Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTOTANGA WHAKATAU Ā-TURE> WHAKAWĀ

GST input tax deductions, income tax deductions, understated income, shortfall penalties

Decision date | Te Rā o te Whakatau: 5 November 2021

Issue date | Te Rā Tuku: 14 April 2022

TDS 22/06

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This document is a summary of the original technical decision so it may not contain all the facts or assumptions relevant to that decision.

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Subjects | Ngā kaupapa

GST: Input tax deductions; Income tax: Deductions, understated income; TAA: Shortfall penalties.

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer and Compliance Services, Inland Revenue
Commissioner or CIR	Commissioner of Inland Revenue
GST	Goods and services tax
GSTA	Goods and Services Tax Act 1985
ITA	Income Tax Act 2007
TAA	Tax Administration Act 1994
TCO	Tax Counsel Office, Inland Revenue

Taxation laws | Ngā ture tāke

The legislation considered in this document is:

- Goods and Services Tax Act 1985 (**GSTA**);
- Income Tax Act 2007 (**ITA**); and
- Tax Administration Act 1994 (**TAA**).

Facts | Ngā meka

1. The Taxpayer is a company that provides business advisory and consultancy services. The Taxpayer argued that it and its sole director and shareholder (the Director) were also directors of Company A which is part of a company group. Company A was placed into voluntary liquidation during the income tax period under dispute.

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2. The Director filed the Taxpayer's two 6-monthly GST returns and an income tax return that were subject to the dispute.

3. Following an analysis of the information requested from the Taxpayer, Customer and Compliance Services, Inland Revenue (**CCS**) considered that the Taxpayer may have claimed input tax deductions and income tax deductions it was not entitled to and may have understated its income in its income tax return.

Issues | Ngā take

4. The main issues considered were:

   - whether the Taxpayer was entitled to the input tax deductions it claimed in its GST returns;
   - whether the Taxpayer was entitled to the deductions it claimed in its income tax return;
   - whether the Taxpayer included all of its income in its income tax return;
   - whether the Taxpayer was liable for the following shortfall penalties:
     - gross carelessness;
     - not taking reasonable care; or
     - unacceptable tax position.

5. A preliminary issue on the onus and standard of proof was also considered.

Decisions | Ngā whakatau

6. The Tax Counsel Office (**TCO**) decided that:

   - the Taxpayer was not entitled to claim the input tax deductions in dispute in its GST returns;
   - the Taxpayer was not entitled to claim the deductions in dispute in its income tax return, except for an amount of interest paid on loans;
   - the Taxpayer understated the income amount in its income tax return;
   - the Taxpayer met the requirements for all the proposed shortfall penalties. In such cases, the highest penalty is imposed. The Taxpayer was liable to pay a shortfall penalty for gross carelessness.

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Reasons for decisions | Ngā take mō ngā whakatau

Preliminary issue | Take tōmua: Onus and standard of proof

7. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]

8. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is "more likely than not".[5] Whether the Taxpayer has discharged the onus of proof is considered in the other issues.

Issue 1 | Take tuatahi: Input tax deductions

9. In Issue 1, all legislative references are to the GSTA unless stated otherwise.

10. The Taxpayer claimed input tax deductions for goods and services it acquired, including insurance, motor vehicle expenses, lunches, valuation and purchase of assets. No further explanation of these items was provided by either party.

11. CCS argued that due to the lack of documentation, particularly tax invoices, the Taxpayer did not discharge its onus to show that the Commissioner's assessments were wrong.

12. The calculation of GST payable by a registered person is set out in s 20. Briefly, the input tax that a registered person has paid for acquiring goods and services for making taxable supplies can be offset against the GST output tax payable on taxable supplies made by the person in the same period.

13. To deduct input tax on a supply, the following requirements must be met:

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[1] Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the TRA or a court) are civil proceedings.

[2] Section 149A(2) of the TAA.

[3] *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

[4] Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

[5] *Miller v Minister of Pensions* [1947] 2 All ER 372, 374.

