TAX INFORMATION BULLETIN

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REGULAR FEATURES

DUE DATES REMINDER

November 2005

7 Provisional tax instalments due for people and organisations with a March balance date

21 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

December 2005

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

These dates are taken from Inland Revenue's *Smart business tax due date calendars 2004–2005 and 2005–2006*. These calendars reflect the due dates for small employers only—less than $100,0000 PAYE and SSCWT deductions per annum.

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 NOT TAKING REASONABLE CARE

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 141A of the Act on taxpayers who do not take reasonable care in carrying out their tax obligations. Where a taxpayer does not meet the standard of reasonable care, 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, and is intended to complement and be read together with *Standard Practice Statement* INV-200, *Shortfall penalties – not taking reasonable care* appearing in *Tax Information Bulletin* Vol 10, No 3 (March 1998) which applies to tax positions taken before 1 April 2003. The main features of this statement are:

- The standard of "reasonable care" in respect of section 141A involves establishing what a reasonable person would do in the same circumstances and takes into account such factors as the age, health, and background of the taxpayer in question.
- The statement provides guidance as to how the standard of reasonable care is applied to various types of taxpayers, e.g., business persons, clients of agents, and tax specialists. It also examines how the reasonable care standard applies in certain situations such as receipt of Inland Revenue advice, complexity of the law, materiality, and arithmetical errors.
- The reasonable care standard does not mean perfection, but refers to the effort required commensurate with the reasonable person in the taxpayer's circumstances.
- In determining whether the standard of reasonable care has been met, the Commissioner will consider the likelihood of a tax shortfall, the quantum of the shortfall and the difficulty of preventing a tax shortfall.
- Although a taxpayer is liable for the actions of their employees, the question of whether the taxpayer has taken reasonable care must still be considered.
- The shortfall penalty payable by the taxpayer, for not taking reasonable care, can be reduced for the taxpayer's previous behaviour, voluntary disclosure or where the tax shortfall is temporary. (The penalty can also be increased where the taxpayer obstructs the Commissioner.)
- In the Commissioner's view, section 141JAA, which provides for the penalty payable to be capped in some situations, is only applicable after other reductions have been made.

2. Background

2.1 Following a review of the compliance and penalties legislation, the Tax Administration Amendment Act (No 2) 1996 introduced new rules to address problems that existed with the previous legislation. The problems that were identified in the review included unfairness to the majority of taxpayers who comply with the law, unnecessary costs to those involved, unclear legal processes and requirements, and rules that did not fit in with the self-assessment environment.

2.2 The Taxpayer Compliance, Penalties, and Disputes Resolution Bill – Commentary on the Bill (September 1995) ("Commentary on the Bill") states that:

> The reforms proposed in this bill will promote fairer and more effective enforcement of the Inland Revenue Acts. They will enhance taxpayers' understanding of their obligations and the standards expected of them and will improve consistency in the application of penalties overall and between different tax types.

2.3 Section 139 sets out the purpose of the penalties legislation as being the encouragement of voluntary compliance and co-operation with the Department, the consistent and impartial imposition of penalties, and the setting of penalties to fit the seriousness of the breach of tax obligations.

2.4 As part of these reforms, new civil penalties were introduced to replace additional tax and penal tax. These penalties include a late filing penalty, late payment penalty, shortfall penalties, and various other civil penalties. This statement provides an explanation of some interpretative aspects of one of the shortfall penalties – the penalty for not taking reasonable care covered by section 141A of the Act.

2.5 Following the enactment of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, there have been some changes to the legislation that applies to a tax position that a taxpayer takes, generally, on or after 1 April 2003. These further changes are noted in this statement and include the monetary cap of $50,000 on the shortfall penalty payable by the taxpayer for not taking reasonable care, which in some circumstances is provided for under section 141JAA.

2.6 This interpretation statement applies, except as otherwise specified, with respect to tax obligations, liabilities, and rights that are to be performed under or arise in respect of:

(a) The Income Tax Act 1994 in relation to the tax on income in the 1997-98 income year and subsequent years to and including the 2004-05 income year and then the Income Tax Act 2004, in relation to the tax on income in the 2005-06 and subsequent income years:

(b) The Goods and Services Tax Act 1985 in relation to supplies made in taxable periods commencing on or after 1 April 1997.

3. Issue

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

4. Legislation

4.1 Section 15B sets out the taxpayer's tax obligations:

[taxpayer's tax obligations applicable **prior to the 2002-03 income year**]

15B Taxpayer's tax obligations

15B A taxpayer must do the following:

(a) Unless the taxpayer is a non-filing taxpayer, correctly determine the amount of tax payable by the taxpayer under the tax laws:

(b) Deduct or withhold the correct amounts of tax from payments or receipts of the taxpayer when required to do so by the tax laws:

(c) Pay tax on time:

(d) Keep all necessary information (including books and records) and maintain all necessary accounts or balances required under the tax laws:

(e) Disclose to the Commissioner in a timely and useful way all information (including books and records) that the tax laws require the taxpayer to disclose:

(f) To the extent required by the Inland Revenue Acts, co-operate with the Commissioner in a way that assists the exercise of the Commissioner's powers under the tax laws:

(g) Comply with all the other obligations imposed on the taxpayer by the tax laws.

(h) If a natural person to whom section 80C applies, inform the Commissioner that the person has not received an income statement for an income year, if the income statement is not received by the date prescribed by section 80C(2) or (3):

(i) If the taxpayer is a natural person, correctly respond to any income statement issued to the taxpayer.

["taxpayer's tax obligations" applicable **to the 2002-03 and subsequent income years** remain as applicable prior to the 2002-03 income year except for the addition of section 15B(aa)]

(aa) If required under a tax law, make an assessment:

4.2 A shortfall penalty for "not taking reasonable care" may be imposed under section 141A:

[for "tax positions" taken **prior to 1 April 2003**]

141A Not taking reasonable care

(1) A taxpayer is liable to pay a shortfall penalty if the taxpayer does not take reasonable care in taking a taxpayer's tax position (referred to as "not taking reasonable care") and the taking of that tax position by that taxpayer results in a tax shortfall.

(2) The penalty payable for not taking reasonable care is 20% of the resulting tax shortfall.

(3) A taxpayer who, in taking a taxpayer's tax position, has used an acceptable interpretation of the tax law is also a taxpayer who has taken reasonable care in taking the taxpayer's tax position.

[for "tax positions" taken on **or after 1 April 2003**]

141A Not taking reasonable care

(1) A taxpayer is liable to pay a shortfall penalty if the taxpayer does not take reasonable care in taking a taxpayer's tax position (referred to as "not taking reasonable care") and the taking of that tax position by that taxpayer results in a tax shortfall.

(2) The penalty payable for not taking reasonable care is 20% of the resulting tax shortfall.

(3) A taxpayer, who takes an acceptable tax position is also a taxpayer who has taken reasonable care in taking the taxpayer's tax position.

(4) Subsection (3) and section 141B (1B) do not exclude a taxpayer who makes a mistake in the calculation or recording of numbers in a return from being liable for a penalty for not taking reasonable care.

4.3 The following terms are defined in section 3(1):

"**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:

[definition of "tax law" **prior to 1 April 2002**]

"**Tax law**" means—

(a) A provision of the Inland Revenue Acts or an Act that an Inland Revenue Act replaces:
(b) An Order in Council or a regulation made under another tax law:
(c) A non-disputable decision:
(d) In relation to an obligation to provide a tax return or a tax form, also includes a provision of the Accident Rehabilitation and Compensation Insurance Act 1992 or a regulation made under that Act or the Accident Insurance Act 1998 or a regulation made under that Act.

[definition of "tax law" with effect **on or after 1 April 2002**)

"**Tax law**" means—

(a) A provision of the Inland Revenue Acts or an Act that an Inland Revenue Act replaces:
(b) An Order in Council or a regulation made under another tax law:
(c) A non-disputable decision:
(d) In relation to an obligation to provide a tax return or a tax form, also includes a provision of the Accident Rehabilitation and Compensation Insurance Act 1992 or a regulation made under that Act or the Accident Insurance Act 1998 or a regulation made under that Act or the Injury Prevention, Rehabilitation, and Compensation Act 2001 or a regulation made under that Act:

[for "tax positions" taken **prior to 1 April 2003**]

"**Tax position**" means a position or approach with regard to tax possible, under one or more tax laws, including without limitation

(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:

[for "**tax positions**" taken **on or after 1 April 2003**]

"**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**" means a person who—
(a) Is liable to perform, or to comply with, a tax obligation; or
(b) May take a tax position,—
whether as principal, or as an agent or employee or officer of another person, or otherwise:

[for "Taxpayer's tax position" taken **prior to the 2002-2003 income year**]

"**Taxpayer's tax position"** means—
(a) Unless paragraph (b) applies, 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) If
  (i) The tax is income tax; and
  (ii) The taxpayer alters a tax position taken in a tax return or in an income statement before the earlier of-
    (A) The issue of an assessment in respect of the tax; and
    (B) The due date for payment of the tax,-
the tax position the taxpayer takes or is deemed to take in the last amended tax return or in the last amended income statement received by the Commissioner before the issue of the assessment or the deemed assessment or before the due date, whichever applies:

[for "Taxpayer's tax position" taken with application to the **2002-2003 and subsequent income years**]

"**Taxpayer's tax position**" means—
(a) A tax position taken by a taxpayer in or in respect of–
(b) (repealed)

5. Shortfall penalty for not taking reasonable care

The shortfall penalty payable under section 141a

5.1 Section 141A(1) provides for a shortfall penalty to be imposed on a taxpayer for "not taking reasonable care" in the taking of a taxpayer's tax position. Where that tax position results in a tax shortfall:

> A taxpayer is liable to pay a shortfall penalty if the taxpayer does not take reasonable care in taking a taxpayer's tax position (referred to as "not taking reasonable care") and the taking of that tax position by that taxpayer results in a tax shortfall.

5.2 The shortfall penalty for not taking reasonable care is 20% of the resulting tax shortfall (section 141A(2)).

> (2) The penalty payable for not taking reasonable care is 20% of the resulting tax shortfall.

5.3 The terms "shortfall penalty", "taxpayer's tax position", "tax position", and "tax shortfall" are all defined in section 3(1).

5.4 There is no definition for the term "reasonable care" in the Act. However, section 141A(3) provides that a taxpayer who has used an "acceptable interpretation" (or with application to tax positions taken on or after 1 April 2003, a taxpayer who "takes an acceptable tax position"), in taking a taxpayer's tax position is one who has taken reasonable care in the taking of the taxpayer's tax position. Section 141A(3) states:

> (3) A taxpayer who takes an acceptable tax position is also a taxpayer who has taken reasonable care in taking the taxpayer's tax position.

5.5 Interpretation Statement IS0055 provides the Commissioner's view on what is an unacceptable tax position (applicable to tax positions taken on or after 1 April 2003).

5.6 With application to a tax position taken on or after 1 April 2003, section 141A(4) provides that a taxpayer who makes a mistake in the calculation or recording of numbers in a return is specifically not excluded from being liable for a penalty for not taking reasonable care under section 141A. Section 141A(4) states:

> (4) Subsection (3) and section 141B(1B) do not exclude a taxpayer who makes a mistake in the calculation or recording of numbers in a return from being liable for a penalty for not taking reasonable care.

5.7 In this context, it is considered that "return" refers to the taxpayer's tax return. "Tax return" is defined in the Act.

> "**Tax return**" means a form or document that a taxpayer is required by a tax law—
>
> (a) To complete; and
>
> (b) To provide to the Commissioner,—
>
> whether in electronic or written form and whether provided in respect of a period or not; and also includes a tax form issued by another taxpayer that the taxpayer provides to the Commissioner:

5.8 It is noted that section 141A(4) does not provide that the taxpayer who makes a mistake in the calculation or recording of numbers in a return is necessarily liable for a shortfall penalty under section 141A.

Extent of application of section 141A

5.9 It should be noted that section 141A also applies to employers who do not take reasonable care in their tax obligations in respect of the deduction of tax from employees. The definitions of "tax law" and "tax position" mean that section 141A can apply to any of the Inland Revenue Acts. However, for the Child Support Act 1991 and Student Loan Scheme Act 1992, section 141A applies only in respect of employer obligations under these Acts.

6. Not taking reasonable care

Introduction

6.1 As noted above, there is no definition for the term "reasonable care" in the Act. The word "care" is defined in T*he New Shorter Oxford English Dictionary on Historical Principles* (Brown, L, (ed.), volume 1, (Oxford: Oxford University Press, 1993)), at page 516) to mean:

> … 3 serious attention, heed, caution, pains (assembled with care; handle with care) …

6.2 In the context of section 141A(1), the word "care" suggests the attention that a taxpayer takes in the taking of the taxpayer's tax position, with the adjective "reasonable" being used to describe the level or standard of attention required. In *The New Shorter Oxford English Dictionary on Historical Principles*, volume 2, at page 2496, "reasonable" is defined to mean:

> … 5 Within the limits of reason; not greatly less or more than might be thought likely or appropriate; moderate, …

6.3 Thus, taking reasonable care is giving appropriately serious attention to imposed obligations. Lack of reasonable care has long been one of the constituents of the tort of negligence. It is, therefore, helpful as background to consider the law relating to the tort of negligence.

Negligence in tort

6.4 In defining the standard of care in negligence cases, the Courts have laid down the concept of the "reasonable person". Alderson B in *Blyth v Birmingham Waterworks* (1856) 11 Ex 781 at page 784 stated:

> Negligence is the omission to do something which a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs, would do; or do something which a prudent and reasonable man would not do.

6.5 The standard of care in negligence is not dependent upon the person's individual characteristics (*Glasgow Corporation v Muir* [1943] AC 448 at page 457 per Lord Macmillan): the standard is that of a reasonable person. Consequently, the circumstances of the person may dictate that they seek outside assistance (Todd, S, (ed.), *The Law of Torts in New Zealand*, 3rd edition, (Wellington: Brookers Limited, 2001) at pages 389-392). Therefore, an incapacitated person, whether in law or physically, can be held to have been negligent when he or she has attempted to do something beyond his or her capacity (*Spiers v Gorman* [1966] NZLR 897 at pages 905 – 906 (a minor); *Billy Higgs & Sons Ltd v Baddeley* [1950] NZLR 605 at page 614 (physical incapacity)).

6.6 In this context, when using an expert's assistance, it is necessary that the expert is advised of all necessary information. In the tax context, it was held in *Pech v Tilgals* [1994] ATC 4206 that, when instructing tax agents, a taxpayer's standard of care requires that the tax agent is comprehensively instructed and that the tax return that the principal is declaring to be correct must be inspected by the principal following its completion. However, it was also held that it was not necessary for the taxpayer to cover every contingency exhaustively by acquainting him or herself with all possible considerations that a reasonable person would not deal with.

6.7 The standard of care of a reasonable person does not require perfection. As Laidlaw J said in the Canadian case of *Arland v Arland and Taylor* [1955] OR 131 at page 142:

> [The reasonable man] is not an extraordinary or unusual creature; he is not superhuman; he is not required to display the highest skill of which anyone is capable; he is not a genius who can perform uncommon feats, nor is he possessed of unusual powers of foresight. **He is a person of normal intelligence who makes prudence a guide to his conduct**. He does nothing that a prudent man would not do and does not omit to do anything that a prudent man would do. **He acts in accordance with general and approved practice. His conduct is guided by considerations which**

> **ordinarily regulate the conduct of human affairs**. His conduct is the standard adopted by the community by persons of ordinary intelligence and prudence.
> [emphasis added]

6.8 The use of hindsight is not relevant in determining whether or not a person has been negligent. In *Duchess of Argyll v Beuselinck* [1972] 2 Lloyds Rep 172 at page 185, Megarry J stated:

> In this world there are few things that could not have been better done if done with hindsight. The advantages of hindsight include the benefit of having a sufficient indication of which of the many factors present are important and which are unimportant. But hindsight is no touchstone of negligence.

6.9 In tort, a reasonable person takes notice of standards that are authoritative, sensible, accepted, or persuasive (*Froom v Butcher* [1975] 3 All ER 520 at page 526 per Lord Denning) and, in so doing, will be expected to keep abreast of such standards if it is reasonable to do so (*Graham v Co-operative Wholesale Society Ltd*. [1957] 1 WLR 511).

6.10 In *Paris v Stepney Borough Council* [1951] AC 367, it was held that the degree of care required was dependent upon the gravity of the consequences if anything went wrong; a higher degree of care is required when the consequences of getting it wrong are serious.

Reasonable care in relation to the particular person

6.11 As to the degree of care required, there are traditionally no "high" or "low" standards, to use the terminology in *Russell v Harris* [1960] NZLR 902. Much care or little care may be needed depending upon the circumstances.

6.12 In tort, an inexperienced person is required to exercise the care of the ordinary person. The clearest example of this in relation to negligence is the English Court of Appeal case of *Nettleship v Weston* [1971] 3 All ER 581. The case involved the alleged negligence of Mrs Weston who was learning to drive when she caused an accident. It is well established that a person driving a motor vehicle owes a duty of care to any passengers in the vehicle as well as to other persons on or near the roadways. One of the issues for the court was whether or not Mrs Weston had breached this duty by not taking reasonable care. Lord Denning MR made the following observations regarding the standard of reasonable care at page 586:

> It is no answer for him to say: "I was a learner-driver under instruction. I was doing my best and could not help it." The civil law permits no such excuse. It requires of him the same standard of care as any other driver. "It eliminates the personal equation and is independent of the idiosyncrasies of the particular person whose conduct is in question": see *Glasgow Corpn v Muir* [1943] 2 All ER 44 at 48 per Lord Macmillan. The learner-driver may be doing his best, but his incompetent best is not good enough. He must drive in as good a manner as a driver of skill, experience and care, who is sound in wind and limb, who makes no errors of judgment, has good eyesight and hearing and is free from any infirmity.

6.13 In this regard, the test is not whether a person has tried to exercise reasonable care, but rather whether he or she has in fact done so (*Bailey v Taylor* [1936] NZLR 806). This indicates that the test for reasonable care is an objective one.

6.14 In the case of persons who hold themselves out as experts in a particular area, such as a specialist surgeon, the standard of care may be higher. In the *Law of Torts in NZ*, 3rd edition, Brookers 2001, it is stated at page 385 that, in the case of those who have special skills, the standard of conduct must conform to that which ought to be attained by persons holding themselves out as possessing the relevant skills. *Bannerman, Brydone Forster & Co v Murray* [1972] NZLR 411 is New Zealand Court of Appeal authority for this proposition (in relation to solicitors). However, an expert in a particular field is not required to exercise a greater degree of care than an ordinary person unless he or she holds him or herself out to be such (*Stokes v Guest, Keen & Nettlefold (Bolts and Nuts) Ltd* [1968] 1 WLR 1776).

6.15 As can be seen from the cases, the test for reasonable care in the tort of "negligence" is generally objective. The rationale behind this common law test is that people are not to be encouraged to engage in something beyond their capabilities. *Clerk & Lindsell* on Torts, 18th ed, London, Sweet & Maxwell 2000 speculate that insurance considerations have contributed to the objective standard, being that of the activity rather than the actor and state at paragraph 7.163, in relation to *Nettleship v Weston*:

> **Policy justification** Basing the objective standard on the activity rather than the actor gives the reasonable expectations of the claimant priority over those of the defendant. This policy is most evident in cases where the activity affects the safety of the general public and where, as a consequence, it is likely that those undertaking the activity will be insured.

6.16 However, there is some authority for the consideration of personal characteristics or circumstances in the application of the tort test of negligence, albeit in exceptional circumstances. *Salmond on the Law of Torts*, 16th ed, at page 225 discusses the standard of care in relation to actions

which the person is compelled to carry out. After stating that the test for negligence is objective, *Salmond* qualifies the test in the following terms:

> If, however, a person thus deficient in some attribute of the ordinary and average man is placed without his own choice in some situation where the possession of that attribute is requisite for the avoidance of harm, he is not responsible for negligence merely because the ordinary man could have avoided the accident. He must be judged with reference to his own capacities of mind and body, and if he does his best, he does enough, even though a man better endowed would have been bound to do much more. A blind man must not voluntarily do an act which can be safely done only by those who have eyes to see, but if he has such action thrust upon him through no choice of his, he will not be judged as though he could see.

6.17 There are also cases that have considered the culpability of the defendant. At page 391 of The *Law of Torts in New Zealand*, 3rd ed, Brookers, 2001, it is stated:

> … that in exceptional circumstances the courts' insistence on the maintenance of strictly objective standards … gives way in the face of the plaintiff's innocence of any culpability or fault.

6.18 *Mansfield v Weetabix* Ltd [1998] 1 WLR 1263 is cited in this respect. The case concerned a driver who could not function properly because, unknown to him, he suffered from malignant insulinoma which starved the brain of glucose. Accordingly, an accident in which he crashed into the plaintiff's shop was not his fault and he was not negligent. Leggatt LJ, in the English Court of Appeal, rejected strict liability in the following words:

> In my judgment the standard of care that Mr Tarleton was obliged to show in these circumstances was that which is to be expected of a reasonably competent driver unaware that he is or may be suffering from a condition that impairs his ability to drive. To apply an objective standard in a way that did not take account of Mr Tarleton's condition would be to impost strict liability. But that is not the law.

6.19 The Law of Torts in New Zealand goes on to state that mental disability stands on the same footing as physical disability so far as the standard of care issue is concerned. It is noted that this approach has been taken in Canada in cases such as Buckley v Smith Transport [1946] 4 DLR (Ont CA) but not in Australia (in Adamson v Motor Vehicle Insurance Trust [1956] WALR 56). However, as discussed later in this statement, there is Australian authority that supports some consideration being given to the person's experience, education and skills in determining whether there has been a lack of reasonable care in the tax context.

Negligence in a tax context

6.20 In *Case W4* (2003) 21 NZTC 11,034, which concerned "gross carelessness", Judge Barber, in the TRA, referred to the circumstances of the taxpayer in the application of the test for "reasonable care". He stated at page 11,044 of the judgment as follows:

> I can accept that the test of reasonable care is whether a taxpayer of ordinary skill and prudence would have foreseen as a reasonable probability or likelihood the prospect that an act, or failure to act, would cause a tax shortfall, **having regard to all the circumstances**.
>
> As with gross carelessness, whether the taxpayer acted intentionally is not a consideration. It is not a question of whether the taxpayer actually foresaw the probability that the act or failure to act would cause a tax shortfall, but whether a reasonable person **in the circumstances of the taxpayer** would have seen the tax shortfall as a reasonable probability. Reasonable care must include exercising reasonable diligence to determine the correctness of a return. It must also include the keeping of adequate books and records or to properly substantiate items, and generally making a reasonable attempt to comply with the tax law. **The effort required of the taxpayer is commensurate with the reasonable person in the taxpayer's circumstances. What must be expected is the achievement of a standard appropriate to the category of taxpayer, rather than that of the individual taxpayer concerned**. Materiality must be implicit in the standard of reasonable care so that consideration will be given not only to the nature of the shortfall, but also to its size in relation to the taxpayer. This means there may be varying degrees of care required depending on the particular circumstances.
> [emphasis added]

6.21 This clearly contemplates consideration of the circumstances of the taxpayer.

6.22 In the earlier decision of Judge Barber in *Case W3* (2003) 21 NZTC 11,014, which concerned gross carelessness and, in the alternative, lack of reasonable care, there was no discussion of the taxpayer's circumstances. However, there was no reason for a lesser standard to be applied in that case as the taxpayer was an accountant. In *Case W3*, the issue was whether a higher standard was required but, on the facts, Judge Barber did not find it necessary to decide on the matter.

6.23 Therefore, it can be seen that the common law in applying a test of reasonable care to determine whether a breach of duty has occurred, applies an objective test that is not generally qualified by the characteristics or circumstances of the person. It is necessary, however, to consider the particular circumstances and background to section 141A.

Legislative background

6.24 Determining what constitutes "reasonable care" and where it must be taken requires consideration of legislative intent. In this respect, the statutory context of section 141A and background materials to the legislation are relevant.

6.25 *The Taxpayer compliance, standards and penalties*: a Government discussion document (August 1994) at page 19 stated the following:

> Reasonable care will become a basic standard that all taxpayers must exercise in fulfilling any tax obligation. The standard requires taxpayers to take the same level of care that a reasonable person would take in the same circumstances. **What is reasonable depends on the facts and circumstances of each situation, including the person's experience, education and skills.** It equates with the concept of negligence in the civil law of torts, for which the jurisprudence is well established.
> [emphasis added]

6.26 However, the *Commentary on the Bill* at page 11 states that the standard of care required is determined by focusing on the "reasonable" person, i.e. one of ordinary skill and prudence:

> The test of reasonable care is whether a person of ordinary skill and prudence would have foreseen as a reasonable probability or likelihood the prospect that an act (or failure to act) would cause a tax shortfall, having regard to all the circumstances.

6.27 The *Commentary on the Bill* at page 11 also notes that the taxpayer's intention is irrelevant, as is whether or not the taxpayer foresaw that a shortfall would result:

> The test does not depend on the taxpayer's intention, or whether the taxpayer actually foresaw that the act or failure to act would cause the shortfall; rather, it asks whether a reasonable person would have foreseen it.

6.28 When the Taxpayer Compliance, Penalties, and Disputes Resolution Bill (1995) was introduced into Parliament, the then Minister of Revenue used the following example to illustrate these points to highlight the focus on the person of ordinary skill and prudence:

> The test of reasonable care is whether a person of ordinary skill and prudence would have foreseen as a reasonable probability the prospect that an act would cause a tax shortfall, having regard to all the circumstances. (NZPD Vol 550, 1995: 9339)

6.29 However, the issue of a particular taxpayer's circumstances was specifically addressed when the Finance and Expenditure Committee reported back on the above Bill. The report included the following:

> **We examined the "reasonable care" policy statement (refer Appendix I) that the department intends to publish in a Tax Information Bulletin after enactment of the bill**. The statement defines the standard and describes in detail the intended operation of the penalty. It emphasises the flexible character of the standard, the relative ease with which it should be met by a very significant majority of taxpayers, **the importance of the particular circumstances of each taxpayer**, and the essentially non-onerous obligations the standard is intended to impose.
>
> 1. Conclusion
>
> Having considered the statement and having derived comfort from the examples in the statement, we determined that the "reasonable care" provision should not be amended. However, this is only on the basis that the concepts and interpretations outlined in the draft policy statement represent the department's application of the law, without change. **We expect the courts to regard our comments in this report, together with the department's declared intentions set out in Appendix I, to represent Parliament's intentions in regard to the meaning and administration of the Act in this respect**, as well as in respect of other key aspects discussed elsewhere in this report.
> [emphasis added]

6.30 The FEC report appears to support the Parliamentary intention being that, although the test is objective, the personal circumstances of the taxpayer are taken into account in establishing whether the taxpayer has exercised reasonable care. In other words, it is necessary to consider what a reasonable person in the taxpayer's circumstances would have done.

6.31 The discussion on reasonable care in T*ax Information Bulletin*, Vol 8, No 7 (October 1996) at page 11 is consistent with the above approach:

> The reasonable care test requires a taxpayer to exercise the care that a reasonable person would be likely to exercise in the taxpayer's circumstances to fulfil the tax obligations. It is not a question of whether the taxpayer actually foresaw the probability that the act or failure to act would cause a tax shortfall, but whether a reasonable person in the same circumstances would have foreseen the shortfall as a reasonable probability. It equates with the concept of negligence in the civil law of Torts, and the jurisprudence is well established: "Negligence is to be measured objectively by ascertaining what in the circumstances would be done or omitted by the reasonable man." (*Meulen's Hair Stylists Ltd. v CIR*; *Meulen's Hair Stylists (Lambton Quay) Ltd. v CIR* [1963] NZLR 797).
>
> In the tax context, reasonable care includes exercising reasonable diligence to determine the

> correctness of the tax position. It also includes keeping adequate books and records to substantiate items properly, and generally making a reasonable attempt to comply with the tax law. The reasonable care test is not intended to be overly onerous to taxpayers. Reasonable care does not mean perfection. The effort required of the taxpayer is commensurate with that of a reasonable person **in the taxpayer's circumstances**.
> [emphasis added].

6.32 The TIB discussion continues:

> The circumstances that may be taken into account when determining whether a taxpayer has exercised reasonable care include:
> - the complexity of the law and the transaction (the difficulty in interpreting complex legislation);
> - the materiality of the shortfall (the gravity of the consequence and the size of the risk);
> - the difficulty and expense of taking the precaution;
> - the taxpayer's age, health and background.
>
> [emphasis added]

6.33 This also indicates a test where attributes of the taxpayer such as age, health, and background are taken into account in establishing whether reasonable care has been exercised.

6.34 Other tax jurisdictions have similar provisions where the setting of a standard of care is required. Consideration of these provisions and their application may be helpful.

The Australian approach to the particular circumstances of the taxpayer

6.35 Section 141A was largely derived from the equivalent Australian provision (section 226G of the Income Tax Assessment Act 1936). Section 226G provides that a penalty tax may be imposed where shortfalls are caused by a failure to take reasonable care. Accordingly, Australian case law on section 226G is of some relevance. The Australian provision provides:

> Subject to this Part, if:
> (a) a taxpayer has a tax shortfall for a year; and
> (b) the shortfall or part of it was caused by the failure of the taxpayer or of a registered tax agent to take reasonable care to comply with this Act or the regulations;
>
> the taxpayer is liable to pay, by way of penalty, additional tax equal to 25% of the amount of the shortfall or part.

6.36 Section 226G differs from section 141A in that it specifically penalises taxpayers for their tax agents' failures to take reasonable care, although, in other respects, the interpretation and application of the Australian provision are useful as a basis for understanding section 141A.

6.37 In the explanatory memorandum to the Taxation Law Amendment (Self Assessment) Bill 1992 (Cth), which introduced section 226G of the Australian Act, the standard of reasonable care was described in terms of a taxpayer's circumstances:

> The effort required is one commensurate with all the taxpayer's circumstances, including the taxpayer's knowledge, education, experience and skill.

6.38 *Case 34/95* 95 ATC 319 at page 324 and *Arnett & Ors v FCT* 98 ATC 2137 at page 2,140 cite this passage from the explanatory memorandum with approval, as do *Schott v FCT* 1999 ATC 2,234 at 2,236 – 2,237, *Cripps v FCT* 1999 ATC 2428, and *Davis v FCT* 2000 ATC 2,044 at 2,050.

6.39 In this context, the Australian Tax Office (the "ATO") issued *Taxation Ruling* TR 94/4, where it promulgated its understanding of the meaning of taking reasonable care under section 226G of the Australian Act. Paragraph 6 of the ruling describes the standard of care to be the reasonable, ordinary person – this indicating a similar basis to the person of ordinary skill and prudence used in the Commentary to the Bill. However, it also takes into account the person's circumstances, for example, the experience, education and skill of the person:

> The reasonable care test requires a taxpayer to take the care that a reasonable ordinary person would take in all the circumstances of the taxpayer to fulfil the taxpayer's tax obligations. Provided that a taxpayer may be judged to have tried his or her best to lodge a correct return, having regard to the taxpayer's experience, education, skill and other relevant circumstances, the taxpayer will not be liable to pay penalty.

6.40 Paragraph 14(f) of *Taxation Ruling* TR 94/4, cited with approval in the Administrative Appeals Tribunal Case 11/97 97 ATC 173 at page 187, considered the issue of interpretations of tax laws in the context of the lack of reasonable care penalty provision:

> On questions of interpretation, reasonable care requires a taxpayer to come to conclusions that would be reasonable for an ordinary person to come to in the circumstances of the taxpayer. If the taxpayer is uncertain about the correct tax treatment of an item, reasonable care requires the taxpayer to make reasonable enquiries to resolve the issue. This is different from the reasonably arguable position standard [i.e. the equivalent of unacceptable interpretation in New Zealand], which does not look at the taxpayer's efforts in resolving the issue, nor the circumstances of the taxpayer, but solely at the merits of the arguments in support of a position.

