SHORTFALL PENALTY FOR NOT TAKING REASONABLE CARE

SUMMARY

1.1 All legislative references in this statement are to the Tax Administration Act 1994 unless otherwise stated.

1.2 This statement provides a detailed interpretative explanation of the shortfall penalty imposed by the Commissioner under section 141A of the Act on taxpayers who do not take reasonable care in carrying out their tax obligations. Where a taxpayer does not meet the standard of reasonable care, the result may be that too little tax is paid or payable or a tax benefit, credit, or advantage is overstated. This interpretation statement deals with some interpretative issues relating to the section, and is intended to complement and be read together with *Standard Practice Statement* INV-200, *Shortfall penalties – not taking reasonable care* appearing in *Tax Information Bulletin* Vol. 10, No 3 (March 1998) which applies to tax positions taken before 1 April 2003. The main features of this statement are:

- The standard of "reasonable care" in respect of section 141A involves establishing what a reasonable person would do in the same circumstances and takes into account such factors as the age, health, and background of the taxpayer in question.

- The statement provides guidance as to how the standard of reasonable care is applied to various types of taxpayers, e.g., business persons, clients of agents, and tax specialists. It also examines how the reasonable care standard applies in certain situations such as receipt of Inland Revenue advice, complexity of the law, materiality, and arithmetical errors.

- The reasonable care standard does not mean perfection, but refers to the effort required commensurate with the reasonable person in the taxpayer's circumstances.

- In determining whether the standard of reasonable care has been met, the Commissioner will consider the likelihood of a tax shortfall, the quantum of the shortfall and the difficulty of preventing a tax shortfall.

- Although a taxpayer is liable for the actions of their employees, the question of whether the taxpayer has taken reasonable care must still be considered.

- The shortfall penalty payable by the taxpayer, for not taking reasonable care, can be reduced for the taxpayer's previous behaviour, voluntary disclosure or where the tax shortfall is temporary. (The penalty can also be increased where the taxpayer obstructs the Commissioner.)

- In the Commissioner's view, section 141JAA, which provides for the penalty payable to be capped in some situations, is only applicable after other reductions have been made.

2. BACKGROUND

2.1 Following a review of the compliance and penalties legislation, the Tax Administration Amendment Act (No 2) 1996 introduced new rules to address problems that existed with the previous legislation. The problems that were identified in the review included unfairness to the majority of taxpayers who comply with the law, unnecessary costs to those involved, unclear legal processes and requirements, and rules that did not fit in with the self-assessment environment.

2.2 The Taxpayer Compliance, Penalties, and Disputes Resolution Bill – Commentary on the Bill (September 1995) ("Commentary on the Bill") states that:

> The reforms proposed in this bill will promote fairer and more effective enforcement of the Inland Revenue Acts. They will enhance taxpayers' understanding of their obligations and the standards expected of them and will improve consistency in the application of penalties overall and between different tax types.

2.3 Section 139 sets out the purpose of the penalties legislation as being the encouragement of voluntary compliance and co-operation with the Department, the consistent and impartial imposition of penalties, and the setting of penalties to fit the seriousness of the breach of tax obligations.

2.4 As part of these reforms, new civil penalties were introduced to replace additional tax and penal tax. These penalties include a late filing penalty, late payment penalty, shortfall penalties, and various other civil penalties. This statement provides an explanation of some interpretative aspects of one of the shortfall penalties – the penalty for not taking reasonable care covered by section 141A of the Act.

2.5 Following the enactment of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, there have been some changes to the legislation that applies to a tax position that a taxpayer takes, generally, on or after 1 April 2003. These further changes are noted in this statement and include the monetary cap of $50,000 on the shortfall penalty payable by the taxpayer for not taking reasonable care, which in some circumstances is provided for under section 141JAA.

2.6 This interpretation statement applies, except as otherwise specified, with respect to tax obligations, liabilities, and rights that are to be performed under or arise in respect of:

(a) The Income Tax Act 1994 in relation to the tax on income in the 1997-98 income year and subsequent years to and including the 2004-05 income year and then the Income Tax Act 2004, in relation to the tax on income in the 2005-06 and subsequent income years:

(b) The Goods and Services Tax Act 1985 in relation to supplies made in taxable periods commencing on or after 1 April 1997.

3. ISSUE

3.1. The issue addressed by this statement is the Commissioner's interpretation of section 141A with particular emphasis on the meaning of the standard of "reasonable care".

4. LEGISLATION

4.1 Section 15B sets out the taxpayer's tax obligations:

[taxpayer's tax obligations applicable **prior to the 2002-03 income year**]

15B Taxpayer's tax obligations

15B A taxpayer must do the following:

(a) Unless the taxpayer is a non-filing taxpayer, correctly determine the amount of tax payable by the taxpayer under the tax laws:

(b) Deduct or withhold the correct amounts of tax from payments or receipts of the taxpayer when required to do so by the tax laws:

(c) Pay tax on time:

(d) Keep all necessary information (including books and records) and maintain all necessary accounts or balances required under the tax laws:

(e) Disclose to the Commissioner in a timely and useful way all information (including books and records) that the tax laws require the taxpayer to disclose:

(f) To the extent required by the Inland Revenue Acts, co-operate with the Commissioner in a way that assists the exercise of the Commissioner's powers under the tax laws:

(g) Comply with all the other obligations imposed on the taxpayer by the tax laws.

(h) If a natural person to whom section 80C applies, inform the Commissioner that the person has not received an income statement for an income year, if the income statement is not received by the date prescribed by section 80C(2) or (3):

(i) If the taxpayer is a natural person, correctly respond to any income statement issued to the taxpayer.

["taxpayer's tax obligations" applicable **to the 2002-03 and subsequent income years** remain as applicable prior to the 2002-03 income year except for the addition of section 15B(aa)]

(aa) If required under a tax law, make an assessment:

4.2 A shortfall penalty for "not taking reasonable care" may be imposed under section 141A:

[for "tax positions" taken **prior to 1 April 2003**]

141A Not taking reasonable care

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

(2) The penalty payable for not taking reasonable care is 20% of the resulting tax shortfall.

(3) A taxpayer who, in taking a taxpayer's tax position, has used an acceptable interpretation of the tax law is also a taxpayer who has taken reasonable care in taking the taxpayer's tax position.

[for "tax positions" taken **on or after 1 April 2003**]

141A Not taking reasonable care

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

(2) The penalty payable for not taking reasonable care is 20% of the resulting tax shortfall.

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

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

4.3 The following terms are defined in section 3(1):

"Correct tax position" means the correct tax position established under one or more tax laws:

"Shortfall penalty" means a penalty imposed under any of sections 141A to 141K for taking an incorrect tax position or for doing or failing to do anything specified or described in those sections:

[definition of "tax law" **prior to 1 April 2002**]

"Tax law" means—

(a) A provision of the Inland Revenue Acts or an Act that an Inland Revenue Act replaces:

(b) An Order in Council or a regulation made under another tax law:

(c) A non-disputable decision:

(d) In relation to an obligation to provide a tax return or a tax form, also includes a provision of the Accident Rehabilitation and Compensation Insurance Act 1992 or a regulation made under that Act or the Accident Insurance Act 1998 or a regulation made under that Act.

[definition of "tax law" with effect **on or after 1 April 2002**)

"Tax law" means—

(a) A provision of the Inland Revenue Acts or an Act that an Inland Revenue Act replaces:

(b) An Order in Council or a regulation made under another tax law:

(c) A non-disputable decision:

(d) In relation to an obligation to provide a tax return or a tax form, also includes a provision of the Accident Rehabilitation and Compensation Insurance Act 1992 or a regulation made under that Act or the Accident Insurance Act 1998 or a regulation made under that Act or the Injury Prevention, Rehabilitation, and Compensation Act 2001 or a regulation made under that Act:

[for "tax positions**" taken prior to 1 April 2003**]

"Tax position" means a position or approach with regard to tax possible, under one or more tax laws, including without limitation

(a) A liability for an amount of tax, or the payment of an amount of tax:

(b) An obligation to deduct or withhold an amount of tax, or the deduction or withholding of an amount of tax:

(c) A right to a tax refund, or to claim or not to claim a tax refund:

(d) A right to a credit of tax, or to claim or not to claim a credit of tax:

(e) The provision of a tax return, or the non-provision of a tax return:

(f) The derivation of an amount of gross income or exempt income or a capital gain, or the inclusion or non-inclusion of an amount in gross income:

(g) The incurring of an amount of expenditure or loss, or the allowing or disallowing as a deduction of an amount of expenditure or loss:

(h) The availability of net losses, or the offsetting or use of net losses:

(i) The attaching of a credit of tax, or the receipt of or lack of entitlement to receive a credit of tax:

(j) The balance of a tax account of any type or description, or a debit or credit to such a tax account:

(k) The estimation of the provisional tax payable:

(l) Whether the taxpayer must request an income statement or respond to an income statement issued by the Commissioner:

(m) The application of section 33A(1):

(n) A right to a rebate:

[for "tax positions" taken **on or after 1 April 2003**]

"Tax position" means a position or approach with regard to tax under one or more tax laws, including without limitation a position or approach with regard to–

(a) A liability for an amount of tax, or the payment of an amount of tax:

(b) An obligation to deduct or withhold an amount of tax, or the deduction or withholding of an amount of tax:

(c) A right to a tax refund, or to claim or not to claim a tax refund:

(d) A right to a credit of tax, or to claim or not to claim a credit of tax:

(e) The provision of a tax return, or the non-provision of a tax return:

(f) The derivation of an amount of gross income or exempt income or a capital gain, or the inclusion or non-inclusion of an amount in gross income:

(g) The incurring of an amount of expenditure or loss, or the allowing or disallowing as a deduction of an amount of expenditure or loss:

(h) The availability of net losses, or the offsetting or use of net losses:

(i) The attaching of a credit of tax, or the receipt of or lack of entitlement to receive a credit of tax:

(j) The balance of a tax account of any type or description, or a debit or credit to such a tax account:

(k) The estimation of the provisional tax payable:

(l) Whether the taxpayer must request an income statement or respond to an income statement issued by the Commissioner:

(m) The application of section 33A(1):

(n) A right to a rebate:

"Tax shortfall", for a return period, means the difference between the tax effect of—

(a) A taxpayer's tax position for the return period; and

(b) The correct tax position for that period,—

when the taxpayer's tax position results in too little tax paid or payable by the taxpayer or another person or overstates a tax benefit, credit, or advantage of any type or description whatever by or benefiting (as the case may be) the taxpayer or another person:

"Taxpayer" means a person who—

(a) Is liable to perform, or to comply with, a tax obligation; or

(b) May take a tax position,—

whether as principal, or as an agent or employee or officer of another person, or otherwise:

[for "Taxpayer's tax position" taken **prior to the 2002-2003 income year**]

"Taxpayer's tax position" means—

(a) Unless paragraph (b) applies, a tax position taken by a taxpayer in or in respect of-

(i) A tax return; or

(ii) An income statement; or

(iii) A due date:

(b) If

(i) The tax is income tax; and

(ii) The taxpayer alters a tax position taken in a tax return or in an income statement before the earlier of-

(A) The issue of an assessment in respect of the tax; and

(B) The due date for payment of the tax,-

the tax position the taxpayer takes or is deemed to take in the last amended tax return or in the last amended income statement received by the Commissioner before the issue of the assessment or the deemed assessment or before the due date, whichever applies:

[for "Taxpayer's tax position" taken with application to the **2002-2003 and subsequent income years**]

"Taxpayer's tax position" means—

(a) A tax position taken by a taxpayer in or in respect of–

(b) (repealed)

5. SHORTFALL PENALTY FOR NOT TAKING REASONABLE CARE

THE SHORTFALL PENALTY PAYABLE UNDER SECTION 141A

5.1 Section 141A(1) provides for a shortfall penalty to be imposed on a taxpayer for "not taking reasonable care" in the taking of a taxpayer's tax position. Where that tax position results in a tax shortfall:

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

5.2 The shortfall penalty for not taking reasonable care is 20% of the resulting tax shortfall (section 141A(2)).

> (2) The penalty payable for not taking reasonable care is 20% of the resulting tax shortfall.