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- Goods or services must have been acquired. It is not enough that a payment to a registered person is identified, it must have sufficient connection to the supply of goods and services.[6]
- The goods or services acquired must have been used for, or available for use in, making taxable supplies (s 20(3C)).[7]
- The taxpayer must have held the relevant tax invoices when the input tax deductions were claimed (s 20(2)(a)).
- The tax invoice must generally satisfy the requirements for a "tax invoice" (ss 24(3) or 24(4)). The requirement for a tax invoice is an evidential requirement of the GSTA to ensure real supplies are being made which are within the GST base.[8]
- It is not enough that the taxpayer merely shows there was a supply made to them. It must go further and provide sufficient particulars of the supply, generally in a tax invoice.[9]
- In some circumstances, an input tax deduction can be claimed without a tax invoice. These include where:
  - A tax invoice is not required for supplies made for a consideration of $50 or less (s 24(5)).
  - The Commissioner has provided a waiver under s 24(6).
  - There is a supply of second-hand goods to which s 24(7) applies and sufficient records are maintained as required.
- Even if the above requirements for an input tax deduction are satisfied, the Commissioner may determine that no such deduction is available if sufficient records are not kept in accordance with s 75.

14. In this dispute, the Taxpayer provided several documents as evidence. None of the documents that related to the relevant GST periods were tax invoices or show the amount of GST on individual supplies. It is not enough that the documents show that payments were made – the Taxpayer must show that any payments it made had a sufficient connection to its taxable supply. Further, there was no suggestion of a waiver being granted by the Commissioner under s 24(6). Therefore, the Taxpayer did

[6] *CIR v New Zealand Refining Co Ltd* (1997) 18 NZTC 13,187 at 13,193.
[7] *Case Z12* (2009) 24 NZTC 14,142; *CIR v Trustees in the Mangaheia Trust* (2009) 24 NZTC 23,711.
[8] *Case Z12* at [27].
[9] *Case 1/2012* (2012) 25 NZTC 1,013 at [147].

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not satisfy the onus of proof to show that it acquired the services for which it claimed input tax deductions, and so was not entitled to the input tax deductions claimed.

Issue 2 | Take tuarua: Income tax deductions

15. In Issue 2, all legislative references are to the ITA unless stated otherwise.
16. CCS considered that some of the expenditure deducted by the Taxpayer in its income tax return was not incurred by the Taxpayer but by either Company A or by the Director. Further, CCS argued that the Taxpayer had not provided sufficient documentation to support deductions for guarantee payments, loans written off (bad debts), interest paid or other miscellaneous expenses.
17. The Taxpayer argued that it incurred certain expenses for these reasons:
    - The Taxpayer took over the operation conducted by the Director as a sole trader, including the liabilities, obligations and income streams of the operation.
    - The Taxpayer was providing director services for Company A. As a result of Company A's liquidation, the Taxpayer (as Company A's director) was required to meet some of the company's liabilities under legislation.
18. Section DA 1, referred to as the general permission, contains the general rule allowing deductions. A taxpayer can deduct expenditure or loss under s DA 1(1)(a) if the taxpayer shows the following:
    - They have incurred the expenditure or loss. "Incurred" means a taxpayer must have either paid for or become "definitively committed to the expenditure"[10] and the expenditure must constitute an existing obligation.[11]
    - There is sufficient nexus or connection between the expenditure or loss and the derivation of income by the taxpayer. This is established by determining the true character of the payment.[12]
19. However, even if a person is allowed a deduction under s DA 1, the deduction may be denied under s DA 2 if one or more of the general limitations apply:

[10] *FC of T v James Flood* (1953) 88 CLR 492. See also *New Zealand Flax Investments Ltd v FC of T* (1938) 61 CLR 179 at 207.

[11] *A M Bisley & Co Ltd & Ors v CIR* (1985) 7 NZTC 5,082.

[12] *CIR v Banks* [1978] 2 NZLR 472 (CA), *Buckley & Young Ltd v CIR* [1978] 2 NZLR 485 (CA).

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- The private limitation denies a deduction for expenditure or loss to the extent it is of a private or domestic nature.[13]
- The capital limitation denies a deduction for expenditure or loss to the extent it is of a capital nature.[14]

20. TCO concluded that the Taxpayer had not shown, on the balance of probabilities, that it had incurred a large amount of the expenditure subject to the dispute, and therefore a deduction was not allowable, because:
    - There was no evidence that the Taxpayer had assumed the legal obligations of Company A as a director, and in any case a non-natural person cannot be a director of a company.
    - The Taxpayer had not provided any documentation to support the argument that it had assumed the liabilities that the Taxpayer purportedly took over from the Director.
    - The tax invoices provided by the Taxpayer showed the expenditure was incurred by Company A or by the Director in their personal capacity.
    - The Taxpayer had not provided documentation to show that all of the miscellaneous expenditure claimed was business related.

21. Having determined that the general permission was not satisfied for the expenditure claimed, it was not necessary for TCO to consider whether the general limitations applied.

