

TAX COMPLIANCE

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Report to the
Treasurer and Minister of Revenue
by a Committee of Experts
on Tax Compliance

DECEMBER 1998

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A report to the Treasurer and Minister of Revenue by a
Committee of Experts on Tax Compliance
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Tony Molloy QC has over three decades combined full-time law practice with contributions to legal education, lecturing in equity as well as tax law and corporation law. Dr Molloy has published widely, including the text, *Molloy on Income Tax*, for which he received a doctorate of laws. In 1984, Dr Molloy became one of the youngest barristers to have been elevated to the rank of Queen's Counsel, and both before that time and since, he has been counsel in many leading tax cases. He has also practised in canon law as counsel in the ecclesiastical courts of the Roman Catholic Church. He was awarded the New Zealand Sesquicentennial Medal in 1990 for his services to New Zealand. One of Dr Molloy's particular interests is wine making under the St Nesbit label.

John Prebble, BA, LLB (Hons) (Auckland); BCL (Oxford); JSD (Cornell); Inner Temple (London) is a professor and former dean of law at Victoria University of Wellington. Professor Prebble practises as a barrister in the areas of tax law and policy, which are also his major research interests. Professor Prebble was a member of the New Zealand government's tax reform Consultative Committees on Full Imputation in Company Taxation and on International Taxation in the late 1980s. He has held research fellowships or visiting positions as a teacher or scholar at universities and institutes in the United States, Britain, the Netherlands, Italy, Australia as well as in New Zealand. Professor Prebble was formerly a Governor of the Asian Pacific Tax and Investment Research

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GOVERNMENT STATEMENT

The Government welcomes the Report of the Committee of Experts on Tax Compliance, and congratulates the Committee on its work. Its terms of reference were wide-ranging. Its approach is in line with the Government's revenue strategy. The Government is pleased with the quality and scope of the report, and has decided to work through its recommendations as follows:

- Recommendations on aspects of the taxation of charities and amateur sports bodies will be included in the Government's tax policy work programme, but the issues involved are complex. They need careful consideration. Since the tax policy work programme is, in the near future, fully committed to other priorities, those recommendations will not be considered in the short term.
- Recommendations on the project which is rewriting the Income Tax Act will be referred by the Government for consideration to the Rewrite Advisory Panel, a group of specialists advising on that project.
- Recommendations closely related to the Government's existing project on the reduction of the business compliance costs imposed by taxation will be incorporated by the Government into that project.
- Where policy recommendations are outside those three areas, public submissions will be sought in line with the Government's generic tax policy process.

The Committee of Experts on Tax Compliance was appointed by the Government in March 1998. The Committee's terms of reference broadly required it to consider and make recommendations on tax compliance costs and the robustness of the tax system against avoidance and evasion.

The Committee reported on 18 December 1998. The Government regards the report as a valuable contribution which reinforces many of the themes of its current tax policy. In particular, the Committee recommends that "the Government should continue to restrict the conditions that make tax avoidance possible by continuing its broad-base, low-rate tax policy".

The Government had, in its July 1997 *Revenue Strategy*, emphasised that broad-based taxes reduce distortions among different forms of earning, saving, investment and consumption, and reduce the opportunities and incentives to engage in tax avoidance. That document recognised the importance of identifying and closing loopholes offering opportunities for tax avoidance and evasion, and maintaining vigorous enforcement action.

The Government, in that revenue strategy, recognised the importance of tax simplification as a means towards lower compliance costs. The Government is pleased to see that the Committee's recommendations endorse this strategy. The effective and efficient operation of our tax system makes, as the Committee observes, a crucial contribution to national well-being.

The Committee has, in addition to making tax policy recommendations, commented and made recommendations on a number of operational aspects of the Inland Revenue Department. The Committee notes, for example, the Department's conclusion that it needs to increase the emphasis on countering tax avoidance and evasion.

The report recognises that Inland Revenue has, in the past decade, implemented significant improvements, but has also identified areas such as technical skill levels as in need of further improvement. Its recommendations endorse the Government's view of the right strategic direction for further change in the Department.

Committee recommendations on Inland Revenue operations come, of course, within the statutory responsibilities of the Commissioner of Inland Revenue. The Government has directed the Commissioner to consider those recommendations, and report back to the Government.

The Committee, in its overriding recommendation, highlights the fact that tax systems, of their very nature, need to be kept under continuous review. The Government concurs entirely with that finding, and thanks the Committee for an exceptionally valuable contribution towards that on-going review process.

Rt Hon W F Birch
Treasurer

Hon Bill English
Minister of Finance and
Minister of Revenue

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LETTER OF TRANSMITTAL

18 December 1998

Rt Hon WF Birch
Treasurer and Minister of Finance

Hon Max Bradford
Minister of Revenue

Dear Ministers

On behalf of the Committee of Experts on Tax Compliance, I am pleased to submit to you the committee's report.

In accordance with the committee's terms of reference, the report considers and makes recommendations on tax compliance costs and the robustness of the tax system against avoidance and evasion.

The committee is confident that its work makes a valuable contribution to the New Zealand tax system, the effective and efficient operation of which is of crucial importance to the well-being of the country.

The committee records its appreciation of the very able assistance it has received from officials of the Inland Revenue Department and the Treasury.

Yours sincerely

Sir Ian McKay
Chair

PREFACE

1. New Zealand has had a tax system since the earliest days of colonial settlement: in the early colonial period, customs and excise duties provided over 90 per cent of tax revenue, the balance being provided by stamp duties. The first income tax was levied by the Land and Income Tax Assessment Act 1891 at the rate of sixpence in the pound on taxable income up to £1,000, and one shilling in the pound on any balance for individuals, and one shilling in the pound for companies.¹

2. Today, the government collects over \$30 billion in taxes, through two main bases: the income tax and the goods and services tax. The Inland Revenue Department is one of the largest departments of state, with over 4,500 staff in 30 offices throughout the country.

3. New Zealanders deserve a good tax system. Taxes fund vital public services, like hospitals, the police and our schools. Taxes also have powerful effects on the size and shape of the New Zealand economy. They make an impact directly and indirectly on how, where and when New Zealanders save, work and invest.

4. A good tax system needs to be robust and efficient both in terms of revenue collection and compliance costs. It was against this background that the committee had its genesis.

Establishment of the committee

5. The government announced the formation of the committee on 31 March 1998. The committee's terms of reference are set out on page xxix. In brief, they require the committee to consider and make recommendations on two main areas: tax compliance costs and the robustness of the tax system against avoidance and evasion.

6. In April 1998, the Treasurer and the Minister of Revenue at that time provided the committee with a set of guidelines for interpreting the committee's terms of reference. These guidelines, the text of which is reproduced in appendix 1, showed how the terms of reference interacted

¹ For those raised in the decimal/metric age, these rates equate to 2½ per cent and 5 per cent, respec-

with existing tax policy activities, such as the rewriting of the Income Tax Act 1994.

Conduct of the committee's activities

7. At its first meeting the committee agreed to seek public submissions, so that it could gain from the experiences of others in formulating its recommendations. The committee accordingly called for submissions through a press release, advertisements in major metropolitan and provincial newspapers, and by way of the Treasury and Inland Revenue websites. Many submissions were received from individuals, firms and professional bodies. The committee would like to record here its appreciation to all those who made submissions.

8. Although the submissions contained many worthwhile suggestions, not all suggestions are mentioned in the committee's report, often because they were outside the terms of reference. In other cases, the committee did not have sufficient time to give the suggestions the detailed examination that would have been necessary to convert them into viable proposals. However, where appropriate, the committee has referred to the matters raised, with a recommendation that the government give them attention as part of its tax policy work programme. Inevitably, the committee did not share all the views put forward in submissions, and on occasion, has recorded this in the report.

9. The committee's terms of reference are very wide. This breadth in part reflects the scope of the tax system. To meet the reporting deadline imposed by the government, the committee needed to be selective in its approach. The committee has, therefore, concentrated on areas where it considers that it has the greatest skills and experience. In those areas that require review but where, for whatever reason, the committee has been unable to undertake complete analysis of the issue, the committee has recommended that the government ensure that the appropriate review does take place. See appendix 3 for the list of some of the more important omitted topics.

Compliance costs

10. Compliance costs are ‘the costs incurred by taxpayers in meeting the requirements laid on them by the tax law and the revenue authorities. They are costs over and above the actual payment of tax and over and above any distortion costs inherent in the nature of tax.’²

11. The only comprehensive study of tax compliance costs in New Zealand estimated, for the 1990-91 year, that New Zealand business spent over 46 million hours complying with tax laws and spent a further \$600 million in fees to external advisers. In aggregate, the study estimated annual compliance costs at \$1,882 million.³

12. Compliance costs clearly are a significant factor in the design of the tax system. The committee believes that the government should take into account the following when considering compliance costs:

The recognition that there is no simple or single solution that of itself will reduce compliance costs to business.

The need to develop a reliable indicator of the extent to which compliance costs are holding back the economy, and to use this as a benchmark for a publicly stated and measurable goal of containing, and later reducing, compliance costs.

The need to maintain an active focus on opportunities to ease the compliance cost burden placed on small, and small to medium-sized, entities.

The need to weigh carefully the balance between imposing compliance costs on third party agents, for example, banks and employers, and securing universal tax administrative and compliance efficiencies.

13. At the same time, the committee notes that it behoves the government and the public to keep always in mind that the major costs of the tax system to society are not compliance costs but allocative costs. The committee does not minimise the significance of compliance costs, which are a major topic of its terms of reference, but it keeps them in

² Sandford C, 1995, ‘The Rise and Rise of Tax Compliance Costs’ in Sandford (ed), *Tax Compliance Costs Measurement and Policy*.

³ Sandford C, and Hasseldine J, 1992, *The Compliance Costs of Business Taxes in New Zealand*.

perspective. The committee addresses this perspective in paras 1.6 to 1.14 of this report.

14. The committee makes a number of specific recommendations directed at reducing compliance costs. As with robustness, reducing compliance costs is not something that can be achieved immediately or as the result of a single initiative. The committee's overall recommendation on compliance costs is, therefore, that the government needs to keep under continuing and active review all elements of the tax system that impose significant compliance costs on taxpayers. The government's aim should be to identify the need for or appropriateness of individual compliance measures, to identify opportunities that changed circumstances and technologies may allow, and to develop appropriate initiatives.

The robustness of the tax system

15. The tax system, including policy formation and legislation, must be as robust as necessary to protect the revenue in New Zealand's sometimes aggressive commercial environment.

16. The committee considers that, at an administrative level, a sufficiently robust system would:

Be alert to the fact that people at the helm of business entities have a duty to their companies to see that not only do they pay every dollar that the law does require, but that they do not pay one dollar more than that.

Monitor and initiate appropriate audit and policy responses to the attitudes and initiatives of significant participants in the business and investment sectors and to all tax-planning arrangements being employed.

Test all such arrangements thoroughly in relation to all relevant tax provisions, taking care not to nullify the work of the Parliament by failing to apply the laws it enacts.

Make full use of the range of remedies and procedures available, including practices for obtaining declaratory and injunctive relief.

Ensure that no arrangements are permitted to proceed so far as to expose the public moneys to risk and have in place systems enabling the size of such revenue risks to be clear at all times.

Test in court any arrangements which appear ‘too good to be true’, or which attempt to defeat the income tax legislation.

Be intolerant of affront and obstruction, particularly when yielding to it might create a perception that might is right.

Ensure that when prosecution is appropriate, it is not derailed through lack of proper appreciation of the ability to prove by inference from proven or provable facts.

Employ staff with educational and professional qualifications, experience, and skills appropriate to the complexity of the legislation being administered by the Inland Revenue Department, and appropriate to meet on equal terms those who would aggressively test the legislation.

Encourage employees, even at the cost of creating internal tensions, to observe fully their duty under section 6(1) of the Tax Administration Act 1994 ‘at all times to use their best endeavours to protect the integrity of the tax system’.

17. Much of the report deals, either directly or indirectly, with testing whether the tax system, and the way it is administered by the Inland Revenue Department, measures up to these standards.

18. The committee is not the first group to investigate the tax system. As the list in appendix 9 shows, in the last two decades the New Zealand tax system has undergone significant reform, often based on the work of other expert committees. Much has already been done to ensure that the tax system is robust.

19. Three projects that have made, or should make when fully implemented, major strides towards ensuring a robust tax system, are:

the Organisational Review of Inland Revenue, conducted by a committee headed by Sir Ivor Richardson,⁴

the rewriting of the Income Tax Act 1994, and

the department’s project, Directions: Customer Requirements.⁵

20. Creating and maintaining a robust, efficient tax system is a process not an event. The committee has been able to examine only a limited

⁴ For an outline of the review, see the notes in appendix 2.

⁵ For a description of the project, see appendix 5.

number of key areas. Our overriding recommendation to the government, therefore, is to keep the tax system under constant review.

21. The committee also makes many recommendations directed towards making the tax system more robust. See page xxxi for a summary of those recommendations.

Outline of the report

22. The committee's report is in four parts.

23. Part I deals with tax compliance costs. The committee begins with a discussion of the principles of simplicity and coherence in tax laws. The committee explains how tax laws strike a compromise between simplicity and neutrality. The committee uses the term 'fiscal paradox' to explain why the tax system is often so complex: the more neutral and more equitable a government makes a tax system, the more complex that system becomes. This paradox shapes the results of modern tax reform, as most governments rightly regard neutrality and equity as key goals of tax policy.

24. The report then proceeds to consider the government's project of rewriting the Income Tax Act. The committee includes specific recommendations on ways in which it believes the rewrite project could be improved. The report goes on to consider some aspects of the capital-revenue boundary, one of the most problematical features of the tax system. The committee was concerned that the opportunity for taxpayers to characterise otherwise taxable income as capital receipts presents a significant risk, and makes a number of recommendations to limit this opportunity. Then the committee considers tax-exempt entities, particularly the appropriateness of the existing scope of certain tax exemptions, and the exemption from tax of certain compensation paid by tax-exempt entities to their employees.

25. Part I also contains some chapters that analyse specific areas that raise compliance cost concerns. The committee makes a number of recommendations that it hopes will lead to lower compliance costs. The committee also refers to the project 'Directions: Customer Requirements' being undertaken at present by the government and the Inland Revenue Department.

26. Part II of report deals with the robustness of the tax system against avoidance and evasion. The committee begins the part with an analysis of the terms tax mitigation, avoidance and evasion, and goes on

to discuss tax avoidance within a policy framework. Some particular topics are then examined: the loss attributing qualifying company rules and contrived depreciation deduction schemes.

27. Tax evasion and the so-called hidden economy are serious threats to the revenue and are the subject of detailed discussion in chapter 7 of the report. Chapters 8 to 11 deal with specific powers of the Commissioner of Inland Revenue, and procedures affecting the robustness of the tax system. Topics covered include the Commissioner's powers to gather information, legal professional privilege, and the provisions relating to the assessment of tax, disputes resolution and withholding payments. The committee makes recommendations on ways in which the current approach to collecting taxes could be improved.

28. Penalties for non-compliance are an essential element of a robust tax system. The government introduced new penalties provisions into the tax laws in 1996. Because of the newness of the regime, and in the light of the fact that the government intends to undertake a post-implementation review of these provisions in 1999, the committee does not make any major recommendations for change. The committee does, however, make recommendations on specific matters it believes should form part of that review.

29. Chapter 13 contains the committee's discussion of one of its more important topics: how the Inland Revenue Department should apply the law. The part concludes with the committee's analysis of the tax implications of electronic commerce.

30. Part III discusses the role of tax advisers in the tax system. Because of the complexity of the tax system, many taxpayers, particularly business taxpayers, need professional assistance in understanding and complying with tax laws. The conduct of those advisers is, therefore, an important part of how the tax system operates. The committee discusses whether greater regulation of tax advisers is warranted, drawing on the registration and regulation regimes operating in a number of other countries. The committee concludes that professional bodies should continue to have responsibility for regulating the ethical conduct of their members, but must be more vigilant if self-regulation is not to give way to external control.

31. Part IV of the report is concerned with operational matters. The committee discusses such matters as the Inland Revenue Department's relationship with the public, how the Inland Revenue Department issues

rulings on its interpretation of the law and the Inland Revenue Department's budget.

32. The scope of the committee's report is broad. The committee has considered and has made many recommendations on tax compliance costs and on ways to make the tax system more robust against avoidance and evasion. The committee hopes its work will contribute to the efficiency and effectiveness of the tax system in New Zealand and, therefore, to the well-being of the country.

Ian McKay
Tony Molloy
John Prebble
John Waugh

TERMS OF REFERENCE

THE COMMITTEE is to consider and make recommendations on the following with a view to considering their implications for future policy:

- tax compliance costs, including how tax laws may be simplified and made more coherent and understandable while ensuring an appropriate balance between the levels of complexity, fairness, accuracy and economic efficiency;
- how to make the tax system more robust against avoidance and evasion (identifying and bearing in mind the underlying causes of such activity), with particular regard to:
 - the use of tax driven structures lacking business reality;
 - abuse or complicity by tax advisers;
 - standards of conduct for tax advisers;
 - concealment and other tax related offences, and the possibility of confiscating concealed profits;
 - the lack of prosecutions to prevent harmful tax practices and schemes;
 - the adequacy of the current penalties regime, including criminal penalties;
 - how to achieve disclosure of tax schemes affecting the instance of tax payable by greater than \$100,000;
 - the possibility of treating the failure to disclose (or falsification of material facts) by a person experienced in tax matters as a serious criminal offence, and establishing it as punishable by a maximum penalty of 10 years imprisonment where more than \$5 million in tax revenue is involved; and
 - the possibility of recovering from large-scale, tax-evasion schemes (say \$100,000 and over) and those who aid them, profits attributable to the use of unpaid tax (unjust enrichment); and
 - the internationalisation of the economy, including electronic commerce.

xxx

The committee is required to make its recommendations on the above consistent with:

- the Coalition Agreement;
- the government's revenue strategy;
- the generic tax policy process;
- the maintenance of a broad-base, low-rates and tax system;
- the maintenance of the existing tax rates and tax mix;
- there being no decrease in the extent to which the income tax laws focus on the taxation of a comprehensive definition of income;
- there being no decrease in total tax revenue;
- there being no increase in overall compliance costs.

The committee will not consider the recommendations of the Commission of Inquiry into Certain Matters Relating to Taxation.

The committee is required to report to the government by 21 December 1998.

LIST OF RECOMMENDATIONS

THE COMMITTEE RECOMMENDS that any proposals for change emerging from its report and listed below should proceed through the generic tax policy process. The summary recommendations set out here should be read in the context in which they appear in the report.

2 The rewrite project

Interpretation

The government should review section AA 3(1) as a whole (para 2.73). In considering this recommendation, the government should make explicit that provisions that are intended to operate only in a particular manner or in a particular context should not apply in other contexts (para 2.41), and consider whether the reference to the core provisions in section AA 3(1) of the Income Tax Act 1994 should stay (para 2.58).

The government should review the way in which the interpretation provisions of the Income Tax Act 1994, together with the organisational scheme operate in relation to the ‘local context’ of a statutory rule (para 2.71). Alternatively, the government should consider whether section AA 3(1) should omit any reference to the way in which the Act is organised, in order to avoid the possibility of perverse interpretations (para 2.74). If sections AA 1 and AA 3 are to remain in the statute, the Income Tax Act 1994 should state that its interpretation provisions do not oust any statutory generally-applicable rules of interpretation unless the former are clearly inconsistent with the latter (para 2.76).

The government should undertake a thorough study of the courts’ interpretation of income tax legislation with a view to determining whether Parliament should be satisfied with present practices and emphasis, or whether the rewrite should mandate a change (para 2.89).

In the rewriting process, when a rule is to provide that a particular receipt is to be taxed, it is better to frame the provision as a rule, rather than to define the receipt as something that it is not, followed by another rule that taxes the item that is defined (para 2.99).

The uncertainty that has arisen over whether certain judge-made timing rules have survived the change to a ‘gross income’ approach of the rewrite should be resolved (para 2.118).

Organisation

There should be an assessment of the value of the benefits to be obtained from continuing on the present drafting course, that is, one based on functional organisation, together with an assessment of the work involved in reorganising the statute on a regime-by-regime basis. The government should consider having those assessments done, with a view to deciding whether to persist with the functional organisation of the Income Tax Act (para 2.141). If the government determines to adhere to a formalistic organisational structure, it should consider allocating a specific part or subpart to rules about valuation, which at present are not gathered together in the manner that is standard for the rewritten Act (para 2.188).

The phrase ‘under ordinary concepts’ in section CD 5 should be eliminated, and the provision should be rephrased using the term ‘income’ without qualification (para 2.155). Section CD 5 should be the first charging provision that places ‘income’ within ‘gross income’ and, as the calculations are worked through, ‘net income’ and ‘taxable income’. Alternatively, section CD 5 could be woven into section BC 4, where it could act as the core provision that initially captures gross income as annual gross income (para 2.159).

The government should give some priority in the rewrite programme to the following topics: apportionment, movement of assets in and out of the tax base, accounting for long-term contracts and tax avoidance provisions (para 2.171).

Drafting policies

Statute-wide drafting policies should not be adopted as a matter of principle without reasonably rigorous practical testing (para 2.183).

Some advantage may be had in splitting the Income Tax Act 1994 into two separate Acts, one for provisions of general application, removing some relatively complex groups of provisions, that concern only a limited number of taxpayers, into a second Act. The government should direct officials to evaluate whether such an approach should be taken (para 2.184).

Schedule 23 should be kept under continuous review and updated whenever there is renumbering. The ambulatory nature of the rewrite process has some advantages, but regular changes make the statute difficult for users to follow (para 2.185). The government should also consider including in the Act a schedule of the monetary thresholds that are scattered throughout the Income Tax Act (para 2.186).

The Inland Revenue Department should establish a special ‘repairs and maintenance’ unit to address promptly any queries raised as to the effect on established principles of the rewritten Income Tax Act, to deal with any unintended outcomes identified, and to provide an administrative mechanism to ensure both that the general body of taxpayers and tax advisers are informed of issues as they arise, and that remedial legislation is developed and introduced at the first opportunity (para 2.187).

The department should redraft the existing qualified accruals rules determinations in an endeavour to publish fresh drafts at the same time as the proposed exposure draft of part E of the Act is published. When possible, each determination should follow one of a limited number of standard templates. The procedure for issuing determinations should take on the basic features of the generic tax policy process (para 2.196).

Additional matters

New Zealand should return to formal annual taxing Acts (para 2.200).

The rewrite should include a provision to state the law on the relationship between the Income Tax Act and fraud, so that there can be no doubt that even though taxpayers may have strictly complied with the requirements of the Income Tax Act, or believe that they have done so, when the facts of the case require it they can still be described as dishonest, and be guilty of fraud (para 2.201).

Legislation that affects the operation of the Income Tax Act should be listed in a schedule, which should begin with a statement to the effect that the omission of any legislation does not mean that the omitted Act does not affect the operation of either that Act or the Income Tax Act (paras 2.203, 2.205). An additional schedule could list sections of the Crimes Act 1961 that are potentially relevant to income tax fraud (paras 2.204, 2.205).

3 Aspects of the capital-revenue boundary

The government should consider legislation to ensure that payments for restrictive covenants involving services (para 3.22), inducement payments (para 3.32), certain capital contribution payments, and other similar payments should be taxable (para 3.42). The submissions by the Investment Savings and Insurance Association of New Zealand to the committee on investment gains of collective investment vehicles should be evaluated with a view to introducing legislation to remedy the problems that the Association has identified (para 3.4).

4 Charities and other tax-exempt entities

The government should review the law and practice relating to the income tax exemption in section CB 4(1)(h) for amateur sports bodies (para 4.9), and also the threshold in section DJ 17 to ascertain whether it is sufficiently high enough to meet its objective of reducing compliance costs (para 4.11). The income tax exemption in section CB 5(1)(i) for trustees of sick, accident and death benefit funds should be repealed (paras 4.15, 4.25). The net income derived by charities and other tax-exempt entities from commercial activities unrelated to their exempt purpose should be taxable (para 4.17). The exemption from fringe benefit tax in section CI 1(m) for benefits provided by charitable organisations to their employees should be repealed (para 4.22). Superannuation schemes for the benefit of employees of charitable organisations should not be eligible for charitable tax exemptions (para 4.24).

5 Some specific concerns

Tax treatment of expenditure on motor vehicles

The government should develop a universal approach to the tax treatment of motor vehicles (para 5.7).

Fringe benefit tax

There should be no change in the present formula for calculating the value of the fringe benefit of a motor vehicle (para 5.16), but the Inland Revenue Department should publish in the *Tax Information Bulletin* a full and informative explanation of the rationale underlying the use of the factor of 24 per cent of the original GST-inclusive cost price as a method for determining the base fringe benefit value of a motor vehicle (para 5.17).

GST on fringe benefits should be returned on the FBT return rather than the GST return (para 5.18).

Use of money interest

The question of charging use of money interest to those paying FBT annually should be pursued in the context of the review of obligations of business taxpayers. If this review should not result in any simplification for small taxpayers paying FBT, the government should consider the removal of the use of money interest charge from fringe benefit taxpayers who pay annually (para 5.25).

Provisional tax

The government should monitor the use by taxpayers of the election to estimate income to prevent divergent outcomes relating to use of money interest (para 5.31).

Payment and refunds

The government should publish a discussion document that sets out the debate on amalgamating payment dates to allow informed public consideration of the issues and to provide for public submissions. The discussion document should clearly distinguish the needs and concerns of the small, small to medium, and large businesses (para 5.47).

The government should also consider implementing, at the first practical opportunity, a universal rule that when the due date for the payment of tax falls on a non-business day, the due date moves to the next working day (paras 5.53, 5.54).

The routine practice of applying refunds to meet outstanding debts should be modified to allow discretion in its application (paras 5.57, 5.59). Taxpayers should be able to request a refund of an amount of tax not subject to a dispute provided certain criteria are met. For income tax, the refund would be subject to the Commissioner's discretion as to the calculation of the appropriate amount of refund (para 5.65).

Depreciation

There should be no increase in the \$200 threshold for the low value write-off (para 5.72). When assets are purchased at the same time from the same supplier, the threshold should be increased to allow up to \$500 in assets purchased at the same time from the same supplier to be immediately deductible, providing no asset exceeds \$200 in value (para 5.78).

Consideration should also be given to either an increase in, or the removal of, the ceiling that limits the application of the pooling approach to depreciation (para 5.88).

Goods and services tax

A registered person who is no longer eligible to use the payments basis of accounting should be able to continue accounting in that way for a further year before being required to adopt the invoice basis of accounting. The government should also consider an increase in the threshold to account for inflation (para 5.94).

The Inland Revenue Department should publish a statement about its operational policy on GST tax invoices, identifying the errors that are considered significant and the errors that are not (para 5.99). There should be no increase in the \$50 threshold for tax invoices (para 5.103).

GST secondary use adjustments for private or exempt use should be moved to the period in which the annual income tax return is filed, except when the adjustment involves the procedures available for acquisitions of items under \$10,000 (para 5.108).

Financial arrangements

As part of the rewrite process, the government should consider a year-end valuation approach as an alternative to the current rules for valuing financial arrangements (para 5.118). Rewriting the accrual rules determinations should be given a high priority (para 5.120).

Readability of statements

The redesign of statements of account should be given priority (para 5.124).

Education

The Inland Revenue Department should publish booklets for specific industry groups, advising taxpayers of their tax obligations and the tax treatment of specific transactions (para 5.128).

6 Tax mitigation, avoidance and evasion

Anti-avoidance rule

The government should continue to restrict the conditions that make tax avoidance possible by continuing its broad-base, low-rate policy (para 6.37).

The general anti-avoidance rule in sections BG 1 and GB 1 of the Income Tax Act 1994 should not affect the application of any principles of common law. This position should be made completely clear in order to ensure that the courts are not precluded from applying common law anti-avoidance rules like the fiscal nullity doctrine (paras 6.42, 6.53).

The application of the anti-avoidance rule is automatic. This feature should be made absolutely clear in the legislation (paras 6.44, 6.53). An amendment should be made to clarify that any reconstruction under section GB 1 applies from the date of the original avoidance arrangement (paras 6.46, 6.53).

The department should review existing interpretation statements, interpretation guidelines and public rulings that depend on high-level legal analysis to determine whether these statements should be revised. The department should immediately withdraw any statements found to be deficient without waiting until replacement drafts are available. In particular, the department should immediately withdraw the 1990 policy statement on section 99 of the Income Tax Act 1976. The department should obtain external expert input into interpretation guidelines and interpretation statements before they are released for consultation, especially for issues involving complex reasoning. Particular care should be taken when including generic examples in statements. The department should also reconsider and refine its apparent view on how the form/substance and sham/genuine analysis should be approached (para 6.101).

Loss attributing qualifying companies

The government should examine loss attributing qualifying companies to determine whether the use of loss attributing qualifying companies as tax avoidance vehicles is a threat to the tax base, whether the use of loss attributing qualifying companies is consistent with the government's tax policy in relation to forestry, and whether the provisions as to loss attributing qualifying companies should be amended or repealed (para 6.114).

7 Tax evasion and the hidden economy

The goal of the Inland Revenue Department in improving the taxation of the hidden economy should be a sustained accretion of improvements that steadily whittle away at the amount of tax that is evaded and that enable the department to respond quickly to new business techniques or

to new systems of concealment that offer opportunities for new methods of evasion (para 7.40).

The targeting of audits should not be based solely on the amount of tax being evaded by a particular taxpayer, but should also be directed to types of tax evasion that involve many taxpayers evading tax on small amounts of income (para 7.42)

The Inland Revenue Department should continually identify opportunities for tax evasion by taxpayers and new opportunities to use withholding tax methodologies. The department should also develop a strong community awareness of the cost to the community of tax evasion and review the law relating to non-cash transactions (para 7.45).

The department should work closely with community groups, tax practitioners and particularly specialists in public awareness campaigns to develop industry profiles and more effective compliance at all levels. The focus of the community awareness programme should be on the costs of the cash economy to the community, the fact that there is no excuse for the non-declaration of income, education through school curricula, the seriousness of the consequences of detection, the details of the department's initiatives on the cash economy, and the publication of instances of evasion that have been identified, and where appropriate, the actions taken (para 7.51).

The law relating to non-cash transactions should be clarified so that such transactions do give rise to taxable income even when they cannot be converted into cash (para 7.55). The department should effectively communicate a suitable explanation of the tax law relating to barter transactions to those sectors of the community where barter transactions are prevalent (para 7.56).

8 Disclosure

Section 15B(e) of the Tax Administration Act 1994, which states that taxpayers must disclose to the Commissioner in a timely and useful way all information required to be disclosed under the tax laws, should be amended to identify the different categories of required disclosure: information specifically required by statute, information required by the department in a prescribed form, and information requested by the department from specific taxpayers (para 8.4).

The department should consider a review of each of the purposes of the tax return to decide if the return is the most appropriate vehicle for these functions (para 8.19).

An examination should be made of the application of technology to the government's disclosure requirements (para 8.20).

The government should consider a review of the records that a taxpayer must keep under self-assessment. The review should be undertaken at the same time as the review of return filing obligations (para 8.21).

The Inland Revenue Department should prepare and send out to taxpayers forms to guide them through their key annual income tax activities, and also to act as a record for audit purposes (para 8.25).

As part of the review of penalties to be conducted in 1999, there should be public discussion on disclosure (paras 8.27, 8.33).

9 The Commissioner's information-gathering powers

An amendment should be made to section 16 of the Tax Administration Act 1994 to give the Commissioner authority to remove books or documents from premises for the purpose of making copies (paras 9.25, 9.35). The government should also clarify the ambit of section 16(2) to ensure that it applies to third parties (paras 9.30, 9.35).

The words 'necessary or relevant' in section 17 encourage taxpayers to raise spurious arguments and should be removed (paras 9.23, 9.35). Section 17 should also be amended to deem the records of an offshore entity controlled by a New Zealand resident to be under the control of that New Zealand resident (paras 9.18, 9.35). The section should be further amended to give the Commissioner the discretion to require that documents requisitioned under that section should be sent to an Inland Revenue office (para 9.24, 9.35).

The government should await the outcome of the Law Commission's study of legal professional privilege before making any decisions on this matter in relation to tax (paras 9.59, 9.63). In the meantime, amendments should be made to section 20 first, to ensure the physical protection of documents once a claim for privilege is made, and secondly, to require the identification of documents for which privilege is being claimed as a condition of obtaining privilege (paras 9.60, 9.61, 9.63).

10 Assessments and disputes resolution

The time bar for amending assessments should be suspended for the period between one month after the issue of a section 17 notice in which the taxpayer is advised that non-compliance will result in such suspension and the taxpayer's compliance with the notice. The statutory minimum periods for keeping records should be extended by the period for which the time bar is suspended (para 10.8).

The onus of proof in civil proceedings, except for civil penalties for evasion, should continue to lie with the taxpayer. The law should be clarified expressly to provide that if a taxpayer is able to prove on the balance of probabilities that the Commissioner's assessment is excessive by at least a certain amount, the court should be able to reduce the Commissioner's assessment by that amount (para 10.13).

11 Tax collection

Withholding payment regulations

The current withholding system should continue to apply if, and to the extent that, there is a risk that the business to which the withholding system applies may not be in a position to meet its income tax liability. Smaller businesses, irregular activities, or infrequent activities, such as sphagnum moss collection, game hunting and certain labour-only services which are activities specifically covered by the regulations are more likely to run this risk (para 11.16).

The definition of 'withholding payment' should be amended to exclude first, payments made to a GST registered person for the supply of services when the payer holds at the time a GST tax invoice disclosing the GST-inclusive value of that supply except in specific areas of revenue risk (paras 11.22, 11.28), and secondly, payments made by people in the household sector to the extent that the payments are of a private nature (paras 11.25, 11.28).

Interest on underpayments

Questions about relief from the use of money interest rules should be fully addressed as part of the review of the penalties provisions to be conducted by the Inland Revenue Department in 1999 (para 11.37).

The government should consider removing the application of the 5 per cent penalty to taxpayers who fail to pay on time, but who correct that error within a few days of the due date for payment. The government

should also consider reducing the incremental late payment penalty of 2 per cent per month to 1 per cent per month (para 11.43).

Tax recovery

The requirement in section HK 11(1)(c)(ii), that the purpose of an arrangement must have the effect of avoiding tax, should be amended so that it is an alternative or disjunctive requirement only (para 11.52).

12 Penalties

There should be no major changes to the penalties provisions until they are subject to post-implementation review in 1999 (para 12.9). The government should, however, specifically require the review team to report on whether the government's performance expectations of taxpayers are reasonable, whether, and to what extent, a past record of good behaviour should be taken into account in deciding to impose penalties or to escalate enforcement, whether the fairness of the penalties provisions is apparent to all taxpayers, and whether taxpayers who comply can see that those who do not comply are adequately punished (para 12.7).

13 Applying the law

The government should ensure that the Inland Revenue Department reviews staff skill levels, and further, that the department ensures that recruitment, retention and continuing education policies are fully adequate to establish and maintain the staff skill levels that are necessary (paras 13.41, 13.121).

The Inland Revenue Department should remove from its internal practices and procedures and from public statements any suggestions that section BG 1 should be read restrictively rather than liberally (paras 13.53, 13.121).

The Inland Revenue Department should always be alert to the possibility of criminal fraud by taxpayers, and when fraudulent activity is detected, the department should ensure that its officers are aware that the Crimes Act 1961 is the appropriate vehicle for prosecution (paras 13.89, 13.121).

14 The tax implications of electronic commerce

The government should monitor and should continue to participate in the efforts of the OECD in developing tax policy on electronic commerce

and should seriously consider any recommendations that are proposed (para 14.35).

15 Tax advisers

Whether or not they are members of professional bodies, officers of the Inland Revenue Department who encounter misconduct by tax advisers should be able to have it drawn to the attention of the appropriate body. Because of the secrecy requirements in section 81 of the Tax Administration Act 1994, the first step should be internal to the department. Section 81 would need to be amended to allow the department then to report such misconduct. The government should consider such an amendment (para 15.11). The penalties provisions should be allowed to operate for some time to gauge their effect in practice, with a later review, if necessary, to consider the desirability of having penalties apply directly to tax advisers (para 15.14).

16 Relationship with taxpayers

Thorough surveys should take place to determine whether the department should continue to use the customer needs model and, if so, whether any measures are necessary to deal with the contradictions between the roles of taxpayer and customer (para 16.23).

The Inland Revenue Department should abandon the motto, 'It's our job to be fair'. If consideration is given to adopting a replacement motto, it should be tested carefully, not only by research to discover taxpayers' reactions, but also by measuring the motto against the legal and administrative duties of the Inland Revenue Department (para 16.31).

The department's decision to investigate the possibility of attitude-forming campaigns should be implemented more rapidly than is currently proposed (para 16.36).

Section 81(1) of the Tax Administration Act 1994 should be amended to clarify that the administration exception in that provision permits the Commissioner to disclose taxpayer affairs for the purpose of responding to publicity about the department's activities when the Commissioner considers in good faith that such disclosure is necessary to safeguard the integrity of the tax system (para 16.41).

17 The rulings process

The department should consider the way in which product rulings are issued. Issuing product rulings should be discretionary, as is the case

with public rulings. In exercising its discretion to issue public and product rulings, the department should take into account the policy implications of such rulings (para 17.40).

18 The Inland Revenue Department's Budget

The government should encourage the Commissioner fully to utilise the scope for flexibility within the government's budget processes. The government should also keep the whole issue of management flexibility in the context of budget issues under review (para 18.22).

Part I

Tax Compliance Costs

CHAPTER 1 – SIMPLICITY AND COHERENCE

SUMMARY

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Introduction

1.1 New Zealand first enacted an income tax law in 1891. Since that time, the legislation has become increasingly complex. For many years, people have entertained hopes that tax law can be made simpler, only to have those hopes disappointed as reforms have added more and more pages of legislation. Many taxpayers and their advisers feel let down by the process of tax reform. Why do things seem to get worse rather than better? Why can governments not make a better job of reform?

1.2 These are good questions. With all the resources that have been poured into decades of tax reform, both in New Zealand and in other countries, taxpayers may come to believe that a measure of scepticism is justified on their part: surely, reformers could do better if only they tried harder. On the face of it, this is a reasonable conclusion. But it fails to take into account a pervasive and ultimately unresolvable factor: the paradox of tax policy, which may be called for convenience ‘the fiscal paradox’.

The fiscal paradox, neutrality and complexity

1.3 The fiscal paradox is that the more neutral and more equitable a government makes its income tax system, the more complex that system becomes. This paradox shapes the results of modern tax reform, because most governments rightly regard neutrality and equity as key goals of tax policy.

1.4 The policy of neutrality stipulates that the tax system should be neutral between taxpayers: as far as possible all income should be taxed in the same manner, whoever the taxpayers, whatever the form of the transaction, and whatever the structure of the business or investment. To put it another way, the tax system should not influence people's economic decisions, and income should be taxed according to a 'comprehensive' definition. During the late 1980s, the pursuit of neutrality led New Zealand to eliminate many of the provisions of the Income Tax Act 1976 that preferred one type of business activity, or one type of investment structure over others.

1.5 The policy of equity stipulates that people similarly situated should be taxed in the same way at the same rate.

Economic costs of taxation

1.6 Taxation imposes economic costs on society arising from the costs of compliance and administration, and the effects on taxpayer behaviour. These costs are different from the revenue cost of the tax itself, which is a transfer of wealth from the taxpayer to the government, and so is not itself a net cost to society. Compliance, administration, and behavioural costs of taxation are, however, costs to society. Called dead-weight costs these are the costs incurred as a result of the tax system which are not expended directly for consumption or wealth-generating activities. Reducing these costs, which is a goal of the committee, is therefore beneficial to society.

1.7 For every dollar of tax collected, the Inland Revenue Department's administration costs are on average, 1.2 cents. Thus for every dollar of tax collected, the government expends 98.8 cents on goods and services other than revenue collection. Taxpayers and others also incur costs in meeting their obligations under the tax laws. These compliance costs can be quite significant. Borne in the first instance by the person incurring the costs, they are ultimately a cost to society.

1.8 The effect of taxation on behaviour is a far larger deadweight cost than compliance and administrative costs. Taxation affects individuals' decisions to improve their skills, participate in the labour force, work, save, invest and take risks. Of particular concern is the way in which taxation affects investment decisions.

1.9 Without tax, investors generally will invest in sectors where they expect to earn the highest return commensurate with risk. This pattern of investment maximises the wealth of the investor and of society. If the tax

system imposes a different rate of tax on different investments, it distorts investment decisions, with the result that society's wealth is not maximised. This effect is known as allocative inefficiency.

1.10 For example, assume an investment opportunity is expected to earn a 10 per cent pre-tax return, and will be subject to 33 per cent tax. The investment will return 6.7 per cent to the investor (the post-tax return), but 10 per cent to society (since society would earn the total 10 per cent return, divided between the investor and the government). An alternative investment may earn an 8 per cent return but, due to tax concessions, it is taxed at an effective rate of 10 per cent. This investment earns the investor an after-tax return of 7.2 per cent, so this is the investment that the investor will choose. However, the investment earns society a total return of only 8 per cent. The tax system would, therefore, be encouraging private investors to make investments which do not earn society as high a return as it would earn if the tax system were not distorting investment decisions.

1.11 These allocative costs have generally been recognised as by far the greatest costs of the tax system. A conservative estimate⁶ of the allocative or deadweight costs relating to taxing employment income in New Zealand in 1991 was 18 cents per dollar collected. The deadweight costs of taxes on income from capital, for example, interest, dividends and rent, would be considerably higher.

1.12 Ideally, all income should be taxed at as even a rate as possible. Pursuing horizontal equity, however, brings disadvantages in terms of simplicity and compliance costs. For example, the accrual rules in subpart HF of the Income Tax Act 1994 are intended to measure the actual (economic) income from financial arrangements in which the legal entitlement to income is deferred beyond the period in which the income arises. While it is clear that compliance costs would be reduced by repealing the accrual rules, the economic costs in terms of increasing tax distortions and the resulting allocative efficiency costs may well be far greater.

1.13 Treating different forms of income differently not only offends horizontal equity and increases deadweight costs, it also creates boundaries, which create opportunities for tax arbitrage and, therefore, tax

⁶ Diewert and Lawrence, 1994, *The Marginal Costs of Taxation in New Zealand*, Swan Consultants Ltd.

avoidance.⁷ It also increases the complexity and reduces the coherence of the tax system, especially when accompanied by anti-avoidance rules designed to prevent the unintended exploitation of the comparatively favourable tax regime.

1.14 Designing a tax system requires an appreciation of certain trade-offs. On the one hand, the system should be simple and should minimise compliance costs, administrative costs and economic efficiency costs. On the other hand, the system should also pursue horizontal and vertical equity objectives, and whatever social and economic policy objectives the government wishes to further through the tax system.

Complexity in drafting

1.15 To the question, ‘Why does the Income Tax Act 1994 not contain one simple provision that taxes people on their income from year to year?’, the answer is that first, the Act does contain such a provision, it is currently numbered as section CD 5; and secondly, most of the other charging, deductions, and timing provisions in part C to part N of the Act, and the definition provisions in part O, have a different, though closely related, function to promote neutrality and horizontal equity. Part J, repealed from the start of the 1998-99 income year, and part K are exceptions.⁸

1.16 Together, parts C to O, without parts J and K, make up well over 90 per cent of the Act. Broadly speaking, these provisions prevent taxpayers converting gains from revenue to capital. The provisions also prevent taxpayers creating or accelerating expenses that can be deducted in calculating net income, and also deferring the recognition of income and, therefore, its taxation, from one year to the next. If taxpayers engage in this last practice, they get an economic benefit from the time value of money.

1.17 If allowed, each of these activities erodes the revenue base, affects the Act’s neutrality, and reduces horizontal equity. A few provisions have the opposite effect, that is, they prevent people being taxed twice on the same income, or being taxed at a rate that is too high in their personal circumstances.

⁷ See discussion in paras 6.18 to 6.34.

⁸ These parts provide for surcharges, rebates, and credits that are driven by the government’s social and economic policy. They are administered through the tax system, but are not strictly speaking part of it. An example is subpart KD, which provides for family tax credits.

Political and social policies

1.18 Two factors that add complexity appear to be tax policies but are more correctly categorised as political or social policies. These factors are the lack of a comprehensive tax on capital gains and the progressive income tax scale.

1.19 As noted above, the Income Tax Act 1994 contains provisions to prevent people converting revenue gains to capital gains, or capital expenditure to deductible revenue expenditure.

1.20 The second factor is a function of a policy sometimes called vertical equity, which stipulates that richer people should pay a bigger fraction of their income in tax than poorer people. An income tax system achieves vertical equity by having a progressive average scale of tax rates. That is, lower slices of an individual's income are taxed at lower rates than higher slices. From 1 July 1998, taking into account the low income rebate, New Zealand's marginal tax scale is as follows:

<i>Income</i>	<i>Tax Rate</i>
\$0 – \$9,500	15%
\$9,501 – \$38,000	21%
above \$38,000	33%

1.21 Neither the absence of a comprehensive tax on capital gains nor a progressive scale is an essential feature of an income tax regime. But for historical, social and political reasons, New Zealand embraces both. Consideration of these features is outside the committee's terms of reference. Generally speaking, the exemption for capital gains favours richer people over poorer people, because the former are more often in a position to derive economic gains as capital rather than as revenue. On the other hand, a progressive scale favours poorer people, because it causes them to pay a smaller fraction of their income in tax.

1.22 Importantly for the committee's terms of reference, a progressive scale entails greater complexity than a single flat tax rate, because there must be rules to ensure that the Crown taxes income at the different rates that are appropriate for the individuals who derive the economic benefit of the income.

1.23 The fact that New Zealand does not have a comprehensive capital gains tax in itself creates complexity. From this fact, it may be inferred that if there were such a tax, this would solve the issue of complexity. But that does not necessarily follow. Introducing some models

might make the situation more complex, although equity would be enhanced. The capital gains tax envisaged in the 1989 government discussion document is simpler than some models. On balance, in terms of complexity, the lack of a comprehensive tax on capital gains may be beneficial.⁹

1.24 The last paragraph does not express an opinion on whether New Zealand should tax capital gains. The reason for taxing these gains would be to eliminate the current tax preference in favour of gains that occur in a capital form. The committee merely points out that taxing capital gains, like almost anything else that a tax system does to promote economic neutrality, entails complexity and costs of compliance.

Examples of the fiscal paradox in action

1.25 Examples of policies that promote neutrality and that lead to complexity are not hard to find. The committee takes one case in which Parliament's object is to prevent taxpayers exploiting a potential absence of neutrality; a second case in which the government tried to prevent people being taxed at an inappropriately high rate; and a third case, in which the overall policy is to relieve the taxpayer from unduly high rates, but where Parliament was required to incorporate additional rules to frustrate taxpayers who might otherwise exploit elements of the regime favourable to them. These examples illustrate the problems of both a progressive scale and the lack of a comprehensive tax on capital gains. The examples are the accrual rules, the still-born tax credit system for superannuation funds and life offices, and the imputation system for company and shareholder taxation.

The accrual rules

1.26 Properly called the 'qualified accruals rules', these rules are found in subpart EH of the Income Tax Act 1994. They are generally regarded as the most complex regime in the Act. Their function is to prevent taxpayers exploiting the time value of money. Take a taxpayer who lends \$1,000 for, say, five years, for a single payment of \$1,645 that is payable at the end of the five years. The amount of \$645 represents

⁹ Examples of design issues affecting the complexity of a capital gains tax include indexation for inflation; definition of disposal, for example, involuntary dispositions; timing of recognition of a gain, for example, a realisation or accrual basis; form of introduction and associated transitional issues; treatment of personal assets especially personal residences; extent of roll-over relief, for example, intra-group transactions; treatment of capital losses; same or different tax rate.

interest at 10 per cent per annum, compounding monthly, and is the compensation to the taxpayer for not being able to use the \$1,000 over the five-year period. But in the absence of the accrual rules or similar provisions no tax is payable until the end of year five. Conversely, taxpayers can achieve an effect that is similarly beneficial from an economic point of view, by borrowing for a term and incurring and deducting all interest on day one. This technique was fundamental to many tax-saving schemes of the early 1980s in which interest was payable to parties who were based in the Cook Islands and were associated with the taxpayer.

1.27 The accrual rules oblige taxpayers to spread interest on a loan or debt over the duration of the contract. But to operate effectively, the rules must cover not only loans, but also other financial arrangements that can have similar economic effects, such as, credit sales, bonds, transactions involving foreign exchange, and so on. The upshot is that the methods of calculation and of application of the rules are very complex. Indeed, it is doubtful whether the rules could have operated at all before the ready availability of programmable calculators. On the other hand, the rules have the benefit of taxing people who are parties to financial arrangements and whose gains arise from year to year in the same way in which wage and salary earners are taxed. In short, the rules promote neutrality and horizontal equity between the two groups.

The tax credit system

1.28 New Zealand tries to tax all forms of savings at the same rate through rules known as ‘TTE’, that is, taxed, taxed, exempt. Contributions to savings, or to bank accounts are from *taxed* income; accretions of income earned by savings, or by bank balances are *taxed* as they are added to savings; and when savings are paid out on retirement or otherwise, the payments are *exempt* in the hands of the recipient.

1.29 When a superannuation fund earns money on principal that its members have contributed, the fund pays tax on the accretion. The tax is levied at a flat 33 per cent, the same rate as the tax on money held in other investment vehicles, such as companies, life insurance funds, and so on.

1.30 On the other hand, individuals are taxed on a progressive scale. What happens to income in a savings institution that belongs to an individual whose marginal tax rate is less than 33 per cent? One way or another, New Zealand tries to ensure that such income is taxed at the individual’s rate, not at the rate of 33 per cent that applies to the institution.

1.31 When the savings vehicle is a bank account and the income is interest, this objective is relatively easy to attain. The bank deducts withholding tax from interest that it credits to depositors' accounts. It pays the tax to the Inland Revenue Department. As taxpayers, depositors file individual returns of income, and pay extra tax or receive a refund, according to whether tax was withheld from their interest at the appropriate rate.

1.32 When the vehicle is a company, the imputation system has a similar effect. The company pays tax at 33 per cent, but attaches a credit for the tax to dividends paid to shareholders. If the tax that the company paid was at a rate higher than a shareholder's personal marginal rate, the shareholder receives a credit for the excess.

1.33 It is very hard to apply machinery of this sort to superannuation funds. Superannuation funds pool the savings of members, so cannot easily identify interest. Superannuation funds do not pay dividends on a regular basis, so cannot impute credits to members as companies impute credits to shareholders. The result is that, but for specific legislative initiatives, taxpayers with a marginal tax rate of, say, 21 per cent will pay tax at 21 per cent on interest on bank deposits, but will incur tax at the rate of 33 per cent on accretions to their interests in superannuation funds.

1.34 The government sought to address this anomaly in 1998 by proposing a system of tax credits. The government was unable to secure the passage of these rules through Parliament. These rules would have allowed superannuation funds and life offices to credit tax paid at the fund level to the individual savers. Excess tax paid on behalf of low-rate fund members would have been credited to their account. This proposal would have had the effect of taxing members at their individual tax rate.

1.35 The mechanism required to achieve this result, however, was necessarily complex, and would have imposed compliance costs. When this mechanism was framed in legislation, that legislation could not help but be complicated. The mechanism compounds in one set of rules three requirements that are complex even when they are found individually. These requirements are rules that provide for one taxpayer's circumstances to influence the tax rate enjoyed by another taxpayer, rules about apportionment, and rules that keep benefits isolated and identified over a number of tax years.

The imputation system for company and shareholder taxation

1.36 The Income Tax Act 1994 contains different rules for taxing income earned through different legal entities, required by virtue of the different legal relationships and different entitlements to income. In principle, the Act should tax the income earned by or on behalf of an individual at the time it is earned.

1.37 To achieve the goals of equity and efficiency, the person who should be taxed, or who should bear the tax, is the person entitled to the income earned on his or her behalf. Equity is measured by the relative tax burdens of people, not of legal entities.

1.38 Efficiency is also achieved by measuring and regulating the tax impact on the people who control investments and who make decisions on how much they work, save and invest. These people may act through companies, but individuals make the decisions, and they do so, by and large, in their self-interest. It may appear, then, that the way to achieve the goal of taxing the income of individuals is to tax them on income received, imposing tax when a shareholder receives a dividend, without imposing any company tax.

1.39 Such an approach would be simple, and would reduce compliance costs. But it would not achieve the goal of taxing income earned at the individual level, because the income may not be received until some years after it is earned by the company. The longer the period of deferral between the time of earning and the time of receipt, the greater the reduction in the effective tax rate. Taxing company income on the basis of distributions alone, therefore, would violate objectives of horizontal equity and efficiency, because shareholder income earned through different companies could be subject to different effective tax rates, depending on the distribution policies of the companies.

1.40 A way around this difficulty would be to attribute company income directly to shareholders. The shareholders could then be taxed directly on the income attributed to them through the company. This solution, however, introduces its own complexities. The shareholders would have to know their share of the taxable income of the company. Requiring the company to notify shareholders of their income would address the problem, but would carry compliance costs. The taxable income would need to be allocated across the shareholders according to their participant rights at particular times of the year. The shareholders would still have to pay tax, and they might have cash flow difficulties if the company had not paid them a dividend. Addressing the problem in this

way would also negate some of the savings expected to be achieved through the proposed reforms to eliminate the filing of tax returns, as shareholders would have to file tax returns to pay their tax on attributed company earnings.

1.41 The method actually used to pay tax on company earnings is the imputation system, by which the company calculates and pays tax on its earnings on behalf of its shareholders. Its shareholders are taxed on dividends, but are entitled to a credit for tax paid by the company on their behalf. This method achieves the compliance cost savings of having the company calculate and pay the tax, but the tax burden is imposed as proxy for the shareholders being charged tax on their share of the company's taxable income for the current year.

1.42 The imputation system works well for companies. However, different rules are necessary for different legal entities because of the legal relationships created by different entities, and because of the difficulties of determining who is entitled to income earned through them. For example, people working in partnerships are taxed directly on income earned through the partnership. The partners are co-owners of the underlying assets of the partnership and legally own their share of the income earned by the partnership. Trust income has its own regime. Broadly speaking, income that is distributed is taxed to beneficiaries who receive it, and income that is retained is taxed to the trustee.

1.43 While the policy goal is the same, namely that the cost of the tax should be borne by the person entitled to the income, and should be determined at the time the income is earned, different legal mechanisms are used because of the different legal relationships that arise.

1.44 An irony of the full imputation regime is that, although its purpose is to liberate taxpayers from the non-neutrality of the former system of taxing both companies and shareholders, most of its provisions are designed to prevent taxpayers creating other non-neutral entities, by converting revenue into capital or by exploiting rate differentials between different taxpayers. Take, for example, the 10 or 12 pages of rules in subpart ME of the Income Tax Act 1994, which govern the operation of imputation credit accounts.

1.45 Though framed as rules that govern this particular kind of memorandum account, the provisions are, in fact, substantive rules that determine how and when companies are permitted to attach tax credits to dividends. Broadly speaking, the principal objective of the rules is to ensure that the people, who as shareholders indirectly bear tax that is

paid by a company are, first, the same people who derive the benefit of that tax when it is distributed as a credit, and secondly, when they derive that benefit, they do so in shares that are proportionate to their shares in the company. That is, shareholders who enjoy a low tax rate cannot transfer the benefit of tax credits to shareholders who have a higher rate. This objective is pursued within an overall framework that, for reasons of practicality, treats company profits and tax as the fungible sums that they undoubtedly are, and does not require companies to make an artificial link between an identified dollar of profit and a particular 33 cents of tax levied on that dollar.

Summary

1.46 These days, people generally regard taxes as a cost that they bear in order to maintain the kind of society that they hope to enjoy. There is, of course, disagreement on the level of tax that is most efficient for this purpose. But people are less willing to bear the compliance and administrative costs of taxation, because they are aware that these imposts are mere transaction costs that, in themselves, have no direct value to society or to the individual. As the committee explained earlier,¹⁰ the behavioural costs of taxation are an even more serious burden on society than compliance and administration costs.

1.47 While it is generally agreed that there should be some taxation, people, especially those in business, are dissatisfied by levels of compliance and administrative costs, and entertain hopes that these costs can be significantly reduced. These hopes are not entirely misplaced. Throughout this report, the committee recommends improvements that can be made to the tax system, many of which are already under way. But at the same time, the committee emphasises that income tax, for all its virtues as a source of public funds, is a system that by its very nature results in rather heavy compliance and administrative costs. These costs must fall more heavily on businesses than on employees, because of the greater complexity of the affairs of businesses. In the wider interest of containing overall deadweight costs, businesses and in particular employers are convenient vehicles for achieving administrative goals. This consideration raises important issues of whether, when businesses are used in this way, they should be compensated by the government for net costs borne

¹⁰ See paras 1.6, 1.8

in the wider interest of the taxpaying community. This matter is outside the committee's terms of reference.

1.48 The costs just mentioned are necessarily increased in jurisdictions employing progressive tax rate scales. However, while there are many reasons for complexity in income tax law, the most pervasive is the policy of making the tax system as neutral and as equitable as possible.

1.49 The committee has gone into some detail in its discussion of what it has called 'the fiscal paradox' because it believes that the operation of this influence is not well understood. Many people have heard that the major values of tax policy are neutrality, horizontal equity and simplicity (being shorthand for minimised costs of compliance and administration). What they have not heard is that these values are in conflict. Even many tax professionals have a less than perfect understanding of the problem. The committee hopes that its explanation and the examples that it has chosen will shed light on the subject.

CHAPTER 2 – THE REWRITE PROJECT

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INTRODUCTION

Terms of reference, committee guidelines, and stage that the rewrite has reached

2.1 The first of the committee’s terms of reference requires the committee to consider ‘tax compliance costs, including how tax laws may be simplified and made more coherent and understandable ...’ In amplification, the committee’s guidelines state: ‘the committee should comment on the extent to which the rewrite and simplification projects are achieving this term of reference’.¹¹ An extract from the guidelines asks:

Are there changes to the rewrite project which would enable it to better achieve the term of reference? In particular, is the rewritten Act: appropriately structured; with an appropriate level of detail; and expressed in plain language; given: the complexity of the policy expressed in the Act; and the ability of taxpayers to exploit lack of detail?

2.2 The guidelines might equally have referred to taxpayers’ ability to exploit an excess of detail: sometimes, broadly stated rules are more effective than detailed rules.

¹¹ For the text of the guidelines, see appendix 1.

2.3 This part of the report addresses these issues, but the committee notes that the rewrite is an ambulatory project that has a long distance to travel before it is complete. So far, the former legislation has been reorganised into the proposed new structure, the 'core provisions'¹² have been enacted, with consequent alterations throughout the Act. The alterations that are consequent on the terms of the core provisions are largely mechanical, but they are extensive. The government plans to release a proposed draft of parts C, D, and E of the Act (receipts, expenditure and timing) in June 1999. Subsequent stages of the rewrite process will include the redrafting of parts F to O.

2.4 The release of the draft of parts C, D, and E will not occur before the committee's report is finalised. As a result, the committee does not have a finished product to work on in its attempt to evaluate the rewrite project. The burden of the committee's comments is therefore directed to matters of principle, though the report comments on matters of detail where the rewrite project has reached a stage where that is possible. The committee considers in particular the issue of the interpretation of the Income Tax Act 1994, having posed the following questions:

What approach is taken by the courts to the interpretation of tax legislation?

What changes were introduced with the enactment of the legislation in 1994, in particular sections AA 1 and AA 3?

Did the changes introduced in the 1994 Act achieve their objective?

What does the committee recommend should be done?

2.5 In summary, the committee has found first, that the New Zealand courts have adopted a relatively restrictive approach to interpreting tax statutes, see para 2.22. Secondly, the objective of the interpretation provisions in the 1994 Act appears to oblige the court to adopt a more purposive approach and to abstain from a restrictive construction, but sections AA 1 and AA 3 promise more than they achieve, see para 2.90. Among many recommendations, both specific and general, the committee has been led to recommend that there should be an assessment of whether the Act should change to a regime-based structure. This change

¹² Part B, Income Tax Act 1994.

would entail a significant shift of direction for the rewrite process, see para 2.141.

2.6 This section of the report should be read bearing two factors in mind. First, even commentators who conscientiously take into account the unfinished state of the rewrite run some risk of inadvertent unfairness to the project. Secondly, the organisation of the statute and certain other major characteristics of the rewrite were fixed not by officials within Inland Revenue, but on the basis of government decisions.

PRINCIPLES OF STATUTORY INTERPRETATION

Introduction

2.7 People often have difficulty with interpreting legislation, particularly tax legislation. When applied to the facts of a particular case, the words of a statute may be ambiguous or, while apparently clear, may lead to a result that seems to be unjust, absurd, or out of line with other parts of the Act. In these circumstances courts turn for help to principles of statutory interpretation that have developed over many decades. For lawyers and officials, therefore, the term ‘statutory interpretation’ carries a great deal of freight. It refers to whole volumes of principles, rules, and maxims that courts call in aid to help them to interpret difficult passages in statutes.

2.8 One of the more important objectives of the rewrite project appears to be to affect in some degree the process of statutory interpretation as it applies to the Income Tax Act. A number of different objectives have been explained to the committee. This report will explain and evaluate those different objectives in due course, and will attempt to determine the extent to which the objectives are achieved or achievable. First it is helpful shortly to explain what statutory interpretation entails, and how courts go about interpreting legislation.

Interpretation of penal and remedial statutes

2.9 Courts adopt a number of approaches to statutory interpretation. One approach involves categorising the statute in question, and employing principles that are thought to be appropriate for that category of legislation. In the present context, the categories of ‘remedial’ and ‘penal’ are relevant. Remedial legislation is designed to repair some defect that has become apparent in the existing law. Penal legislation, which includes criminal statutes, exacts penalties for breaking rules.

2.10 Historically, courts have adopted opposing approaches to these two categories. Since *Heydon's* case (1584),¹³ whenever a court has categorised legislation as remedial it has tried to work out the purpose of the legislation, and in interpreting the statute it has endeavoured to promote that purpose. For example, when a provision is ambiguous, the court will interpret it in the manner that best promotes what the court sees as the overall purpose of the Act.

2.11 In contrast, when courts categorise statutes as penal they are apt to interpret them restrictively, in order to narrow their scope. The reason is that by imposing penalties penal statutes interfere with the liberty of the subject or take the subject's money or property by fines or forfeitures. Courts take the view that penalties should be imposed only when it is very clear that such was Parliament's intention. Importantly in the present context, courts historically categorised tax statutes as penal, or analogous to penal, because they take money compulsorily from the citizen.

2.12 The judgments of New Zealand courts expressly hewed to this approach to revenue statutes until relatively recent times. For example, in *Plimmer v CIR*,¹⁴ Barrowclough CJ cited with approval the following passage from *IRC v Ross & Coulter (Blandoch Distillery Ltd)*: 'If the provision is reasonably capable of two alternative meanings, the courts will prefer the meaning more preferable to the subject.'¹⁵ In *Mangin v CIR*,¹⁶ the Privy Council approvingly quoted from Rowlatt J in *Cape Brandy Syndicate v IRC*.¹⁷ In what is possibly the most cited explanation of the restrictive approach to interpreting tax statutes in English jurisprudence, Rowlatt J said:

One has merely to look at what was clearly said. There is no room for intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.

2.13 For a long time, New Zealand's Parliament has tried to prevent courts from interpreting penal, tax, or any other statutes in a restrictive

¹³ 3 Co Rep 7a.

¹⁴ [1958] NZLR 147 at 151

¹⁵ [1948] 1 All ER 616

¹⁶ [1971] NZLR 591 at 594

¹⁷ [1921] 1 KB 64 at 71

manner. Instead, by section 5(j) of the Acts Interpretation Act 1924, Parliament deemed all statutes to be ‘remedial’, which meant that courts should interpret them according to the purposive approach ordained by *Heydon’s* case. To make sure that there was no doubt, section 5(j) goes further, and directs that every Act shall ‘receive such fair, large, and liberal construction and interpretation as will best ensure the attainment of the object of the Act ... according to its true intent, meaning, and spirit’.

Interpreting tax statutes

2.14 Although section 5(j) deems all statutes to be remedial and lays down rules of interpretation that appear to be generally applicable, the courts do not accord section 5(j) a status that is superior to judge-made rules of statutory interpretation. There is not a hierarchy of rules. Rather, courts treat the rules of statutory interpretation as a group of principles whose status is initially equal. In any individual case, a court gives primacy to the most appropriate principle. In statutory interpretation, the courts avoid hard and fast rules. The importance of any particular principle varies from case to case depending on the facts of the case and on the provision that is to be interpreted.

2.15 One result is that when it comes to interpreting tax legislation, section 5(j) has little effect on New Zealand courts. In *CIR v International Importing Ltd*,¹⁸ Turner P said that section 5(j) ‘is normally of little material assistance in the construction of revenue statutes’. His Honour explained that the reason is that the object of a revenue statute is to collect tax, and surely it cannot be right that all tax statutes should be interpreted to, in the words of section 5(j), ‘ensure the attainment of [that] object’. To put it another way, the courts would explain that they do not approach the Income Tax Act with an assumption that the statute has an overall purpose to maximise tax. In other words, classifying a statute as a tax statute does not of itself help to resolve ambiguities.

2.16 Rowlatt J’s approach in the passage quoted above from *Cape Brandy Syndicate v IRC* appears to conflict with section 5(j) of the New Zealand Acts Interpretation Act 1924. To mention one point of difference, consider the judge’s reference to ‘equity about a tax’. Here, the judge uses the word ‘equity’ in its archaic meaning of ‘the equity of a statute’. In this meaning, ‘equity’ refers to the spirit or underlying

¹⁸ [1972] NZLR 1095 at 1096

meaning of the statute. Rowlatt J denies that a tax statute can have an ‘equity’ or spirit, but section 5(j) directs the courts to identify the ‘true intent, meaning and spirit’ of all Acts, and to interpret them in that light. As explained above, the Privy Council cited Rowlatt J with approval in *Mangin v CIR*.

2.17 Part of the explanation may be that although the principles of statutory interpretation are often called ‘rules’ the courts treat them more as guidelines whose importance varies relative to one another depending on the facts and nature of the case. One commentator went as far as to say, ‘A court invokes whichever of the rules produces a result that satisfies its sense of justice in the case before it’.¹⁹ In declining to apply section 5(j), and in approving Rowlatt J’s *mot*, Turner P in the *International Importing* case and the Privy Council in *Mangin* were treating section 5(j) as if it had the same status as other ‘rules’ of statutory interpretation.

Modern developments in the interpretation of tax statutes

2.18 Modern courts tend to draw back from the unequivocal import of Rowlatt J’s words. In *CIR v Alcan New Zealand Ltd*,²⁰ the Court of Appeal referred to the quotation from *Cape Brandy Syndicate v IRC* and to the surrounding text in the judgment in *Mangin v CIR*. Speaking for the court, McKay J said: ‘It would be a mistake to read this passage as putting revenue statutes in some different category from other legislation with their own peculiar rules of interpretation.’

2.19 Whether New Zealand courts, or some of them, continue to make the ‘mistake’ that was identified by McKay J, of treating tax statutes differently from other legislation, is not something that can be demonstrated scientifically one way or the other. The difficulty is that legal reasoning in general, and statutory interpretation in particular, do not lend themselves to scientific analysis, nor even, beyond a certain point, to the rules of logic.

2.20 Take the decision in the *Alcan* case itself. After detailed analysis, the court interpreted the statutory provision in question according to its literal meaning and came down against the Commissioner. But many people would conclude that Parliament, had it thought about the matter,

¹⁹ Willis, ‘Statute Interpretation in a Nutshell’ (1938) 16 Canadian Bar Review 16, quoted in Dias, RWM, 1964, *Jurisprudence*, 2d ed 108.

²⁰ [1994] 3 NZLR 439 at 443

would not have intended the result of that decision, which was, in effect, to allow the taxpayer to exploit a loophole in the legislation.

Summary of the position up to the 1994 Act

2.21 In the circumstances of the case, bearing in mind New Zealand courts' ordinary approach to statutory interpretation, the committee, and most lawyers, would say that in *Alcan*, the court had no option but to apply the literal words of the Act. Some would say that although the *Alcan* court applied the existing legislation correctly, the law needed changing in order to enjoin a more purposive approach to interpreting tax statutes. Others would argue that even the existing law that the court purported to apply should have led the court to a more purposive interpretation, closed the loophole, and decided the case in favour of the Commissioner. Yet others would oppose such a degree of purposive interpretation, taking the view that the law is what Parliament says it is, not what Parliament might have said, had it thought further.

2.22 Whichever opinion is correct as far as the *Alcan* case is concerned, it is certainly true that in comparison with, say, United States courts, New Zealand courts adopt a relatively restrictive approach to statutory interpretation in general and to interpreting tax statutes in particular. Whether it is desirable to move to this more purposive approach is a matter for debate.

Changes wrought by 1994 Act

2.23 In the preceding paragraphs, the committee has tried to explain just what it is that the text of the 1994 Act, as amended in 1996, addresses about the way in which income tax legislation is interpreted. Secondly, the committee has tried to shed light on the difficulty of the drafters' task by explaining something of the considerations that entrenched the traditional approach. In summary, the objective of the interpretation provisions in the 1994 Act appears to be to oblige the courts to adopt a more purposive approach in interpreting the Act, and to abstain from restrictive construction. In the next sections of this report the committee attempts to evaluate the success of the 1996 drafting.

2.24 The foundations of the interpretation provisions of the Act are sections AA 1 and AA 3(1), which read:

AA 1 Purposes of Act

AA 1 The main purposes of this Act are

- (a) to impose tax on income;
- (b) to impose obligations in respect of tax;
- (c) to set out rules to be used to calculate the tax and to satisfy the obligations imposed.

AA 3 Interpretation

AA 3(1) The meaning of a provision of this Act is found by reading the words in context and, particularly, in light of the purpose provisions, the core provisions and the way in which the Act is organised.

Significance of section AA 1

2.25 On the face of it, section AA 1 is so obvious as to be redundant. But considering section AA 1 in the light of judicial statements both explicit and implicit to the effect that revenue statutes do not have purposes that can helpfully be consulted to inform the process of statutory interpretation, the committee can understand the objectives of the drafters of section AA 1. If there is to be an attempt to instill a more purposive approach to the interpretation of the Income Tax Act, it is worthwhile to attempt to set out the fundamental purpose of the statute if it can be done in such a way that is helpful to interpretation.

2.26 As it stands, section AA 3(1) tries to instruct judges to interpret the Act in the light of its purpose, and section AA 1 makes that purpose explicit: to wit, and broadly, to impose tax. That is, sections AA 1 and AA 3(1) appear to be intended to oblige courts (or to entitle them, depending on one's point of view) to interpret the Income Tax Act in a more purposive way, more akin to the American manner than to the traditional New Zealand approach.

2.27 Ordinarily, if Parliament expresses purposes like the purpose in section AA 1 at all, it makes them part of the long title of the statute in question. Importing the purpose into the first section of the Act itself, and adding section AA 3, seems to have been calculated to raise the Income Tax Act's primary purpose provision to a greater level of significance.

2.28 The difficulty with what the drafters seem to have tried to achieve in section AA 1 is the problem that this report has already discussed: fundamentally, the objective of any revenue legislation is to collect tax, whether this objective is expressly stated as in section AA 1

or not. The courts have long taken the view that Parliament cannot mean that any ambiguity in a taxing statute should be resolved in favour of maximising the tax take.²¹

2.29 The terms of section AA 1 may provide grounds for arguing that a court construing the Income Tax Act 1994 should revise the view that has just been described. But in the opinion of the committee this argument would not be successful, and section AA 1 would not achieve that objective. That objective would require a much more fundamental change on the part of the courts. If Parliament seeks to change the courts' approach to interpreting the Income Tax Act in this radical manner, it will be necessary to enact much more specific purpose provisions than section AA 1 and, one might add, much more specific directory provisions than section AA 3.

Evaluation of section AA 3(1)

2.30 Section AA 3(1) requires more extended evaluation, organised by reference to the four factors that it stipulates as having to influence interpretation: context, purpose provisions, core provisions, and the way in which the Act is organised.

2.31 The committee first disposes of a drafting comment: the section should read as originally drafted by the Law Commission,²² not 'in light of the purpose provisions' but 'in the light of the purpose provisions'. Syntactically, English prose requires the use of the definite article 'the' in this passage, because the metaphor in section AA 3(1) refers to a particular light (the light of the purpose provisions), not to light in general nor to light as an abstract concept.

Context

2.32 Section AA 3(1)'s opening words are no more than a statement of one of the common law approaches to statutory interpretation: 'The meaning of a provision of this Act is found by reading the words in context...' However, reported cases show that 'context' in this sense has different meanings depending on the relevant circumstances of the case in question. The meaning of the word varies from the total historical context of an Act together with Parliament's apparent intention at the

²¹ *CIR v International Importing Ltd* [1972] NZLR 1095 at 1096 per Turner J, CA, discussed above in para 2.15.

²² NZLC R17 *A New Interpretation Act*, 1990, page 12.

time that the Act was passed, or to merely the language of the adjacent part of the statute, or something in between. Sometimes a judgment mentions more than one meaning of ‘context’.

2.33 For example, in *CIR v Alcan New Zealand Ltd*,²³ the Court of Appeal quoted Richardson J in *Challenge Corporation Ltd v CIR* to this effect:

Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole statute, analysing its structure and analysing the relationships between the various provisions and recognising any discernible themes and patterns and underlying policy considerations.²⁴

In deciding the case the *Alcan* court considered both the ‘historical context of the whole statute’ and ‘the relationships between [its] various provisions’. In the end, the court gave precedence to the latter, with the result, as mentioned, of allowing the taxpayer to exploit a loophole.

2.34 If the court had instead given the full effect to the historical context of the provision that was urged by counsel for the Commissioner, it would have overridden the literal words of the statute and reached the opposite conclusion, and decided the case in favour of the Commissioner. This contrast reflects a relatively common pattern in tax cases where statutory construction is finely balanced: a narrow, literal interpretation helps the taxpayer, whereas a broader, more purposive interpretation helps the Commissioner. It follows that the word ‘context’ alone, without amplification, does not advance the apparent objective of the rewrite with which this part of the committee’s report is concerned: to instill into courts a generally broader purposive approach to interpretation of tax statutes.

2.35 If a more liberal approach, less constrained by the language used, is considered desirable, section AA 3(1) should refer to factors such as historical context and apparent policy. In fact, as explained below, the remainder of section AA 3(1) may limit rather than amplify ‘context’, by referring to ‘core provisions’ and ‘the way in which the Act is organised’. The third element, the reference to ‘purpose provisions’, will

²³ [1994] 3 NZLR 439 at 444

²⁴ [1986] 2 NZLR 513 at 549

probably be neutral, except where relatively narrow purpose provisions are enacted for particular sections or groups of sections. In this latter case, the effect of ‘context’ will be amplified.

Local context

2.36 Officials advised the committee that the government had an additional, though related, objective in drafting section AA 3(1). This objective was to persuade courts to interpret provisions according to their purpose as revealed by their locality within the Act. For example, an anti-avoidance provision, located in a subpart of the Act reserved for anti-avoidance provisions, should be interpreted as an anti-avoidance provision only, and not as a provision that enables taxpayers to contrive transactions with structures that entitle people to claim deductions that would not otherwise be allowed (which is sometimes the fate of anti-avoidance provisions).

2.37 Another example flows from a canon of statutory interpretation often employed by the courts: to try to interpret crucial statutory terms in a way that ensures that the terms bear the same meaning wherever they are used in the Act. *CIR v Alcan New Zealand Ltd*²⁵ may be considered as a case where the court observed this canon, choosing an interpretation that allowed ‘company’ and ‘group’ to keep consistent meanings throughout the Act. Maintaining this consistency entailed rejecting the Commissioner’s submission.

2.38 The committee agrees with officials that the problem identified in para 2.34 is serious and a worthwhile objective for the rewrite process to address. The best result would be for the rewrite process to achieve a statute where the kinds of interpretation problems that the above examples illustrate will not occur: the outcome of the rewrite would be a statute where sections are not only clear in themselves, but also do not have inadvertent effects beyond the drafter’s intention. However, no-one can be sure that such a result could be achieved, and later amendments would always put it at risk. Accordingly, the committee agrees with officials that a back-up interpretation rule is a sensible precaution. The question is, does section AA 3(1) as drafted fulfil this backup role?

2.39 The committee believes that it does not. It is a general principle of constructing not only statutes but all documents that a document

²⁵ [1994] 3 NZLR 439 (CA)

should be interpreted as a whole. Accordingly, when a court looks to context to interpret a statutory provision, it will inevitably be influenced by the rest of the Act. Moreover, as has been explained, ‘there is no equity about a tax’.²⁶ That is, courts approach rules in tax statutes neutrally, without preconceptions: if a rule appears at first sight to operate in one context, that alone is no reason to conclude that it does not also operate in a different context.

2.40 The committee returns to the example mentioned above, an anti-avoidance provision that is inadvertently framed in a way that enables taxpayers to use the provision to qualify for deductions that the legislature had not intended. In the committee’s opinion, if the anti-avoidance rule were placed in a local context of a series of other anti-avoidance rules the court would take that location into account. But by itself, the placement of the provision within such a local context would not be enough to frustrate a taxpayer who wished to rely on the rule for some other purpose if the language of the rule supported that reliance.

2.41 The committee **recommends** that drafters should revisit section AA 3(1) and make explicit that provisions that are intended to operate only in a particular manner or in a particular context, should not apply in other contexts.

Purpose provisions

2.42 The 1994 Act is organised in fourteen parts, A to O, plus part Y, which contains amendments, repeals, savings, and transitional provisions. Each part after A is organised in subparts, for example DA, DB, DC, and so on. In each part, the first subpart is reserved for purpose provisions: BA, CA, DA, EA, and so on. So far, only subpart BA has been drafted and inserted into the Act.

2.43 As mentioned in para 2.25, the committee agrees that it is worthwhile attempting to draft section AA 1 to express the fundamental purposes of the Act. However, the committee has reservations about the formulation adopted. There is both ambiguity and superfluity in the current terminology of section AA 1. As to ambiguity, the word ‘income’ in its ordinary sense, does not capture all of the intended tax base, for example, as the committee points out in para 2.48, the Act taxes certain

²⁶ *Cape Brandy Syndicate v IRC* [1921] 1 KB 64 at 71, Rowlatt J, discussed above in para 2.12.

capital gains. As to superfluity, paragraphs (b) and (c) of section AA 1 do not add to paragraph (a).

2.44 One possibility is to redraft section AA 1 to say that the main purpose of the Act is to impose a tax on income as that term is used in the statute. The drawback of this draft is that it makes section AA 1 clearly only a mere description of the Act.

2.45 The difficulties in drafting section AA 1 do not markedly diminish when considering drafting purposes for individual parts of the Act. In fact, the Inland Revenue Department advised that the rewrite process may move its focus from part-based purpose provisions to purpose provisions that relate to subparts. Even that exercise may prove unrewarding, depending on the relative heterogeneity of the subpart in question. However, where it is helpful, the committee certainly sees value in purpose provisions for specific sections or groups of sections that have a common subject matter.

2.46 The challenge of drafting meaningful purpose provisions for whole parts of the Act may be illustrated by examining part C, Income Further Defined and part M, Tax Payments, by way of examples.

Purpose provisions and part C

2.47 Part C, Income Further Defined, brings into the income tax net most of the multifarious and miscellaneous kinds of income that one could imagine, together with a number of categories of receipt that are treated as income but that would ordinarily be regarded as receipts of a capital nature. At one extreme is the generality of section CD 5, which captures all items that are income according to the ordinary meaning of the word, though it uses the unnecessarily tortured prose of ‘any amount that is included in gross income under ordinary concepts’ to do so.

2.48 Among the provisions that capture as income items that would be capital according to the ordinary usage of the term are section CD 1(f) (in some circumstances, profits²⁷ on land held as a capital asset that is subdivided and sold); section CE 1(e) (premiums paid for leases); section CF 2(1)(f) (certain issues of bonus shares by companies); and section CD 4 first limb (profits²⁸ on the sale of personal property held on capital or private account where the taxpayer has a business of dealing in

²⁷ The Income Tax Act 1994 uses the term ‘any amount’.

²⁸ See footnote 28

property of a similar kind). The committee has not overlooked that in a line of cases beginning with *Hazeldine v CIR*,²⁹ the courts drew the teeth of the predecessor to this provision so that the rule does not have the effect that the drafter appears to have intended. *Hazeldine* holds that the first limb rule applies only to property that the taxpayer has committed to his or her business. Wilson J came to this conclusion notwithstanding that profits on the sale of a property that has been committed to a business are taxable as business income in any event.

2.49 Examples of particular provisions in part C that capture particular kinds of income include subpart G (income attributed to New Zealand taxpayers from controlled foreign entities and foreign investment funds); subpart I (fringe benefits); and subpart J (income from minerals, from films; and from certain special kinds of transactions that relate to petroleum mining). Part C also includes rules about life insurance, primary producer cooperatives, international sea freight and renting films. To climax the miscellany, subpart CB contains 15 sections that, in contrast to the rest of part C, are about exempt income.

2.50 Part C also illustrates the difficulty of composing purpose provisions for subparts. For example, referring to some provisions mentioned in the previous paragraph, subpart CJ covers a wide and miscellaneous range of kinds of income from: minerals, timber, flax, films, and four or five different kinds of income from petroleum mining and associated activities. Subpart CN is similar, embracing outward-bound sea carriage, non-resident film renters, and several modes of carrying on life insurance or underwriting businesses.

Purpose provisions and part M

2.51 Part M, Tax Payments, exemplifies a different kind of mixing of categories. Subpart MB deals with provisional tax, which is essentially a collection mechanism. On the other hand, subpart MF deals with branch equivalent tax accounts, which are the mechanism for calculating people's income tax in respect of their interests in controlled foreign companies. Subpart MF does, it is true, involve payments of tax. But it is essentially a fasciculus of substantive rules, albeit framed in a mechanical form, that constitutes a large fraction of New Zealand's controlled foreign company regime. Even in form, subpart MF has little similarity to

²⁹ [1968] NZLR 474, Wilson J

the provisional tax rules of subpart MB. The other subparts of part M deal with other matters again, some of which have some similarity to one or the other of subparts MB and MF.

2.52 These lists of the components of part M, and of the components of part C discussed above, illustrate the difficulty, and probably the impossibility, of drafting any but the most generalised rules that could capture the purposes of the whole of each of these parts in a way that will help interpretation. Examinations of other parts of the Act lead to similar conclusions. In fact, the Inland Revenue Department drafting team advised the committee that it is coming to the same conclusion: in the team's view it may be that some, at least, of the proposed purpose provisions will never be drafted.

Core provisions

2.53 The second factor that section AA 3(1) directs to be taken into account in interpreting the Act is the core provisions, that is, part B. The function of the core provisions has changed as the rewriting process has progressed. Originally,³⁰ the core provisions were to collect the major rules of the Act: the rule imposing income tax, the rule taxing business income, the basic rule that allows deductions, the general anti-avoidance rule, and so on. The reorganised 1994 Act, as originally enacted in December 1994, (before the rewrite of the core provisions by the Taxation (Core Provisions) Act 1996) had the core provisions as shown in Table 1 on page 30.

2.54 The role of the core provisions has steadily developed and now, in a paraphrase of the words of section BA 1, it is essentially to impose income tax and to explain the scheme of the Act and the relationship between its different parts. For example, part B explains that to arrive at taxable income the major steps are: to add all gross income, to subtract allowable deductions, leaving net income. From net income one subtracts any losses carried forward from earlier years, finally to reach taxable income. Each of these steps refers the reader to other parts of the Act. For example, in calculating gross income, one goes to any and all provisions in parts C to I that relate to the taxpayer in question.

³⁰ Consultative Committee on the Taxation of Income from Capital, *The Core Provisions of the Income Tax Act 1976*, Discussion Paper, September 1990, para 1.3.

TABLE 1: CORE PROVISIONS

	<i>1994 Act (before 1996 No 67)</i>	<i>Corresponding 1976 Act provision</i>
BB 1	Income tax imposed	38(1),(2)
BB 2	Rates to be fixed by annual taxing Act	39(1)–(3)
BB 3	Liability to tax of income derived from New Zealand and abroad	242
BB 4	Items included in assessable income	65(a) excluding the proviso 65(2)(b) 65(2)(e) excluding the proviso) 65(2)(l)
BB 5	Amounts remitted to be taken into account in computing income	78(1)–(3)
BB 6	No deductions unless expressly provided	101
BB 7	Expenditure or loss incurred in production of assessable income	104
BB 8	Certain deductions not permitted	106(1)(a),(j),(k),(o)
BB 9	Agreements purporting to alter incidence of tax to be void	99(2)
BB 10	Rebates to be deducted from income tax	57 (1)
BB 11	Arrangements for relief from double taxation, and exchange of information	294(1)–(4) 292(2)

2.55 One of the purposes of the original core provisions was to give the reader a snapshot overview of the Act. In one sense this objective is achieved; that is, the sense in which one gets an overview of a book from a rather terse table of contents. But the new core provisions do not afford an overview in the sense of a summary of the major highlights of the Act.

2.56 That original objective may have been over-ambitious. Now, second and third purposes of the core provisions have come to the fore, and the original objective has been abandoned. The second purpose is to gather in one place the normative links that bind together the other parts of the Act. A third purpose is to add more normative links so as to ensure that each link is made explicit, and that no step of reasoning relies on necessary implication. Providing these additional links may well be a useful function, though it has to be said that much income tax legislation seems to operate well enough without such rules. For example, the former section 65(2)(a) of the Income Tax Act 1976 provided that business profits were assessable as income. It was not thought necessary to have

in addition an express rule equivalent to the current section BD 1(1), which ensures that this form of gross income, now caught by section CD 3, is added into a taxpayer's gross income calculation.

2.57 Thus, the core provisions serve as a quick response should, for example, intrepid taxpayers one day be tempted to argue that just because the Act labels an item as gross income it does not necessarily follow that taxpayers must take this item into account when calculating how much tax to pay. But it is not clear to the committee how the current core provisions are likely to help future courts or officials to interpret the Act, as provided by section AA 3(1). At the same time, neither does it seem likely that the core provisions will obscure or hamper the interpretation process: they seem to be neutral as far as interpretation goes.

2.58 Neutrality is not a good enough reason to leave the core provisions as one of the elements that contributes to interpreting the Income Tax Act. Despite the bland appearance of the core provisions, it is impossible to predict whether counsel in some future case may be able to seize on one or other of those rules to support an otherwise questionable argument. The committee **recommends** that the government should reconsider whether the reference to the core provisions in section AA 3(1) should stay.

The organisation of the Act

2.59 The third factor that section AA 3(1) directs to be taken into consideration for interpretation purposes is 'the way in which the Act is organised'. The organisational scheme of the Act is one of formal function rather than of regime. This functional scheme entails that provisions that operate in the same manner are grouped together in the same part of the Act. Thus, for instance, provisions framed as deductions are grouped in part D, rules framed as anti-avoidance provisions are in part G, and anything that involves a credit is in part L.

2.60 One result is that rules that deal with substantively quite different kinds of factual situations are found cheek by jowl. For instance, within part F, Apportionment and Recharacterised Transactions, Matrimonial Transfers in subpart FF follows Amalgamation (of companies) in part FE and precedes Apportionment of Interest Costs in subpart FG. Another result is that regimes that in the 1976 Act were collected together are scattered in different parts of the 1994 Act. For example, the rules that apply to controlled foreign companies are mostly in subparts CG, MF, and OD.

2.61 A third result is that the location of a rule depends on its form rather than on its substance. Take, for instance, the rule that taxes the profits on certain land sales when the profit is largely the result of a zoning change. Most of this regime is found in section CD 1, particularly section CD 1(2)(e). The bite of this regime tapers by 10 per cent each year until after the taxpayer has owned the land in question for ten years there is no tax to pay at all.

2.62 It happens that when the rules about zoning were inserted in 1975, Parliamentary Counsel chose to frame the tapering rule as a deduction, first capturing the whole of relevant profits, and then allowing a deduction that grows at ten per cent annually until by year 10 of land ownership, there is no profit left to tax. Because it allows a deduction, the tapering rule is separated from the rest of the regime, and appears in the Act as section DJ 14. The rule could just as well, and more consistently with readers' intuition, have been framed positively, to tax the appropriate percentage of profit for each year of ownership: 90 per cent for one year, 80 per cent for two years, and so on.

Implications of the statute's form-based organisation

2.63 The formal, rather than substantive, nature of the Act's organisation that the committee describes above is a fundamental and pervasive aspect of the rewrite. A thorough understanding of the Act's organisational principles is important to an understanding of the organisation itself. An analogy helps. Consider a criminal code. Criminal codes are ordinarily organised in the manner of the New Zealand Crimes Act 1961. That is, offences of similar kinds are grouped together: fraud, theft, assaults, offences against public order, and so on. As an alternative, it would be possible to organise a criminal code according to penalties or procedures: offences carrying a fine, offences carrying less than three months' imprisonment, offences carrying less than seven years' imprisonment, very serious offences, and capital offences would be a possible categorisation, perhaps overlain by procedural aspects of offences: offences triable by information, by indictment, or by either, and with or without the right of trial by jury.

2.64 In fact, as far as the committee knows, no-one has ever organised a criminal code in the manner just described, but such an essentially formal or procedurally based approach affords a reasonably close analogy to the organisation of the rewritten Income Tax Act.

2.65 The discussion above suggests that the place of a rule in the organisational scheme of the Act will ordinarily shed no light on the way

in which the rule is to be interpreted. Indeed, and subject to what is said in the next section of this report, as a general principle, a rule's place in the Act's scheme *will not* influence the interpretation of the rule. At best, it would be a factor to consider in some cases. The reason is that if a court calls on the scheme of a statute for help in interpreting it, the court does so because it is trying to work out the substance of Parliament's intention in respect of that rule. The place of the rule in the statute and its relationship with other rules may help the court in this task. But if the location of the rule is purely a matter of form and of the way in which the rule functions, and not a matter of the relationship between the rule and other rules that together with the rule form a coherent regime, then generally speaking the location of the rule vis-à-vis other rules can shed little light on interpretation problems. Subject to what this reports says earlier about the concept of the local context of a rule within an Act,³¹ at best the location will be irrelevant and at worst misleading.

Organisational scheme and local context

2.66 The situation described in the preceding paragraph is in a sense the opposite of what officials intended. Officials explained to the committee that one hoped-for benefit from the Act's functional organisation was that courts would be more ready to confine rules within their own appropriate local contexts, and would be less inclined to permit, say, an anti-avoidance rule to have the effect of allowing an unintended deduction. The report addresses this issue under the heading 'Local context' above, see paras 2.36 to 2.41.

2.67 The result is that, on one hand, the organisational scheme isolates provisions from other sections of the regimes of which they form part, so that courts lose the benefit of being able to interpret sections in the light of other nearby parts of their regimes. Further, because regimes are scattered it is not possible to have over-arching regime-specific purpose provisions to inform the interpretation process.

2.68 On the other hand, if provisions are clearly identified by function, it may be that carefully drafted interpretation rules could ensure that courts would not allow them to influence the interpretation of provisions with other functions.

³¹ See paras 2.36 to 2.41

2.69 In this last context, in theory the functional organisational scheme has the merit of enabling the courts and other readers to identify the purported function of any particular provision. However, that identification process could be achieved in ways that would not require the various regimes and sub-regimes of the Act to be disaggregated and spread through the statute.

2.70 For example, it would be possible within a part of the Act devoted to, say, the imputation regime or trusts or controlled foreign companies to set aside subparts for anti-avoidance rules, for rules that relate to accounts that must be kept, and so on. In principle, such smaller, regime-specific subparts would serve drafters' purposes better than purely functional subparts, because the operational effect of sections would be limited by both function and regime, and not by function alone, as is the case with the Act's present organisational scheme.

2.71 The committee **recommends** that the government should review the way in which the Act's interpretation provisions together with the organisational scheme operate in relation to what the committee has called the 'local context' of a statutory rule. The committee endorses the intention of the rewrite process that the Act should be interpreted in a manner that prevents rules from operating outside the context where Parliament intended them to operate, but is of the opinion that the present interpretation provisions do not achieve that goal.

Reference to organisational scheme in section AA 3(1)

2.72 As mentioned, section AA 3(1)'s reference to the Income Tax Act's organisational scheme cannot logically refer to substantive, regime-based, relationships between sections because the scheme does not have a substantive basis. What effect might there be from the direction in section AA 3(1) to courts to take into account 'the way in which the Act is organised'?

2.73 The committee suspects that it is unlikely that courts will be misled. The organisational scheme of the Act is so clearly unrelated to substance that it is hard to see a court being influenced by that organisational scheme in the process of statutory interpretation, notwithstanding the clear direction in section AA 3(1). However, it is hard to predict what might happen in marginal cases, particularly tax cases, which often come before High Court judges who are not familiar with the idiosyncrasies of tax law. Statutory interpretation arguments based on the Act's organisational structure and authorised by section AA 3(1), but having no substantive merit, could lead to perverse results. The effect of this

recommendation, combined with the recommendations in paras 2.41, 2.58 and 2.71, is that the committee **recommends** that section AA 3(1) should be reviewed as a whole.

2.74 If the government accepts the committee's recommendation to review the Act's interpretation provisions insofar as they relate to its organisational scheme these concerns will no doubt be addressed. If that recommendation is not adopted, the committee alternatively **recommends** that the government should consider whether section AA 3(1) should omit any reference to the way in which the Act is organised, in order to avoid the possibility of perverse interpretations.

2.75 The immediately preceding sections of this report are concerned with the implications that the Act's formal organisational structure has for interpretation purposes. Elsewhere in this report the committee discusses the advantages that those who established the architecture of the Act have sought from the method of organisation that they specified, see paras 2.126 to 2.147.

Relationship between the Acts Interpretation Act 1924 and the Income Tax Act 1994

2.76 Sections AA 1 and AA 3(1) of the Income Tax Act 1994, taken together, probably do not conflict with section 5(j) of the Acts Interpretation Act 1924. Rather, they may be seen as a particular application of the principles of section 5(j), which is probably the intention of the drafter. However, one member of the committee finds the position uncertain, and foresees possible submissions to courts in future cases that sections AA 3(1) and AA 1 together oust section 5(j) and any other relevant general interpretation provisions from application to the Income Tax Act. The committee believes it unlikely that drafters of the Income Tax Act had this intention. However, if sections AA 1 and AA 3 are to remain in the statute, in order to put the matter beyond doubt, the committee **recommends** that the Income Tax Act should state that its interpretation provisions do not oust any statutory generally-applicable rules of interpretation unless the former are clearly inconsistent with the latter.

The rewrite's objectives as to interpretation provisions

2.77 Redrafting the income tax legislation is one thing. The way in which people, especially judges, interpret the redraft is another. Those responsible for the rewrite have clearly given considerable thought to the interpretation question. One result is that the new Act contains a number of interpretation provisions of novel forms. Of these provisions, this re-

port has discussed sections AA 1 and AA 3(1) at some length. However, in the end the committee has been left in a state of some uncertainty as to just what it is that the rewrite process is attempting to achieve as far as interpretation is concerned. There are five explanations, of increasing levels of intensity:

- 1 There is no intention to change the way in which tax statutes are interpreted at all.
- 2 There is no intention to change the way in which tax statutes are interpreted, but drafters have added or will add some instructional material (notably sections AA 1 and AA 3(2) and the proposed purpose provisions) for the benefit of readers without legal education, who are not familiar with the principles of statutory interpretation.
- 3 While there is no intention to change the way in which tax statutes are interpreted, drafters hope the new interpretation provisions will change the result in particular cases.
- 4 There is no intention to change the general way in which tax statutes are interpreted, but there is an intention to emphasise a principle that rules should be interpreted according to their local context in the Act.
- 5 There is an intention to make a reasonably major change, towards a more purposive style of interpretation.

2.78 Officials' explanations to the committee support variously explanations 1 to 4. Officials disavow explanation 5. The committee deals with these possible objectives below, though in a different order.

Instructional objective

2.79 To the extent that the rewrite's interpretation provisions try to instruct lay people in methods of statutory interpretation they are misconceived. The committee hopes that it has made the point in earlier parts of this chapter that statutory interpretation is an inexact, multi-faceted exercise, replete with guidelines that confuse the uninitiated by (a) often appearing to be inconsistent with one another, and (b) masquerading in the form of rules. It is hard to see that choosing two or three of these guidelines (as section AA 3(1) does) and stating them in a very concise form, will help lay people to interpret the Act.

2.80 Take, for instance, section AA 3(1)'s reference to 'the way in which the Act is organised'. It is certainly true that this passage reflects the 'organisation and scheme' approach to statutory interpretation that is

often enjoined by modern judges. But that approach does not take us very far in difficult cases. For example, the Court of Appeal in *CIR v Alcan New Zealand Ltd*,³² quoted Richardson J in *Challenge Corporation Ltd v CIR*,³³ to the effect that the ‘scheme of the legislation’ is one of the ‘twin pillars’ of statutory construction (the other being the ‘relevant objectives’ of the legislation). But in most cases one can look at the scheme of the relevant legislation at different levels of generality.

2.81 The *Alcan* case was no exception. One possibility, urged by counsel for the Commissioner, was that the scheme of the Income Tax Act insofar as it applied to corporate groups was that all companies that were members of a group had to be resident in New Zealand. Another possibility, ultimately adopted by the court, was that the word ‘company’ retained the same meaning throughout the Act, a meaning that included non-resident companies. The court adopted this second approach because it fitted best with the literal words of the Act. But it is hard to see how lay people could be assisted towards a similar result in respect of either the 1976 Act or the rewritten Act by knowing that they are expected to interpret the legislation by taking into account ‘the way in which the Act is organised’. If anything, lay people taking the instructions in section AA 3(1) at all seriously risk being misled into undue confidence in their interpretations of statutory ambiguities.

The local context rule

2.82 The committee has discussed the rewrite team’s ideas about interpretation according to local context in para 2.52 of this report. It suffices to repeat that while the committee sees some merit in the team’s overall policy of, for example, taking precautions to ensure that anti-avoidance rules cannot be exploited to permit contrived deductions, in the committee’s opinion the measures taken in the rewritten Act will not achieve that objective.

Change of result

2.83 Officials explained that while the rewrite was not calculated to change the courts’ approach to statutory interpretation, it was intended to change the result in particular cases. Two examples were given: the one just mentioned (anti-avoidance rules being exploited to permit deduc-

³² [1994] 3 NZLR 439 at 444

³³ [1986] 2 NZLR 513 at 549

tions) and *CIR v Alcan New Zealand Ltd*, where the Court of Appeal decided the case by following the literal words of the statute. The result was to sanction a loophole that led to an asymmetry in tax treatment to the advantage of the taxpayer and to the disadvantage of the Commissioner.

Change of approach

2.84 The committee considers that, if the courts were to change their methods of statutory interpretation to a degree that was sufficient to achieve changes of result in cases similar to those just described one could not describe the change as merely a change of emphasis that would lead to different results in particular cases. On the contrary, the changes would mean that the courts are henceforth to take an avowedly purposive approach to interpreting the Act, bearing in mind that its overriding and fundamental purpose is, in the words of section AA 1(a), 'to impose tax on income'. This change moves away from both the pro-taxpayer tilt seen in such cases as in *Plimmer v CIR*,³⁴ and the according of equal status to the literal and the purposive approaches to statutory interpretation, seen in *CIR v Alcan New Zealand Ltd*.³⁵

2.85 The committee would see these developments as a sea change in statutory interpretation. They would entail interpreting the Income Tax Act 1994 in a different manner from other statutes. Officials disagree: they do not see the interpretation provisions as having such a profound effect. Further, it was suggested that the examples of particular cases where results would change had perhaps not been well chosen. Probably, the results in those cases would not change, but results in other, presumably closer, cases would be expected to change, though no examples were suggested.

Interpretation provisions: what should be done?

2.86 The committee concludes from the foregoing discussion that more consideration should be given to the interpretation provisions of the rewritten Income Tax Act, and to the objectives that the interpretation provisions are expected to serve.

2.87 Approaches to statutory interpretation do not fit neatly into two categories, strict and purposive. Rather, there is a continuum, leading

³⁴ [1958] NZLR 147, Barrowclough CJ, discussed above, para 2.12

³⁵ [1994] 3 NZLR 439 CA, discussed above, para 2.18

from the very strict to the very purposive. Generally, common law jurisdictions tend to be stricter in statutory interpretation than civil law jurisdictions. Among common law jurisdictions, New Zealand and other countries that follow the English approach are more literalist than countries that follow the United States approach.

2.88 Some believe that New Zealand would be better off, at least in tax cases, to move along the continuum towards the more purposive approach of the United States. The committee mentioned in para 2.34 the relatively common pattern in tax cases where interpretation is finely balanced: a narrow, literal interpretation helps the taxpayer, whereas a broader, more purposive interpretation helps the Commissioner. The argument is that a shift along the continuum towards a more purposive approach would achieve a better balance between the taxpayer and the Commissioner.

2.89 Some members of the committee would support a change of this nature. Others do not, noting that a possible cost is that the law might become less certain. Most see at least some case for interpreting tax legislation differently from other legislation, though at this stage the case is not yet fully made out. Be that as it may, it appears that the rewrite process has not yet included a thorough study of the courts' interpretation of income tax legislation with a view to determining whether Parliament should be satisfied with present practices and emphasis, or whether the rewrite should mandate a change. The committee **recommends** that the government should consider this issue and, if there appears to be a case for change, proposals should be formulated for study pursuant to the generic tax policy process.

2.90 Secondly, the committee returns to sections AA 1 and AA 3(1). To the committee, these sections promise more than they achieve. It may be that no official has ever expected that they would do more than explain to lay people how the Act should be interpreted (and the committee has explained that such an expectation is misguided). But such is not the public perception of sections AA 1 and AA (3) 1, nor (in the committee's experience) is it the general expectation in the operations sections of the Income Revenue Department. It behoves the government to decide what the interpretation provisions should achieve, and to have them drafted in a manner that achieves that result.

2.91 An external factor that contributes to the need for this exercise is the possibility that the Acts Interpretation Bill that is currently undergoing study will be enacted. It is at least arguable that the counterpart in the

Bill to the existing section 5(j) of the Acts Interpretation Act 1924 mandates a slightly narrower, more literal approach to statutory interpretation than does the text of section 5(j). In particular, the Bill does not deem all legislation to be ‘remedial’, and uses much more restrained language than section 5 (j)’s familiar ‘fair, large, and liberal’. If the Bill indeed mandated stricter approach than the 1924 Act, the government needs to be aware that the Bill will apply to all legislation including income tax law.

ASPECTS OF THE REWRITTEN STATUTE

Plain language drafting

2.92 The rewrite attempts to redraft the text of the Act in plain language, so that the probable users can follow it. Broadly speaking, the committee agrees that this level is appropriate, and, so far as redrafting has gone, the committee is of the opinion that the drafting team has achieved the language level that was planned. In this area of language, however, the committee has several reservations.

2.93 The first is that the government should be careful not to raise too far people’s expectations about how easily they will be able to understand the rewritten Act. The reason is that several factors cause difficulties for people who try to understand statutory rules, and unfamiliar or long words and elaborate sentence constructions are only one of those factors.

2.94 Equally important is the factor that all disciplines use terminology that carries a great deal of freight. This usage is inevitable if people are to avoid explaining fundamental, or even higher level, concepts whenever they make a statement or frame a rule within their discipline. Tax law is no different. Take, for example, section BC 3(2), which reads:

If a taxpayer has one type of schedular gross income for an income year, the taxpayer’s schedular income tax liability for the year is the amount that would be the taxpayer’s income tax liability for the income year if the taxpayer’s only gross income for the year were that schedular gross income.

2.95 Apart from ‘schedular’ (which has no particular meaning in this context apart from acting as a kind of label) each word in this passage is relatively plain and simple. Yet it is unlikely that many people could understand the passage without some study. Plain language alone does not immediately make a statute clear.

Interpretation provisions

2.96 A further reservation as to comprehensibility of the legislation arises from the use of interpretation provisions. Interpretation provisions can contribute greatly to the accessibility of the core meaning of statutory rules. But if too much of a rule is moved to the interpretation section, the rule becomes hard to understand and to reconstruct. This appears to have happened to the general anti-avoidance provision, which has been disassembled from its former incarnation as a single rule, section 99 of the 1976 Act, and now appears partly in each of sections BG 1, GB 1, and OB 1, the definition section.

2.97 Anyone coming fresh to section BG 1 would have some difficulty in working out what the section is about without referring to section OB 1, which defines ‘tax avoidance’ and ‘tax avoidance arrangement’. