

Example 1: Simple Notice of Proposed Adjustment

Notice of Proposed Adjustment

Name: Lottsa Frenz Ltd
IRD number: 01-234-567
Date issued: 24 October 1996

Proposed adjustments

Adjustments to be made as follows:

GST Return Period	Taxable value of fringe benefits provided	GST value - deemed supply	Total GST on sales and income as returned	Amended total GST on sales and income
31.05.95	\$1,125.00	\$125.00	\$ 4,201.33	\$ 4,326.33
31.07.95	\$1,125.00	\$125.00	\$ 5,263.22	\$ 5,388.22
30.11.95	\$1,125.00	\$125.00	\$ 2,365.00	\$ 2,490.00
31.01.96	<u>\$1,125.00</u>	<u>\$125.00</u>	<u>\$ 6,154.88</u>	<u>\$ 6,279.88</u>
	\$4,500.00	\$500.00	\$17,984.43	\$18,484.43

Total GST in Dispute = \$500.00

Facts

In January 1995 Lottsa Frenz Ltd purchased a Ford Fairlane car, to be used by the principal shareholder, Mr Frenz for business purposes.

Mr Frenz also uses the car to tow his privately owned boat to the beach when he goes fishing, and sometimes Mrs Frenz uses it to do the shopping.

The car can be used by Mr or Mrs Frenz on any day of the week.

Tax laws

Section CI (1) of the Income Tax Act 1994 provides:

In the FBT rules, "Fringe Benefit", in relation to any employee and to any quarter means any benefit that consists of -

- (a) The use or enjoyment, in relation to the employee, at any time during the quarter of a motor vehicle owned, leased or rented by the person who makes the vehicle available to the employee:
- (b) The availability for the private use or enjoyment of the employee at any time during the quarter of a motor vehicle that is so owned, leased or rented."

Section 21 (3) of the Goods and Services Tax Act 1985 provides:

"....the granting of that Fringe Benefit shall, except to the extent that any amount has been paid by that other person for the receipt or enjoyment of that fringe benefit, be deemed to be a supply of goods and services made by that registered person in the course of a taxable activity carried out by that person."

Issues

Is the car available for private use at all times, and therefore subject to FBT in full, or only available on those days the company authorises its use and it is used?

Is the availability of the car for the above purposes a Fringe Benefit in terms of section CI(1) of the Income Tax Act 1994 and therefore a deemed supply for GST purposes pursuant to section 21(3) of the Goods and Services Tax Act 1985?

Propositions of law

“If a business car is available to an employee at any time during a day, then that employee is deemed to have a fringe benefit, for the full day.” - *Case P26 (1992)*
14 NZTC, 4196

“The definition of private use or enjoyment (as defined in Section CI (1) of the Income Tax Act 1994) included travel which conferred a benefit of a private or domestic nature on a person. The availability of the vehicles on a daily basis for family matters was clearly for their private use or enjoyment...” - *Case R37 (1994)*
16 NZTC 6,208

(For the purposes of this example fringe benefit adjustments were included in a separate NOPA.)

Example 2: Adjustments arising from an audit

From start of audit to NOPA stage

In August 1995 Mr S M Iles filed his GST return for the two month return period ended 31 July 1995. This return showed that Mr Iles was to receive a GST refund.

Inland Revenue checked the company's compliance history then selected the return for a routine check by an investigator.

During the audit the investigator asked for copies of tax invoices for the major expense items in the return period. The investigator found that the refund was largely due to the purchase of capital equipment, but

he also noted that a significant amount of private expenditure had been claimed. Mr Iles' accountant, Ms Smith, agreed that the private expenditure should be disallowed, and that it would not be included as business expense when preparing the end of year accounts.

As a result of this review Inland Revenue decided to conduct an in depth investigation of the taxpayer's affairs when the income tax return for the 1996 financial year was filed.

On 11 October 1996 Inland Revenue sent the following initial audit letter to the accountant, plus a copy to the taxpayer:

11 October 1996

Bob, Bill & Jo
Chartered Accountants
Box 010
Neveville 1310



Attn.: Ms Smith

Name: S M Iles Panelbeaters
IRD number: 02-345-678
Our reference: AXR/BL3/WUZ

I have been instructed to conduct an audit of your client's tax affairs. This audit will cover income tax, goods and services tax and payroll related taxes.

The audit will initially cover these periods:

- 01 April 1995 to 31 March 1996 for Income Tax
- 01 August 1995 to 31 March 1996 for GST
- 01 April 1995 to 31 March 1996 for Payroll related revenues.

The audit will consist of :

1. An initial interview with the person(s) responsible for implementing and supervising the accounting system.
2. Obtaining and reviewing the necessary records and documentation.
3. Performing appropriate substantive and compliance tests.
4. A discussion regarding any differences.

Please arrange for the following business records and information to be available:

- Chart of accounts, journals, ledgers and trial balances
- Bank statements, cheque butts and deposit details
- Daybooks and cashbooks
- Stock sheets and full details of debtors and creditors
- Invoices for purchases and other expenses, plus receipts and proof of payments made
- Sale agreements and other documentation
- Wage records
- Asset registers
- Fringe benefit tax records
- Access to all other prime records.

I'm making this request under Section 17 of the Tax Administration Act 1994.

I have also enclosed a copy of the booklet "A Guide to Inland Revenue Audits" for your client's information.

If you have any questions about this audit, or if you need any further information, please contact me on extension 86412.

Yours faithfully

A N Other
Investigator

c.c. Mrs M Iles
P O Box 11-111
Neveville

As a result of the later audit the following issues were highlighted:

1. Three cheques, totalling \$12,375 were deposited into Mrs Iles' personal bank account. The Commissioner contends that these cheques relate to services provided by Mr Iles in carrying out his panel beating business.
2. Mr Iles uses his motor vehicle for private and business purposes. No apportionment of motor vehicle expenses has been made to account for private usage of the vehicle. No records have been

maintained to establish the percentage of business use.

3. \$2,500 of the amount claimed for repairs and maintenance was for the laying of a pathway by Pathways Limited at Mr & Mrs Iles' home.

Mr Iles agreed in writing to the third item, in a letter dated 12 December.

The matters outlined above were recorded in a written report prepared by the investigator, and approved by his reporting officer. On 20 January the Commissioner issued the following NOPA:

Notice of Proposed Adjustment

Sim Iles Panelbeaters

IRD Number: 02-345-678

For the income year ended 31 March 1996

Date of Issue: 20 January 1997

Proposed adjustments

Taxable income as per return	\$125,000.00
Add proposed adjustments:	
(A) Cheques received from customers not included in income (Excl GST)	\$11,000.00
(B) Motor vehicle expenses disallowed (Excl GST)	\$ 1,500.00
(C) Repairs and Maintenance disallowed (Excl GST)	<u>\$ 2,500.00</u>
	<u>\$ 15,000.00</u>
Amended taxable income	\$140,000.00

- (D) The Commissioner proposes to assess penal tax of 150% on the total of proposed adjustment A:

Tax on total of Proposed Adjustment A	x	150%	=	Penal Tax
\$3,630.00	x	150%	=	\$5,445.00

Notes to proposed adjustments:

- (i) The Commissioner proposes to issue any reassessment stating the original due date as the date for payment of the tax.
- (ii) Consequential adjustments to the GST returns of Sim Iles Panelbeaters will be addressed in a separate Notice of Proposed Adjustment.

Adjustment A

Facts

A.1 The following cheques were deposited into Mr Iles' wife's private cheque account -

Date	Amount	Drawer
16-6-95	7,312.50	John Smith
22-8-95	1,687.50	F.R. Edwards
12-12-95	3,375.00	J.K. Hart

A.2 These cheques were made out for cash and the Commissioner contends that they relate to services provided by Sim Iles Panelbeaters to the payers of the cheques. All of the cheques were paid directly into Mrs Iles' personal cheque account. The cheques totalled \$12,375.00. These cheques were business income derived by Mr Iles trading as Sim Iles Panelbeaters.

A.3 As business income these amounts are considered to include GST. The proposed adjustment to Mr Iles income tax return is to increase his taxable income by \$11,000.00, being the total of the cheques less the GST component of \$1,375.00

Tax laws

A.4 The amounts should have been included in the assessable income of Mr Iles in terms of section BB 4(a) of the Income Tax Act 1994 (section 65(2)(a) Income Tax Act 1976). Section BB 4 of the Income Tax Act 1994 (section 65(2) of the 1976 Act) provides:

“Without in any way limiting the meaning of the term, the assessable income of any person shall for the purposes of this Act be deemed to include, save so far as express provision is made in this Act to the contrary, -

(a) All profits or gains derived from any business...”

