TAX INFORMATION BULLETIN

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This *Tax Information Bulletin* is also available on the internet in PDF. Our website is at **www.ird.govt.nz**

It has other Inland Revenue information that you may find useful, including any draft binding rulings and interpretation statements that are available.

If you prefer to get the *TIB* from our website and no longer need a paper copy, please let us know so we can take you off our mailing list. You can do this by completing the form at the back of this *TIB*, or by emailing us at **IRDTIB@datamail.co.nz** with your name and details.

THIS MONTH'S OPPORTUNITY FOR YOU TO COMMENT

Inland Revenue produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents.

Because we are keen to produce items that accurately and fairly reflect taxation legislation, and are useful in practical situations, your input into the process—as perhaps a user of that legislation—is highly valued.

The following draft items are available for review/comment this month, having a deadline of 31 October 2004.

Ref.	**Draft type**	**Description**
IS0060	Interpretation statement	Shortfall penalty for taking an abusive tax position
IS0062	Interpretation statement	Shortfall penalty—evasion

Please see page 30 for details on how to obtain a copy.

Ref.	**Draft type**	**Description**
DDG0093	Provisional depreciation determination	Integrated silk flower arrangements

Please see page 18 for the text of this draft.

BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently.

The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates tax liability based on it.

For full details of how binding rulings work, see our information booklet *Adjudication & Rulings, a guide to binding rulings (IR 715)* or the article on page 1 of *Tax Information Bulletin* Vol 6, No 12 (May 1995) or Vol 7, No 2 (August 1995).

You can download these publications free from our website at **www.ird.govt.nz**

PRODUCT RULING – BR PRD 04/10

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by BNZ Investment Management Limited as Administration Manager of The BNZ International Equity Index Fund.

Taxation Laws

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of section HH 3(5) and the section OB 1 definitions of "qualifying trust" and "superannuation fund".

The Arrangement to which this Ruling applies

The Arrangement is the operation of the BNZ International Equity Index Fund ("the Fund") pursuant to the Trust Deed of the Fund, dated 1 July 2001, as amended by a Deed of Amendment dated 21 December 2001 ("the Trust Deed"). The Trust Deed will be further amended as soon as practicable following the issuing of this ruling by a Deed of Amendment and the final Deed of Amendment will not be materially different from the draft Deed of Amendment provided to the Rulings Unit on 11 June 2004 ("the Amending Deed").

Further details of the Arrangement are set out in the paragraphs below.

1. The Fund invests in equity securities that correspond to the composition of the Morgan Stanley Capital International World Index ("MSCI"), modified such that the securities invested in will be of those countries specified in Part A of Schedule 3 to the Act ("grey-list countries") that each comprise 1% or more of the MSCI ("the BNZ Index"). The Fund has been designed to enable investors to obtain, through one security, the same financial results that can be obtained through the direct investment in the securities of those companies that make up the BNZ Index.

2. The Trustee of the Fund ("the Trustee") is Trustees Executors Superannuation Limited. In July 2003, TOWER Trust Superannuation Limited (as a result of a change in ownership) reverted to its former name of Trustees Executors Superannuation Limited.

3. The Administration Manager of the Fund is BNZ Investment Management Limited (the "Administration Manager"). The Investment Manager of the Fund is State Street Global Advisors, Australia, Limited ("the Investment Manager").

4. The Sponsor of the Fund is the Bank of New Zealand ("the Sponsor").

5. The Fund is a wholesale superannuation fund into which other wholesale and retail superannuation funds invest. The Fund was established for the purpose of being a wholesale investment vehicle for retail superannuation funds, other wholesale superannuation funds and for the purpose of providing retirement benefits to the limited number of natural persons who invest directly in it. Unless the prior approval of the Trustee, with the consent of the Sponsor, is obtained, the minimum initial investment into the Fund is NZ$200,000.

6. The Fund is registered under the Superannuation Schemes Act 1989.

7. The Trust Deed states that:

   > The investment policy of the Fund will be:
   >
   > (a) to invest the Fund (other than the Cash Pool) in accordance with Schedule 2 to this Deed only in such investments as the Trustee considers

necessary to track the modified grey list components of the World Index; and

(b) to invest the Cash Pool in restricted investments, being deposits with banks, and futures contracts.

8. The Fund buys and sells shares as required to ensure that it continues to correspond to the BNZ Index. Such buying and selling will not be motivated by any intention to derive a profit or gain from such sales. In this regard, the Trust Deed states:

> The Fund and the Trustee do not have an intention to profit from holding, acquiring or selling Index Company securities.

9. The Applicant has confirmed that all material aspects of the previous rulings (Prv 97/125, Prv 01/11, Prv 01/65, Prv 01/114, Prd 97/38, Prd 01/30 and Prd 02/01), relating to the Fund, have been complied with, except that:

   (a) The earliest rulings did not refer to the Investment Manager's ability to sell securities where an individual security was outside its tracking weight, and

   (b) In some cases investments from natural persons have been below $200,000.

10. The only amendments to the Trust Deed are those contained in the Amending Deed. There has not been any material change to the management or operation of the Fund since its establishment.

Date of adjustments

11. The Fund is re-balanced in the following circumstances:

    - If a security is outside its BNZ Index weight by the lesser of
        - 0.5% of the total Fund, whether positive or negative, or
        - three times the BNZ Index weight of the individual security, and
        - when the periodic (currently quarterly) adjustments are made to the MSCI, and
        - if there are any MSCI market driven changes (as identified in clause 3.3 of the current *MSCI Methodology Book: MSCI Standard Index Series Methodology*) or corporate actions such as a merger, takeover, new listing or reduction or increase in capital affecting any index company in the BNZ Index.

12. Such re-balancing will occur at the earliest practicable time after the above events have occurred and in any event within five business days.

Events that trigger acquisitions or realisations

13. There are certain reasons or events when investments held by the Fund will have to be bought or sold. The Trustee will only dispose of securities (other than cash pool investments) if:

    - the Fund is wound up
    - there is a change in the BNZ Index and composition of the securities of the Fund no longer tracks the BNZ Index (whether as a result of a change to the countries included or a change to the securities included)
    - there is a compulsory acquisition of one of the Fund's securities or a security is acquired on a compulsory acquisition, merger or takeover which does not track the BNZ Index
    - there is a net withdrawal of funds from the Fund by members
    - there is a claim on the Trustee in respect of the Fund which cannot be otherwise satisfied, or
    - the Fund is re-balanced in accordance with the first bullet point in paragraph 11, earlier.

Rights issues

14. In the event of any rights issue by an index company, the Investment Manager will retain the entitlement and take up the securities if the securities the subject of the entitlement will be immediately included in the BNZ Index.

15. Notwithstanding paragraph 14, if the securities the subject of the entitlement are over-represented, the Investment Manager will sell the entitlement and reinvest the proceeds in the index companies to track the BNZ Index.

16. If the Investment Manager does not know whether the securities the subject of the entitlement will be included in the Index the Investment Manager will sell the entitlement at the earliest practicable time (and in any event within five business days) and reinvest the proceeds in the index companies to track the BNZ Index.

Mergers, takeovers and share buy-backs

17. The BNZ Index may be adjusted from time to time because of mergers, takeovers, share buy-backs, distributions of capital, cash issues, and substitutions of companies in the BNZ Index.

18. In the event of a merger or takeover of a BNZ Index company the Investment Manager will adjust the Fund portfolio at the earliest practicable time (but in any event within five business days) to the time the

BNZ Index is adjusted. The Fund will not accept an offer unless as a consequence of not accepting the offer the Fund would track the BNZ Index less accurately than if it had accepted the offer.

19. The Investment Manager will not participate in an optional share buy-back by a BNZ Index company.

Hedging

20. There is no specific provision in the Trust Deed that allows the Fund to hedge foreign exchange risks.

21. The Fund will not take any action to hedge or manage foreign exchange risks or exposures that arise from the investments of the Fund being held in non-New Zealand currencies.