6.41 Paragraph 6 of T*axation Ruling* TR 94/4 was cited with approval in *Cripps v FCT*; and in *Re Carlaw*

and FCT 95 ATC 2166. *Re Carlaw* considered, among other things, whether a taxpayer, who claimed a deduction for meal expenses, was liable for a penalty under section 226G. On the basis that he had taken advice from a qualified tax agent and the fact that the deduction claimed was reasonably arguable if, in fact, incorrect, the taxpayer was successful in his appeal against the penalty imposed. At page 2,170, McMahon (DP) stated:

> The taxpayer is a truck driver. He made claims for deductions pursuant to advice he received from a qualified tax agent, who had been engaged by his union. If a man in that position is advised that he may make a claim, can it be said that he fails to take reasonable care to comply with the Act if the claim is unsuccessful? I think not. Clearly the mere fact that a claim is made can not thereby render the conduct of a taxpayer careless, particularly when that claim is reasonably arguable.
> …
>
> That advice had some measure of support from *Case U148* [87 ATC 868], from the article of Mr Durack which I have quoted, and from observations made in [*FCT v Edwards* 94 ATC 4255] and in [*Roads & Traffic Authority v FCT* 93 ATC 4508]. Although in the circumstances of Mr Carlaw's employment and consumption of food I do not consider that the expenditure claim is properly deductible, I do not consider that he has displayed a failure to take reasonable care to comply with the Act in making his claim.

6.42 In contrast, in Re Sparks v FCT 43 ATR 1,324, although the taxpayer and his wife employed an accountant to make their returns, it was held that Mr Sparks was liable for a shortfall penalty for not taking reasonable care because he had failed to inform his accountant of certain interest income. Mr and Mrs Sparks had failed to return that interest in their annual returns. Mr Sparks notified the Commissioner of this when he was advised that he was to be audited. Mrs Sparks also notified the Commissioner of the omission in her returns, although at the time she had not been advised of any prospective audit. Although Mr and Mrs Sparks employed an accountant to make their returns, the Tribunal upheld that there was no cause to possibly remit the tax penalty payable by Mr Sparks under section 226G, on the basis that they had received erroneous advice. "Mr Sparks simply failed to inform his accountant of the existence of the interest income" (paragraph 9 of Re Sparks).

6.43 *Case 34/95* concerned the actions of a tax agent who incorrectly claimed a deduction for a superannuation contribution for a taxpayer. The Australian provision is wider than the New Zealand provision and attributes to the taxpayer, any lack of reasonable care on the part of the tax agent. In *Case 34/95*, the Tribunal applied the reasonable person test. The Tribunal held that the taxpayer's agent had failed to take reasonable care, and, accordingly, in affirming the taxpayer's tax shortfall penalty, the Tribunal was "satisfied [that] the tax shortfall was caused by the failure of the taxpayer or tax agent to take reasonable care to comply with the Act". The Tribunal made the following statement referring to the appropriate standard of care:

> 21. The explanatory memorandum to the Taxation Laws Amendment (Self Assessment) Bill 1992, the Bill which introduced section 226G to the Act, illuminates Parliament's intended meaning of the phrase "reasonable care". In that document, at page 80, it is explained that reasonable care "requires a taxpayer to make a reasonable attempt to comply with the provisions of [the Act] and regulations. The effort required is one commensurate with all the taxpayer's circumstances, including the taxpayer's knowledge, education, experience, and skill".

6.44 In short, the Australian provision seems to require that the taxpayer's circumstances including the taxpayer's knowledge, education, experience, and skills are to be taken into account in determining whether they have taken reasonable care.

Canadian approach to the particular circumstances of the taxpayer

6.45 Section 227.1(1) of the Canadian Income Tax Act 1994 imposes a liability to deduct tax on the directors of a corporation where the corporation has failed to deduct the tax.

6.46 Section 227.1(3) provides that a director is not liable under subsection (1) if the director exercised:

> … the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.

6.47 *CCH Canadian Tax Reporter Commentary* on the Canadian Income Tax Act 1994 provides the following comment on section 227.1(3):

> The leading case on the standard of care requirement under subsection 227.1(3) is the Federal Court of Appeal decision in *Soper v. The Queen*, (F.C.A.) 97 DTC 5407. The Court in Soper began its analysis on the issue by summarizing the common law standard applicable to directors. The Court quoted from the seminal judgement in *Re City Equitable Fire Insurance Company*, [1925] 1 Ch. 407 (C.A.) (referred to above), which set out the minimum standard of care, diligence and skill required of directors under the common law:
>
> > …
> >
> > The Court in Soper held that the statutory standard of care under subsection 227.1(3) is, in many ways, the same as that under the common

law. In particular, the Court held that the standard of care laid down in subsection 227.1(3) is inherently flexible. **Rather than treating directors as a homogeneous group of professionals whose conduct is governed by a single, unchanging standard, the provision embraces a subjective element which takes into account the personal knowledge and background of the director, as well as his or her corporate circumstances in the form of, among other things, the company's organization, resources, customs and conduct. Thus, more is expected of individuals with superior qualifications and business experience, as compared to individuals without such qualifications and experience. According to the Court, the standard of care set out in subsection 227.1(3) is neither purely objective nor purely subjective. Rather, the provision contains both objective elements (embodied in the reasonable person language) and subjective elements (inherent in individual considerations like "skill" and the idea of "comparable circumstances"). Accordingly, the standard can be properly described as "objective subjective"**.

[emphasis added]

6.48 It is, therefore, apparent that the approach taken in Canada, in setting the threshold for reasonable care in a taxation context, is to take into account the circumstances of the person such as education and business experience.

Application of the "negligence" test to the standard of reasonable care

6.49 It is also apparent that a test, taking into account the taxpayer's age, health, and background, was what the New Zealand legislators intended. The standard of care for negligence is generally accepted as purely objective, being the level of care a reasonable person would take in the same circumstances. The jurisprudence in relation to tort law does not generally permit factors such as the taxpayer's age, health, and background to be taken into account in applying the test.

6.50 It is considered that a test which takes into account the taxpayer's circumstances better fulfils the intention of section 141A and, as discussed above, was what Parliament intended. This view is supported by the discussion document, the report of the Finance and Expenditure Committee, and *TIB* Vol 8, No 7 (October 1996).

6.51 It would also appear that this interpretation accords with the scheme and purpose of the penalty provisions of the Tax Administration Act. The purposes of the penalty provisions are set out in section 139.

> **139** The purposes of this Part are—
> (a) To encourage taxpayers to comply voluntarily with their tax obligations and to co-operate with the Department; and
> (b) To ensure that penalties for breaches of tax obligations are imposed impartially and consistently; and
> (c) To sanction non-compliance with tax obligations effectively and at a level that is proportionate to the seriousness of the breach.

6.52 It is considered that section 139 supports a test that takes account of the taxpayer's circumstances in interpreting what is "not taking reasonable care". The taxpayer's circumstances would encompass the factual background as well as the personal attributes of the taxpayer, such as age, health and background. The wording of the purpose provision does not support a regime of penalising taxpayers who complete tax returns with reasonable care. Therefore, the underlying purpose of the regime would seem to support taking account of the characteristics of the taxpayer, such as the taxpayer's age, health, and background, as well as objective elements, when considering the application of section 141A.

6.53 This approach has been followed in Canada and Australia. It is also noted that the Australian Administrative Tribunal in numerous cases (Schott, Cripps, Davis, and Arnett) refer to Case 34/95 and its citation of the explanatory memorandum regarding the taking into account of the particular circumstances of the taxpayer. Carlaw and Cripps also refer to the ATO Taxation Ruling TR 94/4 relating to a person's particular circumstances. It would seem that the same reasoning as set out in the Australian memorandum could be applied in New Zealand.

Implications for tax specialists

6.54 It is also necessary to examine the implications for tax specialists. If a taxpayer consults a tax specialist or agent, the taxpayer would generally be taking reasonable care in terms of the legislation and common law, provided that all relevant tax details are disclosed to the tax specialist or agent. As to the tax specialist's own obligations, the tort of negligence is generally focused on owing a duty of care to a person as in the case of the specialist surgeon holding himself or herself out as an expert to a patient and carrying out surgery on the patient. However, the question arises as to what is the duty of care on tax specialists **in terms of their own tax obligations** as possibly they are

not holding themselves out as tax specialists to the Commissioner when they are filing their own tax returns. In terms of the test of what a reasonable person in the taxpayer's circumstances would do, it would follow that the standard of care for a tax specialist would be higher than the standard for an ordinary taxpayer. This would seem to accord with the intention of the legislation, which is that taxpayers are diligent in fulfilling their tax obligations. This is also consistent with lowering the standard of reasonable care to take account of instances where health, age, and background are factors in not meeting the normal standard.

6.55 The ATO ruling (*Taxation Ruling* TR 94/4) does not specifically cover the above issue. Paragraph 36 of the ruling does, however, discuss the example of the standard of care required by a tax agent in attending to a client's tax affairs being higher than that of an ordinary taxpayer. The ruling states, in relation to an example:

> The standard of care required by a tax agent is higher than that expected of an ordinary taxpayer due to the knowledge, education, skill and experience of the agent obtained from continual exposure to the operation of the financial system and similar transactions in numerous clients. When examining a taxpayer's affairs, a tax agent would be expected to apply this experience to the taxpayer's situation and to ask the questions necessary to correctly prepare the client's return.

6.56 In the New Zealand Taxation Review Authority decision, *Case W3*, referred to above, Judge Barber was asked to consider whether an accountant would be held to a higher standard than a layperson in the preparation of his own GST return. Although Judge Barber did not find it necessary to determine the issue, he stated as follows:

> … [Counsel for the Commissioner] seems to accept that such an aspect can be put to one side and the focus can be upon what the ordinary person should have done in such a case. [Counsel for the Commissioner] submits that, even on that basis, the disputant's lack of investigation into, or his disregard of, record keeping requirements is below the level which a prudent person would be expected to adopt and shows a careless approach to the correct returning of output tax on the $37,864.09 additional income.

Non-natural person liability for lack of reasonable care

6.57 Questions of vicarious liability may arise where the responsibility for taking a tax position is delegated. In the case of a corporate or "non-natural person" taxpayer, all such responsibility will necessarily be delegated to a natural person. However, the same law as to vicarious liability would apply in either situation; the actions of an employee, in the course of his or her employment, are attributed to the employing company as to any other employer.

Vicarious liability

6.58 It is vicarious liability that is relevant to the taking of reasonable care since "not taking reasonable care" is not concerned with intention or mens rea. The classic statement from *Salmond on Torts* (9th ed), p 95, as to vicarious liability in terms of employers was adopted by Lord Thankerton in the Privy Council case of *Canadian Pacific Railway Co v Lockhart* [1942] 2 All ER 464 at 467:

> It is clear that the master is responsible for acts actually authorised by him: for liability would exist in this case, even if the relation between the parties was merely one of agency, and not of service at all. But a master, as opposed to the employer of an independent contractor, is liable even for acts which he has not authorised provided that they are so connected with acts which he has authorised that they may rightly be regarded as modes – although improper modes – of doing them. In other words, a master is responsible not merely for what he authorises his servant to do, but also for the way in which he does it… On the other hand, if the unauthorised and wrongful act of the servant is not so connected with the authorised act as to be a mode of doing it, but is an independent act, the master is not responsible; for in such a case the servant is not acting in the course of his employment, but has gone outside of it.

6.59 The decision in Canadian Pacific Railway Co v Lockhart was followed by the New Zealand Court of Appeal in Union Steam Ship Company of New Zealand v Colville [1960] NZLR 100 and would, thus, appear to be good law in New Zealand.

Vicarious liability as it applies to supervision and delegation of tasks to staff

6.60 Although the definition of "taxpayer" is wide, not taking reasonable care relates to the "taxpayer's tax position" which is "a tax position taken by a taxpayer in or in respect of a tax return; or an income statement; or a due date". Taxpayers are responsible for the acts of their employees provided the acts were within the acts authorised for that employee. Therefore, if an employee fails to meet the reasonable care standard in taking a tax position, the taxpayer employer is liable for the failure, whether the taxpayer is a natural person or not. The only difference between the application of this rule to natural person taxpayers and non-natural person taxpayers is that a non-natural person must act through agents and employees as it is incapable of acting otherwise.

6.61 Although a taxpayer is liable for the actions of their employees, the question of whether the taxpayer has taken reasonable care must still be considered.

6.62 The question arises as to the application of the test where it considers the age, health and background of the taxpayer when it is an employee who is acting on the taxpayer's behalf. There are several points to be made in this respect. An employee authorised to take the tax position may take reasonable care based on his or her age, health or background. However, the authorisation of that person may expose the taxpayer to the lack of reasonable care penalty should a tax shortfall result. This is so whether a natural person taxpayer authorised that employee or another employee of a non-natural person taxpayer authorised that person to take the taxpayer's tax position.

6.63 The question would be whether a reasonable person would have delegated to that person the preparation of the tax return and the taking of a tax position on the taxpayer's behalf. If the extent and nature of some incapacity of the employee would be known or suspected by a reasonable employer (or the taxpayer's employee who delegated the task to that person) then this would constitute not taking reasonable care. If, as a consequence, a tax shortfall arose in relation to that tax position, section 141A would apply. It would not be the acts of the incapable employee that would constitute not taking reasonable care provided that the incapable employee met the standard for a person in their circumstances. It would be the delegation of the task to that person whether by the taxpayer or an authorised employee of the taxpayer that would constitute not taking reasonable care.

6.64 The same principles would apply to the employees who, while not preparing the tax return, do perform other relevant functions concerned with the taking of a tax position. If, for example, a storeman provides incorrect stock figures to the accountant preparing the tax return and there is a tax shortfall as a result then, depending on the circumstances, this could be a failure to take reasonable care in the taking of the tax position.

6.65 The principles in relation to liability for employees and their failure to take reasonable care can be summarised as follows:

- The employer is vicariously liable for the acts of employees committed in the course of employment.
- The same principles of vicarious liability will also apply to taxpayers, whether natural persons or not, who delegate the preparation of tax returns to employees.
- The use of an employee that a reasonable person would know or suspect to be incapable of correctly filing the tax return can expose the taxpayer to a shortfall penalty for not taking reasonable care. This would apply regardless of whether the task is delegated by the taxpayer or by another employee of the taxpayer.
- The lack of care would also encompass situations where employees provide assistance or information to be used in taking a tax position, or perform other relevant functions concerned with taking a tax position. Taxpayers are equally liable for the actions of these employees, as they are for the actions of the staff member who actually prepares the tax return.
- The penalty can apply regardless of whether the employee completing the return took reasonable care given their age, health and background. The penalty is applied to the taxpayer – not the employee.

Indicia of not taking reasonable care for the purposes of section 141a

6.66 Having established that the test for not taking reasonable care is similar to that of negligence in tort, but taking into account the taxpayer's circumstances, it is necessary to apply this test in the tax context. What factors indicate that a taxpayer has or has not taken reasonable care in taking a taxpayer's tax position? This involves determining what a taxpayer of ordinary skill and prudence would do or not do in the taxpayer's circumstances. Those circumstances include the taxpayer's attributes (such as age, health, background, etc) and this may have an impact on the level of care to be exercised.

The reasonable person test – some factors to be considered in relation to the standard.

6.67 When the Taxpayer Compliance, Penalties, and Disputes Resolution Bill was introduced into Parliament, the Minister of Finance stated:

> What is reasonable will depend on the type of obligation involved. For example, a salary and wage earner will generally satisfy the reasonable care test by carefully following the tax guide. Reasonable care for a business taxpayer will include putting into place appropriate record-keeping systems and other procedures to ensure that the business income and expenditure is properly recorded and classified for tax purposes. (NZPD Vol 550, 1995:9339)

6.68 The *Commentary on the Bill* at page 12 was more specific:

> The circumstances that will be taken into account when determining whether a taxpayer has exercised reasonable care may include the complexity of the law and the transaction, the materiality of the shortfall (the gravity of the consequence and the size of the risk) and the difficulty and expense of taking the precaution.

6.69 Traditionally, it could be said in tort law that there are four main factors to be considered in setting the standard of reasonable care:

- Probability of injury (or in a tax context, the likelihood of a tax shortfall);
- Gravity of the risk (which in a tax context would be the quantum of the shortfall);
- Burden of precautionary measures (which in a tax context would be the difficulty of preventing a tax shortfall); and
- Social value of the activity (which is not relevant in the tax context).

6.70 Mason J provided a helpful summary of the legal position in *Wyong Shire Council v Shirt* (1980) 146 CLR 40 at 47-48 which is consistent with those circumstances to be taken into account set out in the *Commentary on the Bill* and quoted above. Mason J said:

> In deciding whether there has been a breach of the duty of care the tribunal of fact must first ask itself whether a reasonable man in the defendant's position would have foreseen that his conduct involved a risk of injury to the plaintiff or to a class of persons including the plaintiff. If the answer be in the affirmative, it is then for the tribunal of fact to determine what a reasonable man would do by way of response to the risk. The perception of the reasonable man's response calls for a consideration of **the magnitude of the risk and the degree of the probability** of its occurrence, along with **the expense, difficulty and inconvenience of taking alleviating action** and **any other conflicting responsibilities** which the defendant may have. It is only when these matters **are balanced out that the tribunal of fact can confidently assert what is the standard of response** to be ascribed to the reasonable man placed in the defendant's position. [emphasis added]

6.71 The criteria for consideration provided by Mason J have subsequently been quoted and applied by the Court of Appeal in *Wilson & Horton v AG* [1997] 2 NZLR 513, 521.

6.72 The *Commentary on the Bill* is consistent with this when it states:

> The circumstances that will be taken into account when determining whether a taxpayer has exercised reasonable care may include: the complexity of the law and the transaction, the materiality of the shortfall (the gravity of the consequence and the size of the risk) and the difficulty and expense of taking the precaution.

6.73 The *Commentary on the Bill* also indicates the factors to be considered for business taxpayers:

> For a business, reasonable care will also take into account the size and nature of the business, the internal controls in place and business record keeping practices.

6.74 In summary, factors indicating that a taxpayer has not taken reasonable care will depend on the particular obligations of the taxpayer. The obligations of a salary or wage earner are likely to be satisfied by carefully following the tax guide. However, in a more complex tax situation, such as that of a business, reasonable care by a taxpayer will mean using an accounting system appropriate to the size, number and complexity of transactions. Taking reasonable care may also mean delegating those tasks relevant to the taking of a tax position only to appropriate staff. These matters will be highlighted further in the discussion below under the headings, "the likelihood of a tax shortfall", "the quantum of a tax shortfall" and the "difficulty of preventing a tax shortfall".

Example one

A staff member of a large business makes an error of $10,000 in transferring figures from work papers to the GST return. The owner of the business is aware that the same staff member has made a similar transposition error in the previous period's GST return. In this case, it could be concluded that a reasonable owner would have foreseen a risk and put simple checks in place that would at least reduce the risk of obvious errors. Therefore, the taxpayer would be liable for a shortfall penalty for not taking reasonable care in respect of the second shortfall. (Whether the first shortfall would give rise to a penalty would depend on the particular circumstances of the error in that instance.)

Example two

In a similar scenario to example one, a staff member of a large business makes an error of $10,000 in transferring figures from work papers to the GST return. The owner of the business is aware that the same staff member has made a similar transposition error in the previous period's GST return. After the first error, the owner provided additional training for the staff member on the requirements for GST and also implemented a system whereby the GST returns were checked by a supervisor before they were submitted to the IRD. Although a second error was subsequently made, it involved the transposition of two figures from the working papers to the GST return. Instead of an amount of $111,570, the amount shown on the GST return as a refund was $111,750. In this case, as a reasonable owner, the owner has put simple checks into place to reduce the risk of obvious errors and the error is relatively minor. Therefore, the taxpayer would not be liable for a shortfall penalty for not taking reasonable care in respect of the second shortfall. (As for example one, whether the first shortfall would give rise to a penalty would depend on the particular circumstances of the error in that instance.)

Likelihood of a tax shortfall

6.75 One aspect of determining whether or not a person has taken reasonable care concerns whether or not the consequences of a person's action or inaction would have been foreseeable to the person (*Duchess of Argyll v Beuselinck* [1972] 2 Lloyds Rep 172 at page 185; *Wyong Shire Council v Shirt* (1980) 146 CLR 40 at page 47). The *Commentary on the Bill* at page 11 puts it this way:

> The test of reasonable care is whether a person of ordinary skill and prudence would have foreseen as a reasonable probability or likelihood the prospect that an act (or failure to act) would cause a tax shortfall, having regard to all circumstances.
>
> The test does not depend on the taxpayer's intention, or whether the taxpayer actually foresaw that the act or failure to act would cause a shortfall; rather, it asks whether a reasonable person would have foreseen it.

6.76 The difficulty of balancing the risk of an event happening against the difficulty of eliminating the risk was discussed by Lord Reid in *Overseas Tankship* (UK) v *The Miller Steamship Co Pty (The Wagon Mound* (No2)) [1966] 2 All ER 709 (PC). Lord Reid stated at page 719:

> Bolton v Stone ([1951] 1 All ER 1078, [1951] AC 850, HL.), posed a new problem. There a member of a visiting team drove a cricket ball out of the ground on to an unfrequented adjacent public road and it struck and severely injured a lady who happened to be standing in the road. … So it could not have been said that, on any ordinary meaning of the words, the fact that a ball might strike a person in the road was not foreseeable or reasonably foreseeable. It was plainly foreseeable; but the chance of its happening in the foreseeable future was infinitesimal. … The House of Lords held that the risk was so small that in the circumstances a reasonable man would have been justified in disregarding it and taking no steps to eliminate it.
>
> It does not follow that, no matter what the circumstances may be, it is justifiable to neglect a risk of such a small magnitude. A reasonable man would only neglect such a risk if he had some valid reason for doing so: eg, that it would involve considerable expense to eliminate the risk. He would weigh the risk against the difficulty of eliminating it. … In the present case there was no justification whatever for discharging the oil into Sydney Harbour. Not only was it an offence to do so, but also it involved considerable loss financially. If the ship's engineer had thought about the matter there could have been no question of balancing the advantages and disadvantages. From every point of view it was both his duty and his interest to stop the discharge immediately. …
>
> If a real risk is one which would occur to the mind of a reasonable man in the position of the defendant's servant and which he would not brush aside as far-fetched, and if the criterion is to be what that reasonable man would have done in the circumstances, then surely he would not neglect such a risk if action to eliminate it presented no difficulty, involved no disadvantage and required no expense. …
>
> The most that can be said to justify inaction is that he would have known that this could only happen in very exceptional circumstances; but that does not mean that a reasonable man would dismiss such risk from his mind and do nothing when it was so easy to prevent it. If it is clear that the reasonable man would have realised or foreseen and prevented the risk, then it must follow that the appellants are liable in damages. …

6.77 Accordingly, it must be considered whether a reasonable person would have foreseen that consequence and the actions that that reasonable person would have taken to prevent the risk foreseen.

6.78 Materiality may be relevant in determining whether a taxpayer has taken reasonable care. In many cases a tax shortfall may be considered material, where the shortfall is a substantial amount in comparison to the taxpayer's tax liability, and it is considered that a reasonable person would have foreseen that something was incorrect. However, although the quantum of the tax shortfall is relevant, other factors may also indicate whether the taxpayer has taken reasonable care.

Example three
a further $10,000 from his return. It can be accepted from the proportionally large amount of the omission that the taxpayer should have been aware that not all income had been returned. This is regardless of whether or not the taxpayer used an agent to complete his return. The tax shortfall is large relative to the taxpayer's taxable income. In the absence of any special circumstances, the taxpayer breached the standard of reasonable care in this case.

Example four
In contrast to the previous example, a large company returns taxable income of $50,000,000, but omits an additional $10,000 of assessable income. Subject to consideration of the circumstances that led to the error, the amount of the omission when compared with the taxable income of the company does not support the view that there was a lack of reasonable care. The tax shortfall, in relation to the taxable income, may mean that the company, despite the error, still took reasonable care in the preparation of its income tax return.

6.79 In some cases, it may also be appropriate to consider the quantum of the assessable income of the taxpayer for the relevant period when a tax shortfall arises in respect of an error in relation to assessable income. Other relevant matters might include the total deductions of a taxpayer where a tax shortfall relates to an incorrect deduction. The number of transactions, whether giving rise to the assessable income or deductions, may also be a factor to be considered. For example, it would be easier to review and check a smaller number of transactions rather than a large volume. This is, however, subject to the expectation that to take reasonable care with a large volume of transactions or transactions involving large amounts, suitable systems to deal with these transactions would be expected to be in place.

6.80 To summarise, in respect of the likelihood of a tax shortfall, the test is whether a reasonable person, in the circumstances of that taxpayer, would have foreseen the likelihood of a tax shortfall. The test is not whether the taxpayer concerned foresaw the tax shortfall. Factors indicating that a taxpayer may not have taken reasonable care include:

- repeated errors where the taxpayer has been advised or is otherwise aware that mistakes have previously been made;
- systems' failures, the risks of which are foreseeable or for which the taxpayer has not established adequate safeguards and monitoring;
- delegating matters relating to the taking of a tax position to employees who are known or would be suspected by a reasonable employer of lacking the capacity to take reasonable care (for example, inadequately trained staff or inexperienced or temporary staff); and
- the size of the tax shortfall, in that an error of a substantial amount in comparison to the taxpayer's tax liability or assessable income would be more easily foreseen.

Quantum of tax shortfall

6.81 The T*axpayer compliance, standards and penalties*: a Government Discussion document at page 18 states that failure to fulfil statutory obligations should normally attract a sanction:

> The fundamental obligation on taxpayers is to pay the correct amount of tax on time. Failure to satisfy this or any other legal requirement imposed on taxpayers by Parliament should normally attract a sanction.

6.82 However, the gravity of the risk or the size of the tax shortfall is a relevant factor to be considered in determining the standard of care required.

Difficulty of preventing a tax shortfall

6.83 A reasonable person takes notice of standards that are authoritative, sensible, accepted or persuasive, and, in so doing, keeps abreast of such standards if it is reasonable to do so (*Froom v Butcher* [1975] 3 All ER 520 at page 526; *Graham v Co-operative Wholesale Society Ltd* [1957] 1 WLR 511). In the context of tax law, a taxpayer exercising reasonable care would make use of up-to-date, freely available material such as tax guides issued by the Inland Revenue Department, T*ax Information Bulletins*, public rulings, and interpretation statements and guidelines (or if he or she did not have the necessary skills to do so, would seek help). A taxpayer with relatively simple tax affairs, such as a salary and wage earner, would be expected at least to consider relevant tax guides issued by the Inland Revenue Department and seek clarification if necessary.

Tax agents and advisors

6.84 Generally, a taxpayer will not be liable for a shortfall penalty for not taking reasonable care in respect of the lack of care by the agent, in respect of the provision of advice or in respect of the agent's preparation of the tax return. The Taxpayer Compliance Penalties and Disputes Resolution Bill (September 1995) states:

> Taxpayers are also required to take reasonable care in interpreting the law. If they are uncertain as to the tax treatment of an issue, reasonable care will require them to make inquiries to resolve this, by consulting the Inland Revenue Department or a tax adviser. A taxpayer who has reasonably relied on the advice of a tax adviser or the department will usually be considered to have exercised reasonable care. However, a failure to provide adequate information when seeking advice, a failure to provide reasonable instructions to a tax adviser, or unreasonable reliance on a tax adviser or on wrong advice may still expose the taxpayer to a penalty for lack of reasonable care.

6.85 A taxpayer who takes reasonable care will make inquiries if they are uncertain over a tax matter. This may involve consultation with Inland Revenue or a tax advisor and will require the taxpayer to provide adequate information when seeking the advice. Where that taxpayer seeks advice on a particularly complex tax issue, it may be quite reasonable for the taxpayer to rely on a tax agent's advice without much questioning. However, where the advice appears manifestly wrong or unreasonable on the basis of the taxpayer's own knowledge, a taxpayer who takes reasonable care will question such advice. This does not imply though that the taxpayer is required to have any particular knowledge of tax laws.

6.86 To summarise, in respect of the difficulty of preventing a tax shortfall, it is considered that a taxpayer who takes reasonable care:

- will, if necessary, seek help, although a wage or salary earner may generally satisfy the reasonable care test by carefully following the tax guide and it is considered that taxpayers with more complex tax affairs will follow appropriate guidance from Tax Information Bulletins and other up-to-date public and freely available guidance or interpretative material issued by the Inland Revenue Department;
- will consult Inland Revenue or a tax advisor where they are uncertain as to the tax treatment of an issue;
- will provide adequate information when seeking advice to resolve a tax matter;
- will question advice where it appears manifestly wrong or unreasonable, on the basis of the taxpayer's own knowledge; and
- will utilise adequate systems appropriate for the size of the business and the number and complexity of the transactions.

Example five

A taxpayer engages an agent to complete her income tax return. She provides her agent with her dividend statements. However, due to the disorderly manner in which she keeps her papers, she omits one of the statements, which is for a large amount of money. In the absence of any special circumstances, the taxpayer in this case will be liable to a penalty for not taking reasonable care with the information she provided to her agent.

Example six

A taxpayer is audited and is found to have incorrectly claimed private motor vehicle expenses against business income. In a subsequent year the taxpayer's return is prepared by an agent and the same expenses matter results in a shortfall. Depending on the circumstances, the taxpayer may have displayed a lack of reasonable care for this second omission. The taxpayer should have been alerted by the previous audit discrepancy and ensured that the subsequent return was correctly completed. (It is possible, depending on the circumstances that a shortfall penalty might also apply in relation to the first shortfall.)

Inland Revenue advice

6.87 If a taxpayer seeks advice from Inland Revenue disclosing all relevant facts, and follows that advice, this would be taking reasonable care, unless there was some reason for the taxpayer to question that advice, if, for example, the taxpayer still has doubts due to his or her own tax knowledge or conflicting advice has been received from a tax agent. However, this would only be the case if the taxpayer has provided full and correct facts when obtaining advice from the Department. The taxpayer, since the onus of proof of taking reasonable care rests with him or her, should document any oral advice from Inland Revenue showing details of when and from whom the advice was sought or retain any written advice from Inland Revenue.

Summary – not taking reasonable care

6.88 The test of "reasonable care" is what a reasonable person in the taxpayer's circumstances would have done in the same situation. The taxpayer's circumstances would encompass the factual situation as well as the personal attributes of the taxpayer such as age, health and background. For business taxpayers, this is likely to include the size and nature of the business, the internal controls in place and the record keeping practices. In addition, various circumstances, which may indicate the level of care necessary to fulfil tax obligations in the taking of the taxpayer's tax position include:

- the extent and complexity of tax law underpinning the particular type of tax obligation;
- the likelihood of a tax shortfall;
- the quantum of tax shortfall; and
- the difficulty of preventing a tax shortfall.

It is also emphasised that the reasonable care test does not mean perfection. The effort required of the taxpayer is commensurate with the reasonable person in the taxpayer's circumstances.

7. Reductions, increases and a cap on the shortfall penalty

Overview

7.1 The shortfall penalty for not taking reasonable care is subject to various possible reductions of the shortfall penalty payable. These are provided for under sections 141FB (previous behaviour), 141G (voluntary disclosure) and 141I (temporary shortfall). However, section 141J (limitation of reduction) provides where the taxpayer qualifies for a reduction in shortfall penalty under both section 141G and where there is a temporary tax shortfall, the shortfall penalty is reduced only once and that will be by 75%.

7.2 Although the above sections provide for the shortfall penalty to be reduced in a number of situations, the shortfall penalty payable for not taking reasonable care is also subject to 25% increase, under section 141K, if the taxpayer obstructs the Commissioner in determining the correct tax position.

7.3 Section 141JAA, which applies only to tax positions taken on or after 1 April 2003, provides that the shortfall penalty payable by the taxpayer for not taking reasonable care may not be more than $50,000, if the taxpayer voluntarily discloses the tax shortfall or the Commissioner determines the shortfall within specified time limits and provided section 141K does not apply.

Shortfall penalty reductions

7.4 Section 141FB was replaced effective 21 December 2004. Section 141FB provides for a 50% reduction of the amount of the shortfall penalty that would otherwise be payable if the taxpayer is not:

- convicted of an offence that is a disqualifying offence; or
- liable for another shortfall penalty that is a disqualifying penalty.