A.5 Section EB 1 of the Income Tax Act 1994 (section 75 of the 1976 Act) applies because the money was credited to another person or dealt with on behalf of him. Section EB 1 of the Income Tax Act 1994 (section 75(1) of the 1976 Act) provides:

“For the purposes of this Act every person shall be deemed to have derived income although it has not actually been actually paid to or received by the person, or already become due or receivable, but has been credited in account, or reinvested, or accumulated, or capitalised, or carried to any reserve, sinking, or insurance fund, or otherwise dealt with in the person's interest or on the person's behalf.”

Legal issues

A.6 Whether the amounts in question were business profits of Mr Iles trading as Sim Iles Panelbeaters pursuant to section BB 4(a) of the Income Tax Act 1994 (section 65(2)(a) of the 1976 Act).

A.7 Whether the amounts paid into Mrs Iles' bank account were derived by Sim Iles Panelbeaters under section EB 1 of the Income Tax Act 1994 (section 75(1) of the 1976 Act) and were paid to Mrs Iles on behalf of Sim Iles Panelbeaters.

Propositions of law

A.8 The propositions relied on by the Commissioner include:

Profits or gains arising from the current operations (day to day) of a business are assessable: [as in *CIR v City Motor Services Ltd* [1969] NZLR 1010]

Income is derived even though it may not have been actually paid to or received by the taxpayer: [as in *Case N40* (1991) 13 NZTC 3,344]

Section EB 1 of the Income Tax Act 1994 (section 75(1) of the 1976 Act) is directed to the form in which income is derived. Therefore income is derived by a taxpayer even if it does not reach the taxpayer, provided it is dealt with on the taxpayer's behalf: [as in *CIR v Farmers Trading Co Ltd* (1989) 11 NZTC 6,007]

Adjustment B

Facts

B.1 Mr Iles owns a motor vehicle and uses it for private and business purposes. During the 1996 income year no apportionment of the deduction for motor vehicle expenses was made to account for the significant private usage of the vehicle. No logbook has ever been used for this vehicle to establish the business use proportion, as required by the legislation. When no logbook is kept the business use proportion is limited to 25 percent of total use of the motor vehicle.

Tax laws

B.2 Section DH 1 of the Income Tax Act 1994 (106B of the 1976 Act) prevents a deduction being claimed for motor vehicle expenses

“(1) Except as provided in this section, no deduction in relation to expenditure incurred by a taxpayer in respect of or in relation to a motor vehicle used in gaining or producing assessable income of a taxpayer in any year shall be allowed under section BB 7 in calculating that assessable income in that income year;...

(3) Where in any income year a motor vehicle is used by a taxpayer partly for business purposes and partly for other purposes, there shall be allowed as a deduction in that income year the proportion of all expenditure incurred by the taxpayer in relation to the motor vehicle that reflects the proportion of business use of the vehicle to its total use in that income year, as that business use proportion is determined in accordance with sections DH 2 to DH 4 of this Act.”

B.3 Section DH 4 of the Income Tax Act 1994 (section 106E of the 1976 Act) dictates the deductible portion for business use expenditure when no log book is maintained:

“Where, in respect of any taxpayer and any period, -

(a) The period is not a logbook application period to which the business use proportion of a vehicle established by a logbook maintained under section DH 3 can be applied; and

(b) The taxpayer has not maintained for that period the details referred to in section DH 2, -

for the purposes of section DH 1 the business use proportion of the motor vehicle for that period shall be limited to the proportion of actual business use or 25 percent of total use of the motor vehicle, whichever is less, during the relevant period.”

Legal issues

- B.4 Whether the motor vehicle was used partly for business purposes and partly for private purposes.
- B.5 Whether the period is a logbook application period.
- B.6 Whether the business use proportion of the expenditure can be limited to 25% of the actual motor vehicle expenses.

Propositions of law

B.7 The propositions relied on by the Commissioner include:

A person must maintain sufficient records to enable the Commissioner to readily ascertain that person’s liability to tax: [as in *Case L106 (1989) 11 NZTC 1,593*]

If inadequate records are maintained it is appropriate to limit the business use portion to 25%: [as in *Case L106 (1989) 11 NZTC 1,593*].

Adjustment C

Of the amount claimed for repairs and maintenance, \$2500.00 was for the laying by Pathways Limited of a pathway at Mr Iles’ home.

The Commissioner and Mr Iles agree by letter dated 12 December 1996 that this adjustment should be made.

Adjustment D

Facts

D.1 The following cheques were deposited to Mrs Iles’ private cheque account -

Date	Amount	Drawer
16-6-95	7,312.50	John Smith
22-8-95	1,687.50	F.R. Edwards
12-12-95	3,375.00	J.K. Hart

D.2 These cheques were made out for cash and the Commissioner contends that they relate to services provided by Sim Iles Panelbeaters.

D.3 Mr Iles knew that these cheques related to services provided by Sim Iles Panelbeaters. Mr Iles personally banked the cheques into Mrs Iles’ personal cheque account. Mr Iles knew that these amounts should have been included in his income tax return. The total amount of the cheques was not included as income Mr Iles’ income tax return.

D.4 The Commissioner considers that Mr Iles evaded or attempted to evade the assessment of or payment of tax by not including the amount of these cheques in his income tax return.

Tax laws

D.5 Section 186 of the Tax Administration Act 1994 (section 420 of the Income Tax Act 1976) provides:

“If any taxpayer evades, or attempts to evade, or does any act with intent to evade, or makes default in the performance of any duty imposed upon the taxpayer by this Act or the Income Tax Act 1994, or the regulations made under those Acts, with intent to evade, the assessment or payment of any sum which is or may become chargeable against the taxpayer by way of tax, (which sum is referred to in sections 187 to 191 as the “deficient tax”), the taxpayer shall be chargeable, by way of penalty for that offence, with additional tax (referred to in sections 187 to 193 as “penal tax”) not exceeding an amount equal to treble the amount of the deficient tax.”

Legal issues

D.6 Whether Mr Iles evaded, attempted to evade or did any act with intent to evade, the assessment and payment of tax on the income comprised in the cheques.

D.7 Whether Mr Iles knew that the cheques were income derived by him trading as Sim Iles Panelbeaters.

Propositions of law

D.8 The propositions relied on by the Commissioner include:

“A person who knowingly and consciously omits to return income for taxation purposes, evades income tax.” - *Case P29 1992 14 NZTC 4213*

The Commissioner’s NOPA was issued on 20 January 1997. Accordingly Mr Iles has two months from that date to respond (i.e., until 20 March 1997). Mr Iles can either do nothing or issue a Notice of Response. If he issues a Notice of Response he could take one of the following four approaches:

- accept all of the proposed adjustments
- accept some of the proposed adjustments and reject others
- reject some of the proposed adjustments and not refer to others;
- reject all of the proposed adjustments.

These approaches are contained in the scenarios on the following pages.

Scenario 1: Taxpayer rejects some adjustments, accepts others

Notice of Response

**SM Iles trading as
Sim Iles Panelbeaters**

IRD NO: 02-345-678

Date of Issue: 10 March 1997

Proposed Adjustment A

Items in error

A.1 Proposed Adjustment A is wrong. The cheques were not for work done by Sim Iles Panelbeaters.

Tax laws

A.2 Section BB 4(a) of the Income Tax Act 1994 (section 65(2)(a) of the 1976 Act) does not apply.

A.3 Section EB 1 of the Income Tax Act 1994 (section 75 of the 1976 Act) does not apply.

Facts in error

A.4 The cheques were not for services provided by Sim Iles Panelbeaters.

Additional facts

A.5 The cheques were paid to Mrs Iles as gifts

Additional legal issues

A.6 There are no additional legal issues. The cheques were not income of Sim Iles Panelbeaters.

Propositions of law

A.7 Sim Iles Panelbeaters relies on the following propositions of law:

Gifts are not assessable income.

Money paid to one person is not income of another person.

Proposed Adjustment B

B.1 Proposed Adjustment B is accepted .

Proposed Adjustment D

Item in error

D.1 Proposed Adjustment D is wrong. The cheques are not income of Sim Iles Panelbeaters and so I could not have intended to evade income tax.

Tax laws

D.2 Section BB 4(a) of the Income Tax Act 1994 (section 65(2)(a) of the 1976 Act) does not apply.

D.3 Section EB 1 of the Income Tax Act 1994 (section 75 of the 1976 Act) does not apply.

Facts in error

D.4 The cheques were not for services provided by Sim Iles Panelbeaters. I did not intend to evade tax because the cheques were not for my business.

Additional facts

D.5 The cheques were paid to Mrs Iles as gifts.

Additional legal issue

D.6 There are no additional legal issues. The cheques were not income of Sim Iles Panelbeaters. I did not intend to evade tax.

D.7 The amount of penal tax charged is too high.