5.3 The terms "shortfall penalty", "taxpayer's tax position", "tax position", and "tax shortfall" are all defined in section 3(1).

5.4 There is no definition for the term "reasonable care" in the Act. However, section 141A(3) provides that a taxpayer who has used an "acceptable interpretation" (or with application to tax positions taken on or after 1 April 2003, a taxpayer who "takes an acceptable tax position"), in taking a taxpayer's tax position is one who has taken reasonable care in the taking of the taxpayer's tax position. Section 141A(3) states:

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

5.5 Interpretation Statement IS0055 provides the Commissioner's view on what is an unacceptable tax position (applicable to tax positions taken on or after 1 April 2003).

5.6 With application to a tax position taken on or after 1 April 2003, section 141A(4) provides that a taxpayer who makes a mistake in the calculation or recording of numbers in a return is specifically not excluded from being liable for a penalty for not taking reasonable care under section 141A. Section 141A(4) states:

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

5.7 In this context, it is considered that "return" refers to the taxpayer's tax return. "Tax return" is defined in the Act.

> **"Tax return"** means a form or document that a taxpayer is required by a tax law—
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> (a) To complete; and
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> (b) To provide to the Commissioner,—
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> whether in electronic or written form and whether provided in respect of a period or not; and also includes a tax form issued by another taxpayer that the taxpayer provides to the Commissioner:

5.8 It is noted that section 141A(4) does not provide that the taxpayer who makes a mistake in the calculation or recording of numbers in a return is necessarily liable for a shortfall penalty under section 141A.

Extent of application of section 141A

5.9 It should be noted that section 141A also applies to employers who do not take reasonable care in their tax obligations in respect of the deduction of tax from employees. The definitions of "tax law" and "tax position" mean that section 141A can apply to any of the Inland Revenue Acts. However, for the Child Support Act 1991 and Student Loan Scheme Act 1992, section 141A applies only in respect of employer obligations under these Acts.

6. NOT TAKING REASONABLE CARE

INTRODUCTION

6.1 As noted above, there is no definition for the term "reasonable care" in the Act. The word "care" is defined in *The New Shorter Oxford English Dictionary on Historical Principles* (Brown, L, (ed.), volume 1, (Oxford: Oxford University Press, 1993)), at page 516) to mean:

> … **3** serious attention, heed, caution, pains (assembled with care; handle with care) …

6.2 In the context of section 141A(1), the word "care" suggests the attention that a taxpayer takes in the taking of the taxpayer's tax position, with the adjective "reasonable" being used to describe the level or standard of attention required. In *The New Shorter Oxford English Dictionary on Historical Principles*, volume 2, at page 2496, "reasonable" is defined to mean:

> … **5** Within the limits of reason; not greatly less or more than might be thought likely or appropriate; moderate, …

6.3 Thus, taking reasonable care is giving appropriately serious attention to imposed obligations. Lack of reasonable care has long been one of the constituents of the tort of negligence. It is, therefore, helpful as background to consider the law relating to the tort of negligence.

NEGLIGENCE IN TORT

6.4 In defining the standard of care in negligence cases, the Courts have laid down the concept of the "reasonable person". Alderson B in *Blyth v Birmingham Waterworks* (1856) 11 Ex 781 at page 784 stated:

> Negligence is the omission to do something which a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs, would do; or do something which a prudent and reasonable man would not do.

6.5 The standard of care in negligence is not dependent upon the person's individual characteristics (*Glasgow Corporation v Muir* [1943] AC 448 at page 457 per Lord Macmillan): the standard is that of a reasonable person. Consequently, the circumstances of the person may dictate that they seek outside assistance (Todd, S, (ed.), *The Law of Torts in New Zealand*, 3rd edition, (Wellington: Brookers Limited, 2001) at pages 389-392). Therefore, an incapacitated person, whether in law or physically, can be held to have been negligent when he or she has attempted to do something beyond his or her capacity (*Spiers v Gorman* [1966] NZLR 897 at pages 905 – 906 (a minor); *Billy Higgs & Sons Ltd v Baddeley* [1950] NZLR 605 at page 614 (physical incapacity)).

6.6 In this context, when using an expert's assistance, it is necessary that the expert is advised of all necessary information. In the tax context, it was held in *Pech v Tilgals* [1994] ATC 4206 that, when instructing tax agents, a taxpayer's standard of care requires that the tax agent is comprehensively instructed and that the tax return that the principal is declaring to be correct must be inspected by the principal following its completion. However, it was also held that it was not necessary for the taxpayer to cover every contingency exhaustively by acquainting him or herself with all possible considerations that a reasonable person would not deal with.

6.7 The standard of care of a reasonable person does not require perfection. As Laidlaw J said in the Canadian case of *Arland v Arland and Taylor* [1955] OR 131 at page 142:

> [The reasonable man] is not an extraordinary or unusual creature; he is not superhuman; he is not required to display the highest skill of which anyone is capable; he is not a genius who can perform uncommon feats, nor is he possessed of unusual powers of foresight. **He is a person of normal intelligence who makes prudence a guide to his conduct.** He does nothing that a prudent man would not do and does not omit to do anything that a prudent man would do. **He acts in accordance with general and approved practice. His conduct is guided by considerations which ordinarily regulate the conduct of human affairs.** His conduct is the standard adopted by the community by persons of ordinary intelligence and prudence.
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> [emphasis added]

6.8 The use of hindsight is not relevant in determining whether or not a person has been negligent. In *Duchess of Argyll v Beuselinck* [1972] 2 Lloyds Rep 172 at page 185, Megarry J stated:

> In this world there are few things that could not have been better done if done with hindsight. The advantages of hindsight include the benefit of having a sufficient indication of which of the many factors present are important and which are unimportant. But hindsight is no touchstone of negligence.

6.9 In tort, a reasonable person takes notice of standards that are authoritative, sensible, accepted, or persuasive (*Froom v Butcher* [1975] 3 All ER 520 at page 526 per Lord Denning) and, in so doing, will be expected to keep abreast of such standards if it is reasonable to do so (*Graham v Co-operative Wholesale Society Ltd.* [1957] 1 WLR 511).

6.10 In *Paris v Stepney Borough Council* [1951] AC 367, it was held that the degree of care required was dependent upon the gravity of the consequences if anything went wrong; a higher degree of care is required when the consequences of getting it wrong are serious.

REASONABLE CARE IN RELATION TO THE PARTICULAR PERSON

6.11 As to the degree of care required, there are traditionally no "high" or "low" standards, to use the terminology in *Russell v Harris* [1960] NZLR 902. Much care or little care may be needed depending upon the circumstances.

6.12 In tort, an inexperienced person is required to exercise the care of the ordinary person. The clearest example of this in relation to negligence is the English Court of Appeal case of *Nettleship v Weston* [1971] 3 All ER 581. The case involved the alleged negligence of Mrs Weston who was learning to drive when she caused an accident. It is well established that a person driving a motor vehicle owes a duty of care to any passengers in the vehicle as well as to other persons on or near the roadways. One of the issues for the court was whether or not Mrs Weston had breached this duty by not taking reasonable care. Lord Denning MR made the following observations regarding the standard of reasonable care at page 586:

> It is no answer for him to say: "I was a learner-driver under instruction. I was doing my best and could not help it." The civil law permits no such excuse. It requires of him the same standard of care as any other driver. "It eliminates the personal equation and is independent of the idiosyncrasies of the particular person whose conduct is in question": see *Glasgow Corpn v Muir* [1943] 2 All ER 44 at 48 per Lord Macmillan. The learner-driver may be doing his best, but his incompetent best is not good enough. He must drive in as good a manner as a driver of skill, experience and care, who is sound in wind and limb, who makes no errors of judgment, has good eyesight and hearing and is free from any infirmity.

6.13 In this regard, the test is not whether a person has tried to exercise reasonable care, but rather whether he or she has in fact done so (*Bailey v Taylor* [1936] NZLR 806). This indicates that the test for reasonable care is an objective one.

6.14 In the case of persons who hold themselves out as experts in a particular area, such as a specialist surgeon, the standard of care may be higher. In the *Law of Torts in NZ*, 3rd edition, Brookers 2001, it is stated at page 385 that, in the case of those who have special skills, the standard of conduct must conform to that

which ought to be attained by persons holding themselves out as possessing the relevant skills. *Bannerman, Brydone Forster & Co v Murray* [1972] NZLR 411 is New Zealand Court of Appeal authority for this proposition (in relation to solicitors). However, an expert in a particular field is not required to exercise a greater degree of care than an ordinary person unless he or she holds him or herself out to be such (*Stokes v Guest, Keen & Nettlefold (Bolts and Nuts) Ltd* [1968] 1 WLR 1776).

6.15 As can be seen from the cases, the test for reasonable care in the tort of "negligence" is generally objective. The rationale behind this common law test is that people are not to be encouraged to engage in something beyond their capabilities. *Clerk & Lindsell on Torts*, 18th ed, London, Sweet & Maxwell 2000 speculate that insurance considerations have contributed to the objective standard, being that of the activity rather than the actor and state at paragraph 7.163, in relation to *Nettleship v Weston:*

> **Policy justification** Basing the objective standard on the activity rather than the actor gives the reasonable expectations of the claimant priority over those of the defendant. This policy is most evident in cases where the activity affects the safety of the general public and where, as a consequence, it is likely that those undertaking the activity will be insured.

6.16 However, there is some authority for the consideration of personal characteristics or circumstances in the application of the tort test of negligence, albeit in exceptional circumstances. *Salmond on the Law of Torts*, 16th ed, at page 225 discusses the standard of care in relation to actions which the person is compelled to carry out. After stating that the test for negligence is objective, *Salmond* qualifies the test in the following terms:

> If, however, a person thus deficient in some attribute of the ordinary and average man is placed without his own choice in some situation where the possession of that attribute is requisite for the avoidance of harm, he is not responsible for negligence merely because the ordinary man could have avoided the accident. He must be judged with reference to his own capacities of mind and body, and if he does his best, he does enough, even though a man better endowed would have been bound to do much more. A blind man must not voluntarily do an act which can be safely done only by those who have eyes to see, but if he has such action thrust upon him through no choice of his, he will not be judged as though he could see.

6.17 There are also cases that have considered the culpability of the defendant. At page 391 of *The Law of Torts in New Zealand*, 3rd ed, Brookers, 2001, it is stated:

> … that in exceptional circumstances the courts' insistence on the maintenance of strictly objective standards … gives way in the face of the plaintiff's innocence of any culpability or fault.

