less than the Approved Refund Level;
- comprehensive customer profiles exist for all cases selected, viewable online and with print report option;
- a referral facility exists between users at the same or different locations;
- reports listing cases selected for manual release of refund;
- reports are generated listing cases selected as requiring audit cases to be opened;
- a report is generated of refunds not released within a specific number of days since return lodged; and
- a report is generated of cases consistently less than the approved refund level, to assist with potential fraud identification.

The following basic diagram illustrates the GST refund screening process and also the additional functionality that enables identification of GST refunds, which are less than the approved refund level. This diagram has been adapted from an internal document received from the New Zealand revenue department (New Zealand Tax Office (Author Unknown): undated a).
Figure 2.4: GST refund screening process

**REFUNDS < ARL**
- Lists GST refunds that are frequently handled and used to identify potential fraud cases.

**< ARL**
- DW-G-R-A-S-S- Table

**> ARL**
- NON SELECTED REFUND RELEASE REPORT
  - Lists non selected cases up to 10 working days after the return was filed. Refunds to be manually released.

**SELECTION SCREEN**
- Multiple selection options, eg greater or less than ARL, Industry Code, Zero Rated Supplies etc

**CUSTOMER PROFILE**
- Comprehensive Customer Profile report produced for each customer selected and reviewed by Screener

**SCREENER IDENTIFIES RISK?**
- YES
  - **SCREENER REFERS CASES TO "TEAM LEADER"**
  - **"TEAM LEADER" ALLOCATES TO INVESTIGATOR AND PROVIDES CUSTOMER PROFILE**
  - **INVESTIGATOR IDENTIFIES DISCREPANCY?**
    - YES
      - INVESTIGATION CONTINUES
    - NO
      - REPORT MONITORING RESULTS OF SELECTION CRITERIA

- NO
  - **REFUND RELEASE REPORT**
    - Screener releases refund
  - **OPEN AUDIT CASE REPORT**
    - Screener opens Audit case

**REFUND RELEASED BY INVESTIGATOR**
- PROVIDES FEEDBACK FOR FUTURE RISK SELECTIONS
2.5 SARS refund process

The SARS operates in a similar manner. A refund in excess of an approved refund limit is investigated. This process ensures that all refunds above a certain approved limit are subjected to an investigation before the refund is paid to the taxpayer. It would appear that the SARS and the New Zealand tax office have very good control over the payment of refunds. However, considering the total coverage of audits conducted by SARS, a taxpayer not receiving a refund in excess of the refund limit, has a smaller possibility of being subjected to an investigation. The following example is used to illustrate this statement (assume a tax rate of 25%):

Taxpayer 1

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>R</strong></td>
<td></td>
</tr>
<tr>
<td>Income</td>
<td>200 000</td>
</tr>
<tr>
<td>Expenses</td>
<td>100 000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>100 000</td>
</tr>
<tr>
<td>Tax payable</td>
<td>25 000</td>
</tr>
</tbody>
</table>

* Assume that R30 000 does not rank for a tax deduction and that the taxpayer is not paying employees’ tax.

The R25 000 tax payable is only due once the assessment is raised. As there is no refund due, this taxpayer will not automatically be subject to an audit, although the taxpayer has claimed expenses not qualifying for a tax deduction. Tax payable should therefore be R25 000 plus R7 500 (25% x R30 000).
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>R 200 000</td>
</tr>
<tr>
<td>Expenses</td>
<td>R 100 000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>R 100 000</td>
</tr>
<tr>
<td>Tax payable</td>
<td>R 30 000</td>
</tr>
<tr>
<td>Less tax paid</td>
<td>R 50 000</td>
</tr>
<tr>
<td>Tax refund</td>
<td>R 20 000</td>
</tr>
</tbody>
</table>

If it is assumed that the approved refund limit is R10 000, the refund due to this taxpayer will be subject to investigation and all refunds in excess of this limit will be subjected to an investigation process.

However, having regard to the total percentage of individual cases audited (1,4%), taxpayer one has a very slim chance of ever being audited, although he might be the taxpayer with the higher risk. It is debatable whether this process can be challenged in terms of the Constitution of the Republic of South Africa, Act No 108 of 1996 and the Promotion of Administrative Justice Act, 2000. In terms of the constitution everyone is equal before the law and has the right of equal benefit of the law. Paragraph 3 of the promotion of administrative justice act stipulates that any administrative action, which materially affects the rights of any person, must be procedurally fair. Whether taxpayer “two” can challenge the SARS based on the fact that only a small percentage of taxpayers are audited who are not in a refund position, but all taxpayers who will receive a refund over a predetermined limit are be subjected to investigation, has not yet been tested in courts of law.
2.6 Conclusion

This chapter has dealt with the various case selection methodologies used by revenue authorities and particularly that of the SARS. The main concerns identified by the writer of this thesis are summarised as follows:

- no feedback loop exists between the actual results achieved by the audit team and the risks determined by the risk profilers;
- it is questionable whether the increase in the strike rate can be attributed to the implementation of the business intelligence unit; and
- a taxpayer not receiving a refund in excess of the refund limit, has a smaller possibility of being subjected to investigation.

The use of computerised risk programs, industry profiles and third party data is evident in the abovementioned case selection methodologies. Each of these important elements of the case selection process is discussed in the following chapters.
3.1 Introduction

One of the methods of case selection used by many revenue authorities is a computerised database program. A database-designed, case selection tool is designed to identify high-risk cases with the minimum taxpayer contact. This method of risk profiling is used by revenue authorities such as SARS, New Zealand, Sweden as well as others to provide a basis of case selection for audit, using only the data captured from the returns filed at the revenue offices.

3.2 Database programs as case selection tool

The New Zealand tax office uses a database program designed to provide an audit selection program that will calculate all potential risks (Philp: 2004). The purpose of such a tool is to provide cases for audit by identifying quantified discrepancies or risks. For each taxpayer, certain financial data is extracted from the various returns submitted. The following data is captured, namely:

- trading account;
- profit and loss account;
- balance sheet;
- income tax returns;
- General Sales Tax returns; and
- payroll returns.

The data is then exported from the main computer system and put into a Microsoft Access database used to calculate risks. To enable the computer program to select high-risk cases, it must be programmed to identify specific cases to be selected for audit. To obtain these results certain queries are written for the database program. A
typical query, for example, would be a large variance of the gross profit percentage from one year to another. The New Zealand database system, like most other similar systems, operates on a points system (Philip: 2004). If, for example, a certain variance in gross profit percentage is detected, a point will be allocated for the risk. All taxpayers are scored, but the taxpayers with the highest risk can obviously be targeted for audit purposes.

One of the most advanced automated, case selection systems is that of Michigan’s revenue compliance bureau. The bureau has implemented a state-of-the-art, fully integrated information technology solution that is revolutionising the way in which they administer their entire audit compliance process (Haas: 2001). The system, known as the Field Audit Research, Selection, Tracking and Reporting (FARSTAR) system is more than simply an audit selection program. This system addresses all areas of the selection and compliance process. The audit staff of the Bureau can perform their duties completely electronically. The auditors are connected through laptop computers to all the various computer systems. An automated tool facilitates downloading of new audit assignments, uploading of final audit information, progress tracking and other management functions. Potential audit cases are selected by using an automated, rules-based system that automatically extracts the required data from the Treasury data warehouse, before processing the data against the rules.

As with all similar systems, potential audit cases are selected by using an automated rules-based system that automatically extracts the required data from the data warehouse, before processing the data against the rules base. The profiling or case selection staff can directly access data from this system and use it to analyse the taxpayer’s information or review the results of the rules. The auditor can then either accept the case for audit or elect to move it to a “reviewed, but not recommended for audit” category. All the screening results are stored in the data warehouse for future review. If a case is assigned to an auditor, an electronic audit case is generated with the following information:

- all relevant taxpayer data (downloaded from the data warehouse);
• the rule base findings;
• the manual screening results as determined by the screener; and
• the audit instructions.

All the information is therefore available for the audit staff to conduct an audit using web servers. The process is conceptually illustrated as follows (adapted from the state of Michigan Department of Treasury):

![Diagram](image)

**Figure 3.1: Computerised case selection system**
The SARS introduced a database program called the SARS Audit Risk Analysis Program (hereafter referred to as SARAP) (Gordhan: 2001). The Swedish International Development Co-operation Agency supports this system. The Commissioner of the South African Revenue Services stated in a media release that the system equips SARS with customised risk analysis software that compares favourably with the most sophisticated programmes used world-wide (Gordhan: 2001). The software program used is known as the Eskort software system and is already in use in several countries around the world. The Eskort system provides the framework for developing risk-related rules, which will then be applied to the data held by Revenue. The system therefore uses a knowledge base, which simulates a human’s mode of reasoning. The data is then tested against these rules by the computer program. Rules are written in the form of “if-then” constructs, where “If” would represent the condition and “then” the conclusion. Using the gross profit percentage of a company as an example, the condition tests the value of the field against predetermined thresholds. The conclusion of the rule-based analysis would be either to take further action or not. As in the case of New Zealand, the system allocates high-risk cases based on a risk scoring method. Not only will cases be identified on points, but also on certain deficiencies. An example of a deficiency is where there is a large increase in bad debts claimed on a year-to-year basis. Based on these rules the system will indicate the case as either high or low risk.

The process is illustrated as follows:
The SARS is currently involved in a restructuring process, whereby they are developing their Business Intelligence Unit (Schlenther: 2004). This unit is responsible for allocation of cases to the audit teams. The computerised method of case selection is currently only used on companies and close corporations (Gordhan: 2001). It is suggested that this method of case selection should be extended to include data from all income tax returns, such as personal income tax returns, trusts and estates. The discussion earlier in this study on case selection methodology indicated that other cases are also selected for audit from a specific class of taxpayers. To ensure equal representation in this method of case selection, the SARS should extend the SARAP system to include all companies, trusts and individuals. The SARS has indicated in a report to the Standing Committee on Public Accounts that enhancements were made to the system and the
development of the system for the use within the Value-Added Tax environment has progressed (South African Revenue Services, 2003b:13). The Revenue Services added:

There are currently approximately 490 000 corporate risk profiles on record. These profiles provide more information than was in existence at the end of 2001/2002 as a result of program enhancements developed during the year. These profiles are being used, as required, by the risk profiling teams in the larger offices all over the country. The development of the system for use within the VAT environment has progressed.

The report further indicates that the computerised system of risk profiling will be developed for the individual income tax and employees’ tax components in future.

Random sampling is a method that will ensure that all taxpayers have the same chance of being selected for audit. According to the SARS annual report (2002/03) the number of cases on register is as follows (South African Revenue Services: 2003a):

- Individuals 5 106 512
- Companies 3 885 136

It is assumed that trusts are classed as individuals in this report. The annual report, however, listed trusts separately when it reported on non-assessed returns. It is therefore possible to distinguish between trusts, individuals and companies. With regard to the clearly recognisable classes of taxpayers, it is suggested that SARS should use stratified random sampling to select cases in which the SARAP system is used for audit. Stratified random sampling ensures, with a greater degree of certainty, a sample representation, from a population with clearly distinguishable strata (sub-populations). With this type of sampling, the SARS can be ensured of representation from all groups, irrespective of sample size, because it has been built into the sampling strategy from the very beginning. If the methodology is to audit only high-risk cases, the system must at least include all classes of taxpayers. This will ensure that the program screens all taxpayers.
3.3 The advantages and disadvantages of a database selection program

Using a database system to identify risks for case selection has several advantages:

- all taxpayers are subject to risk profiling;
- although all taxpayers are scored, only those with the highest risks need be targeted;
- it is a time saving method of risk profiling as data from each taxpayer is not collated on a manual basis;
- the criteria for profiling is standardised; and
- this method of profiling is flexible, as the rules can be adapted to changing circumstances.

However, there are certain disadvantages in using this system:

- it is submitted that not all taxpayers necessarily complete their tax returns correctly, which could then contribute to distorted results; and
- if the rules for the system are not effective, cases with potential low risks might be identified, thus resulting in the need for database management.

