SHORTFALL PENALTY – UNACCEPTABLE INTERPRETATION AND UNACCEPTABLE TAX POSITION

1. SUMMARY

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

1.2 The Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 amended section 141B with effect from 1 April 2003. This Interpretation Statement sets out the Commissioner's view on shortfall penalties imposed under section 141B of the Tax Administration Act 1994 ("the TAA") for an "unacceptable interpretation" of a tax law in relation to a tax position taken by a taxpayer (applicable before 1 April 2003) and an "unacceptable tax position" taken by a taxpayer on or after 1 April 2003.

1.3 As the law before the 2003 amendment remains relevant to taxpayers who are or may become involved in the dispute resolution process for tax positions taken prior to 1 April 2003, the Commissioner's view on the earlier provision relating to "unacceptable interpretation" will be considered first. It is considered appropriate that the statement is ordered in this way, as not only is there greater interpretative difficulty associated with the previous provision, but it is considered that a number of the interpretative issues addressed, in respect of the previous provision, apply to the current provision.

1.4 This Interpretation Statement covers particularly:

- what is an unacceptable tax position;
- can a mistake of fact lead to an unacceptable interpretation;
- the meaning of the test "about as likely as not to be correct"; and
- what are the changes relevant to a taxpayer's tax position taken on or after 1 April 2003?

1.5 In summary, the conclusions of this Interpretation Statement for tax positions taken before 1 April 2003 are:

1. An "interpretation" involves a person formulating an understanding or explanation of something and the person must have turned his or her mind to a tax law before an interpretation of it can be said to be made.

2. Section 141B relates to the understanding and application of a tax law by the taxpayer to a set of facts.

3. A simple mistake is neither an application nor an interpretation of a tax law.

4. A mistake of law may be based on a mistake of fact but, on the facts, there may also be an unacceptable interpretation.

5. Where a tax shortfall is caused by a mistake of fact and there is no interpretation or application of a tax law, a taxpayer might still be liable, under section 141A, for "not taking reasonable care".

6. A tax agent's interpretation will be imputed to the taxpayer where the agent, who completes the taxpayer's tax return, takes the tax position on the taxpayer's behalf.

7. The non-application of a tax law will be an "interpretation or an interpretation of an application of a tax law", if a taxpayer turned his or her mind to whether or not that tax law applied to a particular factual situation.

8. There must be, at least, about an equal chance of an interpretation being likely to be correct as it is to be incorrect. The use of the word "about" makes the test less stringent but the interpretation still needs to be close to or around 50% likely to be correct.

9. In determining whether an unacceptable interpretation has been taken in arriving at a tax position, matters that must be considered include all Court or Tribunal decisions and relevant extrinsic materials issued up to one month before the tax position has been taken.

10. Before section 141B applies, the tax shortfall must exceed the given threshold.

1.6 In summary, the conclusions of the interpretation statement **in respect of the changes** to section 141B, that relate to tax positions taken on or after 1 April 2003 are:

1. The making of an "interpretation or an interpretation of an application of a tax law" is not longer required for the application of section 141B.

2. To take an unacceptable tax position, a taxpayer is required merely to take a tax position that, when viewed objectively, fails to meet the standard of being about as likely as not to be correct.

3. An unacceptable interpretation of the law can give rise to an unacceptable tax position, but is no longer a requirement of section 141B.

4. The threshold levels, which a tax shortfall must exceed to qualify as an unacceptable tax position, have increased.

5. Penalties of 20% may be reduced to 10% as a result of a taxpayer's prior good compliance.

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

2. BACKGROUND

2.1 Section 139 of the TAA states that the purpose of Part IX - Penalties is to encourage taxpayers to comply voluntarily with their tax obligations, ensure that penalties for breaches of tax obligations are imposed impartially and consistently and to sanction non-compliance with tax obligations effectively and at a level that is proportionate to the seriousness of the breach. This Interpretation Statement deals with the situation where a penalty is imposed because there is a shortfall of the taxpayer's tax obligations as a result of the taxpayer's tax position based on an "unacceptable interpretation" or an "unacceptable tax position", as provided for under section 141B.

2.2 Section 141B provides for a shortfall penalty (defined in section 3(1) TAA):

> **"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:

2.3 Section 141B(1) defines what is meant by "an unacceptable interpretation" in relation to a "tax position" taken by a taxpayer. Before the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 significantly amended section 141B in relation to tax positions taken on or after 1 April 2003, the provision applicable to obligations relating to the 1997/98 and subsequent income years and to dutiable periods commencing on or after 1 April 1997 read:

> **141B UNACCEPTABLE INTERPRETATION**
>
> (1) In relation to a tax position taken by a taxpayer, an unacceptable interpretation—
>
> (a) Is an interpretation or an interpretation of an application of a tax law; and
>
> (b) Viewed objectively, that interpretation or application fails to meet the standard of being about as likely as not to be correct.

2.4 The amended provision, as a result of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, is applicable to tax positions taken on or after 1 April 2003. The amended section 141B(1) reads:

> **141B UNACCEPTABLE TAX POSITION**
>
> (1) A taxpayer takes an unacceptable tax position if, viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct.
>
> (1B) A taxpayer does not take an unacceptable tax position merely by making a mistake in the calculation or recording of numbers in a return.

2.5 A comparison of section 141B, both before and after the 2003 amendment, highlights that, despite some fundamental similarities, the application of these provisions may differ for the same set of facts. The earlier provision defines "unacceptable interpretation" as "an interpretation or an interpretation of an application of a tax law" and sets out the test by which to judge the interpretation or application as unacceptable. In contrast, the amended provision refers to neither an interpretation nor an application but merely sets out the test by which the tax position of the taxpayer is judged unacceptable. The amended provision, section 141B(1B), also exempts some mistakes from

being considered "unacceptable tax positions". Whether a tax shortfall is due to a mistake in the calculation or recording of numbers will depend on the facts in each case.

2.6 Common to section 141B both before and after the 2003 amendment are the preliminary requirements that the taxpayer must have taken a tax position from which a tax shortfall arises and that tax shortfall exceeds the thresholds set out in section 141B(2). If any of these elements are unable to be established, the taxpayer will not be liable for any shortfall penalty under section 141B.

3. LEGISLATION

Tax Administration Act 1994

3.1 The Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 amended a number of provisions relating to "Unacceptable Interpretation". The provisions set out below are as they read prior to the passing of that Act. These are followed by the amended provisions.

Legislation relating to tax positions taken before 1 April 2003

3.2 Section 3(1) provides a definition for "tax position":

> **"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:

3.3 Section 141B imposes a shortfall penalty on taxpayers who take an "unacceptable interpretation":

141B UNACCEPTABLE INTERPRETATION

141B(1) In relation to a tax position taken by a taxpayer, an unacceptable interpretation—

(a) Is an interpretation or an interpretation of an application of a tax law; and

(b) Viewed objectively, that interpretation or application fails to meet the standard of being about as likely as not to be correct.

141B(2) A taxpayer is liable to pay a shortfall penalty if—

(a) The taxpayer's tax position involves an unacceptable interpretation of a tax law; and

(b) The tax shortfall arising from the taxpayer's tax position exceeds both—

(i) $10,000; and

(ii) The lesser of $200,000 and one percent of the taxpayer's total tax figure for the relevant return period.

141B(3) For the purposes of this section, a taxpayer's total tax figure is—

(a) The amount of tax paid or payable by the taxpayer in respect of the return period for which the taxpayer takes the taxpayer's tax position before, in the case of income tax, any group offset election or subvention payment; or

(b) Where the taxpayer has no tax to pay in respect of the return period—

(i) Except in the case of GST, an amount equal to the product of—

(A) The net loss of a taxpayer in respect of the return period, ascertained in accordance with the provisions of the Income Tax Act 1994, are to be used in this subsection as if they had a positive value; and

(B) The basic rate of income tax for companies in the relevant return period; or

(ii) In the case of GST, the refund of tax to which the taxpayer is entitled for the return period,—

that is shown as tax paid or payable, or as net losses of the taxpayer, or as a refund to which the taxpayer is entitled, in a tax return provided by the taxpayer for the return period.

141B(4) Where subsection (2) applies, the shortfall penalty payable is 20% of the resulting tax shortfall.

141B(5) For the purposes of this section, the question whether any interpretation of a tax law is acceptable or unacceptable shall be determined as at the time at which the taxpayer takes the taxpayer's tax position.

141B(6) For tax positions involving an interpretation of a tax law or laws that have been taken into account in a tax return, the time the taxpayer takes the taxpayer's tax position is when the taxpayer provides the return containing the taxpayer's tax position. If the taxpayer does not provide a tax return for a return period, the taxpayer takes the taxpayer's tax position on the due date for providing the tax return.

141B(7) The matters that must be considered in determining whether the tax position taken by a taxpayer involves an unacceptable interpretation of a tax law include—

(a) The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and

(b) Decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).

141B(8) For the purpose of determining whether the resulting tax shortfall is in excess of the amounts specified in subsection (2)(b),—

(a) A tax return provided by—

(i) A partnership; or

(ii) Any other group of persons that derive or incur amounts jointly or that are assessed together,—

is to be treated as if it were a tax return of every taxpayer who is a partner in the partnership or person in such group; and

(b) The tax rate in a return period applying to a partnership is deemed to be the same as the basic rate of income tax for companies for the relevant period.

141B(9) The amounts or the percentage specified in subsection (2) may be varied from time to time by the Governor-General by Order in Council.

Legislation relating to tax positions taken on or after 1 April 2003

3.4 For tax positions taken on or after 1 April 2003, section 141B has the revised heading "Unacceptable Tax Position". In this amended provision, the references to "interpretation" and "application" are largely removed and the monetary limits for tax shortfalls, above which a taxpayer is liable for a shortfall penalty, are increased.

141B UNACCEPTABLE TAX POSITION

(1) A taxpayer takes an unacceptable tax position if, viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct.

(1B) A taxpayer does not take an unacceptable tax position merely by making a mistake in the calculation or recording of numbers in a return.

(2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an unacceptable tax position and the tax shortfall arising from the taxpayer's tax position is more than both—

(a) $20,000; and

(b) the lesser of $250,000 and 1% of the taxpayer's total tax figure for the relevant return period.

…

(5) For the purposes of this section, the question whether any interpretation of a tax law is acceptable or unacceptable shall be determined as at the time at which the taxpayer takes the taxpayer's tax position.

…

(7) The matters that must be considered in determining whether the taxpayer has taken an unacceptable tax position include—

(a) The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and

(b) Decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).