Borrowing

22. Clause 10.1 (c) of the Trust provides:

> …The Trustee may:
>
> borrow money for the purpose of the Fund upon terms and conditions agreed by the Sponsor and the Trustee and charge all or part of the assets of the Fund with repayment and payment of interest on the moneys so borrowed;

23. Pursuant to the ruling, the Fund can only borrow in the following circumstances:

- To temporarily fund the redemption of units when the cash pool has insufficient funds; this borrowing must be repaid at the earliest practicable time, and in any event any such borrowing will be repaid within three business days
- Where a security is sold and another purchased and a settlement mismatch occurs resulting in the Fund's bank account becoming inadvertently overdrawn, and in this event for no longer than strictly necessary
- To temporarily fund the purchase of securities in order to rebalance following a merger, where pursuant to the merger payment due to the Fund for securities that have been disposed of has been delayed (such delay being beyond the control of the Fund), and in this event for no longer than strictly necessary, or
- For advances (not to exceed total borrowings of $5,000) by the Administration Manager to the Fund to meet expenses of the Fund, where the Administration Manager's expense account is insufficient to enable the Administration Manager to meet such expenses.

Cash investments held by the Fund

24. Although it is not an objective of the Fund to hold cash, the Trustee and the Investment Manager may hold cash to facilitate the easier administration of the Fund. The cash held by the Trustee and the Investment Manager is on "call". Wherever possible, futures contracts will be entered into by the Investment Manager to cover cash held by the Investment Manager. This is known as "equitised cash".

25. The Investment Manager or the Trustee will hold cash in the following circumstances:

- Following the sale of securities in the course of tracking the BNZ Index or in the course of a compulsory acquisition, merger, takeover, share buy-back or distribution of capital pending the reinvestment of that cash
- Following a contribution to the Fund, pending the investment of that contribution
- Following the sale of securities to meet a request for withdrawal by a member
- When a dividend is paid to the Fund in respect of an investment in a security
- To accumulate the minimum amount of cash required to allow for minimum trade sizes and to obtain a reasonable representation of the number of securities on the BNZ Index ("the minimum investment level"). The Investment Manager has advised that this amount is presently approximately $US3 million. The minimum investment level may increase (or reduce) in the future to the extent that a different amount is required to purchase the equivalent representation of securities on the BNZ Index.

26. The Investment Manager may hold up to an amount equivalent to the minimum investment level in cash (including both free and equitised cash). This threshold may be exceeded in the following circumstances:

- for up to ten business days preceding an MSCI Structural Change or for up to three business days following a significant new investment
- for up to three business days after an MSCI Structural Change
- for up to ten business days prior to a pending withdrawal in respect of which it has received a withdrawal request.

27. In addition to any funds held by the Investment Manager, the Trustee may hold up to NZ$2 million in cash. This threshold may be exceeded in the following circumstances:
    - for up to ten business days if there are withdrawals pending in respect of which it has received a withdrawal request, or
    - for up to three business days if the excess results from a significant new investment.
28. At all times, there is a limit on the total cash (including cash held by the Trustee and free and equitised cash held by the Investment Manager) of 5% of the total Fund (except if there is a significant withdrawal or investment).
29. The Investment Manager will use best endeavours to equitise all cash, subject to futures contract size constraints.
30. The following futures contracts are used:

Country	Contract
Australia	SPI200
Canada	S&P/TSE60
Japan	Topix
Germany	DAX
United Kingdom	FTSE100
United States	S&P500

31. In the event that alternative futures contracts in one or more markets enable improved tracking of the BNZ Index, or that one or more of the above contracts ceases to exist, the Investment Manager will use such alternative contract or contracts.

Dividends

32. The Investment Manager will receive the dividend (and other income) distributions from the securities in which funds are invested and will hold these as part of the cash pool, subject to the terms of paragraph 25 above.
33. The Investment Manager will not elect to participate in any dividend reinvestment plan.

Foreign currencies

34. The Investment Manager may enter into spot foreign exchange contracts where these are necessary in order to purchase or sell the foreign currencies necessary to invest in BNZ Index securities. These contracts are not speculative and are settled within two business days.

Suspension of subscriptions and withdrawals

35. Clause 18.7 of the Trust Deed enables the Fund to suspend the payment of benefits relating to withdrawal requests. The Fund has not previously suspended withdrawals. The Fund also has the power under clause 3.2 of the Trust Deed to refuse any application for membership without giving reasons. The Fund has never exercised this power.
36. The Fund will only suspend withdrawals or subscriptions in the following exceptional circumstances:
    - if the volume of withdrawals is too large to be processed, or
    - if the volume of withdrawals exceeds the immediately available funds, or
    - trading on the relevant equity markets has been suspended.
37. Any suspension will only be for three business days unless the exceptional circumstance giving rise to the need to suspend is beyond the control of the Trustee and Investment Manager, in which case the suspension will only be for such period as is strictly necessary for the Trustee and/or the Investment Manager to recover from that event.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) The Fund will not be resettled in order to enhance the performance of the Fund or to minimise losses of the Fund in any way.

b) Subject to condition (a), if the Fund is resettled this Ruling will continue to apply until resettlement. If the Fund is resettled this Ruling shall not apply from the date of resettlement.

c) The Fund is an investment vehicle primarily for investment into by superannuation funds which are themselves either: (i) widely-held investment vehicles for direct investment by natural persons or, (ii) vehicles for investment (directly or indirectly) by other superannuation funds that are widely-held vehicles for direct investment by natural persons.

d) The Fund is registered under the Superannuation Schemes Act 1989.

e) All investors in the Fund who are not natural persons are registered under the Superannuation Schemes Act 1989.

f) The existing binding private ruling for the Fund (BR Prv 04/28) remains in force and continues to apply in all respects to the Arrangement.

How the Taxation Laws apply to the Arrangement

Subject in all respects to any assumption or condition stated earlier, the Taxation Laws apply to the Arrangement as follows:

- The Fund is a "superannuation fund" as that term is defined in section OB 1.
- The Fund is a "qualifying trust" as that term is defined in section OB 1.
- Investors are not assessable to income tax on withdrawals from the Fund, by virtue of section HH 3(5).

The period or income year for which this Ruling applies

This Ruling will apply for the period 1 July 2004 to 30 June 2007.

This Ruling is signed by me on the 30th day of June 2004.

Martin Smith
Chief Tax Counsel

PRODUCT RULING – BR PRD 04/11

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by the University of Otago Foundation Trust ("the Trust").

Taxation Laws

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of sections BD 2(1)(b), BD 2(1)(e), EF 1, and the definition of "accrual expenditure" in section OB 1.

The Arrangement to which this Ruling applies

The Arrangement concerns an agreement titled the Sponsorship Agreement for Indefinite Naming Rights ("the Sponsorship Agreement") that is entered into between the Trust, the University of Otago ("the University"), and a taxpayer in business ("the Business Sponsor"). Further details of the Arrangement are set out in the paragraphs following.

1. The Trust is a charitable trust that was established for purposes in connection with the University by a deed of trust dated 20 August 2002.

2. The University is a tertiary institution established under Part XVI of the Education Act 1989.

3. The Trust, the University, and a Business Sponsor will enter into the Sponsorship Agreement pursuant to which the Business Sponsor will make a single payment to the Trust and in consideration of the payment the Trust will grant to the Business Sponsor exclusive naming rights to a particular activity of the University ("the University Activity") and incidental sponsorship services.

4. Upon the execution of a Sponsorship Agreement the University will assign to the Trust the right to grant for an indefinite term exclusive naming rights to a Business Sponsor by way of a deed titled "Deed of Assignment of Indefinite Naming Rights" ("the Deed of Assignment").

5. The Trust will provide the Business Sponsor with naming rights and acknowledgement for any of the following University Activities:

   - Professorial Chairs
   - Research Centres
   - Scholarships, and
   - Fellowships.