6.18 *Mansfield v Weetabix Ltd* [1998] 1 WLR 1263 is cited in this respect. The case concerned a driver who could not function properly because, unknown to him, he suffered from malignant insulinoma which starved the brain of glucose. Accordingly, an accident in which he crashed into the plaintiff's shop was not his fault and he was not negligent. Leggatt LJ, in the English Court of Appeal, rejected strict liability in the following words:

> In my judgment the standard of care that Mr Tarleton was obliged to show in these circumstances was that which is to be expected of a reasonably competent driver unaware that he is or may be suffering from a condition that impairs his ability to drive. To apply an objective standard in a way that did not take account of Mr Tarleton's condition would be to impost strict liability. But that is not the law.

6.19 *The Law of Torts in New Zealand* goes on to state that mental disability stands on the same footing as physical disability so far as the standard of care issue is concerned. It is noted that this approach has been taken in Canada in cases such as *Buckley v Smith Transport* [1946] 4 DLR (Ont CA) but not in Australia (in *Adamson v Motor Vehicle Insurance Trust* [1956] WALR 56). However, as discussed later in this statement, there is Australian authority that supports some consideration being given to the person's experience, education and skills in determining whether there has been a lack of reasonable care in the tax context.

NEGLIGENCE IN A TAX CONTEXT

6.20 In *Case W4* (2003) 21 NZTC 11,034, which concerned "gross carelessness", Judge Barber, in the TRA, referred to the circumstances of the taxpayer in the application of the test for "reasonable care". He stated at page 11,044 of the judgment as follows:

> I can accept that the test of reasonable care is whether a taxpayer of ordinary skill and prudence would have foreseen as a reasonable probability or likelihood the prospect that an act, or failure to act, would cause a tax shortfall, **having regard to all the circumstances.**
>
> 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.
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> **The effort required of the taxpayer is commensurate with the reasonable person in the taxpayer's circumstances. What must be expected is the achievement of a standard appropriate to the category of taxpayer, rather than that of the individual taxpayer concerned.** Materiality must be implicit in the standard of reasonable care so that consideration will be given not only to the nature of the shortfall, but also to its size in relation to the taxpayer. This means there may be varying degrees of care required depending on the particular circumstances.
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> [emphasis added]

6.21 This clearly contemplates consideration of the circumstances of the taxpayer.

6.22 In the earlier decision of Judge Barber in *Case W3* (2003) 21 NZTC 11,014, which concerned gross carelessness and, in the alternative, lack of reasonable care, there was no discussion of the taxpayer's circumstances. However, there was no reason for a lesser standard to be applied in that case as the taxpayer was an accountant. In *Case W3*, the issue was whether a higher standard was required but, on the facts, Judge Barber did not find it necessary to decide on the matter.

6.23 Therefore, it can be seen that the common law in applying a test of reasonable care to determine whether a breach of duty has occurred, applies an objective test that is not generally qualified by the characteristics or circumstances of the person. It is necessary, however, to consider the particular circumstances and background to section 141A.

LEGISLATIVE BACKGROUND

6.24 Determining what constitutes "reasonable care" and where it must be taken requires consideration of legislative intent. In this respect, the statutory context of section 141A and background materials to the legislation are relevant.

6.25 The *Taxpayer compliance, standards and penalties: a Government discussion document* (August 1994) at page 19 stated the following:

> Reasonable care will become a basic standard that all taxpayers must exercise in fulfilling any tax obligation. The standard requires taxpayers to take the same level of care that a reasonable person would take in the same circumstances**. What is reasonable depends on the facts and circumstances of each situation, including the person's experience, education and skills**. It equates with the concept of negligence in the civil law of torts, for which the jurisprudence is well established.
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> [emphasis added]

6.26 However, the *Commentary on the Bill* at page 11 states that the standard of care required is determined by focusing on the "reasonable" person, i.e. one of ordinary skill and prudence:

> The test of reasonable care is whether a person of ordinary skill and prudence would have foreseen as a reasonable probability or likelihood the prospect that an act (or failure to act) would cause a tax shortfall, having regard to all the circumstances.

6.27 The *Commentary on the Bill* at page 11 also notes that the taxpayer's intention is irrelevant, as is whether or not the taxpayer foresaw that a shortfall would result:

> The test does not depend on the taxpayer's intention, or whether the taxpayer actually foresaw that the act or failure to act would cause the shortfall; rather, it asks whether a reasonable person would have foreseen it.

6.28 When the Taxpayer Compliance, Penalties, and Disputes Resolution Bill (1995) was introduced into Parliament, the then Minister of Revenue used the following example to illustrate these points to highlight the focus on the person of ordinary skill and prudence:

> The test of reasonable care is whether a person of ordinary skill and prudence would have foreseen as a reasonable probability the prospect that an act would cause a tax shortfall, having regard to all the circumstances. (NZPD Vol 550, 1995: 9339)

6.29 However, the issue of a particular taxpayer's circumstances was specifically addressed when the Finance and Expenditure Committee reported back on the above Bill. The report included the following:

> **We examined the "reasonable care" policy statement (refer Appendix I) that the department intends to publish in a Tax Information Bulletin after enactment of the bill.** The statement defines the standard and describes in detail the intended operation of the penalty. It emphasises the flexible character of the standard, the relative ease with which it should be met by a very significant majority of taxpayers, **the importance of the particular circumstances of each taxpayer**, and the essentially non-onerous obligations the standard is intended to impose.
>
> 1. Conclusion
>
> Having considered the statement and having derived comfort from the examples in the statement, we determined that the "reasonable care" provision should not be amended. However, this is only on the basis that the concepts and interpretations outlined in the draft policy statement represent the department's application of the law, without change. **We expect the courts to regard our comments in this report, together with the department's declared intentions set out in Appendix I, to represent Parliament's intentions in regard to the meaning and administration of the Act in this respect**, as well as in respect of other key aspects discussed elsewhere in this report.
>
> [emphasis added]

6.30 The FEC report appears to support the Parliamentary intention being that, although the test is objective, the personal circumstances of the taxpayer are taken into account in establishing whether the taxpayer has exercised reasonable care. In other words, it is necessary to consider what a reasonable person in the taxpayer's circumstances would have done.

6.31 The discussion on reasonable care in *Tax Information Bulletin*, Vol 8, No 7 (October 1996) at page 11 is consistent with the above approach:

> The reasonable care test requires a taxpayer to exercise the care that a reasonable person would be likely to exercise in the taxpayer's circumstances to fulfil the tax obligations. 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 same circumstances would have foreseen the shortfall as a reasonable probability. It equates with the concept of negligence in the civil law of Torts, and the jurisprudence is well established: "Negligence is to be measured objectively by ascertaining what in the circumstances would be done or omitted by the reasonable man." (*Meulen's Hair Stylists Ltd. v CIR*; *Meulen's Hair Stylists (Lambton Quay) Ltd. v CIR* [1963] NZLR 797).
>
> In the tax context, reasonable care includes exercising reasonable diligence to determine the correctness of the tax position. It also includes keeping adequate books and records to substantiate items properly, and generally making a reasonable attempt to comply with the tax law. The reasonable care test is not intended to be overly onerous to taxpayers. Reasonable care does not mean perfection. The effort required of the taxpayer is commensurate with that of a reasonable person **in the taxpayer's circumstances**.
>
> [emphasis added].

6.32 The TIB discussion continues:

> The circumstances that may be taken into account when determining whether a taxpayer has exercised reasonable care include:
>
> - the complexity of the law and the transaction (the difficulty in interpreting complex legislation);

- the materiality of the shortfall (the gravity of the consequence and the size of the risk);
- the difficulty and expense of taking the precaution;
- **the taxpayer's age, health and background**.

[emphasis added]

6.33 This also indicates a test where attributes of the taxpayer such as age, health, and background are taken into account in establishing whether reasonable care has been exercised.

6.34 Other tax jurisdictions have similar provisions where the setting of a standard of care is required. Consideration of these provisions and their application may be helpful.

THE AUSTRALIAN APPROACH TO THE PARTICULAR CIRCUMSTANCES OF THE TAXPAYER

6.35 Section 141A was largely derived from the equivalent Australian provision (section 226G of the Income Tax Assessment Act 1936). Section 226G provides that a penalty tax may be imposed where shortfalls are caused by a failure to take reasonable care. Accordingly, Australian case law on section 226G is of some relevance. The Australian provision provides:

> Subject to this Part, if:
>
> (a) a taxpayer has a tax shortfall for a year; and
>
> (b) the shortfall or part of it was caused by the failure of the taxpayer or of a registered tax agent to take reasonable care to comply with this Act or the regulations;
>
> the taxpayer is liable to pay, by way of penalty, additional tax equal to 25% of the amount of the shortfall or part.

6.36 Section 226G differs from section 141A in that it specifically penalises taxpayers for their tax agents' failures to take reasonable care, although, in other respects, the interpretation and application of the Australian provision are useful as a basis for understanding section 141A.

6.37 In the explanatory memorandum to the Taxation Law Amendment (Self Assessment) Bill 1992 (Cth), which introduced section 226G of the Australian Act, the standard of reasonable care was described in terms of a taxpayer's circumstances:

> The effort required is one commensurate with all the taxpayer's circumstances, including the taxpayer's knowledge, education, experience and skill.

6.38 *Case 34/95* 95 ATC 319 at page 324 and *Arnett & Ors v FCT* 98 ATC 2137 at page 2,140 cite this passage from the explanatory memorandum with approval, as do *Schott v FCT* 1999 ATC 2,234 at 2,236 – 2,237, *Cripps v FCT* 1999 ATC 2428, and *Davis v FCT* 2000 ATC 2,044 at 2,050.

6.39 In this context, the Australian Tax Office (the "ATO") issued *Taxation Ruling* TR 94/4, where it promulgated its understanding of the meaning of taking

reasonable care under section 226G of the Australian Act. Paragraph 6 of the ruling describes the standard of care to be the reasonable, ordinary person – this indicating a similar basis to the person of ordinary skill and prudence used in the Commentary to the Bill. However, it also takes into account the person's circumstances, for example, the experience, education and skill of the person:

> The reasonable care test requires a taxpayer to take the care that a reasonable ordinary person would take in all the circumstances of the taxpayer to fulfil the taxpayer's tax obligations. Provided that a taxpayer may be judged to have tried his or her best to lodge a correct return, having regard to the taxpayer's experience, education, skill and other relevant circumstances, the taxpayer will not be liable to pay penalty.

6.40 Paragraph 14(f) of *Taxation Ruling* TR 94/4, cited with approval in the Administrative Appeals Tribunal *Case 11/97* 97 ATC 173 at page 187, considered the issue of interpretations of tax laws in the context of the lack of reasonable care penalty provision:

> On questions of interpretation, reasonable care requires a taxpayer to come to conclusions that would be reasonable for an ordinary person to come to in the circumstances of the taxpayer. If the taxpayer is uncertain about the correct tax treatment of an item, reasonable care requires the taxpayer to make reasonable enquiries to resolve the issue. This is different from the reasonably arguable position standard [i.e. the equivalent of unacceptable interpretation in New Zealand], which does not look at the taxpayer's efforts in resolving the issue, nor the circumstances of the taxpayer, but solely at the merits of the arguments in support of a position.

