[Interpretation statement IS0060 issued by Adjudication & Rulings in August 2004]

SHORTFALL PENALTY FOR GROSS CARELESSNESS

1. SUMMARY

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

1.2 This statement provides a detailed interpretative explanation of the shortfall penalty imposed by the Commissioner under section 141C on taxpayers who are grossly careless in carrying out their tax obligations. Where a taxpayer is grossly careless, the result may be that too little tax is paid or payable or a tax benefit, credit, or advantage is overstated. This interpretation statement deals with some interpretative issues relating to the section. The main features of this statement are:

- "Gross carelessness" is defined in section 141C(3) to mean doing or not doing something in a way that, in all the circumstances, suggests or implies complete or a high level of disregard for the consequences.
- The test for gross carelessness is objective and is based on what a reasonable person would foresee as being conduct which creates a high risk of a tax shortfall occurring.
- Gross carelessness involves recklessness but, unlike evasion, does not require an element of *mens rea* or intent to breach a tax obligation.
- The statement provides guidance as to how the gross carelessness standard is applied to various situations.

2. BACKGROUND

2.1 Following a review of the compliance and penalties legislation, the Tax Administration Amendment Act (No 2) 1996 introduced new rules. The review noted that the legislation was unfair to the majority of taxpayers who comply with the law and entailed unnecessary costs to affected taxpayers. It also noted that the legal processes and requirements were unclear and that the rules did not fit in with the self-assessment environment. As part of the ensuing reforms, additional tax and penal tax were replaced with various new civil penalties including late filing and payment penalties and shortfall penalties, etc.

2.2 The purpose of the new regime, as set out in section 139, is to encourage voluntary compliance and to impose consistent and impartial penalties which reflect the seriousness of the breach of tax obligations.

2.3 The penalties regime is again being reviewed and a discussion document *Taxpayer compliance, standards and penalties: a review* was released in

August 2001. To date, some amendments have been made as a result of this review. Those amendments include reductions in the rate of some shortfall penalties on the basis of previous behaviour (section 141FB) and the amendment to the shortfall penalty imposed under section 141B to being one which applies when a taxpayer takes an unacceptable tax position. The amendments that have already been passed have prompted the withdrawal of various shortfall penalty Standard Practice Statements in relation to tax positions taken on or after 1 April 2003.

2.4 This interpretation statement provides an explanation of some interpretative aspects of one of the shortfall penalties – the shortfall penalty for gross carelessness covered by section 141C. The statement applies, except as otherwise specified, in respect of tax positions taken in the 1997-98 and subsequent income years and gross carelessness in relation to goods and services tax ("GST") on or after 1 April 1997, these being the dates from which section 141C applied following the enactment of the penalties regime. Given that the focus of this statement is on what constitutes "gross carelessness", the definition of which in section 141C(3) has not been amended under the current review, this statement will cover much of the same ground as the now withdrawn Standard Practice Statement INV-210 *Shortfall penalties – gross carelessness*. It will, however, reflect recent amendments to the legislation as well as incorporating case law issued since the standard practice statement was issued. The principles outlined in this statement are consistent with those outlined in the withdrawn Standard Practice Statement.

3. ISSUES

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

4. LEGISLATION

4.1 Section 141C imposes a shortfall penalty for gross carelessness:

> **(1)** A taxpayer is liable to pay a shortfall penalty if the taxpayer is grossly careless in taking a taxpayer's tax position (referred to as "gross carelessness").
>
> **(2)** The penalty payable for gross carelessness is 40% of the resulting tax shortfall.
>
> **(3)** For the purposes of this Part, gross carelessness means doing or not doing something in a way that, in all the circumstances, suggests or implies complete or a high level of disregard for the consequences.
>
> **(4)** A taxpayer who takes an acceptable tax position is also a taxpayer who has not been grossly careless in taking the taxpayer's tax position.