Propositions of law

D.8 Sim Iles Panelbeaters relies on the following propositions of law:

Gifts are not assessable income.

If a person doesn't know that income is theirs that person cannot knowingly evade tax.

From the above Notice of Response only Proposed Adjustments A & D are still unresolved. The Commissioner cannot issue an assessment because not all the issues have been finalised. However, the Commissioner may advise the taxpayer to make a voluntary payment on account of the tax owing.

The file now progresses to the conference stage. Once the Commissioner receives Mr Iles' Notice of Response, he will write to Mr Iles and advise whether or not he accepts the Notice of Response. If the Commissioner does not accept the Notice of Response he will organise a conference to try to refine and resolve the outstanding issues.

4 April 1997



Bob, Bill & Jo
Chartered Accountants
Box 010
Neveville 1310

Attn.: Ms Smith

Name: S M Iles Panelbeaters
IRD number: 02-345-678
Our reference: AXR/BL3/WUZ

Dear Madam

Thank you for your Notice of Response dated 10 March 1997.

You have accepted proposed adjustment B, so this leaves only proposed adjustments A & D unresolved. After reviewing your Notice of Response in relation to those adjustments I advise that the Commissioner still believes that proposed Adjustments A& D are correct.

To help resolve this issue I will contact you to arrange a time to discuss these issues further.

Yours faithfully

AN Other
Investigator

At the conference stage Mr Iles, Mrs Iles and their accountant attend. The investigator advises them why the cheques are still considered to be income of Sim Iles Panelbeaters and therefore assessable to Mr Iles. Mr and Mrs Iles and their accountant agree to go away and reconsider their position.

A further conference is arranged for a date two weeks later. At that second conference Mr Iles agrees that the cheques were income from the services of Sim Iles

Panelbeaters. Mr Iles does not agree that penal tax should be charged. To ensure that this issue is finalised the investigator asks Mr Iles to sign a written acceptance of the proposed adjustment. A written agreement is signed.

The sole remaining issue is penal tax. As this issue cannot be agreed upon by further conferences the investigator issues a Disclosure Notice to Mr Iles requiring him to provide a Statement of Position.

Disclosure notice

10 May 1997

To: Mr Simon Iles
P O Box 11-111
Neveville

IRD No: 02-345-678

Take Notice that the Commissioner of Inland Revenue hereby requires you to provide a Statement of Position on or before 10 July 1997, being two months from the date of issue of this Notice. The Commissioner has no power to accept a Statement of Position filed after that date. However, you may apply to the High Court for additional time to file the Statement of Position, provided such application is made before the expiry date above.

In terms of section 89M(3) of the Tax Administration Act 1994, the Commissioner is required to advise you of section 138G, the evidence exclusion rule. The evidence exclusion rule has the effect of preventing any further facts, evidence, issues or propositions of law being argued in a challenge, subject to limited judicial discretion, or unless the Commissioner and the taxpayer agree to add material to the Statement of Position.

Accordingly, it is in your best interest to ensure all material that you consider relevant to a challenge is included in the Statement of Position.

This request is issued pursuant to section 89M of the Tax Administration Act 1994 and relates to the unresolved issues arising from the Notice of Proposed Adjustment issued on 20 January 1997.

If you fail to comply with the terms of this Notice within two months from the date of issue of this Notice you will be deemed to have accepted the Commissioner's position as stated in the Commissioner's Notice of Proposed Adjustment dated 20 January 1997.

DATED at Wellington this 10th day of May 1997.

A. N. Other

for and on behalf of the
Commissioner of Inland Revenue

Because the Commissioner initiated the proposed adjustment the Commissioner must attach his Statement of Position to the Disclosure Notice.

Mr Iles' Statement of Position is received on 30 June 1997. It does not reveal any new facts or evidence so the Commissioner does not need to issue an amended Statement of Position.

The investigator considers Mr Iles' Statement of Position to satisfy himself that the proposed adjustment is still correct. If he considers that the proposed adjustment is still correct the file is then ready to be referred to the Adjudication Unit. The investigator collates all the documentation, NOPA, Notice of Response, Written Agreements, Statements of Position, and relevant evidence held. An Adjudication Referral coversheet is completed.

Referral to Adjudication

Cover Sheet

Taxpayer: Mr Simon Iles
IRD no: 02-345-678
Address: P O Box 11-111 Neveville
Telephone: (05) 276-4391

Agent: Ms Smith, Bob, Bill & Jo
Address: P O Box 010, Neveville
Telephone: (05) 294-5312

Inland Revenue Officer: A N Other
Office: Wellington
Telephone: (04) 2222-000

Attachments

- Notices(s) of Proposed Adjustment
- Notice(s) of Response
- Commissioner's rejection of Notice of Response
- Conference details
- Commissioner's Statement of Position¹
- Taxpayer's Statement of Position¹
- Commissioner's Statement of Position reply¹
- Documentary evidence (as listed)¹

Schedule of adjustments

Disputed Proposed Adjustments

<i>Issue</i>	<i>Period</i>	<i>Amount</i>
Penal tax on income not returned	31/3/96	\$5,445

Other issues - Accepted or Deemed accepted

<i>Issue</i>	<i>Period</i>	<i>Amount</i>
Income not returned	31/3/96	\$11,000
Motor vehicle expenses disallowed	31/3/96	\$1,500
Repairs and Maintenance expenses disallowed	31/3/96	\$2,500

Period	Extension Time Bar	Date Return filed	Due date for payment of tax	Expiry date of time bar
31/3/96	N/A	7 June 1996		31 March 2001

Documentary evidence²

- Copies of cheques issued for year ended 31/3/96
- Copies of bank statements for year ended 31/3/96
- Interview notes with drawers of the cheques
- Interview notes, held with Mr Iles
- Interview notes, held with Mrs Iles

1. These documents are not included in this scenario

2. This is not a comprehensive list of the material that would ordinarily be forwarded to Adjudication.

Once the officer has prepared the referral notice, he will send a letter to Mr Iles' agent advising her that the file will be referred to Adjudication, and asking whether she wants any further previously-disclosed material added.

16 July 1997

Bob, Bill & Jo
Chartered Accountants
Box 010
Neverville 1310



Attn.: Ms Smith

Name: S M Iles Panelbeaters
IRD number: 02-345-678
Our reference: AXR/BL3/WUZ

Dear Madam

Thank you for your Statement of Position dated 30 June 1997.

Here is a copy of the cover sheet which will be sent to the Adjudication Unit.

Please check this document carefully. If there are any other documents which you have already disclosed to Inland Revenue, but which are not included in the documents attached and which you would like to be sent to the Adjudication Unit, please advise me as soon as possible.

To give you time to respond we will hold the file at this office for a further 10 working days. If you have not replied before that time I will send the file to the Adjudication Unit for review. If we receive your reply shortly after the file has been referred to the Adjudication Unit the additional material will be forwarded on to the Unit once we receive your reply. It is in your interest to respond as quickly as possible.

Yours faithfully

AN Other
Investigator

Once the file is at Adjudication, the Adjudicator will review the merits of each argument and determine which is the most legally correct based on the facts, evidence, issues and propositions disclosed.

The Adjudicator will then send a copy of the decision to both the investigator and the taxpayer. In this example the Adjudicator has found that penal tax should be assessed to Mr Iles. A new assessment will also be issued which will contain all the adjustments

referred to in the original NOPA. The new assessment will disallow the deduction for the path, disallow 75% of the motor vehicle expenses claimed, include the cheques banked into Mrs Iles account and include an amount of penal tax.

Once the assessment has been issued Mr Iles will have two months to file a case in the TRA or the High Court.

Scenario 2: Taxpayer rejects some adjustments, makes no mention of others

The following Notice of Response would have achieved the same end result, except that instead of accepting Proposed Adjustment B in writing, Mr Iles would be deemed to have accepted it by not rejecting it within the response period.

Notice of Response

**SM Iles trading as
Sim Iles Panelbeaters**

IRD NO: 02-345-678

Date of Issue: 10 March 1997

Items in error

- A.1 Proposed Adjustment A is wrong. The cheques were not for work done by Sim Iles Panelbeaters.

Tax laws

- A.2 Section BB 4(a) of the Income Tax Act 1994 (section 65(2)(a) of the 1976 Act) does not apply.
- A.3 Section EB 1 of the Income Tax Act 1994 (section 75 of the 1976 Act) does not apply.

Facts in error

- A.4 The cheques were not for services provided by Sim Iles Panelbeaters.

Additional facts

- A.5 The cheques were paid to Mrs Iles as gifts

Additional legal issues

- A.6 There are no additional legal issues. The cheques were not income of Sim Iles Panelbeaters.

Propositions of law

- A.7 Sim Iles Panelbeaters relies on the following propositions of law:
- Gifts are not assessable income.
- Money paid to one person is not income of another person.