6.41 Paragraph 6 of *Taxation Ruling* TR 94/4 was cited with approval in *Cripps v FCT*; and in *Re Carlaw and FCT* 95 ATC 2166. *Re Carlaw* considered, among other things, whether a taxpayer, who claimed a deduction for meal expenses, was liable for a penalty under section 226G. On the basis that he had taken advice from a qualified tax agent and the fact that the deduction claimed was reasonably arguable if, in fact, incorrect, the taxpayer was successful in his appeal against the penalty imposed. At page 2,170, McMahon (DP) stated:

> The taxpayer is a truck driver. He made claims for deductions pursuant to advice he received from a qualified tax agent, who had been engaged by his union. If a man in that position is advised that he may make a claim, can it be said that he fails to take reasonable care to comply with the Act if the claim is unsuccessful? I think not. Clearly the mere fact that a claim is made can not thereby render the conduct of a taxpayer careless, particularly when that claim is reasonably arguable.
>
> …
>
> That advice had some measure of support from *Case U148* [87 ATC 868], from the article of Mr Durack which I have quoted, and from observations made in [*FCT v Edwards* 94 ATC 4255] and in [*Roads & Traffic Authority v FCT* 93 ATC 4508]. Although in the circumstances of Mr Carlaw's employment and consumption of food I do not consider that the expenditure claim is properly deductible, I do not consider that he has displayed a failure to take reasonable care to comply with the Act in making his claim.

6.42 In contrast, in *Re Sparks v FCT* 43 ATR 1,324, although the taxpayer and his wife employed an accountant to make their returns, it was held that Mr Sparks was liable for a shortfall penalty for not taking reasonable care because he had failed to inform his accountant of certain interest income. Mr and Mrs Sparks

had failed to return that interest in their annual returns. Mr Sparks notified the Commissioner of this when he was advised that he was to be audited. Mrs Sparks also notified the Commissioner of the omission in her returns, although at the time she had not been advised of any prospective audit. Although Mr and Mrs Sparks employed an accountant to make their returns, the Tribunal upheld that there was no cause to possibly remit the tax penalty payable by Mr Sparks under section 226G, on the basis that they had received erroneous advice. "Mr Sparks simply failed to inform his accountant of the existence of the interest income" (paragraph 9 of *Re Sparks*).

6.43 *Case 34/95* concerned the actions of a tax agent who incorrectly claimed a deduction for a superannuation contribution for a taxpayer. The Australian provision is wider than the New Zealand provision and attributes to the taxpayer, any lack of reasonable care on the part of the tax agent. In *Case 34/95*, the Tribunal applied the reasonable person test. The Tribunal held that the taxpayer's agent had failed to take reasonable care, and, accordingly, in affirming the taxpayer's tax shortfall penalty, the Tribunal was "satisfied [that] the tax shortfall was caused by the failure of the taxpayer or tax agent to take reasonable care to comply with the Act". The Tribunal made the following statement referring to the appropriate standard of care:

> 21. The explanatory memorandum to the Taxation Laws Amendment (Self Assessment) Bill 1992, the Bill which introduced section 226G to the Act, illuminates Parliament's intended meaning of the phrase "reasonable care". In that document, at page 80, it is explained that reasonable care "requires a taxpayer to make a reasonable attempt to comply with the provisions of [the Act] and regulations. The effort required is one commensurate with all the taxpayer's circumstances, including the taxpayer's knowledge, education, experience, and skill".

6.44 In short, the Australian provision seems to require that the taxpayer's circumstances including the taxpayer's knowledge, education, experience, and skills are to be taken into account in determining whether they have taken reasonable care.

CANADIAN APPROACH TO THE PARTICULAR CIRCUMSTANCES OF THE TAXPAYER

6.45 Section 227.1(1) of the Canadian Income Tax Act 1994 imposes a liability to deduct tax on the directors of a corporation where the corporation has failed to deduct the tax.

6.46 Section 227.1(3) provides that a director is not liable under subsection (1) if the director exercised:

> … the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.

6.47 *CCH Canadian Tax Reporter Commentary* on the Canadian Income Tax Act 1994 provides the following comment on section 227.1(3):

> The leading case on the standard of care requirement under subsection 227.1(3) is the Federal Court of Appeal decision in *Soper v. The Queen*, (F.C.A.) 97 DTC 5407. The Court in *Soper* began its analysis on the issue by summarizing the common law

standard applicable to directors. The Court quoted from the seminal judgement in *Re City Equitable Fire Insurance Company*, [1925] 1 Ch. 407 (C.A.) (referred to above), which set out the minimum standard of care, diligence and skill required of directors under the common law:

> …
>
> The Court in *Soper* held that the statutory standard of care under subsection 227.1(3) is, in many ways, the same as that under the common law. In particular, the Court held that the standard of care laid down in subsection 227.1(3) is inherently flexible. **Rather than treating directors as a homogeneous group of professionals whose conduct is governed by a single, unchanging standard, the provision embraces a subjective element which takes into account the personal knowledge and background of the director, as well as his or her corporate circumstances in the form of, among other things, the company's organization, resources, customs and conduct. Thus, more is expected of individuals with superior qualifications and business experience, as compared to individuals without such qualifications and experience. According to the Court, the standard of care set out in subsection 227.1(3) is neither purely objective nor purely subjective. Rather, the provision contains both objective elements (embodied in the reasonable person language) and subjective elements (inherent in individual considerations like "skill" and the idea of "comparable circumstances"). Accordingly, the standard can be properly described as "objective subjective".**

[emphasis added]

6.48 It is, therefore, apparent that the approach taken in Canada, in setting the threshold for reasonable care in a taxation context, is to take into account the circumstances of the person such as education and business experience.

APPLICATION OF THE "NEGLIGENCE" TEST TO THE STANDARD OF REASONABLE CARE

6.49 It is also apparent that a test, taking into account the taxpayer's age, health, and background, was what the New Zealand legislators intended. The standard of care for negligence is generally accepted as purely objective, being the level of care a reasonable person would take in the same circumstances. The jurisprudence in relation to tort law does not generally permit factors such as the taxpayer's age, health, and background to be taken into account in applying the test.

6.50 It is considered that a test which takes into account the taxpayer's circumstances better fulfils the intention of section 141A and, as discussed above, was what Parliament intended. This view is supported by the discussion document, the report of the Finance and Expenditure Committee, and TIB Vol 8, No 7 (October 1996).

6.51 It would also appear that this interpretation accords with the scheme and purpose of the penalty provisions of the Tax Administration Act. The purposes of the penalty provisions are set out in section 139.

> **139** The purposes of this Part are—

(a) To encourage taxpayers to comply voluntarily with their tax obligations and to co-operate with the Department; and

(b) To ensure that penalties for breaches of tax obligations are imposed impartially and consistently; and

(c) To sanction non-compliance with tax obligations effectively and at a level that is proportionate to the seriousness of the breach.

6.52 It is considered that section 139 supports a test that takes account of the taxpayer's circumstances in interpreting what is "not taking reasonable care". The taxpayer's circumstances would encompass the factual background as well as the personal attributes of the taxpayer, such as age, health and background. The wording of the purpose provision does not support a regime of penalising taxpayers who complete tax returns with reasonable care. Therefore, the underlying purpose of the regime would seem to support taking account of the characteristics of the taxpayer, such as the taxpayer's age, health, and background, as well as objective elements, when considering the application of section 141A.

6.53 This approach has been followed in Canada and Australia. It is also be noted that the Australian Administrative Tribunal in numerous cases (Schott, Cripps, Davis, and Arnett) refer to Case 34/95 and its citation of the explanatory memorandum regarding the taking into account of the particular circumstances of the taxpayer. Carlaw and Cripps also refer to the ATO Taxation Ruling TR 94/4 relating to a person's particular circumstances. It would seem that the same reasoning as set out in the Australian memorandum could be applied in New Zealand.

Implications for tax specialists

6.54 It is also necessary to examine the implications for tax specialists. If a taxpayer consults a tax specialist or agent, the taxpayer would generally be taking reasonable care in terms of the legislation and common law, provided that all relevant tax details are disclosed to the tax specialist or agent. As to the tax specialist's own obligations, the tort of negligence is generally focused on owing a duty of care to a person as in the case of the specialist surgeon holding himself or herself out as an expert to a patient and carrying out surgery on the patient. However, the question arises as to what is the duty of care on tax specialists **in terms of their own tax obligations** as possibly they are not holding themselves out as tax specialists to the Commissioner when they are filing their own tax returns. In terms of the test of what a reasonable person in the taxpayer's circumstances would do, it would follow that the standard of care for a tax specialist would be higher than the standard for an ordinary taxpayer. This would seem to accord with the intention of the legislation, which is that taxpayers are diligent in fulfilling their tax obligations. This is also consistent with lowering the standard of reasonable care to take account of instances where health, age, and background are factors in not meeting the normal standard.

6.55 The ATO ruling (*Taxation Ruling* TR 94/4) does not specifically cover the above issue. Paragraph 36 of the ruling does, however, discuss the example of the standard of care required by a tax agent in attending to a client's tax affairs

being higher than that of an ordinary taxpayer. The ruling states, in relation to an example:

> The standard of care required by a tax agent is higher than that expected of an ordinary taxpayer due to the knowledge, education, skill and experience of the agent obtained from continual exposure to the operation of the financial system and similar transactions in numerous clients. When examining a taxpayer's affairs, a tax agent would be expected to apply this experience to the taxpayer's situation and to ask the questions necessary to correctly prepare the client's return.

6.56 In the New Zealand Taxation Review Authority decision, Case *W3*, referred to above, Judge Barber was asked to consider whether an accountant would be held to a higher standard than a layperson in the preparation of his own GST return. Although Judge Barber did not find it necessary to determine the issue, he stated as follows:

> … [Counsel for the Commissioner] seems to accept that such an aspect can be put to one side and the focus can be upon what the ordinary person should have done in such a case. [Counsel for the Commissioner] submits that, even on that basis, the disputant's lack of investigation into, or his disregard of, record keeping requirements is below the level which a prudent person would be expected to adopt and shows a careless approach to the correct returning of output tax on the $37,864.09 additional income.

NON-NATURAL PERSON LIABILITY FOR LACK OF REASONABLE CARE

6.57 Questions of vicarious liability may arise where the responsibility for taking a tax position is delegated. In the case of a corporate or "non-natural person" taxpayer, all such responsibility will necessarily be delegated to a natural person. However, the same law as to vicarious liability would apply in either situation; the actions of an employee, in the course of his or her employment, are attributed to the employing company as to any other employer.

VICARIOUS LIABILITY

6.58 It is vicarious liability that is relevant to the taking of reasonable care since "not taking reasonable care" is not concerned with intention or *mens rea*. The classic statement from *Salmond on Torts* (9th ed), p 95, as to vicarious liability in terms of employers was adopted by Lord Thankerton in the Privy Council case of *Canadian Pacific Railway Co v Lockhart* [1942] 2 All ER 464 at 467:

> It is clear that the master is responsible for acts actually authorised by him: for liability would exist in this case, even if the relation between the parties was merely one of agency, and not of service at all. But a master, as opposed to the employer of an independent contractor, is liable even for acts which he has not authorised provided that they are so connected with acts which he has authorised that they may rightly be regarded as modes – although improper modes – of doing them. In other words, a master is responsible not merely for what he authorises his servant to do, but also for the way in which he does it… On the other hand, if the unauthorised and wrongful act of the servant is not so connected with the authorised act as to be a mode of doing it, but is an independent act, the master is not responsible; for in such a case the servant is not acting in the course of his employment, but has gone outside of it.