4.2 Section 3(1) contains various definitions:

> In this Act, unless the context otherwise requires,–
>
> …
>
> **“Acceptable tax position”** means a tax position that is not an unacceptable tax position:
>
> …
>
> **“Correct tax position”** means the correct tax position established under one or more tax laws:
>
> …
>
> **“Shortfall penalty”** means a penalty imposed under any of sections 141A to 141K for taking an incorrect tax position or for doing or failing to do anything specified or described in those sections:
>
> …
>
> **“Tax position”** means a position or approach with regard to tax under one or more tax laws, including without limitation a position or approach with regard to–
>
> (a) A liability for an amount of tax, or the payment of an amount of tax:
>
> (b) An obligation to deduct or withhold an amount of tax, or the deduction or withholding of an amount of tax:
>
> (c) A right to a tax refund, or to claim or not to claim a tax refund:
>
> (d) A right to a credit of tax, or to claim or not to claim a credit of tax:
>
> (e) The provision of a tax return, or the non-provision of a tax return:
>
> (f) The derivation of an amount of gross income or exempt income or a capital gain, or the inclusion or non-inclusion of an amount in gross income:
>
> (g) The incurring of an amount of expenditure or loss, or the allowing or disallowing as a deduction of an amount of expenditure or loss:
>
> (h) The availability of net losses, or the offsetting or use of net losses:
>
> (i) The attaching of a credit of tax, or the receipt of or lack of entitlement to receive a credit of tax:
>
> (j) The balance of a tax account of any type or description, or a debit or credit to such a tax account:
>
> (k) The estimation of the provisional tax payable:
>
> (l) Whether the taxpayer must request an income statement or respond to an income statement issued by the Commissioner:
>
> (m) The application of section 33A(1):
>
> (n) A right to a rebate:
>
> …
>
> **“Tax shortfall”**, for a return period, means the difference between the tax effect of–
>
> (a) A taxpayer’s tax position for the return period; and
>
> (b) The correct tax position for that period,–
>
> when the taxpayer’s tax position results in too little tax paid or payable by the taxpayer or another person or overstates a tax benefit, credit, or advantage of any type or description whatever by or benefiting (as the case may be) the taxpayer or another person:

…

"Taxpayer'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.

…

"Unacceptable tax position" is defined in section 141B.

5. SHORTFALL PENALTY FOR GROSS CARELESSNESS

INTRODUCTION

5.1 Section 141C(1) imposes a shortfall penalty on a taxpayer who is grossly careless in taking a taxpayer's tax position, with application to tax obligations in relation to periods commencing on or after 1 April 1997. The behaviour standard covered by this section is referred to as "gross carelessness":

> A taxpayer is liable to pay a shortfall penalty if the taxpayer is grossly careless in taking a taxpayer's tax position (referred to as "gross carelessness").

5.2 "Gross carelessness" is defined in section 141C(3) as follows:

> For the purposes of this Part, gross carelessness means doing or not doing something in a way that, in all the circumstances, suggests or implies complete or a high level of disregard for the consequences.

5.3 For the shortfall penalty to apply, a "taxpayer's tax position" must have been taken which results in a "tax shortfall". "Taxpayer's tax position" is defined in section 3(1) to mean a "tax position" taken by a taxpayer in or in respect of a tax return, an income statement or a due date. The term "tax position" is defined in section 3(1) to mean a position or approach with regard to tax under one or more tax laws. The definition includes a non-exhaustive list of tax laws, a position or approach to which would constitute a tax position e.g. a liability for an amount of tax; a right to a rebate; etc. The term "tax shortfall" is defined in section 3(1) to mean the difference between the taxpayer's tax position for the return period and the correct tax position, as established under one or more tax laws (definition of "correct tax position" in section 3(1)), where the taxpayer's tax position results in too little tax paid or payable, or overstates a tax benefit etc.

