Inland Revenue
Te Tari Taake

EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY | HUKIHUKI HURANGA - MŌ TE TĀKUPU ME TE MATAPAKI ANAKE

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INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

Shortfall penalty for gross carelessness

Issued | Tukuna: Issue date

IS XX/XX

This interpretation statement explains the meaning of gross carelessness in s 141C of the Tax Administration Act 1994.

All legislative references are to the Tax Administration Act 1994 unless otherwise stated.

REPLACES | WHAKAKAPIA

- **IS0060:** Shortfall penalty for gross carelessness (August 2004) *Tax Information Bulletin* Vol 16, No 8 (September 2004): 10

Contents | Ihirangi

Introduction | Whakataki

1. Section 141C imposes a shortfall penalty for gross carelessness where:
   - the taxpayer takes a tax position;
   - a tax shortfall arises from the tax position;
   - the taxpayer is grossly careless in taking the tax position.
2. The penalty applies to tax positions taken in relation to most tax types including GST and income tax. Income tax includes withholding-type taxes treated as income tax, eg, PAYE, FBT, and resident withholding tax.
3. The penalty is 40% of the tax shortfall.
4. **IS XX/XX: Shortfall penalties – requirements for a "tax position" and a "tax shortfall" (PUB00500b)** explains the requirements for a "tax position" and a "tax shortfall".
5. This interpretation statement explains the meaning of "gross carelessness".
6. **IS XX/XX: Shortfall penalties – reductions and other matters (PUB00500c)** explains when a shortfall penalty is reduced (or increased), what happens when a taxpayer could be liable for more than one penalty, and the assessment, payment and disputing of shortfall penalties.

Summary | Whakarāpopoto

7. In summary, this interpretation statement explains the meaning of "gross carelessness" as follows:

   - Gross carelessness means doing or not doing something in a way that, in all the circumstances, suggests or implies complete or a high level of disregard for the consequences.[1]
   - Gross carelessness involves more than mere inadvertence or lack of reasonable care.
   - For conduct to be grossly careless it must create a high risk of a tax shortfall occurring, where the risk and its consequences would have been foreseen by a reasonable person in the taxpayer's circumstances.
   - Failing to give any thought to an obvious and serious risk constitutes gross carelessness.
   - Whether the taxpayer acted intentionally is not a consideration.
   - A person who takes reasonable care in taking the tax position has not been grossly careless.
   - A taxpayer who takes an acceptable tax position is also a person who has not been grossly careless in taking that tax position.[2]

Analysis | Tātari

The meaning of "gross carelessness"

8. "Gross carelessness" is defined in s 141C(3) and means doing or not doing something in a way that, in all the circumstances, suggests or implies complete or a high level of disregard for the consequences.

9. In *Case W4*, Judge Barber said that gross carelessness is characterised by conduct that creates a high risk of a tax shortfall occurring where the risk and its consequences would be foreseen by a reasonable person in the circumstances:[3]

> [44] … the definition of "gross carelessness" refers to a high level of disregard for the consequences and is characterised by conduct which creates a high risk of a tax shortfall

[1] Section 141C(3).

[2] Section 141C(4).

[3] *Case W4* (2003) 21 NZTC 11,034 (TRA).

> occurring where this risk and its consequences would have been foreseen by a reasonable person in the circumstances.

10. In any situation it is necessary to determine what constitutes a "high" risk or "high" level of disregard for the consequences, as opposed to a risk arising from a lack of reasonable care.