3.4 Database management

To limit the risk of unsuccessful identification of potential risk cases by the computerised system, it is suggested that a feedback loop should be part of any such process in order to evaluate the effectiveness of the risk profiling database system. The risk profilers should provide regular feedback on the accuracy of the data captured. They should also perform random tests to verify whether all sections of the return are completed and captured correctly. Another area of concern is that there appears to be a lack of regular feedback on the effectiveness of the rules of the SARS and New Zealand cases. A management system will ensure that the rules are effective and are constantly evaluated and, where necessary, changed to optimise the effectiveness of the system.
It is therefore suggested that the process should include the management of the system.

This process is illustrated by the writer as follows:
Information received from filed returns

Data captured from filed returns

Application of rules by system

Cases identified as high risk by system

Amend/Add/Delete rules where required

Random verification of data captured

Test effectiveness of rules on cases identified by system

Determine reasons for non-identification of cases by system if manual selection process indicated a high-risk case. Evaluate the rule that selected a case as high risk. If valid, the rule is correct; if low risk, the rule should be amended or deleted.

Figure 3.3: Data management process
3.5 Conclusion

A well-designed database system will contribute to the efficiency of any risk profiling section. However, it is clear that the rules created for identification of risks are one of the most important factors in the whole process. If the rules are not effective, cases will be erroneously identified as high-risk by the computer. It is therefore submitted that if any revenue department using this system of case selection does not have an effective system whereby new rules are written and existing rules are evaluated, case selection might not be as effective as it should be.

A database risk identification system is one method to determine risks. Another method to determine risk is to establish the risk of a specific industry. The taxpayer operating in that industry may then be selected for audit. The following chapter in this study explains how an industry profile should be established for tax purposes.
CHAPTER 4
THE ROLE OF INDUSTRY PROFILES

4.1 Introduction

Professionals in the economic environment are regular users of industry data. Industry data can be in the form of statistical data, such as a gross profit percentage for the industry, industry trends, export data and other. The industry profile is used to identify leading – and lagging – industries within a region, to provide background information for meetings with prospective investors in a specific industry or, a more general use, to provide a better understanding of the existing industries within a community.

The SARS introduced a research and analysis unit during 2001/2002. The Commissioner stated in the annual report of 2001/2002 that one of the primary deliverables of the unit is to generate taxpayer profiles to expedite investigations and audits (South African Revenue Services: 2002a). The 2003 annual report stated that one of the factors that contributed to the surplus in the revenue target was the enforcement campaign directed at high-risk industries (South African Revenue Services: 2003a). Results from these high-risk industries yielded more than R726 million in additional tax revenue. These industries included the music industry, micro lending, the wine industry, as well as others. The Australian tax office stated in their compliance program for 2002-03, that part of their compliance plan was to increase their focus on tax performance at both the individual business and industry level (Australian Government Publications: 2003).

To enable the revenue authorities to achieve improved results by focusing on specific industries, it is important for these authorities to have a clear understanding of the industry. To achieve this, an industry profile must be compiled, with specific reference to the relevant tax law applicable to the industry.
4.2. What is an industry profile?

An industry profile is a detailed description compiled from research that is conducted on a specific industry. The industry is analysed from researched data such as product lines, suppliers, buyers, the legal environment, distribution channels and other categories. Depending on the target audience, the information needs in an industry profile would differ from one organization to another. One must also not confuse an industry profile with an industry analysis. An analysis requires more technical assistance from economists and industry experts. There is normally a large amount of economic data published on industries; however, the researcher should refrain from using excess information. The information in the profile should focus on the end user. The ability of the end user to interpret the data should therefore be considered.

For tax purposes, the relevant tax law applicable to the particular industry should form part of the profile. The objective of the industry profile, for tax purposes, is to enable risk profilers and auditors to have a clear understanding of the industry and the tax risks inherent to the industry.

4.3 How to compile an industry profile

There are many different ways to conduct an investigation and compile an industry profile. For tax purposes the profile should give the auditor a clear understanding of the industry and the inherent tax risks of that specific industry. This could be a daunting task, which requires both published data and “first-hand” information from interviews with members operating in the industry. Locating information can sometimes be difficult and time-consuming. The researcher must endeavour to present a profile that is complete and accurate. The compiler of the profile must always take note of the date that information was released. Industry statistics might be available on the Internet or in publications, but may be out-dated.
To summarise, the following important issues must be considered when compiling a profile:

- the industry must be clearly defined;
- consideration must be given to the end user of the information;
- the amount of detail required;
- the time period in which data is extracted (an industry census may provide extensive detail on the internet, but may be years old);
- the specific economic details needed for the profile; and
- the application of the tax law and other legal requirements.

The following template has been designed by the writer as a guideline to compiling an industry profile, with specific reference to the requirements of tax authorities.

i. Industry description

The use of a general industry description, such as the manufacturing industry, may be clear but such a broad-base description may also result in the researcher having to collect an unnecessarily large amount of statistical data and perform unnecessarily detailed economic analyses. The industry description should contain the following details:

- A description of the product or service produced or provided by the industry. If a plastic manufacturing business is profiled, the description would include details such as:
  - categorising the industry, in this case part of the manufacturing trade;
  - the type of products manufactured, for example, pipes, bottles and bags; and
  - what are the largest markets served by the industry?
ii. Industry data

Industry data should consist of the following:

- the number of cases on the tax registers for the specific industry (tax offices use codes to identify industries and this information should be available from their database system);
- any information available on suspicious activities or any non-compliance relating to the industry;
- legislation requirements: certain industries, such as banks, are required to obtain a license before they can operate as a financial institution;
- sources of income: the sources of income should be stated, for example, commission income, remuneration and other;
- seasonal factors, if any: certain industries such as the building industry have off-peak periods; it is important to mention such seasonal factors as they will have an impact on the turnover of an industry in an off-peak period;
- government incentives: list all government incentives, such as incentives received from the Department of Trade and Industry or the motor industry development programme (MIDP) allowances;
- whether the industry imports or exports goods: importing or exporting of goods is relevant when discussing the tax consequences of the industry, such as duties and value added tax; and
- method of payment; indicate whether the industry makes use of electronic payments, cash payments or both; the method of payment will be an indicative factor in determining the risks in the specific industry.

iii. Economic overview
An economic overview included in a profile will provide the researcher with information on the industry’s recent performance, the present status relating to the economy and possible future forecasts. The Internet provides the researcher with useful information on various industries that will assist in compiling an economic overview of a specific industry.

iv. Industry or Trade Associations and Stakeholders

Many industries have trade associations. These trade associations could provide the researcher with important information regarding the industry. An example of such an association is the Master Builders Association with which certain building contractors are registered. The researcher can therefore obtain a list of all registered builders and compare this with the tax register. There are numerous controlling bodies for different industries and these bodies could provide the researcher with extremely useful information.

The sectors within an industry should also be identified. If, as an example, the real estate industry is to be profiled, the following sectors will have a direct relationship with this industry:

- estate agents;
- property developers;
- auctioneers; and
- the local sheriff’s office (sale of properties in execution).

The role of each sector must be determined in relation to how these sectors form part of the bigger picture of the industry profile. The relevant tax implications should also be stated. In the fore-mentioned example, the information obtained from the local sheriff’s office could provide details of property speculators.
v. **Tax and accounting implications**

It has been submitted that merely listing the relevant sections of the Income Tax Act or Value-Added Tax Act is not sufficient for the purposes of compiling an industry profile for tax purposes. Having researched the industry, the inherent tax risks should be addressed in this section. It is also possible that high-risk candidates were identified during the research stage and a list of such candidates may be useful for the risk profiler. Using the real estate example, a possible tax risk would be that estate agents only declare commission in terms of the “gross income” definition on the date of registration of a property and not on the date by which all suspensive conditions in the sales agreement have been met. If the accounting treatment of a transaction differs from that of the tax practice, the different treatment must be detailed. The tax and accounting implications should provide the end-user with the following information:

- the relevant sections of the Taxation Acts, with a brief explanation on each;
- the inherent tax risks of the industry;
- a listing of any tax incentives applicable to the industry and how they are treated for tax purposes; for example, the motor industry development programme in the motor industry;
- a list of court decisions applicable to the industry (the list must focus on tax issues relevant to the industry; in the construction industry case law on section 24C of the Act will be relevant);
- Income Tax or Value-Added tax practice notes; and
- accounting statements relevant to the industry, if the tax treatment differs from the accounting treatment of transactions.
vi. References

References used to compile the industry report must be cited at the end of the profile, to provide the end-user with the relevant references used. When a profile is specifically compiled for the revenue authorities, reference must be made to internal and external sources. It is proposed that references should be written in an appropriate and consistent style.

4.4. Practical example

To illustrate the practical use of an industry profile the following profile has been compiled by the writer on the real estate industry. The profile does not represent a comprehensive profile of the industry but focuses on property speculators and estate agents.

4.4.1 Description of the industry

A growing property market has presented property speculators with the opportunity to make capital and/or revenue profits on property transactions. Speculators, including estate agents, are well informed regarding the property market. They are therefore in a position to identify potential high yield transactions. Often speculators will buy in on the first phase of new developments and sell once the whole development has been sold out and a demand still exists for the property. Properties administered by the Sheriff and properties repossessed by banks are also sources used by speculators to acquire new properties.

Due to the upsurge in property values in Port Elizabeth the market has shown an increase in property speculation. The speculator seeks opportunities in the immovable property market in order to be the first party to purchase or acquire newly developed
plots or units in a newly developed townhouse complex or land development. The speculator’s intention is to keep the property for a short period of time and sell when there is a high demand for new properties at a much higher selling value.

The speculator’s main objective is to gain a high profit margin in a relatively short period of time. In some instances speculators sell land or townhouse units before the transfer of immovable property by the Deeds Office into their name can effectively take place.

4.4.2 Industry data (including registration and legal requirements)

The real estate industry is characterised by various role players. These role players include buyers and sellers of property, estate agents, conveyancers, financial institutions as well as electricians and pest controllers. In the real estate industry, the estate agent plays a crucial role in connecting the seller and buyer, referring property transfers to the conveyancers and referring clients to financial institutions and providers of other services.

The two main controlling bodies involved with estate agents are:

- the Estate Agency Affairs Board, who’s function it is to regulate the estate agency industry by licensing practitioners; and
- the Institute of Estate Agents which acts as a “trade union” on behalf of the estate agents.

Estate agents operate either independently or under a principal. In order to register as a principal estate agent, whether as a director of a company, a member of a close corporation, a member of a partnership or a sole trader, a person must be qualified as a full status estate agent. Full status is acquired by:

- passing the Estate Agency Affairs Board examination; or
• having served a year’s candidature under the supervision and control of a qualified estate agent; or
• having been exempted from the prescribed training.

In terms of section 10 of the Estate Agency Affairs Act, No 112 of 1976, all principals must keep a proper set of accounting records of all transactions pertaining to the estate agency business, including records of trust monies held by the firm on behalf of other persons. The act states the following:

The board shall cause -

a) to be kept in one of the official languages at an address in the Republic approved by the Minister such accounting records as are necessary fairly to reflect and explain the state of affairs -
   i) of all moneys received or expended by it in terms of this Chapter;
   ii) of all its assets and liabilities;
   iii) of all its financial transactions and the financial position of its business; and

b) as soon as possible, but not later than six months, after the end of each financial year, annual financial statements to be prepared showing, with all the appropriate particulars, the moneys received and the expenditure incurred by it during, and its assets and liabilities at the end of, the financial year.

c) The accounting records and financial statements referred to in subsection (2) shall be audited by an auditor appointed by the board.

4.4.3 Economic Overview

The South African residential property market has recorded strong growth since the beginning of 2000. According to the East Cape Property Guide (Author unknown: 2003) house prices during the past four years up to the first quarter of 2004 recorded a
nominal growth in house prices of 16.2% per annum. Real growth in house prices (after taking an average headline consumer price inflation (CPI) rate of 6.7% into account) was 8.9% per annum over the same period. In the first quarter of 2004, nominal year-on-year growth of 22.3% in house prices was recorded. This was the highest nominal growth since the 24.7% registered in the fourth quarter of 1983.

This strong growth performance has caused a vast increase in the price of houses. The price of a house would, for example, have increased from R240 000 in the fourth quarter of 1999, to R488 000 in the first quarter of 2004 (Swain: 2003). Interest rates declined between June and December 2003 by 550 basis points and caused mortgage bond repayments to decrease approximately by 27%, which has increased the affordability of housing. This drop in interest rates also favoured the speculators in the industry.

