

Omitted income, shortfall penalties

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TDS 23/14

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Subjects | Kaupapa

Whether the Taxpayer returned all their assessable income for the income years in dispute. If not, whether the Taxpayer was liable for shortfall penalties.

Taxation laws | Ture tāke

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

Facts | Meka

1. The dispute concerned the tax treatment of various amounts paid to an individual Taxpayer over several income years. The Taxpayer proposed adjustments in relation to undisclosed dividend income, beneficiary income and other income that CCS had assessed as derived by the Taxpayer.
2. The Taxpayer was in full-time employment and also involved in their family's business operations. The family's business was in a group structure involving both company and trust entities.
3. One of the family companies owned and operated a business (the Company). The Company's leasehold interest in a property was acquired by the local Council for the construction of a road. The Company subsequently transferred amounts to entities associated with the Taxpayer. The Taxpayer also received amounts directly from the Council in relation to the leasehold acquisition.
4. One of the family trusts (the Trust) made regular payments into the Taxpayer's bank accounts.
5. In addition, there were unexplained cash deposits and payments made to the Taxpayer's bank accounts and to the Taxpayer's credit card (unexplained deposits).
6. CCS issued reassessments to the Taxpayer for the years in dispute.¹ As part of the reassessments CCS imposed an evasion shortfall penalty of 150% of the tax shortfall.² The penalty was reduced by 50% for previous behaviour.³ As noted above at [1], the

¹ Under s 89C(eb) of the Tax Administration Act 1994 (TAA).

² Under s 141E of the TAA.

³ Under s 141FB of the TAA.

Taxpayer initiated the dispute by proposing adjustments to the reassessments issued by CCS.

Issues | Take

7. The preliminary issues were:
 - The onus and standard of proof.
 - Was the CSOP issued within the two-month response period?
8. The main issues were:
 - Were the assessments issued by CCS (without first issuing a NOPA) valid?
 - Were amounts paid to the Taxpayer in relation to the Company undisclosed dividend income?
 - Were amounts paid to the Taxpayer by the Trust undisclosed beneficiary income?
 - Were the unexplained deposits assessable income to the Taxpayer?
 - Was CCS entitled to amend the Taxpayer's assessments to increase the amounts outside the four-year time bar period set out in s 108 of the TAA?
 - Was the Taxpayer liable for evasion shortfall penalties in relation to the tax shortfalls?

Decisions | Whakataurua

9. The Tax Counsel Office decided:
 - The onus was on the Taxpayer to prove that the amounts received were not taxable income. The onus was on CCS to prove that the Taxpayer was liable under s 141E of the TAA for a shortfall penalty for evasion or a similar act. The standard of proof was the balance of probabilities.
 - The CSOP was validly issued within the 2-month response period.
 - The reassessments issued by CCS were made under s 89C(eb) of the TAA and were not invalid.
 - The amounts received from the Company and the Council were the Taxpayer's dividend income.
 - For the earlier income years in dispute, the deposits from the Trust were the Taxpayer's beneficiary income.

- For the latter income years in dispute, the deposits from the Trust were not the Taxpayer's beneficiary income.
- Most of the unexplained deposits were the Taxpayer's income under ordinary concepts.
- The time bar in s 108(1) of the TAA did not prevent the Commissioner from making the reassessments because exceptions to the time bar (under s 108(2)) applied in the circumstances.
- The Taxpayer was liable for evasion shortfall penalties on the tax shortfalls arising due to the Taxpayer not returning the unexplained deposits. The shortfall penalties were correctly reduced by 50% for previous behaviour.
- However, the Taxpayer was not liable for evasion shortfall penalties on the tax shortfalls from the dividend income, the beneficiary income and most of the unexplained deposits.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary Issue 1 | Take tōmua tuatahi: Onus and standard of proof

10. The onus of proof in civil proceedings⁴ is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.⁵ The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.⁶
11. The standard of proof in civil proceedings is the balance of probabilities.⁷ This standard is met if it is proved that a matter is "more likely than not".⁸ TCO applied a similar standard to considering the issues in this dispute, given the Taxpayer's ability to challenge any subsequent assessments that are made in civil proceedings.
12. Accordingly, in this dispute:

⁴ Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

⁵ Section 149A(2) of the TAA.

⁶ *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

⁷ 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.

⁸ *Miller v Minister of Pensions* [1947] 2 All ER 372, 374.