11. In *Case 11/2016,* Judge Sinclair said that to meet the gross carelessness test something more than mere inadvertence is required. The carelessness must be "flagrant".[4]

12. In *Case W4,* Judge Barber said gross carelessness under s 141C must be something similar to recklessness.[5] In *R v Caldwell,* Lord Diplock said that recklessness covered a range of states of mind from failing to give any thought to whether there is a risk to recognising the existence of a risk and deciding to ignore it.[6] In *R v Howe,* the Court of Appeal recognised that recklessness was not limited to deliberate risk taking but includes failing to give any thought to an obvious and serious risk.[7]

13. The test for gross carelessness does not require that the taxpayer foresaw that their act or failure to act created a high risk of a tax shortfall occurring. Rather, the test is an objective one, based on what a reasonable person in the taxpayer's circumstances would foresee as conduct creating a high risk of a tax shortfall occurring.[8]

14. Further, whether the taxpayer acted intentionally is not a consideration.[9] In *Case W4,* Judge Barber said that if intention or knowledge was involved then there would be tax evasion rather than gross carelessness:

> [45] It seems to me that if *mens rea* [the mental element of intention] is involved then there must be tax evasion rather than gross carelessness. …

15. It is the taxpayer's conduct and circumstances existing at the time it took the relevant tax position or positions that are relevant in determining whether a taxpayer has been grossly careless.[10] Section 141C(3) requires that "all the circumstances" are considered in determining whether a taxpayer has been grossly careless. This requirement means that whether certain behaviour is grossly careless depends on the circumstances in each case.[11]

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[4] *Case 11/2016* (2016) 27 NZTC 3-033 (TRA) at [123].

[5] *Case W4* at [48].

[6] *R v Caldwell* (1981) 1 All ER 961 (HL) at 964.

[7] *R v Howe* (1982) 1 NZLR 618 (CA).

[8] *Case 9/2014* (2014) 26 NZTC 2-019 (TRA) at [88].

[9] *Case W4* at [60].

[10] *Case 9/2018* (2018) 28 NZTC 4-016 (TRA) at [98].

[11] *Case W4* at [60].

16. Circumstances that could be relevant in determining whether a taxpayer is grossly careless include:

- the person's experience, education and skills;
- the significance of the transaction, or transactions of a similar nature when viewed together, in the context of the taxpayer's business or activities;[12]
- the size of the tax shortfall;[13]
- the scale and duration of activities;[14]
- warnings given by Inland Revenue or advisors in relation to the risk of the tax shortfall;
- pressures experienced by the taxpayer; and[15]
- the short time-frame between the purchase and the sale of the property.[16]

Depending on the particular facts, other circumstances may be relevant.

17. The person's experience, education and skills could include experience in relevant tax laws, particular knowledge relevant to the tax position taken, or general commercial or business experience. The relevance of the person's experience, education and skills is illustrated in three cases:

- In *Case W4,* Judge Barber referred to the disputant's lengthy experience in business and preparing GST returns for both himself and his company.
- In *Case 10/2016,* Judge Sinclair referred to the sole director and shareholder's familiarity with mortgage documentation and the mortgagee sale process in the context of concluding whether a reasonable person in his position could have been expected to know that the bank does not act as agent for a mortgagor in realising its securities.[17]

[12] See *Case W4* and *Case 9/2015* (2015) 27 NZTC 3-008 (TRA) for examples of how these circumstances were considered in determining whether the taxpayer was grossly careless.

[13] See *Case W4* for an example of how this circumstance was considered in determining whether the taxpayer was grossly careless.

[14] See *Case 5/2013* (2013) 26 NZTC 2-004 (TRA) for an example of how this circumstance was considered in determining whether the taxpayer was grossly careless.

[15] See *Case W3* (2003) 21 NZTC 11,014 (TRA) for an example of how this circumstance was considered in determining whether the taxpayer was grossly careless.

[16] See *Case W4* for an example of how this circumstance was considered in determining whether the taxpayer was grossly careless.

[17] *Case 10/2016* (2016) 27 NZTC 3-032 (TRA).

- In *Case 9/2015,* Judge Sinclair accepted that the taxpayer was not knowledgeable in tax and accounting matters but nevertheless referred to him being a successful business man and qualified civil engineer.[18]

18. Example | Tauira 1 illustrates a situation where the taxpayer's experience, education and skills were a significant factor in concluding the taxpayer was grossly careless.

Example | Tauira 1 – Consideration of taxpayer's experience, education and skills when determining gross carelessness

Reema, a chartered accountant, provides consultancy services. Over the years, Reema has returned consultancy income and claimed deductions for various expenses related to her consultancy business.

