Inland Revenue
Te Tari Taake

Interpretation Statement IS0062 issued by the Office of the Chief Tax Counsel in November 2006.

SHORTFALL PENALTY—EVASION

1. SUMMARY

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

1.2 This statement provides a detailed interpretative explanation of the shortfall penalty imposed under section 141E for "evasion or a similar act", with particular emphasis on what constitutes evasion "or a similar act".

1.3 Section 141E(1) imposes a penalty for two types of behaviour that may occur in taking a tax position.

- The first, in paragraph (a), is evasion (of the assessment or payment of tax by a taxpayer for themselves or another).
- The second type, in the remaining paragraphs of section 141E(1), requires knowledge of the breaches set out in those paragraphs (misapplying a deduction or withholding tax, or not making tax deductions, or obtaining or attempting to obtain a refund for the taxpayer themselves or another knowing there is no entitlement to such a refund).

1.4 Evasion occurs when a taxpayer deliberately breaches a tax obligation. The required mental element for evasion will be present if the taxpayer knew or strongly suspected that the taxpayer's course of conduct would breach a tax obligation. In other words, evasion requires intentional behaviour or subjective recklessness; negligence and carelessness are insufficient.

1.5 The other paragraphs of section 141E(1) set out various acts or omissions which constitute a "similar act" to evasion. They all require that the act or omission occurs "knowingly". The following points should be noted in relation to this knowledge requirement:

- These other paragraphs require that the taxpayer has knowledge of doing the act (or the omission); unlike evasion they do not require that the taxpayer has knowledge that the act or omission is in breach of a tax obligation;
- The knowledge requirement can be satisfied by actual knowledge of or subjective recklessness toward the doing of the act (or of the omission). Like evasion, negligence and carelessness are insufficient to satisfy the test.

1.6 The statutory defence (in section 141E(2)) that can apply to section 141E(1)(b) (misapplying a deduction or withholding tax) applies only where the deduction has since been accounted for, and the taxpayer establishes (on the balance of

probabilities) that the illness, accident, or other cause beyond their control directly caused the breach.

1.7 Apportionment of a shortfall penalty (provided for in section 141F(2)) between the taxpayer (for example, a company) and the officer of the taxpayer involved is possible where the breach is failing to make or account for a deduction, or misapplying or permitting misapplication of a deduction. The criteria for determining the apportionment are the relative actions or omissions of the company and the officer involved, and the reasonableness of those actions or omissions.

2. BACKGROUND

2.1 In March 1998, a Standard Practice Statement was published which dealt with the evasion or similar act penalty (INV-220). This appeared in *Tax Information Bulletin* Vol 10, No 3 (March 1998). This Standard Practice Statement has now been withdrawn in relation to tax positions taken on or after 1 April 2003. Standard Practice Statements dealing with shortfall penalties were withdrawn at this time due to the enactment of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, which made various changes to the shortfall penalty regime. One of these changes was the introduction of section 141FB, which deals with the reduction of penalties for previous behaviour.

2.2 The focus of this Interpretation Statement is on what constitutes "evasion or a similar offence". As no changes were made to this concept, this Interpretation Statement will cover some of the same ground as the Standard Practice Statement, but will reflect recent amendments to the legislation and incorporate case law issued since the Standard Practice Statement was issued. The principles outlined in this statement are consistent with the Standard Practice Statement. They are also consistent with the brief examples of evasion contained in *Tax Information Bulletin* Vol 8, No 7 (October 1996) and the example of evasion given in "Shortfall penalties for failure to deduct or account for PAYE", *Tax Information Bulletin* Vol 12, No 5 (May 2000). It should be noted, however, that of the factors set out in bullet points as factors to consider in the latter *Tax Information Bulletin*, only the fifth bullet point is relevant where it is the evasion shortfall penalty that is under consideration.

3. LEGISLATION

3.1 Section 3(1) includes the following definitions:

> **3 Definitions**
>
> (1) In this Act, unless the context otherwise requires,—
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> …
>
> **"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:

3.2 Section 4A sets out how to interpret provisions relating to a taxpayer's tax position and obligations:

4A. Construction of certain provisions—

(1) In this Act—

(a) A provision referring to a tax liability or to a tax obligation, or to something a person must do, refers to a taxpayer's liability or obligation under a tax law:

(b) A provision referring to a taxpayer taking a tax position or to a taxpayer's tax position, also refers to the taxpayer's—

(i) Claiming or returning or not claiming or returning the tax position; or

(ii) Paying or deducting or not paying or deducting an amount of tax; or

(iii) Being placed in the tax position,—

whether knowingly or intentionally or involuntarily:

(c) A provision referring to a tax position taken in a tax return refers to a tax position taken explicitly or implicitly in the tax return:

(ca) A provision referring to a tax position taken in an income statement refers to a tax position taken explicitly or implicitly in the income statement, whether or not the tax position was included by the Commissioner in the income statement:

(d) A provision referring to a taxpayer's obligation to pay an amount of tax refers to the taxpayer's obligation to pay tax to the Commissioner:

(e) A provision referring to a taxpayer's obligation to provide a tax return refers to the taxpayer's obligation to complete and provide the tax return to the Commissioner:

(f) A provision referring to a taxpayer's obligation to provide a tax form refers to the taxpayer's obligation to complete and provide the tax form to the person entitled to it:

(g) A provision referring to any tax (including, for the avoidance of doubt, a penalty) or interest is to be taken to be a reference to all, or part, or the relevant part, of the tax or interest.

(2) For the purposes of this Act—

(a) A company is deemed to make a dividend withholding payment deduction when payment is made to the company of a foreign withholding payment dividend:

(b) A deduction is deemed to be made when payment is made of the net amount of any source deduction payment:

(c) The amount of a deduction described in paragraph (a) or paragraph (b) is deemed to have been applied for a purpose other than in payment to the Commissioner if the amount is not paid to the Commissioner by the relevant due date:

(d) If the amount of a deduction described in paragraph (a) or paragraph (b) is not paid to the Commissioner by the due date, the amount is deemed to be unpaid tax.

(3) References in this Act to tax liabilities in respect of making, or accounting for, deductions of tax under the PAYE rules, to the extent necessary, are also to be construed as including references to liabilities in respect of making, or accounting for,—

(a) Deductions of premiums payable under the Accident Rehabilitation and Compensation Insurance Act 1992 or regulations made under

that Act or the Accident Insurance Act 1998 or a regulation made under that Act; or

(aa) deductions of levies under the Injury Prevention, Rehabilitation, and Compensation Act 2001 or a regulation made under that Act; or

(b) Deductions under the Child Support Act 1991; or

(c) Repayment deductions or other deductions under the Student Loan Scheme Act 1992,—

where the relevant liabilities arise or are to be performed at the same time as the tax liabilities under the PAYE rules.

(4) Where a taxpayer required to provide a return under any of sections NC 15, NF 4, NG 11, and NH 3 of the Income Tax Act 2004—

(a) Furnishes a return that shows a liability to pay tax under that section; and

(b) The tax is required to be paid by a due date for a return period; and

(c) The liability shown in the return is greater than the tax that the taxpayer paid by the due date—

the taxpayer's tax position in respect of the due date is the tax paid and not the amount of tax shown as payable in the tax return.

(5) If a taxpayer does not provide a tax return for a return period, the taxpayer is deemed, in relation to each type of tax, to take, in respect of every due date that would be covered by a tax return for the return period if a return were provided, a tax position that is based on the tax of that type paid by the taxpayer for that return period.