5.4 With effect from 26 March 2003, in relation to tax positions taken on or after 1 April 2003, a taxpayer who takes an acceptable tax position is deemed not to have been grossly careless (section 141C(4)) (previously, for the proviso to apply, the taxpayer was required to have used an "acceptable interpretation" in taking the taxpayer's tax position.). An "acceptable tax position" is defined in section 3(1) to mean a tax position that is not an "unacceptable tax position" i.e. the tax position, viewed objectively, fails to meet the standard of being

about as likely as not to be correct (definition of "unacceptable tax position" in section 3(1); section 141B(1)). Clearly, to be an acceptable tax position, it is not necessary for the tax position to be correct – if it were, there would be no tax shortfall on which a shortfall penalty could be imposed. Rather, an acceptable tax position will also include tax positions which, although incorrect, are sufficiently "close" to being correct that a shortfall penalty should not be imposed i.e. borderline cases.

5.5 The shortfall penalty for gross carelessness is 40% of the resulting tax shortfall (section 141C(2)). This is subject to various reductions potentially available under sections 141FB (previous behaviour), 141G (voluntary disclosure), 141I (temporary shortfall) and 141J (limitation of reduction). The penalty is also subject to a 25% increase under section 141K if the taxpayer obstructs the Commissioner in determining the correct tax position. The following related Standard Practice Statements may assist in the interpretation and application of these adjustment provisions:

- 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));
- INV-295 *Reduction of Shortfall Penalties for Previous Behaviour* (published in *Tax Information Bulletin* Vol 16, No 3 (April 2004));

5.6 The manner in which gross carelessness shortfall penalties are assessed is governed by section 94A. In challenging the imposition of the penalty, the onus of proof rests with the taxpayer to show that he or she was not grossly careless (limb (b) of section 149A(2)). The standard of proof is the balance of probabilities (section 149A(1)).

5.7 The gross carelessness shortfall penalty provisions do not apply to certain non-filing taxpayers (section 141JA) but, from 1 April 2004, they will apply to PAYE intermediaries (section 141JB).

5.8 This interpretation statement will focus on the concept of what constitutes "gross carelessness" pursuant to section 141C(3). As noted above, however, in a given situation it would first be necessary to show that a taxpayer had taken a taxpayer's tax position which had resulted in a tax shortfall.

GROSS CARELESSNESS

5.9 As noted, "gross carelessness" is defined in section 141C(3) to mean:

> For the purposes of this Part, gross carelessness means doing or not doing something in a way that, in all the circumstances, suggests or implies complete or a high level of disregard for the consequences.

5.10 In *Case W4* (2003) 21 NZTC 11,034 at paragraph 44, Barber DJ held that the definition of "gross carelessness":

> … refers to a high level of disregard for the consequences and is characterised by conduct which creates a high risk of a tax shortfall occurring where this risk and its consequences would have been foreseen by a reasonable person in the circumstances.

5.11 *Case W4* concerned a taxpayer who, along with the company he owned, was involved in land development and speculative building transactions. The taxpayer had been responsible for the preparation of his own and the company's GST returns for a number of years. In late 1997, he purchased a property and claimed an input tax deduction on it in his return for the taxable period ended 31 December 1997. On 20 May 1998, the taxpayer entered into an agreement to sell the property, with settlement occurring in November 1998. No output tax on the sale was returned in the taxable period ended 30 November 1998. The omission was discovered during an audit of the taxpayer's affairs and the taxpayer subsequently signed an agreed adjustment in relation to the amount he had actually received from the sale which was $20,000 less than what had been agreed when the agreement for sale and purchase was originally entered into. In August 2000, the Commissioner issued a Notice of Proposed Adjustment in which the $20,000 was included as output tax in the taxable period ended 30 November 1998 and a shortfall penalty was proposed for gross carelessness of $4,846.06 (being 40% of the tax fraction of the net proceeds received from the sale). A shortfall penalty for not taking reasonable care was proposed in the alternative. Following the issue of an adjudication report, assessments were issued incorporating the proposed adjustment to the output tax and the shortfall penalty for gross carelessness.