7.5 The relevant part of section 141FB is set out below:

…

(2) A shortfall penalty (called the current penalty) for which a taxpayer is liable under any of sections 141A to 141D is reduced, to 50% of the amount that would be payable by the taxpayer in the absence of this section, if the taxpayer is not—
(a) convicted of an offence that is a disqualifying offence:
(b) liable for another shortfall penalty that is a disqualifying penalty for the purpose of this subsection.

(3) For the purpose of this section—

disqualifying offence means—
(a) an offence under section 143A, 143B, 143F, 143G, 143H or 145 for which a conviction is entered—
(i) on or after 26 March 2003; and
(ii) before the taxpayer takes the tax position to which the current penalty relates:
(b) an offence under section 143 or 144 that relates to the type of tax to which the current penalty relates and for which a conviction is entered—
(i) on or after 26 March 2003; and
(ii) after the date that precedes, by the period specified in subsection (4), the date on which the taxpayer takes the tax position to which the current penalty relates; and
(iii) before the taxpayer takes the tax position to which the current penalty relates

disqualifying penalty means—
(a) for the purpose of subsection (1), a shortfall penalty that—
(i) relates to the type of tax to which the current penalty relates; and
(ii) is for evasion or a similar act; and
(iii) is not reduced for voluntary disclosure by the taxpayer; and
(iv) relates to a tax position that is taken on or after 26 March 2003 and before the date on which the taxpayer takes the tax position to which the current penalty relates:
(b) for the purpose of subsection (2), a shortfall penalty that—
(i) relates to the type of tax to which the current penalty relates; and
(ii) if the current penalty is—
…
(B) for not taking reasonable care or taking an unacceptable tax position, is a shortfall penalty of any sort; and
(iii) is not reduced for voluntary disclosure by the taxpayer; and
(iv) relates to a tax position that is taken—
(A) on or after 26 March 2003; and
(B) after the date that precedes, by the period specified in subsection (4), the date on which the taxpayer takes the tax position to which the current penalty relates; and
(C) before the date on which the taxpayer takes the tax position to which the current penalty relates.

(4) The period referred to in the definitions of disqualifying offence and disqualifying penalty, in subsection (3), and in subsection (5) is—
(a) 2 years, if the current penalty relates to—
(i) the taxpayer's application of the PAYE rules:
(ii) fringe benefit tax:
(iii) goods and services tax:
(iv) resident withholding tax:
(b) 4 years, if the period is not given by paragraph (a).

(5) For the purpose of subsections (1) and (2), a shortfall penalty that relates to a tax shortfall arising from a tax position taken by a taxpayer is determined as if the taxpayer were not liable for a shortfall penalty that relates to a tax shortfall arising from another tax position taken by the taxpayer, if—
(a) the Commissioner becomes aware of both tax shortfalls as a consequence of a single investigation or voluntary disclosure; and
(b) the taxpayer—
(i) takes both tax positions on the same date:
(ii) is not liable for a shortfall penalty at any time in the period specified in

subsection (4) that ends on the earliest date on which the taxpayer takes a tax position that gives rise to a tax shortfall of which the Commissioner becomes aware as a consequence of the investigation or disclosure to which paragraph (a) refers.

7.6 In the case of a penalty for not taking reasonable care in respect of GST, FBT, PAYE or RWT, if the taxpayer has not been liable to pay a tax shortfall penalty relating to the same tax type within the previous two years (not being a penalty reduced for voluntary disclosure), the 50% reduction provided for under section 141FB can apply. For other tax types, there is a four year period of "good behaviour" required. The reduction applies separately for each type of tax such as PAYE, income tax and GST. A penalty imposed in respect of one tax does not mean that the reduction is not available for other tax types. If the taxpayer has made a voluntary disclosure, this does not interrupt the taxpayer's good behaviour period.

7.7 Section 141G provides for reducing the shortfall penalty for voluntary disclosure of the tax shortfall. The relevant parts of section 141G state:

> **141G. Reduction in penalty for voluntary disclosure of tax shortfall—**
>
> (1) A shortfall penalty payable by a taxpayer under any of sections 141A to 141EB may be reduced if, in the Commissioner's opinion, the taxpayer makes a full voluntary disclosure to the Commissioner of all the details of the tax shortfall, either—
>
> (a) Before the taxpayer is first notified of a pending tax audit or investigation (referred to in this section as "pre-notification disclosure"); or
>
> (b) After the taxpayer is notified of a pending tax audit or investigation, but before the Commissioner starts the audit or investigation (referred to in this section as "post-notification disclosure").
>
> …
>
> (3) The level by which the shortfall penalty is reduced—
>
> (a) For pre-notification disclosure is 75%:
>
> (b) For post-notification disclosure is 40%.
>
> ...

7.8 Where there is a temporary tax shortfall, section 141I provides for reducing the shortfall penalty. The relevant part of the section states:

> 141I. Reduction where temporary shortfall—
>
> (1) A shortfall penalty payable by a taxpayer under any of sections 141A to 141EB must be reduced if and to the extent that the tax shortfall is temporary.
>
> (2) The level by which a shortfall penalty is to be reduced for a temporary tax shortfall is 75% of the penalty that applies to all or that part of the tax shortfall that is a temporary tax shortfall.
>
> …

The application of section 141J

7.9 A shortfall penalty payable by the taxpayer, for example, under section 141A (for not taking reasonable care), may qualify to be reduced under sections 141G (for making a voluntary disclosure in accordance with this provision) and also under section 141I (if the shortfall penalty is payable in respect of a temporary shortfall). Therefore, it appears that these provisions have the potential to provide for a 75% reduction under section 141G and also a 75% reduction under section 141I. However, in this situation, section 141J limits the reductions available for the taxpayer. Section 141J provides:

> **141J. Limitation on reduction of shortfall penalty—**
> If—
>
> (a) A taxpayer who is liable to pay a shortfall penalty makes a voluntary disclosure in accordance with section 141G or section 141H; and
>
> (b) The shortfall penalty is payable in respect of a temporary tax shortfall,—
>
> **the shortfall penalty—**
>
> (c) **Is to be reduced only once**; and
>
> (d) Will be reduced by 75%.
>
> [emphasis added]

7.10 Accordingly, where a taxpayer may qualify for their shortfall penalty payable under section 141A to be reduced under more than one of the reduction provisions, section 141J provides that the shortfall penalty will be reduced only once and, as set out in section 141J(d), that reduction will be 75%.

7.11 As section 141J provides for a limitation on some shortfall penalty reductions, this section can only effectively apply after the application of the reduction provisions.

Shortfall penalty monetary cap

7.12 Section 141JAA provides that "a shortfall penalty payable by a taxpayer for not taking reasonable care …, may not be more than $50,000", provided the other conditions of the section are met. The section states:

> (1) Despite section 141J, a shortfall penalty payable by a taxpayer for not taking reasonable care, or for taking an unacceptable tax position, may not be more than $50,000 if the taxpayer voluntarily discloses the shortfall, or the Commissioner determines the shortfall, no later than the date that is the later of—
>
> …

7.13 It is noted that, unlike sections 141FB, 141G and 141I, section 141JAA does not actually "reduce" the penalty. It merely provides that the penalty may not be more than $50,000. The only way in which it can be determined that the penalty would otherwise be more than $50,000 is to work through the sections needed to calculate the shortfall penalty

payable. Therefore, it is necessary to consider section 141A, under which the penalty originates, and then apply the reduction provisions, as modified by section 141J.

7.14 It is also noted that although section 141JAA refers to "a shortfall penalty payable by the taxpayer for not taking reasonable care", the section does not specifically refer to section 141A, the provision under which this shortfall penalty originates.

7.15 This contrasts with the terminology used in the reduction provisions, which specifically refers to the shortfall penalty payable under the relevant originating section. (For the present discussion, the originating sections are sections 141A to 141EB, but, as noted above, section 141JAA is applicable only to shortfall penalties that originate from sections 141A and 141B.)

7.16 It is considered that this difference in the terminology supports the view that the shortfall penalty payable by the taxpayer, to which section 141JAA applies, is that payable under the originating provision, but reduced by the applicable reduction provisions. Accordingly, it would not be appropriate for section 141JAA to refer to the penalty payable under section 141A when the penalty that originated under that provision may have been reduced by the application of the reduction provisions.

7.17 Although the use of "despite" at the beginning of section 141JAA could indicate that section 141JAA is to be applied either "after applying" section 141J or "to the exclusion of" section 141J, it is considered that, in the context of the whole of section 141, section 141JAA should not be applied to the exclusion of section 141J, but after section 141J (in situations where the application of section 141J is appropriate). Therefore, it would follow that section 141JAA should also be applied after the reduction provisions.

7.18 The alphanumeric order of the particular provisions also supports the view that section 141JAA should be applied after the application of the reduction provisions. Although not conclusive in itself, it is considered that, had it been intended that the capping provision of section 141JAA be applied before the reduction sections, the capping provision would have been inserted in a location before the reduction provisions.

7.19 Accordingly, it is considered that it is only by applying the reduction provisions first, that the "shortfall penalty payable", to which section 141JAA refers, can be determined. The application of section 141JAA can then provide a cap to the shortfall penalty, if the time requirements of section 141JAA are met.

7.20 A final point to consider, in this respect, is the reason for setting the cap for these penalties at $50,000 under section 141JAA. The discussion document *Taxpayer compliance, standards and penalties: a review* (2001) states:

> 8.35 A monetary cap on the shortfall penalty for lack of reasonable care will be introduced. Such a cap would ensure that the penalty for such breaches is not out of step with other monetary penalties imposed under the Tax Administration Act. In addition, a cap is likely to reduce compliance and administrative costs as taxpayers will have less incentive to dispute the imposition of a penalty they consider unfair.
>
> 8.36 **The cap will be set at $50,000 per tax position, which equates to the maximum criminal penalty imposed under the Income Tax Act**. Taxpayers who deliberately attempt to abuse the existence of this cap will risk incurring the uncapped gross carelessness penalty (set at 40 percent of the shortfall). To ensure that taxpayers still have an incentive to take reasonable care over very significant tax positions, the cap will be limited to those shortfalls identified through voluntary disclosure or Inland Revenue audit within two months of filing the return.
>
> [emphasis added]

7.21 Accordingly, if section 141JAA was applied before the other reduction provisions, the correspondence with the maximum criminal penalty would be defeated.

Section 141JAA applies after the reduction provisions

7.22 It is considered that the shortfall penalties payable by the taxpayer for not taking reasonable care under section 141A are reduced, as applicable by the reduction provisions, before the application of section 141JAA. It is also considered that section 141JAA is applied after the application of section 141J, if the taxpayer is eligible for deductions under section 141G and also section 141I. Accordingly, under the reduction provisions, the shortfall penalty payable by the taxpayer for not taking reasonable care or for taking an unacceptable tax position is to be reduced by a maximum of 75%. Then, if section 141JAA is also applicable, the resultant shortfall penalty payable for not taking reasonable care may not be more than $50,000 if the taxpayer either voluntarily discloses the shortfall or the Commissioner determines the shortfall within the given time periods.

7.23 This view also means that the intended correspondence of the capped shortfall penalty under section 141JAA with the maximum criminal penalty is maintained.

7.24 Therefore, it is the Commissioner's view that the section 141JAA cap of $50,000, on the shortfall

penalty payable by a taxpayer for not taking reasonable care is only applicable **after** all other relevant reductions have been made, including the limiting provision of section 141J.

7.25 It should be noted that section 141JAA also applies to shortfall penalties under section 141B, for taking an unacceptable tax position. This is discussed in the Interpretation Statement IS0055.

Section 141JAA provides

7.26 *Prima facie*, there are two situations when the shortfall penalty for not taking reasonable care may not be more than $50,000. These are:

- if the taxpayer voluntarily discloses the shortfall; or
- the Commissioner determines the shortfall,

provided these events occur within the time constraints set out in section 141JAA (1)(a) and (b).

7.27 "Commissioner" is defined in section 3 as meaning:

> "**Commissioner of Inland Revenue**", or "**Commissioner**", means the Commissioner of Inland Revenue appointed or deemed to have been appointed under this Act; and includes any person for the time being authorised to exercise or perform any of the powers, duties, or functions of the Commissioner:

7.28 Accordingly, in the clause "the Commissioner determines the shortfall", it is considered that "Commissioner" (i.e. the person who determines the shortfall) includes any person for the time being authorised to exercise or perform any of the powers, duties or functions of the Commissioner.

7.29 Before going on to consider the meaning of "determines" in this context, it is helpful to consider what it is that must be determined, i.e. "the shortfall".

What is "the shortfall"?

7.30 In the context of section 141JAA, it is considered that "the shortfall", that the Commissioner determines, refers to "the tax shortfall", as it is only in respect of a tax shortfall that the shortfall penalties, referred to in section 141JAA, apply. "Tax shortfall" is defined in section 3 of the Act as follows:

> "T**ax 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:

7.31 A tax shortfall indicates that there is a difference between the correct tax position and the taxpayer's tax position. Therefore, it is considered that if "the Commissioner determines the shortfall"; the Commissioner determines the difference between the correct tax position and the taxpayer's tax position. As the difference is between two amounts, it is considered that section 141JAA requires the Commissioner to determine the **amount** of the tax shortfall.

7.32 An examination of the sections, under which a taxpayer becomes liable to pay a shortfall penalty for not taking reasonable care or for taking an unacceptable tax position, supports this view.

7.33 Section 141A(1) provides that a taxpayer is liable to pay a shortfall penalty, if the taking of the tax position without reasonable care **results in a tax shortfall**:

> A taxpayer is liable to pay a shortfall penalty if the taxpayer does not take reasonable care in taking a taxpayer's tax position (referred to as "not taking reasonable care') and the taking of that tax position by that taxpayer results in a tax shortfall. [emphasis]

7.34 Section 141A(2) provides that the amount of the penalty payable is a percentage of the resulting tax shortfall:

> (2) The penalty payable for not taking reasonable care is 2**0% of the resulting** tax shortfall.
>
> [emphasis added]

7.35 Section 141B(4) provides similarly in respect of unacceptable tax position.

7.36 Therefore, for the two shortfall penalty situations to which section 141JAA applies, the penalty payable by the taxpayer only arises if there is a tax shortfall and the amount of the shortfall penalty payable is directly proportional to the amount of the tax shortfall in each case. Accordingly, for a shortfall penalty to be payable by a taxpayer for not taking reasonable care or for taking an unacceptable tax position, it is necessary to identify the amount of the tax shortfall.

7.37 This is also supported by the definition of "shortfall penalty" in section 3, which states:

> "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.

7.38 For a penalty to be "imposed", the penalty must be quantified and, as the amount is a percentage of the tax shortfall, it is necessary that the tax shortfall is quantified.

7.39 Therefore, it follows that for section 141JAA to apply to "a shortfall penalty … payable by a

taxpayer for not taking reasonable care or for taking an unacceptable tax position", the amount of the tax shortfall is quantified either by disclosure by the taxpayer or as the Commissioner determines.

Ordinary meaning of "determines"

7.40 As "determines" is not defined in section 3 of the Act or section OB 1 of the Income Tax Act 1994, it is appropriate to consider the ordinary meaning of the word.

7.41 The *Shorter Oxford Dictionary* 5th ed (2002) provides the following relevant definition:

> **determine**: verb trans 4 settle or decide (a dispute, controversy, etc., or a sentence, conclusion, issue, etc.) as a judge or arbiter

7.42 Using this definition, it appears that, in the context of section 141JAA, when "the Commissioner determines the shortfall", the Commissioner makes a decision about the shortfall or decides the shortfall. Typically, the Commissioner would decide the shortfall as a result of an audit, but the means by which "the Commissioner determines the shortfall" are not defined in the legislation.

Interpretation of "determines" by the courts

7.43 The meaning of "determines" was discussed by the Supreme Court of Victoria in *City of Heidelberg v McPherson* [1964] VR 783. The relevant section in that case used the words "… where any council determines that the execution of any works of the construction of a private street is necessary". Although the provision is different, it is helpful to note that the Court described the meaning of "determines" as "decides or forms the opinion" (p 785).

7.44 In *Muir v Inland Revenue Commissioners* [1966] 3 All ER 38, the English Court of Appeal considered the meaning of the phrase:

> An appeal, once determined by the commissioners, shall be final, and neither the determination of the commissioners nor the assessment made thereon shall be altered, except … (s. 50 (2) Income Tax Act 1952)

7.45 The court held that:

> It is plain that there the words "determined" and "determination" are equivalent to: decided and decision … (p 48)

7.46 Although referring to the word in the past tense, this view mirrors that of the Australian court in the *City of Heidelberg* case: to determine is to decide. This meaning is consistent with the ordinary meaning of "determine", i.e. "settle or decide as a judge or arbiter". In each case, something is decided by the party who is determining it.

7.47 To consider the application of this meaning in the context of the legislation, it is appropriate to consider some of the background to the introduction of section 141JAA.

Background to the introduction of section 141JAA

7.48 Section 141JAA was inserted in the Act by the enactment of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003.

7.49 As part of the preliminary consultation process prior to enactment of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, a discussion document, *Taxpayer compliance, standards and penalties*: a review (August 2001) was issued for comment. Under Chapter 8 of the document, "Two further issues relating to shortfall penalties", the document outlined the following background and proposed reform:

> **Additional issue: A cap on the penalty for lack of reasonable care**
>
> **Background**
>
> 8.33 Where a tax shortfall is large, the corresponding shortfall penalty is also large. In most cases this is appropriate – but the Government is concerned about the application of the lack of reasonable care penalty to very large errors which are speedily identified and corrected. For example, a business taxpayer under calculated their GST outputs by $45 million and, because no systems were in place to identify this shortfall, the under-calculation results in unpaid GST of $5 million. Inland Revenue identities the shortfall and determines a lack of reasonable care: the penalty is $1 million.
>
> 8.34 Given the nature of the breach, the Government considered the size of the penalty in such cases is excessive.
>
> **Proposed reform**
>
> 8.35 A monetary cap on the shortfall penalty for lack of reasonable care will be introduced. Such a cap would ensure that the penalty for such breaches is not out of step with other monetary penalties imposed under the Tax Administration Act. In addition, a cap is likely to reduce compliance and administrative costs as taxpayers will have less incentive to dispute the imposition of a penalty they consider unfair.
>
> 8.36 The cap will be set at $50,000 per tax position, which equates to the maximum criminal penalty imposed under the Income Tax Act. Taxpayers who deliberately attempt to abuse the existence of this cap will risk incurring the uncapped gross carelessness penalty (set at 40 percent of the shortfall). To ensure that taxpayers still have

> an incentive to take reasonable care over very significant tax positions, t**he cap will be limited to those shortfalls identified through voluntary disclosure or Inland Revenue audit within two months of filing the return**.
>
> [emphasis added]

7.50 From the discussion document, it appears that the intention of the proposed reform was that the cap would be limited to tax shortfalls identified through voluntary disclosure or Inland Revenue audit, within the required time limit.

Timing of "determines"

7.51 It is noted that no reference was made in the proposal for the legislation requiring either a NOPA to be issued or for an agreed adjustment to be obtained, before the $50,000 monetary cap be applied to the shortfall penalty payable by the taxpayer. Further, a NOPA is the first step in the disputes resolution process and the imposition of the penalty will not necessarily be a matter which proceeds under the disputes resolution process. Therefore, it is not appropriate to equate the word "determines" with "has issued a NOPA".

7.52 For similar reasons, "the Commissioner determines" cannot relate to the decision of Adjudication (or other assessing officer), at the end of the disputes resolution process, as the time limits in the disputes resolution process for the various documents are such that this process could not be completed within the time set out in section 141JAA. It is also inappropriate to require an adjustment to be agreed by the taxpayer within the time limits set out in section 141JAA, as the taxpayer has a statutory right to dispute or challenge their assessment in accordance with the time limits set out in the disputes resolution process. Further, section 141JAA refers to "determines" in the context of the situation where "the Commissioner determines the tax shortfall". Therefore, on the legislation, it appears that once the Commissioner (or one of his authorised officers) decides that there is a relevant tax shortfall within the time limits set out in the section, the cap applies.

7.53 This view is supported by the fact that the legislation provides for no particular process by which the Commissioner communicates the fact to the taxpayer that a shortfall is "determined" or decided within the terms of section 141JAA. The legislation merely requires that either the voluntary disclosure of a shortfall by the taxpayer within the time limits (for which a penalty in excess of $50,000 is payable by the taxpayer for not taking reasonable care), or the Commissioner deciding that there is such a shortfall within the time limits, is sufficient for the application of the section.

Conclusion

7.54 Section 141JAA was enacted with the intention of recognising the taxpayer who voluntarily discloses a shortfall within the given time limits or for whom the Commissioner decides that there is a relevant shortfall, within the given time limits. This latter case may occur, for example, in an audit where an investigator identifies a relevant tax shortfall. The essence is that, for the monetary cap to apply, the relevant tax shortfall is either disclosed by the taxpayer within the time limits or a person, authorised by the Commissioner, decides that there is a relevant tax shortfall, within the time limits. The section does not require the Commissioner to issue a NOPA in respect of the tax shortfall or obtain an agreed adjustment within the given time limits. Accordingly, it is considered that the taxpayer should benefit from the monetary cap as soon as the Commissioner (as defined in section 3) decides the amount of the shortfall, if the time requirements of section 141JAA are met and section 141K does not apply.

Shortfall penalty increases

7.55 Section 141K provides for an increased penalty where the taxpayer obstructs the Commissioner. Section 141JAA does not apply if section 141K applies. Section 141K states:

> **141K. Increased penalty for obstruction—**
>
> (1) A shortfall penalty payable by a taxpayer under any of sections 141A to 141EB may be increased by the Commissioner if the taxpayer obstructs the Commissioner in determining the correct tax position in respect of the taxpayer's tax liabilities.
>
> (2) The level by which a shortfall penalty may be increased for obstruction is 25%.

Related Standard Practice Statements

7.56 The following related Standard Practice Statements may also assist in the interpretation and application of the above adjustment provisions to the shortfall penalty for not taking reasonable care:

- 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)); and
- INV-295 *Reduction of Shortfall Penalties for Previous Behaviour* (published in *Tax Information Bulletin* Vol 16, No 3 (April 2004)).

SHORTFALL PENALTY – UNACCEPTABLE INTERPRETATION AND UNACCEPTABLE TAX POSITION

1. Summary

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

1.2 The Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 amended section 141B with effect from 1 April 2003. This Interpretation Statement sets out the Commissioner's view on shortfall penalties imposed under section 141B of the Tax Administration Act 1994 ("the TAA") for an "unacceptable interpretation" of a tax law in relation to a tax position taken by a taxpayer (applicable before 1 April 2003) and an "unacceptable tax position" taken by a taxpayer on or after 1 April 2003.

1.3 As the law before the 2003 amendment remains relevant to taxpayers who are or may become involved in the dispute resolution process for tax positions taken prior to 1 April 2003, the Commissioner's view on the earlier provision relating to "unacceptable interpretation" will be considered first. It is considered appropriate that the statement is ordered in this way, as not only is there greater interpretative difficulty associated with the previous provision, but it is considered that a number of the interpretative issues addressed, in respect of the previous provision, apply to the current provision.

1.4 This Interpretation Statement covers particularly:

- what is an unacceptable tax position;
- can a mistake of fact lead to an unacceptable interpretation;
- the meaning of the test "about as likely as not to be correct"; and
- what are the changes relevant to a taxpayer's tax position taken on or after 1 April 2003?

1.5 In summary, the conclusions of this Interpretation Statement for tax positions taken before 1 April 2003 are:

1. An "interpretation" involves a person formulating an understanding or explanation of something and the person must have turned his or her mind to a tax law before an interpretation of it can be said to be made.
2. Section 141B relates to the understanding and application of a tax law by the taxpayer to a set of facts.
3. A simple mistake is neither an application nor an interpretation of a tax law.
4. A mistake of law may be based on a mistake of fact but, on the facts, there may also be an unacceptable interpretation.
5. Where a tax shortfall is caused by a mistake of fact and there is no interpretation or application of a tax law, a taxpayer might still be liable, under section 141A, for "not taking reasonable care".
6. A tax agent's interpretation will be imputed to the taxpayer where the agent, who completes the taxpayer's tax return, takes the tax position on the taxpayer's behalf.
7. The non-application of a tax law will be an "interpretation or an interpretation of an application of a tax law", if a taxpayer turned his or her mind to whether or not that tax law applied to a particular factual situation.
8. There must be, at least, about an equal chance of an interpretation being likely to be correct as it is to be incorrect. The use of the word "about" makes the test less stringent but the interpretation still needs to be close to or around 50% likely to be correct.
9. In determining whether an unacceptable interpretation has been taken in arriving at a tax position, matters that must be considered include all Court or Tribunal decisions and relevant extrinsic materials issued up to one month before the tax position has been taken.
10. Before section 141B applies, the tax shortfall must exceed the given threshold.

1.6 In summary, the conclusions of the interpretation statement **in respect of the changes** to section 141B, that relate to tax positions taken on or after 1 April 2003 are:

1. The making of an "interpretation or an interpretation of an application of a tax law" is not longer required for the application of section 141B.
2. To take an unacceptable tax position, a taxpayer is required merely to take a tax position that, when viewed objectively, fails to meet the standard of being about as likely as not to be correct.
3. An unacceptable interpretation of the law can give rise to an unacceptable tax position, but is no longer a requirement of section 141B.
4. The threshold levels, which a tax shortfall must exceed to qualify as an unacceptable tax position, have increased.

5. Penalties of 20% may be reduced to 10% as a result of a taxpayer's prior good compliance.

6. In the Commissioner's view, section 141JAA, which provides for the penalty payable to be capped in some situations, is only applicable after all other reductions have been made.

2. Background

2.1 Section 139 of the TAA states that the purpose of Part IX - Penalties is to encourage taxpayers to comply voluntarily with their tax obligations, ensure that penalties for breaches of tax obligations are imposed impartially and consistently and to sanction non-compliance with tax obligations effectively and at a level that is proportionate to the seriousness of the breach. This Interpretation Statement deals with the situation where a penalty is imposed because there is a shortfall of the taxpayer's tax obligations as a result of the taxpayer's tax position based on an "unacceptable interpretation" or an "unacceptable tax position", as provided for under section 141B.

2.2 Section 141B provides for a shortfall penalty (defined in section 3(1) TAA):

> "**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:

2.3 Section 141B(1) defines what is meant by "an unacceptable interpretation" in relation to a "tax position" taken by a taxpayer. Before the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 significantly amended section 141B in relation to tax positions taken on or after 1 April 2003, the provision applicable to obligations relating to the 1997/98 and subsequent income years and to dutiable periods commencing on or after 1 April 1997 read:

> **141B UNACCEPTABLE INTERPRETATION**
>
> (1) In relation to a tax position taken by a taxpayer, an unacceptable interpretation—
>
> (a) Is an interpretation or an interpretation of an application of a tax law; and
>
> (b) Viewed objectively, that interpretation or application fails to meet the standard of being about as likely as not to be correct.

2.4 The amended provision, as a result of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, is applicable to tax positions taken on or after 1 April 2003. The amended section 141B(1) reads:

> **141B UNACCEPTABLE TAX POSITION**
>
> (1) A taxpayer takes an unacceptable tax position if, viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct.
>
> (1B) A taxpayer does not take an unacceptable tax position merely by making a mistake in the calculation or recording of numbers in a return.

2.5 A comparison of section 141B, both before and after the 2003 amendment, highlights that, despite some fundamental similarities, the application of these provisions may differ for the same set of facts. The earlier provision defines "unacceptable interpretation" as "an interpretation or an interpretation of an application of a tax law" and sets out the test by which to judge the interpretation or application as unacceptable. In contrast, the amended provision refers to neither an interpretation nor an application but merely sets out the test by which the tax position of the taxpayer is judged unacceptable. The amended provision, section 141B(1B), also exempts some mistakes from being considered "unacceptable tax positions". Whether a tax shortfall is due to a mistake in the calculation or recording of numbers will depend on the facts in each case.

2.6 Common to section 141B both before and after the 2003 amendment are the preliminary requirements that the taxpayer must have taken a tax position from which a tax shortfall arises and that tax shortfall exceeds the thresholds set out in section 141B(2). If any of these elements are unable to be established, the taxpayer will not be liable for any shortfall penalty under section 141B.

3. Legislation

Tax Administration Act 1994

3.1 The Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 amended a number of provisions relating to "Unacceptable Interpretation". The provisions set out below are as they read prior to the passing of that Act. These are followed by the amended provisions.

Legislation relating to tax positions taken before 1 April 2003

3.2 Section 3(1) provides a definition for "tax position":

> "T**ax position**" means a position or approach with regard to tax possible under one or more tax laws, including without limitation—
>
> (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:

3.3 Section 141B imposes a shortfall penalty on taxpayers who take an "unacceptable interpretation":

141B UNACCEPTABLE INTERPRETATION

141B(1) In relation to a tax position taken by a taxpayer, an unacceptable interpretation—
(a) Is an interpretation or an interpretation of an application of a tax law; and
(b) Viewed objectively, that interpretation or application fails to meet the standard of being about as likely as not to be correct.

141B(2) A taxpayer is liable to pay a shortfall penalty if—
(a) The taxpayer's tax position involves an unacceptable interpretation of a tax law; and
(b) The tax shortfall arising from the taxpayer's tax position exceeds both—
(i) $10,000; and
(ii) The lesser of $200,000 and one percent of the taxpayer's total tax figure for the relevant return period.

141B(3) For the purposes of this section, a taxpayer's total tax figure is—
(a) The amount of tax paid or payable by the taxpayer in respect of the return period for which the taxpayer takes the taxpayer's tax position before, in the case of income tax, any group offset election or subvention payment; or
(b) Where the taxpayer has no tax to pay in respect of the return period—
(i) Except in the case of GST, an amount equal to the product of—
(A) The net loss of a taxpayer in respect of the return period, ascertained in accordance with the provisions of the Income Tax Act 1994, are to be used in this subsection as if they had a positive value; and
(B) The basic rate of income tax for companies in the relevant return period; or
(ii) In the case of GST, the refund of tax to which the taxpayer is entitled for the return period,—

that is shown as tax paid or payable, or as net losses of the taxpayer, or as a refund to which the taxpayer is entitled, in a tax return provided by the taxpayer for the return period.

141B(4) Where subsection (2) applies, the shortfall penalty payable is 20% of the resulting tax shortfall.

141B(5) For the purposes of this section, the question whether any interpretation of a tax law is acceptable or unacceptable shall be determined as at the time at which the taxpayer takes the taxpayer's tax position.

141B(6) For tax positions involving an interpretation of a tax law or laws that have been taken into account in a tax return, the time the taxpayer takes the taxpayer's tax position is when the taxpayer provides the return containing the taxpayer's tax position. If the taxpayer does not provide a tax return for a return period, the taxpayer takes the taxpayer's tax position on the due date for providing the tax return.

141B(7) The matters that must be considered in determining whether the tax position taken by a taxpayer involves an unacceptable interpretation of a tax law include—
(a) The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and
(b) Decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).

141B(8) For the purpose of determining whether the resulting tax shortfall is in excess of the amounts specified in subsection (2)(b),—
(a) A tax return provided by—

(i) A partnership; or
(ii) Any other group of persons that derive or incur amounts jointly or that are assessed together,—

is to be treated as if it were a tax return of every taxpayer who is a partner in the partnership or person in such group; and

(b) The tax rate in a return period applying to a partnership is deemed to be the same as the basic rate of income tax for companies for the relevant period.

141B(9) The amounts or the percentage specified in subsection (2) may be varied from time to time by the Governor-General by Order in Council.

Legislation relating to tax positions taken on or after 1 April 2003

3.4 For tax positions taken on or after 1 April 2003, section 141B has the revised heading "Unacceptable Tax Position". In this amended provision, the references to "interpretation" and "application" are largely removed and the monetary limits for tax shortfalls, above which a taxpayer is liable for a shortfall penalty, are increased.

141B UNACCEPTABLE TAX POSITION

(1) A taxpayer takes an unacceptable tax position if, viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct.

(1B) A taxpayer does not take an unacceptable tax position merely by making a mistake in the calculation or recording of numbers in a return.