…

3.5 Section 141JAA provides that for tax positions taken on or after 1 April 2003, subject to certain requirements, there is a cap of $50,000 on the penalty for taking an unacceptable tax position:

> **141JAA SHORTFALL PENALTY FOR NOT TAKING REASONABLE CARE OR FOR TAKING UNACCEPTABLE TAX POSITION MAY NOT BE MORE THAN $50,000**
>
> (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 –
>
> (a) the date that is 3 months after the due date of the return to which the shortfall relates; and
>
> (b) the date that follows the due date of the return to which the shortfall relates by the lesser of –
>
> (i) 1 return period; and
>
> (ii) 6 months
>
> (2) This section does not apply if section 141K applies.

3.6 Amendments to the definitions in section 3 include a revision to the definition of "tax position". The revised definition omits "possible" after "regard to tax" and inserts "a position or approach with regard to". The revised part of this definition is set out below. The remainder of the definition is otherwise unchanged to that set out above and applicable before the 2003 amendment.

> **"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 —
>
> …

3.7 The amended section 3 also provides definitions for "unacceptable tax position" and "acceptable tax position" applicable on or after 1 April 2003 and repeals the definition of "acceptable interpretation":

> **"unacceptable tax position"** is defined in section 141B.
>
> "**acceptable tax position"** means a tax position that is not an unacceptable tax position.

3.8 Section 141FB provides for a reduction of penalties in some circumstances. The following legislation was effective 26 March 2003 until 21 December 2004 with application to a tax position that a taxpayer took on or after 1 April 2000 unless the taxpayer was liable, before 26 March 2003, to pay a shortfall penalty for taking the tax position. The relevant parts of section 141FB, effective 26 March 2003 until 21 December 2004, state:

141FB REDUCTION OF PENALTIES FOR PREVIOUS BEHAVIOUR

…

(2) A shortfall penalty payable by a taxpayer under any of sections 141A to 141D (called in this section the **current penalty**) is reduced to 50% of the penalty that would otherwise be payable under those sections if, after the date specified in subsection (3) and before the date on which the taxpayer becomes liable for the current penalty, the taxpayer has not been liable to pay a shortfall penalty that –

(a) Related to the same type of tax as does the current penalty; and

(b) If the current penalty is for –

(i) Evasion or a similar act, was for evasion or a similar act;

(ii) Gross carelessness or taking an abusive tax position, was for evasion or a similar act or for gross carelessness or for taking an abusive tax position

(iii) Not taking reasonable care or taking an unacceptable tax position, was a shortfall penalty; and

(c) Was not reduced for voluntary disclosure by the taxpayer; and

(d) Was eligible for a reduction under this subsection.

(3) The date referred to in subsection (2) precedes the date on which the taxpayer becomes liable for the current penalty by:

(a) 2 years, if the current penalty relates to the taxpayer's application of the PAYE rules, to fringe benefit tax, to goods and services tax, to resident withholding tax; or

(b) 4 years, if the current penalty relates to any other type of tax.

(4) For the purpose of subsection (2), if a taxpayer is liable for shortfall penalties that relate to tax shortfalls of which the Commissioner becomes aware as a consequence of a single investigation or voluntary disclosure, all the shortfall penalties are treated as a single combined penalty.

[emphasis from original text]

3.9 However, effective 21 December 2004, section 141FB was replaced. The relevant parts of the replacement section state:

141FB. Reduction of penalties for previous behaviour—

…

(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—

…

(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—

(A) for gross carelessness or taking an abusive tax position, is a shortfall penalty for evasion or a similar act or for gross carelessness or taking an abusive tax position:

(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.

[emphasis from original text]

4. AN UNACCEPTABLE INTERPRETATION - BEFORE 1 APRIL 2003

4.1 Before the amendment to section 141B was enacted in 2003, the section was entitled "Unacceptable interpretation" and the section provided the definition for "unacceptable interpretation". This is set out again below for convenience:

> (1) In relation to a tax position taken by a taxpayer, an unacceptable interpretation—
>
> (a) Is an interpretation or an interpretation of an application of a tax law; and
>
> (b) Viewed objectively, that interpretation or application fails to meet the standard of being about as likely as not to be correct.

4.2 For there to be a penalty for an unacceptable interpretation:

- the taxpayer must have taken a tax position;
- a tax shortfall arises from that tax position; and
- that tax shortfall exceeds the amount referred to in section 141B(2)(b).

4.3 These preliminary requirements were highlighted by Barber DCJ in *Case U47* (2000) 19 NZTC 9,410:

> 34. In terms of considering whether there has been an "[un]acceptable interpretation" by the disputant [taxpayer] as required by s 141B(1), it is necessary in terms of s 141B(2) that the disputant [taxpayer] has taken a tax position, that there has been a tax shortfall arising from that tax position and that the tax shortfall exceeds the amounts referred to in s 141B(2)(b). (p 9,417)

4.4 If any of these elements are unable to be established, the taxpayer will not be liable for any shortfall penalty under section 141B for unacceptable interpretation. It is appropriate, therefore, to establish the Commissioner's view on the meaning of each of these requirements.

The preliminary requirements

Tax position

4.5 In relation to the first requirement that a taxpayer must have taken a tax position, the "taxpayer's tax position" must be determined, as it is from that tax position that any tax shortfall will be calculated. The terms "taxpayer's tax position" and "tax position" are defined in section 3(1) of the TAA. These definitions are set out below.

4.6 The definition of "tax position" sets out the subject of the position or approach with regard to tax under a tax law that the taxpayer may take. The definition of "taxpayer's tax position" sets out the places where the taxpayer takes a "tax position".

> **"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:
>
> **"Taxpayer's tax position"** means–
>
> (a) 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:
>
> …

4.7 A "tax return" is defined, in section 3(1) of the TAA:

> **"Tax return"** means a form or document that a taxpayer is required by a tax law—
>
> (a) To complete; and
>
> (b) To provide to the Commissioner,—
>
> 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:

4.8 "Tax law" is defined in section 3(1) of the TAA:

> **"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:…

4.9 A tax return would include, for example, a GST return, being a form that the taxpayer is required by a tax law to complete and provide to the Commissioner. (Section 61B of the Goods and Services Act 1985 also provides that offences committed in relation to goods and services tax are subject to the shortfall penalties.)

4.10 Having determined where a taxpayer takes a tax position, what is a tax position? The definition of "tax position" is broad and inclusive "without limitation". "Tax position" means a position or approach with regard to tax possible under one or more tax laws (refer definition above).

A tax position and *Case U47*

4.11 In *Case U47*, Barber DCJ considered the question of when a tax position is taken. In this case, there was both an error of fact and an error of law in respect of a claim for a GST input tax deduction. The disputant, who was registered for GST on an invoice basis, entered into an agreement to purchase land for its own use. The vendor of the land was not GST registered. Therefore, the transaction should have been treated as the purchase of secondhand goods for GST purposes.

4.12 In addition, although the agreement provided for part of the purchase price to be paid in one GST period and the other part in the next GST period, the purchaser's accountant's employee, despite having no tax invoice for the transaction, prepared the purchaser's GST return for the first period as if the whole purchase price had been paid. A GST input tax deduction based on the whole price was, therefore, claimed in the first period. This gave rise to an agreed tax shortfall that exceeded the threshold amounts for a shortfall penalty for "unacceptable interpretation" set out in section 141B(2).

4.13 Although the taxpayer claimed that the employee had not attempted to interpret the GST Act in a manner to put a different interpretation on it, the TRA held that, notwithstanding the employee may have never looked at the appropriate section of the GST Act, the employee was considered to have made an interpretation of the relevant tax laws. Barber DCJ held that, in filing the GST return for the first period and incorrectly claiming the GST input credit component for the whole sum, the taxpayer had taken a tax position. The tax agent's interpretation of the tax law was imputed to the taxpayer.

4.14 In this case, the tax position was taken in a "tax return" as defined in the TAA, being the GST return required by tax law to be completed and provided to the Commissioner.

Tax shortfall

4.15 The second of the essential requirements for the application of section 141B is that there is a tax shortfall. "Tax shortfall" is defined in section 3(1) of the TAA as the tax effect of a taxpayer's tax position for the return period and the correct tax position for that period when the taxpayer's tax position results in too little tax being payable or a benefit being overstated to the advantage of the taxpayer or another person. The definition states:

> **"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:

4.16 The tax position with which the taxpayer's tax position is compared is the "correct tax position". "Correct tax position" is also defined in section 3(1) of the TAA:

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

4.17 In each case, therefore, the "correct tax position" in accordance with the tax laws and the "taxpayer's tax position" are compared for a return period and if, for that return period, the tax effect of the difference results in too little tax being payable or a benefit being overstated for a return period, the difference is the tax shortfall for that period.

4.18 In short, the taxpayer's tax shortfall will be established by a comparison of the tax liability as set out in the taxpayer's return and the correct liability.

Tax shortfall threshold

4.19 The third of the preliminary requirements to be established is that the tax shortfall must exceed the threshold amounts referred in section 141B(2)(b). In relation to tax position taken before 1 April 2003, the tax shortfall must exceed both:

(i) $10,000; and

(ii) The lesser of $200,000 and one percent of the taxpayer's total tax figure for the relevant return period.

Total tax figure

4.20 "Total tax figure" is defined in section 141B(3):

> **141B(3) For the purposes of this section, a taxpayer's total tax figure is -**
>
> **(a) The amount of tax paid or payable by the taxpayer in respect of the return period for which the taxpayer takes the taxpayer's tax position** before, in the case of income tax, any group offset election or subvention payment; or

(b) Where the taxpayer has no tax to pay in respect of the return period -

(i) Except in the case of GST, an amount equal to the product of-

(A) The net loss of a taxpayer in respect of the return period, ascertained in accordance with the provisions of the Income Tax Act 1994, are to be used in this subsection as if they had a positive value; and

(B) The basic rate of income tax for companies in the relevant return period; or

(ii) In the case of GST, the refund of tax to which the taxpayer is entitled for the return period, -

that is shown as tax paid or payable, or as net losses of the taxpayer, or a refund to which the taxpayer is entitled, in a tax return provided by the taxpayer for the return period.

[emphasis added]

4.21 Although the term "total tax figure" may suggest that the total tax figure is the correct tax figure for the relevant return period, the wording of section 141B(3)(a) (set out above), implies that the "total tax figure" is the figure of tax paid or payable according to the taxpayer's return. This contrasts with the view that the use of "payable" might suggest that that figure is correct because it is the correct tax which is "payable".