5.12 In the hearing before the Taxation Review Authority, the Commissioner contended that the taxpayer had been reckless in not returning the output tax on the sale of the property in either the correct taxable period or some later taxable period. The Commissioner noted that the taxpayer had failed to have an adequate system in place to ensure that the output tax was returned and contended that, having claimed an input tax credit when the property was purchased, the taxpayer should have been aware of the need to return the output tax when it was sold a short time later, particularly given his long experience in GST matters and the past assistance and previous warnings given to him by the Inland Revenue Department. The taxpayer contended that he had tried to comply with his GST obligations but that human error, rather than a systems failure, had caused the failure to return the output tax. This human error, he contended, was caused by extenuating circumstances related to the pressure and stress he was under at the time.

5.13 At paragraph 48 of *Case W4*, Barber DJ stated that gross carelessness "must be something similar to recklessness", noting that the degree of negligence under section 141C will be of a greater magnitude than that required for the imposition of a shortfall penalty under section 141A for not taking reasonable care. At paragraph 46, he held that "gross carelessness" was a relative term and whether or not it is present will depend upon the circumstances in each case.

5.14 Barber DJ went on to consider case law on the concept of "recklessness". Citing *R v Caldwell* [1981] All ER 961 and *R v Howe* [1982] 1 NZLR 618, he held at paragraph 49 that a person who fails to give any thought to the consequences of his or her behaviour or to an obvious or serious risk has acted recklessly.

5.15 In the joint judgment of the Court of Appeal in *Howe* at page 623, the determination of whether or not there had been reckless behaviour was described in this way:

> As to recklessness, there has been a line of cases in England of high authority affirming that this word has no separate legal meaning. And that, **although involving more than mere carelessness, it is not limited to deliberate risk-taking but includes failing to give any thought to an obvious and serious risk**: *R v Caldwell* [1982] AC 341; [1981] 1 All ER 961, *R v Lawrence*, *R v Pigg* [1982] 2 All ER 591; [1982] 1 WLR 762. [Emphasis added]

5.16 The scope of conduct encompassed in the concept of recklessness was described by Lord Diplock in *Caldwell* at page 964 in this way:

> … recklessness covers a whole range of states of mind from failing to give any thought at all to whether or not there is any risk of those harmful consequences, to recognising the existence of the risk and nevertheless deciding to ignore it.

5.17 In Australia, the penalty provision relating to "recklessness" was directly equated with that of gross carelessness in *Tax Ruling 94/4*:

> Briefly stated, recklessness is gross carelessness – the doing of something which in fact involves a risk, whether the doer realises it or not, and the risk being such, having regard to all the circumstances, that the taking of that risk would be described as "reckless" (*Shawinigan Ltd v Vokins & Co Ltd* [1961] 3 All ER 396). In other words, recklessness involves the running of what a reasonable person would regard as an unjustifiable risk (*Reed (Albert E) & Co Ltd v London and Rochester Trading Co Ltd* [1954] 2 Lloyds Rep 463).

5.18 At paragraph 17 of *Tax Ruling 94/4*, recklessness is described as follows:

> A person would be acting recklessly if:
>
> (a) the person did an act which created a risk of a particular consequence occurring (e.g. a tax shortfall);
>
> (b) a reasonable person who, having regard to the particular circumstances of the person, knew or ought to have known the facts and circumstances surrounding the act would have or ought to have been able to foresee the probable consequences of the act;
>
> (c) the risk would have been foreseen by a reasonable person as being great, having regard to the likelihood that the consequences would occur, and the likely extent of those consequences (e.g. the size of the tax shortfall); or
>
> (d) when the person did the act, he or she either was indifferent to the possibility of there being any such risk, or recognised that there was such risk involved and had, nonetheless, gone on to do it. That is, the person's conduct clearly shows disregard of, or indifference to, consequences foreseeable by a reasonable person.