Reema did not file income tax returns for the income years ended 31 March 2022 and 31 March 2023, and default assessments were issued. It was established that Reema had earned consultancy income in both years. The amount of consultancy income earned in each of the income years was around 75% less than that earned in the past. It was also discovered that Reema had been mixing her personal and business expenses and was unable to provide supporting information to show that some of the expenses were genuinely related to the consultancy business. There was a tax shortfall.

A reasonable person with the same skills and experience as Reema (a chartered accountant with years of experience in advising business clients and filing her own income tax and GST returns) would have been aware of the requirements to:

- maintain proper business records, including properly recording expenses and retaining copies of invoices for expenditure claimed;
- file income tax returns on time; and
- return the amounts earned from the provision of consultancy services as income.

Further, a reasonable person in Reema's circumstances would have foreseen that treating the consultancy income as non-taxable by not declaring it as income in her income tax return, despite receiving regular amounts into her bank account for consultancy services, created a high risk of a tax shortfall occurring in each of the income years.

A question arises as to the relevance of the consultancy income earned in the relevant income years being considerably lower than that earned in previous income years (75% lower). It is considered that in this situation a reasonable person with the same skills and experience as Reema, where the consultancy income was her main source of

[18] *Case 9/2015* (2015) 27 NZTC 3-008 (TRA).

income, would have foreseen that treating the (reduced) amount of consultancy income as non-taxable, created a high risk of a tax shortfall occurring.

Accordingly, it is considered that Reema was grossly careless.

Person who takes reasonable care is not grossly careless

19. A person who takes reasonable care is not grossly careless. In *Case W4,* Judge Barber said the degree of negligence for gross carelessness was greater than for a shortfall penalty for not taking reasonable care:

> [48] Clearly, any degree of negligence under the s 141C shortfall penalty provision will be of a greater magnitude than under s 141A.

20. Taking reasonable care includes exercising reasonable diligence to determine the correctness of a return, keeping adequate records and generally making a reasonable attempt to comply with the tax law. In *Case W4,* Judge Barber said:

> [60] As with gross carelessness, whether the taxpayer acted intentionally is not a consideration. It is not a question of whether the taxpayer actually foresaw the probability that the act or failure to act would cause a tax shortfall, but whether a reasonable person in the circumstances of the taxpayer would have seen the tax shortfall as a reasonable probability. **Reasonable care must include exercising reasonable diligence to determine the correctness of a return. It must also include the keeping of adequate books and records or to properly substantiate items, and generally making a reasonable attempt to comply with the tax law**. [Emphasis added]

21. Further, generally a taxpayer who relies on an action or advice of their tax advisor in taking a tax position takes reasonable care.[19] This position is subject to exceptions, which are discussed in **IS XX/XX: Shortfall penalty for not taking reasonable care (PUB00498)** at [25] and [26].

22. It follows that a person who takes reasonable care by doing the following would also not be grossly careless:

- exercising reasonable diligence to determine the correctness of a return, keeping adequate records and generally making a reasonable attempt to comply with the tax law; and/or
- relying on an action or advice of their tax advisor.

Distinguishing between gross carelessness and not taking reasonable care

23. As discussed at [10] and [19], the carelessness involved in gross carelessness is of a greater magnitude that that involved in not taking reasonable care.

[19] Section 141A(2B).

24. In determining whether a taxpayer's conduct in the circumstances constitutes not taking reasonable care or gross carelessness, it is necessary to make a judgement about where the dividing line between the two standards is.

25. Where that dividing line is depends on the particular facts of the case. Example | Tauira 2, Example | Tauira 3 and Example | Tauira 4 illustrate situations where the carelessness involved is of a greater magnitude than involved in not taking reasonable care and is gross carelessness.

Example | Tauira 2 – Determining the magnitude of carelessness

Over a 10-year period, the Jones Family Trust bought eight properties, built houses on them and sold them.

Despite the scale and frequency of these transactions, the trust did not file income tax or GST returns. The trustees considered the properties were used as family residences, so were not subject to income tax or GST.