*The Eastern Cape market*

The Eastern Cape has been one of the main beneficiaries of the property boom according to ABSA’s quarterly residential property market survey (Minton: 2003). The Eastern Cape showed a 33.5 per cent year-on-year average growth in prices for the first quarter of 2004, which is second only to the 34.4 per cent leap in prices in KwaZulu-Natal. The average price of a home in the Mandela Metropole between January and March was R432 893 compared to R363 749 in the rest of the province. The average price of houses in the Eastern Cape, according to ABSA, in the three different categories rose as follows during the second quarter of 2002 compared with the same quarter of 2001:

<table>
<thead>
<tr>
<th>Square metres</th>
<th>% Increase Nominal</th>
<th>% Increase Real</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small Houses (80 –140)</td>
<td>10</td>
<td>2.3</td>
</tr>
<tr>
<td>Medium Houses (141-220)</td>
<td>12.1</td>
<td>3.4</td>
</tr>
<tr>
<td>Large Houses (221– 400)</td>
<td>13</td>
<td>4.4</td>
</tr>
</tbody>
</table>

*Table 4.1: Increase in house prices in the Eastern Cape*
A combination of factors probably led to this strong price performance. These include the following:

- personal tax relief announced in the budget;
- a reduction in transfer duties;
- an increase in disposable income;
- a relatively weak exchange rate boosting foreign purchasing;
- more buyers from disadvantaged communities entering the formal market;
- stiff competition between banks for business; and
- a shortage of new residential property and a general expectancy that interest rates would not reach 1998 record levels and no further increases were anticipated in the immediate future.

The East Cape Property Guide (Author unknown: 2003) also indicated that infrastructure developments in projects, such as Coega, are creating tangible, positive side effects resulting in a dramatic increase in the purchasing of homes in the lower to middle market in Port Elizabeth and Uitenhage. The Coega deep harbour project has boosted demand for all types of housing in Bluewater Bay, the closest residential area to Coega. This development has already increased prices of an average three-bedroom family home from R250 000 to R350 000. The plots of vacant land on the beachfront have increased from R130 000 to R450,000.

The unusual growth in the residential property market has increased the opportunity for speculation. It is suspected that property speculators and estate agents are exploiting this market. The collection of tax revenue by the SARS is expected to benefit from this in the form of higher Income Tax, Capital Gains Tax and Transfer Duty.

4.4.4 Role players

There are various role players within the industry. A brief description of each of these is discussed below:
The estate agent

The estate agent is the link between the seller and the prospective purchasers. The estate agent should ensure that the “Offer to Purchase” documents are duly drawn up and explained to both parties (the seller and the purchaser) and should also ensure that it is duly signed. The estate agent charges a fee for services rendered, which is commonly known as estate agent commission. This commission is payable by either the purchaser or seller, depending on the terms and conditions stipulated in the Deed of Sale contract and is only paid to the estate agent on the date of transfer of the immovable property at the Deeds Office into the name of the purchaser.

The conveyancing attorney

The conveyancing attorney ensures that the Deed of Sale documents and legal procedures comply with the requirements of various laws which govern the sale of immovable property and the eventual transfer of the immovable property into the name of the purchaser. The conveyancing attorney charges a fee for attending to legal aspects of transferring the property into the name of the purchaser, which is referred to as transfer fees. The seller pays these fees on the date of registration of the property into the name of the purchaser.

The financial institution

Should the purchaser not be in a position to purchase the immovable property in cash, a financial institution is approached to finance the purchase of the immovable property. This financial transaction (once approved by the bank) is referred to as a bond granted on the security of the immovable property.

Bond originator
The bond originator operates as a financial broker between the purchaser of the immovable property and the various finance houses, negotiating the best interest rate and insurance package for the client. The bond originator receives a commission from the finance houses for successful referrals.

The Receiver of Revenue

The sale of fixed property is either subject to transfer duty or value-added tax (VAT). In the event of the seller being a non-VAT vendor, the transaction will be subject to transfer duty, depending on the purchase price. The transfer duty payable is based on a percentage sliding scale determined by the selling price of the immovable property. An exemption currently (with effect from 1 March 2004) applies to transactions of less than R150 000. In the event of immovable property being sold by a VAT vendor, VAT becomes payable by the purchaser at the standard rate, currently 14%. This transaction is exempt from transfer duty as it subject to VAT at the standard rate. The transfer duty section issues an exemption certificate to indicate to the Deeds Office that no transfer duty is payable by the purchaser.

The Deeds Office

The Deeds Office is the controlling body which ensures that all transactions of immovable property (amongst other legal documents) are lodged and duly registered into the name of the new owner. An electronic link is available to the SARS which allows the SARS office to perform a search on the properties registered in the name of any taxpayer.

4.4.5 Tax implications and tax risks

Income tax and capital gains tax
Since the introduction of capital gains tax (hereafter referred to as CGT) it is submitted that speculators are tempted to declare taxable profits as capital gains. It is therefore important to understand the tax treatment of the sale of property.

“Gross income” is defined in Section 1 of the Act as follows:

“Gross income”, in relation to any year or period of assessment, means-

(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

(ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued or in favour of such person from a source within or deemed to be within the Republic, during such year of period of assessment, excluding receipts or accruals of a capital nature, but including…….(own underlining)

“Receipts or accruals of a capital nature” are not defined in the Act, however. Therefore, to determine whether an amount is of a capital or revenue nature, reference must be made to relevant case law to determine whether an amount is of a capital or revenue nature. With the introduction of CGT a certain percentage of all capital gains (not revenue gains) are to be included as taxable income. CGT was introduced into the Act by the introduction of the Eighth Schedule and applies to disposals of assets. If a sale of a property is therefore regarded as a revenue profit, the total profit would be regarded as income in terms of the definition of “gross income”. If the proceeds are regarded as a capital receipt in terms of this definition, a portion (depending on the inclusion rate applicable, twenty five per cent for individuals and fifty per cent for companies and trusts) would be included in taxable income. There are a number of exclusions, such as gains on a primary residence that will be excluded from CGT.

The following factors (which have been established by a number of court decisions) must be considered when deciding whether the profit is of a capital or revenue nature:
- the original intention with which the taxpayer acquired the asset and the intention prior to the sale of the asset;
- the occupation of the taxpayer;
- the length of time for which the asset was held;
- history of previous sales;
- income flow of the asset;
- the manner of disposal; and
- how the property was financed.

Guidelines with reference to case law

In ELANDSHEUWEL FARMING (EDMS) BPK v SBI, 1978 (1) SA 101(A), 39 SATC 163, it was held by Corbett JA that the proceeds from the sale of an asset will normally be in the nature of income and taxable if the asset was acquired and held for the purpose of resale at a profit in a scheme of profit-making, but the proceeds of an asset held to produce income such as rent would normally be regarded as capital.

In MALAN v KBI, 1981 (2) SA 91 (G) the court held that because the burden of proof was placed on the taxpayer by section 82 of the Act, the court will place reliance on the taxpayer’s evidence regarding his or her state of mind, but will also consider other factors.

In CIR v RICHMOND ESTATES (Pty) Ltd, 1956 (1) SA 602 (A), 20 SATC 355, Centlivres CJ, said the following:

“the fact that a taxpayer decides to sell capital assets at a profit cannot per se make the resulting profit subject to tax”.

In JOHN BELL & CO (PTY) LTD V SIR, 1976 (4) SA 415 (A), 38 SATC 87, Wessels JA, said that something more is required in order to change the character of the asset from one of an investment to an asset that is taken into stock-in-trade.
In NATAL ESTATES LTD V SIR, 1975 (4) SA 177 (A), 37 SATC 193, it was held that all the facts of the case should be considered when an asset is disposed of. In deciding whether a taxpayer has changed his original intention in regard to a particular asset the courts will consider the history and activities of the taxpayer. In this case it was held that that the land which has originally been acquired with the intention of holding it as capital was not decisive so as to preclude a change of intention by the taxpayer. The court further held that only when a taxpayer carried on a business of buying land for resale and then selling that land originally acquired as capital could become stock-in-trade.

**Employees’ tax**

Employees’ tax is required to be withheld from remuneration payable by an employer to an employee in terms of the Fourth Schedule to the Act.

“Remuneration” is defined in paragraph 1 of the Fourth Schedule as an amount of income that is paid or payable to a person by way of any

- salary, leave pay, allowance, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, superannuation allowance, retiring allowance or stipend;
- whether in cash or otherwise; and
- whether or not for services rendered.

The following employees’ tax risks should be taken into account when dealing with estate agents:

- tax deductions not made in terms of a directive granted by SARS;
- "spotters fees" paid to individuals in respect of referrals;
- expenses paid on behalf of agents and/or principal (agents request the conveyer to pay third party debt and the balance of commission to the agent);
- income- splitting between husband and wife;
Pay-as-you-earn not calculated and paid in respect of director's remuneration; and
the net amount paid by cheques or electronic payments not corresponding with the commission contract.

**Transfer duty**

In terms of section 2 of the Transfer Duty Act, transfer duty shall be levied on the value of any property acquired by any person by way of a transaction or in any other manner, or on the amount by which the value of any property is enhanced by the renunciation of an interest in or restriction upon the use or disposal of that property. The rates of transfer duty charged depend on whether the property is acquired by a natural person, or a person other than a natural person.

**Acquisition of property by trusts and companies**

The Revenue Laws Amendment Act, 2002, amended the definition of “property”. The definition has been extended to include:

- an interest in a “residential property company”;
- an interest in a holding company (which includes a close corporation) where that company would be a “residential company” if all its subsidiaries’ assets were held by it;
- a contingent right to a residential property or a contingent right to the first two items above held by a discretionary trust, other than a special trust, where the acquisition of the right is -
  - in consequence of an agreement for consideration in relation to property held by the trust;
  - accompanied by a change in the debt or security structure of the trust; or
  - accompanied by a change in the trust’s trustees.

“Residential property” is also a new definition and includes:
• a dwelling, house, holiday home, apartment, or similar abode;
• improved or unimproved land zoned for residential use; and
• any real right to these properties.

Properties held by a substantial business enterprise are excluded from the definition. This excludes:

• an apartment complex, hotel, guesthouse, or similar structure of more than five units, provided that they have been rented out to five or more persons unconnected to their owner; or
• any fixed property of a vendor forming part of an enterprise for VAT purposes.

A “residential property company” is defined as:

a company (including a close corporation) where the only asset or the majority of the assets in value of that company comprises either residential property, an indirect holding in such property, or a contingent right to such property or holding through a trust.

The sale of a member’s interest in a residential property company, or the change of trustees in a discretionary trust that holds property, will therefore (after 12 December 2002) be subject to transfer duty.

The tax risk associated with this change in legislation is that a change in the trustees, or beneficiaries, of a trust is only registered by the Master of the High Court. These types of transactions can therefore easily be affected without informing SARS. It can therefore be of value to investigate all changes of trustees and/or changes in beneficial interest at the Master’s Offices, or the Registrar of Companies.

Nomination agreements
Section 16 of the Transfer Duty Act now provides as follows in respect of property sold to a person (agent/nominator) who is acting on behalf of some other person (principle/nominee):

Persons who acquire property on behalf of others shall disclose the names of their principals.

(1) Where property is sold to a person who is acting as an agent for some other person, the person so acting as agent shall disclose to the seller or his or her agent the name and address of the principal for whom he or she acts, and furnish the seller or his or her agent with a copy of the documents appointing him or her as agent -

I. If the sale is by auction, on the day of acceptance by the auctioneer of his or her offer; or

II. If the sale is otherwise than by auction, on the day of conclusion of the agreement of sale.

The provisions of section 16 are intended to address the abuse by persons who acquire property for themselves, with the intention of reselling the property at a profit. These persons enter into agreements with the sellers which entitle them or their nominees to acquire properties. These properties were then transferred directly to the nominee, who had, in fact, acquired the property from the nominator (original buyer) and not the original seller.

The risk inherent to a nomination agreement is in cases where a transaction to acquire a property provides for the purchaser to nominate another person as purchaser, and the requirements of section 16 have not been met, the first-mentioned person will for the purposes of the Transfer Duty Act be regarded as having acquired the property in his or her own right. He or she and the nominee will be deemed not to be alternative, but successive purchasers where the above conditions have not been met.