Proposed Adjustment D

Item in error

- D.1 Proposed Adjustment D is wrong. The cheques are not income of Sim Iles Panelbeaters and so I could not have intended to evade income tax.

Tax laws

- D.2 Section BB 4(a) of the Income Tax Act 1994 (section 65(2)(a) of the 1976 Act) does not apply.
- D.3 Section EB 1 of the Income Tax Act 1994 (section 75 of the 1976 Act) does not apply.

Facts in error

- D.4 The cheques were not for services provided by Sim Iles Panelbeaters. I did not intend to evade tax because the cheques were not for my business.

Additional facts

- D.5 The cheques were paid to Mrs Iles as gifts.

Additional legal issue

- D.6 There are no additional legal issues. The cheques were not income of Sim Iles Panelbeaters. I did not intend to evade tax.
- D.7 The amount of penal tax charged is too high.

Propositions of law

- D.8 Sim Iles Panelbeaters relies on the following propositions of law:
- Gifts are not assessable income.
- If a person doesn't know that income is theirs that person cannot knowingly evade tax.

In response to the Notice of Response opposite, Inland Revenue would issue the following letter:

4 April 1997



Bob, Bill & Jo
Chartered Accountants
Box 010
Neveville 1310

Attn.: Ms Smith

Name: S M Iles Panelbeaters
IRD number: 02-345-678
Our reference: AXR/BL3/WUZ

Dear Madam

Thank you for your Notice of Response dated 10 March 1997.

You have not referred to proposed adjustment B in your Notice of Response. Under section 89I of the Tax Administration Act 1994 you are deemed to have accepted this proposed adjustment and cannot later challenge this adjustment.

Proposed adjustments A & D remain unresolved. After reviewing your Notice of Response in relation to those adjustments I advise that the Commissioner maintains the view that proposed Adjustments A& D are correct.

To help resolve matters I will contact you to arrange a time to discuss these issues further.

Yours faithfully

AN Other
Investigator

This file would then proceed to conference stage as in scenario 1 above.

Scenario 3: Commissioner accepts taxpayer's Notice of Response

Inland Revenue receives a Notice of Response from Mr Iles as in scenario 1. If the Commissioner accepts the points raised by Mr Iles he will send Mr Iles a letter to that effect.



4 April 1997

Bob, Bill & Jo
Chartered Accountants
Box 010
Neveville 1310

Attn.: Ms Smith

Name: S M Iles Panelbeaters
IRD number: 02-345-678
Our reference: AXR/BL3/WUZ

Dear Madam

Thank you for your Notice of Response dated 10 March 1997.

I advise that the Commissioner agrees with the points raised in your Notice of Response. Proposed Adjustments A & D should not be made.

As you have accepted proposed adjustments B & C an assessment will be raised taking these adjustments into account. A notice of Assessment will be issued shortly.

Please note that as these adjustments have been agreed to in writing, neither you nor the Commissioner can review or challenge these adjustments in the future.

Yours faithfully

AN Other
Investigator

Scenario 4: Commissioner accepts part of Notice of Response

The Commissioner receives a Notice of Response from Mr Iles as in scenario 1. The Commissioner accepts that adjustment "D" should not be made, and sends Mr Iles a letter to that effect.



4 April 1997

Bob, Bill & Jo
Chartered Accountants
Box 010
Neveville 1310

Attn.: Ms Smith

Name: S M Iles Panelbeaters
IRD number: 02-345-678
Our reference: AXR/BL3/WUZ

Dear Madam

Thank you for your Notice of Response dated 10 March 1997.

I advise that the Commissioner agrees that proposed adjustment D should not be made. This leaves only proposed adjustment A outstanding.

To help resolve this issue I will contact you to arrange a time to discuss it further.

Yours faithfully

AN Other
Investigator

Example 3: Multi Period, Multi Revenue Audit

Jay & Co were subject to a multi year, multi revenue audit. The audit started in July 1997, with the field work completed in October 1997. The investigator and Jay and Co's Financial Controller agreed to discuss any proposed adjustments during the field work stage, and if these could not be resolved then a NOPA would be issued as soon as possible afterwards.

NOPA 1 was issued on 5 September 1997. The issue concerned the deductibility of lease rental payments. Following issue of NOPA 1, Jay & Co wrote back agreeing to the adjustment.

The amounts and years were:

1993	\$1,000.00
1994	\$1,200.00
1995	\$1,500.00
1996	\$2,000.00

NOPA 2 was issued on 29 September 1997. The issue concerned depreciation which was said to have been over claimed. Following a Notice of Response from Jay & Co and further discussions during the conference stage, Jay & Co accepted that the adjustments were valid.

The amounts and years were:

1993	\$180.00
1994	\$200.00
1995	\$220.00
1996	\$250.00

NOPA 3 was issued on 15 October 1997. There were three issues covered. The first was GST on fringe benefits, the second concerned GST input tax credits not allowable and the third issue concerned hire costs not being deductible for tax purposes. Jay & Co accepted the GST on fringe benefits adjustment by letter, and filed a Notice of Response in relation to the GST input tax credit claims. Jay & Co made no mention of hire costs.

The amounts in contention and the years/periods were:

GST on fringe benefits

12/95	\$220.00
6/96	\$180.00
12/96	\$120.00

GST input tax credits

12/95	\$780.00
12/96	\$440.00
12/96	\$120.00

Hire costs

1994	\$375.00
1995	\$560.00
1996	\$900.00

NOPA 4 was issued on 5 November 1997. The issues concerned the deductibility of planning fees, and development expenditure on a land subdivision scheme. Jay & Co called the investigator advising that they did not accept either adjustment and would file a Notice of Response in due course. The Notice of Response only referred to development expenditure. It did not mention the matter of planning fees.

The amounts in contention and the years were:

Planning costs

1993	\$1,275.00
1994	\$2,500.00

Development expenditure

1994	\$1,850.00
1995	\$11,000.00

NOPA 5 was issued on 27 November 1997. The issue concerned the deductibility of establishment costs for a new, wholly owned operating company that had been established by Jay & Co. Inland Revenue received a Notice of Response from Jay & Co. During the conference stage, Jay & Co agreed to the issue in writing.

The tables on page 21 summarise the NOPAs issued and the status of individual issues at the end of the conference stage:

Income Tax issues	NOPA #	Agreed/deemed agreed?	1996	1995	1994	1993
<i>Income tax issues</i>						
Lease payments	1	Yes	\$2,000.00	\$1,500.00	\$1,200.00	\$1,000.00
Depreciation	2	Yes	\$250.00	\$220.00	\$200.00	\$180.00
Hire costs	3	Yes	\$900.00	\$560.00	\$375.00	
Planning fees	4	Yes			\$1,850.00	\$1,275.00
Development costs	4	No		\$11,000.00	\$2,500.00	
Establishment costs	5	Yes		\$2,000.00		

GST issues	NOPA #	Agreed/deemed agreed?	12/96	6/96	12/95
GST on fringe benefits	3	Yes	\$120.00	\$180.00	\$220.00
GST credits disallowed	3	No	\$440.00		\$780.00

The Commissioner's Statement of Position was issued in December 1997. It included a full description of the two issues still in contention, being development costs (1994 and 1995 years) and GST input tax credits (12/95 and 12/96 periods). As all other issues were agreed upon, or were deemed accepted, the Commissioner's Statement of Position will only require a brief

note to the effect that the issues have been agreed to or were deemed to be accepted.

Also in December 1997, the Commissioner issued income tax assessments for the 1993 and 1996 tax years, as there were no issues still in contention in these years. A GST assessment for the 6/96 period was also issued, as there were also no unresolved issues in this period.

Example 4: Profit from Sale of Shares

Notice of Proposed Adjustment

Name: Linen Co Ltd
IRD number: 03-456-789
Date issued: 10 November 1996

Proposed adjustments

- The Commissioner proposes to increase your assessable income for the year ended 31 March 1994 by the sum of \$500,000.00 being the gain on sale of shares.