22. For bad debts, a taxpayer is allowed a deduction, under s DB 31, for a bad debt to the extent that it is written off in the income year. A debt is bad when a reasonably prudent commercial person would conclude there is no reasonable likelihood that the debt will be paid.[15] Writing off a debt as bad requires more than a mere recognition by the taxpayer that it is unlikely to be paid. Appropriate bookkeeping entries are required.[16]

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[13] *CIR v Haenga* (1985) 7 NZTC 5,187 (CA), *Reid v CIR* (1990) 12 NZTC 7,153 (HC).

[14] The approach to distinguish between capital and revenue expenditure follows the tests set out in *BP Australia Ltd v FCT* [1965] 3 All ER 209, which has been adopted in subsequent New Zealand cases, see for example *CIR v Wattie* (1998) 18 NZTC 13,991 (PC) and *Poverty Bay Electric Board v CIR* (1999) 19 NZTC 15,001 (CA).

[15] *Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263.

[16] *Case N69* (1991) 13 NZTC 3,541 at 3,547, *Case P53* (1992) 14 NZTC 4,370 at 4,377, *Case W3* (2003) 21 NZTC 11,014. See also Public Ruling BR Pub 18/07: *Income Tax and Goods and Services Tax – writing off debts* as published in *Tax Information Bulletin* Vol 30, No 9 (October 2018) at 3.

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23. While the Taxpayer's financial statements showed a difference in its loan balances between two income years, there were no notes to suggest that the difference reflected an amount being repaid or written off. Nor did the Taxpayer provide any evidence to show that the loan was written off in the relevant income tax year. Therefore, it was concluded that the deduction for bad debts was not allowed.

24. Turning to the interest paid, a company is allowed a deduction, under s DB 7, for interest incurred. This supplements the general permission and, among other things, overrides the capital limitation (s DB 7(8)). The only requirement is that the taxpayer shows that it has incurred the interest. The purpose of the underlying loan, or the use of the loaned monies, is not relevant for a deduction under s DB 7.

25. TCO concluded that the bank statements provided by the Taxpayer did show that it obtained loans and paid interest on those loans. The Taxpayer had therefore incurred some interest. It was concluded that the Taxpayer was allowed a deduction for the amount of interest shown on the bank statements it provided.

Issue 3 | Take tuatoru: Understated income

26. In Issue 3, all legislative references are to the ITA unless otherwise stated.

27. CCS considered that the Taxpayer had understated its income in its income tax return. This was based on deposits shown in the Taxpayer's bank accounts and the difference between the sales returned in the tax return and corresponding GST returns. CCS argued the Taxpayer had not provided sufficient evidence to prove these amounts were not income.

28. When a taxpayer provides insufficient evidence of their return of income, the Commissioner can use the information in her possession to reach a reasonable conclusion about the income of a taxpayer.[17]

29. Where the Commissioner determines from the information available to her that a taxpayer has an amount of income, the onus is on the taxpayer to prove that the amount is not income.[18] The taxpayer is required to do more than simply provide a credible possible alternative explanation for the amounts.[19] The taxpayer must prove

[17] *Case 2/2017* [2017] NZTRA 02, (2017) 28 NZTC 4,001 at [9].

[18] *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Case Y3* (2007) 23 NZTC 13,028; *Case X16* (2005) 22 NZTC 12,216.

[19] *Case S30* (1995) 17 NZTC 7,207 at 7,211; *Case E69* (1982) 5 NZTC 59,378.

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on the balance of probabilities that the Commissioner's proposed assessments of income are wrong and by how much they are wrong.[20]

30. Further, an amount is business income if it is derived from the current operations of a business or arises in the ordinary course of the business.[21] The unexplained bank deposits in this case may have been business income.[22]

31. In this dispute, the Taxpayer did not provide an explanation about its income and CCS was entitled to make a reasonable assessment of the Taxpayer's income based on the information it had about the Taxpayer's business. TCO concluded that the Taxpayer had not satisfied the onus of proof that the income amount proposed by CCS was wrong and considered that the basis for CCS's assessment was a reasonable one.

Issue 4 | Take tuawhā: Shortfall penalties

32. In Issue 4, all legislative references are to the TAA unless stated otherwise.

33. In this dispute, the Taxpayer took tax positions in its GST returns and income tax return. The tax shortfalls for each period in dispute are the difference between the tax effect of the Taxpayer's tax position and the tax effect of the correct tax position.

34. CCS submitted that the Taxpayer was liable for a gross carelessness shortfall penalty or, alternatively, a shortfall penalty for not taking reasonable care for the tax positions taken in the GST and income tax returns. As a further alternative, CCS submitted that, if the Taxpayer was not liable to pay a penalty for not taking reasonable care for the income tax shortfall, the Taxpayer was liable to pay an unacceptable tax position shortfall penalty.