Other value-added tax risks
The following other value-added tax risks apply:

- under-declaration of turnover or commission: the estate agent or immovable property speculator is registered for VAT purposes, but does not declare all VAT transactions;
- turnover threshold exceeded but not registered for VAT purposes (every person who carries on a business is liable to register for VAT if the total value of his taxable supplies in a period of twelve months exceeds R300 000);
- non-VAT registered estate agent charges VAT, but does not declare the VAT;
- non-Vat registered estate agents are making use of copies of standard deed of sale documentation, thereby using the same pre-printed estate agent commission ratio as a VAT-registered estate agent will charge. The seller/purchaser merely pays the total commission amount (inclusive of VAT) to the estate agent and the VAT portion is not declared by the estate agent.

4.5 Conclusion

To compile an industry profile for tax purposes the researcher must take note of the fact that the end-user is the revenue department. Social issues are often discussed in industry profiles such as the fact that:

- the industry attracts very few women;
- employees work in all weather conditions; and
- formal development programmes are not provided for every employee.

It is submitted that a profile for tax purposes would not require extensive elaboration (if any) on social issues, which will in most cases be irrelevant information. The profile should, however, contain the rationale and justification for assigning specific tax risk areas to the industry. The industry profile is the stepping-stone for in-depth profiling of individual cases in the industry.
This chapter has discussed the role of an industry profile as part of a comprehensive risk management programme. To illustrate such a profile, an example of a profile of the real estate industry has been compiled. During the course of the discussion, a number of recommendations have been made which can be used to compile such a profile. The recommendations included a framework for an industry profile which includes the following:

- industry description;
- industry data;
- an economic overview;
- discussion on the industry and trade associations and stakeholders;
- the tax and accounting implications; and
- the use of references.

Previous chapters have discussed particular aspects of the process for uncovering tax avoidance practices. Other aspects to be covered in the following chapters include the use of third party data and the role of the risk profiler. All these procedures and processes form a holistic approach to the selection of a particular case for a tax audit.
CHAPTER 5  
THIRD PARTY DATA  

5.1 Introduction  

Data is received by revenue authorities from sources other than from returns filed by taxpayers. This data is referred to as third party data. Third party data is used to establish cross-references to income declared. Tax fraud or tax evasion is often detected from information received from informers who disclose information to the revenue authorities. The Australian revenue department indicated in their annual report of 2002/03 that a variety of methods used to identify those involved in evasion and fraud (Australian Government Publications: 2003). One of these methods is using information from other government agencies, including the Department of Immigration, Multicultural and Indigenous Affairs. The report further indicated that of particular value are the reports of significant and suspicious transactions and overseas money transfers provided by the Australian Financial Act. Another source of information used by the Australian tax office is from the community through the tax evasion hotline. The Australian tax office continues to work in close partnership with law enforcement agencies, including the Australian federal police and the director of public prosecutions (Australian Government Publications: 2003).

5.2 The practical application of third party data  

The SARS gathers information from various third parties. This process is described as “information mining”. The information is then used to select taxpayers for investigation based on information obtained from outside sources (South African Revenue Services: 2003b). The tip-offs SARS receives also contribute to the risk profiling system. However, the SARS does not act on all the tip-offs, but uses the information to pick up trends (Stuart: 2003). The music industry was one of such industries. Informers can make a valuable contribution towards identifying on taxpayers who are evading tax. When information is received from such an informer it would be to the advantage of the SARS to obtain sufficient information from the informer, who in most
instances remains anonymous. The informer's intimate knowledge about the suspicious activities of the suspect must be fully utilised to ensure maximum advantage to the revenue authority. Normally such information is captured on a report. The SARS also has a “hotline” number through which it receives these tip-offs. The information is then referred to the risk profiling section to analyse the potential risks. It is debatable whether information received by a call centre is the most appropriate way of dealing with informants. For example, an informant can phone the call centre, giving very limited information on the taxpayer under suspicion. If the call centre agent is not knowledgeable on the specific industry or the tax, which relates to the incident, the agent might not prompt the informant for further information that is vital to establish the actual non-compliance. Informants may also report activities of non-compliance using a suspicious activity report.

5.3 Suspicious activity report

A suspicious activity report contains information concerning the possible evasion of tax. If a person has any knowledge of a taxpayer or customs-clients not complying with the tax laws in South Africa it is important to notify the South African Revenue Service as soon as possible. Such reports will allow the SARS to attend to its responsibilities of ensuring a tax-compliant South Africa. A generic form known as a Suspicious Activity Report (hereafter referred to as a SAR) was designed to record the minimum information required by the SARS to respond to suggestions of non-compliance. (An example of this form is attached as Annexure II.)

According to the information on the SARS website (www.sars.gov.za) a suspicious activity refers to any conducted or attempted activity or pattern or display of transactions which are suspect or appear to give reason to suspect. Some typical examples would be:

- a person or business being eligible for any type of tax, but not paying any form of tax;
• a person or business employing people and deducting employees’ tax from the employees but not issuing IRP5 certificates to the employees;
• a person or business being eligible for any type of tax, being registered for the tax, but not submitting the required returns to SARS;
• a person living beyond his obvious financial means or displaying unusually high life-style patterns in comparison with a person having similar levels of income;
• a person found to be carrying an unusually large amount of currency in any form, whilst travelling into or out of South Africa;
• a person who derives income from a criminal activity;
• a person or business submitting VAT refund-claims that are fraudulent and do not reflect the truth;
• a person or business liable to be registered for VAT, but not being so registered;
• a person or business owing SARS money as a result of an assessment or schedule, but not paying SARS; or
• a person not making a truthful submission in a return or submission to SARS.

Such information is forwarded to the risk profiler to analyse the data submitted on this form. The profiler might obtain other third party data to build a profile of the taxpayer. Depending on the nature of the risk, the profiler might allocate the report to the audit section for investigation. This form is available on the SARS website.

5.4 The Financial Intelligence Centre Act

The Financial Intelligence Centre Act, No 38 of 2001, (hereafter referred to as FICA) was established as a financial intelligence centre and money laundering advisory council in order to combat money laundering activities and to impose certain duties on industries and other persons who might be used for money laundering purposes. Several definitions of money laundering are available and according to Rossouw (2003), money laundering is defined by the South African Law Commission as follows:
The manipulation of illegally acquired wealth in order to obscure its true source or nature ...[which] is achieved by performing a number of transactions with the proceeds of criminal activities that, if successful, will leave the illegally derived proceeds appearing as a product of legitimate investments or transactions (Rossouw, 2003:1).

FICA defines money laundering as: “An activity which has or is likely to have the effect of concealing or disguising the nature, source, location, disposition or movement of the proceeds of unlawful activities or any interest which anyone has in such proceeds…” (Fenner, 2003:1).

In layman’s terms money laundering can be described as the manipulation of money or property in order to misrepresent its true source or nature. The FICA Act furthermore restricts the undertaking of business by any institution (such as bankers, attorneys and estate agents) with any person unless the institution has taken steps to establish and verify the identity of the client. This third party information can be valuable to the SARS as non-compliant or non-registered clients should be reported to the SARS. In terms of section 29 of the FICA Act certain persons must report any suspicion (suspicion is not defined in the FICA Act and must therefore be given its ordinary meaning). The Act states the following:

A person who carries on a business or is in charge of or manages a business or who is employed by a business and who knows or suspects that –

a) the business has received or is about to receive the proceeds of unlawful activities;

b) a transaction or series of transactions to which the business is a party –
   i) facilitated or is likely to facilitate the transfer of the proceeds of unlawful activities;
   ii) has no apparent business or lawful purpose;
   iii) is conducted for the purpose of avoiding giving rise to a reporting duty under this Act; or
iv) may be relevant to the investigation of an evasion or attempted evasion of a duty to pay any tax, duty or levy imposed by legislation administered by the Commissioner for the South African Revenue Service; or
c) the business has been used or is about to be used in any way for money laundering purposes,
must, within the prescribed period after the knowledge was acquired or the suspicion arose, report to the Centre the grounds for the knowledge or suspicion and the prescribed particulars concerning the transaction or series of transactions (own underlining).

Valuable third party information is therefore obtained by role players in the private sector, which can and should be used by the SARS to ensure that all taxpayers are compliant or to reduce the tax gap. It is the opinion of the writer that information obtained by these institutions is not effectively communicated to the various audit sections in SARS and an electronic link with the various institutions would enhance the risk profiles conducted by SARS on any taxpayer.

The SARS has electronic links with other organisations to assist them with the identification of risks. The following are examples of electronic links available to the SARS:

- vehicle ownership database (NATIS);
- Registrar of Companies (CIPRO);
- customer credit bureau (ITC); and
- Deeds Office – details of all property registrations.

SARS has indicated that, as part of its transformation plans, it will be implementing intelligent third party interfaces (electronic links) with financial institutions such as banks and insurance industries as well as links with medical aids (South African Revenue Services: 2003b).
5.5 Application of third party data

The following hypothetical example is used to illustrate how the SARS could effectively use the third party data. An informer completes a suspicious activity report. The informer indicates on this report that the taxpayer is evading tax on the rental income he receives. The taxpayer has filed a return declaring only a salary of R200 000 per annum for the current tax year and a salary of R160 000 for the previous tax year.

The SARS can now perform a vehicle search and property search on the taxpayer. This data extraction exercise indicates that the taxpayer has two very expensive vehicles and four properties registered in his name. The deed search history further indicates that two properties were sold during the previous tax year. Comparing this data with the tax returns submitted will indicate the following possible risks:

- rental income has not been declared, as indicated by the informant;
- possible under-declaration of income based on the fact that two expensive vehicles have been purchased; the SARS will establish how these vehicles were financed;
- the taxpayer could be speculating with properties, in which case no profits were declared; and
- the possible under-declaration of capital gains tax if the full profit on the sale of properties is not taxable.

This example clearly illustrates the effectiveness of third party data used in conjunction with electronic links to other organisational data bases. The SARS has also embarked on an exercise whereby third party data is used to compare interest paid by financial institutions with that of the interest declared by the taxpayer in the tax return. According to a media release the SARS reviewed 577 000 records received from external agents. Over 200 000 showed a discrepancy between the tax declarations and the information provided by external agents (Gordhan: 2003b).
Another example of the effective use of third party data is illustrated in the case of the
IRS. The IRS allows a tax deduction for a child living with the taxpayer. The IRS does
not have the necessary data to verify the credit due to the taxpayer as a result of this
deduction at the time a tax return is submitted. To improve the IRS’s audit identification
process this department concluded an agreement with the Department of Health and
Human Services to access data collected by this department. The Health and Human
Services record data on the birth registrations and other details such as the residential
address of a parent. This assists the IRS to identify a child’s residence. The data is then
compared with the information on the return filed and used to determine whether the
taxpayer qualifies for the tax credit. As a result of this development the IRS developed a
new audit selection program to use the health and human services’ data to identify
potential erroneous claims.

5.6 Risk related to using third party data

The data of a taxpayer, captured by the SARS on their database, is obtained from
information submitted by the taxpayers on their returns. It is therefore possible that data,
such as an identity number, might change but is not being indicated on the tax return
and therefore not amended on the SARS database. If the SARS obtains, for example,
the database of the deeds office, (which also contains information such as identity
numbers and other) and downloads this information onto the SARS database, the
possibility exists that the identity numbers of a particular person on the two databases
will not correspond. It is recommended that if the SARS wishes to identify possible non-
disclosure of property transactions by a taxpayers, it would need to use more than one
criterion to link the details of properties registered in a taxpayer’s name. The following
example illustrates this principle:

Taxpayer A has been registered with SARS since 1950. The taxpayer’s ID number on
the SARS database is captured in 1950 as 19500102 5001 008. He has been issued
with a new ID number during 1996. His ID number is now 19500102 5001 084. If he
purchases a property after 1996, the Deeds Office will record this transaction using his
new ID. If data-matching between the two databases is performed using only the ID
number, the SARS might not be able to link this transaction to the records of the taxpayer due to the fact that the ID number was not changed for the tax records.