4.22 Bearing in mind that section 141B(6) broadly provides that a tax position is taken when the taxpayer provides the return, it could be that the return may show a figure for tax payable but the tax is not yet due until, for example, the terminal tax date. However, the figure remains payable according to the return.

4.23 This latter view is consistent with the concluding words of subsection 141B(3)(b) (set out again below) which qualify the whole provision. These concluding words apply to cover all possible shortfalls dealt with in section 141B, i.e., whether there is tax to pay, a loss, or a GST refund and they provide that the "total tax figure":

> … that is **shown as tax paid or payable**, or as net losses of the taxpayer, or as a refund to which the taxpayer is entitled, **in a tax return provided by the taxpayer** for the return period.
>
> [emphasis added]

4.24 The word "entitled" is used in both the concluding words of section 141B(3) and also in subsection (3)(ii) (set out above). In the context of the provision, the "entitlement" appears to refer to the figure or amount shown "in the tax return provided by the taxpayer for the return period".

4.25 It is the Commissioner's view that the total tax figure for the relevant return period, as required to establish a taxpayer's tax shortfall under section 141B(2), is the figure shown as tax paid or payable, the net loss of the taxpayer multiplied by the basic rate of income tax or their GST refund entitlement, that the taxpayer has provided in the tax return for the period.

Returns by partnerships

4.26 Section 141B(8) applies where there are returns completed by a partnership or groups of persons.

> **141B(8)** For the purpose of determining whether the resulting tax shortfall is in excess of the amounts specified in subsection (2)(b),—
>
> (a) A tax return provided by—
>
> (i) A partnership; or
>
> (ii) Any other group of persons that derive or incur amounts jointly or that are assessed together,—
>
> is to be treated as if it were a tax return of every taxpayer who is a partner in the partnership or person in such group; and
>
> (b) The tax rate in a return period applying to a partnership is deemed to be the same as the basic rate of income tax for companies for the relevant period.

4.27 The effect of section 141B(8) is that, in establishing whether a partnership or other like entity has exceeded the threshold set by section 141B(2)(b), the shortfall incurred by the partnership is considered against the partnership's income, treating the partnership as a separate entity. The company tax rate is to be used in any threshold calculations in accordance with section 141B(8)(b).

The preliminary requirements are satisfied

4.28 Assuming that the preliminary requirements of section 141B(1) are satisfied, it is then appropriate to consider whether there has been an "unacceptable interpretation" in accordance with section 141B.

What is an unacceptable interpretation?

4.29 Section 141B(1) defines an "unacceptable interpretation":

> **141B(1)** In relation to a tax position taken by a taxpayer, an unacceptable interpretation -
>
> (a) Is an interpretation or an interpretation of an application of a tax law; and
>
> (b) Viewed objectively, that interpretation or application fails to meet the standard of being about as likely as not to be correct.

4.30 An unacceptable interpretation under section 141B requires both of the above limbs to be satisfied. Under (a), for there to be an unacceptable interpretation, there must firstly be either an "interpretation" of a tax law or "an interpretation of an application of a tax law" and under (b), that interpretation or interpretation of an application of a tax law, when viewed objectively, must not satisfy the required standard of "being about as likely as not to be correct". It is appropriate, therefore, to consider what is an interpretation of a tax law and what is an interpretation of an application of a tax law.

Interpretation of a tax law

4.31 The word "interpretation" is not defined in the Act. It is, therefore, necessary to consider other sources to ascertain its meaning.

4.32 *The Oxford Companion to Law*, by David M Walker, Clarendon Press, Oxford, 1980 defines "interpretation or construction" as:

> The process of determining the meaning of a text, such as that of a statute, or deed or will, in the circumstances which are under consideration.

4.33 *The New Shorter Oxford Dictionary on Historical Principles* defines "interpretation" as follows:

> **interpretation** n **1** The action of explaining the meaning of something; spec. the proper explanation or signification of something ... **2** An explanation given; a way of explaining; (a) construction put upon an action etc. ...

and the word "interpret" is given a similar meaning:

> **interpret 1** Explain the meaning of... b Explain to oneself, understand. ... **2** Give a particular explanation of; explain or construe (an action etc.) in a specified manner. ... **3** Give the meaning or explanation of something; ...

4.34 The above definitions indicate that "interpretation" involves the formulation of an understanding or explanation of something, and that a person must have turned his or her mind in some way to that "something" before formulating such understanding or explanation.

The meaning of interpretation as applied by the Courts

4.35 Prior to *Case U47,* the courts had not considered the meaning of "interpretation" in the context of the Act. The meaning of the term has, however, been considered in other contexts which may provide guidance for the present application. Wylie J in *Shotter v Westpac Banking Corporation* [1988] 2 NZLR 316 (HC) considered the term as it appeared in section 6(2)(a) of the Contractual Mistakes Act 1977. Section 6(2(a) of the Contractual Mistakes Act prevents relief under section 7 of that Act, if the mistake, made by a party to a contract, was a mistake in the "interpretation" of that contract.

4.36 Section 6(2)(a) of the Contractual Mistakes Act states:

> (2) For the purposes of an application for relief under section 7 of this Act in respect of any contract, -
>
> (a) A mistake, in relation to that contract, does not include a mistake in its interpretation.
>
> …

4.37 The case of *Shotter* concerned a company which borrowed $100,000 from a bank. The loan was secured by a mortgage in favour of the bank. The bank also required Mr Shotter to personally guarantee the loan, as well as other liabilities the company had established with the bank. Mr Shotter, who was not a director or employee of this company, was of the belief that his personal guarantee was limited to the $100,000 loan. When the bank established that

the company did not have the resources to meet its outstanding liabilities, it turned to Mr Shotter to meet those liabilities.

4.38 Mr Shotter issued proceedings against the bank attacking the validity of the guarantee. Amongst other things, Mr Shotter claimed that in entering the guarantee, he was influenced by a material mistake, namely, that he was of the mistaken belief that the guarantee related only to one singular advance (the $100,000 loan). As such, Mr Shotter argued that he was entitled to relief under section 7 of the Contractual Mistakes Act.

4.39 The High Court held that Mr Shotter was not entitled to rely on section 7 of the Contractual Mistakes Act because, under section 6(2)(a), a contractual mistake does not include a mistake made in the interpretation of a contract. Mr Shotter's mistake was caused by his interpretation of the guarantee and, despite the Court's recognition that it was highly unlikely that he had read the document, Mr Shotter was, therefore, unable to obtain any relief that was available under the Contractual Mistakes Act.

4.40 In reaching this conclusion, Wylie J defined the term "interpretation":

> I think it is clear, …that the mistake of Mr Shotter was in misunderstanding what the guarantee document said as to the extent of his liability in the sense of what debts of [the company] were being guaranteed. Was that misunderstanding a mistake as to its "interpretation"? I think it was. **It is true that to the lawyer "interpretation" is commonly understood to mean reaching of a conclusion as to the meaning of a document after careful study and analysis of the words used in accordance with the established rules of construction. There was nothing of the sort here. It is not even suggested that Mr Shotter read the document or any material part of it. Can an understanding of the meaning of a document in those circumstances be described as an "interpretation"? First I do not think "interpretation" in s 6(2)(a) is used in the technical lawyer's sense I have described.** In my view it must be equally applicable to the situation of a layman who, taking the risk of advising himself as to the meaning of a document simply reads and thinks he understands it. **It must be equally applicable to the layman who only reads a part of the document because he thinks he need not trouble himself with some of the more wordy clauses or the "fine print". It would seem strange to me if it were otherwise. Why should the prudent person who takes proper if mistaken advice, lose the benefit of the Act, while the foolish person who takes the risk on himself be protected?** If I am correct up to this point what then of the layman who makes no attempt to read the document, but simply signs on the basis of a general description of the document, e.g. as in this case that it is a guarantee? **I think that a signatory in that situation who assumes, because it is a guarantee and that it is for a particular purpose - in this case the raising of a specific loan - his liability thereunder must therefore be limited to that specific loan, is placing his own interpretation on the document however ill-formed and baseless it may be.** (p 330)
>
> [emphasis added.]

4.41 From Wylie J's comments, it can be concluded that the word "interpretation" has been given a wide meaning. It is irrelevant whether a person has actually read the document. If a person has some general knowledge of what the document is about and has signed that document, that person has interpreted that document in accordance with section 6(2)(a) of the Contractual Mistakes Act.

4.42 The High Court in *Shivas v Bank of New Zealand* [1990] 2 NZLR 327 took the same approach as Wylie J in *Shotter*. In *Shivas*, an accountant mistook the contents of his client's guarantee to the bank. Despite the court assuming that the accountant had not read the guarantee, Tipping J held that he had made a mistake in the interpretation of the document. Tipping J stated at pages 361-362:

> In so far as [the accountant] may have failed to **notice** when signing the guarantee that one year's interest and costs were added to the primary limit, I am of the opinion that this represents a mistake in the interpretation of the contract. **If he had read it and misunderstood it then it would clearly have been a mistake in interpretation. I cannot see that he can be in a better position through having formed an erroneous impression as a result of not having read the document at all.** In this respect I follow the approach to the question of interpretation as discussed by Wylie J in Shotter's case ...
>
> ... In agreement with Wylie J **I would equate a failure to read or properly to read a contractual document with a** misunderstanding **of its effect having read it or after having had it erroneously explained.**
>
> [emphasis added.]

4.43 Therefore, it appears that an "interpretation" can mean something wider than a careful consideration of a particular provision or document, to reach a conclusion as to its meaning, or operation and effect. An interpretation, in relation to the Contractual Mistakes Act, seems to also encompass brief readings, or even not reading at all, whereby the person assumes the meaning of a provision or document or places his or her own interpretation on it.

4.44 *Shotter* and *Shivas* both concerned situations where the signatories had not even turned their minds to the specific details or contents clearly spelt out in the contracts. They had not read them. In both cases, however, the signatories still reached certain conclusions as to the meaning of those contracts because they had some general understanding of what those contracts were about.

4.45 On the basis of *Shotter* and *Shivas*, in order for a party to have interpreted (or misinterpreted) a contract, it is enough if they have a general understanding of the contract. It is not necessary for the party to have turned their mind to the specific details of the contract. In other words, a party does not need to read a contract in order to fall within the ambits of section 6(2)(a) of the Contractual Mistakes Act.