(6) Where—

(a) A provision (in this subsection referred to as ``the relevant provision'') of this Act applies in respect of a taxpayer making an objection to or a challenge in respect of an assessment or other disputable decision, but not to both; and

(b) It is necessary or appropriate for the purposes of another provision of this Act that applies with respect to objections or challenges, but not to both, that the relevant provision apply,—

the relevant provision is to be read as if it referred with respect to both objections and challenges.

3.3 Section 141E imposes a liability for a shortfall penalty in the following terms:

141E Evasion or similar act

(1) A taxpayer is liable to pay a shortfall penalty if, in taking a tax position, the taxpayer—

(a) Evades the assessment or payment of tax by the taxpayer or another person under a tax law; or

(b) Knowingly applies or permits the application of the amount of a deduction or withholding of tax made or deemed to be made under a tax law for any purpose other than in payment to the Commissioner; or

(c) Knowingly does not make a deduction or withholding of tax required to be made by a tax law; or

(d) Obtains a refund or payment of tax, knowing that the taxpayer is not lawfully entitled to the refund or payment under a tax law; or

(da) Attempts to obtain a refund or payment of tax, knowing that the taxpayer is not lawfully entitled to the refund or payment under a tax law; or

(e) Enables another person to obtain a refund or payment of tax, knowing that the other person is not lawfully entitled to the refund or payment under a tax law; or

(f) Attempts to enable another person to obtain a refund or payment of tax, knowing that the other person is not lawfully entitled to the refund or payment under a tax law—

(referred to as "evasion or a similar act").

(2) No person shall be chargeable with a shortfall penalty under subsection (1)(b) if that person satisfies the Commissioner that the amount of the deduction has been accounted for, and that the person's failure to account for it within the prescribed time was due to illness, accident, or some other causes beyond the person's control.

(3) If a taxpayer enables or attempts to enable another person to obtain a refund or payment of tax, knowing that the other person is not lawfully entitled to the refund or payment under a tax law, the taxpayer is liable to pay to the Commissioner an amount equal to the shortfall penalty that would have been imposed if the other person's tax position had been the taxpayer's tax position.

(4) The penalty payable for evasion or a similar act described in subsection (1) is 150% of the resulting tax shortfall.

3.4 Section 141F provides:

141F Commissioner to determine portions in which shortfall penalty payable by taxpayer and officers of taxpayer

(1) If—

(a) A taxpayer is required to make or account for a deduction or withholding of tax under a tax law; and

(b) An officer of the taxpayer fails to make a deduction or withholding of tax under a tax law or applies or permits to be applied the amount of the deduction or withholding of tax other than in payment to the Commissioner,—

one shortfall penalty, calculated in accordance with this Part, may be imposed in respect of each tax position taken by the taxpayer.

(2) If the Commissioner determines that a shortfall penalty is required to be imposed, the Commissioner may determine the portion that each of the taxpayer and the officers is to be liable for that penalty having regard to—

(a) The acts or omissions of the taxpayer and the officers; and

(b) Whether those acts or omissions were reasonable in the circumstances of the case.

4. EVASION OR A SIMILAR ACT

BACKGROUND TO THE SHORTFALL PENALTY FOR EVASION OR A SIMILAR ACT

A tax position

4.1 Section 141E imposes a shortfall penalty for "evasion or a similar act". A shortfall penalty is a penalty imposed as a percentage of a tax shortfall, or deficit or understatement of tax, which results from certain actions on the part of a taxpayer. For a shortfall penalty to apply, a "taxpayer's tax position" must have been taken and have resulted 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. This definition is "without limitation" and, therefore, very broad. This is further indicated by section 4A, which defines the construction of certain provisions, and, in respect of "tax position" provides:

> **4A. Construction of certain provisions—**
>
> (1) In this Act—
>
> (a) A provision referring to a tax liability or to a tax obligation, or to something a person must do, refers to a taxpayer's liability or obligation under a tax law:
>
> (b) A provision referring to a taxpayer taking a tax position or to a taxpayer's tax position, also refers to the taxpayer's—
>
> (i) Claiming or returning or not claiming or returning the tax position; or
>
> (ii) Paying or deducting or not paying or deducting an amount of tax; or
>
> (iii) Being placed in the tax position,—
>
> whether knowingly or intentionally or involuntarily:
>
> (c) A provision referring to a tax position taken in a tax return refers to a tax position taken explicitly or implicitly in the tax return:
>
> (ca) A provision referring to a tax position taken in an income statement refers to a tax position taken explicitly or implicitly in the income statement, whether or not the tax position was included by the Commissioner in the income statement:

4.2 "Tax position" is, thus, a wide term and would appear to encompass all eventualities: it includes acts and omissions (including filing a return or not filing a return) whether involuntary or knowing, and if a return is made it includes implicit as well as explicit tax positions. 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.

The penalty

4.3 The Act divides actions of taxpayers which would result in a tax shortfall into five categories of fault, or breach, with a specified penalty rate for each category. At the extreme end of the scale is behaviour covered by section 141E and subject to a penalty of 150% of the resulting tax shortfall.

4.4 Section 141E(1) imposes a shortfall penalty on a taxpayer who evades the assessment or payment of tax for themselves or others, or who knowingly misapplies a deduction or withholding tax, or who knowingly does not make tax deductions, or who obtains or attempts to obtain a refund for themselves or another knowing there is no entitlement to such a refund. Thus section 141E(1) essentially contains two types of behaviour: the first, in paragraph (a) is evasion; the second type, in the remaining paragraphs of section 141E(1), requires knowledge of the breaches set out in those paragraphs.

4.5 The shortfall penalty of 150% of the resulting tax shortfall is subject to various reductions potentially available under sections 141FB (previous behaviour: 50%), 141FD (shareholders of loss attributing qualifying companies); 141G (voluntary disclosure: 40% or 75%), 141I (temporary shortfall: 75%) 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)) (NB: this item was under review when this Exposure Draft was published; see Exposure Draft ED-0086);

4.6 It should also be noted that where the shortfall penalty results from the failure to make or account for deductions or withholding taxes or from applying those to a purpose other than payment to the Commissioner, there is an ability (section 141F) for the Commissioner to apportion the shortfall penalty between a company taxpayer and its officers involved.

4.7 Unlike the other shortfall penalties, the burden of proving "evasion or a similar act" to which section 141E applies is specifically placed on the Commissioner (section 149A(2)). However, as with the other shortfall penalties, it is a civil penalty and the standard of proof is therefore the balance of probabilities (section 149A(1)).

The relationship of the shortfall penalty with criminal prosecution

4.8 Another unique feature of "evasion or a similar act" is that, as well as giving rise to liability for a shortfall penalty, there is the prospect of a criminal prosecution. Section 143B(2) provides that it is a criminal offence for a person to evade or attempt to evade the assessment or payment of tax by themselves or another. Section 143B(1) covers acts (such as not making tax deductions or providing false returns) which are done either with the intent of evading the assessment or payment of tax, or in order to obtain a refund or payment of tax for themselves or any other person with the knowledge that there is no entitlement to such a refund or payment. The penalty for an offence under section 143B is imprisonment for a term not exceeding 5 years or a fine not exceeding $50,000, or both.

4.9 Criminal liability for the tax deduction offences (misapplying or not making deductions) is imposed by section 143A. It is headed "knowledge offences" and includes the same tax deduction offences in paragraphs 143A(1)(d) and (e) as set out in paragraphs 141E(1)(b) and (c). The penalty for an offence against section 143A is $25,000 for a first offence and $50,000 for subsequent offences. For misapplying deductions there is provision, in some situations, for imprisonment for a term not exceeding 5 years or a fine not exceeding $50,000, or both (section 143A(8)). For these criminal prosecutions the onus of proof is on the Commissioner (section 149A(4)). The standard of proof is beyond reasonable doubt (section 149A(3)).