5.19 At paragraph 49 of *Case W4*, Barber DJ held that the test for gross carelessness was an objective one. That is, the test is based on what a

reasonable person would foresee as being conduct which creates a high risk of a tax shortfall occurring.

5.20 At paragraph 45 of *Case W4*, Barber DJ accepted that the gross carelessness penalty provision does not require an element of mens rea or intent to breach a tax obligation (see also *Case W3* (2003) 21 NZTC 11,014 at paragraph 111; *Taxpayer Compliance, Penalties, and Disputes Resolution Bill – Commentary on the Bill* (September 1995) at page 14; *Tax Information Bulletin* Vol 8, No 7 (October 1996) at page 18). In this regard, the gross carelessness standard may be distinguished from that of evasion (the shortfall penalty for which is contained in section 141E) which also requires an element of recklessness (*Godfrey Allan Ltd v CIR* (1980) 8 NZTC 61,548; *Case E26* (1981) 5 NZTC 59,154; *Case H90* (1986) 8 NZTC 619; *Case M17* (1990) 12 NZTC 2,749; *Case P13* (1992) 14 NZTC 4,083).

5.21 In *Case W4*, Barber DJ concluded that the taxpayer had been grossly careless in not returning the output tax on the sale of the property in the correct taxable period. At paragraph 41, he noted that the failure to return the output tax had been a repeated one – first, by failing to return it in his own return in the correct taxable period, then by alleging that it had been returned in the company's return, then advising that he had taken steps to return it in his March 1999 return, but ultimately not returning the output tax at all. Barber DJ at paragraphs 65 – 69 explained why he doubted the taxpayer's credibility and stated that he found it hard to believe that the taxpayer had not been grossly careless or that the omission was not done intentionally (at paragraph 73, he stated that the taxpayer was fortunate not to be facing a shortfall penalty for evasion). In particular, while he accepted that the taxpayer had been under some stress at the time, he based his decision that the taxpayer had been grossly careless on the taxpayer's lengthy experience in GST matters, the fact there had been previous audits which resulted in warnings being given as well as assistance, the short time frame between the purchase and the sale of the property, and the significance of the transactions.

5.22 *Case W3* also concerned, among other things, whether or not a gross carelessness shortfall penalty should be imposed on the taxpayer for not returning certain outputs in the return for the taxable period ended 31 March 1998. The outputs not returned related to debts which the taxpayer did not intend to collect because he considered that any attempts to recover them would be futile. At the time, the taxpayer had been under pressure caused by eight charges having been laid for using a document to defraud. Barber DJ held that there was a tax shortfall in the relevant taxable period because the debts had not been written off, as required under limb (c) of section 26(1) of the Goods and Services Tax Act 1985, and because no credit notes had been issued pursuant to section 25 of that Act. At paragraph 110, Barber DJ held that the pressures that the taxpayer had been under at the time meant that a high level of carelessness or a high level of disregard for the consequences had not been present. At paragraph 112, he agreed with the Commissioner's alternative argument that the taxpayer had not taken reasonable care and that therefore a shortfall penalty was chargeable under section 141A.

5.23 In summary, then, the above discussion indicates that gross carelessness is similar to recklessness but, unlike evasion which also involves recklessness, it does not require an element of *mens rea* or intent to breach a tax obligation. A number of characteristics of gross carelessness may be identified from the above analysis:

- Grossly careless conduct implies a complete or high level of disregard for the consequences;
- Grossly careless conduct creates a high risk of a tax shortfall occurring.
- The risk involved in, and the consequences of, grossly careless conduct would have been foreseen by a reasonable person in the circumstances.
- Failing to give any thought to an obvious and serious risk constitutes gross carelessness.
- Gross carelessness involves more than mere inadvertence or lack of reasonable care.
- Whether or not gross carelessness is present will depend upon the circumstances in each case.
- The test for whether or not gross carelessness is present is objective, being similar to that for "recklessness".