4.46 The above cases are consistent with the decision of the TRA in *Case U47*. However, one question that could be raised in relation to the tax legislation, is whether a taxpayer merely has to have a general knowledge of the existence of a general body of tax laws which may or may not apply to that taxpayer's situation, or whether that taxpayer has to actively turn his or her mind to a specific tax law. At first glance, this appears to be answered by the reference to "a tax law" in the phrase "interpretation or an interpretation of an application of a tax law". The reference is not in a general sense to "tax laws". The reference to "a tax law" indicates that a taxpayer must turn his or her mind to a specific tax law and reach a conclusion as to the meaning of that tax law. In *Case U47*, Barber DCJ said:

> 36. I agree with counsel for the defendant that whenever a person turns his or her mind to a tax law such as the application or non-application of the GST Act or its provisions, whether or not actually reading the statute in question an interpretation occurs. (pp 9,417-9,418)

4.47 He continued:

> 44. … it is not necessary that he specifically identify the section number or actually read the section at issue. It is merely necessary that he turns his mind to the general purport of the relevant section with a general awareness of its existence even if having an erroneous view as to its contents and effects. (p 9,420)

4.48 To summarise the above authorities, the term "interpretation" encompasses more than the technical study and analysis of words of a document to understand its meaning. An interpretation involves the reaching of a conclusion on the meaning of a document or tax law. The taxpayer need not have specifically identified the section. It is sufficient that the taxpayer turned his or her mind to the general purport of the relevant legislation and came to a conclusion as to the law.

Interpretation of an application of a tax law

4.49 Section 141B(1) also provides for "unacceptable interpretation" when there has been "an interpretation of an application" of a tax law. The question is what is the meaning of "an interpretation of an application"?

4.50 Some explanation for the wording of the section can be found in the legislative history of the provision. An earlier version of section 141B(1)(a) of the Act was applicable prior to the 1 April 1997. This original version of the provision included the words:

> … an interpretation that … involves the interpretation or application of that tax law

4.51 The 1997 amendment that introduced the phrase:

> … an interpretation of an application

sought to simplify the provision, but not change the meaning of it. It is, therefore, the Commissioner's view that section 141B(1), as applicable before the 2003 amendment, refers to an interpretation of a tax law and an application of a tax law. The following discussion will be based on this assumption.

4.52 "Application" is not defined in the Act. *The New Shorter Oxford Dictionary on Historical Principles* gives the following definition:

> **application** ... 2 ... use, employment; a specific use or purpose to which something is put... 3 The bringing of a general or figurative statement, a theory, principle, etc., to bear upon a matter; applicability in a particular case, relevance; the bringing of something to bear practically in a matter, practical operation. ...

4.53 To what, however, is the tax law to be applied? The above definition refers to "specific use", "particular case" and "in a matter". Each of these phrases suggests that "application" is used with reference to a particular factual situation. Therefore, it is the Commissioner's view that, for the present issue, it may be inferred that the tax law is being applied to the facts. This is consistent with the application of section 141B by Barber DCJ in *Case U47*.

An unacceptable interpretation or interpretation of an application - conclusion

4.54 Based on the above analysis, it is the Commissioner's view that an "unacceptable interpretation" is when the taxpayer applies their understanding of the tax law to a particular factual scenario. It is not necessary for the taxpayer to have read or even identified the particular tax law. The requirement is that the taxpayer has turned his or her mind to a tax law and determined the legal effect of that tax law. It is then a further requirement that, when viewed objectively, the application of that interpretation is about as likely as not to be correct. Section 141B(1)(a) refers to both an "interpretation or an interpretation of an application of that tax law". The two parts, although set out as alternatives, are each a necessary part of the other for the establishment of a tax position. An interpretation requires an application of the tax law and an application requires an interpretation of a tax law. For there to be an "unacceptable interpretation", both the interpretation and the application of the tax law require that they be applied to the taxpayer's particular factual scenario.

Can a mistake of fact lead to an unacceptable interpretation?

4.55 The question arises as to whether a tax shortfall caused by a simple mistake of fact which led to, for example, the wrong law being applied, is an unacceptable interpretation. The taxpayer may have applied the law correctly to the facts as he or she believed them to be but, when the true facts are considered, the end result is that of an incorrect tax position.

An interpretation of a tax law is necessary

4.56 It is the Commissioner's view that section 141B does not apply to tax shortfalls caused **solely** by mistakes of fact. Section 141B is concerned with the application of the tax laws rather than the facts to which they are applied. Both the scheme and purpose of the legislation and the wording of section 141B support this view. For example, section 141B(7) provides that:

> **141B(7)** The matters that must be considered in determining whether the tax position taken by a taxpayer involves an unacceptable interpretation of a tax law include—
>
> (a) The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and
>
> (b) Decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).

4.57 There are no references in section 141B(7) to the determination of facts or the correctness of the facts in determining whether there has been an unacceptable interpretation. It may also be significant that section 141B(7) refers to the actual or potential application to the "tax position of all the tax laws that are relevant" and the definition of "tax position" in section 3(1) refers to a position

or approach with regard to tax possible under one or more tax laws. There is no reference to factual mistakes.

4.58 It is appropriate to consider section 141A which sets out the shortfall penalty provision for not taking reasonable care.

> **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.

4.59 Both section 141A and 141B, therefore, provide for a penalty of 20% of the resulting tax shortfall, the former "for not taking reasonable care", the latter when section 141B(2) applies and a taxpayer's tax position involves "an unacceptable interpretation of the tax law". This might be seen as suggesting offences which were different but which were of equal culpability.

4.60 The question could be posed as to the application of section 141A, relating to lack of reasonable care, when it is considered that the taxpayer, had they not relied on incorrect facts, would have made an acceptable interpretation. As a mere mistake of fact does not give rise to an unacceptable interpretation, it would seem, that if the taxpayer relies on incorrect facts, there might be liability under section 141A if there was a lack of reasonable care in ascertaining those facts.

4.61 The effect of section 141A(3) must be considered in this context.

> (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.

4.62 It is considered that section 141A(3) was intended to reinforce the objective nature of the test for unacceptable interpretation under section 141B. It will be remembered that the test under section 141B is an objective one and is not dependant on the efforts of the taxpayer or their advisers. It is, therefore, the Commissioner's view that section 141A(3) was enacted in order to prevent the imposition of a shortfall penalty under section 141A where a taxpayer had made an acceptable, albeit incorrect, interpretation which led to a tax shortfall and where that acceptable interpretation had been reached with a lack of reasonable care. This fits with the scheme of the Act that it is not necessary to consider the efforts of a taxpayer in arriving at an interpretation.

The interpretation of section 141B(1) and Case U47

4.63 Judge Barber, in *Case U47* considered the relationship between errors of fact and law:

> 45. … Certainly … there has been an interpretation "of an application of" a tax law. This is because the staff member took an interpretation that a requirement to hold a tax invoice did not apply to the transaction in question for the purposes of claiming the GST input credit deduction. (p 9,420)

4.64 In setting out his reasons for the decision of the TRA, Judge Barber seemed to be of the view that an error of fact could lead to an unacceptable interpretation as he stated that the test in section 141B was to compare the interpretation with that based on the land being a secondhand good.

> 46. … It is the correct position on the basis of the land being a "secondhand good" which must be determined for the purposes of the s 141B test, because in this case the property constituted secondhand goods. (p 9,420)

4.65 Nevertheless, His Honour then goes on to consider the interpretation taken by the taxpayer's accountant on behalf of the taxpayer.

> 51. The disputant emphasized that he merely made a mistake about a material fact i.e. he assumed that the vendor was GST registered. However, he thought that no invoice was needed in that situation because **he thought the agreement became the necessary invoice, and that is an unacceptable interpretation**. **His mistake of law may have been based on a mistake of fact but there was still an unacceptable interpretation** of the tax law.
>
> [emphasis added]

4.66 From paragraph 51 of the report of the TRA decision, it would seem that Judge Barber was considering the correctness or otherwise of the application of the law to the facts as the accountant believed them to be. It was only the mistake of fact that led the accountant to consider the tax invoice point at all. The issue of whether or not the agreement for sale and purchase constituted a tax invoice is irrelevant to the shortfall based on the true facts. Although an agreement for sale and purchase would not normally meet the legislative requirements for a "tax invoice", it was the accountant's failure to realise that the definition of "input tax" and the effect of section 20(3)(a)(ia) GST Act applied to the transaction and limited the input tax deduction that led to the shortfall. With respect, Judge Barber seems to have determined whether the interpretation was acceptable based on the facts as the taxpayer believed them to be, i.e. that there was a taxable supply where a tax invoice was required to claim an input tax deduction

4.67 There appears, therefore, to be some uncertainty as to the law in New Zealand and it may be helpful to consider other jurisdictions. Australia has a similar shortfall regime regarding the "reasonably arguable" application of a law.

Acceptable interpretation / "reasonably arguable" position – the Australian view

4.68 Section 222C of the Australian Income Tax Assessment Act 1936 (AITAA) deals with whether the correctness of the treatment of the application of a law is "reasonably arguable" and provides:

> For the purposes of this Part:
>
> (a) the correctness of the treatment of the application of a law; or

(b) another matter;

is reasonably arguable if, having regard to the relevant authorities and the matter in relation to which the law is applied or the other matter, it would be concluded that what is argued for is about as likely as not to be correct.

4.69 Section 226K AITAA imposes a penalty where a position is taken that is not "reasonably arguable". Section 226K 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 taxpayer , in a taxation statement, treating an income tax law as applying in relation to a matter or identical matters in a particular way; and
>
> (c) the shortfall or part, as the case may be, so caused exceeded whichever is the higher of:
>
> (i) $10,000; or
>
> (ii) 1% of the taxpayer's return tax for that year; and
>
> (d) when the statement was made, it was not reasonably arguable that the way in which the application of the law was treated was correct;
>
> the taxpayer is liable to pay, by way of penalty, additional tax equal to 25% of the amount of the shortfall or part.

4.70 When section 141B of the New Zealand legislation was initially drafted, it also used the phrase "reasonably arguable", consistent with the Australian provision. *The Commentary to the Taxpayer Compliance, Penalties, and Disputes Resolution Bill* recommended that "reasonably arguable" be changed to "unacceptable interpretation" in the New Zealand legislation. The reason the Commentary cites for recommending this change was that the threshold level of a "reasonably arguable position" did not meet the higher requisite threshold of being a position that was "about as likely as not to be the correct tax position". The Australian provision, however, despite retaining the criteria of a "reasonably arguable position", specifically provides for this same test. Therefore, the difference in the terminology between the Australian and New Zealand provisions ("unacceptable interpretation" as opposed to "reasonably arguable") is not indicative of differences in the application or meaning of the two sections.