Income as returned	\$4,500,000.00
Adjustments: gain on sale of shares	<u>\$ 500,000.00</u>
Income as Adjusted	<u>\$5,000,000.00</u>

Facts

- In February 1993 Linen Co Ltd sold its interests in Woolmakers Ltd. This left Linen Co Ltd with surplus cash available to reinvest in a complementary business activity. In March 1993 the Board of Directors of Linen Co Ltd discussed a report obtained from its financial advisers (Money Help Ltd) which indicated that an investment in a silk producing company would be an ideal complementary business. A suitable candidate was suggested.
 - Veiled Textiles Ltd, formerly Bird & Bird Shelf 29 Ltd, was incorporated on 1 March 1993 with a share capital of \$100.00. On 1 April 1993, Linen Co Ltd purchased the shares in Veiled Textiles Ltd and increased the share capital by \$999,900.00 giving paid up capital of \$1,000,000.00.
 - Also on 1 April 1993, Veiled Textiles Ltd invested \$1,000,000.00 in Silk Makers Ltd by way of redeemable preference shares. Silk Makers Ltd invested the funds in Thai Silk Company by way of loan.
 - On 31 March 1994, Silk Makers Ltd redeemed its shares from Veiled Textiles Ltd. Also on 31 March 1994 Linen Co Ltd sold the shares in Veiled Textiles Ltd for \$1,500,000.00. The \$500,000.00 gain on the sale of the shares is considered to be assessable.
 - Neither Veiled Textiles Ltd nor Silk Makers Ltd had any assets other than the \$1,000,000.00 investment. It has not been explained how the shares in Veiled Textiles Ltd were worth \$500,000 more than the value of the only asset (\$1,000,000.00).
 - Neither Veiled Textiles Ltd nor Silk Makers Ltd attempted to or was in a position to conduct a silk manufacturing business. The investment by Linen Co Ltd in Veiled Textiles Ltd was not for the purpose of conducting a genuine complementary business but was to enable the short term investment of surplus funds until such time as a suitable alternative presented itself.
 - Linen Co Ltd acquired the shares for the purpose of reselling or otherwise disposing of them. Linen Co Ltd sold the shares within 12 months of acquiring them. The explanation given by Linen Co Ltd for acquiring the

shares is not supported by the events occurring after the shares had been acquired. The purpose of Linen Co Ltd in acquiring the shares was not diversification into a complementary business, the shares were acquired for the purpose of resale or other disposition.

Tax laws

3. Section BB 4 of the Income Tax Act 1994 provides:

“Without in any way limiting the meaning of the term, the assessable income any person shall for the purposes of this Act be deemed to include, save so far as express provision is made in this Act to the contrary, -

(c) All profits or gains derived from the sale or other disposition of any personal property or interest in personal property (not being property or an interest in property which consists of land),... if the property was acquired for the purpose of selling or otherwise disposing of it...”

Issues

4. **The primary issue is:**

Whether the gain realised on the sale of the shares is assessable to Linen Co Ltd.

4.1 **Secondary issues include:**

Whether the shares were acquired with the purpose of resale or other disposition.

If there was more than one purpose for acquiring the shares, whether the dominant purpose was resale.

Propositions of law

5. **The Commissioner relies on the following propositions of law:**

Circumstances relevant in deciding whether the intention of resale exists include the nature of the asset, the number of similar transactions, the period of ownership and the circumstances of purchase and use. [as in: *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346]

In the case of shares, the length of time they are held is of particular importance. [as in: *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346]

The test of purpose is subjective requiring the consideration of the state of mind of the purchaser at the time of acquisition of the property: [as in: *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346]

If there is more than one purpose, the test is whether the dominant purpose is one of sale or other disposition. [as in: *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346]

If there is a purpose of resale it is irrelevant if the sale is a means to an end. [as in: *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346]

The nature of the asset purchased is an important consideration as is the period for which it is held: [as in *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346]

It is incorrect to say that the purchase of any asset as a hedge against the depreciating value of money falls outside section BB 4 (c): [as in *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346]

Notice of Response

Linen Co Ltd

IRD No: 03-456-789

Date of Issue: 25 November 1996

Items in error

1. No adjustment should be made to the assessable income amount returned by Linen Co Ltd for the year ended 31 March 1994. The Commissioner is not correct in his proposal to treat the gain on the sale of the shares as assessable income. The gain is a capital gain.

Tax laws

2. Section BB 4 does not apply.
 - 2.1 Capital gains are not assessable under the Income Tax Act.

Facts in error

3. The shares were not purchased with the intention of resale.

Additional facts

4. The shares were acquired to provide Linen Co Ltd with a subsidiary company through which it could explore new business opportunities. This was undertaken on the advice of Mr Smythe of Money Help Ltd. Those new business opportunities did not eventuate so the shares were sold.
 - 4.1 The short term investment of funds by Silk Makers Ltd in the Thai Silk Company was part of the strategy recommended by Mr Smythe. Mr Smythe's report recommended an indirect investment initially to enable Linen Co Ltd to easily withdraw from the investment if forays into the silk market proved not to be viable. The short term investment does not detract from the intention of Linen Co Ltd to purchase the shares for long term holding to enable exploration of a new business opportunity.
 - 4.2 Using a subsidiary company not otherwise visibly linked to Linen Co Ltd meant that if further investment in the silk business occurred and subsequently did not prosper the goodwill of Linen Co Ltd would not be lost.
 - 4.3 It is not correct to say that Veiled Textiles Ltd nor Silk Makers Ltd had no assets other than the \$1,000,000.00 investment. The investment by Silk Makers Ltd in the Thai Company was by way of loan at 17% interest payable at the end of the term. Consequently at the time the shares were sold Silk Makers Ltd had a right to interest on the loan of \$170,000.00 at net present value on the date of sale. As 100% owner of Silk Makers Ltd, Veiled Textiles Ltd also had the right to that interest had it wound up Silk Makers Ltd. The balance of the \$500,000.00 can be said to be what an arm's length party would pay for the right to access an established association with an international silk manufacturer.
 - 4.4 The establishment of links with an international silk manufacturer is evidence that Linen Co Ltd acquired the shares in Silk Co Ltd to diversify its business affairs.

Additional legal issues

5. There are no additional legal issues. The question remains whether the gain on sale of the shares is assessable or not.

Propositions of law

6. **Linen Co Ltd relies on the following propositions of law:**

The purpose test is subjective. As a company has no mind of its own, its purpose falls to be determined on the state of mind of the persons exercising the company's will.

It is a question of fact and degree whether the company had a subjective purpose of resale at the time of acquiring the shares.

The length of time that the shares were held is not determinative of the purpose for which the shares were acquired.

The length of time the shares were held must be considered in the light of the purpose for which they were acquired.

Commissioner's Statement of Position

Linen Co Ltd

IRD No: 03-456-789

Date of issue: 31 January 1997

Outline of facts

1. Linen Co Ltd is a limited liability company incorporated on 20 April 1967. Its directors and shareholders are Elizabeth Linen and Lance Linen, holding 100,000 shares each.
 - 1.1 In November 1992, Linen Co Ltd entered into a sale and purchase agreement for the sale of its interests in Woolmakers Ltd. The sale was finalised on 5 February 1993. After the sale of Woolmakers Ltd, Linen Co Ltd had significant surplus cash available. At the same time as the sale of Woolmakers Ltd, Linen Co Ltd sought advice from Mr Smythe of Money Help Ltd in relation to reinvestment of the surplus funds. A complementary activity was desired and on 28 February 1993 Mr Smythe provided a report to Linen Co Ltd. In that report Mr Smythe recommended that Linen Co Ltd invest in silk manufacturing; a relatively new industry in New Zealand.
 - 1.2 The report detailed how the investment could be made and noted that in the interim it may be preferable to invest in an observatory capacity rather than directly in silk manufacturing. The reason for the initial indirect investment was to enable Linen Co Ltd to withdraw from the investment if it was ultimately not suitable or the silk market was not as lucrative as anticipated.