6. The single payment made by the Business Sponsor to the Trust upon entering into the Sponsorship Agreement is non-refundable.

7. No party to the Sponsorship Agreement may assign any of its rights, interests, or obligations granted therein.

8. The Business Sponsor will incur the sponsorship expenditure to secure promotion and advertising of its name and profile in connection with the University Activity it has sponsored (“the Sponsored Activity”).

9. The Trust and the University will use the name of the Sponsored Activity in all publications, advertising, signage and other activities connected with the Sponsored Activity.

10. The Sponsorship Agreement will be binding on the parties for an indefinite term and no party may terminate the Sponsorship Agreement by giving notice to the other parties.

11. No party to the Sponsorship Agreement can modify its terms for as long as the Sponsored Activity continues.

12. The Business Sponsor’s appointment as sponsor of the University Activity is subject to the guidelines contained in the University’s Guidelines on Major Sponsorship and Policy on Naming.

13. In particular the Trust and the University will not enter into a Sponsorship Agreement that requires the University to provide consideration to the sponsor or anyone designated by the sponsor with respect to employment in the University, enrolment in a University course of study, or a University procurement contract.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) The Business Sponsor must be carrying on an existing business and not establishing a market for a new business.

b) The Business Sponsor must enter into the Agreement with the sole purpose of advertising and promoting that existing business.

c) The University Activity in respect of which the sponsorship expenditure is made must be relevant to the actual or potential customer base of that business so that expenditure of that nature can reasonably be considered to be targeted to that customer base.

d) No part of the sponsorship expenditure is or can be refundable to the Business Sponsor in any circumstances.

e) Neither the Trust, the University, nor the Business Sponsor may assign any of its rights, interests or obligations under the Agreement.

How the Taxation Laws apply to the Arrangement

Subject in all respects to any assumption or condition stated above, the Taxation Laws apply to the Arrangement as follows:

- Sponsorship expenditure that is made by a Business Sponsor entering into the Agreement with the Trust and the University will not be expenditure of a capital nature under section BD 2(1)(e).
- Sponsorship expenditure that is made by a Business Sponsor entering into the Agreement with the Trust and the University will be an allowable deduction under section BD 2(1)(b).
- There is no unexpired portion for the purposes of section EF 1(1)(b).

The period or income year for which this Ruling applies

This Ruling will apply for the period 30 June 2004 to 1 July 2007.

This Ruling is signed by me on the 2nd day of July 2004.

Martin Smith
Chief Tax Counsel

INTERPRETATION STATEMENTS

This section of the *Tax Information Bulletin* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

SHORTFALL PENALTY FOR GROSS CARELESSNESS

1. Summary

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

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

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

2. Background

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

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

2.3 The penalties regime is again being reviewed and a discussion document *Taxpayer compliance, standards and penalties: a review* was released in August 2001. To date, some amendments have been made as a result of this review. Those amendments include reductions in the rate of some shortfall penalties on the basis of previous behaviour (section 141FB) and the amendment to the shortfall penalty imposed under section 141B to being one which applies when a taxpayer takes an unacceptable tax position. The amendments that have already been passed have prompted the withdrawal of various shortfall penalty standard practice statements in relation to tax positions taken on or after 1 April 2003.

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

amendments to the legislation as well as incorporating case law issued since the standard practice statement was issued. The principles outlined in this statement are consistent with those outlined in the withdrawn standard practice statement.

3. Issues

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

4. Legislation

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

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

4.2 Section 3(1) contains various definitions:

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

5. Shortfall penalty for gross carelessness

Introduction

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

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

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

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

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

5.4 With effect from 26 March 2003, in relation to tax positions taken on or after 1 April 2003, a taxpayer who takes an acceptable tax position is deemed not to have been grossly careless (section 141C(4)) (previously, for the proviso to apply, the taxpayer was required to have used an "acceptable interpretation" in taking the taxpayer's tax position). An "acceptable tax position" is defined in section 3(1) to mean a tax position that is not an "unacceptable tax position" ie the tax position, viewed objectively, fails to meet the standard of being about as likely as not to be correct (definition of "unacceptable tax position" in section 3(1), section 141B(1)). Clearly, to be an acceptable tax position, it is not necessary for the tax position to be correct—if it were, there would be no tax shortfall on which a shortfall penalty could be imposed. Rather, an acceptable tax position will also include tax positions which, although incorrect, are sufficiently "close" to being correct that a shortfall penalty should not be imposed, ie borderline cases.

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

- INV-231 *Temporary Shortfall – permanent reversal* (published in *Tax Information Bulletin* Vol 11, No 8 (September 1999))
- INV-251 *Voluntary Disclosures* (published in *Tax Information Bulletin* Vol 14, No 4 (April 2002))
- INV-260 *Notification of a Pending Audit or Investigation* (published in *Tax Information Bulletin* Vol 12, No 2 (February 2000))
- INV-295 *Reduction of Shortfall Penalties for Previous Behaviour* (published in *Tax Information Bulletin* Vol 16, No 3 (April 2004)).

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

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

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

Gross carelessness

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A person would be acting recklessly if:

(a) the person did an act which created a risk of a particular consequence occurring (eg a tax shortfall);

(b) a reasonable person who, having regard to the particular circumstances of the person, knew or ought to have known the facts and circumstances surrounding the act would have or ought to have been able to foresee the probable consequences of the act;

(c) the risk would have been foreseen by a reasonable person as being great, having regard to the likelihood that the consequences would occur, and the likely extent of those consequences (eg the size of the tax shortfall); or

(d) when the person did the act, he or she either was indifferent to the possibility of there being any such risk, or recognised that there was such risk involved and had, nonetheless, gone on to do it. That is, the person's conduct clearly shows disregard of, or indifference to, consequences foreseeable by a reasonable person.

5.19 At paragraph 49 of *Case W4*, Barber DJ held that the test for gross carelessness was an objective one. That is, the test is based on what a reasonable person would foresee as being conduct which creates a high risk of a tax shortfall occurring.

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

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

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

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

- Grossly careless conduct implies a complete or high level of disregard for the consequences.
- Grossly careless conduct creates a high risk of a tax shortfall occurring.
- The risk involved in, and the consequences of, grossly careless conduct would have been foreseen by a reasonable person in the circumstances.
- Failing to give any thought to an obvious and serious risk constitutes gross carelessness.

- Gross carelessness involves more than mere inadvertence or lack of reasonable care.
- Whether or not gross carelessness is present will depend upon the circumstances in each case.
- The test for whether or not gross carelessness is present is objective, being similar to that for "recklessness".

Distinguishing between gross carelessness and not taking reasonable care

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

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

5.26 For example, in *Case W4* Barber DJ held that the taxpayer had been grossly careless. His finding as to gross carelessness was based on a number of facts, namely the repeated failure to return the output tax in question, the taxpayer's lengthy experience in GST matters, the warnings resulting from and the assistance given in previous tax audits, and the short timeframe between the purchase of the property (when an input tax credit was claimed) and its sale. It is not obvious, however, whether any one of these factors in isolation would have been sufficient basis for a finding of gross carelessness as opposed to a lack of reasonable care. In such a situation, it is considered that the fact that the transaction was a significant one involving a large amount of output tax would involve the taxpayer in conduct which would put a reasonable person on alert, especially when coupled with a short timeframe between purchase and sale. Any argument that the person was not aware of the high risk involved in his or her behaviour would be weakened by there having been previous audits on similar issues which had resulted in both warnings and assistance being given by Inland Revenue staff.

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

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

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

- a large tax shortfall (whether resulting from a single transaction or from a number of similar transactions)
- a significant transaction, or transactions of a similar nature when viewed together, when compared to the taxpayer's business or taxable activity
- indifference to an obvious risk of a possible tax shortfall occurring

- a relatively short period of time between the purchase and sale of an item where the purchase triggered a tax effect that the taxpayer recognised
- the taxpayer being experienced in the relevant tax laws
- a failure by the taxpayer to heed previous warnings or to take on board suggestions of tax advisors (whether by the Inland Revenue Department or other professional people) which were aimed at reducing the likelihood of errors occurring.