4.71 The earlier version of section 141B(1)(a) of the Act, prior to 1 April 1997, more closely followed the Australian provision. For convenient reference, the earlier version of section 141B(1) is set out again below:

> For the purposes of this Part, an unacceptable interpretation of a tax law is, in relation to a tax position taken be a taxpayer, an interpretation that -
>
> (a) Involves the interpretation or application of that tax law; and
>
> (b) Fails to meet the standard of being, viewed objectively, about as likely as not to be correct.

4.72 As stated above, section 141B, as amended in 1997, was not intended to change the meaning of the section. On this basis, commentaries that have considered section 222C(1) AITAA will be useful to help ascertain the meaning of "interpretation or interpretation of the application of a tax law" in the context of section 141B(1).

4.73 Section 222C AITAA uses the phrase "the treatment of the application of a law" when defining the term "reasonably arguable". Section 141B uses a similar phrase. When defining the term "unacceptable interpretation", section 141B(1) uses the phrase "an interpretation or an interpretation of an application of a tax law". The utilisation of such similar terminology suggests a similar approach in both jurisdictions and strengthens the view that discussion and commentary on the Australian legislation may assist in the application of the New Zealand provisions.

4.74 An Australian Administrative Appeals Tribunal case that made some reference to "reasonably arguable position" was *Ryvitch v FCT* 2002 ATC 2188. The taxpayer in this case had initially appealed to the Federal Court regarding the deductibility of losses which depended on the existence of a partnership. The Federal Court held that the existence of the partnership was arguable at the time the taxpayer claimed the deductions. On that basis, the taxpayer had not been reckless and the issue of penalties was remitted to the Commissioner for reconsideration. The Commissioner reduced the penalties to 25% under section 226G for failure to take reasonable care. The taxpayer argued that her returns were not wrong because of carelessness or an omission to take into account relevant facts or a failure to address a relevant issue but rather that she had misunderstood the relevant facts. Although the Administrative Appeals Tribunal further reduced the quantum of additional tax from 25% to 15% of the shortfall, it was stated that:

> At the hearing, reference was made to s. 226K…
>
> It seems clear that the question before the Federal Court of whether the development was carried on as a partnership or by [the company] in its own right was a question of fact and did not involve a conclusion of law. Consequently, it is difficult to see that s. 226K has any relevance to the matter of additional tax. (pp 2,193–2,194)

4.75 *The Explanatory Memorandum to the Taxation Laws Amendment (Self-Assessment) Bill* 1992 (Australia) supports the view that where the taxpayer misunderstands the facts, this is not in itself a breach of the "reasonably arguable" position requirement. The memorandum states:

> ***What is a reasonably arguable position?***
>
> A position taken by a taxpayer will be reasonably arguable if, on an objective analysis of the law and the application to the relevant facts, it would be concluded that the taxpayer's position was about as likely as not to be correct.
>
> …
>
> Honest errors of fact or calculation will not attract section 226K, which requires a taxpayer to positively treat an income tax law as applying in a particular way.

4.76 The Australian Taxation Office issued a ruling TR 94/5. This contains some useful and more detailed discussion on errors of fact. The ruling states at paragraph 9:

> (d) … the reasonably arguable test only applies to tax shortfalls caused by a taxpayer treating an income tax law as applying in a particular way. A taxpayer treats an income tax law as applying in a particular way where the taxpayer concludes that, on the basis of the facts and the way the law applies to those facts, a particular consequence follows (for example, an amount of expenditure incurred is

deductible). Subject to the other preconditions of section 226K, the reasonably arguable test is designed to encourage taxpayers to ensure that the conclusions they reach are sound ones. **However, in some cases, a taxpayer's conclusions on a particular matter may have been based on incorrect primary facts which the taxpayer did not know and could not reasonably be expected to have known were not the proper facts, such as where a taxpayer relies on a bank to provide details of the amount of interest earned on a deposit.** In other cases, the statements in a taxpayer's return may not represent conclusions of the taxpayer, but might reflect errors in calculation or transposition errors. **As a broad rule, where a tax shortfall was caused by an error of fact or calculation section 226K will not apply since the taxpayer will not have treated an income tax law as applying in relation to a matter in a particular way. In this context, errors of fact are errors of primary fact and not wrong conclusions of fact which a taxpayer may make which bear on the correct application of a tax law, such as whether the taxpayer is carrying on a business.** Whether the statements in a taxpayer's return represent conclusions of the taxpayer or were caused by errors of fact or calculation should be determined on the basis of all the available evidence;

[emphasis added]

4.77 It, therefore, appears that the Australian view is that a tax shortfall caused by a mistake of fact that the taxpayer relies on and could not have known was incorrect, and to which the taxpayer applies the correct tax law for those facts, has taken a reasonably arguable position. In contrast, if a tax shortfall is caused by the taxpayer making an incorrect conclusion of fact, albeit that the correct tax law is applied to that conclusion, the taxpayer's position does not pass the reasonably arguable test.

Mistakes of Fact

4.78 A tax shortfall, caused by a factual mistake not involving an interpretation or application of the law, is not within section 141B. Section 141B requires that there is an interpretation or application of a tax law. If the tax shortfall is caused by a mistake of fact, as opposed to a conclusion or inference involving the application or interpretation of the law, section 141B cannot apply. Examples to illustrate this are as follows:

Example 1

A taxpayer, who manufactures widgets, receives invoices for widget components. The taxpayer infers from this that the invoices record the purchase of goods for use in the taxpayer's business. He has forgotten that these particular widget components related to his private hobby activity. The taxpayer claims an income tax deduction for these. The tax shortfall is caused by a mistake of fact and does not involve an application of a tax law.

Example 2

A staff member fraudulently charged his personal expenses for widget components to the business. The fact that the taxpayer mistakenly claimed an input tax deduction, believing that these were widget components used in his taxable activity, would not constitute an unacceptable interpretation. The mistake again related to the facts. It was not a mistaken application of a tax law.

4.79 In contrast to Examples 1 and 2, the following example illustrates a mistake in the interpretation or application of a tax law for which the taxpayer may be liable for a shortfall penalty for unacceptable interpretation.

Example 3

A taxpayer claims an income tax deduction for the cost of the widgets, including the GST component paid on the widgets. This is an unacceptable interpretation of section ED 4(2) of the Income Tax Act 1994. Section ED 4(2) states that no deduction shall be allowed for any amount of GST input tax charged, levied or calculated in relation to the supply of goods and services to that person. Therefore, in this last example, the taxpayer is liable for a shortfall penalty for unacceptable interpretation, under section 141B, provided the other requirements of section 141B are met.

4.80 This approach is consistent with the quotation from the ATO set out above, in which the ATO refers to the situation of a taxpayer making an error of fact and distinguishes this from a situation where there is a tax shortfall as a result of a wrong inference from those facts involving the application of a tax law.

Use of tax agent/advisor

4.81 A tax agent may, however, take an interpretation on behalf of a taxpayer (or advise a taxpayer as to the tax law before the taxpayer takes the tax position). How does this impact upon the potential liability for a shortfall penalty under section 141B?

4.82 In *Case U47* Barber DCJ stated:

> 42. … that while the Tax Administration Act 1994 does not give definitive guidance as to whether or not an unacceptable interpretation under section 141B by a tax agent, but adopted by a taxpayer, can be imputed to that taxpayer, the wording of section 141B(1) gives a strong indication that this is intended by the Legislature. That subsection (1) makes no direct reference to the taxpayer's interpretation but states *"In relation to a tax position taken by a taxpayer, an unacceptable interpretation [is]…"*. This leaves the scope as to who initially makes the interpretation rather wide. **It must be the taxpayer who takes the tax position and, by inference, that will include any associated interpretation by an agent.** (p 9,419)
>
> [emphasis added]

4.83 Barber DCJ referred to the general principle of agency law as he continued:

> 42. … the fact that a taxpayer has requested, received and followed the advice of an agent with regard to an interpretation of a tax law, or its application, must mean that the taxpayer has taken an "interpretation" as required under section 141B in line with that taken by the agent in terms of the general principle of agency law. It is not necessary for a taxpayer to have read a tax law but, merely, that the taxpayer has turned his or her mind to the law. It seems to me that the mere fact of a taxpayer referring a matter to a tax agent may often be sufficient to indicate that a taxpayer has turned his or her mind to the tax law in question or to its application. It follows that because I find that the disputant has followed the advice of a tax agent (which advice has led to the making of an unacceptable interpretation), that does not prevent the disputant from being liable for any shortfall penalty payable under s 141B. **That unacceptable interpretation becomes the disputant's interpretation, for the**

purposes of s 141B, by virtue of the disputant's agency arrangement with its Accountant.

[emphasis added]

4.84 When applying the law to the facts before him in *Case U47,* Barber DCJ found that the taxpayer's agent had made an interpretation of the relevant tax laws, or at least an interpretation of the "application" of them. The interpretation was incorrect and this "unacceptable interpretation" was imputed to the taxpayer who, accordingly, was held to have taken the relevant tax position. Under the law of agency, the taxpayer is deemed to have taken a tax position based on an unacceptable interpretation, if his or her agent has made an incorrect interpretation of the relevant tax laws or an interpretation of the "application" of them.

4.85 Another possibility is that the taxpayer may complete his or her own return, but adopt the adviser's interpretation in doing so. Under the Act, in either case, the primary responsibility for tax obligations and liabilities always remains with the taxpayer. A "tax position" is a position or approach taken under one or more tax laws, and it is about the tax position taken by the taxpayer, in relation to his or her tax return, or other matters. The involvement of an agent does not derogate from the taxpayer's overall responsibility for the tax position taken.

4.86 In summary, if a taxpayer has followed the advice of a tax adviser in preparing a tax return, or a tax adviser has prepared the tax return, the taxpayer will be taken to have adopted the interpretation of the tax adviser.

Summary of meaning of "unacceptable interpretation"

- An "interpretation" involves the formulation of an understanding or explanation by a person of something.

- A person must have turned his or her mind to the document (or tax law) before an interpretation of it can be said to be given. However, it is not necessary for that person to have actually read the document (or tax law) in issue. A turning of the mind to the general purport of a section or a tax law in general and adopting a view, as to its meaning, or operation and effect, will suffice as an interpretation.

- Section 141B relates to the understanding and application of a tax law by the taxpayer to a set of facts.