- the onus was on the Taxpayer to prove that the amounts received were not taxable income.
- the onus was on CCS to prove that the Taxpayer was liable under s 141E for a shortfall penalty for evasion or a similar act.
- the standard of proof was the balance of probabilities.

Preliminary Issue 2 | Take tōmua tuarua: Issue of CSOP within the response period

13. The issue was whether the Commissioner’s Statement of Position (CSOP) was issued within the 2-month response period.⁹
14. CCS argued that it sent the CSOP by email to the Taxpayer’s Tax Agent within the response period. However, there was a problem with the Tax Agent’s mailbox.
15. The Taxpayer argued that the CSOP was not issued within the response period because they did not become aware of the CSOP until the response period had expired.
16. TCO considered CCS must “issue” the CSOP within the response period under s 89M(6BA) of the TAA. There was no legislative requirement to notify the Taxpayer. TCO considered that the Taxpayer had not satisfied the burden of proof that the CSOP was not issued within the response period. Further, the Taxpayer’s rights to fair and efficient resolution of the dispute had not been prejudiced.
17. TCO noted that it was ultimately for the Courts to conclude whether the CSOP was issued under s 89M(6BA) of the TAA within the 2-month response period.

Issue 1 | Take tuatahi: Validity of assessments

18. Under Issue 1 in this summary all statutory references are to the TAA unless stated otherwise.
19. The Taxpayer raised a procedural issue regarding CCS’s handling of the audit and dispute. The Taxpayer argued that the assessments made by CCS were not valid as a prior NOPA was not issued.
20. Section 89C(eb) allows CCS to issue an assessment without issuing a NOPA if it has reasonable grounds to believe that the taxpayer has been involved in fraudulent activity. In addition, under s 138E(1)(e)(iv), challenge rights are not conferred to matters

⁹ Section 89AB of the TAA.

left to the discretion, judgment, opinion, approval, consent, or determination of the Commissioner in s 89C. This would include the Commissioner's judgment or opinion that the taxpayer was involved in fraudulent activity (in s 89C(eb)). Therefore, the Taxpayer was unable to challenge CCS's exercise of its discretion under s 89C(eb).

21. TCO considered:

- Whether CCS had reasonable grounds to believe that the Taxpayer had been involved in fraudulent activity was a matter which s 89C(eb) left to CCS's judgment or opinion. It was unnecessary to determine if the grounds relied on were reasonable. It was sufficient that CCS believed the grounds were reasonable.
- CCS had formed a view that the Taxpayer was involved in fraudulent activity by not returning income from multiple sources in their income tax returns. CCS issued reassessments for income tax without first issuing a NOPA based on that belief.

22. Accordingly, TCO concluded that:

- The reassessments made by CCS under s 89C(eb) were not invalid.
- Section 138E applied in the current instance, so that the Taxpayer did not have challenge rights in relation to CCS's decision to invoke s 89C(eb).
- Therefore, the decision was not a matter which may be put in issue in challenge proceedings and, as such, CCS was not required to establish that they had reasonable grounds to believe that the Taxpayer had been involved in fraudulent activity.

Issue 2 | Take tuarua: Undisclosed dividend income

23. The issue was whether the Taxpayer derived dividend income from the Company in the relevant income year.
24. CCS considered that the amounts paid by the Company and the Council were dividends paid to the Taxpayer. CCS considered that the payments were caused by a shareholding relationship because the amounts would not have been paid to the Taxpayer in the absence of the Taxpayer's association with the shareholders of the Company. TCO noted that the Taxpayer did not dispute this conclusion.
25. The Taxpayer argued that the compulsory acquisition of the Company's leasehold interest caused the closure of its business and the Company's shareholders resolved to commence the strike-off process and allow a liquidator to be appointed. The Taxpayer

argued that the transfers were not dividends but distributions of capital reserves in the course of liquidation. Further, the Taxpayer argued that transfers made prior to the shareholder's resolution were interest free loans.