After the sale of the third property, the trust's solicitor suggested the trustees get tax advice on the transactions. The trustees did not get any tax advice.

During an audit, it was determined the trust had engaged in the activities regularly and systematically, indicating a business operation rather than mere personal use and that income tax and GST was payable on seven of the eight property sales (one property met the main home exemption). A tax shortfall arose.

A reasonable person in the trustees' circumstances would have foreseen, in light of the large number of properties purchased, improved and sold, the high risk of a tax shortfall occurring. Further, the trust's solicitor identified the risk of a tax liability and raised it with the trustees. Despite this, the trustees obtained no tax advice.

The trust's conduct in the circumstance suggests it had a high level of disregard for the accuracy of its tax returns, so was grossly careless.

Given the duration and scale of the activities, this outcome would be unchanged even if the trust's solicitor did not suggest the trustees get tax advice. However, if the duration and scale of activities was significantly less, the likelihood the trust was grossly careless would reduce. However, in that case other circumstances (such as the tax risk being identified by the trust's solicitor but ignored by the trustees) would still be relevant in determining whether the trust was grossly careless.

Example | Tauira 3 – Determining the magnitude of carelessness

Sunrise Developments Ltd was established in August 2024. The company entered into an agreement for the sale and purchase of farmland, intending to subdivide it and build houses for sale.

On incorporation, the company claimed an input tax credit on the full purchase price of $500,000 in its GST return for the taxable period ended 31 August 2024.

In October 2024, a newspaper report detailed the proposed establishment of a new highway near the land, which the company believed would adversely affect its ability to sell the residential properties.

The company sold the land in December 2024 for $490,000.

The person usually responsible for preparing the returns was on annual leave when the return was due for the taxable period in which the land was supplied. The staff member filling in did not realise that output tax on the sale of the property needed to be returned. Consequently, no output tax on the sale was returned in the correct taxable period, nor was it ever returned after the usual staff member responsible for preparing the GST returns returned from leave.

A reasonable person would have been aware of the GST implications of the transaction because an input tax credit on the purchase of the property had been claimed. Given the relatively short period between the purchase and sale of the property (August 2024 to December 2024), a reasonable person would have heightened awareness of the need to return output tax on the sale, especially given the input tax credit claimed at the time of purchase. As well, given the large amount of output tax payable, a reasonable person would recognise the importance of accurately reporting such a significant transaction and would not have inadvertently omitted to return output tax.

Further, while the staff member who completed the return was temporarily filling in for the usual staff member, a reasonable person would have recognised there was an obvious and serious risk that a tax shortfall would occur if an inadequately trained person completed the return, so would have put in place procedures to ensure no error was made. The fact the error was not rectified in a later taxable period when the usual staff member returned from leave also suggests the company had a high level of disregard for the accuracy of its return. Accordingly, it is considered that the company was grossly careless.

This outcome may have been different if the tax shortfall resulted from a transaction that was relatively insignificant because the output tax on the transaction, when viewed in isolation, was relatively small or was one of several similar transactions. It could be

argued in this situation that a reasonable person may have failed to notice the output tax on one transaction had not been returned.

In such a case whether the taxpayer had been grossly careless would need to be determined by considering the full set of facts. If, for example, most of a taxpayer's transactions were of a similar nature to the one in question, then potential exists for a large tax shortfall to occur over a period through multiple small errors. In such a case, the adequacy of the accounting system would need to be determined. If the taxpayer had been warned previously that their accounting system was inadequate to ensure the correct amount of tax was identified, then disregarding those warnings would be evidence of an indifference to an obvious risk of a possible tax shortfall occurring. If, however, the taxpayer had made a real attempt to implement system improvements, obtaining further advice where necessary, it is likely the taxpayer's conduct would not be regarded as having created a high risk of a tax shortfall occurring.

Example | Tauira 4 – Determining the magnitude of carelessness

Cher runs a building recycling operation, buying and selling material and fittings from buildings that are to be demolished or refurbished. Her suppliers are both registered and unregistered persons for GST purposes.