4.10 Section 149(5) states that the Commissioner may not prosecute a taxpayer for taking an incorrect tax position if a shortfall penalty has been imposed for taking that incorrect tax position. However, section 149(4) specifically provides that the Commissioner can impose civil penalties (which includes the evasion shortfall penalty) after a taxpayer has been prosecuted for an offence under the Act, regardless of whether the prosecution was successful or not.

4.11 It is considered that the reference to whether or not the prosecution was successful is an acknowledgement of the different standards of proof on the Commissioner in this area. As noted above, in criminal prosecutions the Commissioner has the onus of proof to the standard of "beyond reasonable doubt" (see sections 149(3) and 149A(4)). For the shortfall penalty of evasion, the Commissioner has the onus of proof to the standard of "balance of probabilities" (see sections 149A(1) and 149A(2)). Because of this difference, it is possible that the Commissioner may fail to satisfy the evidential standard in a criminal prosecution, yet have sufficient evidence to satisfy the lower threshold of the balance of probabilities for the evasion shortfall penalty.

4.12 In determining whether to impose a shortfall penalty for evasion the Commissioner will consider a number of criteria including:

- Whether the taxpayer has been previously prosecuted and/or been subject to shortfall penalties for evasion;
- The reason given by the taxpayer for his/her behaviour;

- The degree of culpability of the taxpayer;
- The likelihood of future compliance;
- The degree of cooperation received from the taxpayer;
- The effect on promoting voluntary compliance; and
- The duty to protect the integrity of the tax system.

4.13 Where the taxpayer has been prosecuted for evasion the following additional factors will be considered:

- Whether the taxpayer was successfully prosecuted under section 143B of the Act; and
- Comments made by the judge in sentencing the offender (in the event of a successful prosecution).

4.14 Although the Act provides for both civil and criminal forms of evasion, in the remainder of this Interpretation Statement the focus will be on the civil shortfall penalty for "evasion or a similar act" provided for by section 141E(1). The concept of "evasion" in paragraph (a) will be considered first, followed by the knowledge offences in the remaining paragraphs of section 141E(1).

The concept of evasion

4.15 Evasion is unique amongst the shortfall penalties in that it requires *mens rea* or the mental element of intention. This distinction was recognised in *Case W4* (2003) 21 NZTC 11,034 where Judge Barber stated:

> 44 …. "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 [but may not have been foreseen by the taxpayer in question].
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> 45 **It seems to me that if *mens rea* is involved then there must be tax evasion** rather than gross carelessness.
>
> [Emphasis and bracketed words added]

4.16 The need for a mental element was also recognised in an *obiter* comment in *CIR v Peterson* (2002) 20 NZTC 17,589 where Hammond J stated that evasion occurs when a taxpayer **seeks to** reduce tax through fraudulent misrepresentation:

> 30 It has long been recognised that there are three broad categories by which taxpayers may seek to reduce the burden of tax. The first is outright taxation evasion. This is really a form of fraudulent misrepresentation, and is subject to heavy penalties, and even the criminal law.

Mens rea *or the mental element of evasion*

4.17 There is long-standing case law on the specific mental element required to constitute evasion. The requirement is that the taxpayer has endeavoured or intended to avoid the payment of tax. In *Taylor v Attorney-General* [1963] NZLR 261, in relation to section 231 of the Land and Income Tax Act 1954, McGregor J considered the meaning of the word "evade". At page 262 he stated:

> The meaning... most consonant with the intention of the Legislature is that adopted in the High Court of Australia in *Wilson v Chambers Proprietary Ltd.* (1926) 38 C.L.R. 131. In dealing with a section of the Customs Act "No person shall evade payment of any duty which is payable". Higgins J (ibid., 148*)* expresses the view "To say the least 'evade' would seem to **connote the exercise of will in avoiding**; whereas a mere failure to pay may be by accident or mistake". Starke J adverts to the intentional avoidance of payment and says: "Clearly, in my opinion, the word 'evade' in the Act **does not necessarily involve any device or underhand dealing for the purpose of escaping duty; but on the other hand it involves something more than a mere omission or neglect to pay the duty**. It involves, in my opinion, the intentional avoidance of payment in circumstances indicating to the party that he is or may be under some obligation to pay duty. **The circumstances may consist of knowledge, or neglect of available means of knowledge**, that the omission to pay is or may be in contravention of the Customs law' (ibid., 151).
>
> In my view the word "evade" associated with the expressions "attempts to evade" or "does any act with intent to evade" **includes an element of intent** ....This also seems to be in conformity with the view of Knox CJ in the same case, when he says: "The distinction in meaning between the words 'evade' and 'avoid' is well established, and a charge of evading payment is **not made out by evidence which proves no more than that the person charged failed or omitted to pay an amount payable** by him" (ibid.,136).
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> [emphasis added]

4.18 It can be seen from these comments that the taxpayer's intention is relevant in determining whether the person has evaded the assessment or payment of tax. Simply establishing that a person has failed to return or pay tax on an amount will not be sufficient to prove evasion. The intention or *mens rea* element of evasion will be satisfied if the taxpayer knew that their act or omission was in breach of a tax obligation.

Recklessness is sufficient mens rea

4.19 It is clear that intention or actual knowledge will satisfy the *mens rea* element of evasion. In addition, in a number of cases decided under the previous penal tax regime the courts have also held that in some cases recklessness will also satisfy the *mens rea* element of evasion. This is illustrated by Judge Barber in *Case S100* (1996) 17 NZTC 7,626 at page 7,627:

> The respondent accepts that it must prove an intent on behalf of the objector to evade payment of tax and that evade is more than failing or omitting to pay and is more than mere negligence. **However, recklessness can amount to evasion.** A deliberate disregard of one's obligations may amount to recklessness as may an appreciation of a positive risk and proceeding regardless. [Emphasis added]

4.20 For further examples where recklessness has been held to be sufficient to constitute evasion see *Case N6* (1991) 13 NZTC 3,043, 3,046; *Case N53* (1991) 13 NZTC 3,419, 3,420; *Case Q19* (1993) 15 NZTC 5,104, 5,107; and *Case Q20* (1993) 15 NZTC 5,108.

4.21 In considering the meaning of "recklessness" it is helpful to refer to the meaning given to the term in the criminal law. This was the approach taken by Judge Willy in *Case P29* (1992) 14 NZTC 4,213 discussed at paragraph 4.26 below.

4.22 In the criminal law "recklessness" has in the past been given two inconsistent meanings: objective or inadvertent recklessness and subjective recklessness. The general position in the criminal law in New Zealand is that recklessness is to be tested subjectively, unless the context of the legislation requires an objective interpretation. *Adams on Criminal Law* (Brookers, April 2006) at paragraph CA20.24 states:

> **Two meanings of "recklessness"**
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> In modern case law "recklessness" has been given two inconsistent meanings; one requires actual awareness of the risk of committing the alleged offence while the other does not require such awareness. While the first of these has been recognised as the basic meaning of the concept in this country and in other common law jurisdictions, (see CA20.25; *Sansregret v R* (1985) 17 DLR (4th) 577; [1985] 1 SCR 570 (SCC); *R v Smith* (1982) A Crim R 437 (HC); *R v G* [2003] UKHL 50; [2003] 4 All ER 765 (HL)), "inadvertent recklessness" may still be relevant in some contexts. …
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> **(1) Recklessness as the conscious taking of an unreasonable risk**
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> This is commonly described as "subjective recklessness", to emphasise the need for actual awareness, or "Cunningham recklessness", after the first modern English case which clearly adopted this meaning: *R v Cunningham* [1957] 2 QB 396; [1957] 2 All ER 412 (CA). In 1970 a UK Law Commission Working Paper formulated the test as follows:
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> "A person is reckless if, (a) knowing that there is a risk that an event may result from his conduct or that a circumstance may exist, he takes that risk; and (b) it is unreasonable for him to take it having regard to the degree and nature of the risk which he knows to be present."
>
> This was adopted in *R v Stephenson* [1979] QB 695 (CA).
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> **(2) Inadvertent recklessness**
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> In *Commissioner of Police of the Metropolis v Caldwell* [1982] AC 341, also reported as *R v Caldwell* [1981] 1 All ER 961 (HL), the House of Lords had to interpret s 1 Criminal Damage Act 1971 (UK) which makes it an offence to damage property "being reckless" as to whether property would be damaged. The majority held that "reckless" should be given its ordinary meaning, which it held was not confined to cases where the risk was actually foreseen, and that a person is reckless as to whether property would be damaged if (p 354; p 966):
>
> (1) He does an act which in fact creates an obvious risk that property will be damaged; and

> (2) When he does the act he either has not given any thought to the possibility of there being any such risk or has recognised that there was some risk involved and has nevertheless gone on to do it.

4.23 The extract above from *Adams on Criminal Law* notes that subjective recklessness has been recognised as the basic meaning of the concept in this country and in other common law jurisdictions. However, it also notes that inadvertent or objective recklessness may still be relevant in some contexts. This has been confirmed by the Court of Appeal in *R v Harney* [1987] 2 NZLR 576 at 579:

> Subject to the requirements of particular contexts, however, we incline to the view that "recklessly" has usually been understood in New Zealand to have the meaning given in pre-*Caldwell* textbooks [i.e. a subjective meaning].

4.24 *Harney* can be compared with *R v Howe* [1982] 1 NZLR 618, an earlier Court of Appeal case in which an objective meaning of recklessness was adopted. However, it has been suggested that the objective meaning adopted in *Howe* can be attributed to the particular context in which that case was decided and that it does not support the general application of an objective standard in New Zealand (see *Adams on Criminal Law* at paragraph 20.25).

4.25 For other non-tax cases, which support the subjective interpretation of recklessness see *Bottrill v A* [2001] 3 NZLR 622 (CA) at para 170; *R v H* (1989) 4 CRNZ 461, 464 and *R v Stephens* (unreported, High Court, T 91/83, Auckland, 8 December 1983)

4.26 In *Case P29* Judge Willy traversed the taxation case law and the New Zealand criminal law cases on recklessness. Following the case law discussion, he held that recklessness was to be tested subjectively. At page 4,222 he stated:

> Although those expressions of what is the proper test to be applied in New Zealand relate to specific provisions of the Crimes Act I nevertheless think they are of general guidance to this Authority in deciding how to approach questions of recklessness in the context of the objector's obligation to disclose all of his taxable income in any given year. In doing so however it must be borne clearly in mind that there is still an ingredient of moral turpitude in a finding of recklessness. It must never in my view be confused with mere negligence or inattention. Before recklessness can be said to exist some degree of knowledge must be present. As it is put by Mr Simon France in his article "A reckless approach to liability" 1988 18 VUWLR 144 at p 146 the person must:
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> > Have ignored a risk they knew to be present so as to avoid the unpleasantness of having their suspicions confirmed.
>
> Where negligence is alleged no actual knowledge of the relevant matter of fact need be present. For various policy reasons the law of negligence has substituted for actual knowledge of the facts some presumed knowledge which would have been acquired by the use of reasonable foresight. Where recklessness is alleged the Commissioner must prove beyond reasonable doubt that the facts which were actually known to the taxpayer were such that they must have put him on enquiry that the income returned for tax purpose was understated. Faced with those facts the Commissioner must then show that the taxpayer made the conscious decision to ignore them and to return the understated income without making any further enquiry.

> Conclusion
>
> I endeavour to approach the question of whether the objector in this case was reckless having regard to that subjective test.

4.27 Judge Willy's adoption in *Case P29* of the subjective meaning of recklessness is supported by Judge Barber's comment in *Case S100* set out in paragraph 4.19 above, where he states that a deliberate disregard of one's obligations may amount to recklessness. The "deliberate disregard" of an obligation implies that the taxpayer has knowledge of the risk that the obligation exists.

4.28 While *Cases P29* and *S100* support a subjective meaning of recklessness, it is noted that in *Case M117* (1990) 12 NZTC 2,749, a case involving a knowledge offence, Judge Barber made the obiter comment that recklessness should be tested objectively. At page 2,755 Judge Barber stated:

> My analysis of the objector's conduct, as shown by the evidence, does not reveal to me any degree of recklessness. Possibly, she has been rather careless, or even negligent, but she was always concerned about her obligations and failed to meet them through pressures of work and pressures in her personal life and, apparently, due to a certain amount of confusion and muddlement. These aspects are quite inconsistent with recklessness. I was not addressed on the concept of recklessness but it seems helpful to refer to the criminal law. In *R v Caldwell* [1982] AC 341 the House of Lords applied an objective test of whether or not a defendant is shown to have acted recklessly. The New Zealand Court of Appeal applied *Caldwell* in *R v Howe* [1982] 1 NZLR 618, a case involving allegations of riotous damage, and said at p 623: -
>
> > "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."
>
> All in all, the approach of the objector may have been casual, but not to the extent of recklessness.

4.29 Judge Barber's comment in *Case M117* that recklessness is to be tested objectively is based on a brief analysis of *Howe* and *Caldwell*. However, as represented by *Harney* (discussed from paragraph 4.23) the general position in the criminal law in New Zealand is that recklessness is to be tested subjectively, unless the context of the legislation requires an objective interpretation. It is noted that *Case M117* was decided three years after *Harney*. It is unclear why Judge Barber did not refer to this case.

4.30 It is considered that when balanced against *Cases P29* and *S100* and the comments of the Court of Appeal in *Harney* on recklessness in the criminal law, the weight of authority indicates that recklessness is to be tested subjectively for the purposes of the evasion penalty.

4.31 It is considered that based on the case law discussed above subjective recklessness is sufficient to satisfy the *mens rea* requirement of evasion. A taxpayer will be subjectively reckless if the taxpayer avoids tax in

circumstances where the taxpayer knew or strongly suspected that the taxpayer's conduct would breach a tax obligation.

4.32 The next question is whether recklessness is sufficient *mens rea* for evasion under the current penalties regime. Section 141E sets out the current evasion civil penalty:

> **141E Evasion or similar act—**
>
> (1) A taxpayer is liable to pay a shortfall penalty if, in taking a tax position, the taxpayer—
>
> (a) **Evades** the assessment or payment of tax by the taxpayer or another person under a tax law; or
>
> (b) **Knowingly** applies or permits the application of the amount of a deduction or withholding of tax made or deemed to be made under a tax law for any purpose other than in payment to the Commissioner; or
>
> (c) **Knowingly** does not make a deduction or withholding of tax required to be made by a tax law; or
>
> (d) Obtains a refund or payment of tax, **knowing** that the taxpayer is not lawfully entitled to the refund or payment under a tax law; or
>
> (da) attempts to obtain a refund or payment of tax, **knowing** that the taxpayer is not lawfully entitled to the refund or payment under a tax law; or
>
> (e) Enables another person to obtain a refund or payment of tax, **knowing** that the other person is not lawfully entitled to the refund or payment under a tax law; or
>
> (f) attempts to enable another person to obtain a refund or payment of tax, **knowing** that the other person is not lawfully entitled to the refund or payment under a tax law—
>
> (referred to as "evasion or a similar act").
>
> (2) No person shall be chargeable with a shortfall penalty under subsection (1)(b) if that person satisfies the Commissioner that the amount of the deduction has been accounted for, and that the person's failure to account for it within the prescribed time was due to illness, accident, or some other cause beyond the person's control.
>
> (3) If a taxpayer enables or attempts to enable another person to obtain a refund or payment of tax, knowing that the other person is not lawfully entitled to the refund or payment under a tax law, the taxpayer is liable to pay to the Commissioner an amount equal to the shortfall penalty that would have been imposed if the other person's tax position had been the taxpayer's tax position.
>
> (4) The penalty payable for evasion or a similar act described in subsection (1) is 150% of the resulting tax shortfall.
>
> [Emphasis added]

4.33 From the words of section 141E(1) it can be seen that the evasion penalty is a knowledge offence. The evasion penalty is imposed upon a taxpayer who evades or knowingly commits an action that affects their liability to pay tax. It is noted that the current penalty regime continues to use the word "evade".