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

Examples

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

Example 1

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

Should a shortfall penalty for gross carelessness be imposed?

The taxpayer must have been aware that the supply of the property had GST consequences because it claimed an input tax credit on its purchase. In this light, given the relatively short period of time between when the property was purchased and when it was sold, a reasonable person would have been aware that output tax was payable on its sale. As well, given the large amount of output tax payable, a reasonable person would not have inadvertently omitted to return it. In this regard, while the staff member who completed the return was temporarily filling in for the usual staff member, a reasonable person would have recognised that there was an obvious and serious risk that a tax shortfall would occur if an inadequately trained person completed the return and would therefore have put in place procedures to ensure that no error was made. The fact that the error was not rectified in a later taxable period when the usual staff member returned from leave also indicates that the company showed a high level of disregard for the accuracy of its return. Hence, it is considered that the company was grossly careless and that the shortfall penalty should be imposed.

Example 2

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

In this instance, buying secondhand goods is a regular part of the taxpayer's business. The fact that recording or calculation errors by the taxpayer in relation to the input tax claimable on secondhand goods have previously been identified on a number of occasions is an indication that a reasonable person, in the same circumstances, would have recognised the obvious and serious risk involved. As such, the errors are **not** the type of mistakes that occur because of mere inadvertence and which do not suggest or imply complete or a high level of disregard for all the consequences so as to constitute gross carelessness.

Rather, in this case, once the nature of the errors had been identified, and it was recognised that such errors could potentially recur on a regular basis, a reasonable person would have ensured that such errors did not recur by following the advice previously given and putting in place an adequate record keeping system, including checks, to identify goods purchased from unregistered persons. Not to have done so indicates indifference to the serious risk of this type of error recurring and a high level of disregard for the consequences. Therefore, it is considered that the taxpayer has been grossly careless and that a shortfall penalty under section 141C should be imposed.

Example 3

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

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

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

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

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

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

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

Please quote reference: DDG0093

INTEGRATED SILK FLOWER ARRANGEMENTS – DRAFT PROVISIONAL DEPRECIATION DETERMINATION

The Commissioner proposes to issue a Provisional Depreciation Determination that will insert a new provisional asset class ("Integrated silk flower arrangements") into General Depreciation Determination DEP1 in:

- The industry categories "Hotels, motels, restaurants, cafés, taverns and takeaway bars", "Residential rental property chattels", and "Shops", and
- The asset category "Office furniture and equipment".

The provisional asset class "Integrated silk flower arrangements" is a new introduction. The proposed depreciation rates are 63.5 % DV and 63.5 % SL, based on an estimated useful life of two years.

The draft determination follows.

PROVISIONAL DEPRECIATION DETERMINATION PROV[X]

This determination may be cited as "Determination PROV[X]: Tax Depreciation Rates Provisional Determination Number [X]".

1. Application

This determination applies to taxpayers who own assets in the "Office equipment and furniture" asset category.

This determination applies to "depreciable property" other than "excluded depreciable property" for the 2003/2004 and subsequent income years.

2. Determination

Pursuant to section EG 10 (1)(b) of the Income Tax Act 1994 I hereby amend Determination DEP1: Tax Depreciation Rates General Determination Number 1 (as previously amended) by:

- Inserting into the industry categories "Hotels, motels, restaurants, cafés, taverns and takeaway bars", "Residential rental property chattels" and "Shops", and the asset category "Office equipment and furniture", in the appropriate alphabetical order, the provisional asset class, estimated useful life, and diminishing value and straight-line depreciation rates listed below.

Office equipment and furniture	Estimated useful life (years)	DV banded dep'n rate (%)	SL equiv banded dep'n rate (%)
Integrated silk flower arrangements	2	63.5	63.5

3. Interpretation

In this determination, unless the context otherwise requires, expressions have the same meaning as in the Income Tax Act 1994.

If you wish to make a submission on the proposed changes, please write to:

Manager Field Liaison & Communication
Adjudication & Rulings
Inland Revenue Department
National Office
PO Box 2198
Wellington

Email: **rulings@ird.govt.nz**

We need to receive your submission by 31 October 2004 if we are to take it into account in finalising the determination.

NEW LEGISLATION

FRINGE BENEFIT TAX – PRESCRIBED RATE OF INTEREST ON LOW-INTEREST, EMPLOYMENT-RELATED LOANS

The prescribed rate of interest used to calculate fringe benefit tax for low-interest, employment-related loans has increased from 7.50% to 8.02% for the quarter beginning 1 October 2004.

The rate is regularly reviewed to ensure it is in line with the Reserve Bank's survey of first mortgage interest rates. It was last changed with effect from the quarter beginning 1 July 2004.

The new rate was approved by Order in Council on 23 August 2004.

Income Tax (Fringe Benefit Tax, Interest on Loans) Amendment Regulations (No 3) 2004 2004/247.

FORESTS AMENDMENT ACT 2004 – TAX-RELATED PROVISIONS

Introduction

The Forests Amendment Act 2004 ("the Act"), enacted on 19 May 2004, amends the Forests Act 1949 and includes a number of tax-related provisions.

Indigenous forest provisions, first inserted by amendment of the Forests Act in 1993, included new controls on the felling and milling of indigenous forest timber. However, forests on certain land, including land originally reserved under the South Island Landless Mäori Act 1906 (also known as the "South Island Landless Natives Act 1906" or "SILNA"), were exempted from the new controls.

Governments have subsequently sought ways to protect the exempted SILNA forests, particularly forests of high conservation value. One approach taken has been either to purchase land with standing timber or pay landowners for agreeing to a Conservation Covenant or Nga Whenua Rahui permanently protecting the trees.

Key features

The tax-related provisions of the Act either exempt some of these payments from income tax or provide for exemptions by Order in Council. These provisions, and the Orders in Council apply retrospectively.

Power to specify that a payment of money is not gross income

Section 21 of the Act empowers the Governor-General, in accordance with a recommendation of the Minister of Finance, to specify that a payment of money made in consideration of the entering into of a conservation covenant over specified Mäori land is not gross income of the recipient. This provision is intended to ensure that such payments made as part of the government's 2002 SILNA Policy Package are not subject to income tax.

It is expected that a number of payments made since September 2003 will be exempted from income tax in an Order in Council before the end of the current calendar year. They will include three payments to trustees for the beneficial owners of land in the West Rowallan Survey District and one payment to trustees for the beneficial owners of land in the Hokonui Survey District.

Certain payments of money not assessable or gross income

Section 22 exempts from income tax certain payments to the Proprietors of Waitutu Incorporated. The payments were made under the deed of settlement referred to in the Waitutu Block Settlement Act 1997 and occurred in the 1995-96 to 1999-2000 income years. They resulted in the protection of indigenous forest in the Waitutu Block. The term "payment of money" is defined, for the purposes of section 22, to include consideration in kind.

Application date

Section 21 of the Act applies from the 2002-03 income year, and section 22 from the 1996-97 income year to the 1999-2000 income year.

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, the Court of Appeal and the Privy Council.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision. Where possible, we have indicated if an appeal will be forthcoming.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

TO DISPUTE/CHALLENGE DEFAULT ASSESSMENTS

Case:	CIR v Taxation Review Authority and Donald Eugene Allen
Decision date:	10 August 2004
Act:	Tax Administration Act 1994
Keywords:	Default assessments, challenges

Summary

To challenge a default assessment a taxpayer must meet the prerequisites of section 138B(3) in that there must be an exchange of a NOPA and NOR.

Facts

On 8 April 2002 the Commissioner issued the Taxpayer with default assessments for income tax received from a partnership in the 2000 and 2001 income tax years.