DISTINGUISHING BETWEEN GROSS CARELESSNESS AND NOT TAKING REASONABLE CARE

5.24 As noted, the carelessness involved in gross carelessness, for which the taxpayer would be liable for a shortfall penalty of 40% under section 141C, will be of a greater magnitude to that involved in not taking reasonable care, for which a taxpayer is liable for a 20% shortfall penalty under section 141A. When determining whether a taxpayer's behaviour in a given situation constitutes a lack of reasonable care or gross carelessness, it will be necessary to make a judgment as to where the "dividing line" between the two standards occurs. While it is not possible to be definitive, it is nevertheless appropriate to consider some guidelines. However, as noted in the summary in the previous paragraph, whether certain behaviour is gross carelessness or merely involves not taking reasonable care will depend upon the circumstances in each case.

5.25 In this regard, gross carelessness, by definition, is conduct which implies a complete or high level of disregard for the consequences and creates a high risk of a tax shortfall occurring; the requisite risk being foreseeable by a reasonable person in the circumstances. In any given situation, therefore, it would need to be determined what constitutes a "high" risk, or a "high" level of disregard for the consequences, as opposed to a risk resulting from a lack of reasonable care.

5.26 For example, in *Case W4* Barber DJ held that the taxpayer had been grossly careless. His finding as to gross carelessness was based on a number of facts, namely the repeated failure to return the output tax in question, the taxpayer's lengthy experience in GST matters, the warnings resulting from and the

assistance given in previous tax audits, and the short time frame between the purchase of the property (when an input tax credit was claimed) and its sale. It is not obvious, however, whether any one of these factors in isolation would have been sufficient basis for a finding of gross carelessness as opposed to a lack of reasonable care. In such a situation, it is considered that the fact that the transaction was a significant one involving a large amount of output tax would involve the taxpayer in conduct which would put a reasonable person on alert, especially when coupled with a short time frame between purchase and sale. Any argument that the person was not aware of the high risk involved in his or her behaviour would be weakened by there having been previous audits on similar issues which had resulted in both warnings and assistance being given by Inland Revenue staff.

5.27 The question arises of whether or not the taxpayer would have been held to be grossly careless had the tax shortfall resulted from a transaction which was relatively insignificant because the output tax on the transaction, when viewed in isolation, was relatively small or was one of a number of similar transactions. It could be argued in this situation that a reasonable person may have failed to notice that the output tax on one transaction had not been returned.

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

5.29 From the above analysis of the facts in *Case W4*, but bearing in mind the principle that whether or not gross carelessness is present is dependent upon the circumstances in each case, it is relevant to consider the following characteristics in determining whether a reasonable person would have foreseen that his or her conduct created a high risk of a tax shortfall occurring i.e. whether the taxpayer had been grossly careless:

- a large tax shortfall (whether resulting from a single transaction or from a number of similar transactions);
- a significant transaction, or transactions of a similar nature when viewed together, when compared to the taxpayer's business or taxable activity;
- indifference to an obvious risk of a possible tax shortfall occurring;
- a relatively short period of time between the purchase and sale of an item where the purchase triggered a tax effect that the taxpayer recognised;

- the taxpayer being experienced in the relevant tax laws;
- a failure by the taxpayer to heed previous warnings or to take on board suggestions of tax advisors (whether by the Inland Revenue Department or other professional people) which were aimed at reducing the likelihood of errors occurring.

5.30 Where few or none of the above characteristics are present, then the less likely it will be that the taxpayer has been grossly careless. However, the taxpayer may nevertheless have not taken reasonable care.

EXAMPLES

The following examples are intended to illustrate the application of the gross carelessness shortfall penalty provision. The focus in these examples is on whether or not the taxpayer has been grossly careless in taking a taxpayer's tax position and therefore the fact that a taxpayer's tax position has been taken which has resulted in a shortfall will be present in all the examples. The application or otherwise of the reduction or increase provisions is not addressed in the examples.