This word has not been defined under either regime, although the courts have discussed the meaning of the word in cases decided under the previous regime (see paragraph 4.19 above). It is considered that the word "evade" in section 141E(1)(a) has the same meaning as it did in the previous regime in section 420 of the Income Tax Act 1976 and that the case law on the meaning of "evades" will continue to apply under the current regime.

4.34 In *Cases P29* and *S100* (discussed at paragraphs 4.26 and 4.27), which were decided under the previous penal tax regime, it was held that subjective recklessness is sufficient *mens rea* for evasion. It is considered that the reasoning underlying these decisions will also apply to evasion under the current penalties regime as the term "evasion" continues to be used in section 141E.

4.35 In addition, the conclusion that the recklessness must be subjective is supported by paragraphs (b) to (f) of section 141E(1), which each deal with an act committed with the knowledge that the act is unlawful. This knowledge requirement is consistent with a subjective approach to recklessness in section 141E(1)(a). That the recklessness must be subjective is also supported by non-tax case law. This non-tax case law has held that the general position is that recklessness is to be tested subjectively unless the context requires otherwise (see discussion from paragraph 4.22). The context of section 141E does not require an objective approach. Rather the context of section 141E, and in particular the knowledge requirement discussed above, supports a subjective approach to recklessness.

4.36 It is considered that subjective recklessness will continue to be sufficient *mens rea* for evasion under the current penalty regime.

Relationship between evasion and gross carelessness

4.37 Having concluded that subjective recklessness is sufficient *mens rea* for evasion under section 141E, the final matter to resolve is the interaction between the evasion and gross carelessness shortfall penalties in respect to recklessness. There is potential for some confusion as to the interaction between these penalties, which is highlighted by Judge Barber's comments in *Case W4* (2003) 21 NZTC 11,034 that "gross carelessness must be something similar to recklessness".

4.38 Section 141C sets out the gross carelessness civil penalty:

> **141C 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.

4.39 It is considered that gross carelessness is similar to objective recklessness. Doing or not doing something in a way that suggests a "high level of disregard for the consequences" could be regarded as reckless. In addition, the words "in all the circumstances" and "suggests or implies", suggest the application of a reasonable person test. Under this wording it appears that the person need not actually have a high level of disregard for the consequences. The definition simply requires that after considering all the circumstances, the taxpayer's conduct "suggests or implies" a high level of disregard for the consequences.

4.40 It is considered that when Judge Barber made the statement in *Case W4* that "gross carelessness must be something similar to recklessness" he was comparing gross carelessness with ***objective*** recklessness. In interpreting the term "gross carelessness" Judge Barber adopted an objective test. At paragraph 44 he stated:

> The term "gross carelessness" for the purposes of the penalties provisions of the Act is defined in s 141C(3) as "doing or not doing of something in a way that, in all the circumstances, suggests or implies a complete or high level of disregard for the consequences". I agree with Ms Parkash 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.**
>
> [Emphasis added]

4.41 Given that Judge Barber adopted an objective test in interpreting the term "gross carelessness", his subsequent statement that gross carelessness must be something similar to recklessness is considered to have been referring to ***objective*** recklessness. This is confirmed by his subsequent comments that if *mens rea* is involved, there is evasion not gross carelessness. Judge Barber stated:

> It seems to me that if mens rea is involved then there must be tax evasion rather than gross carelessness. The defendant seems to accept that, in this case, there was no mens rea or the mental element of intention. While I accept that stance of the defendant, I find it rather generous.

4.42 Judge Barber also found the Commissioner's acceptance that there was no *mens rea* in *Case W4* "rather generous".

4.43 The concept of recklessness can be relevant to both evasion and gross carelessness. Where the taxpayer is subjectively reckless, that is, where the taxpayer strongly suspects that their conduct will result in a breach of a tax obligation and proceeds regardless, this is sufficient *mens rea* for evasion. However, if the taxpayer is objectively reckless; that is, the taxpayer is genuinely unaware that their conduct has created a high risk of a tax shortfall, but the risk and its consequences would have been foreseen by a reasonable person in the circumstances, then this will give rise to a shortfall penalty for

gross carelessness. This is consistent with paragraph 1.2 of the Gross Carelessness Statement published in *Tax Information Bulletin* Vol 16, No 8 (September 2004).

> "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.

4.44 A person who is subjectively reckless in taking a tax position could in some situations satisfy the criteria for both a shortfall penalty for gross carelessness and a shortfall penalty for evasion. Subjective recklessness is likely to satisfy the gross carelessness standard as well as the mental element required for evasion. In such situations, subsections (2) and (3) of section 149 will apply. Subsection (2) states that the taxpayer can only be liable for one shortfall penalty for each tax shortfall and subsection (3) states that the highest penalty will apply. Therefore, if the taxpayer is potentially liable for both evasion and gross carelessness, only the evasion shortfall penalty will apply.

4.45 Thus, subjective recklessness is sufficient *mens rea* for evasion to exist. Recklessness is the conscious taking of a risk; knowing the facts and choosing to ignore them or the need to be on enquiry to which they give rise. If the taxpayer strongly suspects an obligation may exist but does not investigate further before taking a tax position this could amount to recklessness and evasion if a tax shortfall results. By contrast, if the taxpayer is honestly unaware of (and has no reason to be on enquiry as to) an obligation so has no intention to endeavour to avoid it, the penalty for evasion will not apply (although the gross carelessness or lack of reasonable care penalties may).

Proving intent

4.46 As mentioned earlier, the burden of proof is on the Commissioner and the standard is that of the balance of probabilities. This means the Commissioner must prove that it is more likely than not that the taxpayer had the requisite mens rea for evasion. This mens rea requires that the taxpayer knew or strongly suspected that the taxpayer's course of conduct would breach a tax obligation. The test for evasion is a subjective test – it must be proved that the particular taxpayer had certain knowledge, but it can be tested objectively. In other words the requisite knowledge or intention may be inferred through an objective analysis of the surrounding circumstances and conduct.

4.47 In *Lloyds Bank Ltd v Marcan* [1973] 2 All ER 359, the Court stated at page 367-8:

> The word 'intent' denotes a state of mind. A man's intention is a question of fact. Actual intent may unquestionably be proved by direct evidence or may be inferred

> from surrounding circumstances. Intent may also be imputed on the basis that a man must be presumed to intend the natural consequences of his own act: see the judgments of Lord Hatherley LC and Giffard LJ in *Freeman v Pope.*

4.48 In *Case H90* (1986) 8 NZTC 619 at 624 Barber DJ made a similar statement regarding inferring intent:

> … recklessness may amount to intention and that intent can be inferred by reference to such factors as the taxpayer's background and business experience. Evasion includes an element of intent, and actual knowledge can be established by direct evidence or by inference.