On audit, it was found Cher had claimed input tax credits on material purchased from unregistered persons under the secondhand goods provisions in s 20(3)(a)(ia) of the Goods and Services Tax Act 1985, which allows an input tax deduction only to the extent that payment has been made. Cher claimed several input tax credits on secondhand goods purchased from unregistered persons in the taxable period ended 31 March 2025 based on the full purchase price totalling $36,000, when during that period she had paid only $5,000 of the total amount due.

Similar mistakes had been identified during past investigations, and the investigator had advised Cher how to improve her bookkeeping system to prevent similar errors in the future. Despite 12 months having elapsed since this advice was given, Cher had failed to implement the suggested improvements.

Buying secondhand goods is a regular part of Cher's business.

A reasonable person in Cher's circumstances would have foreseen that failing to implement the suggested improvements, including checks, to prevent input tax credits being claimed for secondhand goods not yet paid for, created a high risk of a tax shortfall occurring.

As such, the errors are not mistakes occurring because of mere inadvertence. Cher's conduct indicates indifference to the serious risk of recurring errors and complete or a high level of disregard for the consequences.

If, however, Cher had made a real attempt to implement system improvements, in the absence of any other factors, it is likely her conduct would not be regarded as having created a high risk of a tax shortfall occurring.

Taxpayer who takes an acceptable tax position is not grossly careless

26. A taxpayer who takes an "acceptable tax position" is also a person who has not been grossly careless in taking the tax position.[20]

27. An acceptable tax position is a tax position that is not an "unacceptable tax position".[21] The meaning of unacceptable tax position is explained in **IS XX/XX: Shortfall penalty for taking an unacceptable tax position (PUB00499)**. In summary, an unacceptable tax position is one that, viewed objectively, fails to meet the standard of being "about as likely as not to be correct".[22] Whether the taxpayer believes their tax position was correct or acceptable is irrelevant. A tax position will be "about as likely as not to be correct" if:[23]

    - even though wrong, it can be argued on rational grounds to be right;
    - it is one of which "reasonable minds could differ". There must be room for a real and rationale difference of opinion;
    - it has about an equal chance of being correct.

28. A taxpayer does not take an unacceptable tax position merely by making a mistake in the calculation or recording of numbers used in, or used in preparing, a return.[24]

29. Example | Tauira 5 illustrates a situation where consideration was given to whether the taxpayer's tax position was acceptable.

[20] Section 141C(4).

[21] Section 3(1) definition of "acceptable tax position".

[22] Section 141B.

[23] See IS XX/XX: Shortfall penalty for taking an unacceptable tax position at [15] to [35].

[24] Section 141B(1B).

Example | Tauira 5 – Determining whether the taxpayer's tax position is an acceptable tax position

KiwiSmart Ventures Ltd was recently incorporated to invest in residential property for long-term rental. It buys properties, renovates them if needed and leases them out.

For the year ending 31 March 2024, KiwiSmart Ventures claimed $65,000 as repairs and maintenance expenses.

On investigation, Inland Revenue found that business had begun and that $48,000 of the $65,000 was spent on one untenanted property bought during that year and related to the following work:

- repairing and cleaning the leaking roof;
- replacing unsafe broken porch steps and railings;
- replacing broken bathroom fittings;
- replacing worn carpet and vinyl; and
- repairing and repainting exterior and interior walls

All these repairs were done within months of purchasing the property and were essential so that it could be rented out.

None of the costs of the repairs were treated as capital (non-deductible) in nature. KiwiSmart Ventures argues its bookkeeper did not distinguish between capital and revenue expenses because they thought all the spending was for repairs and maintenance. The Commissioner considered that no deduction was allowed for the repairs of $48,000 because of the capital limitation in s DA 2(1). This was because the expenditure incurred was essential to restore and maintain the functionality of the property to the level required for its intended use for long-term rental. At the time of acquisition, KiwiSmart Ventures recognised it needed to incur further expenditure to bring the property up to the condition desired for its long-term use. The Commissioner also considered that:

- KiwiSmart Ventures should have done more to determine the deductibility or otherwise of the costs. Possible things that would demonstrate what a reasonable person in the circumstances would have done could include researching the issue, seeking advice from the Commissioner or from a tax adviser to determine the deductibility or otherwise of the repair costs because the capital revenue distinction is complex;
- Not doing any of the above suggests a high level of disregard for the consequences, so propose a penalty for gross carelessness.