Example 1

In August 2002, ABC Limited entered into an agreement for sale and purchase for farm land, intending to subdivide it and build houses for sale. In its GST return for the taxable period ended 31 August 2002, it correctly claimed an input tax credit on the full purchase price of $500,000. Because of a newspaper report in October 2002, which detailed the proposed establishment of a sewerage treatment facility a short distance from the land which it considered would adversely affect its ability to sell the residential properties, the company sold the land in December 2002 for $490,000. However, the person usually responsible for the preparation of the returns was on annual leave at the time when the return was due for the taxable period in which the land was supplied, and the staff member who was filling in for him had not realised that output tax on the sale of the property needed to be returned. Consequently, no output tax on the sale was returned in the correct taxable period. Nor was it ever returned, even after the person returned from leave.

Should a shortfall penalty for gross carelessness be imposed?

The taxpayer must have been aware that the supply of the property had GST consequences because it claimed an input tax credit on its purchase. In this light, given the relatively short period of time between when the property was purchased and when it was sold, a reasonable person would have been aware that output tax was payable on its sale. As well, given the large amount of output tax payable, a reasonable person would not have inadvertently omitted to return it. In this regard, while the staff member who completed the return was temporarily filling in for the usual staff member, a reasonable person would have recognised that there was an obvious and serious risk that a tax shortfall would occur if an inadequately trained person completed the return and would therefore have put in place procedures to ensure that no error was

made. The fact that the error was not rectified in a later taxable period when the usual staff member returned from leave also indicates that the company showed a high level of disregard for the accuracy of its return. Hence, it is considered that the company was grossly careless and that the shortfall penalty should be imposed.

Example 2

Mr D runs a building recycling operation, buying and selling material and fittings from buildings that have been demolished or refurbished. His suppliers are both registered and unregistered persons for GST purposes. He claims input tax credits on the material purchased from the unregistered persons under the secondhand goods provisions in limb (a)(ia) of section 20(3) of the Goods and Services Tax Act 1985 which allow an input tax deduction only to the extent that payment has been made. When his tax affairs are investigated, it is discovered that he claimed a number of input tax credits on secondhand goods purchased from unregistered persons in the taxable period ended 31 March 2003 based on the full purchase price totalling $36,000 when during that period he had only paid $5,000 of the total amount due. During past investigations, similar mistakes have been identified where the input tax credit claimed was based on the full purchase price rather than on the amount paid during the taxable period in question. Advice was given by the investigator as to how the taxpayer could improve his bookkeeping system so that similar errors would not occur in the future. Despite 12 months having elapsed since this advice was given, the taxpayer had failed to implement the suggested improvements. In relation to the taxable period now being investigated, the taxpayer stated that the mistake was the result of mere inadvertence. The Commissioner proposes to impose a shortfall penalty for gross carelessness on the resulting tax shortfall.

In this instance, buying secondhand goods is a regular part of the taxpayer's business. The fact that recording or calculation errors by the taxpayer in relation to the input tax claimable on secondhand goods have previously been identified on a number of occasions is an indication that a reasonable person, in the same circumstances, would have recognised the obvious and serious risk involved. As such, the errors are **not** the type of mistakes that occur because of mere inadvertence and which do not suggest or imply complete or a high level of disregard for all the consequences so as to constitute gross carelessness. Rather, in this case, once the nature of the errors had been identified, and it was recognised that such errors could potentially recur on a regular basis, a reasonable person would have ensured that such errors did not recur by following the advice previously given and putting in place an adequate record-keeping system, including checks, to identify goods purchased from unregistered persons. Not to have done so indicates indifference to the serious risk of this type of error recurring and a high level of disregard for the consequences. Therefore, it is considered that the taxpayer has been grossly careless and that a shortfall penalty under section 141C should be imposed.