Evasion– summary

4.49 In summary, evasion:

- Occurs when a taxpayer breaches a tax obligation and the taxpayer knew or strongly suspected that the taxpayer's conduct would result in that breach:
- Requires intentional behaviour or subjective recklessness.

Similar acts

4.50 As mentioned earlier, section 141E(1) essentially contains two types of behaviour. The first is evasion, which is set out in paragraph (a). The second type is set out in the remaining paragraphs of section 141E(1) and requires that the breaches set out in those paragraphs occurred "knowingly". It is this knowledge requirement that makes a breach of one of these paragraphs a "similar act" to evasion. Evasion requires knowledge in that the taxpayer must know or strongly suspect that their conduct will result in the breach of a tax obligation.

"Knowingly"

4.51 The concept of "knowingly" has been discussed in a recent case. *Case W3* (2003) 21 NZTC 11,014 concerned PAYE deductions made by the taxpayer but applied for a purpose other than payment to the Commissioner (section 141E(1)(b)). It was held that the taxpayer had done so knowingly, and Judge Barber made the following observations on "knowingly":

> [53] …. It is not seriously in dispute that this was done "knowingly" in terms of s 141E(1)(b) so there is little point in my traversing the case authorities cited on that concept. However, in looking at that concept, it is settled law that the test of knowledge is subjective, refer *Meulen's Hair Stylists Ltd v C of IR* [1963] NZLR 797 (SC); and that negligence or carelessness are insufficient to satisfy the test of "knowingly" , refer *Meulen's* case and *Godfrey Allan Ltd v C of IR* (1980) 4 NZTC 61,548 (HC). Actually, that is consistent with the current shortfall penalty regime which has separate shortfall penalties for "lack of reasonable care" and "carelessness". The test is whether the failure to account for PAYE was something known to the defendant to have occurred. Recklessness as to whether the PAYE has been paid is sufficient to amount to a known failure to pay — refer *Case R31* (1994) 16 NZTC 6,171. Knowledge of the existence of the facts in question without knowledge of the unlawfulness of an act will be sufficient —

> refer *C of IR v Gordon* (1989) 11 NZTC 6,082 (HC). Knowledge of a responsible officer of a taxpayer company may be attributed to the company — refer *Meulens* case.

4.52 It is worth considering the point regarding the *Gordon* case referred to by Judge Barber. There it was held that as the taxpayer's conduct was only considered to be that of carelessness and failure to interest himself in his obligation to account for tax deductions in that case, it could not be shown that he had "knowingly" done so in terms of section 368(1)(b) of the Income Tax Act 1976. Jeffries J held that there had to be knowledge of the facts relating to the act that was required to be done, but that knowledge that the law made it an offence was not necessary. He stated at page 6,084:

> In my view the word "knowingly", as used in the section, imports only a knowledge of the existence of the facts in question, when those facts are such as bring the act within the provision of the law. The word does not require in its meaning any knowledge of the unlawfulness of such acts. See *CIR v Orme* (1984) 6 NZTC 61,831; (1984) 8 TRNZ 129. A requirement of knowledge does not mean that the act must be done with any specific intent.

4.53 For example, in *Meulens* it was stated at page 799:

> In my opinion if the prosecution proved in each case (not necessarily by direct evidence, which would usually be quite unobtainable but at least by necessary inference from proved facts) that on the 21st day of the relevant month the appellant company, by some responsible officer, had knowledge that a payment was due on the preceding 20th and that it had not then been paid that would clearly be sufficient to establish that the appellant knowingly failed to make the payment.

4.54 Although *Case W3* was on paragraph (b) of section 141E(1), the observations on "knowingly" are applicable to all the paragraphs of section 141E(1) which use that term. It can be seen that many of the points made are consistent with the discussion above on "evasion", however, unlike evasion it does not require any "blameworthy" intent to breach a law that is either known or suspected to exist. "Knowingly":

- requires knowledge of the doing of the act (or of the omission) that amounts to a breach;
- is a subjective test;
- can be satisfied by recklessness, but
- negligence or carelessness is insufficient to satisfy the test.

Paragraph (b) of section 141E(1)

4.55 Paragraph (b) imposes a shortfall penalty on a taxpayer who knowingly applies or permits the application of the amount of a deduction or withholding of tax made or deemed to be made under a tax law for any purpose other than in payment to the Commissioner. As was said in *Case W3* (paragraph 47), three elements must be satisfied before a taxpayer's liability for a shortfall penalty for failure to account for PAYE deductions can be established; namely, he or she must have taken a "tax position", applied or permitted the

application of PAYE deductions for a purpose other than in payment to the Commissioner, and done so knowingly. Barber DJ went on to note that the first two elements are easily satisfied:

> [48] The relevant tax law is s NC 15(1)(c) of the Income Tax Act 1994 which states that the disputant is required to make PAYE deduction payments to the defendant. The disputant made the relevant deductions from the wages of employees and was therefore required to pay same to the defendant but failed to do so. Refraining from filing a return or from making payment of an amount of tax constitutes taking a "tax position" for the purposes of s 141E. It is clear from s 4A(1)(b)(ii) of the TAA that non-payment of PAYE to the defendant by the due date is the taking of a tax position. Further, s 4A(2)(d), together with (b), deems a deduction to be unpaid tax if not paid by the due date. By failing to pay the PAYE deductions by the due date, the defendant has taken a tax position and that is so with a failure to pay any amount of tax.
>
> ….
>
> [53] In accordance with s 4A(2)(c) it is deemed that all those failures to pass on PAYE have been applied for a purpose other than in payment to the defendant.

4.56 The tax position element has been discussed earlier in this statement (see paragraphs 4.1 and 4.2) where the breadth of that term and consequent ease of satisfying it is discussed. In terms of tax positions relating to the deduction offences (such as section 141E(1)(b)) it is worth discussing Judge Barber's reference to "s 4A(2)(d), together with (b)". These are construction provisions which state that a deduction is deemed to be made when payment of any net source deduction payment occurs and, if such a deemed deduction is not paid to the Commissioner by due date it is deemed to be unpaid tax. As mentioned earlier, the section 3(1)(a) definition of "tax position" includes a liability for the payment of an amount of tax, and thus the effect of these construction provisions is that a tax position has been taken.

4.57 Similarly, the second element (that the taxpayer has applied or permitted the application of the amount for any purpose other than in payment to the Commissioner) is satisfied by a deeming provision. Section 4A(2)(c) provides that deemed deduction payments are deemed to have been applied for a purpose other than in payment to the Commissioner. The effect of these construction provisions is that the only element that remains to be proved when section 141E(1)(b) is considered is whether the element of "knowingly" has been met.

4.58 "Knowingly" has been discussed above: it requires knowledge (or subjective recklessness) of the doing of the act (or of the omission) that amounts to a breach. In *Case W3* Judge Barber said (paragraph 53):

> It is settled law that the test of knowledge is subjective, refer *Meulen's Hair Sylists* [sic] *Ltd v CIR* [1963] NZLR 797 (SC); and that negligence or carelessness are insufficient to satisfy the test of "knowingly", refer *Meulen's* case and *Godfrey Allan Ltd v CIR* (1980) 4 NZTC 61,548 (HC)… The test is whether the failure to account for PAYE was something known to the defendant to have occurred. Recklessness as to whether the PAYE has been paid is sufficient to amount to a known failure to pay - refer *Case R31* (1994) 16 NZTC 6,171. Knowledge of the existence of the facts in question without knowledge of the unlawfulness of an act

> will be sufficient - refer *CIR v Gordon* (1989) 11 NZTC 6,082 (HC). Knowledge of a responsible officer of a taxpayer company may be attributed to the company - refer *Meulens* case.

Statutory defence to section 141E(1)(b)

4.59 Section 141E(2) provides no shortfall penalty is chargeable under section 141E(1)(b) if the taxpayer establishes that the PAYE deduction has been accounted for and the failure was due to illness, accident, or some other cause beyond their control. The section states that the taxpayer must "satisfy" the Commissioner that the failure was due to illness. Therefore, the burden of proving the defence is on the taxpayer. The standard of proof is the balance of probabilities (section 149A(1)).

4.60 This defence was raised in *Case W3* where the taxpayer stated the reason he had not paid over the PAYE deductions was due to the Commissioner not releasing a GST refund. Judge Barber traversed case law establishing that a cause beyond the person's control does not refer to liquidity problems:

> [61] It is settled law that liquidity problems are not a matter coming within the confines of provisions equivalent to s 141E(2): refer *Driscoll v C of IR* (1984) 6 NZTC 61,861(HC), *Hammond v Walesby and Paramount Graphics Limited* (1986) 8 NZTC 5,185(HC), and *C of IR v JF McCormick Ltd* [1964] NZLR 56 in particular. These cases show that liquidity problems in general do not constitute a cause beyond the employer's control. This must be particularly so where a taxpayer makes payments of tax deductions with the knowledge that bank overdraft limits are being exceeded as was the case with the present disputant. ….

4.61 The High Court case *C of IR v Joy Wright Ltd* (1984) 6 NZTC 61,788 dealt with the defence for illness. The taxpayer company in that case was charged with knowingly applying PAYE tax deductions for a purpose other than in payment to the Commissioner (under the then effective provision, section 368(3) of the Income Tax Act 1976). Its defence was that the principal officer of the company was in a depressed state due to family and business worries and so the failure was due to illness or other cause beyond the officer's control. The defence was successful in the District Court and on appeal. In dismissing the Commissioner's appeal from the acquittal, Gallen J stated at page 61,790:

> There is very little authority on the interpretation of the section concerned. In *C of IR v JF McCormick Ltd* [1964] NZLR 56, Macarthur J held that the words "illness, accident or other cause beyond his control" appearing in the equivalent section of the Act then in force were not to be construed *ejusdem generis* and that therefore the words "beyond his control" were not to be interpreted in some way as pertaining to illness or accident. He did, however, hold that **that particular defence was only available when it was proved that a situation existed where there was some cause beyond the defendant's control which prevented him from paying** to the Commissioner moneys already held by him and impressed with a trust in favour of the Crown. …
>
> In essence, I consider the situation will always be a matter of degree and will depend upon a factual finding that circumstances existed whereby there was a **direct causal connection between the circumstances put forward as a defence and failure to pay**. .....

> [I]n this case the learned District Court judge clearly found as a fact that the **depressive illness of the principal officer of the respondent resulted in her being unable to integrate her activities sufficiently to carry out that part of her business responsibility which related to the accounting to the Commissioner of Inland Revenue for PAYE deductions**. This is a finding of fact made after hearing the evidence. Clearly he accepted that the degree of disability was sufficient to bring the respondent within the provisions of the proviso to the section. I consider he was entitled so to find.
>
> [Emphasis added]

4.62 The following can be distilled from the words of section 141E(2) and the case law:

- The amount of the deduction must have been accounted for to the Commissioner before the defence can apply;
- There must be a direct causal connection between the circumstances put forward as a defence and the failure to pay; and
- A lack of funds (including due to awaiting payment from the Commissioner on other matters) does not establish the defence.

Apportionment of the penalty

4.63 Section 141F(2) provides that the Commissioner may apportion a shortfall penalty between the taxpayer (for example, a company) and the officer of the taxpayer involved in failing to make or account for a deduction, or in misapplying or permitting misapplication of a deduction. "Officer" is defined (albeit in an inclusive manner) in section 3(1) as:

> for the purposes of sections 89C, 141F, 141G, 142C, and 147 and the definition of "taxpayer" in section 157(10), in relation to a corporate body, includes -
>
> (a) A director or secretary or other statutory officer of the corporate body:
>
> (b) A receiver or a manager of any property of the corporate body, or a person having powers or responsibilities, similar to those of such a receiver or manager, in relation to the corporate body:
>
> (c) A liquidator of the corporate body:

4.64 Section 141F(2) provides that in deciding the apportionment regard is to be had to:

> (a) The acts or omissions of the taxpayer and the officers; and
>
> (b) Whether those acts or omissions were reasonable in the circumstances of the case.

4.65 There is no case law on the section, but it may be relevant to note the following. Despite a submission in relation to section 141F being made by the Institute of Chartered Accountants of New Zealand that:

- the maximum penalty applicable to the officer who commits the offence should be specified, and

- if no such specification is made, guidelines should be provided on how the Commissioner will undertake the apportionment,

the Officials in the *Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* (1997) (to whom the submission was made) declined to make any such specification or provide such a guideline. The reasoning was given as follows (at page 39 of the report):

> The legislation clearly sets out the criteria to be used to determine how any shortfall penalty should be apportioned. The criteria are the relative actions or omissions of the taxpayer and the officers and whether those acts or omissions were reasonable.
>
> We see no reason to limit the potential penalty imposed on an officer beyond the natural limit of the size of the penalty being imposed. There may be cases where it is appropriate that the officer face a significant penalty, which might be prevented from being imposed if a cap were introduced.

4.66 Thus, while there is not any guidance given by case law (as there is no case law on the section) and not a great deal of specificity in section 141F, it is clear that significant penalties to the officers involved were envisaged, and that in determining the apportionment what is to be considered is the relative actions or omissions of the taxpayer and the officers involved, and the reasonableness of those actions or omissions. Where more than one officer is involved, the reasonableness of the acts or omissions of each officer will be considered with a view to establishing whether an apportionment of the penalty between the various officers to take into account relative culpability is appropriate.

4.67 It might be thought that as it is the taxpayer's (ie. the company's) tax liability, the taxpayer is primarily responsible and if the taxpayer has taken no action to monitor the actions of its officers then it is liable for the entire penalty. However, this is not what the legislation and background material indicates. In each case, the acts or omissions of both the taxpayer **and** the officer are to be considered; it is their relative culpability that will determine the apportionment of the penalty. Therefore, even in a situation where the taxpayer (company) is at fault through not having set up monitoring processes, the nature or character of the actions or omissions of the officer could result in part of the penalty being imposed on him or her.

The remaining paragraphs of section 141E(1) and subsection (3)

4.68 The remaining paragraphs of section 141E(1) describe other acts or omissions that will be subject to a shortfall penalty for evasion. When the application of one of the other paragraphs of section 141E(1) is considered, all that must be decided is whether the specified breach (act or omission) occurred, and whether it has occurred "knowingly", which requires only knowledge of, or recklessness towards, the doing of the act (or of the omission) that amounts to the breach.

4.69 The remaining paragraphs of section 141E(1) provide that the following acts or omissions are offences. The knowledge requirement of each paragraph is emphasised.

> (c) **Knowingly** does not make a deduction or withholding of tax required to be made by a tax law; or
>
> (d) Obtains a refund or payment of tax, **knowing** that the taxpayer is not lawfully entitled to the refund or payment under a tax law; or
>
> (da) Attempts to obtain a refund or payment of tax, **knowing** that the taxpayer is not lawfully entitled to the refund or payment under a tax law; or
>
> (e) Enables another person to obtain a refund or payment of tax, **knowing** that the other person is not lawfully entitled to the refund or payment under a tax law; or
>
> (f) Attempts to enable another person to obtain a refund or payment of tax, **knowing** that the other person is not lawfully entitled to the refund or payment under a tax law –

4.70 Paragraph (c) will apply if taxpayer knowingly does not make a deduction or withholding of tax that is required to be made under a tax law.