(2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an unacceptable tax position and the tax shortfall arising from the taxpayer's tax position is more than both—
(a) $20,000; and
(b) the lesser of $250,000 and 1% of the taxpayer's total tax figure for the relevant return period.

…

(5) For the purposes of this section, the question whether any interpretation of a tax law is acceptable or unacceptable shall be determined as at the time at which the taxpayer takes the taxpayer's tax position.

…

(7) The matters that must be considered in determining whether the taxpayer has taken an unacceptable tax position include—
(a) The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and
(b) Decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).

…

3.5 Section 141JAA provides that for tax positions taken on or after 1 April 2003, subject to certain requirements, there is a cap of $50,000 on the penalty for taking an unacceptable tax position:

141JAA SHORTFALL PENALTY FOR NOT TAKING REASONABLE CARE OR FOR TAKING UNACCEPTABLE TAX POSITION MAY NOT BE MORE THAN $50,000

(1) Despite section 141J, a shortfall penalty payable by a taxpayer for not taking reasonable care, or for taking an unacceptable tax position, may not be more than $50,000 if the taxpayer voluntarily discloses the shortfall, or the Commissioner determines the shortfall, no later than the date that is the later of –
(a) the date that is 3 months after the due date of the return to which the shortfall relates; and
(b) the date that follows the due date of the return to which the shortfall relates by the lesser of –
(i) 1 return period; and
(ii) 6 months

(2) This section does not apply if section 141K applies.

3.6 Amendments to the definitions in section 3 include a revision to the definition of "tax position". The revised definition omits "possible" after "regard to tax" and inserts "a position or approach with regard to". The revised part of this definition is set out below. The remainder of the definition is otherwise unchanged to that set out above and applicable before the 2003 amendment.

"**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 —

…

3.7 The amended section 3 also provides definitions for "unacceptable tax position" and "acceptable tax position" applicable on or after 1 April 2003 and repeals the definition of "acceptable interpretation":

"**unacceptable tax position**" is defined in section 141B.

"**acceptable tax position**" means a tax position that is not an unacceptable tax position.

3.8 Section 141FB provides for a reduction of penalties in some circumstances. The following legislation

was effective 26 March 2003 until 21 December 2004 with application to a tax position that a taxpayer took on or after 1 April 2000 unless the taxpayer was liable, before 26 March 2003, to pay a shortfall penalty for taking the tax position. The relevant parts of section 141FB, effective 26 March 2003 until 21 December 2004, state:

141FB REDUCTION OF PENALTIES FOR PREVIOUS BEHAVIOUR

…

(2) A shortfall penalty payable by a taxpayer under any of sections 141A to 141D (called in this section the **current penalty**) is reduced to 50% of the penalty that would otherwise be payable under those sections if, after the date specified in subsection (3) and before the date on which the taxpayer becomes liable for the current penalty, the taxpayer has not been liable to pay a shortfall penalty that –
- (a) Related to the same type of tax as does the current penalty; and
- (b) If the current penalty is for –
  - (i) Evasion or a similar act, was for evasion or a similar act;
  - (ii) Gross carelessness or taking an abusive tax position, was for evasion or a similar act or for gross carelessness or for taking an abusive tax position
  - (iii) Not taking reasonable care or taking an unacceptable tax position, was a shortfall penalty; and
- (c) Was not reduced for voluntary disclosure by the taxpayer; and
- (d) Was eligible for a reduction under this subsection.

(3) The date referred to in subsection (2) precedes the date on which the taxpayer becomes liable for the current penalty by:
- (a) 2 years, if the current penalty relates to the taxpayer's application of the PAYE rules, to fringe benefit tax, to goods and services tax, to resident withholding tax; or
- (b) 4 years, if the current penalty relates to any other type of tax.

(4) For the purpose of subsection (2), if a taxpayer is liable for shortfall penalties that relate to tax shortfalls of which the Commissioner becomes aware as a consequence of a single investigation or voluntary disclosure, all the shortfall penalties are treated as a single combined penalty.

[emphasis from original text]

3.9 However, effective 21 December 2004, section 141FB was replaced. The relevant parts of the replacement section state:

141FB. Reduction of penalties for previous behaviour—

…

(2) A shortfall penalty (called the "current penalty") for which a taxpayer is liable under any of sections 141A to 141D is reduced, to 50% of the amount that would be payable by the taxpayer in the absence of this section, if the taxpayer is not—
- (a) convicted of an offence that is a disqualifying offence:
- (b) liable for another shortfall penalty that is a disqualifying penalty for the purpose of this subsection.

(3) For the purpose of this section

"**disqualifying offence**" means—
- (a) an offence under section 143A, 143B, 143F, 143G, 143H or 145 for which a conviction is entered—
  - (i) on or after 26 March 2003; and
  - (ii) before the taxpayer takes the tax position to which the current penalty relates:
- (b) an offence under section 143 or 144 that relates to the type of tax to which the current penalty relates and for which a conviction is entered—
  - (i) on or after 26 March 2003; and
  - (ii) after the date that precedes, by the period specified in subsection (4), the date on which the taxpayer takes the tax position to which the current penalty relates; and
  - (iii) before the taxpayer takes the tax position to which the current penalty relates

"**disqualifying penalty**" means—

…
- (b) for the purpose of subsection (2), a shortfall penalty that—
  - (i) relates to the type of tax to which the current penalty relates; and
  - (ii) if the current penalty is—
    - (A) for gross carelessness or taking an abusive tax position, is a shortfall penalty for evasion or a similar act or for gross carelessness or taking an abusive tax position:
    - (B) for not taking reasonable care or taking an unacceptable tax position, is a shortfall penalty of any sort; and
  - (iii) is not reduced for voluntary disclosure by the taxpayer; and
  - (iv) relates to a tax position that is taken—

(A) on or after 26 March 2003; and

(B) after the date that precedes, by the period specified in subsection (4), the date on which the taxpayer takes the tax position to which the current penalty relates; and

(C) before the date on which the taxpayer takes the tax position to which the current penalty relates.

(4) The period referred to in the definitions of "disqualifying offence" and "disqualifying penalty", in subsection (3), and in subsection (5) is—

(a) 2 years, if the current penalty relates to—

(i) the taxpayer's application of the PAYE rules:

(ii) fringe benefit tax:

(iii) goods and services tax:

(iv) resident withholding tax:

(b) 4 years, if the period is not given by paragraph (a).

(5) For the purpose of subsections (1) and (2), a shortfall penalty that relates to a tax shortfall arising from a tax position taken by a taxpayer is determined as if the taxpayer were not liable for a shortfall penalty that relates to a tax shortfall arising from another tax position taken by the taxpayer, if—

(a) the Commissioner becomes aware of both tax shortfalls as a consequence of a single investigation or voluntary disclosure; and

(b) the taxpayer—

(i) takes both tax positions on the same date:

(ii) is not liable for a shortfall penalty at any time in the period specified in subsection (4) that ends on the earliest date on which the taxpayer takes a tax position that gives rise to a tax shortfall of which the Commissioner becomes aware as a consequence of the investigation or disclosure to which paragraph (a) refers.

[emphasis from original text]

4. An unacceptable interpretation – before 1 April 2003

4.1 Before the amendment to section 141B was enacted in 2003, the section was entitled "Unacceptable interpretation" and the section provided the definition for "unacceptable interpretation". This is set out again below for convenience:

> (1) In relation to a tax position taken by a taxpayer, an unacceptable interpretation—
>
> (a) Is an interpretation or an interpretation of an application of a tax law; and
>
> (b) Viewed objectively, that interpretation or application fails to meet the standard of being about as likely as not to be correct.

4.2 For there to be a penalty for an unacceptable interpretation:

- the taxpayer must have taken a tax position;
- a tax shortfall arises from that tax position; and
- that tax shortfall exceeds the amount referred to in section 141B(2)(b).

4.3 These preliminary requirements were highlighted by Barber DCJ in Case U47 (2000) 19 NZTC 9,410:

> 34. In terms of considering whether there has been an "[un]acceptable interpretation" by the disputant [taxpayer] as required by s 141B(1), it is necessary in terms of s 141B(2) that the disputant [taxpayer] has taken a tax position, that there has been a tax shortfall arising from that tax position and that the tax shortfall exceeds the amounts referred to in s 141B(2)(b). (p 9,417)

4.4 If any of these elements are unable to be established, the taxpayer will not be liable for any shortfall penalty under section 141B for unacceptable interpretation. It is appropriate, therefore, to establish the Commissioner's view on the meaning of each of these requirements.

The preliminary requirements

Tax position

4.5 In relation to the first requirement that a taxpayer must have taken a tax position, the "taxpayer's tax position" must be determined, as it is from that tax position that any tax shortfall will be calculated. The terms "taxpayer's tax position" and "tax position" are defined in section 3(1) of the TAA. These definitions are set out below.

4.6 The definition of "tax position" sets out the subject of the position or approach with regard to tax under a tax law that the taxpayer may take. The definition of "taxpayer's tax position" sets out the places where the taxpayer takes a "tax position".

> "Tax position" means a position or approach with regard to tax possible under one or more tax laws, including without limitation—
>
> (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:

"**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:

…

4.7 A "tax return" is defined, in section 3(1) of the TAA:

"**Tax return**" means a form or document that a taxpayer is required by a tax law—
(a) To complete; and
(b) To provide to the Commissioner,—
whether in electronic or written form and whether provided in respect of a period or not; and also includes a tax form issued by another taxpayer that the taxpayer provides to the Commissioner:

4.8 "Tax law" is defined in section 3(1) of the TAA:

"**Tax law**" means–
(a) A provision of the Inland Revenue Acts or an Act that an Inland Revenue Act replaces:
(b) An Order in Council or a regulation made under another tax law:
(c) A non-disputable decision:
(d) In relation to an obligation to provide a tax return or a tax form, also includes a provision of the Accident Rehabilitation and Compensation Insurance Act 1992 or a regulation made under that Act or the Accident Insurance Act 1998 or a regulation made under that Act or the Injury Prevention, Rehabilitation, and Compensation Act 2001 or a regulation made under that Act:…

4.9 A tax return would include, for example, a GST return, being a form that the taxpayer is required by a tax law to complete and provide to the Commissioner. (Section 61B of the Goods and Services Act 1985 also provides that offences committed in relation to goods and services tax are subject to the shortfall penalties.)

4.10 Having determined where a taxpayer takes a tax position, what is a tax position? The definition of "tax position" is broad and inclusive "without limitation". "Tax position" means a position or approach with regard to tax possible under one or more tax laws (refer definition above).

<u>A tax position and *Case U47*</u>

4.11 In Case U47, Barber DCJ considered the question of when a tax position is taken. In this case, there was both an error of fact and an error of law in respect of a claim for a GST input tax deduction. The disputant, who was registered for GST on an invoice basis, entered into an agreement to purchase land for its own use. The vendor of the land was not GST registered. Therefore, the transaction should have been treated as the purchase of secondhand goods for GST purposes.

4.12 In addition, although the agreement provided for part of the purchase price to be paid in one GST period and the other part in the next GST period, the purchaser's accountant's employee, despite having no tax invoice for the transaction, prepared the purchaser's GST return for the first period as if the whole purchase price had been paid. A GST input tax deduction based on the whole price was, therefore, claimed in the first period. This gave rise to an agreed tax shortfall that exceeded the threshold amounts for a shortfall penalty for "unacceptable interpretation" set out in section 141B(2).

4.13 Although the taxpayer claimed that the employee had not attempted to interpret the GST Act in a manner to put a different interpretation on it, the TRA held that, notwithstanding the employee may have never looked at the appropriate section of the GST Act, the employee was considered to have made an interpretation of the relevant tax laws. Barber DCJ held that, in filing the GST return for the first period and incorrectly claiming the GST input credit component for the whole sum, the taxpayer had taken a tax position. The tax agent's interpretation of the tax law was imputed to the taxpayer.

4.14 In this case, the tax position was taken in a "tax return" as defined in the TAA, being the GST return required by tax law to be completed and provided to the Commissioner.

Tax shortfall

4.15 The second of the essential requirements for the application of section 141B is that there is a tax shortfall. "Tax shortfall" is defined in section 3(1) of the TAA as the tax effect of a taxpayer's tax position for the return period and the correct tax position for that period when the taxpayer's tax position results in too little tax being payable or a benefit being overstated to the advantage of the taxpayer or another person. The definition states:

> "**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:

4.16 The tax position with which the taxpayer's tax position is compared is the "correct tax position". "Correct tax position" is also defined in section 3(1) of the TAA:

> "**Correct tax position**" means the correct tax position established under one or more tax laws:

4.17 In each case, therefore, the "correct tax position" in accordance with the tax laws and the "taxpayer's tax position" are compared for a return period and if, for that return period, the tax effect of the difference results in too little tax being payable or a benefit being overstated for a return period, the difference is the tax shortfall for that period.

4.18 In short, the taxpayer's tax shortfall will be established by a comparison of the tax liability as set out in the taxpayer's return and the correct liability.

Tax shortfall threshold

4.19 The third of the preliminary requirements to be established is that the tax shortfall must exceed the threshold amounts referred in section 141B(2)(b). In relation to tax position taken before 1 April 2003, the tax shortfall must exceed both:

(i) $10,000; and

(ii) The lesser of $200,000 and one percent of the taxpayer's total tax figure for the relevant return period.

<u>Total tax figure</u>

4.20 "Total tax figure" is defined in section 141B(3):

> **141B(3) For the purposes of this section, a taxpayer's total tax figure is -**
> **(a) The amount of tax paid or payable by the taxpayer in respect of the return period for which the taxpayer takes the taxpayer's tax position** before, in the case of income tax, any group offset election or subvention payment; or
> (b) Where the taxpayer has no tax to pay in respect of the return period -
> (i) Except in the case of GST, an amount equal to the product of-
> (A) The net loss of a taxpayer in respect of the return period, ascertained in accordance with the provisions of the Income Tax Act 1994, are to be used in this subsection as if they had a positive value; and
> (B) The basic rate of income tax for companies in the relevant return period; or
> (ii) In the case of GST, the refund of tax to which the taxpayer is entitled for the return period, -
> that is shown as tax paid or payable, or as net losses of the taxpayer, or a refund to which the taxpayer is entitled, in a tax return provided by the taxpayer for the return period.
>
> [emphasis added]

4.21 Although the term "total tax figure" may suggest that the total tax figure is the correct tax figure for the relevant return period, the wording of section 141B(3)(a) (set out above), implies that the "total tax figure" is the figure of tax paid or payable according to the taxpayer's return. This contrasts with the view that the use of "payable" might suggest that that figure is correct because it is the correct tax which is "payable".

4.22 Bearing in mind that section 141B(6) broadly provides that a tax position is taken when the taxpayer provides the return, it could be that the return may show a figure for tax payable but the tax is not yet due until, for example, the terminal tax date. However, the figure remains payable according to the return.

4.23 This latter view is consistent with the concluding words of subsection 141B(3)(b) (set out again below) which qualify the whole provision. These concluding words apply to cover all possible shortfalls dealt with in section 141B, i.e., whether there is tax to pay, a loss, or a GST refund and they provide that the "total tax figure":

> … that is **shown as tax paid or payable**, or as net losses of the taxpayer, or as a refund to which the taxpayer is entitled, **in a tax return provided by the taxpayer** for the return period.
> [emphasis added]

4.24 The word "entitled" is used in both the concluding words of section 141B(3) and also in subsection (3)(ii) (set out above). In the context of the provision, the "entitlement" appears to refer to the figure or amount shown "in the tax return provided by the taxpayer for the return period".

4.25 It is the Commissioner's view that the total tax figure for the relevant return period, as required to establish a taxpayer's tax shortfall under section 141B(2), is the figure shown as tax paid or payable, the net loss of the taxpayer multiplied by the basic rate of income tax or their GST refund entitlement, that the taxpayer has provided in the tax return for the period.

Returns by partnerships

4.26 Section 141B(8) applies where there are returns completed by a partnership or groups of persons.

> **141B(8)** For the purpose of determining whether the resulting tax shortfall is in excess of the amounts specified in subsection (2)(b),—
> (a) A tax return provided by—
> (i) A partnership; or
> (ii) Any other group of persons that derive or incur amounts jointly or that are assessed together,—
> is to be treated as if it were a tax return of every taxpayer who is a partner in the partnership or person in such group; and
> (b) The tax rate in a return period applying to a partnership is deemed to be the same as the basic rate of income tax for companies for the relevant period.

4.27 The effect of section 141B(8) is that, in establishing whether a partnership or other like entity has exceeded the threshold set by section 141B(2)(b), the shortfall incurred by the partnership is considered against the partnership's income, treating the partnership as a separate entity. The company tax rate is to be used in any threshold calculations in accordance with section 141B(8)(b).

The preliminary requirements are satisfied

4.28 Assuming that the preliminary requirements of section 141B(1) are satisfied, it is then appropriate to consider whether there has been an "unacceptable interpretation" in accordance with section 141B.

What is an unacceptable interpretation?

4.29 Section 141B(1) defines an "unacceptable interpretation":

> **141B(1)** In relation to a tax position taken by a taxpayer, an unacceptable interpretation -
> (a) Is an interpretation or an interpretation of an application of a tax law; and
> (b) Viewed objectively, that interpretation or application fails to meet the standard of being about as likely as not to be correct.

4.30 An unacceptable interpretation under section 141B requires both of the above limbs to be satisfied. Under (a), for there to be an unacceptable interpretation, there must firstly be either an "interpretation" of a tax law or "an interpretation of an application of a tax law" and under (b), that interpretation or interpretation of an application of a tax law, when viewed objectively, must not satisfy the required standard of "being about as likely as not to be correct". It is appropriate, therefore, to consider what is an interpretation of a tax law and what is an interpretation of an application of a tax law.

Interpretation of a tax law

4.31 The word "interpretation" is not defined in the Act. It is, therefore, necessary to consider other sources to ascertain its meaning.

4.32 *The Oxford Companion to Law*, by David M Walker, Clarendon Press, Oxford, 1980 defines "interpretation or construction" as:

> The process of determining the meaning of a text, such as that of a statute, or deed or will, in the circumstances which are under consideration.

4.33 *The New Shorter Oxford Dictionary* on *Historical Principles* defines "interpretation" as follows:

> **interpretation** n **1** The action of explaining the meaning of something; spec. the proper explanation or signification of something ... **2** An explanation given; a way of explaining; (a) construction put upon an action etc. ...

and the word "interpret" is given a similar meaning:

> **interpret** **1** Explain the meaning of... b Explain to oneself, understand. ... **2** Give a particular explanation of; explain or construe (an action etc.) in a specified manner. ... **3** Give the meaning or explanation of something; ...

4.34 The above definitions indicate that "interpretation" involves the formulation of an understanding or explanation of something, and that a person must have turned his or her mind in some way to that "something" before formulating such understanding or explanation.

The meaning of interpretation as applied by the Courts

4.35 Prior to *Case U47*, the courts had not considered the meaning of "interpretation" in the context of the Act. The meaning of the term has, however, been

considered in other contexts which may provide guidance for the present application. Wylie J in *Shotter v Westpac Banking Corporation* [1988] 2 NZLR 316 (HC) considered the term as it appeared in section 6(2)(a) of the Contractual Mistakes Act 1977. Section 6(2(a) of the Contractual Mistakes Act prevents relief under section 7 of that Act, if the mistake, made by a party to a contract, was a mistake in the "interpretation" of that contract.

4.36 Section 6(2)(a) of the Contractual Mistakes Act states:

> (2) For the purposes of an application for relief under section 7 of this Act in respect of any contract, -
>
> (a) A mistake, in relation to that contract, does not include a mistake in its interpretation.
>
> …

4.37 The case of *Shotter* concerned a company which borrowed $100,000 from a bank. The loan was secured by a mortgage in favour of the bank. The bank also required Mr Shotter to personally guarantee the loan, as well as other liabilities the company had established with the bank. Mr Shotter, who was not a director or employee of this company, was of the belief that his personal guarantee was limited to the $100,000 loan. When the bank established that the company did not have the resources to meet its outstanding liabilities, it turned to Mr Shotter to meet those liabilities.

4.38 Mr Shotter issued proceedings against the bank attacking the validity of the guarantee. Amongst other things, Mr Shotter claimed that in entering the guarantee, he was influenced by a material mistake, namely, that he was of the mistaken belief that the guarantee related only to one singular advance (the $100,000 loan). As such, Mr Shotter argued that he was entitled to relief under section 7 of the Contractual Mistakes Act.

4.39 The High Court held that Mr Shotter was not entitled to rely on section 7 of the Contractual Mistakes Act because, under section 6(2)(a), a contractual mistake does not include a mistake made in the interpretation of a contract. Mr Shotter's mistake was caused by his interpretation of the guarantee and, despite the Court's recognition that it was highly unlikely that he had read the document, Mr Shotter was, therefore, unable to obtain any relief that was available under the Contractual Mistakes Act.

4.40 In reaching this conclusion, Wylie J defined the term "interpretation":

> I think it is clear, …that the mistake of Mr Shotter was in misunderstanding what the guarantee document said as to the extent of his liability in the sense of what debts of [the company] were being guaranteed. Was that misunderstanding a mistake as to its "interpretation"? I think it was. **It is true that to the lawyer "interpretation" is commonly understood to mean reaching of a conclusion as to the meaning of a document after careful study and analysis of the words used in accordance with the established rules of construction. There was nothing of the sort here. It is not even suggested that Mr Shotter read the document or any material part of it. Can an understanding of the meaning of a document in those circumstances be described as an "interpretation"? First I do not think "interpretation" in s 6(2)(a) is used in the technical lawyer's sense I have described**. In my view it must be equally applicable to the situation of a layman who, taking the risk of advising himself as to the meaning of a document simply reads and thinks he understands it. **It must be equally applicable to the layman who only reads a part of the document because he thinks he need not trouble himself with some of the more wordy clauses or the "fine print". It would seem strange to me if it were otherwise. Why should the prudent person who takes proper if mistaken advice, lose the benefit of the Act, while the foolish person who takes the risk on himself be protected**? If I am correct up to this point what then of the layman who makes no attempt to read the document, but simply signs on the basis of a general description of the document, e.g. as in this case that it is a guarantee? **I think that a signatory in that situation who assumes, because it is a guarantee and that it is for a particular purpose - in this case the raising of a specific loan - his liability thereunder must therefore be limited to that specific loan, is placing his own interpretation on the document however ill-formed and baseless it may be**. (p 330)
> [emphasis added.]

4.41 From Wylie J's comments, it can be concluded that the word "interpretation" has been given a wide meaning. It is irrelevant whether a person has actually read the document. If a person has some general knowledge of what the document is about and has signed that document, that person has interpreted that document in accordance with section 6(2)(a) of the Contractual Mistakes Act.

4.42 The High Court in *Shivas v Bank of New Zealand* [1990] 2 NZLR 327 took the same approach as Wylie J in *Shotter*. In Shivas, an accountant mistook the contents of his client's guarantee to the bank. Despite the court assuming that the accountant had not read the guarantee, Tipping J held that he had made a mistake in the interpretation of the document. Tipping J stated at pages 361-362:

> In so far as [the accountant] may have failed to **notice** when signing the guarantee that one year's interest and costs were added to the primary limit, I am of the opinion that this represents a mistake in the interpretation of the contract. **If he had read it and misunderstood it then it would clearly**

> **have been a mistake in interpretation. I cannot see that he can be in a better position through having formed an erroneous impression as a result of not having read the document at all**. In this respect I follow the approach to the question of interpretation as discussed by Wylie J in Shotter's case ...
>
> ... In agreement with Wylie J **I would equate a failure to read or properly to read a contractual document with a** misunderstanding **of its effect having read it or after having had it erroneously explained.**
> [emphasis added.]

4.43 Therefore, it appears that an "interpretation" can mean something wider than a careful consideration of a particular provision or document, to reach a conclusion as to its meaning, or operation and effect. An interpretation, in relation to the Contractual Mistakes Act, seems to also encompass brief readings, or even not reading at all, whereby the person assumes the meaning of a provision or document or places his or her own interpretation on it.

4.44 *Shotter* and *Shivas* both concerned situations where the signatories had not even turned their minds to the specific details or contents clearly spelt out in the contracts. They had not read them. In both cases, however, the signatories still reached certain conclusions as to the meaning of those contracts because they had some general understanding of what those contracts were about.

4.45 On the basis of *Shotter* and *Shivas*, in order for a party to have interpreted (or misinterpreted) a contract, it is enough if they have a general understanding of the contract. It is not necessary for the party to have turned their mind to the specific details of the contract. In other words, a party does not need to read a contract in order to fall within the ambits of section 6(2)(a) of the Contractual Mistakes Act.

4.46 The above cases are consistent with the decision of the TRA in *Case U47*. However, one question that could be raised in relation to the tax legislation, is whether a taxpayer merely has to have a general knowledge of the existence of a general body of tax laws which may or may not apply to that taxpayer's situation, or whether that taxpayer has to actively turn his or her mind to a specific tax law. At first glance, this appears to be answered by the reference to "a tax law" in the phrase "interpretation or an interpretation of an application of a tax law". The reference is not in a general sense to "tax laws". The reference to "a tax law" indicates that a taxpayer must turn his or her mind to a specific tax law and reach a conclusion as to the meaning of that tax law. In *Case U47*, Barber DCJ said:

> 36. I agree with counsel for the defendant that whenever a person turns his or her mind to a tax law such as the application or non-application of the GST Act or its provisions, whether or not actually reading the statute in question an interpretation occurs. (pp 9,417-9,418)

4.47 He continued:

> 44. … it is not necessary that he specifically identify the section number or actually read the section at issue. It is merely necessary that he turns his mind to the general purport of the relevant section with a general awareness of its existence even if having an erroneous view as to its contents and effects. (p 9,420)

4.48 To summarise the above authorities, the term "interpretation" encompasses more than the technical study and analysis of words of a document to understand its meaning. An interpretation involves the reaching of a conclusion on the meaning of a document or tax law. The taxpayer need not have specifically identified the section. It is sufficient that the taxpayer turned his or her mind to the general purport of the relevant legislation and came to a conclusion as to the law.

Interpretation of an application of a tax law

4.49 Section 141B(1) also provides for "unacceptable interpretation" when there has been "an interpretation of an application" of a tax law. The question is what is the meaning of "an interpretation of an application"?

4.50 Some explanation for the wording of the section can be found in the legislative history of the provision. An earlier version of section 141B(1)(a) of the Act was applicable prior to the 1 April 1997. This original version of the provision included the words:

> … an interpretation that … involves the interpretation or application of that tax law

4.51 The 1997 amendment that introduced the phrase:

> … an interpretation of an application

sought to simplify the provision, but not change the meaning of it. It is, therefore, the Commissioner's view that section 141B(1), as applicable before the 2003 amendment, refers to an interpretation of a tax law and an application of a tax law. The following discussion will be based on this assumption.

4.52 "Application" is not defined in the Act. *The New Shorter Oxford Dictionary on Historical Principles* gives the following definition:

> **application** ... 2 ... use, employment; a specific use or purpose to which something is put... 3 The bringing of a general or figurative statement, a theory, principle, etc., to bear upon a matter; applicability in a particular case, relevance; the bringing of something to bear practically in a matter, practical operation. ...

4.53 To what, however, is the tax law to be applied? The above definition refers to "specific use", "particular case" and "in a matter". Each of these phrases suggests that "application" is used with reference to a particular factual situation. Therefore, it is the Commissioner's view that, for the present issue, it may be inferred that the tax law is being applied to the facts. This is consistent with the application of section 141B by Barber DCJ in Case U47.

An unacceptable interpretation or interpretation of an application - conclusion

4.54 Based on the above analysis, it is the Commissioner's view that an "unacceptable interpretation" is when the taxpayer applies their understanding of the tax law to a particular factual scenario. It is not necessary for the taxpayer to have read or even identified the particular tax law. The requirement is that the taxpayer has turned his or her mind to a tax law and determined the legal effect of that tax law. It is then a further requirement that, when viewed objectively, the application of that interpretation is about as likely as not to be correct. Section 141B(1)(a) refers to both an "interpretation or an interpretation of an application of that tax law". The two parts, although set out as alternatives, are each a necessary part of the other for the establishment of a tax position. An interpretation requires an application of the tax law and an application requires an interpretation of a tax law. For there to be an "unacceptable interpretation", both the interpretation and the application of the tax law require that they be applied to the taxpayer's particular factual scenario.

Can a mistake of fact lead to an unacceptable interpretation?

4.55 The question arises as to whether a tax shortfall caused by a simple mistake of fact which led to, for example, the wrong law being applied, is an unacceptable interpretation. The taxpayer may have applied the law correctly to the facts as he or she believed them to be but, when the true facts are considered, the end result is that of an incorrect tax position.

An interpretation of a tax law is necessary

4.56 It is the Commissioner's view that section 141B does not apply to tax shortfalls caused **solely** by mistakes of fact. Section 141B is concerned with the application of the tax laws rather than the facts to which they are applied. Both the scheme and purpose of the legislation and the wording of section 141B support this view. For example, section 141B(7) provides that:

> **141B(7)** The matters that must be considered in determining whether the tax position taken by a taxpayer involves an unacceptable interpretation of a tax law include—
>
> (a) The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and
>
> (b) Decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).

4.57 There are no references in section 141B(7) to the determination of facts or the correctness of the facts in determining whether there has been an unacceptable interpretation. It may also be significant that section 141B(7) refers to the actual or potential application to the "tax position of all the tax laws that are relevant" and the definition of "tax position" in section 3(1) refers to a position or approach with regard to tax possible under one or more tax laws. There is no reference to factual mistakes.

4.58 It is appropriate to consider section 141A which sets out the shortfall penalty provision for not taking reasonable care.

> **141A. Not taking reasonable care—**
>
> (1) A taxpayer is liable to pay a shortfall penalty if the taxpayer does not take reasonable care in taking a taxpayer's tax position (referred to as "not taking reasonable care") and the taking of that tax position by that taxpayer results in a tax shortfall.
>
> (2) The penalty payable for not taking reasonable care is 20% of the resulting tax shortfall.
>
> (3) A taxpayer who, in taking a taxpayer's tax position, has used an acceptable interpretation of the tax law is also a taxpayer who has taken reasonable care in taking the taxpayer's tax position.

4.59 Both section 141A and 141B, therefore, provide for a penalty of 20% of the resulting tax shortfall, the former "for not taking reasonable care", the latter when section 141B(2) applies and a taxpayer's tax position involves "an unacceptable interpretation of the tax law". This might be seen as suggesting offences which were different but which were of equal culpability.

4.60 The question could be posed as to the application of section 141A, relating to lack of reasonable care, when it is considered that the taxpayer, had they not relied on incorrect facts, would have made an acceptable interpretation. As a mere mistake of fact does not give rise to an unacceptable interpretation, it would seem, that if the taxpayer relies on incorrect facts, there might be liability under section 141A if there was a lack of reasonable care in ascertaining those facts.

4.61 The effect of section 141A(3) must be considered in this context.

> (3) A taxpayer who, in taking a taxpayer's tax position, has used an acceptable interpretation of the tax law is also a taxpayer who has taken reasonable care in taking the taxpayer's tax position.

4.62 It is considered that section 141A(3) was intended to reinforce the objective nature of the test for unacceptable interpretation under section 141B. It will be remembered that the test under section 141B is an objective one and is not dependant on the efforts of the taxpayer or their advisers. It is, therefore, the Commissioner's view that section 141A(3) was enacted in order to prevent the imposition of a shortfall penalty under section 141A where a taxpayer had made an acceptable, albeit incorrect, interpretation which led to a tax shortfall and where that acceptable interpretation had been reached with a lack of reasonable care. This fits with the scheme of the Act that it is not necessary to consider the efforts of a taxpayer in arriving at an interpretation.

The interpretation of section 141B(1) and Case U47

4.63 Judge Barber, in Case U47 considered the relationship between errors of fact and law:

> 45. … Certainly … there has been an interpretation "of an application of" a tax law. This is because the staff member took an interpretation that a requirement to hold a tax invoice did not apply to the transaction in question for the purposes of claiming the GST input credit deduction. (p 9,420)

4.64 In setting out his reasons for the decision of the TRA, Judge Barber seemed to be of the view that an error of fact could lead to an unacceptable interpretation as he stated that the test in section 141B was to compare the interpretation with that based on the land being a secondhand good.