- A mistake of fact is not an application of a law (nor an interpretation of a tax law). A mistake of fact is a mistake as to what is thought to be a known fact. Mistakes of fact would cover transposition or addition errors, and what would generally be simple factual errors. Mistakes of fact may also dictate the appropriate tax law to apply.

Example 4

A taxpayer gets the wrong depreciation rate when looking up the depreciation rates. The taxpayer knows the relevant asset class but accidentally selects the

depreciation rate for the asset class listed next to the relevant one. Although the taxpayer would claim depreciation at the wrong rate as a result of this error, there would be no interpretation or application of the law by the taxpayer leading to the shortfall.

Example 5

If a taxpayer omits income because of a bank statement error or because a cheque was banked into the wrong account, there would be no interpretation or application of a tax law by the taxpayer as a result of this error.

Example 6

The taxpayer has a transaction with an associated person and, for some reason, the taxpayer was unaware of the relationship. If the transaction is one which requires the interpretation of tax laws, the interpretation of the taxpayer, on the basis that the transaction was not with an associated person, would not be an unacceptable interpretation. The application of the appropriate tax law was based on a mistake of fact.

- A taxpayer's mistake of law may have been based on a mistake of fact but, on the facts, there may also be an unacceptable interpretation.
- Where there is a tax shortfall caused by a mistaken fact, but there was no interpretation or application of a tax law, the taxpayer might, depending on the circumstances and facts, still be liable under section 141A for failing to take reasonable care.
- For the purposes of section 141B, a tax agent's interpretation will be imputed to the taxpayer where the tax position is taken on the taxpayer's behalf by the agent who completes the taxpayer's tax return. The interpretation taken will be that of the taxpayer and will not prevent the taxpayer from being liable for a shortfall penalty under section 141B if an unacceptable interpretation has been made. A taxpayer may also adopt an adviser's interpretation in completing his or her own return.
- The non-application of a tax law will be an "interpretation or an interpretation of an application of a tax law" if a taxpayer turned his or her mind to whether or not that tax law applied to a particular factual situation.

Example 7

A taxpayer may conclude that the registration requirements in section 51 of the GST Act do not apply to his or her particular fact situation. If he or she is wrong, this would be an "unacceptable interpretation".

Summary – shortfall penalties for tax positions taken before 1 April 2003 based on an unacceptable interpretation

4.87 A taxpayer will be liable for a shortfall penalty if:

- the taxpayer has taken a tax position (defined section 3(1) of the TAA);
- based on an unacceptable interpretation of a tax law;
- as a result of which the taxpayer has a tax shortfall (defined section 3(1) of the TAA); and

- the tax shortfall exceeds threshold amounts referred to in section 141B(2)(b).

4.88 The shortfall penalty payable is 20% of the resulting tax shortfall pursuant to section 141B(4), however, sections 141F to K provide conditions under which the Commissioner may reduce or increase penalties. These sections provide no maximum amount for a shortfall penalty imposed for an unacceptable interpretation.

5. SECTION 141B(1)(b) AND THE MEANING OF "ABOUT AS LIKELY AS NOT TO BE CORRECT"

5.1 If there is an interpretation of a tax law or an interpretation of an application of a tax law under section 141B(1)(a), section 141B(1) states that an interpretation is unacceptable, if when:

> (b) Viewed objectively, that interpretation or application fails to meet the standard of being about as likely as not to be correct.

5.2 No statutory guidance is given as to how the phrase, "about as likely as not to be correct", is to be interpreted. However, there are a number of points or inferences that can be drawn from the actual words used and the context of the phrase itself.

5.3 Firstly, the test is an objective one. Accordingly, the taxpayer's efforts or diligence in reaching an interpretation are not relevant for the purposes of satisfying the requirements of section 141B(1)(b).

5.4 The second point to note is the use of the words "as likely as not" in the phrase "as likely as not to be correct". In *Case U47*, Barber DCJ considered the meaning of this phrase and said:

> 37. … the words "as likely as not" indicate an even balance of 50/50. There would need to be an about equal chance of an interpretation being likely to be correct as it is to be incorrect. It follows that where one of two interpretations does not have about a 50% chance of being correct in the view of a Court, the taxpayer will have failed to meet the required standard under limb (b). Corresponding percentages would apply where there are three or more equally likely interpretations i.e. a 33% chance of being correct where there are three interpretations, a 25% chance of being correct where there are four interpretations, and so on. (p 9,418)

5.5 Barber DCJ continued:

> 37. … the word "about", which precedes the above phrase must be taken into account as it makes the test less stringent and provides some latitude in applying the test.

5.6 The word "about" is not defined in the Act. The ordinary meaning, as given in *The New Shorter Oxford English Dictionary on Historical Principles*, is:

> **A** *adv*. **1** Around the outside; on or towards every side; all around. … **4** Near in number, scale, degree, etc. … **5** On any side; somewhere near. …

5.7 In *Case U47*, Barber DCJ discussed the use of the word "about". He said:

> 37. … I accept that the word "about" in the phrase "about as likely as not to be correct" allows for the standard to be met if the interpretation is close to or around 50% likely to be correct. It follows that where a Court subsequently holds an interpretation to be incorrect, the test in section 141B may potentially be satisfied if it is close to being 50% correct. Perhaps that may be the case where a Court finds two possible interpretations attractive, but prefers one to the other. (p 9,418)

5.8 The Australian view on standard of "about as likely as not to be correct" accords with Barber DCJ's approach in *Case U47*. In the decision of the Australian Federal Court in *Walstern Pty Ltd v FC v T* [2003] ATC 5076, Hill J discussed the standard of the very similar phrase "about as likely as not correct", as follows:

> It is not necessary that the decision maker form the view that the taxpayer's argument in an objective sense is more likely to be right than wrong. That this is so follows from the fact that tax has already been short paid, that is to say the premise against which the question is raised for decision is that the taxpayer's argument has already been found to be wrong. Nor can it be necessary that the decision maker form the view that it is just as likely that the taxpayer's argument is correct as the argument which the decision maker considers to be the correct argument for the decision maker has already formed the view that the taxpayer's argument is wrong. The standard is not as high as that. **The word 'about' indicates the need for balancing the two arguments, with the consequence that there must be room for it to be argued which of the two positions is correct so that on balance the taxpayer's argument can objectively be said to be one that while wrong could be argued on rational grounds to be right.**
>
> …
>
> … **the view advanced by the taxpayer must be one where objectively it would be concluded that** having regard to the material included within the definition of 'authority' a reasoned argument can be made which argument when contrasted with the argument which is accepted as correct is about as likely as not correct. That is to say **the two arguments, namely, that which is advanced by the taxpayer and that which reflects the correct view will be finely balanced. The case must thus be one where reasonable minds could differ as to which view**, that of the taxpayer or that ultimately adopted by the Commissioner **was correct**. There must, in other words, be room for a real and rational difference of opinion between the two views such that while the taxpayer's view is ultimately seen to be wrong it is nevertheless 'about'' as likely to be correct as the correct view. A question of judgment is involved. (p 5,095)
>
> [emphasis added]

5.9 It is the Commissioner's view that an interpretation will be "as likely as not to be correct" if, when viewed objectively, that interpretation has about an equal chance (or about a 50% chance) of being likely to be correct as it is to be incorrect. The use of the word "about" makes the test less stringent, but the objective interpretation still needs to be close to or around 50% likely to be correct.

Section 141B(7)

5.10 Section 141B(7) defines the matters that must be considered in determining whether or not the taxpayer has made an unacceptable interpretation of a tax law in the tax position taken.

> **141B(7)** The matters that must be considered in determining whether the tax position taken by a taxpayer involves an unacceptable interpretation of a tax law include -
>
> (a) The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and
>
> (b) Decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).

5.11 Barber DCJ stated in *Case U47* that:

> 39. Section 141B(7) uses the imperative word "must". Accordingly, the matters referred to in paras (a) and (b) of section 141B(7) must be taken into account for the purposes of ascertaining whether an interpretation taken is acceptable. This supports the objective nature of the test in section 141B(1)(b). **Under section 141B(7) it is not simply the tax law (or laws) of which the taxpayer is aware that needs to be taken into account but, rather, that which is actually applicable which must be taken into account to ascertain whether the interpretation taken by the taxpayer is "about as likely as not to be correct" in terms of s 141B(1).** (p 9,418)
>
> [emphasis added]

5.12 Barber DCJ summarised his view:

> 41. … that factors to be taken into account for the purposes of ascertaining on an objective basis whether a taxpayer has taken an interpretation "about as likely as not to be correct" are all tax laws relevant to the facts in question, all Court or Tribunal decisions issued up to one month before the taxpayer takes the taxpayer's tax position, and (in the absence of such case law) relevant extrinsic materials. Section 141B(7), in effect, affirms and endorses the criminal maxim that **ignorance of the law is no excuse**. (p 9,419)
>
> [emphasis added]

5.13 Accordingly, all tax laws that are applicable must be taken into account to ascertain whether the interpretation taken by the taxpayer is "about as likely as not to be correct". Additionally, all case law issued up to one month before the taxpayer's tax position is taken, must be considered and, as subsection 141B(7) is not exhaustive in the list of factors it requires to be taken into account, where there is no relevant case law, it may be appropriate to consider extrinsic materials. Subsection 141B(7) also highlights the objective standard; ignorance of the law is no excuse.

5.14 It is the Commissioner's view that an *acceptable* interpretation by a taxpayer will only be able to be established where either:

(1) that interpretation is in fact correct or

(2) where incorrect but, viewed objectively, the interpretation was "about as likely as not to be correct" (being close to or around 50% likely to be correct).

Summary of the "about as likely as not to be correct" standard

5.15 The standard required under section 141B(1)(b) incorporates the following:

- The standard is to be judged objectively.
- There must be, at least, about an equal chance of an interpretation being likely to be correct as it is to be incorrect. The use of the word "about" makes the test less stringent but the interpretation still needs to be close to or around 50% likely to be correct.
- For the application of section 141B(7), in determining whether an unacceptable interpretation has been taken in arriving at a tax position, matters that must be considered include all Court or Tribunal decisions issued up to one month before the tax position has been taken, and (in the absence of such case law) relevant extrinsic materials.