The steps the Taxpayer took in response were:

- On 10 July 2002 he filed in the Taxation Review Authority ("TRA") a notice of claim and an application to commence a proceeding outside the response period.
- Under cover of a letter dated 31 July 2002, filing with the Commissioner income tax returns for the 2000 and 2001 income tax years and a notice of proposed adjustment ("NOPA") in relation to the Commissioner's 8 April 2002 default assessments.

On 16 September 2002 the Commissioner applied to the TRA, pursuant to section 138H of the Tax Administration Act 1994 ("the TAA"), for an order striking out the Taxpayer's challenge proceedings on the grounds that the Taxpayer had failed to comply with the requirements of section 138B of the TAA.

On 23 September 2002 the Commissioner refused to exercise his discretion under section 89K of the TAA to accept the Taxpayer's NOPA out of time.

Following a hearing in February and March 2003, the TRA, in a decision delivered on 19 May 2003, *(Case W19 (2003) 21 NZTC 11,182)*, declined to strike out the Taxpayer's challenge proceedings.

These proceedings are a judicial review of that decision.

Decision

His Honour commenced by noting that this matter was heard before him the day after the hearing of *CIR v Taxation Review Authority and ABC*. His Honour recorded that in *ABC* he held that section 138B(1) of the TAA required the exchange of NOPA and NOR between the Commissioner and the Taxpayer as a mandatory prerequisite to the Taxpayer's ability to bring challenge proceedings under section 138(1) of the TAA. He adopted the same view here. The same prerequisites apply for sections 138(2) and 138(3) of the TAA. Section 138(3) of the TAA was the relevant provision here.

His Honour rejected the Taxpayer's submission that the TRA decision was not amenable to review.

His Honour also considered that the argument that the Commissioner had somehow estopped himself from challenging the TRA decision was meritless. The purpose of section 138H of the TAA is to contest, rather than accept or submit to, the TRA jurisdiction to hear a challenge proceeding.

The TRA lacks jurisdiction to hear an invalid challenge proceeding and therefore must exercise its section 138H power to strike out a proceeding which has not met the section 138B of the TAA prerequisites.

His Honour held section 138B(3) of the TAA applies where a taxpayer wishes to challenge a default assessment as:

- Section 138B is the only provision of the TAA conferring a right to challenge an assessment.
- An "assessment" includes a default assessment.
- Section 106 of the TAA expressly contemplates that an assessment made under that section may be subject to challenge proceedings. As that

proceeding can only be brought under section 138B of the TAA, the section 138B prerequisites of an exchange of NOPA and NOR apply where the challenge is to an assessment under section 106 of the TAA.

- If section138B of the TAA prerequisites of a NOPA and NOR do not apply to a proceeding challenging a section 106 of the TAA assessment then a defaulting taxpayer would be placed at an advantage over taxpayers who had filed a return.

Here both the Taxpayer's tax return and his NOPA were not only outside the two month response period, but were filed after the Taxpayer had commenced his challenge proceedings. At the time that the challenge was brought he had not complied with the requirements of section 138B(3) of the TAA.

His Honour further found, though strictly unnecessary given the conclusion as to a lack of a valid NOPA, that:

- Section 89D(2) of the TAA made a taxpayer's right to issue a NOPA dependent upon the taxpayer first satisfying his statutory obligation to file a tax return.
- The mere filing of a tax return under section 89D(2) of the TAA would not permit a taxpayer later to challenge a default assessment. That ability to challenge hinges on the taxpayer having filed a NOPA in respect of the default assessment.

Additionally, while the two-month time limit specified in section 89D(5)of the TAA is not made expressly applicable to section 89D(2), the filing of a return is a prerequisite to the right to issue a NOPA. Thus, it must precede or coincide with the issue of the taxpayer's NOPA. A failure to observe the time limit in respect of both the tax return and the NOPA will thus prevent a taxpayer from challenging a default assessment.

His Honour ordered that the decision of the TRA delivered on 19 May 2003 (*Case W19)* is set aside and the TRA proceeding filed by the Taxpayer struck out.

"ROBUST AND PRACTICAL" INVESTIGATION AND ASSESSMENT SURVIVES JUDICIAL REVIEW

Case:	W A Duncan v CIR (Judicial Review)
Decision date:	10 August 2004
Act:	Land and Income Tax Act 1954, Income Tax Act 1976, Judicature Amendment Act
Keywords:	Judicial review, assessments, evasion, objection, intelligibility, assets accretion

Summary

The Applicant sought to judicially review four batches of assessments made over the period 1976-1981. The Department had used charging orders to seize funds and this, it was claimed, rendered the applicant unable to mount a proper objection. The Court found for the Commissioner stating that under all the complex circumstances of this case, his response and methods were robust and practical.

Facts

The Commissioner assessed Mr Duncan, and his companies, Floorlines (NZ) Limited ("Floorlines") and Maudal Investments Limited ("Maudal") for tax on undisclosed income in the years 1967 to 1976. The investigation was prolonged and revealed many anomalies in the way company profits were accounted for. As it became apparent that substantial amounts had been diverted to various staff "welfare" funds, and then to Mr Duncan, the Commissioner issued section 400 notices to recover tax from him and his companies. A series of four assessment batches were made as the ongoing investigation uncovered new information. Ultimately assessments were made for the income tax years from 1964 to 1976. The assessments were amended a number of times as the ongoing investigation revealed further evasion. Mr Duncan and Floorlines objected to the assessments and penalties and the matter went before Thorpe J in 1982. After cross-examination of Mr Duncan, Thorpe J indicated that he had not made out his case and that he should reconsider his position. Mr Duncan then withdrew his objection and the matter went no further.

In 1990 Mr Duncan instructed new counsel who initiated the present judicial review proceedings on the basis that the assessments were "irrational", "unintelligible" and "arbitrary". Various judicial conferences followed whereat the judges directed Mr Duncan to apply to have Floorlines reinstated to the register of companies. Floorlines had been struck off in 1990 upon the Commissioner's application and has not since been reinstated.

Counsel for the applicants moved in mid-2000 for leave of the court to continue the proceeding under Rule 426A of the High Court Rules. The Commissioner counter-applied to have the matters struck out under rr 477 (no reasonable cause of action) and 478 (inordinate delay/ prejudice). The Court directed that the Floorlines application be struck off as the company had not at that time been restored to the register. Leave was granted for Mr Duncan's application to proceed on the basis of affidavit evidence already before the Court. Mr Duncan was also directed to file an amended and simplified statement of claim.

Early in the proceedings Baragwanath J decided that "conflicts of evidence on factual issues were so

deep-seated and fundamental to the case that cross-examination would be required to resolve them."

At the heart of it all were the four assessment "processes":

- In 1976 Mr Duncan was assessed personally for $210,591 underpaid tax for the years 1968-1976 incl. These assessments were accompanied by a letter from the District Commissioner which noted that they "were not final and would be subject to reassessment when the investigation is complete".
- Mr Duncan's solicitors refused to action charging orders made against Mr Duncan's companies so the department issued the same assessments "plus a margin" in the companies' names. This occurred in 1977 and was referred to by the Court as the "round-sum assessments". Neither of these two process assessments were reversed until the third process.
- In 1979 after a full investigation and consideration of objections, further assessments were made of both the companies and Mr Duncan, the latter being assessed on income derived from the companies as deemed dividends.
- Mr Duncan's consistent position was that the concealed income was his and not the companies'. He objected to the deemed dividend assessments and the Commissioner (personally) directed that his objection be allowed as far as was legally permissible. The chief investigator isolated income-earning assets which could only be attributed to the companies and assessed the rest to Mr Duncan. Reassessments were issued in 1981 increasing Mr Duncan's tax deficiency by $200,000-odd and Floorlines' by around the same amount. This concessionary shift was later attacked as a "change in basis of assessment".