> 46. … It is the correct position on the basis of the land being a "secondhand good" which must be determined for the purposes of the s 141B test, because in this case the property constituted secondhand goods. (p 9,420)

4.65 Nevertheless, His Honour then goes on to consider the interpretation taken by the taxpayer's accountant on behalf of the taxpayer.

> 51. The disputant emphasized that he merely made a mistake about a material fact i.e. he assumed that the vendor was GST registered. However, he thought that no invoice was needed in that situation because **he thought the agreement became the necessary invoice, and that is an unacceptable interpretation. His mistake of law may have been based on a mistake of fact but there was still an unacceptable interpretation** of the tax law.
> [emphasis added]

4.66 From paragraph 51 of the report of the TRA decision, it would seem that Judge Barber was considering the correctness or otherwise of the application of the law to the facts as the accountant believed them to be. It was only the mistake of fact that led the accountant to consider the tax invoice point at all. The issue of whether or not the agreement for sale and purchase constituted a tax invoice is irrelevant to the shortfall based on the true facts. Although an agreement for sale and purchase would not normally meet the legislative requirements for a "tax invoice", it was the accountant's failure to realise that the definition of "input tax" and the effect of section 20(3)(a)(ia) GST Act applied to the transaction and limited the input tax deduction that led to the shortfall. With respect, Judge Barber seems to have determined whether the interpretation was acceptable based on the facts as the taxpayer believed them to be, i.e. that there was a taxable supply where a tax invoice was required to claim an input tax deduction

4.67 There appears, therefore, to be some uncertainty as to the law in New Zealand and it may be helpful to consider other jurisdictions. Australia has a similar shortfall regime regarding the "reasonably arguable" application of a law.

Acceptable interpretation / "reasonably arguable" position – the Australian view

4.68 Section 222C of the Australian Income Tax Assessment Act 1936 (AITAA) deals with whether the correctness of the treatment of the application of a law is "reasonably arguable" and provides:

> For the purposes of this Part:
> (a) the correctness of the treatment of the application of a law; or
> (b) another matter;
> is reasonably arguable if, having regard to the relevant authorities and the matter in relation to which the law is applied or the other matter, it would be concluded that what is argued for is about as likely as not to be correct.

4.69 Section 226K AITAA imposes a penalty where a position is taken that is not "reasonably arguable". Section 226K provides:

> Subject to this Part, if:
> (a) a taxpayer has a tax shortfall for a year ; and
> (b) the shortfall or part of it was caused by the taxpayer , in a taxation statement, treating an income tax law as applying in relation to a matter or identical matters in a particular way; and
> (c) the shortfall or part, as the case may be, so caused exceeded whichever is the higher of:
> (i) $10,000; or
> (ii) 1% of the taxpayer's return tax for that year; and
> (d) when the statement was made, it was not reasonably arguable that the way in which the application of the law was treated was correct;

> the taxpayer is liable to pay, by way of penalty, additional tax equal to 25% of the amount of the shortfall or part.

4.70 When section 141B of the New Zealand legislation was initially drafted, it also used the phrase "reasonably arguable", consistent with the Australian provision. *The Commentary to the Taxpayer Compliance, Penalties, and Disputes Resolution Bill* recommended that "reasonably arguable" be changed to "unacceptable interpretation" in the New Zealand legislation. The reason the Commentary cites for recommending this change was that the threshold level of a "reasonably arguable position" did not meet the higher requisite threshold of being a position that was "about as likely as not to be the correct tax position". The Australian provision, however, despite retaining the criteria of a "reasonably arguable position", specifically provides for this same test. Therefore, the difference in the terminology between the Australian and New Zealand provisions ("unacceptable interpretation" as opposed to "reasonably arguable") is not indicative of differences in the application or meaning of the two sections.

4.71 The earlier version of section 141B(1)(a) of the Act, prior to 1 April 1997, more closely followed the Australian provision. For convenient reference, the earlier version of section 141B(1) is set out again below:

> For the purposes of this Part, an unacceptable interpretation of a tax law is, in relation to a tax position taken be a taxpayer, an interpretation that -
>
> (a) Involves the interpretation or application of that tax law; and
>
> (b) Fails to meet the standard of being, viewed objectively, about as likely as not to be correct.

4.72 As stated above, section 141B, as amended in 1997, was not intended to change the meaning of the section. On this basis, commentaries that have considered section 222C(1) AITAA will be useful to help ascertain the meaning of "interpretation or interpretation of the application of a tax law" in the context of section 141B(1).

4.73 Section 222C AITAA uses the phrase "the treatment of the application of a law" when defining the term "reasonably arguable". Section 141B uses a similar phrase. When defining the term "unacceptable interpretation", section 141B(1) uses the phrase "an interpretation or an interpretation of an application of a tax law". The utilisation of such similar terminology suggests a similar approach in both jurisdictions and strengthens the view that discussion and commentary on the Australian legislation may assist in the application of the New Zealand provisions.

4.74 An Australian Administrative Appeals Tribunal case that made some reference to "reasonably arguable position" was Ryvitch v FCT 2002 ATC 2188. The taxpayer in this case had initially appealed to the Federal Court regarding the deductibility of losses which depended on the existence of a partnership. The Federal Court held that the existence of the partnership was arguable at the time the taxpayer claimed the deductions. On that basis, the taxpayer had not been reckless and the issue of penalties was remitted to the Commissioner for reconsideration. The Commissioner reduced the penalties to 25% under section 226G for failure to take reasonable care. The taxpayer argued that her returns were not wrong because of carelessness or an omission to take into account relevant facts or a failure to address a relevant issue but rather that she had misunderstood the relevant facts. Although the Administrative Appeals Tribunal further reduced the quantum of additional tax from 25% to 15% of the shortfall, it was stated that:

> At the hearing, reference was made to s. 226K… It seems clear that the question before the Federal Court of whether the development was carried on as a partnership or by [the company] in its own right was a question of fact and did not involve a conclusion of law. Consequently, it is difficult to see that s. 226K has any relevance to the matter of additional tax. (pp 2,193–2,194)

4.75 The Explanatory Memorandum to the Taxation Laws Amendment (Self-Assessment) Bill 1992 (Australia) supports the view that where the taxpayer misunderstands the facts, this is not in itself a breach of the "reasonably arguable" position requirement. The memorandum states:

> ***What is a reasonably arguable position?***
> A position taken by a taxpayer will be reasonably arguable if, on an objective analysis of the law and the application to the relevant facts, it would be concluded that the taxpayer's position was about as likely as not to be correct.
>
> …
>
> Honest errors of fact or calculation will not attract section 226K, which requires a taxpayer to positively treat an income tax law as applying in a particular way.

4.76 The Australian Taxation Office issued a ruling TR 94/5. This contains some useful and more detailed discussion on errors of fact. The ruling states at paragraph 9:

> (d) … the reasonably arguable test only applies to tax shortfalls caused by a taxpayer treating an income tax law as applying in a particular way. A taxpayer treats an income tax law as applying in a particular way where the taxpayer concludes that, on the basis of the facts and the way the law applies to those facts, a particular consequence follows (for example, an amount of expenditure incurred is deductible). Subject to the other preconditions of section 226K, the reasonably arguable test is

designed to encourage taxpayers to ensure that the conclusions they reach are sound ones. **However, in some cases, a taxpayer's conclusions on a particular matter may have been based on incorrect primary facts which the taxpayer did not know and could not reasonably be expected to have known were not the proper facts, such as where a taxpayer relies on a bank to provide details of the amount of interest earned on a deposit**. In other cases, the statements in a taxpayer's return may not represent conclusions of the taxpayer, but might reflect errors in calculation or transposition errors. **As a broad rule, where a tax shortfall was caused by an error of fact or calculation section 226K will not apply since the taxpayer will not have treated an income tax law as applying in relation to a matter in a particular way. In this context, errors of fact are errors of primary fact and not wrong conclusions of fact which a taxpayer may make which bear on the correct application of a tax law, such as whether the taxpayer is carrying on a business**. Whether the statements in a taxpayer's return represent conclusions of the taxpayer or were caused by errors of fact or calculation should be determined on the basis of all the available evidence;
[emphasis added]

4.77 It, therefore, appears that the Australian view is that a tax shortfall caused by a mistake of fact that the taxpayer relies on and could not have known was incorrect, and to which the taxpayer applies the correct tax law for those facts, has taken a reasonably arguable position. In contrast, if a tax shortfall is caused by the taxpayer making an incorrect conclusion of fact, albeit that the correct tax law is applied to that conclusion, the taxpayer's position does not pass the reasonably arguable test.

Mistakes of fact

4.78 A tax shortfall, caused by a factual mistake not involving an interpretation or application of the law, is not within section 141B. Section 141B requires that there is an interpretation or application of a tax law. If the tax shortfall is caused by a mistake of fact, as opposed to a conclusion or inference involving the application or interpretation of the law, section 141B cannot apply. Examples to illustrate this are as follows:

Example 1
A taxpayer, who manufactures widgets, receives invoices for widget components. The taxpayer infers from this that the invoices record the purchase of goods for use in the taxpayer's business. He has forgotten that these particular widget components related to his private hobby activity. The taxpayer claims an income tax deduction for these. The tax shortfall is caused by a mistake of fact and does not involve an application of a tax law.

Example 2
A staff member fraudulently charged his personal expenses for widget components to the business. The fact that the taxpayer mistakenly claimed an input tax deduction, believing that these were widget components used in his taxable activity, would not constitute an unacceptable interpretation. The mistake again related to the facts. It was not a mistaken application of a tax law.

4.79 In contrast to Examples 1 and 2, the following example illustrates a mistake in the interpretation or application of a tax law for which the taxpayer may be liable for a shortfall penalty for unacceptable interpretation.

Example 3
A taxpayer claims an income tax deduction for the cost of the widgets, including the GST component paid on the widgets. This is an unacceptable interpretation of section ED 4(2) of the Income Tax Act 1994. Section ED 4(2) states that no deduction shall be allowed for any amount of GST input tax charged, levied or calculated in relation to the supply of goods and services to that person. Therefore, in this last example, the taxpayer is liable for a shortfall penalty for unacceptable interpretation, under section 141B, provided the other requirements of section 141B are met.

4.80 This approach is consistent with the quotation from the ATO set out above, in which the ATO refers to the situation of a taxpayer making an error of fact and distinguishes this from a situation where there is a tax shortfall as a result of a wrong inference from those facts involving the application of a tax law.

Use of tax agent/advisor

4.81 A tax agent may, however, take an interpretation on behalf of a taxpayer (or advise a taxpayer as to the tax law before the taxpayer takes the tax position). How does this impact upon the potential liability for a shortfall penalty under section 141B?

4.82 In Case U47 Barber DCJ stated:

> 42. … that while the Tax Administration Act 1994 does not give definitive guidance as to whether or not an unacceptable interpretation under section 141B by a tax agent, but adopted by a taxpayer, can be imputed to that taxpayer, the wording of section 141B(1) gives a strong indication that this is intended by the Legislature. That subsection (1) makes no direct reference to the taxpayer's interpretation but states "In relation to a tax position taken by a taxpayer, an unacceptable interpretation [is]…". This leaves the scope as to who initially makes the interpretation rather wide. **It must be the taxpayer who takes the tax position and, by inference, that will include any associated interpretation by an agent**. (p 9,419)
> [emphasis added]

4.83 Barber DCJ referred to the general principle of agency law as he continued:

> 42. … the fact that a taxpayer has requested, received and followed the advice of an agent with regard to an interpretation of a tax law, or its application, must mean that the taxpayer has taken an "interpretation" as required under section 141B in line with that taken by the agent in terms of the general principle of agency law. It is not necessary for a taxpayer to have read a tax law but, merely, that the taxpayer has turned his or her mind to the law. It seems to me that the mere fact of a taxpayer referring a matter to a tax agent may often be sufficient to indicate that a taxpayer has turned his or her mind to the tax law in question or to its application. It follows that because I find that the disputant has followed the advice of a tax agent (which advice has led to the making of an unacceptable interpretation), that does not prevent the disputant from being liable for any shortfall penalty payable under s 141B. **That unacceptable interpretation becomes the disputant's interpretation, for the purposes of s 141B, by virtue of the disputant's agency arrangement with its Accountant**.
>
> [emphasis added]

4.84 When applying the law to the facts before him in Case U47, Barber DCJ found that the taxpayer's agent had made an interpretation of the relevant tax laws, or at least an interpretation of the "application" of them. The interpretation was incorrect and this "unacceptable interpretation" was imputed to the taxpayer who, accordingly, was held to have taken the relevant tax position. Under the law of agency, the taxpayer is deemed to have taken a tax position based on an unacceptable interpretation, if his or her agent has made an incorrect interpretation of the relevant tax laws or an interpretation of the "application" of them.

4.85 Another possibility is that the taxpayer may complete his or her own return, but adopt the adviser's interpretation in doing so. Under the Act, in either case, the primary responsibility for tax obligations and liabilities always remains with the taxpayer. A "tax position" is a position or approach taken under one or more tax laws, and it is about the tax position taken by the taxpayer, in relation to his or her tax return, or other matters. The involvement of an agent does not derogate from the taxpayer's overall responsibility for the tax position taken.

4.86 In summary, if a taxpayer has followed the advice of a tax adviser in preparing a tax return, or a tax adviser has prepared the tax return, the taxpayer will be taken to have adopted the interpretation of the tax adviser.

Summary of meaning of "unacceptable interpretation"

- An "interpretation" involves the formulation of an understanding or explanation by a person of something.
- A person must have turned his or her mind to the document (or tax law) before an interpretation of it can be said to be given. However, it is not necessary for that person to have actually read the document (or tax law) in issue. A turning of the mind to the general purport of a section or a tax law in general and adopting a view, as to its meaning, or operation and effect, will suffice as an interpretation.
- Section 141B relates to the understanding and application of a tax law by the taxpayer to a set of facts.
- A mistake of fact is not an application of a law (nor an interpretation of a tax law). A mistake of fact is a mistake as to what is thought to be a known fact. Mistakes of fact would cover transposition or addition errors, and what would generally be simple factual errors. Mistakes of fact may also dictate the appropriate tax law to apply.

Example 4
A taxpayer gets the wrong depreciation rate when looking up the depreciation rates. The taxpayer knows the relevant asset class but accidentally selects the depreciation rate for the asset class listed next to the relevant one. Although the taxpayer would claim depreciation at the wrong rate as a result of this error, there would be no interpretation or application of the law by the taxpayer leading to the shortfall.

Example 5
If a taxpayer omits income because of a bank statement error or because a cheque was banked into the wrong account, there would be no interpretation or application of a tax law by the taxpayer as a result of this error.

Example 6
The taxpayer has a transaction with an associated person and, for some reason, the taxpayer was unaware of the relationship. If the transaction is one which requires the interpretation of tax laws, the interpretation of the taxpayer, on the basis that the transaction was not with an associated person, would not be an unacceptable interpretation. The application of the appropriate tax law was based on a mistake of fact.

- A taxpayer's mistake of law may have been based on a mistake of fact but, on the facts, there may also be an unacceptable interpretation.

- Where there is a tax shortfall caused by a mistaken fact, but there was no interpretation or application of a tax law, the taxpayer might, depending on the circumstances and facts, still be liable under section 141A for failing to take reasonable care.
- For the purposes of section 141B, a tax agent's interpretation will be imputed to the taxpayer where the tax position is taken on the taxpayer's behalf by the agent who completes the taxpayer's tax return. The interpretation taken will be that of the taxpayer and will not prevent the taxpayer from being liable for a shortfall penalty under section 141B if an unacceptable interpretation has been made. A taxpayer may also adopt an adviser's interpretation in completing his or her own return.
- The non-application of a tax law will be an "interpretation or an interpretation of an application of a tax law" if a taxpayer turned his or her mind to whether or not that tax law applied to a particular factual situation.

Example 7

A taxpayer may conclude that the registration requirements in section 51 of the GST Act do not apply to his or her particular fact situation. If he or she is wrong, this would be an "unacceptable interpretation".

Summary – shortfall penalties for tax positions taken before 1 April 2003 based on an unacceptable interpretation

4.87 A taxpayer will be liable for a shortfall penalty if:

- the taxpayer has taken a tax position (defined section 3(1) of the TAA);
- based on an unacceptable interpretation of a tax law;
- as a result of which the taxpayer has a tax shortfall (defined section 3(1) of the TAA); and
- the tax shortfall exceeds threshold amounts referred to in section 141B(2)(b).

4.88 The shortfall penalty payable is 20% of the resulting tax shortfall pursuant to section 141B(4), however, sections 141F to K provide conditions under which the Commissioner may reduce or increase penalties. These sections provide no maximum amount for a shortfall penalty imposed for an unacceptable interpretation.

5. Section 141b(1)(b) and the meaning of "about as likely as not to be correct"

5.1 If there is an interpretation of a tax law or an interpretation of an application of a tax law under section 141B(1)(a), section 141B(1) states that an interpretation is unacceptable, if when:

> (b) Viewed objectively, that interpretation or application fails to meet the standard of being about as likely as not to be correct.

5.2 No statutory guidance is given as to how the phrase, "about as likely as not to be correct", is to be interpreted. However, there are a number of points or inferences that can be drawn from the actual words used and the context of the phrase itself.

5.3 Firstly, the test is an objective one. Accordingly, the taxpayer's efforts or diligence in reaching an interpretation are not relevant for the purposes of satisfying the requirements of section 141B(1)(b).

5.4 The second point to note is the use of the words "as likely as not" in the phrase "as likely as not to be correct". In *Case U47*, Barber DCJ considered the meaning of this phrase and said:

> 37. … the words "as likely as not" indicate an even balance of 50/50. There would need to be an about equal chance of an interpretation being likely to be correct as it is to be incorrect. It follows that where one of two interpretations does not have about a 50% chance of being correct in the view of a Court, the taxpayer will have failed to meet the required standard under limb (b). Corresponding percentages would apply where there are three or more equally likely interpretations i.e. a 33% chance of being correct where there are three interpretations, a 25% chance of being correct where there are four interpretations, and so on. (p 9,418)

5.5 Barber DCJ continued:

> 37. … the word "about", which precedes the above phrase must be taken into account as it makes the test less stringent and provides some latitude in applying the test.

5.6 The word "about" is not defined in the Act. The ordinary meaning, as given in *The New Shorter Oxford English Dictionary on Historical Principles*, is:

> **A** adv. **1** Around the outside; on or towards every side; all around. … **4** Near in number, scale, degree, etc. … **5** On any side; somewhere near. …

5.7 In *Case U47,* Barber DCJ discussed the use of the word "about". He said:

> 37. … I accept that the word "about" in the phrase "about as likely as not to be correct" allows for the standard to be met if the interpretation is close to or around 50% likely to be correct. It follows that where a Court subsequently holds an

> interpretation to be incorrect, the test in section 141B may potentially be satisfied if it is close to being 50% correct. Perhaps that may be the case where a Court finds two possible interpretations attractive, but prefers one to the other. (p 9,418)

5.8 The Australian view on standard of "about as likely as not to be correct" accords with Barber DCJ's approach in *Case U47*. In the decision of the Australian Federal Court in *Walstern Pty Ltd v FC v T* [2003] ATC 5076, Hill J discussed the standard of the very similar phrase "about as likely as not correct", as follows:

> It is not necessary that the decision maker form the view that the taxpayer's argument in an objective sense is more likely to be right than wrong. That this is so follows from the fact that tax has already been short paid, that is to say the premise against which the question is raised for decision is that the taxpayer's argument has already been found to be wrong. Nor can it be necessary that the decision maker form the view that it is just as likely that the taxpayer's argument is correct as the argument which the decision maker considers to be the correct argument for the decision maker has already formed the view that the taxpayer's argument is wrong. The standard is not as high as that. **The word 'about' indicates the need for balancing the two arguments, with the consequence that there must be room for it to be argued which of the two positions is correct so that on balance the taxpayer's argument can objectively be said to be one that while wrong could be argued on rational grounds to be right**.
>
> …
>
> … **the view advanced by the taxpayer must be one where objectively it would be concluded that** having regard to the material included within the definition of 'authority' a reasoned argument can be made which argument when contrasted with the argument which is accepted as correct is about as likely as not correct. That is to say the **two arguments, namely, that which is advanced by the taxpayer and that which reflects the correct view will be finely balanced. The case must thus be one where reasonable minds could differ as to which view,** that of the taxpayer or that ultimately adopted by the Commissioner was correct. There must, in other words, be room for a real and rational difference of opinion between the two views such that while the taxpayer's view is ultimately seen to be wrong it is nevertheless 'about'' as likely to be correct as the correct view. A question of judgment is involved. (p 5,095) [emphasis added]

5.9 It is the Commissioner's view that an interpretation will be "as likely as not to be correct" if, when viewed objectively, that interpretation has about an equal chance (or about a 50% chance) of being likely to be correct as it is to be incorrect. The use of the word "about" makes the test less stringent, but the objective interpretation still needs to be close to or around 50% likely to be correct.

Section 141B(7)

5.10 Section 141B(7) defines the matters that must be considered in determining whether or not the taxpayer has made an unacceptable interpretation of a tax law in the tax position taken.

> **141B(7)** The matters that must be considered in determining whether the tax position taken by a taxpayer involves an unacceptable interpretation of a tax law include -
>
> (a) The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and
>
> (b) Decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).

5.11 Barber DCJ stated in Case U47 that:

> 39. Section 141B(7) uses the imperative word "must". Accordingly, the matters referred to in paras (a) and (b) of section 141B(7) must be taken into account for the purposes of ascertaining whether an interpretation taken is acceptable. This supports the objective nature of the test in section 141B(1)(b). **Under section 141B(7) it is not simply the tax law (or laws) of which the taxpayer is aware that needs to be taken into account but, rather, that which is actually applicable which must be taken into account to ascertain whether the interpretation taken by the taxpayer is "about as likely as not to be correct" in terms of s 141B(1)**. (p 9,418) [emphasis added]

5.12 Barber DCJ summarised his view:

> 41. … that factors to be taken into account for the purposes of ascertaining on an objective basis whether a taxpayer has taken an interpretation "about as likely as not to be correct" are all tax laws relevant to the facts in question, all Court or Tribunal decisions issued up to one month before the taxpayer takes the taxpayer's tax position, and (in the absence of such case law) relevant extrinsic materials. Section 141B(7), in effect, affirms and endorses the criminal maxim that i**gnorance of the law is no excuse**. (p 9,419) [emphasis added]

5.13 Accordingly, all tax laws that are applicable must be taken into account to ascertain whether the interpretation taken by the taxpayer is "about as likely as not to be correct". Additionally, all case law issued up to one month before the taxpayer's tax position is taken, must be considered and, as

subsection 141B(7) is not exhaustive in the list of factors it requires to be taken into account, where there is no relevant case law, it may be appropriate to consider extrinsic materials. Subsection 141B(7) also highlights the objective standard; ignorance of the law is no excuse.

5.14 It is the Commissioner's view that an acceptable interpretation by a taxpayer will only be able to be established where either:

(1) that interpretation is in fact correct or

(2) where incorrect but, viewed objectively, the interpretation was "about as likely as not to be correct" (being close to or around 50% likely to be correct).

Summary of the "about as likely as not to be correct" standard

5.15 The standard required under section 141B(1)(b) incorporates the following:

- The standard is to be judged objectively.
- There must be, at least, about an equal chance of an interpretation being likely to be correct as it is to be incorrect. The use of the word "about" makes the test less stringent but the interpretation still needs to be close to or around 50% likely to be correct.
- For the application of section 141B(7), in determining whether an unacceptable interpretation has been taken in arriving at a tax position, matters that must be considered include all Court or Tribunal decisions issued up to one month before the tax position has been taken, and (in the absence of such case law) relevant extrinsic materials.

6. Changes relevant to a taxpayer's tax position taken on or after 1 April 2003

6.1 As a result of the amendments enacted by the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, for tax positions taken on or after 1 April 2003, section 141B no longer refers to an unacceptable "interpretation or interpretation of an application of a tax law". The amended section 141B requires that a person has taken an "unacceptable tax position". There is generally continuity of the application of section 141B to tax positions that are unacceptable because, when viewed objectively, those tax positions do not meet the standard of being about as likely as not to be correct. Accordingly, the **earlier discussion on section 141B, prior to this amendment, remains applicable, except in respect of the changes discussed in this Part 6 of the Statement**.

6.2 Sections 141B(1) and (1B) provide these main changes. However, for convenience, the section 141B is set out in full below:

141B UNACCEPTABLE TAX POSITION

(1) A taxpayer takes an unacceptable tax position if, viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct.

(1B) A taxpayer does not take an unacceptable tax position merely by making a mistake in the calculation or recording of numbers in a return

(2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an unacceptable tax position and the tax shortfall arising from the taxpayer's tax position is more than both—

(a) $20,000; and

(b) the lesser of $250,000 and 1% of the taxpayer's total tax figure for the relevant return period.

(3) For the purposes of this section, a taxpayer's total tax figure is—

(a) The amount of tax paid or payable by the taxpayer in respect of the return period for which the taxpayer takes the taxpayer's tax position before[[, in the case of income tax, any group offset election or subvention payment; or

(b) Where the taxpayer has no tax to pay in respect of the return period—

(i) Except in the case of GST, an amount equal to the product of—

(A) The net loss of a taxpayer in respect of the return period, ascertained in accordance with the provisions of the Income Tax Act 1994, are to be used in this subsection as if they had a positive value; and

(B) The basic rate of income tax for companies in the relevant return period; or

(ii) In the case of GST, the refund of tax to which the taxpayer is entitled for the return period,—

that is shown as tax paid or payable, or as net losses of the taxpayer, or as a refund to which the taxpayer is entitled, in a tax return provided . . . by the taxpayer for the return period.

(4) Where subsection (2) applies, the shortfall penalty payable is 20% of the resulting tax shortfall.

(5) For the purposes of this section, the question whether any interpretation of a tax law is acceptable or unacceptable shall

be determined as at the time at which the taxpayer takes the taxpayer's tax position.

[Effective 21 June 2005, section 141B(5) states:

(5) For the purposes of this section, the question whether any tax position is acceptable or unacceptable shall be determined as at the time at which the taxpayer takes the taxpayer's tax position.]

(6) For tax positions involving an interpretation of a tax law or laws that have been taken into account in a tax return, the time the taxpayer takes the taxpayer's tax position is when the taxpayer provides the return containing the taxpayer's tax position. If the taxpayer does not provide a tax return for a return period, the taxpayer takes the taxpayer's tax position on the due date for providing the tax return.

[Effective 21 June 2005, section 141B(6) states:

(6) The time at which a taxpayer takes a tax position for a return period is -
- (a) the time at which the taxpayer provides the return containing the taxpayer's tax position, if the taxpayer provides a tax return for the return period:
- (b) the due date for providing the tax return for the return period, if the taxpayer does not provide a tax return for the return period.]

(7) The matters that must be considered in determining whether the taxpayer has taken an unacceptable tax position include—
- (a) The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and
- (b) Decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).

(8) For the purpose of determining whether the resulting tax shortfall is in excess of the amounts specified in subsection (2)(b),—
- (a) A tax return provided by—
- (i) A partnership; or
  - (ii) Any other group of persons that derive or incur amounts jointly or that are assessed together,—

is to be treated as if it were a tax return of every taxpayer who is a partner in the partnership or person in such group; and
- (b) The tax rate in a return period applying to a partnership is deemed to be the same as the basic rate of income tax for companies for the relevant period.

(9) The amounts or the percentage specified in subsection (2) may be varied from time to time by the Governor-General by Order in Council.

[emphasis added]

6.3 Therefore, under the revised section 141B, there is no longer a requirement for the taxpayer to have made an interpretation or an interpretation of an application of a tax law, when taking their tax position. The requirement is merely that the taxpayer takes a tax position that is unacceptable if, when viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct. There is no longer a requirement that the taxpayer has turned his or her mind to a tax law. The requirement is merely that a tax position has been taken, which does not meet the required standard.

Tax position

6.4 The definition of "tax position" remains substantially unchanged from that applicable to tax positions taken before 1 April 2003. The text change is confined to first two lines. "With regard to tax possible under one or more tax laws" has been replaced by "with regard to tax under one or more tax laws". "Including without limitation" has been replaced by "including without limitation a position or approach with regard to". The first two lines of the definition applicable before 1 April 2003 are:

> "**Tax position**" means a position or approach with regard to tax possible under one or more tax laws, including without limitation —

6.5 The full definition for application on or after 1 April 2003 is set out again below:

> "**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:

6.6 Unacceptable interpretations of the law fall within section 141B. Tax shortfalls which are not related to interpretations of the tax laws are also covered by section 141B.

Making a mistake in the calculation or recording of numbers in a return

6.7 Section 141B(1B) provides:

> (1B) A taxpayer does not take an unacceptable tax position merely by making a mistake in the calculation or recording of numbers in a return.

6.8 As there is currently no case authority on the interpretation of this section, a view on what is considered a mistake in the "recording of numbers in a return" will taken, based on an analysis of the text and consideration of the purpose of the provision.

6.9 If the taxpayer has merely made a mistake in the calculation or recording of numbers in a return, section 141B(1B) provides that that is not an unacceptable tax position. It is considered that the meaning of a "mistake in a calculation in a return" is clear, therefore, the following discussion will focus on the meaning of a "mistake in the recording of numbers in a return".

Meaning of return

6.10 Section 141B(1B) merely refers to "a return", but as section 141B is applicable to the taxpayer's tax position, it is appropriate to consider the definition of "taxpayer's tax position". This is defined as:

> "**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.

6.11 In the context of section 141B(1B), it is a "tax return" that is relevant. Therefore, in section 141B(1B), it is considered that the "return" refers to a "tax return". "Tax return" is defined in section 3(1) of the Act:

> "**Tax return**" means a form or document that a taxpayer is required by a tax law—
> (a) To complete; and
> (b) To provide to the Commissioner,—
> whether in electronic or written form and whether provided in respect of a period or not; and also includes a tax form issued by another taxpayer that the taxpayer provides to the Commissioner:

6.12 As a "tax return" means a form or document that a taxpayer is required by a tax law to complete and to provide to the Commissioner, it is considered that a mistake in the "recording of numbers in a return" refers to a mistake in the recording of numbers in a form or document that a taxpayer is required by a tax law to complete and to provide to the Commissioner.

6.13 Generally, working papers are not required to be provided to the Commissioner and, therefore, are not part of the "return". However, it is considered that, in some situations, where numbers are unintentionally mis-recorded in the working papers, the mistake is carried through into the tax return and the result is a tax shortfall, this is a mistake of the recording of numbers within the section 141B(1B) exclusion and, as such, the taxpayer has not taken an unacceptable tax position. However, in such a circumstance, pursuant to section 141A(4), the taxpayer may still be liable for a tax shortfall penalty for not taking reasonable care.

Meaning of mistake

6.14 Following the enactment of section 141B(1B), commentary on the section was included in the Tax Information Bulletin ("TIB") Vol. 15, No 5 (May 2003), in an item entitled "Tax compliance, standards and penalties". The item explains what was intended by the enactment, as follows:

> New sections 141A(4) and 141B(1B) clarify that a taxpayer has not taken an unacceptable tax position if a tax shortfall is the result of calculation mistake or **by mis-recording numbers in a return**. It was never intended that the unacceptable tax position penalty apply to calculation or **processing mistakes**. Rather, this penalty applies when a tax shortfall arises because a tax position is not as likely as not to be correct, whether or not the taxpayer actually interpreted the law. If a mistake is of such a magnitude that the mistake breaches the reasonable care standard that shortfall penalty applies. [emphasis added]

6.15 Although "mistake" is not defined in either the Act or in the Income Tax Act 1994, the "Concise Oxford Dictionary" 10th Ed. Revised (2002) provides the following definition:

> **mistake** n. a thing which is not correct, an error of judgment

6.16 It is considered that the relevant part of this definition, in the context of section 141B(1B), is merely that something is not correct. This view supports the approach of the above quotation from the TIB item: a mistake in the recording of numbers in a return refers to the mis-recording of numbers or processing errors in a return. This view is also appropriate to the context, as section 141B(1) refers to "making a mistake in the calculation or recording of numbers".