4.71 Paragraphs (d), (da), (e), and (f) relate to the obtaining of a refund or payment of tax, knowing that there is no entitlement to that refund or payment of tax. Paragraphs (d) and (da) provide that the penalty will apply whether or not the taxpayer is successful in obtaining the refund or payment of tax. Paragraphs (e) and (f) provide that the penalty will also apply to a person who enables or attempts to enable another person to obtain a refund or payment of tax.

4.72 Section 141E(3) quantifies the shortfall penalty imposed on a taxpayer who enables, or attempts to enable, another person to obtain a refund or payment of tax, knowing that the other person is not lawfully entitled to that refund or payment of tax. For the purposes of section 141E(3) the tax position of the taxpayer for whom the refund or payment was sought is treated as being the tax position of the enabling taxpayer. This tax position is then used to calculate the shortfall penalty for evasion that is imposed on the enabling taxpayer.

4.73 This means that two penalties could potentially be imposed in these situations. One penalty could be imposed on the person for whom the refund or payment was sought, and a second penalty could be imposed on the enabling taxpayer.

Examples

4.74 The following examples illustrate the application of the "evasion or a similar act" shortfall penalty. The focus of these examples is on whether the facts constitute "evasion or a similar act". Therefore, it can be assumed that the taxpayer has taken a tax position which has resulted in a shortfall, and this point (and any potential application of the variation in penalty provisions) will not be discussed in the examples. There are further examples in *Tax Information Bulletin* Vol 8, No 7 (October 1996).

Example 1

Mrs A, a small-business person, does not include several items of income in her accounts or tax return as she feels she cannot afford to pay tax on this income.

Should a shortfall penalty for evasion be imposed?

Here, the intention or *mens rea* element of evasion is met, as Mrs A is breaching a known tax obligation.

Example 2

Mr B, who had been teaching overseas, returned to New Zealand leaving $300,000 invested in the country in which he had been living. He had been told by the investment company at the time of investing the money that the investment was tax free within that country and New Zealand. For some time after his return to New Zealand he continued to hold that view. He did not mention the investment income when filing his New Zealand tax returns for the next 10 years. During these 10 years, he said he had gradually become unsure as to whether the income was taxable. The uncertainty, he said, had come from discussions with friends, where he had been given two differing viewpoints. He said he thought perhaps he was not liable for tax, but as time went on his doubts grew. He said that after making further enquiries in about year 5 he was almost certain that the investment income was taxable, but by that stage he was too afraid of the financial consequences of contacting the Department.

Should a shortfall penalty for evasion be imposed?

The intention or *mens rea* element of evasion relates to breaching a known tax obligation or a tax obligation which the taxpayer strongly suspects may exist. Initially there is no intent to evade a known or suspected obligation, so the behaviour does not amount to evasion, although the taxpayer may be liable to a gross carelessness penalty. However, the behaviour later crosses the borderline into evasion. Here, from at least year 5, Mr B strongly suspected an obligation may exist but he chose not to investigate further (for example, by making enquiries of the Department or getting advice from an accountant or lawyer) as he did not want to have his suspicions confirmed. He chose to close his eyes to this issue by deliberately and intentionally refraining from taking any steps to discover the tax status of the income he received. This disregard of a suspected obligation from at least year 5 amounts to subjective recklessness which is sufficient *mens rea* for evasion.

Example 3

Ms C was one of three shareholders and directors of a company which had operated a garden centre from 1993. Ms C had always been the person who prepared and filed the company's PAYE returns. From April this year until October (when it ceased trading) the company's PAYE returns which it filed

were not accompanied by payments. Ms C states that full disclosure has been made to Inland Revenue as to the correct PAYE amounts payable on PAYE returns filed, so she was not trying to evade tax. Ms C also states that since her return from Malaysia in March she has been suffering from a rare disease she contracted there which makes her confused at times and generally has put her under significant stress.

Should a shortfall penalty under section 141E(1)(b) be imposed?

Section 141E(1)(b) imposes a shortfall penalty on a taxpayer who knowingly applies or permits the application of the amount of a deduction or withholding of tax made or deemed to be made under a tax law for any purpose other than in payment to the Commissioner. As discussed earlier in this interpretation statement, the elements of this offence, other than "knowingly", are easily established by virtue of deeming provisions that exist in the Act. The key element is therefore "knowingly". This requires only knowledge of the doing of the act (or of the omission) that amounts to a breach, not any specific (such as evasive) intent. It also does not require knowledge that the act (or omission) amounts to a breach of law, merely that the act (or omission) occurred. The question here then, is whether Ms C (and, therefore, the company for which she is a responsible officer) knew she had failed to make a payment of the PAYE due to the Commissioner. As Ms C normally completes the PAYE returns, it can be inferred that she (and therefore the company) knew that payments were due each month. She also had filed returns for the months in question, and so had knowledge that payments were due in respect of those months.

In this respect it is noted that the fact she did continue to file returns and conduct other business suggests that the disease and stress did not affect her ability to function to the extent that it could be said she did not act "knowingly". While a lapse in concentration occasioned by the stress or the confusion brought on by the disease could be a plausible explanation for a single lapse, this was repetitive and, therefore it can be inferred, knowing behaviour. It can be concluded that Ms C knowingly failed to make the payments.

The next issue is whether the section 141E(2) exclusion applies to prevent section 141(1)(b) applying. For this defence to apply the deductions must since have been paid to the Commissioner, which they have not been. However, assuming they had been, it must be shown that the illness caused the failure to pay the PAYE deductions. Here, when the illness is weighed with the other evidence, it has not been shown that it was the illness which was responsible for the failures. Despite the illness Ms C managed to prepare and file the returns and continue other operations of the company, and while a lapse in concentration or confusion could be a plausible explanation for a single lapse, this was repetitive and, therefore it can be inferred, deliberate behaviour occasioned by something other than confusion. The defence is not an ongoing one, and if Ms C felt unable to prepare and file such returns there was ample time for her to arrange for someone else such as an accountant to

do it instead. Accordingly, the defence under section 141E(2) is not available to the company.

How should the penalty be apportioned between the company and Ms C?

The starting point under section 141E(1)(b) is that the penalty is imposed on the company. However, section 141F(2) allows the Commissioner to apportion certain penalties imposed on a taxpayer between the taxpayer and an officer of the taxpayer. Section 141F(2) can apply where the taxpayer is required to make or account for a deduction or withholding of tax and an officer of the taxpayer fails to do so. In this example, section 141F(2) would allow the Commissioner to apportion the shortfall penalty that the company is liable for under section 141E(1)(b) between the company and Ms C.

To determine the portions that the company and Ms C are to be liable for, it is necessary to consider the *relative* actions or omissions of the company and Ms C and whether they were reasonable. The history and experience of both will be relevant. Here, this was ongoing and deliberate behaviour by Ms C not to pay the PAYE deductions to the Commissioner for a period of 7 months, not a one-off misunderstanding. The company too, however, may be considered blameworthy in not having any systems in place to check such behaviour i.e. the lack of realisation by the other two shareholders and directors as to what was going on over such a prolonged period. Taking into account the deliberateness of Ms C's actions and the company's lack of systems to check such behaviour, it could be considered that Ms C and the company were equally to blame for the shortfall. In this situation, the Commissioner could therefore consider it reasonable to apportion the penalty 50:50.