Evidence was given by Mr Duncan, now 78 years of age, and the Commissioner's chief investigator at the time one Malcolm Macdougall, now 71 and long-retired. Baragwanath J said of the latter:

> "Mr Macdougall is a precise Scot who retired from the Department as a senior inspector. …He is a painstaking and accurate professional. He gave clear concise answers to questions. He had formidable powers of recall. … Mr Macdougall was subjected in cross-examination to a series of interrogations beyond contemplation at the time of his conduct. My conclusion is that his evidence was honest and accurate throughout."

Decision

The first process

On the first assessment process, the words of the District Commissioner that the assessments were "not final" did not mean that they were tentative or other than firm. The labelling used does not determine the character of a transaction *AJ Burr Ltd v Blenheim Borough Council* [1980] 2 NZLR1, 4-5. The charging orders (then under section 210, Land & Income Tax Act 1954) were thus equally valid. The actions complained of pre-dated the *Canterbury Frozen Meat* case [1994] 2 NZLR 681. Even so, they did not offend the principle described therein as the evidence showed that there had been meticulous investigation and were in cross-examination, arithmetically justifiable.

The offending statement merely indicated that the Commissioner reserved the right to exercise his powers under sections 19 and 23 L&ITA 54 to make amended assessments. His Honour thought the use of the term unwise, but it did not, in fact mislead Mr Duncan. Counsel for Mr Duncan had relied on the *Preston v IRC [1985] AC 835* case to argue that such a phrase invalidated the whole assessment.

Regarding the "intelligibility" of the assessment and access to documents, his Honour found that the Commissioner had the power to retain such documents and that the Objector was given access to them at all times. That his tax accountant chose not to avail himself of the offer did not render the assessments invalid.

> "It is not the mark of a man who knows that documents will vindicate him to do nothing about getting access to them and using them to sustain his claim"

Mr Duncan argued that seizure of his funds had effectively crippled him financially and deprived him of the opportunity to secure necessary advice and present a proper case. His Honour found that Mr Duncan in fact did have adequate resources and that his objection rights during the first process were not prejudiced.

As the Department issued section 210 notices on Mr Duncan's companies at this stage, he argued that the Commissioner had confused the legal entities (implying thereby that the process was flawed). His Honour preferred Mr Macdougall's evidence "Mr Duncan told me that all the money was his" and the judge agreed that, on all evidence, notwithstanding legal forms, that Mr Duncan had:

> "… treated the corporate entities as his own creatures and as repositories for what he treated as his own funds, applying and withdrawing moneys at whim, essentially on the basis that they were his to deal with as he pleased, rather than distinct legal creatures constrained by company law and the duty of their directors to perform their obligations…"

This argument is central to Mr Duncan's objections to the latter processes: He always contended that the money was his [para 133] but that the Commissioner could not collect "his" money when it resided under a company name. Latter processes treated the reluctance to disgorge as conduct evidencing Mr Duncan resiling from the "personal property" stance. The objector however, pointed to the later assessments of the companies as being arbitrary as the Commissioner had (he argued) always considered the money to be Duncan's. His Honour held

that it was neither irrational nor disproportionate (in *Wednesbury* terms) to so assess as Mr Duncan had himself used corporate form in incompatible ways. In the end, the Commissioner's approach to these chameleon-like legal forms was "robust and practical".

The second process

The second assessments were against the companies and as they had not objected or had been struck off, the Commissioner argued that Mr Duncan had no standing to raise this issue. Baragwanath J disagreed saying that as abuse of power had been alleged, and a possible consequence was that the companies were struck off, then policy reasons meant that it should be heard.

The 1977 "round sum" assessments were made against Maudal and Floorlines only. They repeated the WA Duncan assessments "plus a margin". His Honour held that the "margin" comment on a file memorandum was misleading and that there had been a hurried, but accurate reassessment in the light of all the facts then known to Mr Macdougall. Further, the Commissioner was correct to act on the companies as Mr Duncan via his solicitors had disavowed the funds as his own when the Commissioner attempted to collect tax owing under the first process.

Arguments made by Mr Duncan based on *Wilson v CIR* (1994) 17 NZTC 12,047 and *Lowe v CIR* [1981] 1 NZLR 326, regarding "intelligibility" of assessments, were rejected:

> "But unlike *Wilson* and *Lowe* this is not a statutory appeal. To succeed on judicial review Mr Duncan must establish not only that no reasonable Commissioner could have made the Second Process assessments but that the argument should be entertained in the first place. *Dandelion II* demonstrates both (pp624-5 paras [92]-[94]) why the Court is reluctant to entertain such challenges by judicial review and pp609-10 para [35] how heavy is the onus on an objector who seeks to challenge the legal validity of an honest assessment"

In any event, the "round sum" assessments were later meticulously refined by Mr Macdougall in the third process and displayed a variance of only 9% from the second. Notices issued on the authority of these assessments (now under section 400, ITA 76) were thus equally valid.

The third process

Mr Duncan engaged a new tax accountant after the second assessments, who demanded an assets accretion accounting to justify the deficient income claimed hitherto by the Department. Mr Macdougall obliged. Analysis by the Court of his exhaustive research and accounting revealed no significant error. As a result, amended assessments were issued to the companies and to Mr Duncan, ascribing to the latter income as deemed dividends. This was as a result of factual and legal deliberations. Mr Duncan's main objection was that the assets accretion analysis was deliberately biased, ignoring large known amounts of opening stock.

Regarding assets accretion generally, his Honour discussed the principles at paras [178 – 188] and endorsed the Australian authority *Trautwein v FCT* (1936) 56 CLR 63 stating that the burden of showing an assessment to be incorrect fell upon Mr Duncan, not the Commissioner. He held that "*Phillips* [*v CIR* [1959] NZLR] (upon which the Objector relied) is not to be taken as deciding that there is something peculiar about "the assets accretion method" that reverses the legal burden of proof."

The "opening stock" issue is illustrative of the difficulty the Court and counsel faced when dealing with factual disputes:

> "This point was not pleaded. But since it was central to Mr Duncan's claim that lack of means to secure advice had caused him prejudice, the Commissioner filed evidence upon it and it was explored as far as was feasible half a century after some of the events said to bear upon it. Mr Duncan claimed to have acquired personally prior to the 1956 Suez crisis and the first oil shock stock of high value and volume which remained in his possession as at the opening date of the first relevant tax year, 1 April 1963."

During the hearing Mr Duncan produced a box of invoices which he said would support his claim. These were analysed by Mr Macdougall and the Court accepted his detailed evidence that the invoices proved, if anything, the opposite.

The Commissioner in the third process assessed Mr Duncan for income he had derived and concealed while dealing in the companies' property and assets. This, Mr Duncan complained, gave rise to double taxation, as the companies and Mr Duncan both paid tax on the same income stream. His Honour accepted that it is only harsh if one lifted the corporate veil on the structures chosen by the Objector. Such application however "…was the inevitable result of Mr Duncan's taking as his own the assets of the companies".

The fourth process

The Commissioner directed his investigations staff to allow Mr Duncan's objection to the third process assessments in part, allowing as little income as possible to Floorlines (the only company objecting at this stage). This exercise was fully supported by revised assets accretion schedules and revised assessments were issued in 1981 increasing Mr Duncan's income and correspondingly reducing Floorlines'. As both had objected to the third process and cases were stated in their respect, the same objection rights were extended to cover the fourth process, notwithstanding that Floorlines' assessment had decreased. Mr Duncan argued that this was legally objectionable as this concession "…wrongly purported to deprive it of greater objection rights than

had been exercised in its objection notice of 20 April 1979 (in response to its third process reassessments)."

His Honour said at para [229]:

> "The Commissioner's direction … was more generous than the logical approach adopted by Mr Macdougall in preparing the Third Process assessments. But there can be no doubt of the Commissioner's authority to review as a matter of fact the judgment made by Mr Macdougall and to substitute his own approach. … I have observed at para [206] that I am not persuaded that on review such result infringes the stringent test of rationality required to give jurisdiction to this Court. Nor can this Court describe it as lacking proportionality. Rather the Commissioner made a conscious effort to respond to the perceived asperity of the double tax. Whether he might as a matter of fact have been more (or less) responsive to Mr Duncan's position was a matter for him, not this Court on review, to decide."