6.17 An "error of judgment" that results in an unacceptable tax position is, effectively, a tax position taken by choice, albeit that it is the incorrect choice. As such it is considered that this meaning of "mistake" is not that intended by the legislation, in this context of providing an exclusion from a shortfall penalty for taking an unacceptable tax position. Therefore, in the following discussion, mistake will be considered to mean merely "a thing which is not correct", rather than an "error of judgment".

6.18 Accordingly, it is considered that, in situations where it is clear that figures have been mistakenly transposed in a return, for example 102 instead of 201, for the purpose of section 141B(1B), such an error is a mistake in the recording of a number in a return. In such a situation, it is considered that a taxpayer has not taken an unacceptable tax position. The mistake is unintentional, not an error of judgment and, therefore, it is within the exclusion set out in section 141B(1B). An error of judgment is considered to be a deliberate choice.

6.19 Such a mistake in the calculation or recording of numbers in a return can occur in a number of situations. For example, a number could be correctly recorded in the working papers, but incorrectly transferred into the tax return. Alternatively, the working papers could be incorrect through a mis-recording of numbers or a calculation mistake and these mistakes could be carried through into the return. In this latter situation, section 141B(1B) would apply, as there is still either a mistake in the calculation, or in the recording of numbers and those numbers are contained in a return. In each of the situations, if the result is a tax shortfall, it is considered that section 141B(1B) provides that the taxpayer has not taken an unacceptable tax position.

6.20 For completeness, it is noted that, although in this situation the taxpayer is considered not to have taken an unacceptable tax position, section 141A(4) provides that "a taxpayer who makes a mistake in the calculation or recording of numbers in a return" is not excluded from being liable for a penalty for not taking reasonable care. Section 141A(4) states:

> (4) Subsection (3) and section 141B(1B) do not exclude a taxpayer who makes a mistake in the calculation or recording of numbers in a return from being liable for a penalty for not taking reasonable care.

6.21 It is noted that section 141A(4) does not provide that a taxpayer who makes a mistake in the calculation or recording of numbers in a return is necessarily liable for a shortfall penalty under section 141A for not taking reasonable care, merely that such penalty is not excluded.

Conclusion

6.22 Based on the above discussion, it is concluded that a mistake in the recording of numbers in a return refers to an unintentional mis-recording of numbers in the taxpayer's tax return. Such a mistake may be, for example, the transposition of numbers (e.g. 102 instead of 201). It is considered that, in the context of section 141B(1B), the intention is to provide an exclusion from a shortfall penalty for taking an unacceptable tax position where the mistake is a result of a calculation error or a mis-recording of numbers in the taxpayer's tax return. It is considered that a mistake, which is an error of judgment, is not within the ambit of section 141B(1B) exclusion, whereas it is considered that a taxpayer who takes a tax position as a result of an unintentional mis-recording of numbers in a return, has not taken an unacceptable tax position, although the taxpayer may still be liable for not taking reasonable care pursuant to section 141A(4).

6.23 It is considered that where section 141B(1B) refers to a mistake in the recording of numbers in a return, the section is referring to situations where an incorrect number is unintentionally recorded in the tax return; where the right number is recorded in the working papers, but it is transferred incorrectly into the tax return; and where an unintentional mis-recording of a number is made in the working papers, and that mistake is carried through into the tax return. In each of the situations, if the result is a tax shortfall, it is considered that section 141B(1B) provides that the taxpayer has not taken an unacceptable tax position, although the taxpayer may still be liable for not taking reasonable care pursuant to section 141A(4).

Monetary threshold increased

6.24 With application to tax positions taken on or after 1 April 2003, section 141B(2) provides that the threshold levels, which the tax shortfall must exceed for a taxpayer to be liable for a tax shortfall penalty for taking an unacceptable tax position, have increased. The current section 141B(2) states:

> (2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an unacceptable tax position and the tax shortfall arising from the taxpayer's tax position is more than both—

(a) $20,000; and
(b) the lesser of $250,000 and 1% of the taxpayer's total tax figure for the relevant return period.

6.25 Therefore, as discussed above (refer paragraphs 4.19 – 4.25), to ascertain if the taxpayer's tax shortfall exceeds the threshold levels, it is necessary to establish the taxpayer's total tax figure. Section 141B(3) defines "total tax figure" (refer paragraph 3.3). Section 141B(4) then sets out the amount of the shortfall penalty (refer paragraph 3.3).

Timing and acceptability of "any interpretation"

6.26 Section 141B(5) provides that the time at which the acceptability or not of any interpretation of a tax law is determined at the time a tax position is taken and as discussed above, section 141B(7) sets out the matters that must be considered in relation to whether an unacceptable tax position has been taken. These two sections were not changed by the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003. Section 141B(5) states:

> (5) For the purposes of this section, the question whether any interpretation of a tax law is acceptable or unacceptable shall be determined as at the time at which the taxpayer takes the taxpayer's tax position.

Reductions, increases and a cap on the shortfall penalty

Overview

6.27 The shortfall penalty for taking an unacceptable tax position is subject to various possible reductions of the shortfall penalty payable. These are provided for under sections 141FB (previous behaviour), 141G (voluntary disclosure), 141H (disclosure of unacceptable tax position) and 141I (temporary shortfall). However, section 141J (limitation of reduction) provides where the taxpayer qualifies for a reduction in shortfall penalty under section 141G or section 141H and also where there is a temporary tax shortfall, the shortfall penalty is reduced only once and that will be by 75%.

6.28 Although the above sections provide for the shortfall penalty to be reduced in a number of situations, the shortfall penalty payable for taking an unacceptable tax position is also subject to 25% increase, under section 141K, if the taxpayer obstructs the Commissioner in determining the correct tax position.

6.29 Section 141JAA, which applies only to tax positions taken on or after 1 April 2003, provides that the shortfall penalty payable by the taxpayer for taking an unacceptable tax position may not be more than $50,000, if the taxpayer voluntarily discloses the tax shortfall or the Commission determines the shortfall within specified time limits, and provided section 141K does not apply.

Shortfall penalty reductions

6.30 Section 141FB provides for the tax shortfall penalty of 20%, for taking an unacceptable tax position, to be reduced by 50% to a tax shortfall penalty of 10%, where there has been prior good compliance by the taxpayer. For section 141FB, effective 26 March 2003 until 21 December 2004, this is provided in section 141FB(2), refer paragraph 3.8 above. For section 141FB, effective 21 December 2004, this is provided in section 141FB(2), as set out in paragraph 3.9 above.

6.31 In the case of a penalty for taking an unacceptable tax position in respect of GST, FBT, PAYE or RWT, if the taxpayer has not been liable to pay a tax shortfall penalty relating to the same tax type within the previous two years (not being a penalty reduced for voluntary disclosure), the 50% reduction provided for under section 141FB can apply. For other tax types, there is a four year period of "good behaviour" required. The reduction applies separately for each type of tax such as PAYE, income tax and GST. A penalty imposed in respect of one tax does not mean that the reduction is not available for other tax types. If the taxpayer has made a voluntary disclosure, this does not interrupt the taxpayer's good behaviour period. Section 141FB applies to a tax position that a taxpayer takes on or after 1 April 2000, unless the taxpayer is liable to pay a shortfall penalty before 26 March 2003.

6.32 Section 141G provides for reducing the shortfall penalty for voluntary disclosure of the tax shortfall. The relevant parts of section 141G state:

> **141G. Reduction in penalty for voluntary disclosure of tax shortfall—**
>
> (1) A shortfall penalty payable by a taxpayer under any of sections 141A to 141EB may be reduced if, in the Commissioner's opinion, the taxpayer makes a full voluntary disclosure to the Commissioner of all the details of the tax shortfall, either—
> (a) Before the taxpayer is first notified of a pending tax audit or investigation (referred to in this section as "pre-notification disclosure"); or
> (b) After the taxpayer is notified of a pending tax audit or investigation, but before the Commissioner starts the audit or investigation (referred to in this section as "post-notification disclosure").
>
> …
>
> (3) The level by which the shortfall penalty is reduced—

(a) For pre-notification disclosure is 75%:
(b) For post-notification disclosure is 40%.

(4) A taxpayer is deemed to have been notified of a pending tax audit or investigation, or that the tax audit or investigation has started, if—
(a) The taxpayer; or
(b) An officer of the taxpayer; or
(c) A shareholder of the taxpayer, if the taxpayer is a close company; or
(d) A tax adviser acting for the taxpayer; or
(e) A partner in partnership with the taxpayer; or
(f) A person acting for or on behalf of or as a fiduciary of the taxpayer,—
is notified of the pending tax audit or investigation, or that the tax audit or investigation has started.

(5) An audit or investigation starts at the earlier of—
(a) The end of the first interview an officer of the Department has with the taxpayer or the taxpayer's representative after the taxpayer receives the notice referred to in subsection (4); and
(b) The time when—
(i) An officer of the Department inspects information (including books or records) of the taxpayer after the taxpayer receives the notice referred to in subsection (4); and
(ii) The taxpayer is notified of the inspection.

6.33 Section 141H provides that the shortfall penalty payable by the taxpayer may be reduced if the taxpayer makes adequate disclosure of the taxpayer's tax position at the time the tax position is taken. Section 141H states:

141H. Reduction for disclosure of unacceptable tax position—

(1) A shortfall penalty payable by a taxpayer under section 141B or section 141D maybe reduced if, in the Commissioner's opinion, the taxpayer makes adequate disclosure of the taxpayer's tax position at the time, determined under section 141B(6), the taxpayer takes the taxpayer's tax position.
(2) The level by which a shortfall penalty is to be reduced for adequate disclosure is 75%.
(3) The Commissioner may from time to time specify—
(a) The type of information required for adequate disclosure; and
(b) The form in which the information must be provided.

6.34 Where there is a temporary tax shortfall, section 141I provides for reducing the shortfall penalty. The relevant part of the section states:

141I. Reduction where temporary shortfall—

(1) A shortfall penalty payable by a taxpayer under any of sections 141A to 141EB must be reduced if and to the extent that the tax shortfall is temporary.
(2) The level by which a shortfall penalty is to be reduced for a temporary tax shortfall is 75% of the penalty that applies to all or that part of the tax shortfall that is a temporary tax shortfall.
(3) A tax shortfall is a temporary tax shortfall for a return period if the Commissioner is satisfied that—
(a) The tax shortfall has been permanently reversed or corrected in an earlier or later return period, so that (disregarding penalties or interest) the taxpayer pays the correct amount of tax or calculates and returns the correct tax liability in respect of the item or matter that gave rise to the tax shortfall; and
(b) No tax shortfall will arise in a later return period in respect of a similar item or matter; and
(c) No arrangement exists in any return period which has the purpose or effect of creating a further related tax deferral or advantage; and
(d) The tax shortfall was permanently reversed or corrected before the taxpayer is first notified of a pending tax audit or investigation.

The application of section 141J

6.35 A shortfall penalty payable by the taxpayer, for example, under section 141B (for taking an unacceptable tax position), may qualify to be reduced under sections 141G or 141H (for making a voluntary disclosure in accordance with these provisions), and also under section 141I (if the shortfall penalty is payable in respect of a temporary shortfall). Therefore, it appears that these provisions have the potential to provide for a 75% reduction under section 141G or 141H and also a 75% reduction under section 141I. However, in this situation, section 141J limits the reductions available for the taxpayer. Section 141J provides:

141J. Limitation on reduction of shortfall penalty—

If—
(a) A taxpayer who is liable to pay a shortfall penalty makes a voluntary disclosure in accordance with section 141G or section 141H; and
(b) The shortfall penalty is payable in respect of a temporary tax shortfall,—

> **the shortfall penalty—**
> (c) **Is to be reduced only once;** and
> (d) Will be reduced by 75%.
> [emphasis added]

6.36 Accordingly, where a taxpayer may qualify for their shortfall penalty payable under sections 141B to be reduced under more than one of the reduction provisions, section 141J provides that the shortfall penalty will be reduced only once and, as set out in section 141J(d), that reduction will be 75%.

6.37 As section 141J provides for a limitation on some shortfall penalty reductions, this section can only effectively apply after the application of the reduction provisions.

Shortfall penalty monetary cap

6.38 Section 141JAA provides that "a shortfall penalty payable by a taxpayer … for taking an unacceptable tax position, may not be more than $50,000", provided the other conditions of the section are met. The section states:

> (1) Despite section 141J, a shortfall penalty payable by a taxpayer for not taking reasonable care, or for taking an unacceptable tax position, may not be more than $50,000 if the taxpayer voluntarily discloses the shortfall, or the Commissioner determines the shortfall, no later than the date that is the later of—
>
> …

6.39 It is noted that, unlike sections 141FB, 141G, 141H and 141I, section 141JAA does not actually "reduce" the penalty. It merely provides that the penalty may not be more than $50,000. The only way in which it can be determined that the penalty would otherwise be more than $50,000 is to work through the sections needed to calculate the shortfall penalty payable. Therefore, it is necessary to consider section 141B, under which the penalty originates, and then apply the reduction provisions, as modified by section 141J.

6.40 It is also noted that although section 141JAA refers to "a shortfall penalty payable by the taxpayer … for taking an unacceptable tax position", the section does not specifically refer to section 141B; the provision under which this shortfall penalty originates.

6.41 This contrasts with the terminology used in the reduction provisions, which specifically refers to the shortfall penalty payable under the relevant originating section. (For the present discussion, the originating sections are sections 141A to 141EB, but, as noted above, section 141JAA is applicable only to shortfall penalties that originate from section 141A and 141B.)

6.42 It is considered that this difference in the terminology supports the view that the shortfall penalty payable by the taxpayer, to which section 141JAA applies, is that payable under the originating provision, but reduced by the applicable reduction provisions. Accordingly, it would be not be appropriate for section 141JAA to refer to the penalty payable under section 141B, when the penalty that originated under that provision may have been reduced by the application of the reduction provisions.

6.43 Although the use of "despite" at the beginning of section 141JAA could indicate that section 141JAA is to be applied either "after applying" section 141J or "to the exclusion of" section 141J, it is considered that, in the context of the whole of section 141, section 141JAA should not be applied to the exclusion of section 141J, but after section 141J (in situations where the application of section 141J is appropriate). Therefore, it would follow that section 141JAA should also be applied after the reduction provisions.

6.44 The alpha numeric order of the particular provisions also supports the view that section 141JAA should be applied after the application of the reduction provisions. Although not conclusive in itself, it is considered that, had it been intended that the capping provision of section 141JAA be applied before the reduction sections, the capping provision would have been inserted in a location before the reduction provisions.

6.45 Accordingly, it is considered that it is only by applying the reduction provisions first, that the "shortfall penalty payable", to which section 141JAA refers, can be determined. The application of section 141JAA can then provide a cap to the shortfall penalty, if the time requirements of section 141JAA are met.

6.46 A final point to consider, in this respect, is the reason for setting the cap for these penalties at $50,000 under section 141JAA. The discussion document "[2001] Taxpayer compliance, standards and penalties: a review" states:

> 8.35 A monetary cap on the shortfall penalty for lack of reasonable care will be introduced. Such a cap would ensure that the penalty for such breaches is not out of step with other monetary penalties imposed under the Tax Administration Act. In addition, a cap is likely to reduce compliance and administrative costs as taxpayers will have less incentive to dispute the imposition of a penalty they consider unfair.
>
> 8.36 **The cap will be set at $50,000 per tax position, which equates to the maximum criminal penalty imposed under the Income Tax Act**. Taxpayers who deliberately attempt to abuse the existence of this cap will risk incurring the uncapped

> gross carelessness penalty (set at 40 percent of the shortfall). To ensure that taxpayers still have an incentive to take reasonable care over very significant tax positions, the cap will be limited to those shortfalls identified through voluntary disclosure or Inland Revenue audit within two months of filing the return.
> [emphasis added]

6.47 Accordingly, if section 141JAA was applied before the other reduction provisions, the correspondence with the maximum criminal penalty would be defeated.

Section 141JAA applies after the reduction provisions

6.48 It is considered that the shortfall penalties payable by the taxpayer for taking an unacceptable tax position under section 141B, are reduced, as applicable by the reduction provisions, before the application of section 141JAA. It is also considered that section 141JAA is applied after the application of section 141J, if the taxpayer is eligible for deductions under sections 141G or 141H and also section 141I. Accordingly, under the reduction provisions, the shortfall penalty payable by the taxpayer for not taking reasonable care or for taking an unacceptable tax position is to be reduced only once and that is by 75%. Then, if section 141JAA is also applicable, the resultant shortfall penalty payable for taking an unacceptable tax position may not be more than $50,000 if the taxpayer either voluntarily discloses the shortfall or the Commissioner determines the shortfall within the given time periods.

6.49 This view also means that the intended correspondence of the capped shortfall penalty under section 141JAA with the maximum criminal penalty is maintained.

6.50 Therefore, it is the Commissioner's view that the section 141JAA cap of $50,000, on the shortfall penalty payable by a taxpayer for taking an unacceptable tax position is only applicable after all other relevant reductions have been made, including the limiting provision of section 141J.

6.51 It should be noted that section 141JAA also applies to shortfall penalties under section 141A for not taking reasonable care. This is discussed in the Interpretation Statement IS00053.

Section 141JAA provides

6.52 Prima facie, there are two situations when the shortfall penalty for taking an unacceptable tax position may not be more than $50,000. These are:

- if the taxpayer voluntarily discloses the shortfall; or
- the Commissioner determines the shortfall,

provided these events occur within the time constraints set out in section 141JAA (1)(a) and (b).

6.53 "Commissioner" is defined in section 3 as meaning:

> "**Commissioner of Inland Revenue**", or "**Commissioner**", means the Commissioner of Inland Revenue appointed or deemed to have been appointed under this Act; and includes any person for the time being authorised to exercise or perform any of the powers, duties, or functions of the Commissioner:

6.54 Accordingly, in the clause "the Commissioner determines the shortfall", it is considered that "Commissioner" (i.e. the person who determines the shortfall) includes any person for the time being authorised to exercise or perform any of the powers, duties or functions of the Commissioner.

6.55 Before going on to consider the meaning of "determines" in this context, it is helpful to consider what it is that must be determined, i.e. "the shortfall".

What is "the shortfall"?

6.56 In the context of section 141JAA, it is considered that "the shortfall", that the Commissioner determines, refers to "the tax shortfall", as it is only in respect of a tax shortfall that the shortfall penalties, referred to in section 141JAA, apply. "**Tax shortfall**" is defined in section 3 of the Act as follows:

> "**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:

6.57 A tax shortfall indicates that there is a difference between the correct tax position and the taxpayer's tax position. Therefore, it is considered that if "the Commissioner determines the shortfall"; the Commissioner determines the difference between the correct tax position and the taxpayer's tax position. As the difference is between two amounts, it is considered that section 141JAA requires the Commissioner to determine the amount of the tax shortfall.

6.58 It follows that for section 141JAA to apply, which only applies if "a shortfall penalty is payable by a taxpayer for not taking reasonable care or for taking an unacceptable tax position", the amount of the tax shortfall must be disclosed by the taxpayer or determined by the Commissioner.

Ordinary meaning of determines

6.59 As "determines" is not defined in section 3 of the Act or section OB 1 of the Income Tax Act 1994, it is appropriate to consider the ordinary meaning of the word.

6.60 The "Shorter Oxford Dictionary" 5th Ed (2002) provides the following relevant definition:

> **determine:** verb trans 4 settle or decide (a dispute, controversy, etc., or a sentence, conclusion, issue, etc.) as a judge or arbiter

6.61 Using this definition, it appears that, in the context of section 141JAA, when "the Commissioner determines the shortfall", the Commissioner makes a decision about the shortfall or decides the shortfall. Typically, the Commissioner would decide the shortfall as a result of an audit, but the means by which "the Commissioner determines the shortfall" are not defined in the legislation.

Interpretation of "determines" by the courts

6.62 The meaning of "determines" was discussed by the Supreme Court of Victoria in *City of Heidelberg v McPherson* [1964] VR 783. The relevant section in that case used the words "… where any council determines that the execution of any works of the construction of a private street is necessary". Although the provision is different, it is helpful to note that the Court described the meaning of "determines" as "decides or forms the opinion" (p 785).

6.63 In *Muir v Inland Revenue Commissioners* [1966] 3 All ER 38, the English Court of Appeal considered the meaning of the phrase:

> An appeal, once determined by the commissioners, shall be final, and neither the determination of the commissioners nor the assessment made thereon shall be altered, except … (s. 50 (2) Income Tax Act 1952)

6.64 The court held that:

> It is plain that there the words "determined" and "determination" are equivalent to: decided and decision … (p 48)

6.65 Although referring to the word in the past tense, this view mirrors that of the Australian court in the City of Heidelberg case: to determine is to decide. This meaning is consistent with the ordinary meaning of "determine", i.e. "settle or decide as a judge or arbiter". In each case, something is decided by the party who is determining it.

6.66 To consider the application of this meaning in the context of the legislation, it is appropriate to consider some of the background to the introduction of section 141JAA.

Background to the introduction of section 141JAA

6.67 Section 141JAA was inserted in the Act by the enactment of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003.

6.68 As part of the preliminary consultation process prior to enactment of the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, a discussion document, "Taxpayer compliance, standards and penalties: a review (August 2001) was issued for comment. Under Chapter 8 of the document, "Two further issues relating to shortfall penalties", the document outlined the following background and proposed reform:

> **Additional issue: A cap on the penalty for lack of reasonable care**
>
> **Background**
>
> 8.33 Where a tax shortfall is large, the corresponding shortfall penalty is also large. In most cases this is appropriate – but the Government is concerned about the application of the lack of reasonable care penalty to very large errors which are speedily identified and correct. For example, a business taxpayer under calculated their GST outputs by $45 million and, because no systems were in place to identify this shortfall, the under-calculation results in unpaid GST of $5 million. Inland Revenue identities the shortfall and determines a lack of reasonable care: the penalty is $1 million.
>
> 8.34 Given the nature of the breach, the Government considered the size of the penalty in such cases is excessive.
>
> **Proposed reform**
>
> 8.35 A monetary cap on the shortfall penalty for lack of reasonable care will be introduced. Such a cap would ensure that the penalty for such breaches is not out of step with other monetary penalties imposed under the Tax Administration Act. In addition, a cap is likely to reduce compliance and administrative costs as taxpayers will have less incentive to dispute the imposition of a penalty they consider unfair.
>
> 8.36 The cap will be set at $50,000 per tax position, which equates to the maximum criminal penalty imposed under the Income Tax Act. Taxpayers who deliberately attempt to abuse the existence of this cap will risk incurring the uncapped gross carelessness penalty (set at 40 percent of the shortfall). To ensure that taxpayers still have an incentive to take reasonable care over very significant tax positions, the **cap will be limited to those shortfalls identified**

> **through voluntary disclosure or Inland Revenue audit within two months of filing the return.**
>
> [emphasis added]

6.69 From the discussion document, it appears that the intention of the proposed reform was that the cap would be limited to tax shortfalls identified through voluntary disclosure or Inland Revenue audit, within the required time limit.

Timing of "determines"

6.70 It is noted that no reference was made in the proposal for the legislation requiring either a NOPA to be issued or for an agreed adjustment to be obtained, before the $50,000 monetary cap be applied to the shortfall penalty payable by the taxpayer. Further, a NOPA is the first step in the disputes resolution process and the imposition of the penalty will not necessarily be a matter which proceeds under the disputes resolution process. Therefore, it is not be appropriate to equate the word "determines" with "has issued a NOPA".

6.71 For similar reasons, "the Commissioner determines" cannot relate to the decision of Adjudication (or other assessing officer), at the end of the disputes resolution process, as the time limits in the disputes resolution process for the various documents are such that this process could not be completed within the time set out in section 141JAA. It is also inappropriate to require an adjustment to be agreed by the taxpayer within the time limits as the taxpayer has a statutory right to dispute or challenge their assessment. Further, section 141JAA refers to "determines" in the context of the situation where "the Commissioner determines the tax shortfall". Therefore, on the legislation, it appears that once the Commissioner (or one of his authorised officers) decides that there is a relevant tax shortfall within the time limits set out in the section, the cap applies.

6.72 This view is supported by the fact that the legislation provides for no particular process by which the Commissioner communicates the fact to the taxpayer that a shortfall is "determined" or decided within the terms of section 141JAA. The legislation merely requires either the voluntary disclosure of a shortfall by the taxpayer within the time limits, for which a penalty in excess of $50,000 is payable by the taxpayer for taking an unacceptable tax position, or the Commissioner decides that there is such a shortfall within the time limits, is sufficient for the application of the section.

Conclusion

6.73 Section 141JAA was enacted with the intention of rewarding the taxpayer who voluntarily discloses a shortfall within the given time limits or for whom the Commissioner decides that there is a relevant shortfall, within the given time limits. This latter case may occur, for example, in an audit where an investigator identifies a relevant tax shortfall. The essence is that, for the monetary cap to apply, the relevant tax shortfall is either disclosed by the taxpayer within the time limits or a person, authorised by the Commissioner, decides that there is a relevant tax shortfall, within the time limits. The section does not require the Commissioner to issue a NOPA in respect of the tax shortfall or obtain an agreed adjustment within the given time limits. Accordingly, it is considered that the taxpayer should benefit from the monetary cap as soon as the Commissioner (as defined in section 3) decides the amount of the shortfall, if the time requirements of section 141JAA are met and section 141K does not apply.

Related Standard Practice Statements

6.74 The following related Standard Practice Statements may also assist in the interpretation and application of the above adjustment provisions to the shortfall penalty for taking an unacceptable tax position:

- INV-231 *Temporary Shortfall – permanent reversal* (published in T*ax 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)); and
- INV-295 *Reduction of Shortfall Penalties* for Previous Behaviour (published in Tax Information Bulletin Vol 16, No 3 (April 2004)).

Summary - changes relevant to a taxpayer's tax position taken on or after 1 April 2003

- To take an unacceptable tax position, a taxpayer is required to take a tax position that when viewed objectively fails to meet the standard of being about as likely as not to be correct. *Section 141B(1)*
- Although the making of an "interpretation or an interpretation of an application of a tax law" is no longer required for the application of section 141B, an unacceptable interpretation of the law can give rise to an unacceptable tax position. *Section 141B(6)*
- The threshold levels which a tax shortfall must exceed to qualify as an unacceptable tax position have increased. *Section 141B(2)*
- Penalties of 20% may be reduced to 10% as a result of a taxpayer's prior good compliance. *Sections 141FB(2) and (3)*
- Subject to certain conditions, the shortfall penalty for not taking reasonable or taking an unacceptable tax position is capped at $50,000. *Section 141JAA(1)*.

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.

FOREIGN CURRENCY AMOUNTS – CONVERSION TO NEW ZEALAND CURRENCY

The tables in this item list exchange rates acceptable to Inland Revenue for converting foreign currency amounts to New Zealand dollars under the controlled foreign company (CFC) and foreign investment fund (FIF) rules for the six months ending 30 September 2005.

The conversion rates for the first six months of each income year are published in the *Tax Information Bulletin* following the end of the September quarter, and the rates for the full 12 months are published at the end of each income year.

To convert foreign currency amounts to New Zealand dollars for any country listed, divide the foreign currency amount by the exchange rate shown.

Note
If you need an exchange rate for a country or a day not listed in the following Tables A and B, please contact one of New Zealand's major trading banks.

Round the exchange rate calculations to four decimal places wherever possible.

Table A

Use this table to convert foreign currency amounts to New Zealand dollars for:

- branch equivalent income or loss under the CFC rules pursuant to section EX 21(4) of the Income Tax Act 2004
- FIF income or loss calculated under the branch equivalent method pursuant to sections EX 21(4), EX 38(1)(b), EX 43 and CQ 2(2) of the Income Tax Act 2004
- foreign tax credits calculated under the branch equivalent method for a CFC under section LC 4(1)(b) of the Income Tax Act 2004
- foreign tax credits calculated under the branch equivalent method for a FIF under sections EX 43(8) & (9) and LC 4(1)(b) of the Income Tax Act 2004
- FIF income or loss calculated under the accounting profits, comparative value (except if Table B applies, ie where the market value of the FIF interest as at the end of the income year or/and at the end of the preceding income year is not zero) or deemed rate of return methods under section EX 42(7), EX 44(7) and EX 45(15) of the Income Tax Act 2004.

Key

x
y

"x" is the exchange rate on the 15th day of the month, or if no exchange rates were quoted on that day, on the next working day on which they were quoted. (Top row for each country)

"y" is the average of the mid-month exchange rates for that month and the previous 11 months. (Bottom row for each country)

Example 1

A CFC resident in Hong Kong has an accounting period ending on 30 September 2005. Branch equivalent income for the period 1 October 2004 to 30 September 2005 is 200,000 Hong Kong dollars (HKD).

HKD 200,000 ÷ 5.4909 = $36,423.90

A similar calculation would be needed for a FIF using the branch equivalent or accounting profits methods.

Example 2

A taxpayer with a 31 March balance date purchases shares in a Philippines company (which is a FIF) for 350,000 pesos (PHP) on 7 September 2005. Using the comparative value or deemed rate of return methods, the cost is converted as follows:

PHP 350,000 ÷ 39.3426 = $8,896.21

Alternatively, the exchange rate can be calculated by averaging the exchange rates "x" that apply to each complete month in the foreign company's accounting period.

Example 3

A CFC resident in Singapore was formed on 21 April 2005 and has a balance date of 31 March 2006. During the period from 1 May 2005 to 30 September 2005, branch equivalent income of 500,000 Singapore dollars (SGD) was derived.

(i) Calculating the average monthly exchange rate for the complete months May-September 2005.

1.1776 + 1.1851 + 1.1386 + 1.1652 + 1.1870 = 5.8535 ÷ 5 = 1.1707

(ii) Conversion to New Zealand currency:

SGD 500,000 ÷ 1.1707 = $427,094.90

Table B

Table B lists the end-of-month exchange rates acceptable to Inland Revenue for the six-month period ending 30 September 2005. Use this table for converting foreign currency amounts to New Zealand dollars for:

- Items "a" (market value of the FIF interest on the last day of the income year) and "c" (market value of the FIF interest on the last day of the preceding income year) of the comparative value formula under section EX 44(1) of the Income Tax Act 2004.
- Foreign tax credits paid on the last day of any month calculated under the branch equivalent method for a CFC or FIF under section LC 4(1)(a) of the Income Tax Act 2004.

Example 4

A New Zealand resident with a balance date of 30 September 2005 held an interest in a FIF resident in Thailand. The market value of the FIF interest at 30 September 2005 (item "a" of the comparative value formula) was 500,000 Thailand baht (THB).