5.7 Conclusion

It is evident that revenue authorities around the world rely on third party data to assist with risk profiling and ultimately case allocation to the audit division. However, there is great potential for the SARS to improve and broaden their relationship with third parties to ensure that taxpayers comply with the tax law. It is suggested that the SARS can obtain third party information from additional sources, to assist with the risk profiling of a taxpayer. The following table illustrates the potential sources and the nature of information, which can be obtained.

<table>
<thead>
<tr>
<th>Source</th>
<th>Information available</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sheriff’s office</td>
<td>Information on possible speculators in properties sold in execution</td>
</tr>
<tr>
<td>Take A Bet (TAB)</td>
<td>Details of betting profits and losses</td>
</tr>
<tr>
<td>Statistics Department</td>
<td>Information on the cost of living of a taxpayer (to assist SARS with cases of possible under-declaration of income)</td>
</tr>
<tr>
<td>Auction firms</td>
<td>Information on regular buyers and sellers (could indicate taxpayers who are speculating with goods)</td>
</tr>
<tr>
<td>Brokers</td>
<td>Information on share transactions</td>
</tr>
<tr>
<td>Harbour authorities</td>
<td>Information on registration of yachts (a taxpayer must have sufficient funds to finance such an item)</td>
</tr>
</tbody>
</table>

Table 5.1: Third party sources
The above are merely a few examples of available third party information. In terms of section 74A of the Income Tax Act, the Commissioner may, for the purposes of the administration of the Act, request any information or documents from a taxpayer. This section should encourage the SARS to consider further electronic links with various institutions to assist with their risk profiling and case selection methodology. Not only is it suggested that the SARS should expand their electronic links with third parties, but should also establish relationships with other stakeholders such as the South African Police Services, Chambers of Commerce, Master Builders Associations and many others, to obtain useful data that can assist the SARS with the profiling of taxpayers and industries.

Other recommendations are made in the chapter to improve the use of third party information, including the use of third-party data flowing from the disclosures under the Financial Intelligence Centre Act. Some reservations were expressed about the use of untrained agents in call centres to fill out Suspicious Activity Reports.

Third party data and industry profiles are examples of data that can assist with risk assessment. The analytical skills of the risk profiler play an important role in the risk profiling and case allocation process. The next chapter discusses the profiler’s contribution to identifying risk.
6.1 Introduction

Once a risk has been detected by the computerised systems, third party data or an industry profile, the question arises whether that risk should indeed be allocated to the tax auditor. This is the task of the risk analyst. The allocation of the case will normally depend on the following factors:

- the financial importance of the case, that is how cost effective it would be to audit the case, taking resources into account;
- the extent of the risk involved in the specific case;
- the integrity of the taxpayer concerned – the history of the taxpayer and his fiscal behaviour will play an important role;
- the case requirements and capacity of the audit section; and
- a predetermined monetary threshold for each specific category of cases.

To profile a taxpayer is nothing more than to build a picture of the taxpayer’s affairs. The following questions will assist to build this profile:

- what the nature of the taxpayer’s business is;
- what other interests, outside of the business under investigation does the taxpayer have? A taxpayer’s Wimpy business might be investigated, but he may be the owner of more that one property; and
• what relationship does the taxpayer have to other taxpayers? He may have an interest in various other close corporations or he might be a trustee or a beneficiary of a trust.

The Finance Minister of the Netherlands, Mr. M Alink, stated that one of the law enforcement components is the examination of returns (Alink: 2004). He further stated that verification and audit is part of the examination process. Mr. Alink made the following statement on risk management:

To make rational choices for a client treatment strategy you need a system of risk management. Risk management can be defined as the systematic process in the course of which people and resources are deployed, based on risk analysis aiming to achieve an optimum result. The risk management process is normally a continuous process. This is necessary because the process must be effective within the environment in which the Tax Administration operates. Risk analysis is the key to the risk management process. It is a proactive and dynamic process through which risks are systematically identified, analysed and assessed, so that it provides the basis for decisions on further actions. It also monitors and reviews the development of risks through measuring taxpayers’ compliance (Alink, 2004:5).

Risk profiling by the risk profiler does not only focus on the financial statements, but also takes into consideration elements external to the financial accounts. A deeds search and vehicle search are typical examples of such external elements.

6.2 Risk analysis program

The key to a successful investigation is the preparation and planning of the case to enable effective management of the investigation. When reviewing information for risk areas the focus is on potential areas of non-compliance. The risk analyst is therefore trying to identify what is missing or lacking in the information available. The risk analyst or profiler should find sufficient evidence of risk to trigger the case for investigation.
It is recommended that a profiler make use of a risk analysis guideline to ensure that all areas of risk are covered. The following risk analysis program is designed to ensure that, when profiling a case, the profiler has utilised all possible internal and external resources to ensure that all risks are detected.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Ensure, via the case allocation tracking system, that the case has not yet been allocated.</td>
</tr>
<tr>
<td>2</td>
<td>Review prior audit actions.</td>
</tr>
<tr>
<td>3</td>
<td>Obtain details of risks identified on the computerised risk selection program, if any.</td>
</tr>
<tr>
<td>4</td>
<td>Obtain details of any suspicious activity reported on the case, if any.</td>
</tr>
<tr>
<td>5</td>
<td>Conduct risk analysis from the financial statements submitted.</td>
</tr>
<tr>
<td>6</td>
<td>Carry out electronic searches, such as a deeds search and a vehicle search.</td>
</tr>
<tr>
<td>7</td>
<td>Search for possible risks in the specific industry using the internet or any industry profile that has been compiled.</td>
</tr>
<tr>
<td>8</td>
<td>Evaluate risks in terms of possible revenue involved to determine whether the case should be allocated to the audit section.</td>
</tr>
</tbody>
</table>

*Table 6.1: Risk analysis program*
6.3 **Financial statements and risk analysis**

Before scrutinising the financial statements for possible risk indicators, the risk profiler may consider environmental factors, which can indicate the probability of risk. Examples of such factors are:

- the nature of industry;
- material changes in the enterprise’s activities;
- changes in shareholding or owners;
- the nature of accounting records; if accounting records are not audited it would indicate greater risk;
- the relationship with other companies or trusts; and
- tax files registered at various Receiver’s offices.

When analysing the financial statements, it is not the task of the risk profiler to conduct a desk audit, but merely to indicate the possible high-risk areas that should be investigated. Although ratio analysis is essential when analysing financial statements, it is in itself of little significance if the ratios computed are not compared with the same or similar ratios in previous financial statements and if it cannot be measured against a standard of performance, such as an industry average. While there are numerous ratios at the disposal of the profiler, only a select few have a specific application to the profiler and SARS. To illustrate the risks that might be indicated by the risk profiler when analysing the financial statements of a company, the following hypothetical financial statements and a summary of the value-added returns is compiled.
Value-added returns submitted:

**Sales including value-added tax:**

<table>
<thead>
<tr>
<th>Month</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 2003</td>
<td>R 819 000</td>
</tr>
<tr>
<td>June 2003</td>
<td>R 1 050 350</td>
</tr>
<tr>
<td>August 2003</td>
<td>R 1 550 750</td>
</tr>
<tr>
<td>October 2003</td>
<td>R 1 650 000</td>
</tr>
<tr>
<td>December 2003</td>
<td>R 1 299 550</td>
</tr>
<tr>
<td>February 2004</td>
<td>R 986 350</td>
</tr>
</tbody>
</table>

**Input tax claimed**

<table>
<thead>
<tr>
<th>Month</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 2003</td>
<td>R 95 000</td>
</tr>
<tr>
<td>June 2003</td>
<td>R 103 000</td>
</tr>
<tr>
<td>August 2003</td>
<td>R 109 000</td>
</tr>
<tr>
<td>October 2003</td>
<td>R 98 000</td>
</tr>
<tr>
<td>December 2003</td>
<td>R 103 330</td>
</tr>
<tr>
<td>February 2004</td>
<td>R 111 670</td>
</tr>
</tbody>
</table>
## Income statement for the year ended 29 February 2004

<table>
<thead>
<tr>
<th>Notes</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>5 461 652</td>
<td>4 394 736</td>
</tr>
<tr>
<td>Less: Cost of Sales</td>
<td>4 700 983</td>
<td>3 730 375</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>760 669</td>
<td>664 061</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest received on current account</td>
<td>331</td>
<td>619</td>
</tr>
<tr>
<td></td>
<td>761 000</td>
<td>664 680</td>
</tr>
</tbody>
</table>

### Expenses

<table>
<thead>
<tr>
<th>Category</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting fees</td>
<td>8 001</td>
<td>4 553</td>
</tr>
<tr>
<td>Advertising</td>
<td>6 913</td>
<td>71 521</td>
</tr>
<tr>
<td>Bank charges</td>
<td>9 392</td>
<td>3 424</td>
</tr>
<tr>
<td>Bad debts</td>
<td>10 000</td>
<td>30 000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>39 301</td>
<td>5 732</td>
</tr>
<tr>
<td>Electricity and water</td>
<td>2 314</td>
<td>2 320</td>
</tr>
<tr>
<td>Finance Charges</td>
<td>22 292</td>
<td>18 137</td>
</tr>
<tr>
<td>Insurance</td>
<td>2 6734</td>
<td>17 604</td>
</tr>
<tr>
<td>Interest</td>
<td>1 648</td>
<td>156</td>
</tr>
<tr>
<td>Motor vehicle expenses</td>
<td>76 149</td>
<td>39 116</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>1 305</td>
<td>4 691</td>
</tr>
<tr>
<td>Rent paid</td>
<td>347 314</td>
<td>335 724</td>
</tr>
<tr>
<td>Salaries: member</td>
<td>3 51 316</td>
<td>36 702</td>
</tr>
<tr>
<td>Telephone</td>
<td>30 803</td>
<td>20 086</td>
</tr>
</tbody>
</table>

Net income before taxation   | 247 518| 74 914 |
Taxation                     | 74 255 | 22 474 |
Net income for the year after taxation | 173 263| 52 440 |

Retained income
Beginning of year | 29 527 | (32 043) |
At the end of the year | 202 790 | 29 527 |
Balance Sheet for the year ended 29 February 2004

<table>
<thead>
<tr>
<th>Notes</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>R</td>
<td>R</td>
</tr>
</tbody>
</table>

**Employment of funds**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td>145 324</td>
<td>184 625</td>
</tr>
</tbody>
</table>

**Current Assets**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock</td>
<td>50 350</td>
<td>223 914</td>
</tr>
<tr>
<td>Trade debtors</td>
<td>36 992</td>
<td>42 050</td>
</tr>
<tr>
<td>Loan to member</td>
<td>181 000</td>
<td>-</td>
</tr>
<tr>
<td>Current account</td>
<td>1 008</td>
<td>154 670</td>
</tr>
<tr>
<td></td>
<td>269350</td>
<td>420 634</td>
</tr>
</tbody>
</table>

**Current Liabilities**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instalment sale creditor</td>
<td>46 965</td>
<td>65 700</td>
</tr>
<tr>
<td>Provision for income tax</td>
<td>20 677</td>
<td>12 655</td>
</tr>
<tr>
<td>Bank overdraft</td>
<td>35 457</td>
<td>6 579</td>
</tr>
<tr>
<td>Creditors</td>
<td>88 585</td>
<td>350 000</td>
</tr>
<tr>
<td></td>
<td>191 684</td>
<td>434 934</td>
</tr>
</tbody>
</table>

Net current liabilities | 77 666 | -14 300 |
|                       | 222 990 | 170 325 |

**Funds Employed**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Members’ contribution</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Accumulated profit</td>
<td>202 790</td>
<td>29 527</td>
</tr>
<tr>
<td></td>
<td>202 890</td>
<td>29 627</td>
</tr>
</tbody>
</table>

**Long term liabilities**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan by member</td>
<td>-</td>
<td>20 881</td>
</tr>
<tr>
<td>Instalment sale creditor</td>
<td>20 100</td>
<td>119 817</td>
</tr>
</tbody>
</table>

|               | 222 990 | 170 325 |
Notes to the financial statements

1. **Stock**

   Stock is valued at the lower of cost or net realisable value.

2. **Insurance**

   Business 6734
   Member 0 (previous year R8 765)

3. **Rent paid**

   N.K Lentoor Family Trust.