6. CHANGES RELEVANT TO A TAXPAYER'S TAX POSITION TAKEN ON OR AFTER 1 APRIL 2003

6.1 As a result of the amendments enacted by the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, for tax positions taken on or after 1 April 2003, section 141B no longer refers to an unacceptable "interpretation or interpretation of an application of a tax law". The amended section 141B requires that a person has taken an "unacceptable tax position". There is generally continuity of the application of section 141B to tax positions that are unacceptable because, when viewed objectively, those tax positions do not meet the standard of being about as likely as not to be correct. Accordingly, the **earlier discussion on section 141B, prior to this amendment, remains applicable, except in respect of the changes discussed in this Part 6 of the Statement.**

6.2 Sections 141B(1) and (1B) provide these main changes. However, for convenience, the section 141B is set out in full below:

> **141B UNACCEPTABLE TAX POSITION**
>
> **(1) A taxpayer takes an unacceptable tax position if, viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct.**
>
> **(1B) A taxpayer does not take an unacceptable tax position merely by making a mistake in the calculation or recording of numbers in a return**
>
> (2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an unacceptable tax position and the tax shortfall arising from the taxpayer's tax position is more than both—
>
> (a) $20,000; and
>
> (b) the lesser of $250,000 and 1% of the taxpayer's total tax figure for the relevant return period.
>
> (3) For the purposes of this section, a taxpayer's total tax figure is—
>
> (a) The amount of tax paid or payable by the taxpayer in respect of the return period for which the taxpayer takes the taxpayer's tax position before[[, in the case of income tax, any group offset election or subvention payment; or
>
> (b) Where the taxpayer has no tax to pay in respect of the return period—

(i) Except in the case of GST, an amount equal to the product of—

(A) The net loss of a taxpayer in respect of the return period, ascertained in accordance with the provisions of the Income Tax Act 1994, are to be used in this subsection as if they had a positive value; and

(B) The basic rate of income tax for companies in the relevant return period; or

(ii) In the case of GST, the refund of tax to which the taxpayer is entitled for the return period,—

that is shown as tax paid or payable, or as net losses of the taxpayer, or as a refund to which the taxpayer is entitled, in a tax return provided . . . by the taxpayer for the return period.

(4) Where subsection (2) applies, the shortfall penalty payable is 20% of the resulting tax shortfall.

(5) For the purposes of this section, the question whether any interpretation of a tax law is acceptable or unacceptable shall be determined as at the time at which the taxpayer takes the taxpayer's tax position.

[Effective 21 June 2005, section 141B(5) states:

(5) For the purposes of this section, the question whether any tax position is acceptable or unacceptable shall be determined as at the time at which the taxpayer takes the taxpayer's tax position.]

(6) For tax positions involving an interpretation of a tax law or laws that have been taken into account in a tax return, the time the taxpayer takes the taxpayer's tax position is when the taxpayer provides the return containing the taxpayer's tax position. If the taxpayer does not provide a tax return for a return period, the taxpayer takes the taxpayer's tax position on the due date for providing the tax return.

[Effective 21 June 2005, section 141B(6) states:

(6) The time at which a taxpayer takes a tax position for a return period is -

(a) the time at which the taxpayer provides the return containing the taxpayer's tax position, if the taxpayer provides a tax return for the return period:

(b) the due date for providing the tax return for the return period, if the taxpayer does not provide a tax return for the return period.]

(7) The matters that must be considered in determining whether the taxpayer has taken an unacceptable tax position include—

(a) The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and

(b) Decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).

(8) For the purpose of determining whether the resulting tax shortfall is in excess of the amounts specified in subsection (2)(b),—

(a) A tax return provided by—

(i) A partnership; or

(ii) Any other group of persons that derive or incur amounts jointly or that are assessed together,—

is to be treated as if it were a tax return of every taxpayer who is a partner in the partnership or person in such group; and

(b) The tax rate in a return period applying to a partnership is deemed to be the same as the basic rate of income tax for companies for the relevant period.

(9) The amounts or the percentage specified in subsection (2) may be varied from time to time by the Governor-General by Order in Council.

[emphasis added]

6.3 Therefore, under the revised section 141B, there is no longer a requirement for the taxpayer to have made an interpretation or an interpretation of an application of a tax law, when taking their tax position. The requirement is merely that the taxpayer takes a tax position that is unacceptable if, when viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct. There is no longer a requirement that the taxpayer has turned his or her mind to a tax law. The requirement is merely that a tax position has been taken, which does not meet the required standard.

Tax position

6.4 The definition of "tax position" remains substantially unchanged from that applicable to tax positions taken before 1 April 2003. The text change is confined to first two lines. "With regard to tax possible under one or more tax laws" has been replaced by "with regard to tax under one or more tax laws". "Including without limitation" has been replaced by "including without limitation a position or approach with regard to". The first two lines of the definition applicable before 1 April 2003 are:

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

6.5 The full definition for application on or after 1 April 2003 is set out again below:

> **"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:

6.6 Unacceptable interpretations of the law fall within section 141B. Tax shortfalls which are not related to interpretations of the tax laws are also covered by section 141B.

Making a mistake in the calculation or recording of numbers in a return

6.7 Section 141B(1B) provides:

> (1B) A taxpayer does not take an unacceptable tax position merely by making a mistake in the calculation or recording of numbers in a return.

6.8 As there is currently no case authority on the interpretation of this section, a view on what is considered a mistake in the "recording of numbers in a return" will taken, based on an analysis of the text and consideration of the purpose of the provision.

6.9 If the taxpayer has merely made a mistake in the calculation or recording of numbers in a return, section 141B(1B) provides that that is not an unacceptable tax position. It is considered that the meaning of a "mistake in a calculation in a return" is clear, therefore, the following discussion will focus on the meaning of a "mistake in the recording of numbers in a return".

Meaning of return

6.10 Section 141B(1B) merely refers to "a return", but as section 141B is applicable to the taxpayer's tax position, it is appropriate to consider the definition of "taxpayer's tax position". This is defined as:

> **"Taxpayer's tax position"** means—
>
> (a) . . . 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) Repealed.

6.11 In the context of section 141B(1B), it is a "tax return" that is relevant. Therefore, in section 141B(1B), it is considered that the "return" refers to a "tax return". "Tax return" is defined in section 3(1) of the Act:

> **"Tax return"** means a form or document that a taxpayer is required by a tax law—
>
> (a) To complete; and

> (b) To provide to the Commissioner,—
>
> 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:

6.12 As a "tax return" means a form or document that a taxpayer is required by a tax law to complete and to provide to the Commissioner, it is considered that a mistake in the "recording of numbers in a return" refers to a mistake in the recording of numbers in a form or document that a taxpayer is required by a tax law to complete and to provide to the Commissioner.

6.13 Generally, working papers are not required to be provided to the Commissioner and, therefore, are not part of the "return". However, it is considered that, in some situations, where numbers are unintentionally mis-recorded in the working papers, the mistake is carried through into the tax return and the result is a tax shortfall, this is a mistake of the recording of numbers within the section 141B(1B) exclusion and, as such, the taxpayer has not taken an unacceptable tax position. However, in such a circumstance, pursuant to section 141A(4), the taxpayer may still be liable for a tax shortfall penalty for not taking reasonable care.

Meaning of mistake

6.14 Following the enactment of section 141B(1B), commentary on the section was included in the *Tax Information Bulletin* ("TIB") Vol. 15, No 5 (May 2003), in an item entitled "Tax compliance, standards and penalties". The item explains what was intended by the enactment, as follows:

> New sections 141A(4) and 141B(1B) clarify that a taxpayer has not taken an unacceptable tax position if a tax shortfall is the result of calculation mistake or **by mis-recording numbers in a return**. It was never intended that the unacceptable tax position penalty apply to calculation or **processing mistakes**. Rather, this penalty applies when a tax shortfall arises because a tax position is not as likely as not to be correct, whether or not the taxpayer actually interpreted the law. If a mistake is of such a magnitude that the mistake breaches the reasonable care standard that shortfall penalty applies.
>
> [emphasis added]

6.15 Although "mistake" is not defined in either the Act or in the Income Tax Act 1994, the "Concise Oxford Dictionary" 10th Ed. Revised (2002) provides the following definition:

> **mistake** n. a thing which is not correct, an error of judgment

6.16 It is considered that the relevant part of this definition, in the context of section 141B(1B), is merely that something is not correct. This view supports the approach of the above quotation from the TIB item: a mistake in the recording of numbers in a return refers to the mis-recording of numbers or processing errors in a return. This view is also appropriate to the context, as section 141B(1) refers to "making a mistake in the calculation or recording of numbers".

6.17 An "error of judgment" that results in an unacceptable tax position is, effectively, a tax position taken by choice, albeit that it is the incorrect choice. As such it is considered that this meaning of "mistake" is not that intended by the legislation, in this context of providing an exclusion from a shortfall penalty for taking an unacceptable tax position. Therefore, in the following discussion, mistake will be considered to mean merely "a thing which is not correct", rather than an "error of judgment".

6.18 Accordingly, it is considered that, in situations where it is clear that figures have been mistakenly transposed in a return, for example 102 instead of 201, for the purpose of section 141B(1B), such an error is a mistake in the recording of a number in a return. In such a situation, it is considered that a taxpayer has not taken an unacceptable tax position. The mistake is unintentional, not an error of judgment and, therefore, it is within the exclusion set out in section 141B(1B). An error of judgment is considered to be a deliberate choice.

6.19 Such a mistake in the calculation or recording of numbers in a return can occur in a number of situations. For example, a number could be correctly recorded in the working papers, but incorrectly transferred into the tax return. Alternatively, the working papers could be incorrect through a mis-recording of numbers or a calculation mistake and these mistakes could be carried through into the return. In this latter situation, section 141B(1B) would apply, as there is still either a mistake in the calculation, or in the recording of numbers and those numbers are contained in a return. In each of the situations, if the result is a tax shortfall, it is considered that section 141B(1B) provides that the taxpayer has not taken an unacceptable tax position.

6.20 For completeness, it is noted that, although in this situation the taxpayer is considered not to have taken an unacceptable tax position, section 141A(4) provides that "a taxpayer who makes a mistake in the calculation or recording of numbers in a return" is not excluded from being liable for a penalty for not taking reasonable care. 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.

6.21 It is noted that section 141A(4) does not provide that a 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 for not taking reasonable care, merely that such penalty is not excluded.