6.59 The decision in *Canadian Pacific Railway Co v Lockhart* was followed by the New Zealand Court of Appeal in *Union Steam Ship Company of New Zealand v Colville* [1960] NZLR 100 and would, thus, appear to be good law in New Zealand.

Vicarious liability as it applies to supervision and delegation of tasks to staff

6.60 Although the definition of "taxpayer" is wide, not taking reasonable care relates to the "taxpayer's tax position" which is "a tax position taken by a taxpayer in or in respect of a tax return; or an income statement; or a due date". Taxpayers are responsible for the acts of their employees provided the acts were within the acts authorised for that employee. Therefore, if an employee fails to meet the reasonable care standard in taking a tax position, the taxpayer employer is liable for the failure, whether the taxpayer is a natural person or not. The only difference between the application of this rule to natural person taxpayers and non-natural person taxpayers is that a non-natural person must act through agents and employees as it is incapable of acting otherwise.

6.61 Although a taxpayer is liable for the actions of their employees, the question of whether the taxpayer has taken reasonable care must still be considered.

6.62 The question arises as to the application of the test where it considers the age, health and background of the taxpayer when it is an employee who is acting on the taxpayer's behalf. There are several points to be made in this respect. An employee authorised to take the tax position may take reasonable care based on his or her age, health or background. However, the authorisation of that person may expose the taxpayer to the lack of reasonable care penalty should a tax shortfall result. This is so whether a natural person taxpayer authorised that employee or another employee of a non-natural person taxpayer authorised that person to take the taxpayer's tax position.

6.63 The question would be whether a reasonable person would have delegated to that person the preparation of the tax return and the taking of a tax position on the taxpayer's behalf. If the extent and nature of some incapacity of the employee would be known or suspected by a reasonable employer (or the taxpayer's employee who delegated the task to that person) then this would constitute not taking reasonable care. If, as a consequence, a tax shortfall arose in relation to that tax position, section 141A would apply. It would not be the acts of the incapable employee that would constitute not taking reasonable care provided that the incapable employee met the standard for a person in their circumstances. It would be the delegation of the task to that person whether by the taxpayer or an authorised employee of the taxpayer that would constitute not taking reasonable care.

6.64 The same principles would apply to the employees who, while not preparing the tax return, do perform other relevant functions concerned with the taking of a tax position. If, for example, a storeman provides incorrect stock figures to the accountant preparing the tax return and there is a tax shortfall as a result

then, depending on the circumstances, this could be a failure to take reasonable care in the taking of the tax position.

6.65 The principles in relation to liability for employees and their failure to take reasonable care can be summarised as follows:

- The employer is vicariously liable for the acts of employees committed in the course of employment.
- The same principles of vicarious liability will also apply to taxpayers, whether natural persons or not, who delegate the preparation of tax returns to employees.
- The use of an employee that a reasonable person would know or suspect to be incapable of correctly filing the tax return can expose the taxpayer to a shortfall penalty for not taking reasonable care. This would apply regardless of whether the task is delegated by the taxpayer or by another employee of the taxpayer.
- The lack of care would also encompass situations where employees provide assistance or information to be used in taking a tax position, or perform other relevant functions concerned with taking a tax position. Taxpayers are equally liable for the actions of these employees, as they are for the actions of the staff member who actually prepares the tax return.
- The penalty can apply regardless of whether the employee completing the return took reasonable care given their age, health and background. The penalty is applied to the taxpayer – not the employee.

INDICIA OF NOT TAKING REASONABLE CARE FOR THE PURPOSES OF SECTION 141A

6.66 Having established that the test for not taking reasonable care is similar to that of negligence in tort, but taking into account the taxpayer's circumstances, it is necessary to apply this test in the tax context. What factors indicate that a taxpayer has or has not taken reasonable care in taking a taxpayer's tax position? This involves determining what a taxpayer of ordinary skill and prudence would do or not do in the taxpayer's circumstances. Those circumstances include the taxpayer's attributes (such as age, health, background, etc) and this may have an impact on the level of care to be exercised.

The reasonable person test – some factors to be considered in relation to the standard.

6.67 When the Taxpayer Compliance, Penalties, and Disputes Resolution Bill was introduced into Parliament, the Minister of Finance stated:

> What is reasonable will depend on the type of obligation involved. For example, a salary and wage earner will generally satisfy the reasonable care test by carefully following the tax guide. Reasonable care for a business taxpayer will include putting into place appropriate record-keeping systems and other procedures to ensure that the business income and expenditure is properly recorded and classified for tax purposes. (NZPD Vol 550, 1995:9339)

6.68 The *Commentary on the Bill* at page 12 was more specific:

> The circumstances that will be taken into account when determining whether a taxpayer has exercised reasonable care may include the complexity of the law and the transaction, the materiality of the shortfall (the gravity of the consequence and the size of the risk) and the difficulty and expense of taking the precaution.

6.69 Traditionally, it could be said in tort law that there are four main factors to be considered in setting the standard of reasonable care:

- Probability of injury (or in a tax context, the likelihood of a tax shortfall);
- Gravity of the risk (which in a tax context would be the quantum of the shortfall);
- Burden of precautionary measures (which in a tax context would be the difficulty of preventing a tax shortfall); and
- Social value of the activity (which is not relevant in the tax context).

6.70 Mason J provided a helpful summary of the legal position in *Wyong Shire Council v Shirt* (1980) 146 CLR 40 at 47-48 which is consistent with those circumstances to be taken into account set out in the *Commentary on the Bill* and quoted above. Mason J said:

> In deciding whether there has been a breach of the duty of care the tribunal of fact must first ask itself whether a reasonable man in the defendant's position would have foreseen that his conduct involved a risk of injury to the plaintiff or to a class of persons including the plaintiff. If the answer be in the affirmative, it is then for the tribunal of fact to determine what a reasonable man would do by way of response to the risk. The perception of the reasonable man's response calls for a consideration of **the magnitude of the risk** and **the degree of the probability** of its occurrence, along with **the expense, difficulty and inconvenience of taking alleviating action** and **any other conflicting responsibilities** which the defendant may have. It is only when these matters **are balanced out that the tribunal of fact can confidently assert what is the standard of response** to be ascribed to the reasonable man placed in the defendant's position.
>
> [emphasis added]

6.71 The criteria for consideration provided by Mason J have subsequently been quoted and applied by the Court of Appeal in *Wilson & Horton v AG* [1997] 2 NZLR 513, 521.

6.72 The *Commentary on the Bill* is consistent with this when it states:

> The circumstances that will be taken into account when determining whether a taxpayer has exercised reasonable care may include: the complexity of the law and the transaction, the materiality of the shortfall (the gravity of the consequence and the size of the risk) and the difficulty and expense of taking the precaution.

6.73 The *Commentary on the Bill* also indicates the factors to be considered for business taxpayers:

> For a business, reasonable care will also take into account the size and nature of the business, the internal controls in place and business record keeping practices.

6.74 In summary, factors indicating that a taxpayer has not taken reasonable care will depend on the particular obligations of the taxpayer. The obligations of a salary or wage earner are likely to be satisfied by carefully following the tax guide. However, in a more complex tax situation, such as that of a business, reasonable care by a taxpayer will mean using an accounting system appropriate to the size, number and complexity of transactions. Taking reasonable care may also mean delegating those tasks relevant to the taking of a tax position only to appropriate staff. These matters will be highlighted further in the discussion below under the headings, "the likelihood of a tax shortfall", "the quantum of a tax shortfall" and the "difficulty of preventing a tax shortfall".

Example one

A staff member of a large business makes an error of $10,000 in transferring figures from work papers to the GST return. The owner of the business is aware that the same staff member has made a similar transposition error in the previous period's GST return. In this case, it could be concluded that a reasonable owner would have foreseen a risk and put simple checks in place that would at least reduce the risk of obvious errors. Therefore, the taxpayer would be liable for a shortfall penalty for not taking reasonable care in respect of the second shortfall. (Whether the first shortfall would give rise to a penalty would depend on the particular circumstances of the error in that instance.)

Example two

In a similar scenario to example one, a staff member of a large business makes an error of $10,000 in transferring figures from work papers to the GST return. The owner of the business is aware that the same staff member has made a similar transposition error in the previous period's GST return. After the first error, the owner provided additional training for the staff member on the requirements for GST and also implemented a system whereby the GST returns were checked by a supervisor before they were submitted to the IRD. Although a second error was subsequently made, it involved the transposition of two figures from the working papers to the GST return. Instead of an amount of $111,570, the amount shown on the GST return as a refund was $111,750. In this case, as a reasonable owner, the owner has put simple checks into place to reduce the risk of obvious errors and the error is relatively minor. Therefore, the taxpayer would not be liable for a shortfall penalty for not taking reasonable care in respect of the second shortfall. (As for example one, whether the first shortfall would give rise to a penalty would depend on the particular circumstances of the error in that instance.)

Likelihood of a tax shortfall

6.75 One aspect of determining whether or not a person has taken reasonable care concerns whether or not the consequences of a person's action or inaction would have been foreseeable to the person (*Duchess of Argyll v Beuselinck* [1972] 2 Lloyds Rep 172 at page 185; *Wyong Shire Council v Shirt* (1980) 146 CLR 40 at page 47). The *Commentary on the Bill* at page 11 puts it this way:

> The test of reasonable care is whether a person of ordinary skill and prudence would have foreseen as a reasonable probability or likelihood the prospect that an act (or failure to act) would cause a tax shortfall, having regard to all circumstances.
>
> The test does not depend on the taxpayer's intention, or whether the taxpayer actually foresaw that the act or failure to act would cause a shortfall; rather, it asks whether a reasonable person would have foreseen it.

6.76 The difficulty of balancing the risk of an event happening against the difficulty of eliminating the risk was discussed by Lord Reid in *Overseas Tankship (UK) v The Miller Steamship Co Pty (The Wagon Mound (No2))* [1966] 2 All ER 709 (PC). Lord Reid stated at page 719:

> *Bolton v Stone* ([1951] 1 All ER 1078, [1951] AC 850, HL.), posed a new problem. There a member of a visiting team drove a cricket ball out of the ground on to an unfrequented adjacent public road and it struck and severely injured a lady who happened to be standing in the road. … So it could not have been said that, on any ordinary meaning of the words, the fact that a ball might strike a person in the road was not foreseeable or reasonably foreseeable. It was plainly foreseeable; but the chance of its happening in the foreseeable future was infinitesimal. … The House of Lords held that the risk was so small that in the circumstances a reasonable man would have been justified in disregarding it and taking no steps to eliminate it.
>
> It does not follow that, no matter what the circumstances may be, it is justifiable to neglect a risk of such a small magnitude. A reasonable man would only neglect such a risk if he had some valid reason for doing so: eg, that it would involve considerable expense to eliminate the risk. He would weigh the risk against the difficulty of eliminating it. … In the present case there was no justification whatever for discharging the oil into Sydney Harbour. Not only was it an offence to do so, but also it involved considerable loss financially. If the ship's engineer had thought about the matter there could have been no question of balancing the advantages and disadvantages. From every point of view it was both his duty and his interest to stop the discharge immediately. …
>
> If a real risk is one which would occur to the mind of a reasonable man in the position of the defendant's servant and which he would not brush aside as far-fetched, and if the criterion is to be what that reasonable man would have done in the circumstances, then surely he would not neglect such a risk if action to eliminate it presented no difficulty, involved no disadvantage and required no expense. …
>
> The most that can be said to justify inaction is that he would have known that this could only happen in very exceptional circumstances; but that does not mean that a reasonable man would dismiss such risk from his mind and do nothing when it was so easy to prevent it. If it is clear that the reasonable man would have realised or foreseen and prevented the risk, then it must follow that the appellants are liable in damages. …

6.77 Accordingly, it must be considered whether a reasonable person would have foreseen that consequence and the actions that that reasonable person would have taken to prevent the risk foreseen.