THB 500,000 ÷ 28.1793 = $17,743.52

Note
An overseas currency converter is available under **How to** on our website **www.ird.govt.nz**

Table A: Mid-month and 12-month cumulative average exchange rate

Country	Currency	Code	15-Apr-05 12-month rate	15-May-05 12-month rate	15-Jun-05 12-month rate	15-Jul-05 12-month rate	15-Aug-05 12-month rate	15-Sep-05 12-month rate
Australia	Dollar	AUD	0.9357	0.9349	0.9264	0.8985	0.9151	0.9181
			0.9189	0.9240	0.9255	0.9253	0.9242	0.9221
Bahrain	Dollar	BHD	0.2718	0.2682	0.2665	0.2544	0.2661	0.2667
			0.2561	0.2595	0.2621	0.2628	0.2642	0.2656
Canada	Dollar	CAD	0.8960	0.9009	0.8861	0.8181	0.8457	0.8359
			0.8633	0.8686	0.8710	0.8673	0.8653	0.8636
China	Yuan	CNY	5.9746	5.8960	5.8546	5.5881	5.7283	5.7214
			5.6317	5.7057	5.7633	5.7787	5.7980	5.8179
Denmark	Krone	DKK	4.1914	4.1761	4.3724	4.1621	4.2338	4.2933
			3.9899	4.0245	4.0700	4.0907	4.1106	4.1338
European Community	Euro	EUR	0.5628	0.5641	0.5881	0.5587	0.5681	0.5766
			0.5371	0.5419	0.5478	0.5505	0.5530	0.5560
Fiji	Dollar	FJD	1.1922	1.1835	1.1940	1.1564	1.1823	1.1885
			1.1618	1.1689	1.1753	1.1767	1.1780	1.1792
French Polynesia	Franc	XPF	66.9043	67.0321	69.9164	66.4206	67.5500	68.5558
			64.0496	64.6246	65.3292	65.6438	65.9453	66.0973
Hong Kong	Dollar	HKD	5.6275	5.5533	5.4995	5.2524	5.4915	5.4939
			5.3003	5.3713	5.4242	5.4377	5.4633	5.4909
India	Rupee	INR	31.2284	30.6240	30.5723	29.1225	30.4693	30.7526
			30.2099	30.4955	30.7093	30.6655	30.6658	30.7191
Indonesia	Rupiah	IDR	6,872.0800	6,749.2150	6,798.0650	6,616.8700	6,928.9550	7,093.5550
			6,265.6413	6,372.4988	6,451.3242	6,515.3158	6,580.7138	6,668.7421
Japan	Yen	JPY	77.9960	76.3937	77.4008	75.8054	77.3514	78.0938
			73.3149	73.9484	74.6216	75.0051	75.3281	75.7873
Korea	Won	KOR	735.5600	715.9100	717.9550	698.1000	717.2500	726.2350
			745.6921	745.5533	744.9175	740.4133	736.2700	733.5763
Kuwait	Dollar	KWD	0.2105	0.2077	0.2067	0.1971	0.2060	0.2066
			0.1996	0.2021	0.2040	0.2044	0.2053	0.2062
Malaysia	Ringgit	MYR	2.7430	2.7069	2.6879	2.5656	2.6531	2.6696
			2.5855	2.6195	2.6460	2.6530	2.6639	2.6766
Norway	Krone	NOK	4.6330	4.5391	4.6109	4.4119	4.4787	4.4927
			4.4348	4.4665	4.4950	4.4901	4.4929	4.4899
Pakistan	Rupee	PKR	42.4440	42.0584	41.9497	40.0037	41.8995	42.0226
			39.8087	40.4322	40.9456	41.1368	41.4031	41.6662
Papua New Guinea	Kina	PGK	2.2242	2.1950	2.1801	2.0862	2.1616	2.1421
			2.0825	2.1085	2.1290	2.1349	2.1456	2.1581
Philippines	Peso	PHP	38.9542	38.2742	38.7445	37.4844	39.1217	39.3426
			37.5208	37.9213	38.2705	38.3783	38.5733	38.7700
Singapore	Dollar	SGD	1.1921	1.1776	1.1851	1.1386	1.1652	1.1870
			1.1351	1.1467	1.1563	1.1587	1.1611	1.1669
Solomon Islands	Dollar	SBD	5.3568	5.2872	5.2669	5.0282	5.2621	5.3051
			5.0608	5.1215	5.1684	5.1854	5.2087	5.2353
South Africa	Rand	ZAR	4.4951	4.4369	4.8377	4.4682	4.4787	4.4890
			4.2397	4.2708	4.3324	4.3754	4.3892	4.4048
Sri Lanka	Rupee	LKR	71.4567	70.8246	70.5695	67.4819	70.9653	71.4654
			68.6710	69.6368	70.3428	70.4240	70.7645	70.9508
Sweden	Krona	SEK	5.1485	5.1513	5.4374	5.2283	5.2736	5.3665
			4.8827	4.9259	4.9863	5.0186	5.0451	5.0831

Country	Currency	Code	15-Apr-05	15-May-05	15-Jun-05	15-Jul-05	15-Aug-05	15-Sep-05
			12-month rate	12-month rate	12-month rate	12-month rate	12-month rate	12-month rate
Switzerland	Franc	CHF	0.8751	0.8714	0.9035	0.8712	0.8817	0.8908
			0.8260	0.8338	0.8438	0.8496	0.8544	0.8592
Taiwan	Dollar	TAI	22.8950	22.3050	22.2550	21.5700	22.5600	23.2150
			22.2983	22.4667	22.5800	22.5454	22.5421	22.6067
Thailand	Baht	THB	28.3346	27.9180	28.6290	27.9672	28.5920	28.6956
			27.0009	27.2946	27.5796	27.7156	27.8179	27.9443
Tonga	Pa'anga	TOP	1.3650	1.3482	1.3414	1.3180	1.3577	1.3730
			1.3202	1.3319	1.3409	1.3446	1.3494	1.3543
United Kingdom	Pound	GBP	0.3836	0.3851	0.3919	0.3847	0.3896	0.3884
			0.3674	0.3710	0.3750	0.3777	0.3802	0.3818
United States	Dollar	USD	0.7222	0.7128	0.7081	0.6760	0.7074	0.7086
			0.6807	0.6898	0.6968	0.6987	0.7022	0.7060
Vanuatu	Vatu	VUV	77.3106	77.2822	77.5410	74.1430	76.8099	77.1804
			74.6138	75.2903	75.7972	75.8692	76.0146	76.1393
Western Samoa	Tala	WST	1.9042	1.8781	1.8793	1.8240	1.8764	1.9161
			1.8561	1.8684	1.8781	1.8782	1.8784	1.8820

Table B: End-of-month exchange rates

Country	Currencies	Code	30-Apr-05	31-May-05	30-Jun-05	31-Jul-05	31 -Aug-05	30-Sep-05
Australia	Dollar	AUD	0.9348	0.9357	0.9176	0.8992	0.9211	0.9092
Bahrain	Dollar	BHD	0.2742	0.2678	0.2633	0.2573	0.2595	0.2603
Canada	Dollar	CAD	0.9116	0.8937	0.8596	0.8420	0.8211	0.8097
China	Yuan	CNY	6.0301	5.8894	5.7888	5.5408	5.5820	5.5839
Denmark	Krone	DKK	4.2022	4.2360	4.3148	4.1942	4.1938	4.2782
European Community	Euro	EUR	0.5647	0.5708	0.5794	0.5630	0.5639	0.5740
Fiji	Dollar	FJD	1.2017	1.1958	1.1809	1.1642	1.1702	1.1764
French Polynesia	Franc	XPF	67.0375	67.8376	68.8834	66.9448	67.0359	68.0896
Hong Kong	Dollar	HKD	5.6767	5.5350	5.4326	5.3084	5.3533	5.3630
India	Rupee	INR	31.4844	30.6963	30.1556	29.3419	29.9596	30.1207
Indonesia	Rupiah	IDR	6,976.2850	6,750.1550	6,788.0600	6,721.1150	7,205.1300	7137.5200
Japan	Yen	JPY	77.1744	76.8195	77.2009	76.5639	76.6334	78.0689
Korea	Won	KOR	730.0050	713.1800	721.0750	702.2750	712.8450	718.4750
Kuwait	Dollar	KWD	0.2124	0.2074	0.2039	0.1993	0.2010	0.2016
Malaysia	Ringgit	MYR	2.7685	2.7039	2.6577	2.5632	2.6002	2.6056
Norway	Krone	NOK	4.5877	4.5403	4.5808	4.4612	4.4673	4.4989
Pakistan	Rupee	PKR	42.8396	41.8187	41.4677	40.4481	40.8278	41.1693
Papua New Guinea	Kina	PGK	2.2278	2.1821	2.1524	2.1094	2.0998	2.0696
Philippines	Peso	PHP	39.3470	38.4305	38.7607	37.9515	38.3867	38.6207
Singapore	Dollar	SGD	1.1969	1.1798	1.1759	1.1342	1.1588	1.1668
Solomon Islands	Dollar	SBD	5.4040	5.3721	5.2050	5.0855	5.1191	5.1641
South Africa	Rand	ZAR	4.4451	4.7259	4.6720	4.5126	4.5050	4.3852
Sri Lanka	Rupee	LKR	72.2160	70.8415	69.6785	68.5122	69.3479	69.8853
Sweden	Krona	SEK	5.1596	5.2316	5.4685	5.2927	5.2661	5.3592
Switzerland	Franc	CHF	0.8685	0.8815	0.8969	0.8781	0.8743	0.8937
Taiwan	Dollar	TAI	22.8900	22.1650	22.1200	21.8000	22.5150	22.9600
Thailand	Baht	THB	28.5257	28.4346	28.6227	28.1784	28.2128	28.1793
Tonga	Pa'anga	TOP	1.3702	1.3491	1.3337	1.3356	1.3282	1.3528
United Kingdom	Pound	GBP	0.3820	0.3905	0.3871	0.3891	0.3859	0.3923
United States	Dollar	USD	0.7286	0.7122	0.6998	0.6837	0.6895	0.6917
Vanuatu	Vatu	VUV	77.9695	77.6653	76.7453	74.7999	75.0016	75.8434
Western Samoa	Tala	WST	1.9247	1.9124	1.8930	1.8381	1.8531	1.8579

NEW LEGISLATION

WITHHOLDING TAX CHANGES FOR FRUIT PICKING CONTRACTORS

The withholding payment regulations have been amended so that they apply to all fruit picking contractors, whether or not they operate through a company. The amendments have been made in response to concerns about tax evasion in the fruit picking industry because payments made to companies were automatically excluded from the withholding tax rules, while payments made to non-company based businesses were subject to the withholding payment rules.

The amendments were made by Order in Council on 29 August 2005.

They apply from 1 April 2006 for services provided for fruit and wine growing activities in the nature of pruning, thinning, picking and packing.

The exclusion previously available for companies in the fruit picking industry has been subject to abuse. This is because of the ease with which companies can be set up and dissolved and therefore used by fruit picking contractors to evade the payment of income tax and PAYE. This has been a concern because enforcement action becomes more difficult when highly mobile contractors leave the country before paying tax in New Zealand.

The main change is to ensure all payments made to contractors are reported to Inland Revenue. The changes also provide that 15% of a payment to a contractor will be required to be withheld as tax unless a contractor holds a certificate from Inland Revenue for a lower or a zero withholding rate.

Notice of the Order was made on 1 September 2005 in the *New Zealand Gazette*.

Income Tax (Withholding Payments) Amendment Regulations 2005 (2005/253)

Correction

EXCESS IMPUTATION CREDITS

In the item published under the section “New Legislation” in the *Tax Information Bulletin,* Vol 17, No 7 (September 2005), pp44–45, please note that the reference to … *excess imputation credits received by an individual or incorporated body*…under the heading “Key Features” (p45) should read …*excess imputation credits received by an individual or* ***un****incorporated body*… (emphasis added).

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, Court of Appeal, Privy Council and the Supreme Court.

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.

HIGH COURT DISMISSES JUDICIAL REVIEW APPLICATION

Case:	Rogerson v Commissioner of Inland Revenue
Decision date:	13 June 2005
Act:	Tax Administration Act 1994 (TAA), sections 6, 6A, 176, 141E and 177C
Keywords:	Judicial review, settlement offer, highest net revenue, reasonableness of settlement offers

Summary

The Commissioner's refusals to accept the taxpayer's settlement offers were not unreasonable and did not breach any statutory duties under section 176 TAA: *Raynel & Anor v Commissioner of Inland Revenue* (2004) 21 NZTC 18,583 and *Clarke v Commissioner of Inland Revenue*; *Money v Commissioner of Inland Revenue* (unreported HC Auckland CIV 2003-404-5631 and CIV 2003-404-2148 applied). The Commissioner was entitled, indeed obliged, to take into account that acceptance of the amounts variously offered, which did not nearly equate with the taxpayer's tax debt, would not protect the integrity of the tax system, nor ultimately collect the highest tax revenue, given the taxpayer's compliance history. The Commissioner was precluded by sections 141E(2) and 177C TAA from accepting the settlement offers.

Facts

The taxpayer, Mr Rogerson, had a long history of non-compliance with tax reporting requirements and non-payment of tax assessed in relation to various related entities, resulting in significant tax arrears.

On 30 May 2000 the Commissioner met with the taxpayer to discuss the arrears. The taxpayer said he had no funds. Subsequently the Commissioner issued NOPAs to the taxpayer and the related entities. The assessments included shortfall penalties. On 18 March 2003 the Commissioner obtained judgment against the taxpayer for $18,658.55.

During 2003, Mr Rogerson made several offers of settlement, which the Commissioner rejected. The Commissioner contended the offers could not be accepted because: (1) section 177C(3) TAA precluded the Commissioner from writing off any amount of outstanding tax if the taxpayer was liable to pay a shortfall penalty for evasion or similar act in respect of that tax; and (2) such a write-off would not promote the principles of voluntary compliance, protection of the integrity of the tax system or ultimately collect the highest net revenue.

The Commissioner applied to have the taxpayer adjudged bankrupt. The taxpayer sought to have the bankruptcy application set aside on the grounds that the Commissioner's refusal of the settlement offers was in breach of the statutory duties under sections 6A and 176 TAA, as there was no evidence that bankruptcy would recover the most revenue over time. The taxpayer also argued that he was suffering from a mental condition that led him to ignore the letters from the Commissioner demanding payment.

Subsequently the Commissioner prosecuted Mr Rogerson and a related entity under section 143A(1)(d) TAA for nine counts of knowingly applying or permitting the application of amounts deducted from employees' wages for a purpose other than payment to the Commissioner. The jury found on the balance of probabilities that the failures to account were due to a cause beyond the taxpayer's control (being his mental disorder of which evidence was given at the trial), and that the amounts due had been accounted for.

Following the trial the Commissioner declined to accept a further settlement offer from the taxpayer because of his continued non-compliance with his tax obligations and his continued failure to pay the outstanding tax.

The taxpayer applied for judicial review of the Commissioner's decisions to refuse to accept the settlement offers. He argued that the decisions:

(1) breached a statutory duty to collect the highest revenue over time; and (2) were unreasonable. He also sought a declaration setting aside the bankruptcy application and the shortfall penalties.

Decision

Potter J, finding for the Commissioner, dismissed the application for judicial review.

Potter J held that the Commissioner had not breached a statutory duty to collect the highest revenue over time in refusing to accept the settlement offers. The duty imposed by secction 6A(3) TAA applied notwithstanding anything in the Inland Revenue Acts, and therefore section 6A(3) TAA prevailed over section 176 TAA. The obligation to collect the highest net revenue was not absolute. The Commissioner was only required to take steps to recover revenue which were practicable and lawful. The Commissioner was required to have regard to the resources available, the importance of promoting compliance (especially voluntary compliance) by all taxpayers, and the compliance costs incurred by taxpayers. The cornerstone of the taxation system was the concept of voluntary compliance. Taxpayers who complied with the requirements of the Inland Revenue Acts were entitled to expect that appropriate and (where necessary) firm action would be taken against taxpayers who shirked their obligations. The Commissioner was entitled, indeed obliged, to take into account that acceptance of the amounts variously offered, which did not nearly equate with the taxpayer's tax debt, would not protect the integrity of the tax system, nor ultimately collect the highest tax revenue, given the taxpayer's compliance history.

On the second issue, Potter J held that the Commissioner's decision to decline to accept the settlement offers was not unreasonable. Section 141E(2) TAA which provided for situations when a shortfall penalty for tax evasion under section 141E(1)(b) TAA should not be chargeable, expressly required as a condition of the exercise by the Commissioner of a discretion in the matter, that the taxpayer had honoured the taxpayer's obligations to the Commissioner and to the taxation system as a whole, by accounting for the deduction for which the taxpayer was liable. Unless the Commissioner could be satisfied that the taxpayer had met those obligations, the Commissioner was precluded from exercising a discretion under section 141E(2) TAA. Similarly under section 177C, outstanding tax including shortfall penalties could not be written off if the taxpayer was liable for shortfall penalties for evasion. The taxpayer had not accounted for the amount of the deductions in terms of s 141E(2) TAA and there was no jurisdiction under section 177C TAA to write off tax because the taxpayer remained liable for shortfall penalties. For the Commissioner to exercise the discretion under section 141E(2) the Commissioner had to be satisfied that the failure to account for the relevant deductions within the prescribed time was due to illness, accident or some other cause beyond the taxpayer's control. The Commissioner was concerned with a much longer period than the period to which the nine charges related, and with a wider spectrum of non-compliance. The discretion under section 141E(2) TAA (if it arose) had to be exercised solely by the Commissioner.

There was nothing irrational or unreasonable about the Commissioner's decision, or the matters taken into account in reaching it.

TAXPAYER CHALLENGES COMMISSIONER'S POWER TO ENFORCE A GUARANTEE

Case:	Michael John Peterson v Commissioner of Inland Revenue (Judicial Review)
Decision date:	31 August 2005
Act:	Tax Administration Act 1994
Keywords:	Securities, guarantee, debt, judicial review.

Summary

The Applicant gave the Commissioner a guarantee in respect of his company's tax debt. The company went into liquidation with the debt outstanding and Commissioner called on the applicant to honour the guarantee. The review proceedings were commenced on the grounds that Commissioner had no power to recover monies other than tax and that the guarantee fell outside the legislation. The Court held that the power to receive a guarantee also included the power to collect on it.

Facts

The applicant was the director of a company which, after the loss of some lucrative agencies, found itself with large debt and tax arrears. The company negotiated an instalment arrangement with the department but fell behind with its payments.

In an attempt to avoid liquidation of the company, the director sought to re-negotiate another instalment arrangement. The department agreed to withdraw liquidation proceedings only if the director provided a personal guarantee in respect of the company's tax debt. At that stage the debt amounted to $76,223.20 and the applicant provided the guarantee in the form of an executed deed for that sum. Four months later the company was placed in liquidation by resolution of its shareholders. The guarantee was sought in reliance upon section 7A Tax Administration Act 1994 (TAA).

The department made demand for the amount outstanding under the guarantee and when it was not forthcoming, commenced proceedings in the District Court to recover the amount. The applicant then commenced these proceedings for judicial review alleging the Commissioner had acted ultra vires in seeking to collect the debt.

Decision

The applicant submitted that recovery under a guarantee is damages (relying upon the decision of the House of Lords in *Moschi v Lep Air Services Limited* [1972] All ER 393) and that the Commissioner does not have the power to seek damages under the Inland Revenue Acts. He submitted also that it follows that section 7A is ineffective when it comes to the enforcement of securities as they are not taxes.

The Commissioner argued that it was irrelevant whether the security was owing as a debt or in damages as the language and intent of section 7A was clear, unambiguous and consistent with the Commissioner's section 6A duty to collect the highest net revenue over time. He also argued that, if it were necessary to determine the matter, the deed characterised the sum as debt rather than damages in *Moshi* terms.

His Honour Justice Lang noted that their Lordships in the *Moshi* case considered that there were two types of guarantee: the first where a guarantor undertook to assume the principal debtor's liability in the case of that person's default; and the second where the guarantor assures the creditor that the principal debtor will perform its liabilities. In this latter case the default of the debtor places the guarantor in breach of his or her contract. Thus the creditor can sue the guarantor for damages. The applicant argued that the deed in question fell into that category. His Honour said:

> "In the circumstances of this case, however, I have concluded that it does not matter whether the Commissioner's claim is characterised as one for damages or for the recovery of a debt. The real issue in either case is whether the Commissioner has the power to enforce the guarantee by instituting proceedings…"

Having reviewed both sections 6 and 7A Justice Lang said that "If the Commissioner was entitled to accept Mr Peterson's guarantee, it would seem logical that he must also be entitled to enforce it."

> "It needs to be remembered, however, that the purpose of most, if not all, securities is to secure the performance of an obligation. It does not matter whether the obligation is primarily that of the principal debtor or a guarantor who provides the security. The importance and value of the security flows from the fact that it provides the recipient with security for the performance of the obligation, regardless of the identity of the person having the primary responsibility for performing that obligation."

His Honour also said that the wording of the section was "sufficiently wide to enable the Commissioner to take security in any situation where that may be necessary to secure the performance of a taxpayer's obligations."

Justice Lang also confirmed that money collected under a guarantee or other security is collected in respect of a tax obligation in one form or other. He referred by way of analogy to the Commissioner's right to enforce other securities such as mortgages or charges. "The fruits of any judgment would then be applied in satisfaction of the tax obligation…"

He concluded:

> "I consider that the meaning of the legislation is plain. Once it has been established that the Commissioner has validly accepted a security in terms of section 7A(1)(a), it must follow that he is also entitled under section 7A(1)(e) to enforce or realise that security in any way that is open to him."

GROUP LOSS OFFSET RULES UNAVAILABLE TO LOSS ATTRIBUTING QUALIFYING COMPANY (LAQC)

Case:	TRA No 006/04, Decision No 015/2005
Decision date:	12 September 2005
Act:	Income Tax Act 1994
Keywords:	Group Loss Offset rules, LAQC losses

Summary

The TRA decided that an LAQC must attribute all losses to its shareholders. It cannot allocate part of its losses to another company in the group under the loss offset rules.

Facts

The Taxpayer was an LAQC. It incurred a tax loss of $1,200,526.09 for the year ended 31 March 2002.

The Taxpayer elected to offset $44,426 of the loss for the 2002 year to companies within the same group of companies pursuant to section IG 2. The remaining $1,156,199.09 was attributed to its shareholders in terms of section HG 16.

The Commissioner contended the loss offset rules applicable to LAQC's override the general provision applying to offset of losses between members of a group of companies. The result was that he required all losses be attributed under the LAQC rules.

Decision

The TRA found that the *maxim generalia specialibus non derogant* does not apply to this case. In other words, the group loss offset provisions are not so repugnant to, or inconsistent with the LAQC provisions that the two are incapable of standing together.

The TRA observed that section HG 16(1)(a) and (b) plainly enact that all losses incurred by a LAQC in any qualifying year are deemed to be incurred by the shareholders and are unavailable for any other purpose.

The TRA noted that the effect of section HG 16(1)(c) is to ensure that certain losses which cannot be brought within

the LAQC regime remain available to be offset against future profits, or against the profits of other companies within the group. An example is losses which cannot be attributed because they occurred when the company did not satisfy s. HG 14. Otherwise LAQC losses must be attributed.

NO TENABLE CAUSE OF ACTION

Case: TRA No 147/04, Decision No 13/2005

Decision date: 12 September 2005

Act: Goods and Services Tax Act

Keywords: Interlocutory application, Strike Out, Summary Judgment Cancelled Supply, GST Invoices.

Summary

The Disputant's Notice of Claim was struck out as it disclosed no tenable course of action.

Facts

This was an application by the Commissioner to have the Disputant's Notice of Claim struck out or in the alternative for summary judgment against the Disputants.

The Disputants (14 in total) had each entered into an agreement for the purchase of an apartment in respect of which they claimed GST input credits on the deposit paid in the GST period ended 31 December 2001.

Prior to claiming the input credit the contracts for the purchase of the apartments were cancelled.

The Disputants never held a tax invoice in respect of the GST input credits claimed.

The Commissioner refused to invoke section 24(6) of the GST Act to determine that tax invoices were not required on the inputs claimed. This decision was never challenged by the Disputants in a Notice of Proposed Adjustment.

In October 2004 the Commissioner issued notices of assessment to each of the Disputants disallowing the input credits claimed.

On 16 December 2004 the Disputants filed a Notice of Claim challenging those assessments, on the following grounds.

a. There was no valid assessment

b. The supplies the subject of the proceedings had not been cancelled

c. The Commissioner had failed to require the vendor to produce tax invoices

d. The Commissioner has "*tacitly or implicitly agreed with the vendor that it need not produce a tax invoice….*"

e. The Commissioner and the Authority have the power to waive the requirement for the production of a tax invoice

f. Section 25 of the GST Act does not apply.

Decision

His Honour decided to grant the Commissioner's strike out application. In doing so His Honour decided it was unnecessary and would be unhelpful to deal with what he called the Commissioner's novel application for summary judgment.

In considering the strike-out application His Honour rejected the submission of the Disputants that a Notice of Claim can only be struck out for "procedural reasons". His Honour noted that this was not supported by authority and was contrary to many cases in which Notices of Claim had been struck out where there had been no tenable cause of action or were otherwise vexatious or frivolous.

In granting the strike out application His Honour stated it was plain that the contracts were cancelled before the Disputants made their input claims and that from the time of cancellation the Disputants were not entitled to any input credit. His Honour went on to state that had an input credit been paid the purchaser would have been required to immediately refund it to the Commissioner pursuant to section 25 of the GST Act.

In regards to the Disputants submission that there had been no lawful assessments issued by the Commissioner His Honour stated that such a submission was simply contrary to the facts.

His Honour then dealt with the Disputants submission that the Commissioners refusal to invoke section 24(6) (to not require a tax invoice) validated the cause of action. His Honour rejected this proposition and accepted that on the facts of this case (where the input credit would have been immediately refundable) the Commissioner's decision not to invoke section 24(6) was the correct one.

His Honour concluded that the Commissioner had demonstrated that the Disputants had no tenable cause of action and because the Notice of Claim was not capable of amendment it would therefore be struck out.

NOTICE OF DEFENCE STRUCK OUT

Case: TRA No 09/012, Decision No 012/2005

Decision date: 8 August 2005

Act: Income Tax Act 1994

Keywords: section HK11, asset stripping, strike out

Summary

The Commissioner's notices of defence in proceedings relating to two section HK11 assessments were struck out.

Facts

The third and fourth disputants (C & G) were assessed under section HK11 as being personally liable for the tax assessed on a company of which they were directors and shareholders. They applied to strike out the Commissioner's notices of defence.

A Ltd was in receivership and reached a compromise with its creditor. Under the compromise, in consideration for a payment the creditor assigned A Ltd's debt to the family trusts of C & G. A Ltd continued to claim deductions for interest payments and its tax losses were transferred to another company. In early 1998 C & G's shares in A Ltd were sold to H for nominal consideration.

A Ltd was removed from the register of companies in July 2000 for failing to file an annual return. In August 2000 the Commissioner sought to have A Ltd restored to the register, but this move was opposed by H. The Commissioner took no further steps to have A Ltd restored.

In March 2001 the Commissioner issued an amended assessment to A Ltd for the 1993 income tax year. The Commissioner, in his covering letter stated that he held C & G jointly and severally liable for the 1993 income tax liability of A Ltd under section HK 11.

Counsel for C & G submitted that based on the legislative history of section HK11, the Commissioner was required to have alleged in his statement of defence that the assets of A Ltd were stripped for the benefit of C & G.

Decision

The Authority considered the legislative purpose of section HK11 by examining its history. Its equivalent provision was first enacted in 1937 to stop gold mining companies from distributing all of their capital via dividends before they were assessed for income tax. The speech of the Minister of Finance in 1991 amending section 276 of the Income Tax Act 1976 was then considered. This speech made reference to asset stripping and depletion. The Authority then considered the decision of the High Court in *Spencer v Commissioner of Inland Revenue* (2004) 21 NZTC 18,825 which had also made a reference to depletion of assets.

Against this background, the Authority held that the legislative intent behind the section was clear. There must be an arrangement that results in the company being unable to pay its tax. The hearing authority must then consider whether there is something about that arrangement which produces that result. That "something" must involve the depletion of assets. The Authority further held that this stripping or depletion of assets must be to the benefit of the director assessed under section HK11.

The Authority held that section HK11 is not a general recovery provision. This aspect of the decision is based on the dicta comments of Thomas J in *BNZ Finance v Holland* (1997) 18 NZTC 13,156 at 13,176.

TRANSACTION HELD TO INVOLVE TAX AVOIDANCE UNDER GOODS AND SERVICES TAX ACT

Case:	Glenharrow Holdings Limited v Commissioner of Inland Revenue
Decision date:	23 August 2005
Act:	Goods and Services Tax Act 1985
Keywords:	sham, avoidance, principal purpose, taxable supplies

Summary

The principal purpose of the transfer of a mining licence was to make a taxable supply. Although the Commissioner did not establish the purchase price was a sham, the transaction involved tax avoidance as the price was grossly inflated.

Facts

This case concerns a GST input claim by Glenharrow Holdings Limited (Glenharrow) relating to the purchase of a greenstone mining licence. The mining licence was issued in November 1990 and due to expire on 14 November 2000. The licence was purchased in 1996 by Michael Meates for $10,000. In 1997 Mr Meates was approached by Gerard Fahey who wanted to purchase the licence. The Court found that Mr Fahey believed the licence area contained a large amount of valuable stone.

Mr Meates asked his cousin, who was not a registered valuer but who had studied valuation as part of his MBA, to value the licence. The cousin "conservatively" valued the licence at $45 million.

Mr Meates told Mr Fahey he would sell the licence for $45 million. Mr Fahey agreed to this price on the basis there would be vendor finance. A skeleton agreement provided for an $80,000 deposit, with the remaining $44,920,000 to be vendor financed. *Glenharrow*, a company controlled by Mr Fahey was nominated as the purchaser. The $80,000 deposit was paid and the licence was transferred to *Glenharrow*. There was an exhange of cheques between the parties, and mortgages executed over the licence and shares in the company in favour of Mr Meates. A debenture over the company's assets was also registered in favour of Mr Meates.

The Commissioner allowed an input claim for the deposit of $80,000. The application for a refund of $4,991,111 for the balance of $44,920,000 was rejected by the Commissioner.

In 1999 *Glenharrow* applied to the Minister of Commerce to vary the conditions of the mining licence and extend the term of the licence to 42 years. It later applied for a new licence to be issued. Both requests were rejected by the Minister. *Glenharrow* sought judicial review in two separate proceedings. *Glenharrow* was successful

in the High Court with its first proceeding. However, *Glenharrow* was unsuccessful in the second review proceeding, which it appealed to the Court of Appeal and Privy Council, losing both appeals.

By the time the licence expired in November 2000 *Glenharrow* had mined only 36 tonnes of rock. The Commissioner argued that there was no credible reason why *Glenharrow* could not have worked the licence from the time that it was purchased to support the position that the vendor financed portion of the purchase price was a sham.

Decision

Sham

Chisholm J found that the full purchase price was not a sham. The evidence of the parties involved in the valuation and transaction was found to be credible. Although "much too optimistic", the parties intended to be bound to the full amount of the transaction. Chisholm J also found the valuation was flawed, but this did not detract from the fact it was genuinely believed to be accurate. The delays in *Glenharrow* commencing mining operations were attributable to Department of Conservation issues and thus the lack of mining activity not found to be inconsistent with the intention of the parties.

Principal purpose of making taxable supplies

The Commissioner submitted that the principal purpose of the parties was to claim a GST refund. Chisholm J held that "principal purpose" was the primary purpose that the taxpayer had in mind or view, and that it is not synonymous with intention or motive. The principal purpose has to be ascertained at the time the transaction takes place, and that actions may speak louder than words in determining what the principal purpose was. Chisholm J also found that both subjective and objective factors may be taken into account. Chisholm J found that the principal purpose of the transaction was to make a taxable supply.

Tax avoidance

This case fell under section 76 prior to its amendment, which required the intent and application of the Act to be defeated. It was common ground that there was an 'arrangement' on the facts of the case. The core issue was whether the Act required a subjective intent to defeat the intent and application of the Act, or whether an objective test should be applied. Chishom J adopted the reasoning in *Ch'elle Properties* [2004] NZLR 274 which held the section was objective in its application. His Honour held that notwithstanding being worded differently from section BG1, section 76 had "all the trappings of an anti-avoidance provision" and needed to be interpreted in a way that would give effect to Parliament's intent.

Chisholm J canvassed factual issues as to whether the consideration was grossly inflated. He concluded that it was. It therefore followed that the intent and application of the Act was defeated. His Honour roughly calculated the required reconstruction to be in the vicinity of $8 million, but requires the valuation expert of the Commissioner to revise his calculations and that a memorandum be submitted to the Court.