4. **Fixed Assets**

<table>
<thead>
<tr>
<th></th>
<th>Equipment</th>
<th>Vehicles</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>R 6389</td>
<td>R 185 864</td>
<td>R 192 253</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>1 896</td>
<td>5 732</td>
<td>7 628</td>
</tr>
<tr>
<td>Current year</td>
<td>2 128</td>
<td>37 173</td>
<td>39 301</td>
</tr>
<tr>
<td>Book value at the end of year</td>
<td>4 024</td>
<td>42 905</td>
<td>46 929</td>
</tr>
</tbody>
</table>

   |          | R 2 365    | R 142 959| R 145 324 |

5. **Loan to member**

   The loan is interest-free, unsecured and not subject to any terms of repayment.
6.4 Possible risk areas to be investigated

The following are the risk areas which could be investigated.

6.4.1 Reconciliation of financial statements and VAT returns

The turnover of the company is understated if compared with the value-added returns submitted. It is possible for the SARS to compare the turnover in the financial statements with that submitted for value-added tax purposes. Any under or over declaration of value-added tax or income tax should be investigated. Due to the fact that the income tax statement excludes value-added tax, the reconciliation should be done as follows:

<table>
<thead>
<tr>
<th>PERIOD</th>
<th>INPUT</th>
<th>Sales Incl. VAT</th>
<th>Zero Rated Sales</th>
<th>VAT per Field 12</th>
<th>Total Sales Excluding VAT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Field 2</td>
<td>Field 12</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apr-03</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jun-03</td>
<td>819,000</td>
<td>-</td>
<td>100,579</td>
<td></td>
<td>718,421</td>
</tr>
<tr>
<td>Aug-03</td>
<td>1,050,350</td>
<td>-</td>
<td>128,990</td>
<td></td>
<td>921,360</td>
</tr>
<tr>
<td>Oct-03</td>
<td>1,550,750</td>
<td>-</td>
<td>190,443</td>
<td></td>
<td>1,360,307</td>
</tr>
<tr>
<td>Dec-03</td>
<td>1,650,000</td>
<td>-</td>
<td>202,632</td>
<td></td>
<td>1,447,368</td>
</tr>
<tr>
<td>Feb-04</td>
<td>1,299,550</td>
<td>-</td>
<td>159,594</td>
<td></td>
<td>1,139,956</td>
</tr>
<tr>
<td></td>
<td>7,356,000</td>
<td>-</td>
<td>6,452,632</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

It is clear from the abovementioned reconciliation that the taxpayer has under-declared the sales for income tax purposes. This difference should be indicated as a risk to the auditor.
The SARS can also reconcile the input tax claimed on the value-added tax return with the expenses claimed in the financial statements. The following calculation illustrates the possible reconciliation which the SARS might apply:

\[
\begin{align*}
\text{Total input tax claimed} & \quad R620\,000 \\
\text{Total expenses excluding value-added tax} & \quad R\,4\,428\,571 \quad (100/14 \times 620\,000)
\end{align*}
\]

<table>
<thead>
<tr>
<th>EXPENSES PER FINANCIAL STATEMENTS</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases</td>
<td>4,517,199</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>513,482</td>
</tr>
<tr>
<td><strong>Less: Non-VAT expenses</strong></td>
<td>-130,339</td>
</tr>
<tr>
<td>Depreciation</td>
<td>39,301</td>
</tr>
<tr>
<td>Interest paid</td>
<td>1,648</td>
</tr>
<tr>
<td>Salaries &amp; wages</td>
<td>51,316</td>
</tr>
<tr>
<td>Fuel *(Assume 50%)</td>
<td>38,074</td>
</tr>
</tbody>
</table>

**TOTAL TAXABLE SUPPLIES**

\[4,900,342\]

From the abovementioned calculation it would appear that expenses might have been overstated for income tax purposes. The taxpayer claimed fewer expenses for value added tax than for income tax. The auditor should therefore investigate the possible risk of the overstatement of expenses for income tax purposes.

### 6.4.2 Financial ratios

To determine whether the business is profitable or not, the gross profit percentage is one of the most important ratios. Gross profit is the difference between sales and cost of sales. The gross profit percentage indicates the effectiveness of an enterprise’s purchasing and pricing policies during the accounting period. The percentage ought to
remain constant even though the sales may vary form period to period. In the example below the gross profit percentage for the two years is calculated as follows:

\[
\text{Gross profit} \times \frac{100}{\text{Sales}}
\]

2003 gross profit percentage: 15.1%
2004 gross profit percentage: 13.9%

The risk profiler should indicate to the auditor the drop in the gross profit percentage. The auditor should establish from the physical audit the reason for this decrease. It is, however, not very difficult to manipulate the gross profit percentage. The sales, purchases and stock figures can merely be adjusted to keep the gross profit percentage constant.

The net profit percentage indicates the profit on sales achieved by the owners after all expenses have been brought into account. The ratio can differ greatly from year to year, but if there are material changes from one period to the next, the auditor must analyse the changes to determine the causes of the difference. The net profit percentage is calculated as follows:

\[
\frac{\text{Net income before taxation}}{\text{Sales}} \times 100
\]

2003 Net profit percentage  1.70%
2004 Net profit percentage  4.53%

The following two calculations can be performed to further investigate the reasons for the differences in the net income before taxation ratio:

- the percentage change in expenses from the previous year; and
- the percentage change in turnover form the previous year.
6.4.3 Balance sheet items

The following risks should be indicated to the auditor for investigation:

- The risk profiler should indicate to the auditor that the low closing stock figure might be a risk. According to Note 1 to the financial statements, the stock is valued at the lower of cost or net realisable value. This method is in line with the provisions of section 22 of the Act which states that stock should be accounted for at the cost price to the taxpayer less any amount considered by the Commissioner as representing the amount by which the value of trading stock has diminished due to damage, deterioration, change in fashion, decrease in market value or any other reason satisfactory to the Commissioner. The fact that closing stock has therefore already been reduced by any provision for obsolete stock should trigger a possible risk. The SARS has issued Practice Note 36 that prescribes the manner in which stock provisions should be accounted for. The practice note states that taxpayers who write off slow-moving and obsolete stock use a variety of questionable methods, without reference to the actual net realisable value. The SARS deemed it therefore necessary to explain their viewpoint in that regard. The SARS stated in this practice note that amounts written off on a fixed percentage basis will not be allowed. Basically the taxpayer must provide the Receiver of Revenue with exact calculations and reasons for the lower valuation of stock.

- The close corporation has only one member. There is a strong possibility that the member is the user of the motor vehicle owned by the close corporation. The member received a salary and will therefore be regarded as an employee of the CC in terms of the definition of “employee” in the Fourth Schedule to the Income Tax Act. A taxable benefit arises where an employee is granted the right of use for private purposes of a motor vehicle, which is owned by his employer (this will include travelling
between the employee's place of residence and his place of work). The cash equivalent of the taxable value to be placed on the use of the vehicle will be calculated at 1,8 percent of the original cost of the vehicle to the employer. The auditor should be alerted to the need to investigate this.

- The loan to the member appears to be interest free as the only interest received was on the current account. In terms of section 64B of the Income Tax Act, secondary tax on companies is levied at the rate of 12,5% on any dividend declared by a company. In terms of section 64B of the Act, an amount will be deemed to have been distributed by a company to a shareholder if any loan, of which a rate of interest is not less that the “official rate of interest” as defined in the Seventh Schedule of the Act, is granted and made available to the shareholder. The risk of underdeclaration of secondary tax on companies should therefore be noted.

6.4.4 Income statement risks

An increase as well as a decrease in expenses might indicate a possible tax risk. It is therefore important to scrutinise the income statement for deviations in year-to-year expenses. Referring to the previous income statement, the risk profiler should indicate the following expenses as possible risks:

- The main risk in the income statement is the rent paid. This expense represents on average more than fifty percent of the expenses. The note to the financial statements indicates that the rent is paid to a trust. It would appear that the trustee of the trust is the member of the close corporation. The benefit of paying excessive rent to the trust is that the trust can distribute the net income to the beneficiaries of the trust. The income is therefore not taxed in the trust at a rate of forty percent, but in the hands of beneficiaries at a potentially lower percentage. In terms of section 25B of the Act the beneficiaries are liable to tax on any part of the
The possible tax savings are illustrated as follows:

Rent paid by Company  R100 000 (R 50 000 excessive)
Trust income  R100 000
Assumed expenses  R  40 000
Net income  R  60 000

The net income is distributed to the three minor beneficiaries having no other income, R20 000 each. No tax is payable by beneficiaries as R20 000 is below the threshold at which a taxpayer becomes liable for tax. The risk profiler should thus indicate this risk to the auditor for investigation. Excessive rent paid by a taxpayer is not an expense incurred in the production of income and should be disallowed for income tax purposes.

It is the purpose of the risk profiler to highlight high risks. Although resources might not allow all areas of risk to be investigated, the following lower risk areas should also be indicated to the auditor:

- The bad debt claimed might only be a provision for doubtful debts and not debt that has been written off as uncollectible. If the debt is not bad, but doubtful, only a provision should be allowed in terms of section 11(j) of the Act.

- In terms of section 11(w) of the Act, the premiums actually paid by the taxpayer (the close corporation) under a policy of insurance taken out on the life of an employee or director are allowable as deductions for tax purposes. Note six to the financial statements indicates a decrease in these insurance premiums. It is therefore possible that the policy has
matured and that the income should be included in the gross income of the taxpayer (paragraph (m) of the definition of gross income in section 1 of the Act). The possibility of a deferred compensation payout should also be investigated. The risk is that the company received the payment and paid it to the director without indicating this in the financial statements. The proceeds are taxable, but the payment to the director might not be tax deductible in terms of section 11(a) of the Act as he is the only member. In ITC 1506, 53 SATC 418 (N), the court refused to allow a section 11(a) deduction for the payment of a gratuity to the majority shareholder. The reason why such a policy was purchased must be established. If the policy was taken out on the life of a beneficiary and the loss of the services of that beneficiary would really have been detrimental to the company had the policy not existed, the deduction would normally be allowed in terms of section 11(a) of the Act. The court held that is was clear from the evidence of the case that even if the agreement in terms of which the company agreed to pay the gratuity to the member on his retirement had never been concluded, the member would have remained with the company at least until the age of sixty and he did not require any inducement from the company to persuade him to either extend his employment with it or to enable the company to retain his services. However, in this case there is only one member and the auditor should establish whether this policy would have motivated the member to continue with the business.

- The advertising expense in the 2003 tax year appears to be excessive compared to the 2004 tax year. The close corporation may attempt to deduct inadmissible expenditure under the heading of advertising charges. Certain advertising expenditure might also be of a capital nature. If for example a permanent structure was erected for advertising, the expense will be regarded as not deductible, being advertising of a permanent nature resulting in the creation of a capital asset.
Having profiled the company and established the possibility of under-declaration of taxable income, the risk profiler might decide to profile the member. Assume that the member has only declared his salary as claimed in the income statement of the company for tax purposes. However, after the risk profiler has obtained third party data such as a property and vehicle search, it could appear, based on the assets of the taxpayer, that not all his taxable income has been declared. If the assets concerned are compared with the income declared in the tax returns, the growth in the value of the assets may indicate a non-declaration of income. The following statement of assets and liabilities is used to illustrate the principle of a capital reconciliation:

Statement of assets and liabilities of member (declared in the personal income tax return)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Fixed Property</strong></td>
<td>350 000</td>
<td>175 000</td>
</tr>
<tr>
<td><strong>Motor vehicle</strong></td>
<td>45 000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Shares at cost</strong></td>
<td>10 000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Bank</strong></td>
<td>10 000</td>
<td>10 000</td>
</tr>
<tr>
<td><strong>Household furniture</strong></td>
<td>50 000</td>
<td>40 000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>475 000</td>
<td>225 000</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Bonds</strong></td>
<td>120 000</td>
<td>80 000</td>
</tr>
<tr>
<td><strong>Other loans</strong></td>
<td>50 000</td>
<td>10 000</td>
</tr>
<tr>
<td><strong>Creditors</strong></td>
<td>8 000</td>
<td>5 000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>178 000</td>
<td>95 000</td>
</tr>
<tr>
<td><strong>Net assets</strong></td>
<td>297 000</td>
<td>130 000</td>
</tr>
</tbody>
</table>
Therefore:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets 2004</td>
<td>R 297 000</td>
</tr>
<tr>
<td>Less assets 2003</td>
<td>R 130 000</td>
</tr>
<tr>
<td></td>
<td>R 167 000</td>
</tr>
</tbody>
</table>

**Add:** expenses (claimed according to tax return)

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Provisional tax payments</td>
<td>R 8 000</td>
</tr>
<tr>
<td>Retirement annuity fund contributions</td>
<td>R 5 000</td>
</tr>
<tr>
<td>Medical expenses</td>
<td>R 3 500</td>
</tr>
<tr>
<td>Cost of living expenses</td>
<td>R 100 000</td>
</tr>
<tr>
<td></td>
<td>R 116 500</td>
</tr>
<tr>
<td></td>
<td>R 283 000</td>
</tr>
</tbody>
</table>

**Less:** income

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary declared</td>
<td>R 51 316</td>
</tr>
<tr>
<td>Dividends</td>
<td>R 5 300</td>
</tr>
<tr>
<td>Interest</td>
<td>R 2 400</td>
</tr>
<tr>
<td>Unexplained growth in assets</td>
<td>R 223 984</td>
</tr>
</tbody>
</table>

**Note**

Cost of living expenses are normally determined from the information supplied by the taxpayer on a prescribed form used by revenue authorities.