6.78 Materiality may be relevant in determining whether a taxpayer has taken reasonable care. In many cases a tax shortfall may be considered material, where the shortfall is a substantial amount in comparison to the taxpayer's tax liability, and it is considered that a reasonable person would have foreseen that something was incorrect. However, although the quantum of the tax shortfall

is relevant, other factors may also indicate whether the taxpayer has taken reasonable care.

Example three

A taxpayer returns $50,000 taxable income but omits a further $10,000 from his return. It can be accepted from the proportionally large amount of the omission that the taxpayer should have been aware that not all income had been returned. This is regardless of whether or not the taxpayer used an agent to complete his return. The tax shortfall is large relative to the taxpayer's taxable income. In the absence of any special circumstances, the taxpayer breached the standard of reasonable care in this case.

Example four

In contrast to the previous example, a large company returns taxable income of $50,000,000, but omits an additional $10,000 of assessable income. Subject to consideration of the circumstances that led to the error, the amount of the omission when compared with the taxable income of the company does not support the view that there was a lack of reasonable care. The tax shortfall, in relation to the taxable income, may mean that the company, despite the error, still took reasonable care in the preparation of its income tax return.

6.79 In some cases, it may also be appropriate to consider the quantum of the assessable income of the taxpayer for the relevant period when a tax shortfall arises in respect of an error in relation to assessable income. Other relevant matters might include the total deductions of a taxpayer where a tax shortfall relates to an incorrect deduction. The number of transactions, whether giving rise to the assessable income or deductions, may also be a factor to be considered. For example, it would be easier to review and check a smaller number of transactions rather than a large volume. This is, however, subject to the expectation that to take reasonable care with a large volume of transactions or transactions involving large amounts, suitable systems to deal with these transactions would be expected to be in place.

6.80 To summarise, in respect of the likelihood of a tax shortfall, the test is whether a reasonable person, in the circumstances of that taxpayer, would have foreseen the likelihood of a tax shortfall. The test is not whether the taxpayer concerned foresaw the tax shortfall. Factors indicating that a taxpayer may not have taken reasonable care include:

- repeated errors where the taxpayer has been advised or is otherwise aware that mistakes have previously been made;
- systems' failures the risks of which are foreseeable or for which the taxpayer has not established adequate safeguards and monitoring;
- delegating matters relating to the taking of a tax position to employees who are known or would be suspected by a reasonable employer of lacking the capacity to take reasonable care (for example, inadequately trained staff or inexperienced or temporary staff); and

- the size of the tax shortfall, in that an error of a substantial amount in comparison to the taxpayer's tax liability or assessable income would be more easily foreseen.

Quantum of tax shortfall

6.81 The *Taxpayer compliance, standards and penalties: a Government Discussion document* at page 18 states that failure to fulfil statutory obligations should normally attract a sanction:

> The fundamental obligation on taxpayers is to pay the correct amount of tax on time. Failure to satisfy this or any other legal requirement imposed on taxpayers by Parliament should normally attract a sanction.

6.82 However, the gravity of the risk or the size of the tax shortfall is a relevant factor to be considered in determining the standard of care required.

Difficulty of preventing a tax shortfall

6.83 A reasonable person takes notice of standards that are authoritative, sensible, accepted or persuasive, and, in so doing, keeps abreast of such standards if it is reasonable to do so (*Froom v Butcher* [1975] 3 All ER 520 at page 526; *Graham v Co-operative Wholesale Society Ltd* [1957] 1 WLR 511). In the context of tax law, a taxpayer exercising reasonable care would make use of up-to-date, freely available material such as tax guides issued by the Inland Revenue Department, *Tax Information Bulletins*, public rulings, and interpretation statements and guidelines (or if he or she did not have the necessary skills to do so, would seek help). A taxpayer with relatively simple tax affairs, such as a salary and wage earner, would be expected at least to consider relevant tax guides issued by the Inland Revenue Department and seek clarification if necessary.

Tax agents and advisors

6.84 Generally, a taxpayer will not be liable for a shortfall penalty for not taking reasonable care in respect of the lack of care by the agent, in respect of the provision of advice or in respect of the agent's preparation of the tax return. The Taxpayer Compliance Penalties and Disputes Resolution Bill (September 1995) states:

> Taxpayers are also required to take reasonable care in interpreting the law. If they are uncertain as to the tax treatment of an issue, reasonable care will require them to make inquiries to resolve this, by consulting the Inland Revenue Department or a tax adviser. A taxpayer who has reasonably relied on the advice of a tax adviser or the department will usually be considered to have exercised reasonable care. However, a failure to provide adequate information when seeking advice, a failure to provide reasonable instructions to a tax adviser, or unreasonable reliance on a tax adviser or on wrong advice may still expose the taxpayer to a penalty for lack of reasonable care.

6.85 A taxpayer who takes reasonable care will make inquiries if they are uncertain over a tax matter. This may involve consultation with Inland Revenue or a tax advisor and will require the taxpayer to provide adequate information when

seeking the advice. Where that taxpayer seeks advice on a particularly complex tax issue, it may be quite reasonable for the taxpayer to rely on a tax agent's advice without much questioning. However, where the advice appears manifestly wrong or unreasonable on the basis of the taxpayer's own knowledge, a taxpayer who takes reasonable care will question such advice. This does not imply though that the taxpayer is required to have any particular knowledge of tax laws.

6.86 To summarise, in respect of the difficulty of preventing a tax shortfall, it is considered that a taxpayer who takes reasonable care:

- will, if necessary, seek help, although a wage or salary earner may generally satisfy the reasonable care test by carefully following the tax guide and it is considered that taxpayers with more complex tax affairs will follow appropriate guidance from *Tax Information Bulletins* and other up-to-date public and freely available guidance or interpretative material issued by the Inland Revenue Department;

- will consult Inland Revenue or a tax advisor where they are uncertain as to the tax treatment of an issue;

- will provide adequate information when seeking advice to resolve a tax matter;

- will question advice where it appears manifestly wrong or unreasonable, on the basis of the taxpayer's own knowledge; and

- will utilise adequate systems appropriate for the size of the business and the number and complexity of the transactions.

Example five

A taxpayer engages an agent to complete her income tax return. She provides her agent with her dividend statements. However, due to the disorderly manner in which she keeps her papers, she omits one of the statements, which is for a large amount of money. In the absence of any special circumstances, the taxpayer in this case will be liable to a penalty for not taking reasonable care with the information she provided to her agent.

Example six

A taxpayer is audited and is found to have incorrectly claimed private motor vehicle expenses against business income. In a subsequent year the taxpayer's return is prepared by an agent and the same expenses matter results in a shortfall. Depending on the circumstances, the taxpayer may have displayed a lack of reasonable care for this second omission. The taxpayer should have been alerted by the previous audit discrepancy and ensured that the subsequent return was correctly completed. (It is possible, depending on the circumstances that a shortfall penalty might also apply in relation to the first shortfall.)

Inland Revenue advice

6.87 If a taxpayer seeks advice from Inland Revenue disclosing all relevant facts, and follows that advice, this would be taking reasonable care, unless there was some reason for the taxpayer to question that advice, if, for example, the taxpayer still has doubts due to his or her own tax knowledge or conflicting advice has been received from a tax agent. However, this would only be the case if the taxpayer has provided full and correct facts when obtaining advice from the Department. The taxpayer, since the onus of proof of taking reasonable care rests with him or her, should document any oral advice from Inland Revenue showing details of when and from whom the advice was sought or retain any written advice from Inland Revenue.

Summary – not taking reasonable care

6.88 The test of "reasonable care" is what a reasonable person in the taxpayer's circumstances would have done in the same situation. The taxpayer's circumstances would encompass the factual situation as well as the personal attributes of the taxpayer such as age, health and background. For business taxpayers, this is likely to include the size and nature of the business, the internal controls in place and the record keeping practices. In addition, various circumstances, which may indicate the level of care necessary to fulfil tax obligations in the taking of the taxpayer's tax position include:

- the extent and complexity of tax law underpinning the particular type of tax obligation;
- the likelihood of a tax shortfall;
- the quantum of tax shortfall; and
- the difficulty of preventing a tax shortfall.

It is also emphasised that the reasonable care test does not mean perfection. The effort required of the taxpayer is commensurate with the reasonable person in the taxpayer's circumstances.

7. REDUCTIONS, INCREASES AND A CAP ON THE SHORTFALL PENALTY

Overview

7.1 The shortfall penalty for not taking reasonable care is subject to various possible reductions of the shortfall penalty payable. These are provided for under sections 141FB (previous behaviour), 141G (voluntary disclosure) and 141I (temporary shortfall). However, section 141J (limitation of reduction) provides where the taxpayer qualifies for a reduction in shortfall penalty under both section 141G and where there is a temporary tax shortfall, the shortfall penalty is reduced only once and that will be by 75%.

7.2 Although the above sections provide for the shortfall penalty to be reduced in a number of situations, the shortfall penalty payable for not taking reasonable

care is also subject to 25% increase, under section 141K, if the taxpayer obstructs the Commissioner in determining the correct tax position.

7.3 Section 141JAA, which applies only to tax positions taken on or after 1 April 2003, provides that the shortfall penalty payable by the taxpayer for not taking reasonable care may not be more than $50,000, if the taxpayer voluntarily discloses the tax shortfall or the Commissioner determines the shortfall within specified time limits and provided section 141K does not apply.

Shortfall penalty reductions

7.4 Section 141FB was replaced effective 21 December 2004. Section 141FB provides for a 50% reduction of the amount of the shortfall penalty that would otherwise be payable if the taxpayer is not:

- convicted of an offence that is a disqualifying offence; or
- liable for another shortfall penalty that is a disqualifying penalty.