- 1.3 In 10 March 1993 the Board of Directors of Linen Co Ltd discussed a report written by Mr Smythe of Money Help Ltd. The Board resolved to accept the advice in the report and sought urgent legal advice from its solicitors Bird & Bird to assess and implement the advice.
- 1.4 Bird & Bird have a number of shelf companies available for clients to purchase. Bird & Bird Shelf 29 Ltd and Bird & Bird Shelf 30 Ltd were two such companies. Both companies had been incorporated on 1 March 1993 each with a share capital of \$100.00 On 1 April 1993 Linen Co Ltd purchased the shares in Bird & Bird Shelf 29 Ltd. On that same date Linen Co Ltd changed the name of Bird & Bird Shelf 29 Ltd to Veiled Textiles Ltd and increased the share capital by \$999,900.00 giving paid up capital of \$1,000,000.00.
- 1.5 Also on 1 April 1993 Linen Co Ltd purchased Bird & Bird Shelf 30 Ltd and changed its name to Silk Makers Ltd. Silk Makers Ltd immediately resolved to issue 1000 redeemable preference shares at a premium of \$999.00 which were subscribed for by Veiled Textiles Ltd. Silk Makers Ltd invested the funds in a Thailand company, Thai Silk Company, which had direct interests in silk manufacturing.
- 1.6 These transactions were all effected and documented as recommended in the Smythe Report. Mr Smythe had connections in Thailand and this was reported to be a common manner of investing in the new silk industry.
- 1.7 In August 1993 the directors of Linen Co Ltd resolved not to proceed with their silk industry foray but to focus on their Linen business. They knew that there were funds available to expand into a sewing factory if the silk investment was not continued with. In February 1994 Linen Co Ltd contacted Mr Smythe to advise that it would not be making further investment in the silk industry. Mr Smythe advised Linen Co Ltd not to wind up Veiled Textiles Ltd as he had a suitable buyer.
- 1.8 On 1 March 1994 Silk Makers Ltd wrote to Thai Silk Company reminding Thai Silk Company that the due date for repayment of the loan was imminent. On 3 March 1994 Silk Makers Ltd wrote to Silk Ltd advising that it would be redeeming its shares on 31 March 1994. On 15 March 1994 Linen Co Ltd entered into an agreement for sale and purchase to sell Veiled Textiles Ltd to Money Help 2 Ltd - a subsidiary of Mr Smythe's company Money Help Ltd.
- 1.9 On 31 March 1994 Thai Silk Company repaid its loan to Silk Makers Ltd and Silk Makers Ltd redeemed its shares from Veiled Textiles Ltd. Also on 31 March 1994 Linen Co Ltd sold the shares in Veiled Textiles Ltd for \$1,500,000.00. The \$500,000.00 gain on the sale of the shares is considered to be assessable.
- 1.10 Neither Silk Co Ltd nor Silk Makers Ltd held any assets other than the \$1,000,000.00 investment. The investment by Silk Makers Ltd in the Thai Company was by way of loan at 17% interest payable at the end of the term. At the time the shares were sold Silk Makers Ltd had a right to interest on the loan of \$170,000 at net present value on the date of sale. As 100% owner of Silk Makers Ltd, Silk Co Ltd also had the right to that interest had it wound up Silk Makers Ltd. The balance of the \$500,000.00 is said to be what an arm's length party would pay for the right to access an established association with an international silk manufacturer.

- 1.11 The extent of the association with an international silk manufacturer is minimal. Veiled Textiles Ltd via its subsidiary had lent \$1,000,000.00 to a Thai company. No further feasibility studies were completed. No liaisons between Linen Co Ltd, Veiled Textiles Ltd or Silk Makers Ltd and the Thai company had occurred. Silk and Silk Makers Ltd had no separate staff of their own. No Linen Co employees had visited Thailand to learn about the silk industry. At no stage during the 12 month period did Linen Co Ltd or its subsidiaries contact personnel agencies or international silk experts with a view to employing them to run or establish a silk business.
- 1.12 From the date of its first investment in a silk company, Linen Co Ltd made no further moves to support its claim that it was intending to diversify into the silk business. At best Linen Co bought the shares in Veiled Textiles Ltd for short term purposes, knowing that it was only committed to the investment for the 12 month duration of the Silk Makers loan or such shorter duration if it could on-sell the loan.
- 1.13 Neither Silk Co Ltd nor Silk Makers attempted to or was in a position to conduct a silk manufacturing business. The investment by Linen Co Ltd in Silk Co Ltd was not for the purpose of conducting a genuine complementary business but was to enable the short term investment of surplus funds until such time as a suitable alternative presented itself. Such an alternative may have ultimately been in the silk industry, but in reality was not. Linen Co Ltd invested the funds in an activity which could have become permanent but which was not at the time the shares in Veiled Textiles Ltd were acquired.
- 1.14 Once the funds from Veiled Textiles Ltd were obtained they were applied toward the acquisition of a sewing factory - Merry Machinists. Plans for this acquisition had begun during the 12 month duration of the Veiled Textiles Ltd holding.
- 1.15 Linen Co Ltd acquired the shares for the purpose of reselling or otherwise disposing of them. Linen Co Ltd sold the shares within 12 months of acquiring them. The explanation given by Linen Co for acquiring the shares is not supported by the events occurring after the shares had been acquired.
- The purpose of Linen Co Ltd in acquiring the shares was not diversification into a complementary business. The shares were acquired to enable short term placement of surplus funds in a liquid investment to ensure their availability for long term placement once a suitable investment had been determined. The shares were therefore acquired for the purpose of resale or other disposition.

Outline of evidence

2. **The Commissioner will use the following evidence in support of his assessment:**

Linen Co Ltd documents

Certificate of Incorporation	20 April 1967
Particulars of Directors and Secretary	20 April 1967
Memorandum of Subscription	20 April 1967
Annual Report	31 March 1993
Annual Report	31 March 1994
Financial Accounts	31 March 1993
Financial Accounts	31 March 1994
Income Tax Return to	31 March 1994

Board meeting minutes

- Resolution to sell Wool Makers Ltd xx December 1992
- Resolution to seek advice on investment of funds available from sale of Woolmakers xx January 1993
- Records discussion on need to keep options open because of fluctuating world markets xx February 1993
- Discussion on Smythe report, resolution to accept Smythe report xx March 1993
- Discussion re legal advice on Smythe report xx March 1993
- Discussion re implementation of Smythe report recommendation xx March 1993
- Confirmation that Smythe report recommendation implemented xx April 1993
- Discussion re long term prospects of Linen Co Ltd - refers to availability of funds in Veiled Textiles Ltd xx May 1993
- Resolution to acquire machinist factory to support linen manufacturing business xx August 1993
- Sought advice on acquiring machinist factory xx September 1993
- Discussion re using funds in Veiled Textiles Ltd to acquire factory - discussion on advice from Mr Smythe xx February
- Resolution to sell Veiled Textiles Ltd xx March 1994
- Discussion re sale of Veiled Textiles Ltd and acquisition of machinist factory. xx March 1994
- Confirmation that sale of Veiled Textiles Ltd completed and funds available to acquire Merry Machinists business xx April 1994

Internal Memos

- xx December 1992
- xx January 1993
- xx February 1993
- xx March 1993
- xx March 1993
- xx March 1993
- xx April 1993
- xx April 1993
- xx May 1993
- xx August 1993
- xx September 1993
- xx February 1994
- xx March 1994
- xx March 1994
- xx April 1994

Letter to Bird & Bird

- 10 March 1993
- 16 March 1994

Money Help Ltd documents

- Report of Mr Smythe 28 February 1993
- Letter Mr Smythe to Linen Co Ltd 4 March 1994
- Agreement for Sale and Purchase of Veiled Textiles Ltd 1 March 1994

Bird & Bird Shelf 29 Ltd/Veiled Textiles Ltd documents

Certificate of Incorporation	1 March 1993
Agreement for Sale and Purchase	25 March 1993
Memorandum of Subscription	1 March 1993
Memorandum of Subscription	1 April 1993
Particulars of Directors and Secretary	1 March 1993
Particulars of Directors and Secretary	1 April 1993
Notice of Change of Name	1 April 1993
Notice of Increase in Share Capital	1 April 1994
Resolution of Board	1 April 1994
Income Tax Return to	31 March 1994

Bird & Bird documents

Settlement statements	27 March 1993
	16 March 1994
Trust account ledgers	1 April 1993
	1 April 1994

Bird & Bird Shelf 30 Ltd/ Silk Makers Ltd documents

Certificate of Incorporation	1 April 1993
Agreement for Sale and Purchase	27 March 1993
Memorandum of Subscription	1 March 1993
Memorandum of Subscription	1 April 1993
Particulars of Directors and Secretary	1 March 1993
Particulars of Directors and Secretary	1 April 1993
Notice of Change of Name	1 April 1993
Resolutions of Board of Directors	1 April 1993
Deed of Loan	1 April 1993
Bank Statements	30 April 1993
Letter to Thai Silk Company	1 March 1994
Letter from Thai Silk Company	15 March 1994
Resolution of Board	1 March 1994
Letter to Veiled Textiles Ltd	15 March 1994
Income Tax Return to	31 March 1994

Other documentary evidence

File notes of interviews during investigation	30 September 1994
	20 February 1995
	14 April 1995
	30 August 1995
File notes held by ANZ Bank	15 March 1993
	20 March 1993
	16 March 1994
File Notes held by Smart Wylie & Baker, Chartered Accountants	15 March 1993
	20 March 1993
	20 April 1993
	16 March 1994
	1 April 1994
	20 April 1994
Agreement for Sale and Purchase of a Business - Merry Machinists	30 April 1994
Notice of Proposed Adjustment	10 November 1995
Notice of Response	19 November 1995

Oral evidence

Oral evidence of Ms Parker, ANZ Bank
Oral evidence of Mr Smart, Smart, Wylie & Baker, Chartered Accountants
Oral evidence of Mrs Graham - New Zealand silk specialist
Oral evidence from Mr Smythe, Money Help Ltd
Oral evidence from Ms Wyse, ANZ Bank Manager
Oral evidence from Linen Co Ltd employees, shareholders and directors.
Oral evidence of Elizabeth Carter
Oral evidence of Bill Carter
Oral evidence of Sam Bird, Bird & Bird
Oral evidence of Mr Sim - Thai Silk Company

Outline of issues

4.1 The primary issue is:

Whether the gain realised on the sale of the shares is assessable to Linen Co Ltd.