This method of determining undeclared income is used by many revenue authorities. In South Africa this unexplained growth is taxed in terms of section 78(1) of the Act. The Commissioner may estimate either in whole or in part the taxable income if he is not satisfied with the information furnished in the tax return. In CIR v BRITZ, 1952, (4) SA 624 (AD) it was held that the Commissioner is authorized to make additional assessments both in regard to identifiable amounts which have escaped taxation in the past and to estimate the amounts. This principle was further confirmed in ITC 195, 1931, 5 SATC 376. In this case it was held that, when in consequence of an investigation by
the auditor it appeared that there was an unexplained increase in capital, the Commissioner was justified in applying section 78(1) of the Act.

6.5 Conclusion

Revenue authorities world-wide rely on the analytical skills of the risk profiler to indicate areas of risk, especially from a financial interpretation perspective. In depth knowledge of the various tax acts and the ability to interpret financial statements are essential for any risk profiler. Access to third party data enhances the profile and can provide the profiler with valuable information on the taxpayer’s actual income as well as his assets and liabilities. A general understanding of the economic environment will further assist the profiler to identify possible focus areas.

This chapter has discussed in details the task of the risk analyst and illustrated the analysis process using a very simple set of financial statements and value-added tax returns. In addition to the actual financial statements and returns submitted by the taxpayer, the analyst will make use of industry profiles relating to the industry in which the taxpayer operates, as well as benchmark ratios established for the industry.

This chapter completes the discussion of the tools available to the revenue authorities in identifying taxpayers for possible audit, these being computerised risk programs, industry profiles, third party data and the skills of the risk analyst. The final chapter will summarise the findings and recommendations made throughout the research process.
CHAPTER 7
CONCLUSION

7.1 Introduction

As was stated in Chapter 1 of this thesis, protection of the tax base of a country and the reduction of the tax “gap” is of the utmost importance to any country. Only thus will the main source of the state revenue be ensured, while maintaining the lowest possible overall tax rates. Taxpayers who evade paying the taxes that they rightfully owe erode the tax base. Revenue authorities need to institute processes to detect tax fraud and, as it is not possible to audit the tax returns of every taxpayer for correctness or to discover every instance of persons who are not registered to pay tax who should be registered, a risk-based case selection methodology is an essential tool.

This thesis has attempted to recommend a case-selection methodology that is holistic in its approach and, in order to do so, has examined the systems used by the SARS and compared them with those of selected countries including Australia, New Zealand and America. Flowing from this research a number of recommendations are made in each of the chapters dealing with various aspects of a risk-based case selection methodology. These recommendations are summarised in paragraph 7.3 below.

Once cases have been identified as being non-compliant by the audit process, the SARS has a whole range of punitive measures which it can apply against the taxpayers concerned.

7.2 Penalties for non-compliance

Allingham and Sandmo (1972) modelled an individual’s choice regarding tax evasion as a choice under uncertainty, a gamble in which there is a trade-off between a gain if the evasion is undetected and a loss if the evasion is detected and penalised. They further
stated that taxpayers are neither honest nor dishonest, but are merely rational calculators of what is in their best interest. It is therefore submitted that one of the determining factors for a taxpayer to “gamble” with this option, is the penalty structure and the risk of being subjected to an audit.

In South Africa income tax evasion is regarded as a crime. Goldswain stated the following in this regard: “Income tax evasion is generally regarded as “white-collar crime”, together with crimes such as fraud, embezzlement, price fixing, misuse of public funds and abuse of political and legal powers” (Goldswain, 2003:26). The Income Tax Act contains a number of penalty provisions which should greatly increase the cost of the tax evasion “gamble”. In terms of section 75 of the Act, any person who fails or neglects to furnish, file or submit any returns or documents shall be guilty of an offence and will be liable on conviction to a fine or to imprisonment for a period not exceeding 24 months. In terms of section 104 of the Act, a person who intends to evade or to assist any other person to evade tax shall also be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding five years.

The main penal provision of the Income Tax Act is section 76. Section 76 provides for a taxpayer to pay additional tax in the following circumstances:

1. A taxpayer shall be required to pay in addition to the tax chargeable in respect of his taxable income—

   (a) if he makes default in rendering a return in respect of any year of assessment, an amount equal to twice the tax chargeable in respect of his taxable income for that year of assessment; or

   (b) if he omits from his return any amount which ought to have been included therein, an amount equal to twice the difference between the tax as calculated in respect of the taxable income returned by him and the tax properly chargeable in respect of his taxable income as determined after including the amount omitted;
(c) if he makes an incorrect statement in any return rendered by him which results or would if accepted result in the assessment of the normal tax at an amount which is less than the tax properly chargeable, an amount equal to twice the difference between the tax as assessed in accordance with the return made by him and the tax which would have been properly chargeable.

This section is known as the “triple tax” provision as it provides for the correct amount tax chargeable on the undisclosed income, which should have been subjected to tax, plus a possible maximum penalty of 200%. Revenue authorities will impose the maximum penalty in cases of tax evasion.

In addition to the risk of the imposition of monetary penalties and/or imprisonment, the risk of public exposure as a tax offender should provide further deterrent to taxpayers contemplating tax evasion. It is therefore recommended that the SARS should make greater use of section 75A of the Act, which allows it to publish for general information such particulars relating to any offence committed by any person, where such person has been convicted of any offence in terms of section 75 or 104.

7.3 Recommendations

As discussed in Chapter 3 of this study, the SARS current case selection methodology is not based on segmentation or audit coverage. As explained previously segmentation refers to the separation of different classes of clients and markets. Market segmentation breaks down the client base into sectors or segments with similar characteristics and features. Other classes of clients may be based on industry types such as financial, real estate and others. It is proposed that the SARS should approach their case selection methodology starting with its audit coverage goals.
7.3.1 Audit Coverage

The audit coverage should include all classes of taxpayers. The first step in the case selection process should be to divide the taxpayers into different segments. If, for example, individuals are used as a segment, these taxpayers can be classified as follows:

- individual taxpayers earning only remuneration, without any deductible allowances or other classes of income;
- individual taxpayers earning investment income;
- individual taxpayers qualifying for the deduction of allowances;
- individual taxpayers earning commission income; and
- individual taxpayers carrying on the business of farming.

The audit coverage should ensure that a percentage of all of the various classes of individuals are audited. Although these individual taxpayers might pose a lower risk than companies, SARS must operate from a total compliance approach, to ensure that all segments of the tax base are audited. Having established the various segments of the tax base, the goal for audit coverage of each segment must be determined. The SARS will have to determine the audit coverage percentage, whilst taking into consideration the available resources. The division dealing with the allocation of cases, ensuring that SARS achieves its audit coverage goals, must manage the audit percentage coverage as well as the number of cases per segment. A further analysis of this data might indicate, assuming that taxpayers are segmented as discussed above, that the audit coverage of certain classes of taxpayers is very low. A more comprehensive analysis of the audit coverage will enable the SARS to identify areas where an increase in the audit coverage might be required.
7.3.2 Selection methodology

It is submitted that the current computerised risk assessment program should include all taxpayers as only company returns are subjected to the aforementioned program and not any other segment of the tax base. This means that other returns, such as those of individuals and trusts are dependant on a manual selection process, not necessarily supported by any specific methodology. Except for refunds, which exceed a certain predetermined limit, the audit coverage of other non-compliant returns is very low, and this in itself poses a compliance risk to the SARS. It would therefore, from a taxpayer’s point of view, who contemplates non-compliance be more beneficial to operate a business through a trust. Unlike a company, a trust would not be screened for any risks by the computerised risk assessment tool. Having regard to the very low audit coverage percentage, the taxpayer using a trust has a very small chance of being audited. Audit selection should be the result of unbiased risk assessment, which is based on statistically determined parameters. This type of case selection will reduce the discretion of tax authorities and will ensure that tax officers do not have the sole discretion whether or not to select a case for audit. It is therefore recommended that the SARS should introduce the SARAP system to all tax returns.

7.3.3 Third party data

According to a benchmarking study (Gallagher: 2004) tax authorities need to have access to other information on taxpayers, relating to their ownership of vehicles, real estate ownership and their interest in other companies. The international benchmark is that this type of information is usually available to tax authorities on-line. As recommended in Chapter 5 of this study (refer to table 5.1), various additional external sources should be made available to the SARS on-line, which will enhance the quality of the profiles conducted by the risk profiler. These sources include the sheriff's office, Take A Bet (TAB), auction firms, brokers and others.
7.3.4 Industry profiles.

The suggested template to be used when compiling an industry drive is discussed in Chapter 4 of this study. A further recommendation was made that the SARS should publish their findings on industry profiles and invite the general public to provide the revenue authority with any information regarding tax evasion or any other general information that will be relevant to the industry. The Australian tax authority has published a detailed report on the building and construction industry on its website (www.ato.gov.za). The report covers the risks that they are addressing, the compliance approach and provides some results. Role players in the industry, such as unions, employer organizations, businesses, individuals and others are invited to provide the Australian revenue authority with any information that will enhance such an industry profile.

7.3.5 All-inclusive case selection process

The following recommended case selection process attempts to illustrate an all-inclusive method of case selection.
Examples
- Vehicle database
- Home affairs department
- Property details
- Details of investment income
- Suspicious activity reports
- Industry trends
- High-risk candidates
- High-risk industries
- Acceptable gross profit margins
- Data obtained from all returns filed;
- Import and export data;
- Feedback on cases audited

Factors to consider
- Audit coverage
- Allocation per segment
- High-risk and/or high yield case

Figure 7.1 Proposed risk selection process
The above-mentioned process would ensure that all income tax returns are subjected to analysis. It will furthermore ensure that all data relating to the taxpayer’s trade, assets and other income are linked to the taxpayer’s file. The computerised risk selection program will identify certain discrepancies and risks, which will ensure that cases are generated for audit. This methodology would at least ensure that all taxpayers are subjected to risk profiling. The risk profiler can then apply further analytical skills to ensure that a case referred to the audit section complies with the strategic goals of SARS.

7.3.6 Feedback

A comprehensive risk-based case selection methodology should be a dynamic process reflecting continuous improvement. The risk selection section should receive feedback on all cases referred to the audit section. The feedback will enable the risk selection section to analyse the results of the process by which cases are referred to the audit section. Although the auditors document their findings and the monetary results of the audit are captured on the case management and tracking system, the audit result is not linked to the initial risk identified by the risk profiler (Schlenther, B. 2004). It is therefore recommended that the SARS audit report should include an evaluation of the risks identified by the risk profiler. Unless specific feedback is provided to the risk profiling section, it is debateable whether the audit result has any relevance to the initial risks identified.

7.4 Tax education

There is also literature that stresses that tax evasion involves more than a cost-benefit calculation as discussed in paragraph 7.2 and reflects the taxpayer’s sense of duty, perception of the fairness of the tax system and trust in the government and the general political system (Slemrod: 2003).