The fourth process was therefore an extension of the third and the Objector could not complain of an amendment which he had effectively requested.

The appeal was dismissed on all grounds advanced by the Objector.

HIGH COURT COSTS FINALISED AT LAST

Case: B L Miller & Ors v CIR; Managed Fashions Limited & Ors v CIR, CA 117/03

Decision date: 10 August 2004

Keywords: Costs

Summary

The taxpayers' appeal was unsuccessful. The costs awarded by the High Court were confirmed.

Facts

This decision was an appeal of a second costs assessment in respect of three decisions relating to the JG Russell tax avoidance template: *Miller v CIR; McDougall v CIR (No 1)* (1996) 18 NZTC 13,001, *Miller v CIR; McDougall v CIR (No 2)* (1997) 18 NZTC 13,127 and *Miller v CIR; McDougall v CIR; Managed Fashions Ltd v CIR* (1997) 18 NZTC 13,219. The High Court Judge, Baragwanath J, had originally awarded some $80,000 to the Commissioner, who had been largely successful in those decisions.

In a decision dated 19 August 2002, the Court of Appeal allowed an appeal by the appellants against the costs awarded against them: *Miller & Ors v CIR; Managed Fashions Ltd & Ors v CIR* (2002) 20 NZTC 17,826. The costs determination was sent back to Baragwanath J and on 20 August 2003 he awarded the Commissioner reduced costs of $41,500 (*Miller v CIR; Managed Fashions Ltd v CIR* (2003) 21 NZTC 18,243).

This decision was therefore an appeal of Baragwanath J's second costs determination.

In the first appeal the Court of Appeal listed concerns it had about certain aspects of the costs originally awarded compared to the costs awarded in *Kemp & Ors v CIR* (1999) 19 NZTC 15,110 (where costs had been paid to the taxpayers). *Kemp* was a judicial review action taken by certain participants using the JG Russell template who had tried to enforce ultra vires settlements with the Commissioner. They were unsuccessful, but had costs paid to them. The appellants also entered into ultra vires settlements, but after the Commissioner resiled from them they did not try to enforce them, but challenged (and reviewed) the assessments instead. Baragwanath J's original costs judgment was made without knowledge of the ultra vires settlements.

The appellants argued that they should be treated in the same way as the *Kemp* litigants and that they should be awarded costs of $85,000 (the same amount the *Kemp* litigants received). They also submitted that Baragwanath J had taken a number of irrelevant factors into account.

Decision

The Court of Appeal discussed Baragwanath J's second costs decision, and the factors he considered in reaching the award of $41,500.

The Court of Appeal firstly considered that the different course followed by the *Kemp* litigants could justify some differential costs treatment. Secondly, costs normally follow the result. The *Kemp* litigants were successful to some extent but the appellants failed in their litigation. Thirdly, if costs had been calculated on the basis of *Auckland Gas* principles (*Auckland Gas Co Ltd v CIR* [1999] 2 NZLR 409) any "discount" for the Commissioner's conduct might have been offset. Baragwanath J did not calculate costs on those principles. Fourthly, the complaints of the appellants mainly related to the weight Baragwanath J put on various factors. The Court of Appeal did not want to interfere with that process. Finally, the costs awarded in *Kemp* was somewhat unusual (and "surprisingly generous"), and there was no requirement that it be replicated in this case.

The appeal was dismissed.

MAREVA INJUNCTION AND CHARGING ORDERS UPHELD

Case:	Donald Eugene Allen, Silver Fern Trustees Limited v CIR
Decision date:	12 August 2004
Act:	Tax Administration Act 1994
Keywords:	Mareva injunction, charging orders

Summary

The appeal against ex parte Mareva injuction and charging orders obtained by the Commissioner was dismissed.

Facts

This is an appeal from the High Court judgment of O'Regan J reported at 21 NZTC 18,137.

This case arises from an investment scheme promoted by two Americans, Messrs Allen and Palmer, which involved or purported to involve purchases of off-shore corporate structures through which high yielding investments were to be made. The off-shore structures typically were said to be based in Panama. The cost of these structures was in the order of US$5,500. Investors were told that the money they put up would generate returns in the order of, or up to, 15% compounding per month which would be remitted to New Zealand tax free.

Between 17 August 1999 and 17 July 2001 approximately $9.5 million was received of which approximately $4.35 million was returned to investors. The Commissioner's case is that, leaving aside the funds which were repaid to investors, the funds which were generated by the scheme were misappropriated in that they were not invested in the manner that was promoted to the investors but rather were used by Messrs Palmer and Allen for their own purposes.

The Commissioner, taking the view that Messrs Allen and Palmer were in partnership, concluded that they had derived income in the 2000 income tax year of $1,757,561.39 and in the 2001 income tax year of $4,287,463.41. This income was allocated equally between the two men in assessments which were made on 8 April 2002 for the 2000 and 2001 income tax years.

On 10 April 2002 the Commissioner issued proceedings against Messrs Allen and Palmer on the basis of the assessments and at the same time applied ex parte for charging orders before judgment and a Mareva injunction. The charging orders were sought in relation to any money owed to Messrs Allen and Palmer by Silver Fern Trustees Ltd, shares held by Mr Allen in Silver Fern Trustees Ltd and interests which the Messrs Allen and Palmer had in a number of motorcycles. The Mareva injunction sought was addressed to Silver Fern Trustees Ltd requiring the retention of net proceeds of sale of a property at Whenuapai, Auckland. The orders were made ex parte by Rodney Hansen J on 11 April 2002.

Decision

The strike out arguments

Mr Allen and the Silver Fern Trustees Limited ("the Taxpayers") argued that the assessments were made under section 92 of the Tax Administration Act 1994 ("the TAA") which could only be used where a return had been filed. The Taxpayers argued the assessments could only be made under section 106 of the TAA.

The Court noted that as they rejected in later paragraphs the argument that where the taxpayer lodged a return following the making of an assessment under section 106 of the TAA, the taxpayer's liability under the original assessment lapsed and the Commissioner was obliged to issue a fresh assessment under section 92 of the TAA, it was not clear to the Court what, if any, legal significance attaches to whether an assessment is made under section 92 or section 106 of the TAA.

The Court held at paragraph 57 that:

> "On an ordinary English approach to the language of section 92, the power to assess under that section is available to the Commissioner when no returns have been lodged but where there is other information available to the Commissioner which permits an appropriate annual assessment to be made. We see no reason to read down section 92 so that it has no application in cases in which section 106 is available."

In any event, if section 106 of the TAA was the only relevant empowering provision, mistaken reliance by the Commissioner on section 92 of the TAA would not invalidate the assessment. This approach is in accordance with ordinary principles of administrative law as exemplified by *A J Burr Limited v Blenheim Borough Council* [1980] 2 NZLR 1 (CA). The assessments are valid until set aside by a court of competent jurisdiction. This is strengthened by the clear policy that underpins section 109 of the TAA.

As to whether the Commissioner was required to cancel the existing assessments when returns were filed, the Court agreed with O'Regan J's view that the use of "subsection" in section 106(1B) of the TAA must have been a mistake. Section 106(1B) of the TAA never had application to an assessment under section 106(1) of the TAA but only to an assessment under section 106(1A). The Court noted the point has now been put beyond doubt by an amendment to section 106(1B) with retrospective effect. The Court considered that although not referred to by Counsel, this amendment was plainly decisive of the Taxpayers' argument.

Charging order arguments

As to the evidential basis for the making of the charging order, after referring to O'Regan J's judgment upholding the evidential basis for the charging order, the Court held at paragraph 69:

> "We agree entirely with O'Regan J on this aspect of the case which we see as too plain for serious argument."