Conclusion

6.22 Based on the above discussion, it is concluded that a mistake in the recording of numbers in a return refers to an unintentional mis-recording of numbers in the taxpayer's tax return. Such a mistake may be, for example, the transposition of numbers (e.g. 102 instead of 201). It is considered that, in the context of section 141B(1B), the intention is to provide an exclusion from a shortfall penalty for taking an unacceptable tax position where the mistake is a

result of a calculation error or a mis-recording of numbers in the taxpayer's tax return. It is considered that a mistake, which is an error of judgment, is not within the ambit of section 141B(1B) exclusion, whereas it is considered that a taxpayer who takes a tax position as a result of an unintentional mis-recording of numbers in a return, has not taken an unacceptable tax position, although the taxpayer may still be liable for not taking reasonable care pursuant to section 141A(4).

6.23 It is considered that where section 141B(1B) refers to a mistake in the recording of numbers in a return, the section is referring to situations where an incorrect number is unintentionally recorded in the tax return; where the right number is recorded in the working papers, but it is transferred incorrectly into the tax return; and where an unintentional mis-recording of a number is made in the working papers, and that mistake is carried through into the tax return. In each of the situations, if the result is a tax shortfall, it is considered that section 141B(1B) provides that the taxpayer has not taken an unacceptable tax position, although the taxpayer may still be liable for not taking reasonable care pursuant to section 141A(4).

Monetary threshold increased

6.24 With application to tax positions taken on or after 1 April 2003, section 141B(2) provides that the threshold levels, which the tax shortfall must exceed for a taxpayer to be liable for a tax shortfall penalty for taking an unacceptable tax position, have increased. The current section 141B(2) states:

> (2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an unacceptable tax position and the tax shortfall arising from the taxpayer's tax position is more than both—
>
> (a) $20,000; and
>
> (b) the lesser of $250,000 and 1% of the taxpayer's total tax figure for the relevant return period.

6.25 Therefore, as discussed above (refer paragraphs 4.19 – 4.25), to ascertain if the taxpayer's tax shortfall exceeds the threshold levels, it is necessary to establish the taxpayer's total tax figure. Section 141B(3) defines "total tax figure" (refer paragraph 3.3). Section 141B(4) then sets out the amount of the shortfall penalty (refer paragraph 3.3).

Timing and acceptability of "any interpretation"

6.26 Section 141B(5) provides that the time at which the acceptability or not of any interpretation of a tax law is determined at the time a tax position is taken and as discussed above, section 141B(7) sets out the matters that must be considered in relation to whether an unacceptable tax position has been taken. These two sections were not changed by the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003. Section 141B(5) states:

> (5) For the purposes of this section, the question whether any interpretation of a tax law is acceptable or unacceptable shall be determined as at the time at which the taxpayer takes the taxpayer's tax position.

REDUCTIONS, INCREASES AND A CAP ON THE SHORTFALL PENALTY

Overview

6.27 The shortfall penalty for taking an unacceptable tax position is subject to various possible reductions of the shortfall penalty payable. These are provided for under sections 141FB (previous behaviour), 141G (voluntary disclosure), 141H (disclosure of unacceptable tax position) and 141I (temporary shortfall). However, section 141J (limitation of reduction) provides where the taxpayer qualifies for a reduction in shortfall penalty under section 141G or section 141H and also where there is a temporary tax shortfall, the shortfall penalty is reduced only once and that will be by 75%.

6.28 Although the above sections provide for the shortfall penalty to be reduced in a number of situations, the shortfall penalty payable for taking an unacceptable tax position is also subject to 25% increase, under section 141K, if the taxpayer obstructs the Commissioner in determining the correct tax position.

6.29 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 taking an unacceptable tax position may not be more than $50,000, if the taxpayer voluntarily discloses the tax shortfall or the Commission determines the shortfall within specified time limits, and provided section 141K does not apply.

Shortfall penalty reductions

6.30 Section 141FB provides for the tax shortfall penalty of 20%, for taking an unacceptable tax position, to be reduced by 50% to a tax shortfall penalty of 10%, where there has been prior good compliance by the taxpayer. For section 141FB, effective 26 March 2003 until 21 December 2004, this is provided in section 141FB(2), refer paragraph 3.8 above. For section 141FB, effective 21 December 2004, this is provided in section 141FB(2), as set out in paragraph 3.9 above.

6.31 In the case of a penalty for taking an unacceptable tax position 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. Section 141FB applies to a tax position that a taxpayer takes on or after 1 April 2000, unless the taxpayer is liable to pay a shortfall penalty before 26 March 2003.

6.32 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%.

(4) A taxpayer is deemed to have been notified of a pending tax audit or investigation, or that the tax audit or investigation has started, if—

(a) The taxpayer; or

(b) An officer of the taxpayer; or

(c) A shareholder of the taxpayer, if the taxpayer is a close company; or

(d) A tax adviser acting for the taxpayer; or

(e) A partner in partnership with the taxpayer; or

(f) A person acting for or on behalf of or as a fiduciary of the taxpayer,—

is notified of the pending tax audit or investigation, or that the tax audit or investigation has started.

(5) An audit or investigation starts at the earlier of—

(a) The end of the first interview an officer of the Department has with the taxpayer or the taxpayer's representative after the taxpayer receives the notice referred to in subsection (4); and

(b) The time when—

(i) An officer of the Department inspects information (including books or records) of the taxpayer after the taxpayer receives the notice referred to in subsection (4); and

(ii) The taxpayer is notified of the inspection.

6.33 Section 141H provides that the shortfall penalty payable by the taxpayer may be reduced if the taxpayer makes adequate disclosure of the taxpayer’s tax position at the time the tax position is taken. Section 141H states:

141H. Reduction for disclosure of unacceptable tax position—

(1) A shortfall penalty payable by a taxpayer under section 141B or section 141D maybe reduced if, in the Commissioner's opinion, the taxpayer makes adequate disclosure of the taxpayer's tax position at the time, determined under section 141B(6), the taxpayer takes the taxpayer's tax position.

(2) The level by which a shortfall penalty is to be reduced for adequate disclosure is 75%.

(3) The Commissioner may from time to time specify—

(a) The type of information required for adequate disclosure; and

(b) The form in which the information must be provided.

6.34 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.

(3) A tax shortfall is a temporary tax shortfall for a return period if the Commissioner is satisfied that—

(a) The tax shortfall has been permanently reversed or corrected in an earlier or later return period, so that (disregarding penalties or interest) the taxpayer pays the correct amount of tax or calculates and returns the correct tax liability in respect of the item or matter that gave rise to the tax shortfall; and

(b) No tax shortfall will arise in a later return period in respect of a similar item or matter; and

(c) No arrangement exists in any return period which has the purpose or effect of creating a further related tax deferral or advantage; and

(d) The tax shortfall was permanently reversed or corrected before the taxpayer is first notified of a pending tax audit or investigation.

The application of section 141J

6.35 A shortfall penalty payable by the taxpayer, for example, under section 141B (for taking an unacceptable tax position), may qualify to be reduced under sections 141G or 141H (for making a voluntary disclosure in accordance with these provisions), 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 or 141H 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]

6.36 Accordingly, where a taxpayer may qualify for their shortfall penalty payable under sections 141B 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%.

6.37 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

6.38 Section 141JAA provides that "a shortfall penalty payable by a taxpayer … for taking an unacceptable tax position, 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—

…

6.39 It is noted that, unlike sections 141FB, 141G, 141H 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 141B, under which the penalty originates, and then apply the reduction provisions, as modified by section 141J.

6.40 It is also noted that although section 141JAA refers to "a shortfall penalty payable by the taxpayer … for taking an unacceptable tax position", the section does not specifically refer to section 141B; the provision under which this shortfall penalty originates.

6.41 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 section 141A and 141B.)

6.42 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 141B, when the penalty that originated under that provision may have been reduced by the application of the reduction provisions.

6.43 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.

6.44 The alpha numeric 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.

6.45 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.

6.46 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 "[2001] Taxpayer compliance, standards and penalties: a review" 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]

6.47 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

6.48 It is considered that the shortfall penalties payable by the taxpayer for taking an unacceptable tax position under section 141B, 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 sections 141G or 141H

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 only once and that is by 75%. Then, if section 141JAA is also applicable, the resultant shortfall penalty payable for taking an unacceptable tax position 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.

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

6.50 Therefore, it is the Commissioner's view that the section 141JAA cap of $50,000, on the shortfall penalty payable by a taxpayer for taking an unacceptable tax position is only applicable after all other relevant reductions have been made, including the limiting provision of section 141J.

6.51 It should be noted that section 141JAA also applies to shortfall penalties under section 141A for not taking reasonable care. This is discussed in the Interpretation Statement IS00053.

Section 141JAA provides

6.52 *Prima facie*, there are two situations when the shortfall penalty for taking an unacceptable tax position 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).

6.53 "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:

6.54 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.

6.55 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"?

6.56 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:

6.57 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.

6.58 It follows that for section 141JAA to apply, which only applies if "a shortfall penalty is payable by a taxpayer for not taking reasonable care or for taking an unacceptable tax position", the amount of the tax shortfall must be disclosed by the taxpayer or determined by the Commissioner.

Ordinary meaning of determines

6.59 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.

6.60 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

6.61 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

6.62 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).

6.63 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)

6.64 The court held that:

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

6.65 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.

6.66 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

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

6.68 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 correct. 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]

6.69 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"

6.70 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 be appropriate to equate the word "determines" with "has issued a NOPA".

6.71 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 as the taxpayer has a statutory right to dispute or challenge their assessment. 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.

6.72 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 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 taking an unacceptable tax position, or the

Commissioner decides that there is such a shortfall within the time limits, is sufficient for the application of the section.

Conclusion

6.73 Section 141JAA was enacted with the intention of rewarding 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.

Related Standard Practice Statements

6.74 The following related Standard Practice Statements may also assist in the interpretation and application of the above adjustment provisions to the shortfall penalty for taking an unacceptable tax position:

- 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)).

Summary - changes relevant to a taxpayer's tax position taken on or after 1 April 2003

- To take an unacceptable tax position, a taxpayer is required to take a tax position that when viewed objectively fails to meet the standard of being about as likely as not to be correct. *Section 141B(1)*
- Although the making of an "interpretation or an interpretation of an application of a tax law" is no longer required for the application of section 141B, an unacceptable interpretation of the law can give rise to an unacceptable tax position. *Section 141B(6)*
- The threshold levels which a tax shortfall must exceed to qualify as an unacceptable tax position have increased. *Section 141B(2)*

- Penalties of 20% may be reduced to 10% as a result of a taxpayer's prior good compliance. *Sections 141FB(2) and (3)*
- Subject to certain conditions, the shortfall penalty for not taking reasonable or taking an unacceptable tax position is capped at $50,000. *Section 141JAA(1).*