26. CCS argued that the dividend exclusion for amounts paid on liquidation did not apply as the Taxpayer was not a shareholder of the Company. Further, CCS disputed the veracity of the special resolution of shareholders.
27. Section CD 26 confirms that an amount paid on the liquidation of a company may not be treated as a dividend if the amount:
 - is paid to a shareholder;
 - is paid in relation to a share on the liquidation of the Company; and
 - does not exceed the available subscribed capital per share calculated under the ordering rule and the available capital distribution amount calculated under s CD 44.
28. After considering the facts and evidence provided by the parties, TCO considered the Taxpayer had not satisfied the onus of proving on the balance of probabilities that the amounts transferred by the Company were not dividend income. There was no contemporaneous documentation to support the Taxpayer's submissions that transfers made prior to the shareholders resolution were interest free loans or to support the veracity of the special resolution authorising liquidation. In any event, since the Taxpayer was not a shareholder of the Company, TCO considered the s CD 26 exclusion for capital distributions on liquidation did not apply.¹⁰
29. Accordingly, TCO agreed with the reassessments made by CCS in relation to dividend income in the relevant income year and concluded the Taxpayer's proposed adjustments should not be made.

Issue 3 | Take tuatoru: Undisclosed beneficiary income

30. The issue was whether amounts paid to the Taxpayer by the Trust were undisclosed beneficiary income.
31. The Taxpayer received regular distributions from the Trust. The distributions were not returned in the Taxpayer's income tax returns. CCS argued the distributions were beneficiary income paid to the Taxpayer. The Taxpayer argued the distributions related

¹⁰ However, as noted above at [24], the Taxpayer was associated with the shareholders of the Company under s CD 6(1)(a)(ii).

to after-tax profits sourced from dividends received by the Trust from two of the family companies.

32. In addition, the Taxpayer argued that certain monthly amounts were distributions to the Taxpayer's parents and were paid directly to the Taxpayer in their capacity as trustee of the Parents Family Trust.¹¹
33. CCS argued that the Trust had insufficient prior-year after-tax profits to account for the payments made to the Taxpayer. In the absence of supporting documentation, CCS argued the amounts deposited into the Taxpayer's personal bank accounts were beneficiary income derived for all the income years in dispute.
34. An amount of income derived in an income year by a trustee of a trust is either beneficiary income or trustee income.¹² "Beneficiary income" is defined in s HC 6 as income derived by a trustee which has either been vested absolutely in interest in a beneficiary in the income year or has been paid to the beneficiary within the income year or the extended period set out in s HC 6(1B).
35. For the purposes of the dispute, TCO divided the income years in dispute in two, and concluded as follows:
 - For the earlier income years in dispute, TCO considered the Taxpayer had not satisfied the onus of proving on the balance of probabilities that the amounts paid to the Taxpayer were not beneficiary income. In particular, TCO considered there was insufficient evidence to support the Taxpayer's position that the amounts received from the Trust were either sourced from after tax distributions or distributions of beneficiary income made to the Taxpayer's parents. As such, TCO considered the amounts received by the Taxpayer in the earlier income years were beneficiary income.
 - For the latter income years in dispute, TCO considered the amounts paid to the Taxpayer were not beneficiary income as the statutory definition contained in s HC 6 was not met. The Trust did not return any income during the latter income years. It followed that the amounts paid to the Taxpayer during the latter income years were not "beneficiary income" as defined in s HC 6. Accordingly, TCO disagreed with the reassessments made by CCS and concluded the Taxpayer's proposed adjustments for the latter income years should be made.

¹¹ The Taxpayer's parents resided in a home owned by the Parents Family Trust and paid the household expenses using distributions from the Trust. The Taxpayer claimed that their parents included the distributions as beneficiary income in their respective individual income tax returns.

¹² Section HC 5.

Issue 4 | Take tuawhā: Unexplained deposits

36. The issue was whether the unexplained deposits (deposits made to bank accounts owned by the Taxpayer or paid against the Taxpayer's credit card) were the Taxpayer's income under ordinary concepts (s CA 1).
37. CCS argued the cash deposits showed the Taxpayer derived income from unexplained sources. Further, CCS argued the deposits were income under ordinary concepts because they were received on a periodic, recurrent and regular basis.
38. The Taxpayer argued that the unexplained deposits were not income under ordinary concepts but non-income amounts received from a number of sources:
- cash allowances received from their employer;
 - loan repayments relating to monies the Taxpayer lent to friends;
 - loans from the Taxpayer's parents;
 - casino winnings and the redeposit of unspent cash withdrawals;
 - transfers between bank accounts of associated entities; and
 - bank errors.
39. TCO summarised the relevant case law for unexplained amounts as follows:
- The taxpayer has the onus of proving that the amounts are not income.¹³ The standard of proof is the balance of probabilities.¹⁴
 - The taxpayer can meet the onus of proof if the taxpayer provides specific details of other sources of funds that are capital or non-taxable in nature.¹⁵
 - The taxpayer is required to do more than simply provide a credible possible alternative explanation for the amounts. The taxpayer must establish that the Commissioner's assessment is incorrect and by how much it is incorrect.¹⁶
40. TCO considered the Taxpayer had not satisfied the onus of proving on the balance of probabilities that the unexplained deposits (except as specified below totalling a relatively small amount) were not income received in the income years in dispute. TCO acknowledged that the Taxpayer had provided some explanations that might be