4.2 Secondary issues include:

Whether the shares were acquired with the purpose of resale or other disposition.

If there was more than one purpose for acquiring the shares, whether the dominant purpose was resale.

Propositions of law

5. The Commissioner relies on the following propositions of law:

Although the test of purpose is subjective, where the taxpayer is a company it is the subjective purpose in the minds of those in control of the company which is determinative.

When subjective purposes are in issue the statements of the taxpayer, or someone who can speak for the taxpayer, are important evidence. These statements must be assessed and tested in the totality of circumstances which will include the nature of the asset, the vocation of the taxpayer, the circumstances of the purchase, the number of similar transactions, the length of time the property was held and the circumstances of the use and disposal of the asset. Actions may speak louder than words and the totality of the circumstances may negate the asserted purpose of the purchase.

The length of time the shares are held before being sold is regarded of particular importance.

If there is more than one purpose, the test is whether the dominant purpose is one of sale or other disposition. If there is a purpose of resale it is irrelevant if the sale is a means to an end.

The nature of the asset purchased is an important consideration as is the period for which it is held.

It is incorrect to say that the purchase of any asset as a hedge against the depreciating value of money falls outside section BB 4(c).

This is the taxpayer's Statement of Position:

Statement of Position

Linen Co Ltd

IRD No. XX-XXX-XXX

Date of issue: 25 November 1996

1. Facts

- 1.1 The facts are largely the same as those outlined in the Commissioner's Statement of Position.
- 1.2 The following additional facts are relevant. The shares were acquired to provide Linen Co Ltd with a subsidiary company through which it could explore new business opportunities. This was undertaken on the advice of Mr Smythe of Money Help Ltd. Those new business opportunities did not eventuate so the shares were sold.
- 1.3 The short term investment of funds by Silk Makers Ltd in the Thai Silk Company was part of the strategy recommended by Mr Smythe. Mr Smythe's report recommended an indirect investment initially to enable Linen Co Ltd to easily withdraw from the investment if forays into the silk market proved not to be viable. The short term investment does not detract from the intention of Linen Co Ltd to purchase the shares for long term holding to enable exploration of a new business opportunity.
- 1.4 Using a subsidiary company not otherwise visibly linked to Linen Co Ltd meant that if further investment in the silk business occurred and subsequently did not prosper the goodwill of Linen Co Ltd would not be lost.
- 1.5 It is not correct to say that Veiled Textiles Ltd nor Silk Makers Ltd had no assets other than the \$1,000,000.00 investment. The investment by Silk Makers Ltd in the Thai Company was by way of loan at 17% interest payable at the end of the term. Consequently at the time the shares were sold Silk Makers Ltd had a right to interest on the loan of \$170,000.00 at net present value on the date of sale. As 100% owner of Silk Makers Ltd, Veiled Textiles Ltd also had the right to that interest had it wound up Silk Makers Ltd. The balance of the \$500,000.00 can be said to be what an arm's length party would pay for the right to access an established association with an international silk manufacturer.
- 1.6 The establishment of links with an international silk manufacturer is evidence that Linen Co Ltd acquired the shares in Silk Co Ltd to diversify its business affairs.

2. Issues

- 2.1. The issues arising are those set out in the Commissioner's Statement of Position.

3. Evidence

3.1 The evidence relied on by Linen Co is largely the same as that outlined in the Commissioner's Statement of Position.

3.2 The following additional evidence is relied on.

Oral evidence of Mr Singh - Managing Director

Ms Milton - Financial Controller

Mr Smart - Accountant

Mr Wood - Thailand agent.

4. Propositions of law

4.1 Linen Co Ltd relies on the following propositions of law:

The purpose test is subjective. As a company has no mind of its own, its purpose falls to be determined on the state of mind of the persons exercising the company's will.

It is a question of fact and degree whether the company had a subjective purpose of resale at the time of acquiring the shares.

The length of time that the shares were held is not determinative of the purpose for which the shares were acquired. The length of time the shares were held must be considered in the light of the purpose for which they were acquired.

Example 5: Late NOPA, Application of Section 113, Tax Administration Act 1994

In June 1996, Anna McAble filed her 1996 IR 5 tax return, which included details of income from her job as a teacher, and the interest income from her bank account. A notice of assessment was issued on 24 June, which showed that she had tax to pay of \$45.63. On 21 July Ms McAble went to Korea to teach English for four months.

In December 1996, when Ms McAble returned to New Zealand, she wrote to her local Inland Revenue office, enclosing two receipts for donations relating to the 1996 financial year:

123 Trundle St
Thorndon
5 December 1996

Dear Sir/Madam

I'm writing about my 1996 tax return, which I completed and filed in June before going overseas. My IRD Number is 04-567-890

During the 1996 year I made donations to the New Zealand Foundation for the Blind and the local branch of New Zealand Purple political party. I was going to claim the donation rebate for these payments when I filed my return, but I hadn't received a receipt from New Zealand Purple, and couldn't find my receipt from the New Zealand Foundation for the Blind before leaving.

When I returned from teaching in Korea I found that the receipt from the Blind Foundation had been in my desk all along, but in the wrong envelope. I have now also received a receipt from New Zealand Purple. Here are both receipts; please could you calculate the correct rebate for me.

Your early response would be appreciated.

A McAble

As a result of this letter, Mr John Smith, an officer of Inland Revenue wrote to Ms McAble as follows:



Inland Revenue
Private Bag
Rukuhia

Phone (05) 495 7900
Extension 86412

12 December 1996

Dear Ms McAble

IRD No: 04-567-890

Our reference: RKH/PCS/JKS

Thank you for your letter of 5 December about your 1996 tax return.

The Tax Administration Act 1994 governs when you may adjust a return you have filed. Specifically, you may dispute an assessment by issuing a Notice of Proposed Adjustment, providing you do so within the applicable response period (two months from the date of the assessment in this case). However, your request is outside the period in which such a Notice may be considered.

Regardless of the above, I accept that a rebate of up to \$500 is allowable for donations made to charitable organisations. Section 113 authorises the Commissioner to alter an assessment to ensure that it is correct at any time, so under that section I have accepted your request to have a rebate calculated on the basis of your \$600 donation to the New Zealand Foundation for the Blind. You will shortly receive an amended assessment allowing this rebate.

New Zealand Purple is not a registered charitable organisation, so I cannot accept your request to claim a rebate for this donation.

If you disagree with this decision you may wish to issue a Notice of Proposed Adjustment. As discussed earlier, generally you must issue such a Notice within the two month response period following the date of the Notice of Assessment. However, the Commissioner may accept a late Notice if he considers that exceptional circumstances have prevented the taxpayer from issuing the Notice of Proposed Adjustment within the applicable response period. If you consider that exceptional circumstances have prevented you from issuing a Notice of Proposed Adjustment previously, you must now write to us detailing the reasons why your notice is late, and enclose your Notice of Proposed Adjustment. I have enclosed a copy of our booklet *Disputing an Assessment (IR 210J)* for your information.

Yours faithfully

John Smith

As a result of the previous letter, Ms McAble sent the following letter, along with a Notice of Proposed Adjustment.

123 Trundle St
Thorndon
19 December 1996

Dear Mr Smith

IRD Number: 04-567-890

Your reference: RKH/PCS/JKS

Thank you for your letter dated 12 December.

When I made my donation to New Zealand Purple they told me that donations were 'tax deductible' - I probably wouldn't have given them anything otherwise!! I believe from what they told me I am entitled to a rebate for the donation made, therefore I enclose my Notice of Proposed Adjustment for the '96 tax year. I apologise for its lateness, however after reading your booklet, I believe that it could be said that 'exceptional circumstances' have prevented me from issuing it earlier.

Although I knew that a receipt from the party was going to be posted shortly, I filed my return without claiming the rebate because I was going overseas, and wanted to tidy up my affairs. I knew that the assessment showing tax to pay would come out while I was away, but didn't worry about it because I thought I would get a refund (eventually), when I sent in my claim for a donation rebate. My mother did tell me in a letter (in August) that the receipt had arrived, but I did not think it was important that any thing be done at that stage.

I anticipate your early reply.

A McAble

Mr Smith subsequently replied to Ms McAble, stating that the reasons given for failure to issue her Notice of Proposed Adjustment did not amount to exceptional circumstances, and therefore the Commissioner was unable to accept it. Ms McAble knew that the assessment was incorrect when filing her return, but she did not take any actions to ensure that it would be corrected within the two months after the issuing of the assessment.