7.5 The relevant part of section 141FB is set out below:

> …
>
> (2) A shortfall penalty (called the current penalty) for which a taxpayer is liable under any of sections 141A to 141D is reduced, to 50% of the amount that would be payable by the taxpayer in the absence of this section, if the taxpayer is not—
>
> (a) convicted of an offence that is a disqualifying offence:
>
> (b) liable for another shortfall penalty that is a disqualifying penalty for the purpose of this subsection.
>
> (3) For the purpose of this section—
>
> **disqualifying offence** means—
>
> (a) an offence under section 143A, 143B, 143F, 143G, 143H or 145 for which a conviction is entered—
>
> (i) on or after 26 March 2003; and
>
> (ii) before the taxpayer takes the tax position to which the current penalty relates:
>
> (b) an offence under section 143 or 144 that relates to the type of tax to which the current penalty relates and for which a conviction is entered—
>
> (i) on or after 26 March 2003; and
>
> (ii) after the date that precedes, by the period specified in subsection (4), the date on which the taxpayer takes the tax position to which the current penalty relates; and
>
> (iii) before the taxpayer takes the tax position to which the current penalty relates
>
> **disqualifying penalty** means—
>
> (a) for the purpose of subsection (1), a shortfall penalty that—
>
> (i) relates to the type of tax to which the current penalty relates; and

(ii) is for evasion or a similar act; and

(iii) is not reduced for voluntary disclosure by the taxpayer; and

(iv) relates to a tax position that is taken on or after 26 March 2003 and before the date on which the taxpayer takes the tax position to which the current penalty relates:

(b) for the purpose of subsection (2), a shortfall penalty that—

(i) relates to the type of tax to which the current penalty relates; and

(ii) if the current penalty is—

…

(B) for not taking reasonable care or taking an unacceptable tax position, is a shortfall penalty of any sort; and

(iii) is not reduced for voluntary disclosure by the taxpayer; and

(iv) relates to a tax position that is taken—

(A) on or after 26 March 2003; and

(B) after the date that precedes, by the period specified in subsection (4), the date on which the taxpayer takes the tax position to which the current penalty relates; and

(C) before the date on which the taxpayer takes the tax position to which the current penalty relates.

(4) The period referred to in the definitions of disqualifying offence and disqualifying penalty, in subsection (3), and in subsection (5) is—

(a) 2 years, if the current penalty relates to—

(i) the taxpayer's application of the PAYE rules:

(ii) fringe benefit tax:

(iii) goods and services tax:

(iv) resident withholding tax:

(b) 4 years, if the period is not given by paragraph (a).

(5) For the purpose of subsections (1) and (2), a shortfall penalty that relates to a tax shortfall arising from a tax position taken by a taxpayer is determined as if the taxpayer were not liable for a shortfall penalty that relates to a tax shortfall arising from another tax position taken by the taxpayer, if—

(a) the Commissioner becomes aware of both tax shortfalls as a consequence of a single investigation or voluntary disclosure; and

(b) the taxpayer—

(i) takes both tax positions on the same date:

(ii) is not liable for a shortfall penalty at any time in the period specified in subsection (4) that ends on the earliest date on which the taxpayer takes a tax position that gives rise to a tax shortfall of which the Commissioner becomes aware as a consequence of the investigation or disclosure to which paragraph (a) refers.

7.6 In the case of a penalty for not taking reasonable care in respect of GST, FBT, PAYE or RWT, if the taxpayer has not been liable to pay a tax shortfall penalty relating to the same tax type within the previous two years (not being a penalty reduced for voluntary disclosure), the 50% reduction provided for under section 141FB can apply. For other tax types, there is a four year period of "good behaviour" required. The reduction applies separately for each type of tax such as PAYE, income tax and GST. A penalty imposed in respect of one tax does not mean that the reduction is not available for other tax types. If the taxpayer has made a voluntary disclosure, this does not interrupt the taxpayer's good behaviour period.

7.7 Section 141G provides for reducing the shortfall penalty for voluntary disclosure of the tax shortfall. The relevant parts of section 141G state:

> **141G. Reduction in penalty for voluntary disclosure of tax shortfall—**
>
> (1) A shortfall penalty payable by a taxpayer under any of sections 141A to 141EB may be reduced if, in the Commissioner's opinion, the taxpayer makes a full voluntary disclosure to the Commissioner of all the details of the tax shortfall, either—
>
> (a) Before the taxpayer is first notified of a pending tax audit or investigation (referred to in this section as "pre-notification disclosure"); or
>
> (b) After the taxpayer is notified of a pending tax audit or investigation, but before the Commissioner starts the audit or investigation (referred to in this section as "post-notification disclosure").
>
> …
>
> (3) The level by which the shortfall penalty is reduced—
>
> (a) For pre-notification disclosure is 75%:
>
> (b) For post-notification disclosure is 40%.
>
> ...

7.8 Where there is a temporary tax shortfall, section 141I provides for reducing the shortfall penalty. The relevant part of the section states:

> **141I. Reduction where temporary shortfall—**
>
> (1) A shortfall penalty payable by a taxpayer under any of sections 141A to 141EB must be reduced if and to the extent that the tax shortfall is temporary.
>
> (2) The level by which a shortfall penalty is to be reduced for a temporary tax shortfall is 75% of the penalty that applies to all or that part of the tax shortfall that is a temporary tax shortfall.
>
> …

The application of section 141J

7.9 A shortfall penalty payable by the taxpayer, for example, under section 141A (for not taking reasonable care), may qualify to be reduced under sections 141G (for making a voluntary disclosure in accordance with this provision) and also under section 141I (if the shortfall penalty is payable in respect of a

temporary shortfall). Therefore, it appears that these provisions have the potential to provide for a 75% reduction under section 141G and also a 75% reduction under section 141I. However, in this situation, section 141J limits the reductions available for the taxpayer. Section 141J provides:

> **141J. Limitation on reduction of shortfall penalty—**
>
> If—
>
> (a) A taxpayer who is liable to pay a shortfall penalty makes a voluntary disclosure in accordance with section 141G or section 141H; and
>
> (b) The shortfall penalty is payable in respect of a temporary tax shortfall,—
>
> **the shortfall penalty—**
>
> (c) **Is to be reduced only once**; and
>
> (d) Will be reduced by 75%.
>
> [emphasis added]

7.10 Accordingly, where a taxpayer may qualify for their shortfall penalty payable under section 141A to be reduced under more than one of the reduction provisions, section 141J provides that the shortfall penalty will be reduced only once and, as set out in section 141J(d), that reduction will be 75%.

7.11 As section 141J provides for a limitation on some shortfall penalty reductions, this section can only effectively apply after the application of the reduction provisions.

Shortfall penalty monetary cap

7.12 Section 141JAA provides that "a shortfall penalty payable by a taxpayer for not taking reasonable care …, may not be more than $50,000", provided the other conditions of the section are met. The section states:

> (1) Despite section 141J, a shortfall penalty payable by a taxpayer for not taking reasonable care, or for taking an unacceptable tax position, may not be more than $50,000 if the taxpayer voluntarily discloses the shortfall, or the Commissioner determines the shortfall, no later than the date that is the later of—
>
> …

7.13 It is noted that, unlike sections 141FB, 141G and 141I, section 141JAA does not actually "reduce" the penalty. It merely provides that the penalty may not be more than $50,000. The only way in which it can be determined that the penalty would otherwise be more than $50,000 is to work through the sections needed to calculate the shortfall penalty payable. Therefore, it is necessary to consider section 141A, under which the penalty originates, and then apply the reduction provisions, as modified by section 141J.

7.14 It is also noted that although section 141JAA refers to "a shortfall penalty payable by the taxpayer for not taking reasonable care", the section does not specifically refer to section 141A, the provision under which this shortfall penalty originates.

7.15 This contrasts with the terminology used in the reduction provisions, which specifically refers to the shortfall penalty payable under the relevant originating section. (For the present discussion, the originating sections are sections 141A to 141EB, but, as noted above, section 141JAA is applicable only to shortfall penalties that originate from sections 141A and 141B.)

7.16 It is considered that this difference in the terminology supports the view that the shortfall penalty payable by the taxpayer, to which section 141JAA applies, is that payable under the originating provision, but reduced by the applicable reduction provisions. Accordingly, it would be not be appropriate for section 141JAA to refer to the penalty payable under section 141A when the penalty that originated under that provision may have been reduced by the application of the reduction provisions.

7.17 Although the use of "despite" at the beginning of section 141JAA could indicate that section 141JAA is to be applied either "after applying" section 141J or "to the exclusion of" section 141J, it is considered that, in the context of the whole of section 141, section 141JAA should not be applied to the exclusion of section 141J, but after section 141J (in situations where the application of section 141J is appropriate). Therefore, it would follow that section 141JAA should also be applied after the reduction provisions.

7.18 The alphanumeric order of the particular provisions also supports the view that section 141JAA should be applied after the application of the reduction provisions. Although not conclusive in itself, it is considered that, had it been intended that the capping provision of section 141JAA be applied before the reduction sections, the capping provision would have been inserted in a location before the reduction provisions.

7.19 Accordingly, it is considered that it is only by applying the reduction provisions first, that the "shortfall penalty payable", to which section 141JAA refers, can be determined. The application of section 141JAA can then provide a cap to the shortfall penalty, if the time requirements of section 141JAA are met.

7.20 A final point to consider, in this respect, is the reason for setting the cap for these penalties at $50,000 under section 141JAA. The discussion document Taxpayer compliance, standards and penalties: a review (2001) states:

> 8.35 A monetary cap on the shortfall penalty for lack of reasonable care will be introduced. Such a cap would ensure that the penalty for such breaches is not out of step with other monetary penalties imposed under the Tax Administration Act. In addition, a cap is likely to reduce compliance and administrative costs as taxpayers will have less incentive to dispute the imposition of a penalty they consider unfair.
>
> 8.36 **The cap will be set at $50,000 per tax position, which equates to the maximum criminal penalty imposed under the Income Tax Act.** Taxpayers who deliberately attempt to abuse the existence of this cap will risk incurring the uncapped gross carelessness penalty (set at 40 percent of the shortfall). To ensure that taxpayers still have an incentive to take reasonable care over very significant tax positions, the cap will be limited to

> those shortfalls identified through voluntary disclosure or Inland Revenue audit within two months of filing the return.
>
> [emphasis added]

7.21 Accordingly, if section 141JAA was applied before the other reduction provisions, the correspondence with the maximum criminal penalty would be defeated.

Section 141JAA applies after the reduction provisions

7.22 It is considered that the shortfall penalties payable by the taxpayer for not taking reasonable care under section 141A are reduced, as applicable by the reduction provisions, before the application of section 141JAA. It is also considered that section 141JAA is applied after the application of section 141J, if the taxpayer is eligible for deductions under section 141G and also section 141I. Accordingly, under the reduction provisions, the shortfall penalty payable by the taxpayer for not taking reasonable care or for taking an unacceptable tax position is to be reduced by a maximum of 75%. Then, if section 141JAA is also applicable, the resultant shortfall penalty payable for not taking reasonable care may not be more than $50,000 if the taxpayer either voluntarily discloses the shortfall or the Commissioner determines the shortfall within the given time periods.

7.23 This view also means that the intended correspondence of the capped shortfall penalty under section 141JAA with the maximum criminal penalty is maintained.

7.24 Therefore, it is the Commissioner's view that the section 141JAA cap of $50,000, on the shortfall penalty payable by a taxpayer for not taking reasonable care is only applicable **after** all other relevant reductions have been made, including the limiting provision of section 141J.

7.25 It should be noted that section 141JAA also applies to shortfall penalties under section 141B, for taking an unacceptable tax position. This is discussed in the Interpretation Statement IS0055.

Section 141JAA provides

7.26 *Prima facie*, there are two situations when the shortfall penalty for not taking reasonable care may not be more than $50,000. These are:

- if the taxpayer voluntarily discloses the shortfall; or
- the Commissioner determines the shortfall,

provided these events occur within the time constraints set out in section 141JAA (1)(a) and (b).