¹³ *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 at 61,283.

¹⁴ *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Case Y3* (2007) 23 NZTC 13,028; *Case X16* (2005) 22 NZTC 12,216.

¹⁵ *Case L40* (1989) 11 NZTC 1,249.

¹⁶ *Case S30* (1995) 17 NZTC 7,207.

credible for some of the transfers or deposits, but the Taxpayer had not provided sufficient evidence to prove on the balance of probabilities that the deposits were not income of the Taxpayer, particularly in light of evidence provided by CCS.

41. However, TCO considered the Taxpayer had satisfied the onus of proving on the balance of probabilities that the following amounts were not income under ordinary concepts:

- deposits that consisted of transfers between the Taxpayer's bank accounts;
- a deposit that consisted of a reimbursement of a business cost; and
- a deposit that was a bank error.

42. Accordingly, TCO concluded:

- The adjustments proposed by the Taxpayer for the deposits specified above at [41] should be made.
- The remaining adjustments proposed by the Taxpayer with respect to the unexplained deposits should not be made.

Issue 5 | Take tuarima: Time bar

43. Under Issue 5 in this summary all statutory references are to the TAA unless stated otherwise.

44. The issue was whether CCS could amend the income tax assessments for the income years in dispute to increase the amounts under s 108(2) of the TAA. Subject to some exceptions, including those in s 108(2) and s 108B, s 108(1) prevents the Commissioner from amending an assessment, to increase the amount assessed or decrease the amount of a net loss, if:

- the taxpayer has furnished an income tax return, and
- an assessment has been made, and
- four years have passed from the end of the tax year in which the taxpayer provides the tax return.

45. However, if an exception applies, the Commissioner may amend an otherwise time-barred assessment.

46. TCO summarised that s 108(2)(b) applies as follows:

- Income of a particular nature is income that has a basic or inherent feature, quality or character. The source of the income is where it is from.

- Income must be mentioned in or with the return of the taxpayer seeking the protection of the time bar. The disclosure of income at some other time, or in another taxpayer's return, will not suffice.
- The omission of income does not need to be fraudulent or deliberate.
- Once it is determined that the time bar exception applies, the Commissioner is not confined to the omitted sums but may amend the whole assessment.

47. TCO considered that:

- The dividend income and the beneficiary income were distinct categories of income (ie, of a particular nature) that were required to be returned, and they were also types of income derived from particular sources (the Company and the Trust respectively).
- The unexplained deposits were periodic amounts and relied on by the Taxpayer to meet regular expenses. As such, they were income of a particular nature. The unexplained deposits were also derived from a particular source or sources, even though the source or sources remained unknown.

48. Accordingly, TCO considered that CCS's opinion that the Taxpayer's income tax returns did not include income of a particular nature or from a particular source was reasonably open to it on the information available to it. Further, TCO considered the Taxpayer had failed to show that CCS did not honestly hold the opinion or misdirected itself as to the legal basis on which the opinion was to be formed. Therefore, TCO concluded that s 108(2)(b) applied to allow the Commissioner to assess the Taxpayer for the income years in dispute.

Issue 6 | Take tuaono: Evasion shortfall penalty

49. Under Issue 6 in this summary all statutory references are to the TAA unless stated otherwise.
50. The issue is whether CCS has discharged its burden of proof that the Taxpayer was liable under s 141E for a shortfall penalty for evasion or a similar act.
51. Section 141E(a) imposes a shortfall penalty on a taxpayer if the following requirements are satisfied:
- The taxpayer has taken a tax position.
 - Taking the tax position has resulted in a tax shortfall.
 - The taxpayer has evaded the assessment or payment of tax by the taxpayer or another person under a tax law.

52. The penalty payable for evasion or similar act is 150% of the resulting tax shortfall.
53. TCO summarised the elements of s 141E(1)(a) as follows:
- The requirement for evasion will be satisfied if the taxpayer knows that their action or omission will breach a tax obligation. There must be some blameworthy act or omission on the part of the taxpayer. The required intent for evasion can be inferred from surrounding circumstances and conduct.
 - Recklessness can amount to evasion. In the context of evasion recklessness involves the conscious taking of risk. Where recklessness is alleged, the Commissioner must prove that:
 - Facts actually known to the taxpayer were such that they must have put the taxpayer on inquiry that a tax obligation may not be met.
 - The taxpayer made a conscious decision to ignore the facts without making further inquiry.

Dividend income

54. The Taxpayer did not return dividend income from the Company in the relevant income year.
55. TCO noted that:
- The receipt from the Council was an unusual or one-off transaction.
 - The Taxpayer had sought specialist advice on the tax treatment of the receipt, including that it could be distributed “tax free” on liquidation.
 - It was not clear if the Taxpayer was aware of the necessary requirements to satisfy the s CD 26 exclusion for shareholder distributions “on liquidation”, in particular that the distribution must be made to the Company’s shareholder and not merely an associated party.
 - While the steps were not executed correctly, CCS had not provided evidence that this was due to recklessness, as opposed to merely a mistake due to a lack of reasonable care or carelessness.
56. Accordingly, TCO concluded that:
- CCS had not provided sufficient evidence that the Taxpayer knew he was breaching a tax obligation or made a conscious decision to ignore his tax obligations.

- CCS had not satisfied the burden of proving evasion in relation to the dividend income.

Beneficiary income

57. The Taxpayer did not return beneficiary income from the Trust in the earlier income years.
58. The relevant facts were:
- The Taxpayer was the sole director of the Trust's corporate trustee and had full access to the Trust's bank account (including signing authority).
 - In their capacity as director of the Trust's corporate trustee, the Taxpayer would have been aware of the contents of the Trust's income tax returns.
 - The Trust did not allocate beneficiary income to the Taxpayer in its income tax returns.
 - The Trust returned trustee income for these periods and the Taxpayer may have considered that the tax liability on the income had been met by the Trust and that there was no further tax obligation.
59. TCO considered that CCS had not provided sufficient evidence that the Taxpayer knew there was a breach of a tax obligation or made a conscious decision to ignore their tax obligations. Accordingly, TCO concluded that CCS had not satisfied the burden of proving evasion in relation to the tax shortfall of beneficiary income in the earlier income years.

Unexplained Deposits

60. The Taxpayer did not return the unexplained deposits as assessable income in the relevant income years.
61. TCO considered the knowledge requirement for evasion would be met if a taxpayer's knowledge must have put them on inquiry that their tax obligations would not be met, but they chose to proceed in spite of that risk.
62. The unexplained deposits were received by the Taxpayer in his bank accounts over a sustained period of time. The total amount of unexplained deposits received each year were not insubstantial and the Taxpayer relied on them to meet regular expenses.
63. TCO inferred from these circumstances that the Taxpayer knew that the unexplained deposits were income and filed their income tax returns without including them knowing that the returns were incorrect and misleading and in breach of their tax

obligations. The Taxpayer had not shown that they had reasonable grounds for believing otherwise.

64. There is no evidence that the Taxpayer made inquiries to determine whether the unexplained deposits were income or not.
65. TCO considered CCS had satisfied its burden of proving that the Taxpayer evaded the assessment or payment of tax when they took tax positions in relation to the unexplained deposits.

Conclusion

66. TCO concluded that:
 - CCS had not satisfied the burden of proving that the Taxpayer evaded the assessment or payment of tax when they took the tax positions with respect to the dividend income and beneficiary income amounts.
 - However, CCS had satisfied the burden of proving evasion in relation to the omitted unexplained deposits.
67. Therefore, the Taxpayer was liable for shortfall penalties for evasion under s 141E only in relation to the unexplained deposits.
68. The resulting outcome was that CCS would need to calculate and reverse the evasion shortfall penalties relating to:
 - the dividend income;
 - the beneficiary income;
 - the amounts that TCO concluded were not income under ordinary concepts.
69. The shortfall penalties were reduced by 50% for previous behaviour.