TAXPAYER MUST ISSUE NOPA TO "DEFAULT" ASSESSMENT

Case:	Donald Eugene Allen v Commissioner of Inland Revenue
Decision date:	8 September 2005
Act:	Tax Administration Act 1994
Keywords:	"Default" assessment, disputes resolution, challenge

Summary

To dispute a "default" assessment a taxpayer must issue a NOPA and file the missing return within the two month response period

Facts

The taxpayer failed to file tax returns for the 2000 and 2001 years. On 8 April 2002, the Commissioner issued "default assessments" under section 106 of the Tax Administration Act 1994 ("TAA"). A notice of claim challenging the default assessments was filed by the taxpayer on 15 July 2002 in the TRA. To bring proceedings under section 138B of the TAA the taxpayer also filed an application under section 138D of the TAA to commence proceedings outside the response period. On 31 July 2002 the taxpayer filed nil income tax returns for the 2000 and 2001 years. Doubting it was necessary to give the TRA jurisdiction to hear the challenge the Taxpayer also filed a "without prejudice" Notice of Proposed Adjustment ("NOPA"). The NOPA contained a request under s 89K of the TAA effectively requesting that the Commissioner accept the NOPA even though it was filed out of time. The Commissioner declined the request on 23 September 2002 and issued a conditional Notice of Response ("NOR") on 30 September 2002 advising the NOPA was rejected as being out of time as well as invalid and the tax assessed in the assessment made on 8 April 2002 was owed.

On 16 September 2002 in the TRA the Commissioner filed a Notice of Defence and an application to strike out the taxpayer's Notice of Claim. In February and March 2003 the Commissioner's strike-out application was heard by the TRA. The TRA declined the application on 19 May 2003. The present judicial review proceedings were then commenced in the High Court by the Commissioner.

Decision

After discussing the three possible interpretations put forward, the Court accepted the interpretation put forward

by the Commissioner. That is:

> "(a) A default assessment under section 106 is not to be treated differently from any other kind of assessment for the purposes of Part 4A and Part 8A. Accordingly, there is no basis to construe section 89D as displacing the normal requirement for a taxpayer who wishes to contest an assessment to do so by way of a NOPA and this must be done within the applicable response period: section 89D(5). That is a prerequisite to the entitlement to challenge an assessment by commencing proceedings in the TRA for the purposes of section 138B(3).
>
> (b) The only difference in the process for challenging a default assessment from the process which applies to other assessments is the requirement in section 89D(2) that the taxpayer must furnish a tax return for the assessment period. However, that provision does not provide for the tax return to be the method of disputing the default assessment. Rather, it is a requirement which must be met before the taxpayer may issue a NOPA under section 89D(1). That is why section 89D(1) is expressed to be subject to section 89D(2).
>
> (c) If a taxpayer wishing to challenge a default assessment has not issued a NOPA in respect of the default assessment under section 89D(1) within the applicable response period in accordance with section 89D(5), which the taxpayer cannot do until he or she has furnished a return of income for the assessment period under section 89D(2), then that taxpayer will not have met the requirements of section 138B(3) and will not therefore be entitled to challenge the default assessment by commencing proceedings in the TRA.
>
> (d) If a taxpayer has commenced proceedings in the TRA without complying with section 138B(3), in the circumstances of the present case, the Commissioner may apply to have the challenge commenced by the taxpayer struck out under section 138H and the TRA should strike the proceedings out because of the failure to comply with section 138B."

The Court also agreed that section 89D(1) of the TAA is expressed in permissive terms ("may") because there is no obligation on a taxpayer to challenge a "default" assessment. However, once the taxpayer decides to assert his or her entitlement to challenge the assessment, then he or she must do so in accordance with the process outlined in Part IVA.

COMMISSIONER OF INLAND REVENUE NOT ABLE TO ADD NEW GROUND TO APPEAL

Case:	Commissioner of Inland Revenue v Zentrum Holdings Ltd and Ngahemi Properties Ltd, as the Zentrum Holdings Group
Decision date:	16 September 2005
Act:	Tax Administration Act 1994
Keywords:	appeal, additional ground, NOPA, SOP

Summary

Justice Keane found in favour of the taxpayer, holding that the Commissioner was unable to raise an issue on appeal that had not been argued in the TRA.

Facts

This is a decision on a threshold issue raised in the appeal.

The matter concerns the affairs of a company, Zentrum Holdings Ltd ("Zentrum"), and Mr John Brown, who is involved as director and principal shareholder. Another of Mr Brown's companies, Marketing Management Holdings Ltd ("MMHL"), is also involved in the arrangements in question. At the relevant time, MMHL had approximately $1 million in losses, and owed further money to Mr Brown.

Mr Brown made significant monetary contributions to Zentrum, which were held on capital account in a shareholder's current account. In 1997, it was agreed between Mr Brown and Zentrum's other director/ shareholder that part of Mr Brown's current account ($1.2m) would be replaced with an interest-bearing loan to Zentrum from Mr Brown.

Mr Brown assigned his loan to Zentrum to MMHL. Zentrum agreed to pay interest to MMHL at the rate of 25%. MMHL paid $1.2m to Mr Brown as consideration, which Mr Brown immediately re-advanced to MMHL. This was done on terms whereby, although interest was to be paid to Mr Brown, it was not required unless it was requested. There was no record that interest was ever requested.

MMHL set off the interest received from Zentrum against its accumulated losses, and made repayments of capital to Mr Brown. The Commissioner assessed this transaction as tax avoidance.

The matter was heard in the TRA. Zentrum was successful in vindicating the returns of income it had made, and the Commissioner's assessments were set aside.

The Commissioner appealed, and included in his grounds for appeal the contention that the transactions in which the disputed assessments were founded amounted to a sham. This issue had not been argued in the TRA, and

arose out of evidence given by the taxpayer during the course of the TRA hearing, and documents discovered afterwards.

The taxpayer challenged the Commissioner's ability to include this issue, arguing that the Commissioner is confined to the grounds on which he made the assessments.

Decision

The Commissioner submitted that whether or not he should be entitled to advance the sham argument should be determined according to the usual principles governing any new point taken on a civil appeal, and without reference *Commissioner of Inland Revenue v V H Farnsworth* [1984] 1NZLR 428 (CA). The Commissioner relied on *Perkowski v Wellington City Corporation* – while a new ground will not usually be permitted if further findings of fact are required, it can be entertained if open on the record of the Court below.

The Commissioner argued that Zentrum was aware of the Commissioner's concerns about the authenticity of the transactions, as they were set out in the Commissioner's first NOPA, as well as responded to in Zentrum's NOR. The Commissioner contended also that Zentrum's second NOR (in response to a further NOPA) went wider and "identified questions, which could only go to whether the transactions were genuine or fictional." These issues were the subject of evidence and submission in the TRA, and central to the Authority's decision.

Finally, the Commissioner contended that Zentrum did not disclose, either prior to the assessment or during the TRA hearing, "documents recording yet a further instance of circularity, demonstrating the transactions to have been no more than a device to deceive the revenue."

The starting point for Justice Keane's decision was *Farnsworth*, and to what extent the principles it stands for continue to apply.

His Honour then noted that:

> "If this issue fell to be decided on ordinary principles, I would find the Commissioner's arguments highly persuasive. But the *Farnsworth* principles on which Zentrum relies, those decided in that case, and those deriving from it, are central to this case; and, if they apply, are fatal to the Commissioner."

After briefly summarising the *Farnsworth* principles, Justice Keane went on to consider the principles of accuracy and fairness, concluding that "[t]he ultimate expression of these principles … is to be found in *Duvall*." In that case, Richardson P said that the Commissioner was "necessarily confined to the stance he had taken and which had been held by the TRA". Furthermore, the Court lacked the jurisdiction to entertain any other basis for the assessment.

His Honour continued:

> "To be complete and intelligible, then, any assessment must be expressed definitively at some point not just as a sum payable but as an expression of statutory liability; and, I consider, **where as here the Commissioner does not issue a statement of position under sectiion 89M, he is bound instead by the ground of assessment which he has given in the notice of proposed adjustment** the taxpayer has rejected by the notice of response triggering the right of challenge."
>
> [emphasis added]

NOPAs and NORs, Justice Keane held, do not serve only to exchange information; they go to issues of fact as well as law, and in order to challenge an assessment, the taxpayer must have rejected the proposed adjustment. While NOPAs and NORs can be overtaken by SOPs, SOPs are not mandatory and in the instant case, none was issued. Accordingly, "the boundaries of the case before the Authority, or this Court, are to be found in the last NOPA and NOR exchange between the Commissioner and the taxpayer".

Although not central to the decision, His Honour added that if he was wrong about this, then the section 108(1) time bar might not necessarily preclude the Commissioner advancing his proposed alternative ground, as no increase in Zentrum's liability is involved. Section 108(1) "speaks in terms of amount rather than liability", and has previously been given its literal meaning in *Dandelion*.

However, His Honour held that the Commissioner is confined in his appeal to the ground on which he assessed Zentrum, and which the Authority disallowed. The Commissioner would not be permitted to run a "sham" argument.

STANDARD PRACTICE STATEMENTS

These statements describe how the Commissioner will, in practice, exercise a discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

REMISSION OF PENALTIES AND INTEREST – SPS 05/10

Introduction

1. This Standard Practice Statement (SPS) sets out the Commissioner's practice in respect to granting remission of penalties and interest under sections 183A, 183ABA and 183D of the Tax Administration Act 1994.

Application

2. This SPS applies to remission requests received on or after 17 October 2005. It replaces SPS *RDC 600 Remission of penalties and interest*, which was originally published in *Tax Information Bulletin* Vol 14, No 12 (December 2002).

3. This SPS does not apply to:

   - shortfall penalties (except those imposed by section 141AA of the Tax Administration Act 1994), and
   - penalties and interest charged on payments by non-custodial or custodial parents under the Child Support Act 1991, and
   - student loan repayments.

4. Unless specified otherwise, all legislative references in this SPS refer to the Tax Administration Act 1994.

Summary

5. Applications for remission under sections 183A and 183D should be made in writing and should be accompanied by supporting information.

6. The Commissioner will remit under section 183A where he is satisfied that the non-compliance has been caused by an event or circumstance that provides reasonable justification or excuse for the omission, and the omission was rectified as soon as practicable.

7. The Commissioner will remit under section 183ABA where:

   - a taxpayer is significantly affected by a "qualifying event", and
   - the taxpayer has applied for remission of the penalties and/or interest as soon as practicable, and
   - the Commissioner is satisfied that the effect on the taxpayer of the occurrence of the qualifying event makes the remission equitable.

8. The Commissioner will remit under section 183D if the Commissioner is satisfied that remission is consistent with the duty to collect over time the highest net revenue that is practicable within the law. Generally, the Commissioner will grant remission of penalties where there was a genuine oversight, a "one-off" situation, or incorrect advice was given by an Inland Revenue officer that led to the taxpayer not filing their return or paying the tax on time.

9. The Commissioner will remit interest in limited circumstances such as where an Inland Revenue officer has given incorrect advice to the taxpayer, and that advice has directly resulted in the non-compliance. However, this is not the only situation in which interest may be remitted. The Commissioner will consider each case on its own merits.

10. Remission applications under sections 183A and 183D will only be considered when the returns relevant to the remission requests have been filed and the tax has been paid.

11. Sections 183A and 183D do not permit remission to be granted for financial reasons. Requests for financial relief are dealt with under sections 176 and 177.

Background

12. Taxpayers are obliged to pay their taxes by the due date. Penalties provide an incentive to all taxpayers to comply with the law. Use-of-money interest provides compensation for the time value of money and compensates the taxpayer or Inland Revenue for the use of money over time.

13. Remission provisions are needed to allow Inland Revenue to accommodate circumstances in which charging a penalty or interest is inappropriate. The procedures Inland Revenue use should ensure taxpayers have been justly treated regardless of the outcome. Inland Revenue will weigh the particular circumstances that exist in each taxpayer's case against the standard practice.

14. Legislation governing remission of penalties and interest is contained in sections 183A, 183ABA and 183D. These sections do not apply to penalties

and interest charged on payments by custodial or non-custodial parents, student loan repayments or to shortfall penalties except shortfall penalties imposed by section 141AA.

15. The legislation governing imposition and non-imposition of penalties is contained in Part IX of the Tax Administration Act 1994. For further details regarding non-imposition of penalties please refer to a separate SPS on instalment arrangements for payment of tax debt.

16. Remission will occur when the tax, penalty or interest is correctly charged at the time but it is decided to relieve the taxpayer of the liability to pay. Cancellation will occur when the tax, penalty or interest was correctly charged at the time but a provision of the legislation relieves the taxpayer from the obligation to pay, such as the successful completion of an instalment arrangement. Reversal will occur when the tax, penalty or interest should not have been charged in the first place. For further details regarding imposition of penalties please refer to a separate SPS on instalment arrangements for payment of tax debt.

Legislation

17. The relevant legislative provisions are:

- sections 140CB, 141AA, 183A, 183ABA and 183D, and
- section OB 1 of the Income Tax Act 2004 (definition of "qualifying event").

Discussion

Remission for reasonable cause

18. Section 183A applies to:

- a late filing penalty
- a non-electronic filing penalty
- initial and incremental late payment penalties
- imputation penalty tax
- dividend withholding payment penalty tax
- Maori authority distribution penalty tax
- a shortfall penalty imposed by section 141AA.

19. The Commissioner may impose Maori authority distribution penalty tax under section 140CB, where a Maori authority fails to pay further income tax as a result of a debit balance in the Maori authority credit account at the end of the year. The amount of the penalty tax is 10% of the amount of further income tax.

20. Pursuant to section 141AA, a person is liable for a shortfall penalty of $250 for each return period if:

    (a) the person fails to deduct non-resident contractors withholding tax from a contract payment made to a non-resident contractor, and

    (b) the non-resident contractor is not liable to pay income tax on the contract payment due to a double tax agreement or other reasons.

    The shortfall penalty imposed under section 141AA is limited to a maximum of $1,000 for each return period.

21. Section 183A does not apply to interest or shortfall penalties (except those imposed by section 141AA).

22. The Commissioner may remit penalties mentioned in paragraph 18 if satisfied that the penalties arose as a result of an event or a circumstance beyond the taxpayer's control and the taxpayer is able to provide in writing reasonable justification for the late filing, non-electronic filing, late payment or failure to deduct non-resident contractors withholding tax. Furthermore, the taxpayer must have filed the return and paid the tax as soon as practicable after the event or circumstance.

23. The term "reasonable" must be applied to the event or circumstance. This is an objective test.

24. Case law has determined that whether an event or circumstance provides a taxpayer with reasonable justification for failing to meet their obligations, the event or circumstance relied on by the taxpayer must firstly be identified. It must then be determined whether the event or circumstance was beyond the control of the taxpayer, and whether the event or circumstance provides the taxpayer with reasonable justification. See *CIR v Fuji Xerox New Zealand Limited* (2001) 20 NZTC 17,470.

25. Section 183A expressly excludes a taxpayer's financial position from the definition of event or circumstance. Requests for financial relief are dealt with under sections 176 and 177.

26. In deciding whether remission is appropriate the Commissioner will consider the following:

    (a) Has the penalty been correctly charged?

    (b) Has the taxpayer paid the tax (and filed the return) in question?

    (c) Why did the taxpayer pay or file late, or not file (electronically or otherwise)?

    (d) Was the non-compliance caused by an event or a circumstance that was beyond the control of the taxpayer? An event or circumstance may include:

    - an accident or a disaster
    - illness or emotional or mental distress.

27. When considering the above-mentioned events or circumstances, Inland Revenue will use the following definitions:

- accident – an event that is without apparent cause or is unexpected
- disaster – sudden or great misfortune or a calamity
- illness – state of being ill
- emotional distress – disturbance of the mind, mental sensation or state
- mental distress – of the mind, done by the mind, affected with mental disorder.

28. Other factors to consider include:

(a) Has this event or circumstance occurred before? Where appropriate, have measures been put in place by the taxpayer to ensure that this situation does not recur in the future? If a similar event occurred in the past, this factor will be taken into account when considering the taxpayer's current request for remission of penalties and interest.

(b) Was the tax paid or return filed as soon as practicable (as soon as is feasible and realistic) or was there no reasonable basis for delay? This will depend on the circumstances of each case. Specifically, was the default corrected as soon as possible after the event or circumstance passed?

(c) Was the non-compliance the result of an act or omission of the taxpayer's agent? Did an event or circumstance beyond the control of the agent cause the non-compliance? Could the default have been avoided by compliance with accepted standards of business organisation and professional conduct?

(d) Any other information that Inland Revenue considers relevant in assessing the application.

Examples:

Emotional or mental distress (late filing penalty)

A taxpayer's return was due on 7 July. The return was near completion and the taxpayer's previous compliance history was exemplary. However, prior to the due date his daughter became seriously ill and was hospitalised. Her condition steadily deteriorated and the family spent a great deal of time at the hospital where she was in intensive care until the first week in September. The taxpayer was unable to contact Inland Revenue during this time.

During this time a reminder notice was issued advising the taxpayer that a late filing penalty would be charged if his current year's income tax return was not filed within 30 days. He filed the overdue return in mid-October, along with a letter from his daughter's doctor verifying her illness and hospitalisation, after the penalty was charged.

In these circumstances, the taxpayer filed the return three months after the due date, but given the "events and circumstances" this would be considered a "practicable" timeframe.

Circumstances beyond the taxpayer's control (non-electronic filing penalty)

An employer is set up for, and has been sending, employer monthly schedules for the last six months. A fire destroys the work premises on the date before it was planned to transmit the current month's schedule. As a back-up to the computer system, the employer has a printed copy of the file stored off-site. The employer decides to copy these details onto a paper-based schedule so that the schedule and payment would reach Inland Revenue on time. The taxpayer provided a report from the New Zealand Fire Service confirming the date and location of the fire and that the fire destroyed the computer system. Any non-electronic filing penalty would be remitted as the event was "beyond the control" of the taxpayer.

Circumstance beyond agent's control (late payment penalty)

An agent was entrusted to pay a client's income tax by the due date of 7 April, as the taxpayer would be overseas at the due date. The cheque was made out for the correct amount, signed and post-dated. The cheque was given to the agent and placed in the office safe. The night before 7 April the office was burgled and the safe and its contents were destroyed. The client's agent provided a New Zealand Police report verifying the date and location of the burglary and that the safe and its contents were destroyed. This is considered to be an event beyond the agent's control.

Remission in circumstances of a "qualifying event"

29. Section 183ABA applies to:

- late filing penalty
- non-electronic filing penalty
- initial and incremental late payment penalties
- interest (also commonly known as "use-of-money interest").

30. Section 183ABA does not apply to shortfall penalties.

31. Section 183ABA allows the Commissioner to remit the type of penalties and interest as mentioned in paragraph 29, where:

(a) a taxpayer is significantly affected by a "qualifying event" (see paragraphs 33 to 39), and

(b) the taxpayer has applied for remission of the penalties and/or interest as soon as practicable, and

(c) the Commissioner is satisfied that the effect on the taxpayer of the occurrence of the qualifying event makes the remission equitable.

32. Taxpayers may be unable to comply with their tax obligations when a "qualifying event" significantly affects them in the following ways:

- The taxpayers' records have been destroyed and thus, the taxpayers are unable to file tax returns.
- The taxpayers are unable to access their records, as in the case of evacuation or destruction of a home or business.
- The taxpayers were unable to make payments or file returns because of higher priorities created by the "qualifying event", such as assisting other victims.

33. Section 183ABA applies only when there is a "qualifying event" as defined under section OB 1 of the Income Tax Act 2004. The extreme climatic conditions that occurred during February 2004 and the storm event that occurred during the month of July 2004 in the Bay of Plenty area were defined as "qualifying events".

34. Section 183ABA may also apply to future qualifying events. These are naturally-occurring events in respect of which a state of emergency is declared and the Governor-General by an Order in Council declares the naturally-occurring event to be a qualifying event.

35. However, section 183ABA only applies to naturally-occurring events, such as floods or storms. It does not apply to incidents of rioting or civil unrest.

36. Once a qualifying event is declared all significantly affected taxpayers qualify. Whether a taxpayer is significantly affected by a qualifying event requires consideration of the relativity of the taxpayer's situation to the qualifying event, and whether the taxpayer was highly or substantially affected as a result of the event.

37. Relief may be granted if the effect on the taxpayer of the qualifying event occurring makes it equitable that the penalty or interest be remitted. In *Ebrahimi v Westbourne Galleries Limited* (1973) AC 360, Lord Wilberforce defined equitable as involving considerations of a personal character arising between one individual and another, which made it unjust or inequitable to insist on legal rights, or to exercise them in a particular way. Therefore, Inland Revenue will consider remission of penalties and interest where the taxpayer's personal situation makes it unjust or unfair not to remit penalties or interest.

38. While the legislation does not fix any time limit for a taxpayer to seek remission the taxpayer should apply for the remission in writing as soon as practicable. Case law defines the term "as soon as practicable" to mean "as soon as is feasible or realistic". This will depend on the circumstances of each case.

39. However, the Commissioner generally considers that taxpayers should apply for the remission of penalties and/or interest within six months from the occurrence of the "qualifying event".

Examples:

Whether a taxpayer is significantly affected by a qualifying event (late filing penalty)

The Governor-General has declared a flood in the Bay of Plenty area as a qualifying event. A taxpayer resides in Auckland and owns business premises in the Bay of Plenty. All the taxpayer's business records were stored in the business premises. The flood destroyed the business records and the taxpayer could not file the tax return by the due date. A late filing penalty is imposed on the taxpayer. The taxpayer provides supporting evidence (for example, a report on the damaged business premises from the insurance company with whom the taxpayer was insured and photos of the taxpayer's business premise after the flood) verifying that his business records were destroyed by the flood. The taxpayer's request for penalty remission will be accepted because Inland Revenue considers the taxpayer is significantly affected by the qualifying event and that it is equitable for the penalties to be remitted.

Applying the same facts as above but where the taxpayer's business records were stored in Auckland and the taxpayer's business premises were unaffected by the flood. In this case, the taxpayer's request for penalty remission will not be accepted because Inland Revenue considers the taxpayer is not significantly affected by the qualifying event.

Whether the taxpayer applied for the remission as soon as practicable (late filing penalty)

The Governor-General has declared a storm in the Auckland area as a qualifying event. A taxpayer's business premises were severely damaged by the storm. The taxpayer was unable to access his records and file a tax return until two months later. Due to the taxpayer's oversight, another seven months elapsed before the taxpayer applies for remission of the late filing penalty. In this case, the Commissioner will not exercise the discretion to remit the penalty because the taxpayer did not apply for the remission as soon as practicable.

Remission consistent with collection of highest net revenue over time

40. Section 183D applies to:
    - a late filing penalty
    - a non-electronic filing penalty
    - initial and incremental late payment penalties
    - a shortfall penalty imposed by section 141AA
    - interest.

41. Section 183D does not apply to shortfall penalties except those imposed by section 141AA (see paragraph 20). There is no requirement to remit all of the penalties and interest. Each case will be considered on its own merits.

42. The Commissioner is required by law to collect the highest net revenue over time, having regard to the resources available, the importance of promoting voluntary compliance and compliance costs incurred by taxpayers. The Commissioner recognises that pursuing the collection of penalties in some circumstances will not meet his legal duty. Those circumstances are where one of the above-mentioned penalties is imposed because of:
    - a genuine error, or
    - a "one-off" situation, or
    - incorrect advice given by Inland Revenue which has directly resulted in the non-compliance.

43. Section 183D is the primary provision under which interest can be remitted. Section 183E also provides for remission of interest but only where the underlying tax is remitted.

44. Under section 183D, the Commissioner may exercise his discretion to remit the total interest payable or part of the interest payable. Section 183D expressly prevents a taxpayer's financial circumstances from being taken into account.

45. Interest will be remitted in limited circumstances such as where an Inland Revenue officer has given incorrect advice to the taxpayer, and that advice has directly resulted in the non-compliance. However, this is not the only situation in which remission of interest may be granted.

Remission due to unintended legislative changes and other reasons

46. The Commissioner must consider each case on its own merits. For details regarding remission of interest arising from an unintended legislative change, please refer to the separate SPS on penalties and interest arising from unintended legislative changes.

47. When considering remission under this section, the taxpayer's financial situation cannot be taken into account. It was not intended that this section be used to remit penalties and interest remaining from longstanding arrears when the taxpayer has financial difficulties and eventually can only pay the core tax or the core tax plus minimal penalties. These cases are dealt with under sections 176 and 177. Refer to the separate SPSs on instalment arrangements for payment of tax debt and writing off tax debt.

48. The taxpayer must have filed the relevant tax return and paid the tax prior to the remission request.

49. In deciding whether remission is appropriate Inland Revenue will consider the answers to the following:

    (a) Has the penalty or interest been correctly charged?

    (b) Has the taxpayer paid the tax (or filed the return) in question?

    (c) Why did the taxpayer pay (or file) late, or not file electronically?

    (d) Whether the non-compliant action was the result of a genuine oversight or a one-off situation:
    - Remitting a penalty for a taxpayer who has not complied due to a genuine oversight or "one-off" situation recognises that penalising a taxpayer for a small failure to comply is counter-productive and may actually reduce voluntary compliance.
    - Requests for remission because of a genuine oversight or a one-off situation apply to penalties only. Inland Revenue will not remit interest in these cases as interest is compensation to the Revenue for the use of the money over time.
    - Interest charged because of a third party default will generally not be considered for remission. In these situations the Commissioner considers the taxpayer should look to that third party for compensation.

    (e) Has Inland Revenue given incorrect advice to the taxpayer, or was there an error in an Inland Revenue publication, which has resulted in the non-compliance?

    If an Inland Revenue officer has given incorrect advice to a taxpayer (for example, the taxpayer has directly been given an incorrect date or amount for tax payment) or the taxpayer relies on incorrect information contained in an Inland Revenue publication,

the imposition of the penalty may adversely affect future compliance by the taxpayer or other taxpayers. However, this does not apply to misinterpretations of what is written in an Inland Revenue publication.

(f) Has Inland Revenue contributed to the quantum of interest as a result of excessive delay (such as computer processing problems)?

If there have been computer delays in the issuing of a statement of account and the taxpayer has made a payment including interest based on their own calculations the additional interest accrued may be remitted in full or in part.

(g) Any other information that Inland Revenue considers relevant in assessing the application. In particular, Inland Revenue will wish to understand how the remission would contribute to collection of the highest net revenue over time and otherwise promote voluntary compliance.

Examples:

One-off situation (late filing penalty and late payment penalty)

An employer has a computer payroll package set up to prepare the employer monthly schedule for ir-FILE. A computer virus was detected on 4 August when the schedule was due for transmission on 5 August. The software developer was called but the problem was not fixed until 7 August when the schedule was prepared and transmitted. On the same day, the remittance slip and payment were sent together with the software developer's report confirming when the virus was detected; the actual location of the virus in the computer system; the effect of the virus on transmission of the employer monthly schedule; and when the problem was finally resolved. The late filing and late payment penalties would be remitted, as this would be a situation beyond the taxpayer's control.

Genuine oversight (late payment penalty)

A new office person had been hired by an employer as a wages clerk. The new person's duties included preparing the wages, maintaining the wage records and preparing the employer monthly schedules and remittances.

The new person arrived in early March and found the wage records in a terrible mess. The person completed and balanced the employer monthly schedule and forwarded it to Inland Revenue by 20 April, and had intended to enclose the monthly remittance for March in the same envelope. Unfortunately, the remittance and the cheque were caught up in some papers and were not discovered until 24 April. The remittance and cheque were promptly delivered to the nearest Inland Revenue office with supporting documentation explaining the background circumstances leading to the oversight and an accompanying letter requesting remission. Remission of the late payment penalty would be granted under section 183D as a genuine oversight.

Incorrect advice (late payment penalty)

A small business taxpayer registered for GST and was a six-monthly payer. However, as business improved the taxpayer elected to file GST returns two-monthly. The taxpayer sought the advice from the nearest Inland Revenue office but, unfortunately, confusion arose over the date the next return was due to be filed, resulting in the imposition of a late payment penalty. The taxpayer sought penalty remission and provided supporting documentation confirming the name of the Inland Revenue officer who gave the advice, the date of obtaining that advice and the contents of that advice. Remission of the late payment penalty would be granted under section 183D due to incorrect information being given by Inland Revenue.

Incorrect advice (interest)

A taxpayer is advised of an incorrect date for PAYE and incurs a late payment penalty and interest. As the late payment penalty and interest were caused by Inland Revenue's error, both the late payment penalty and interest would be remitted. However, the taxpayer would be expected to provide evidence to support that incorrect information was given by Inland Revenue. Relevant evidence may include the name of the Inland Revenue officer who gave the advice, the date of obtaining that advice and the contents of that advice.

Incorrect advice (partial remission of interest)

A taxpayer rang Inland Revenue to find out what interest was accruing on their 2005 income tax account, as they had just received a statement of account showing some interest payable. The due date for the actual income tax was shown as 7 February 2006. They were advised that interest was not accruing so the taxpayer did not make payment immediately. Subsequently, the taxpayer was charged further interest.

Remission was applied for on the grounds that they would have paid immediately had they known of the ongoing liability. Remission of interest was granted in part – the interest that had accrued until the time the taxpayer telephoned Inland Revenue was still payable. However, the taxpayer would be expected to provide evidence to support that incorrect information was given by Inland Revenue. Relevant evidence may include the name of the Inland Revenue officer who gave the advice, the date of obtaining that advice and the contents of that advice.

One-off situation (late filing penalty and late payment penalty)

A taxpayer had tax arrears comprising core tax of $3,000 when the taxpayer left New Zealand in April 1998. However, the taxpayer was unaware of the tax arrears, as the statement of account was sent to the taxpayer's New Zealand residence after he had left the country.

When the taxpayer returned to New Zealand in 2005, the taxpayer discovered the imposition of a late filing penalty, late payment penalties and interest to a total of $40,000. The taxpayer's financial circumstances would not meet the requirements for relief for serious hardship. Inland Revenue may consider remitting the late filing penalty and late payment penalties as a one-off situation once the taxpayer has provided supporting documentation confirming the taxpayer's New Zealand address and his date of departure and re-entry into New Zealand.

STANDARD PRACTICE

The following standard practice applies.

50. When considering the remission provisions of penalties and interest, Inland Revenue considers it important to treat both the taxpayer requesting the remission and all other taxpayers fairly. A lenient remission practice penalises complying taxpayers and may ultimately affect voluntary compliance. However, allowing an inappropriate penalty to stand will also impact on voluntary compliance. Inland Revenue recognises that penalising a taxpayer for a small non-compliant action is counterproductive and may actually reduce voluntary compliance.

51. Applications for remission under sections 183A and 183D should be made in writing and should be accompanied by supporting information.

52. The Commissioner will remit under section 183A:

    - a late filing penalty
    - a non-electronic filing penalty
    - initial and incremental late payment penalties
    - imputation penalty tax
    - dividend withholding payment penalty tax
    - Maori authority distribution penalty tax (see paragraph 19)
    - a shortfall penalty imposed by section 141AA (see paragraph 20)

    where he is satisfied that the non-compliance has been caused by an event or circumstance that provides reasonable justification or excuse for the omission, and the omission was rectified as soon as practicable.

53. The Commissioner will remit under section 183ABA:

    - late filing penalty
    - non-electronic filing penalty
    - initial and incremental late payment penalties
    - interest (also commonly known as "use-of-money interest")

    where:

    (a) a taxpayer is significantly affected by a "qualifying event" (see paragraphs 33 to 39), and

    (b) the taxpayer has applied for remission of the penalties and/or interest as soon as practicable, and

    (c) the Commissioner is satisfied that the effect on the taxpayer of the occurrence of the qualifying event makes the remission equitable.

54. The Commissioner will remit under section 183D:

    - a late filing penalty
    - a non-electronic filing penalty
    - initial and incremental late payment penalties
    - a shortfall penalty imposed by section 141AA
    - interest,

    if to do so is consistent with collection of the highest net revenue over time.

55. Interest will be remitted in extremely limited circumstances such as where an Inland Revenue officer has given incorrect advice to the taxpayer, and that advice has directly resulted in the non-compliance. However, this is not the only situation in which interest may be remitted. The Commissioner must consider each case on its own merits.

56. Remission applications under sections 183A and 183D will only be considered when the returns relevant to the remission requests have been filed and the tax has been paid.

57. Sections 183A and 183D do not permit remission to be granted for financial reasons. Requests for financial relief are dealt with under sections 176 and 177. For further details refer to the relevant SPSs on instalment arrangements for payment of tax debt and writing off tax debt.

This Standard Practice Statement is signed on 17 October 2005.

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