Mr Allen argued that he was entitled not to pay the deferrable tax on the basis that he has issued challenge proceedings in the Taxation Review Authority ("the TRA"). Mr Allen claimed that section 138I(2B) of the TAA should not apply as the assessments in issue were issued before 1 April 2003.

The Court noted the TRA decision dismissing the Commissioner's application for strike out of Mr Allen's challenge but there is still an unresolved appeal against the TRA decision and at least until the appeal has been resolved it might be unsatisfactory to proceed on the assumption that the challenge which has been lodged is effective. While that could be a basis of dismissing this aspect of the appeal there is no need as there are two other reasons to reject Mr Allen's arguments.

The first reason was that due to the limited funds held, section 138I of the TAA would not make any difference to the amount to be retained by the charging order and Mareva injunction.

Secondly, the Commissioner was entitled to invoke section 138I(2B) of the TAA. There are no transitional provisions associated with section 138I(2B) which the Court therefore saw as conferring on the Commissioner a new power which he can exercise at any time on or after 1 April 2003.

Challenges to the Mareva injunction

In terms of whether the Commissioner had a good arguable case, the Court agreed with O'Regan J and for the reasons he had given. On the basis of section 109 of the TAA O'Regan J was reluctant to go behind the assessment and undertake a review of the legal and factual analysis, that found them. That was what challenge proceedings were for.

In any event the Court was firmly of the view that the Commissioner's underlying tax argument is of formidable strength, at least on the basis of the material the Court had seen.

In terms of the non-disclosure arguments, the Court held that the arguments raised by the Taxpayers were carefully reviewed by O'Regan J and the Taxpayers had not come close to persuading the Court that the Judge was wrong.

In terms of the proceeds of the sale of the Whenuapai property, the Taxpayers claimed that the Commissioner had no entitlement to a Mareva injunction against the Silver Fern Trust which it was maintained was a third party distinct legally from Mr Allen.

The Court considered at paragraph 105 that:

> "The grant of a Mareva injunction is most obviously appropriate in cases where the assets to be frozen unquestionably belong to the defendant. But the availability of a Mareva injunction is not confined to that situation. For instance, there may be disputes as to the beneficial ownership of the property in question. The existence of such a dispute is not in itself an objection to the grant of an injunction."

After considering the various authorities in this area the Court found at paragraph 113:

> "Against that background the case for a Mareva injunction is overwhelming. There is a strong case for the view that Mr Allen was part of a fraudulent scheme which involved the misapplication of funds supplied by New Zealand investors. The deposit of $200,000 was paid from the bank account which received those funds. A significant proportion of what the Commissioner alleges was misappropriated wound up in Panama. A little under $2m was paid by Fortune Management, from Panama, to fund the balance required to complete the purchase of the Whenuapai house. Mr Allen did not give any real explanation of this. There is evidence suggesting that Fortune Management had a role in the underlying frauds (given that some of the victims had paid money direct to it). In any event it is well open to inference on the evidence which we have seen that the money used to the purchase of the Whenuapai house represented the proceeds of frauds committed by Mr Allen. The ownership structure associated with the Whenuapai house very much suggests an attempt by Mr Allen to make himself judgment-proof and Silver Fern Trustees Ltd has undoubtedly become mixed up in that attempt. The whole situation is redolent of fraud. Further, it will be recalled that Mr Allen dealt with ASB Bank on the basis that the house was his. It is profoundly unsatisfactory that he should treat the house as his when dealing with the bank as belonging to the trust when he is sued by a creditor."

The Appeal was dismissed.

CONFIDENTIALITY ORDERS OVERTURNED

Case:	C and Multiple Parties v CIR
Decision date:	23 August 2004
Act:	Tax Administration Act 1994
Keywords:	Confidentiality orders

Summary

The High Court set aside certain confidentiality orders relating to a cast before the Court. However, leave was given to appeal (and the taxpayers subsequently appealed).

Facts

The plaintiffs have challenged assessments arising from their involvement in an alleged tax avoidance scheme. The substantive hearing of their test case challenges was being heard in the Auckland High Court.

Confidentiality orders had earlier been obtained by the taxpayers in interlocutory proceedings. The Court

decided those orders should be reviewed as a matter of principle in an interim judgment delivered orally on 30 July 2004. The confidentiality orders were maintained in the interim to allow the plaintiffs to file affidavits as to their personal circumstances to support a further submission that their names should not be published.

In submission counsel for the plaintiffs contended that name suppression ought to be granted in circumstances such as the present where cases are transferred to the High Court from the TRA, or are test cases.

Decision

Justice Venning confirmed his interim decision that the fact that the Tax Administration Act 1994 provides for confidentiality in TRA proceedings does not support the submission that the same confidentiality should apply to proceedings transferred from the TRA or brought as test cases to the High Court.

The starting point is the principle of open justice which applies to tax cases as well as criminal and civil cases in the High Court. While tax cases have additional features, such as evidence of personal financial details, which would generally not be disclosed in civil or criminal cases, privacy in the TRA is preserved by a legislative provision, rather than as a matter of principle. Parliament must be taken to have determined that confidentiality was not appropriate once proceedings are transferred to the High Court or brought to the High Court as test cases.

The Court held that there is no presumption that taxpayers' names will not be published, and that there is a legitimate public interest in tax cases, particularly where the arrangements in issue and challenged by the Commissioner are novel. There is also legitimate interest in the parties involved in them, either as the creators of the arrangement in issue or as investors. There is a proper interest in the collection of tax and in cases involving allegations of arrangements to avoid tax. Some degree of embarrassment and distress might follow publication of names, but this must be balanced against the legitimate public interest in an arrangement that has the potential effect of such magnitude on the tax base.

It was also argued that the fact that so many of the plaintiffs had settled their cases before the hearing began indicated that they were unreasonably pressured by the possibility that their names would be published. Justice Venning held that confidentiality was only one of a list of relevant factors which might influence taxpayers' decision to settle, all of which were valid and unobjectionable reasons for pursuing a settlement. He held that there is nothing improper in the Commissioner agreeing to maintain confidentiality as a term of settlement, and noted that confidentiality is a common term in settlements.

Justice Venning considered the particular circumstances of the parties who sought to maintain confidentiality on the basis of their affidavit evidence. Two claimed the collapse of their firm might result, and another claimed that his employer might require him to stand down from all roles where he interfaces with customers, which would affect his future career prospects. All were particularly sensitive to the allegation of sham made against the authors of the arrangement, but not against the ordinary investors. The Court said a distinction could be made between the two groups, relevant because of counsel's considerable emphasis on the sham allegation in their argument for continued confidentiality. He said that, contrary to the plaintiffs' submission, the media would be well able to make this distinction.

The Judge noted that members of the business community who might deal with the plaintiffs were entitled to know the nature of the allegations made against them, and that the speculation about the arrangement and the professionals associated with it was to the disadvantage of legal and accounting practitioners generally. He also said that professional people such as barristers and solicitors should not be elevated to a special position in relation to confidentiality. The position of these parties was no different to the position of taxpayers in any other case where allegations of sham or avoidance are raised.

Accordingly, the confidentiality orders in relation to certain plaintiffs were set aside, but the affected plaintiffs were allowed four days to consider an appeal, before the decision took effect. The plaintiff subsequently filed an appeal.

REGULAR FEATURES

DUE DATES REMINDER

October 2004

20 Employer deductions

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* due

29 GST return and payment due

November 2004

8 Provisional tax instalments due

For people and organisations with a March balance date

22 Employer deductions

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* due

30 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendar 2004–2005.* The calendar reflects the due dates for small employers only—less than $100,000 PAYE and SSCWT deductions per annum

YOUR CHANCE TO COMMENT ON DRAFT TAXATION ITEMS BEFORE THEY ARE FINALISED

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	Draft interpretation statement	***Comment deadline***
☐	IS0060: Shortfall penalty for taking an abusive tax position	31 October 2004
☐	IS0062: Shortfall penalty—evasion	31 October 2004

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