On the assumption that the costs of $48,000 were in fact of a capital nature, should the proposed shortfall penalty for gross carelessness be imposed?

The first issue is whether it is appropriate to impose a shortfall penalty for gross carelessness in relation to the capital or revenue distinction given it is a contentious area of law and s 141C is a care provision rather than one relating to the accuracy of the tax position taken.

It is possible for a person to be grossly careless in taking a tax position no matter how contentious the applicable provision might be. In such a case, a reasonable person would be aware there was a greater need to research the issue or obtain advice, neither of which KiwiSmart Ventures did.

KiwiSmart Ventures will not have been grossly careless if it took an acceptable tax position.[25] In this case, it is considered KiwiSmart Ventures' tax position (taken on their behalf by their employee bookkeeper) was not an acceptable one. Objectively, its tax position – that the expenditure was deductible where it recognised a need for further expenditure to bring the properties up to the condition essential for long-term use as a rental property – was not "about as likely as not to be correct".[26] It was not close to being correct and there is not room for a real and rationale difference of view.

Nevertheless, KiwiSmart Ventures is not grossly careless in this case. Whether expenditure is of a capital or revenue nature requires a level of judgement based on several factors and KiwiSmart Ventures' relative inexperience counts against it having the required level of judgement. However, that KiwiSmart Ventures did not research the issue or obtain advice is not considered to suggest a total or high level of disregard for the consequences or an indifference to a serious risk that the expenditure would not be deductible. It is not evident that a reasonable person in KiwiSmart Ventures' circumstances would have been aware of the serious risk that the expenditure may not be deductible.

While the tax shortfall constitutes a large proportion of the expenditure deducted by KiwiSmart Ventures in the relevant income year, this factor in isolation is not sufficient to conclude it was grossly careless. Therefore, while KiwiSmart Ventures may not have taken reasonable care in taking its tax position, so may be liable for a shortfall penalty under s 141A, it is not considered in these circumstances that it had a high level of disregard for the consequences when filing its return.

Had there been, for example, earlier warnings from Inland Revenue or advice from a tax agent on the interpretative issue that KiwiSmart Ventures ignored, this would increase the likelihood that it had been grossly careless.

[25] Section 141C(4)

[26] Section 141B.

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In draft form these items may not be relied on by taxation officers, taxpayers, or practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

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References | Tohutoro

Legislative references | Tohutoro whakatureture

Goods and Services Tax Act 1985, s 20(3)(a)(ia)

Tax Administration Act 1994, ss 3(1) ("acceptable tax position", "correct tax position", "tax position", "taxpayer's tax position", "unacceptable tax position"), 141B, 141C

Case references | Tohutoro kēhi

Ben Nevis Forestry Ventures Ltd & v CIR; Accent Management Ltd v CIR [2008] NZSC 115, (2009) 24 NZTC 23,188

Case 5/2013 (2013) 26 NZTC 2-004 (TRA)

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Case 9/2015 (2015) 27 NZTC 3-008 (TRA)

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Case 10/2016 (2016) 27 NZTC 3-032 (TRA)

Case 11/2016 (2016) 27 NZTC 3-033 (TRA)

Case W3 (2003) 21 NZTC 11,014 (TRA)

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IS XX/XX: Shortfall penalties – reductions and other matters *Tax Information Bulletin* Vol xx, No x (month 2025): xx

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IS XX/XX: Shortfall penalty for not taking reasonable care *Tax Information Bulletin* Vol xx, No x (month 2025): xx

IS XX/XX: Shortfall penalty for taking an unacceptable tax position *Tax Information Bulletin* Vol xx, No x (month 2025): xx

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taxpayer's circumstances and an example in an interpretation statement will not necessarily lead to the same tax result. Each case must be considered on its own facts.