To enhance the general taxpaying public’s perception of the fairness of the tax system, it is recommended that a public awareness campaign be undertaken in relation to the audit process discussed in this thesis. The public awareness campaign should inform the public about the process of case selection, including the audit coverage. The Inland
Revenue Services, in America, makes available much information on actual audit coverage (Slemrod: 2003). Slemrod stated the following in this regard: “While perceptions themselves cannot be accurately measured, the IRS makes available much information on actual audit coverage that presumably will influence taxpayers perceptions” (Slemrod, 2003:16). According to the statistics the audit coverage ratio is three times higher for what the IRS classifies as business returns versus non-business returns, 1.55 percent versus 0.51 percent (Slemrod: 2003). The audit coverage published by the SARS only indicates the number of audits conducted per tax type.

The preventative effect of raising public awareness of the potential for a tax audit, together with the threat of severe penalties and the publication of names of tax offenders should be of great assistance in protecting the tax base.

7.5 Conclusion

This study has concluded that where any revenue authority relies on a self-assessment system of calculating the tax liability of a taxpayer, it is important that it should adopt an effective compliance programme. The success of any compliance division lies in an effective and successful case selection system. The SARS is in the stage of developing its case selection methodology and the research has indicated some areas of concern in the case selection process. The SARS will certainly wish to benchmark its case selection methodology against those of other revenue authorities to ensure that it uses a world-class process, which will promote compliance with tax, ensure responsible enforcement and thereby reduce the tax gap. The thesis has made a number of recommendations for improving the current case selection system (some of which may already have been implemented since the writing of this document) and has proposed a number of models. An important outcome of the case selection process is the feedback loop from completed audits to the original risk assessment process, ensuring a dynamic process of continuous self-evaluation and improvement.
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<th>2004/05</th>
<th>2005/06</th>
<th>2006/07</th>
</tr>
</thead>
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<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimate of revenue before tax proposals</td>
<td>329,256</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Tax proposals</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct proposals</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal income tax</td>
<td>-4,062</td>
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<td></td>
</tr>
<tr>
<td>Adjust personal income tax rate structure</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase interest and dividend exemption under 65 years</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase interest and dividend exemption age 65 years and older</td>
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<td></td>
<td></td>
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<tr>
<td>Financial transaction taxes</td>
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</tr>
<tr>
<td>Adjust table for transfer duty</td>
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</tr>
<tr>
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<td>Income tax proposals</td>
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<td></td>
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<tr>
<td>Specific excise taxes: Net Impact</td>
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<td></td>
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<tr>
<td>Increase in duties on bear</td>
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<td></td>
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<tr>
<td>Increase in duties on sparkling wine</td>
<td>6</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in duties on unfortified wine</td>
<td>98</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in cider</td>
<td>21</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in duties on spirits</td>
<td>220</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in excise duties on tabacco products</td>
<td>794</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in Fuel levy</td>
<td>909</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Remove ad valorem duties on computers</td>
<td>-230</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Estimated of revenue after tax proposals</strong></td>
<td>304,459</td>
<td>300,300</td>
<td>326,956</td>
<td>360,266</td>
</tr>
<tr>
<td>Percentage change from previous year</td>
<td>8.90%</td>
<td>10.20%</td>
<td>9.40%</td>
<td></td>
</tr>
<tr>
<td><strong>Expenditure</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Statutory and standing appropriations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of servicing state debt</td>
<td>50,986</td>
<td>47,326</td>
<td>50,432</td>
<td>53,986</td>
</tr>
<tr>
<td>Provincial equitable share</td>
<td>142,386</td>
<td>144,743</td>
<td>159,971</td>
<td>173,852</td>
</tr>
<tr>
<td>Skill development levy</td>
<td>3,600</td>
<td>3,700</td>
<td>4,300</td>
<td>4,500</td>
</tr>
<tr>
<td>Other</td>
<td>386</td>
<td>386</td>
<td>409</td>
<td>420</td>
</tr>
<tr>
<td></td>
<td>197,359</td>
<td>196,154</td>
<td>215,113</td>
<td>232,758</td>
</tr>
<tr>
<td>Appropriate by vote</td>
<td>133,607</td>
<td>135,531</td>
<td>150,291</td>
<td>165,896</td>
</tr>
<tr>
<td><strong>Estimate of national expenditure</strong></td>
<td>336,965</td>
<td>331,685</td>
<td>372,404</td>
<td>410,654</td>
</tr>
<tr>
<td>2003 budget estimate of expenditure</td>
<td>333,965</td>
<td>363,345</td>
<td>395,606</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2003/04</td>
<td>2004/05</td>
<td>2005/06</td>
<td>2006/07</td>
</tr>
<tr>
<td>--------------------------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
</tr>
<tr>
<td></td>
<td>Budget estimate</td>
<td>Revised estimate</td>
<td>Budget estimate</td>
<td>Medium term estimates</td>
</tr>
<tr>
<td><strong>REVENUE</strong></td>
<td>304,459</td>
<td>300,300</td>
<td>326,956</td>
<td>360,266</td>
</tr>
<tr>
<td><strong>EXPENDITURE</strong></td>
<td>333,965</td>
<td>331,685</td>
<td>368,904</td>
<td>404,654</td>
</tr>
<tr>
<td>National budget deficit</td>
<td>-29,506</td>
<td>-31,385</td>
<td>-41,948</td>
<td>-44,388</td>
</tr>
<tr>
<td>Percentage of GDP</td>
<td>-2.40%</td>
<td>-2.60%</td>
<td>-3.10%</td>
<td>-3.00%</td>
</tr>
<tr>
<td>Plus: Extraordinary transfers</td>
<td>-7,000</td>
<td>-7,443</td>
<td>-7,000</td>
<td>-7,000</td>
</tr>
<tr>
<td>Less: Extraordinary receipts</td>
<td>6,341</td>
<td>889</td>
<td>2,742</td>
<td>2,567</td>
</tr>
<tr>
<td><strong>Net borrowing required</strong></td>
<td>-30,165</td>
<td>-37,939</td>
<td>-42,206</td>
<td>-48,821</td>
</tr>
</tbody>
</table>

**Financing**

<table>
<thead>
<tr>
<th></th>
<th>2003/04</th>
<th>2004/05</th>
<th>2005/06</th>
<th>2006/07</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic short-term loans</td>
<td>6,000</td>
<td>6,000</td>
<td>6,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Domestic long-term loans</td>
<td>9,298</td>
<td>26,081</td>
<td>34,328</td>
<td>30,739</td>
</tr>
<tr>
<td>Loans issued for financing:</td>
<td>2,298</td>
<td>18,924</td>
<td>27,328</td>
<td>23,739</td>
</tr>
<tr>
<td>New loans</td>
<td>29,280</td>
<td>46,130</td>
<td>57,526</td>
<td>55,014</td>
</tr>
<tr>
<td>Less Discount</td>
<td>-554</td>
<td>-847</td>
<td>-3,666</td>
<td>-4,505</td>
</tr>
<tr>
<td>Scheduled redemptions</td>
<td>-26,439</td>
<td>-26,558</td>
<td>-26,532</td>
<td>-26,770</td>
</tr>
<tr>
<td>Loans issued for switches</td>
<td>-120</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New loans</td>
<td>7,000</td>
<td>10,167</td>
<td>7,000</td>
<td>7,000</td>
</tr>
<tr>
<td>Less Discount</td>
<td>-116</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans switched</td>
<td>-7,000</td>
<td>-10,171</td>
<td>-7,000</td>
<td>-7,000</td>
</tr>
<tr>
<td>Loans issued for extraordinary purposes</td>
<td>7,000</td>
<td>7,276</td>
<td>7,000</td>
<td>7,000</td>
</tr>
<tr>
<td>New loans</td>
<td>7,000</td>
<td>7,276</td>
<td>7,000</td>
<td>7,000</td>
</tr>
<tr>
<td>Foreign loans</td>
<td>11,767</td>
<td>1,151</td>
<td>5,878</td>
<td>10,082</td>
</tr>
<tr>
<td>New loans</td>
<td>9,310</td>
<td>10,657</td>
<td>7,400</td>
<td>8,100</td>
</tr>
<tr>
<td>Export credit facilities</td>
<td>5,276</td>
<td>3,876</td>
<td>4,675</td>
<td>4,229</td>
</tr>
<tr>
<td>Less Discount</td>
<td>-81</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Redemptions</td>
<td>-2,819</td>
<td>-13,302</td>
<td>-6,198</td>
<td>-2,247</td>
</tr>
<tr>
<td>Change in cash balances</td>
<td>3,100</td>
<td>4,708</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total financing</td>
<td>30,165</td>
<td>37,939</td>
<td>46,206</td>
<td>48,821</td>
</tr>
</tbody>
</table>

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### Suspicious Activity Report

**Part 1 - Selection (Mandatory)**

This part of the report is not optional, please complete the fields as accurately as possible. This will enable SARS to effectively prioritise and allocate it to the relevant department.

<table>
<thead>
<tr>
<th>Field</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of Suspicious Activity</strong></td>
<td>Tell us what kind of non-compliance you are reporting.</td>
</tr>
<tr>
<td><strong>Estimated Loss</strong></td>
<td>Please estimate the financial implication / loss / discrepancy of the non-compliance activity.</td>
</tr>
<tr>
<td><strong>Affected Industry</strong></td>
<td>The industry being affected by the non-compliance activity.</td>
</tr>
<tr>
<td><strong>Province</strong></td>
<td>Province where the non-compliance activity occurred.</td>
</tr>
<tr>
<td><strong>Town/City</strong></td>
<td>Town / City where the non-compliance activity occurred. Please give the full name, do not use abbreviations.</td>
</tr>
<tr>
<td><strong>Description of Suspicious Activity</strong></td>
<td>Please describe in your own words exactly which activity you wish SARS to respond to.</td>
</tr>
</tbody>
</table>

**Part 2 - Subject(1) Details (Please complete mandatory fields)**

A subject is a person and/or a business that you suspect of being non-compliant and would like to report. Please supply as much information as possible.

<table>
<thead>
<tr>
<th>Field</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Name</td>
<td>Trade name or registered name</td>
</tr>
<tr>
<td>Surname</td>
<td>If you supply the surname please supply the first name or initials</td>
</tr>
<tr>
<td>First Name</td>
<td></td>
</tr>
<tr>
<td>Initials</td>
<td></td>
</tr>
<tr>
<td>Date of Birth</td>
<td></td>
</tr>
</tbody>
</table>

**General Information (Please supply at least one entry marked with an *)**

<table>
<thead>
<tr>
<th>Field</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reference Numbers</td>
<td>Reference numbers include numbers like ID, Passport, Tax reference, Vat, Registered numbers. If other is selected, please specify the type.</td>
</tr>
</tbody>
</table>
### Contact Numbers *

**Contact number type**

Contact numbers include Home, Work, Business Telephone numbers as well as Email and Web addresses. If other is selected, please specify type.

<table>
<thead>
<tr>
<th>First number</th>
<th>Second number</th>
<th>Third number</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
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</tr>
</tbody>
</table>

### Address Information *

( Please supply any physical/postal address of the subject )

<table>
<thead>
<tr>
<th>First type of address</th>
<th>Second type of address</th>
<th>Third type of address</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
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<tr>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

### Vehicle registration number *

**Vehicle make and model**

**Vehicle colour**

<table>
<thead>
<tr>
<th>Vehicle registration number</th>
<th>Vehicle make and model</th>
<th>Vehicle colour</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Part 3 - Source Details ( These fields are optional. You may remain anonymous )

Please tell us how you came about knowing of the non-compliant activity you are reporting

<table>
<thead>
<tr>
<th>Source Type</th>
<th>Surname</th>
<th>First Name</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

### Part 4 - Capturer Details ( These fields are optional. You may remain anonymous )
Please tell us about yourself if you are not the source of the information but capturing it on someone's behalf

<table>
<thead>
<tr>
<th>Surname</th>
<th>First Name</th>
<th>Contact number type</th>
</tr>
</thead>
</table>
|                  |                 | Contact numbers include Home, Work, Business Telephone numbers as well as Email and Web addresses. If other is selected, please specify type.

☐ Do you have additional references/subjects that are related or involved in the non-compliance?