Shortfall penalty for gross carelessness

35. Section 141C imposes a shortfall penalty for gross carelessness on a taxpayer if the following requirements are satisfied:[23]

- The taxpayer has taken a tax position.

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[20] *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 at 61,283.

[21] See section CB 1; definition of "business" in s YA 1; *CIR v City Motor Service Ltd* [1969] NZLR 1,010 at 1,017; *FCT v The Myer Emporium Ltd* 87 ATC 4,363; and *FCT v Montgomery* 99 ATC 4,749.

[22] See for example, *Case F42* (1983) 6 NZTC 59,773 and *Case L40* (1989) 11 NZTC 1,249.

[23] The shortfall penalty for gross carelessness is considered in the Interpretation Statement IS0060: *Shortfall Penalty for Gross Carelessness* as published in *Tax Information Bulletin* Vol 16, No 8 (September 2004).

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- Taking the tax position has resulted in a tax shortfall.
- The taxpayer has been grossly careless in taking the taxpayer's tax position. Gross carelessness means doing or not doing something in a way that, in all of the circumstances, suggests or implies a complete or high level of disregard for the consequences (s 141C(3)):
    - Gross carelessness is characterised by conduct which creates a high risk of a tax shortfall occurring where that risk and its consequences would have been foreseen by a reasonable person in the circumstances.[24]
    - The test for gross carelessness is not whether the taxpayer actually foresaw the probability that their act or omission would cause a tax shortfall but whether a reasonable person would have foreseen that probability.[25] Whether the taxpayer has acted intentionally is not a consideration.[26]
    - A person who takes reasonable care is not grossly careless. Taking reasonable care includes exercising reasonable diligence to determine the correctness of a return, keeping adequate records, and generally making a reasonable attempt to comply with tax law.[27]
    - A taxpayer who adequately informs and follows the advice of a qualified tax agent takes reasonable care and is not careless.[28]

36. The following factors may be relevant in determining whether a reasonable person would have foreseen that their conduct created a high risk of a tax shortfall occurring:[29]
    - the significance of the transaction leading to the tax shortfall;
    - the taxpayer's level of experience in the relevant tax laws;
    - previous warnings given by Inland Revenue or advisors in relation to the risk of the tax shortfall.

37. The penalty payable for gross carelessness is 40% of the resulting tax shortfall.

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[24] *Case W4* (2003) 21 NZTC 11,034 at [44].

[25] *Case 9/2014* (2014) 26 NZTC 2,019 at [88].

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

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

[28] *Re Carlaw and FCT* 95 ATC 2166 (AAT); *Re Sparks and FCT* [2000] AATA 28 and see also *Pech v Tilgals* [1994] ATC 4206.

[29] *Case W4*.

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38. Section 141C(4) provides that a taxpayer who takes an acceptable tax position is not grossly careless in taking their tax position. A tax position is an acceptable tax position if it is "about as likely as not to be correct". This is determined objectively.[30]

39. A tax position will be "about as likely as not to be correct" and, therefore, an acceptable tax position, if:

    - The tax position is close to or around 50% likely to be correct.[31]
    - The merits of the arguments supporting the tax position are substantial.[32]
    - On balance, the tax position is one that, while wrong, could be argued on rational grounds to be right.[33]
    - There is room for a real and rational difference of opinion.[34]
    - The taxpayer's tax position is one about which "reasonable minds could differ".[35]

40. It was considered that the Taxpayer's tax positions were not about as likely as not to be correct and, therefore, were not acceptable tax positions. The Taxpayer claimed input tax and income tax deductions without holding the relevant tax invoices or keeping sufficient records to establish that it had incurred the expenses. Also, the Taxpayer did not prove it had included all of its income in its income tax return. The Taxpayer had not provided any information to show CCS's proposed adjustments were wrong or the extent they were wrong. There is, therefore, no room for a real and rational difference of opinion between the Taxpayer's tax position and the correct tax position.

41. TCO considered that the Taxpayer did not take acceptable tax positions in this dispute and the tests for gross carelessness had been met for these reasons:

    - The Taxpayer filed GST and income tax returns that resulted in tax shortfalls.
    - The Taxpayer did not keep adequate records as required by the GSTA and the TAA. It was considered that a reasonable person would foresee the probability that their omission to keep records to substantiate deductions claimed would cause tax shortfalls.
    - Not keeping the required records suggests a complete or high level of disregard for the consequences. It was also considered that the Director, who filed the

[30] See definition of "acceptable tax position" and "unacceptable tax position" in s 3(1) and s 141B.