Example 3

XYZ Limited was recently incorporated to invest in property. It intends to purchase properties, renovating them if necessary, and then leasing them out. In its income tax return for the year ended 31 March 2003, during which it was incorporated, it claimed deductions for expenditure of $25,500 that it identified as being "repairs and maintenance". Upon investigation, the Department determined that $23,000 of this amount had been incurred on one particular property that the company had purchased during the income year. The expenditure included the upgrade of the old water heating system, repapering the entire building, replacing worn carpet, replacing rotten wood, repainting the building, and making extensive repairs to the roof and spouting. The expenditure had been incurred within three months of the purchase of the property and no expenditure incurred at this time had been treated as being of a capital nature. The Commissioner considered that this expenditure was of a capital nature and that therefore no deduction was available except by way of the depreciation regime. He also considered that the complexity of the law on the distinction between capital and revenue expenditure is such that the taxpayer should have obtained professional advice and that to not do so suggests or implies a high level of disregard for the consequences. The Commissioner therefore proposes to impose a shortfall penalty on the tax shortfall for gross carelessness. The taxpayer stated that his bookkeeping system did not distinguish between capital and revenue expenditure because he had thought that all of the disputed expenditure was incurred on repairs and maintenance, not capital items.

Presuming that the $23,000 in expenditure was in fact of a capital nature, should the proposed shortfall penalty be imposed?

A preliminary matter concerns whether or not it is appropriate to impose a shortfall penalty for gross carelessness in relation to the capital / revenue distinction, given that it is a contentious area of law and section 141C is a care provision rather than one which relates to the accuracy of the tax position taken by the taxpayer. In this regard, it is considered that it is possible for a taxpayer to be grossly careless in taking a tax position no matter how contentious the applicable provisions might be (*Taxpayer Compliance, Penalties, and Disputes Resolution Bill – Commentary on the Bill* (September 1995) at page 11 outlines the rationale for this with respect to shortfall penalties for not taking reasonable care and it is considered that it equally applies to a gross carelessness shortfall penalty). In such a case, the situation could be such that a reasonable person would understand that there was an even greater need to research the issue or obtain advice etc., something which the taxpayer in this example did not do.

As well, the proviso in paragraph 141C(4) – that a gross carelessness shortfall penalty will not be imposed where the taxpayer has taken an acceptable tax position – already provides an exception in borderline cases involving interpretation and/or the accuracy of the position taken. In this regard, on the facts of this example, it is not considered that the proviso would apply. That is, to classify the types of expenditure incurred, involving major restoration

work and the replacement of assets, as not being of a capital nature would not constitute the taking of an acceptable tax position.

Nevertheless, it needs to be determined whether or not the taxpayer was grossly careless in this case. In this regard, the tests in relation to the capital/revenue distinction in relation to property purchases are well established in case law. However, whether expenditure is of a capital or revenue nature requires a level of judgment based on a number of factors and the taxpayer's relative inexperience counts against him having the required level of judgment. Consequently, the taxpayer should have obtained professional advice. However, it is not considered that to have not done so indicates either a high level of disregard for the consequences, or an indifference to a serious risk that the expenditure would not be deductible, the factors which reflect gross carelessness. It is not evident that the taxpayer was even aware of the serious risk that the expenditure may not be deductible. As well, while the tax shortfall constitutes a large proportion of the expenditure deducted by the taxpayer, this factor in isolation is not sufficient for a conclusion to be drawn that the taxpayer was grossly careless.

Therefore, while the taxpayer may not have taken reasonable care in taking the taxpayer's tax position, and may consequently be liable for a shortfall penalty under section 141A, it is not considered in these circumstances that the taxpayer had had a high level of disregard for the consequences when it filed its return. That is, there would be no gross carelessness on the part of the taxpayer and no shortfall penalty for gross carelessness should be imposed. Had there been earlier warnings from the Department or advice from a tax agent on the interpretative issue that the taxpayer had ignored, then this would have increased the likelihood that the taxpayer would be held to have been grossly careless.