7.27 "Commissioner" is defined in section 3 as meaning:

> **"Commissioner of Inland Revenue"**, or **"Commissioner"**, means the Commissioner of Inland Revenue appointed or deemed to have been appointed under

> this Act; and includes any person for the time being authorised to exercise or perform any of the powers, duties, or functions of the Commissioner:

7.28 Accordingly, in the clause "the Commissioner determines the shortfall", it is considered that "Commissioner" (i.e. the person who determines the shortfall) includes any person for the time being authorised to exercise or perform any of the powers, duties or functions of the Commissioner.

7.29 Before going on to consider the meaning of "determines" in this context, it is helpful to consider what it is that must be determined, i.e. "the shortfall".

What is "the shortfall"?

7.30 In the context of section 141JAA, it is considered that "the shortfall", that the Commissioner determines, refers to "the tax shortfall", as it is only in respect of a tax shortfall that the shortfall penalties, referred to in section 141JAA, apply. "Tax shortfall" is defined in section 3 of the Act as follows:

> **"Tax shortfall"**, for a return period, means the difference between the tax effect of—
>
> (a) A taxpayer's tax position for the return period; and
>
> (b) The correct tax position for that period,—
>
> when the taxpayer's tax position results in too little tax paid or payable by the taxpayer or another person or overstates a tax benefit, credit, or advantage of any type or description whatever by or benefiting (as the case may be) the taxpayer or another person:

7.31 A tax shortfall indicates that there is a difference between the correct tax position and the taxpayer's tax position. Therefore, it is considered that if "the Commissioner determines the shortfall"; the Commissioner determines the difference between the correct tax position and the taxpayer's tax position. As the difference is between two amounts, it is considered that section 141JAA requires the Commissioner to determine the **amount** of the tax shortfall.

7.32 An examination of the sections, under which a taxpayer becomes liable to pay a shortfall penalty for not taking reasonable care or for taking an unacceptable tax position, supports this view.

7.33 Section 141A(1) provides that a taxpayer is liable to pay a shortfall penalty, if the taking of the tax position without reasonable care results in a tax shortfall:

> A taxpayer is liable to pay a shortfall penalty if the taxpayer does not take reasonable care in taking a taxpayer's tax position (referred to as "not taking reasonable care') and the taking of that tax position by that taxpayer **results in a tax shortfall**.
>
> [emphasis added]

7.34 Section 141A(2) provides that the amount of the penalty payable is a percentage of the resulting tax shortfall:

> (2) The penalty payable for not taking reasonable care is **20% of the resulting** tax shortfall.
>
> [emphasis added]

7.35 Section 141B(4) provides similarly in respect of unacceptable tax position.

7.36 Therefore, for the two shortfall penalty situations to which section 141JAA applies, the penalty payable by the taxpayer only arises if there is a tax shortfall and the amount of the shortfall penalty payable is directly proportional to the amount of the tax shortfall in each case. Accordingly, for a shortfall penalty to be payable by a taxpayer for not taking reasonable care or for taking an unacceptable tax position, it is necessary to identify the amount of the tax shortfall.

7.37 This is also supported by the definition of "shortfall penalty" in section 3, which states:

> "Shortfall penalty" means a penalty imposed under any of sections 141A to 141K for taking an incorrect tax position or for doing or failing to do anything specified or described in those sections.

7.38 For a penalty to be "imposed", the penalty must be quantified and, as the amount is a percentage of the tax shortfall, it is necessary that the tax shortfall is quantified.

7.39 Therefore, it follows that for section 141JAA to apply to "a shortfall penalty … payable by a taxpayer for not taking reasonable care or for taking an unacceptable tax position", the amount of the tax shortfall is quantified either by disclosure by the taxpayer or as the Commissioner determines.

Ordinary meaning of "determines"

7.40 As "determines" is not defined in section 3 of the Act or section OB 1 of the Income Tax Act 1994, it is appropriate to consider the ordinary meaning of the word.

7.41 The *Shorter Oxford Dictionary* 5th ed (2002) provides the following relevant definition:

> **determine**: verb trans 4 settle or decide (a dispute, controversy, etc., or a sentence, conclusion, issue, etc.) as a judge or arbiter

7.42 Using this definition, it appears that, in the context of section 141JAA, when "the Commissioner determines the shortfall", the Commissioner makes a decision about the shortfall or decides the shortfall. Typically, the Commissioner would decide the shortfall as a result of an audit, but the means by which "the Commissioner determines the shortfall" are not defined in the legislation.

Interpretation of "determines" by the courts

7.43 The meaning of "determines" was discussed by the Supreme Court of Victoria in *City of Heidelberg v McPherson* [1964] VR 783. The relevant section in that case used the words "… where any council determines that the execution of any works of the construction of a private street is necessary". Although

the provision is different, it is helpful to note that the Court described the meaning of "determines" as "decides or forms the opinion" (p 785).

7.44 In *Muir v Inland Revenue Commissioners* [1966] 3 All ER 38, the English Court of Appeal considered the meaning of the phrase:

> An appeal, once determined by the commissioners, shall be final, and neither the determination of the commissioners nor the assessment made thereon shall be altered, except … (s. 50 (2) Income Tax Act 1952)

7.45 The court held that:

> It is plain that there the words "determined" and "determination" are equivalent to: decided and decision … (p 48)

7.46 Although referring to the word in the past tense, this view mirrors that of the Australian court in the *City of Heidelberg* case: to determine is to decide. This meaning is consistent with the ordinary meaning of "determine", i.e. "settle or decide as a judge or arbiter". In each case, something is decided by the party who is determining it.

7.47 To consider the application of this meaning in the context of the legislation, it is appropriate to consider some of the background to the introduction of section 141JAA.

Background to the introduction of section 141JAA

7.48 Section 141JAA was inserted in the Act by the enactment of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003.

7.49 As part of the preliminary consultation process prior to enactment of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, a discussion document, *Taxpayer compliance, standards and penalties: a review* (August 2001) was issued for comment. Under Chapter 8 of the document, "Two further issues relating to shortfall penalties", the document outlined the following background and proposed reform:

> **Additional issue: A cap on the penalty for lack of reasonable care**
>
> **Background**
>
> 8.33 Where a tax shortfall is large, the corresponding shortfall penalty is also large. In most cases this is appropriate – but the Government is concerned about the application of the lack of reasonable care penalty to very large errors which are speedily identified and corrected. For example, a business taxpayer under calculated their GST outputs by $45 million and, because no systems were in place to identify this shortfall, the under-calculation results in unpaid GST of $5 million. Inland Revenue identities the shortfall and determines a lack of reasonable care: the penalty is $1 million.
>
> 8.34 Given the nature of the breach, the Government considered the size of the penalty in such cases is excessive.

Proposed reform

8.35 A monetary cap on the shortfall penalty for lack of reasonable care will be introduced. Such a cap would ensure that the penalty for such breaches is not out of step with other monetary penalties imposed under the Tax Administration Act. In addition, a cap is likely to reduce compliance and administrative costs as taxpayers will have less incentive to dispute the imposition of a penalty they consider unfair.

8.36 The cap will be set at $50,000 per tax position, which equates to the maximum criminal penalty imposed under the Income Tax Act. Taxpayers who deliberately attempt to abuse the existence of this cap will risk incurring the uncapped gross carelessness penalty (set at 40 percent of the shortfall). To ensure that taxpayers still have an incentive to take reasonable care over very significant tax positions, **the cap will be limited to those shortfalls identified through voluntary disclosure or Inland Revenue audit within two months of filing the return.**

[emphasis added]

7.50 From the discussion document, it appears that the intention of the proposed reform was that the cap would be limited to tax shortfalls identified through voluntary disclosure or Inland Revenue audit, within the required time limit.

Timing of "determines"

7.51 It is noted that no reference was made in the proposal for the legislation requiring either a NOPA to be issued or for an agreed adjustment to be obtained, before the $50,000 monetary cap be applied to the shortfall penalty payable by the taxpayer. Further, a NOPA is the first step in the disputes resolution process and the imposition of the penalty will not necessarily be a matter which proceeds under the disputes resolution process. Therefore, it is not appropriate to equate the word "determines" with "has issued a NOPA".

7.52 For similar reasons, "the Commissioner determines" cannot relate to the decision of Adjudication (or other assessing officer), at the end of the disputes resolution process, as the time limits in the disputes resolution process for the various documents are such that this process could not be completed within the time set out in section 141JAA. It is also inappropriate to require an adjustment to be agreed by the taxpayer within the time limits set out in section 141JAA, as the taxpayer has a statutory right to dispute or challenge their assessment in accordance with the time limits set out in the disputes resolution process. Further, section 141JAA refers to "determines" in the context of the situation where "the Commissioner determines the tax shortfall". Therefore, on the legislation, it appears that once the Commissioner (or one of his authorised officers) decides that there is a relevant tax shortfall within the time limits set out in the section, the cap applies.

7.53 This view is supported by the fact that the legislation provides for no particular process by which the Commissioner communicates the fact to the taxpayer that a shortfall is "determined" or decided within the terms of section 141JAA. The legislation merely requires that either the voluntary disclosure of a shortfall by the taxpayer within the time limits (for which a penalty in excess

of $50,000 is payable by the taxpayer for not taking reasonable care), or the Commissioner deciding that there is such a shortfall within the time limits, is sufficient for the application of the section.

Conclusion

7.54 Section 141JAA was enacted with the intention of recognising the taxpayer who voluntarily discloses a shortfall within the given time limits or for whom the Commissioner decides that there is a relevant shortfall, within the given time limits. This latter case may occur, for example, in an audit where an investigator identifies a relevant tax shortfall. The essence is that, for the monetary cap to apply, the relevant tax shortfall is either disclosed by the taxpayer within the time limits or a person, authorised by the Commissioner, decides that there is a relevant tax shortfall, within the time limits. The section does not require the Commissioner to issue a NOPA in respect of the tax shortfall or obtain an agreed adjustment within the given time limits. Accordingly, it is considered that the taxpayer should benefit from the monetary cap as soon as the Commissioner (as defined in section 3) decides the amount of the shortfall, if the time requirements of section 141JAA are met and section 141K does not apply.

Shortfall penalty increases

7.55 Section 141K provides for an increased penalty where the taxpayer obstructs the Commissioner. Section 141JAA does not apply if section 141K applies. Section 141K states:

> **141K. Increased penalty for obstruction—**
>
> (1) A shortfall penalty payable by a taxpayer under any of sections 141A to 141EB may be increased by the Commissioner if the taxpayer obstructs the Commissioner in determining the correct tax position in respect of the taxpayer's tax liabilities.
>
> (2) The level by which a shortfall penalty may be increased for obstruction is 25%.

Related Standard Practice Statements

7.56 The following related Standard Practice Statements may also assist in the interpretation and application of the above adjustment provisions to the shortfall penalty for not taking reasonable care:

- INV-231 *Temporary Shortfall – permanent reversal* (published in *Tax Information Bulletin* Vol 11, No 8 (September 1999));
- INV-251 *Voluntary Disclosures* (published in *Tax Information Bulletin* Vol 14, No 4 (April 2002));
- INV-260 *Notification of a Pending Audit or Investigation* (published in *Tax Information Bulletin* Vol 12, No 2 (February 2000)); and
- INV-295 *Reduction of Shortfall Penalties for Previous Behaviour* (published in *Tax Information Bulletin* Vol 16, No 3 (April 2004)).