[31] *Case U47* (2000) 19 NZTC 9,410.

[32] *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115.

[33] *Ben Nevis* and *Walstern v FCT* [2003] FCA 1,428.

[34] *Walstern*.

[35] *Walstern* and *Case X25* (2006) 22 NZTC 12,303.

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returns on behalf of the Taxpayer, had a background that indicated they ought to have a good understanding of the record keeping requirements.

42. The Taxpayer was, therefore, liable to pay a shortfall penalty for gross carelessness.

Shortfall penalty for not taking reasonable care

43. Section 141A imposes a shortfall penalty on a taxpayer for not taking reasonable care if the following requirements are satisfied:[36]

- The taxpayer has taken a tax position.
- The taxpayer's tax position has led to a tax shortfall.
- The taxpayer has not taken reasonable care in taking the taxpayer's tax position.

44. A taxpayer will be treated as having taken reasonable care in these two situations:

- If the taxpayer has relied on the action or advice of a tax advisor engaged by the taxpayer.[37]
- If the taxpayer has taken an acceptable tax position.[38]

45. Case law has also developed the following principles about "reasonable care":

- The test of "reasonable care" is whether a reasonable person in the taxpayer's circumstances would have foreseen a tax shortfall as a reasonable probability.[39]
- Reasonable care includes exercising reasonable diligence to determine the correctness of a return, keeping adequate records to properly substantiate a return and generally making a reasonable attempt to comply with tax law.[40]
- What is considered "reasonable" may vary depending on a number of factors, including:[41]
  - the experience of the taxpayer;
  - the type of tax involved;

[36] The shortfall penalty for not taking reasonable care is considered in Interpretation Statement IS0053: *Shortfall penalty for not taking reasonable care* published in *Tax Information Bulletin* Vol 17, No 9 (November 2005).

[37] Section 141A(2B).

[38] Section 141A(3).

[39] *Case W4* at [59].

[40] *Case W4* at [60]-[61].

[41] *Case W3* (2003) 21 NZTC 11,014.

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- the size and nature of the business;
- the complexity of the law;
- the particular transaction;
- the difficulty and expense of taking appropriate precautions.

46. A taxpayer is vicariously responsible for any tax position taken by its officers or employees.

47. The penalty payable for not taking reasonable care is 20% of the tax shortfall.

48. In this dispute, the Taxpayer was vicariously responsible for the tax positions taken by the Director. It was concluded that the Director did not keep sufficient records to substantiate the deductions claimed and did not take reasonable care in taking the Taxpayer's tax positions. The Taxpayer was, therefore, liable for the shortfall penalty for not taking reasonable care shortfall penalty.

Shortfall penalty for an unacceptable tax position

49. Section 141B imposes a shortfall penalty for an unacceptable tax position on a taxpayer if the following requirements are satisfied:[42]

    - The taxpayer has taken a tax position.
    - The taxpayer's tax position results in a tax shortfall exceeding the threshold in s 141B(2) of being more than both:
        - $50,000, and
        - 1% of the taxpayer's total tax figure for the relevant return period.
    - The tax position is an unacceptable tax position. A tax position will be an unacceptable tax position if:
        - the tax position, viewed objectively, fails to meet the standard of being about as likely as not to be correct, and
        - none of the exceptions in s 141B(1B) to (1D) apply.

50. The shortfall penalty is 20% of the tax shortfall.

[42] The shortfall penalty for taking an unacceptable tax position is considered in the Interpetation Statement IS0055: *Shortfall Penalty – Unacceptable intepretation and unacceptable tax positions* as published in *Tax Information Bulletin* Vol 17, No 9 (November 2005).

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51. In this dispute, TCO concluded that the Taxpayer was liable for a shortfall penalty for taking an unacceptable tax position for these reasons:

- The Taxpayer took a tax position that resulted in tax shortfalls.
- It was already concluded that the Taxpayer's tax position did not meet the standard of being about as likely as not to be correct due to the Taxpayer's lack of documentation (see para 40 above).
- None of the exceptions in s 141(1B) to (1D) applied.
- The tax shortfall exceeded the threshold amounts in s 141B(2).

Shortfall penalties conclusion

52. As the requirements of all three proposed shortfall penalties were satisfied, the highest gross carelessness shortfall penalty was applied to the tax shortfalls arising in each period in dispute. The shortfall penalties for not taking reasonable care and for an unacceptable tax position were not applied (s 149(2) and (3)).

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