The Commissioner was required to accept the adjustment for the donation made to New Zealand Foundation for the Blind because of the provisions of Section 113 of the Tax Administration Act, under which he is required, at any time, to make alterations to an assessment to ensure that it is correct.

Audit procedures

Purpose of an audit

The purpose of an audit is to ensure that the correct amount of tax has been paid and that taxpayers' obligations under the various Inland Revenue Acts have been complied with. An audit might simply be a check of a GST registration, or it could be a full examination of business records. For a detailed description of Inland Revenue's audit procedures, see our booklet *A Guide to Inland Revenue Audits (IR 297)*.

How audits are undertaken

Each type of audit is conducted differently, although the basic procedures are the same. For example, payroll audits may only take one visit, while an investigation often requires repeat visits by an investigator to work at a taxpayer's place of business. Audits may also vary according to the nature of the taxpayer's business activities.

At Inland Revenue we've divided our service areas into various segments based on taxpayers' needs. The segments are:

- Personal Customer Services - for non-business individuals not represented by a tax practitioner
- Business Direct - for business and other customers not represented by a tax practitioner
- Business Link - for business and other customers represented by a tax practitioner
- Corporates - for business groups with a consolidated turnover exceeding \$100 million, and specified industries such as banking and insurance
- Child Support - for custodial and non-custodial parents or guardians.

How taxpayers may be chosen for an audit

A taxpayer may be chosen for an audit based on any one or more of the following:

- a computer analysis of the taxpayer's business accounts or tax returns
- a manual analysis of the taxpayer's business accounts or tax returns
- checking of third party records (such as employer or bank records) and matching to the taxpayer's records
- information received in another audit which suggests that the taxpayer's records should be checked
- a taxpayer's compliance record (whether the taxpayer has complied with the tax laws in the past)
- a taxpayer's payment record (whether the taxpayer has paid taxes on time in the past)
- selection of a particular industry
- examination of a particular issue or problem which affects a group of taxpayers

- a taxpayer's place of residence or location of business if a particular area is selected for audit
- information received from other taxpayers
- a random basis.

We will not tell taxpayers which specific factor or factors led to their selection for an audit.

Case familiarisation

Investigators work in teams comprising a team leader and several team members. The team leader has a quality control function, but investigators are responsible for their own audits.

The case familiarisation phase of an audit task involves an investigator researching background information in order to make informed decisions about whether to carry out subsequent phases of the audit.

Case preparation

Once a decision is made to undertake an audit, the investigator will prepare the case. This phase of the audit involves research to confirm that the issues identified warrant further work. At the end of this research the investigator will generally formulate a Case Plan. Each case has its own characteristics, so there is no set format for the case plan. It will be based on characteristics specific to the case.

Before an audit proceeds beyond the case preparation stage, the investigator will discuss the case plan with the team leader. Following this discussion the team leader may change the focus of the audit if appropriate.

Starting the audit

We will normally send the taxpayer a letter advising of an impending audit. On rare occasions, and only if special circumstances exist, an audit may start with an unannounced visit. An example of this is that Inland Revenue will make unannounced visits to premises and spot check both payroll and GST records to ensure that businesses are in the tax system.

The letter which notifies a taxpayer of an impending audit will advise the scope of the audit, ask for the records and information required and make arrangements for an initial interview.

If a taxpayer questions the Commissioner's authority to request information or records, we may issue a section 17 letter. Emphasis will be placed on reviewing all the information and records that are considered necessary and relevant. If there is delay in providing information and records, or doubt cast on the ability to review certain records, we will consider issuing a section 17 letter.

The initial letter generally won't refer to section 17. However, the use of section 17 requests reinforces the

policy behind the disclosure procedure/evidence exclusion rule that the tax disputes process will only work if there is full disclosure of the matters required. Hence if an informal request for information or records is not complied with, we will request the information or records by way of a formal section 16 or 17 demand.

For larger, team audits, there may be a courtesy phone call advising of an upcoming audit. This will be followed up with a letter which sets out the issues to be discussed at the initial meeting. It is at this stage that the scope of the audit, type of records to be reviewed, the expected duration of the field work phase and details such as accommodation, access to records, taxpayers' office hours, how issues identified will be dealt with in the first instance, audit progress meetings, liaison person and other administrative issues will be discussed. The type of contact and the manner in which initial meetings will be conducted will depend on the nature of the audit.

Contact during the audit

Our emphasis is on resolving issues early, so communication between the investigator and the taxpayer will be an important issue. We expect that all parties to the audit will conduct themselves in a professional and co-operative manner at all times.

Early in the audit there should be discussion on the manner in which issues will be progressed. There could be any number of arrangements, e.g.. advising the taxpayer as each issue arises, or putting information requests in writing on an issue-by-issue basis, or awaiting the completion of field work before issues are tabled. Once an arrangement is made between the investigator and the taxpayer, every effort should be made to abide by it. There should be some form of communication if the agreed arrangements cannot be adhered to by either side for whatever reason. If the taxpayer feels that there has been a lack of communication, he or she should approach the investigator in the first instance.

We anticipate that this communication will lead to the resolution of many issues. Inland Revenue will seek written agreement on issues. The sooner issues are resolved at this stage, the earlier an audit can be completed. In some cases the process could involve swapping letters or issue papers which detail Inland Revenue's views on particular issues. These will not be a substitute for the NOPA. They are a means of identifying and hopefully agreeing on issues. If agreement cannot be reached, then generally a NOPA will be issued.

Technical input

Our investigators will seek technical assistance from other segments of Inland Revenue as required. In each Service Centre there will be sufficient technical and legal support to address the more complex cases/issues.

Review of records

This phase of an audit involves a review of the business and if appropriate, the private records of the taxpayer. The purpose of the review is to familiarise the investigator with the operational processes of the business and to sight evidence to support the tax treatment of transactions recorded in the taxpayer's tax returns.

The investigator may review the taxpayer's business and private records, tax returns and the working papers of both the taxpayer and the taxpayer's agent. As the extent or nature of the taxpayer's records will generally not be known before an audit starts, the initial request for information may be insufficient.

Information subsequently supplied by the taxpayer may lead to further issues arising, in which case the investigator will discuss the matter further with the taxpayer and if necessary, request further information. The aim at all times is to gather the information and records which are necessary to resolve an issue. The sooner "all cards are on the table", the sooner the issue can be resolved/finalised. We will make every attempt to resolve issues which could be contentious before the issue of a NOPA.

Requests for information will vary with the type and scope of an audit. Source records will be reviewed in almost all cases. We expect that the combined effect of the new penalties rules and the evidence exclusion rule will ensure that taxpayers improve their record keeping habits, especially in regards to transactional documentation.

The types of records that may be reviewed include such records as organisation and group structure charts, tax work papers, tax and accounting work paper files, statutory financial statements, management accounts, general and private ledgers, trial balances, charts of accounts, management and board meeting minutes, journals, minute books, contracts, suppliers' vouchers and sales invoices, correspondence between associated parties, inter-company memos, bank statements, motor vehicle log books, accountants' questionnaires, executives' file indexes, consolidation work papers, employee files/employment contracts, seal registers, accounting and tax policy manuals, copies of tax advice received, solicitors'/barristers' advice if fraud, tax avoidance or evasion is involved, auditors' work papers, stock sheets, depreciation schedules and year end work papers.

Inland Revenue has recently started auditing taxpayers' computer systems. We generally undertake this some weeks before the actual field work phase of an audit. If a taxpayer's computer records are to be audited, then we will give advance notice of this event and discuss it fully with the taxpayer. Computer tax auditing has a distinct advantage in timely completion of an audit, which benefits both Inland Revenue and taxpayers.

Disputes Resolution

This appendix contains worked examples of the Disputes Resolution process. They follow the process as explained in the accompanying Tax Information Bulletin, and also give an indication of the level of detail that is expected when completing the various forms.

We suggest that you refer to the main TIB when completing the forms required in the disputes resolution process, as the following examples do not necessarily cover every aspect of the disputes procedures.

This appendix also contains a section on audit procedures, to give you a general outline of how Inland Revenue undertakes tax audits.

Contents

Example 1: Simple Notice of Proposed Adjustment	1
Example 2: Adjustments arising from an audit	2
– Scenario 1: Taxpayer rejects some adjustments, accepts others	9
– Scenario 2: Taxpayer rejects some adjustments, makes no mention of others	15
– Scenario 3: Commissioner accepts taxpayer's Notice of Response	18
– Scenario 4: Commissioner accepts part of Notice of Response	19
Example 3: Multi period, multi revenue audit	20
Example 4: Complex example - profit from sale of shares	22
Example 5: Late NOPA, application of Section 113, Tax Administration Act	33
Audit procedures	36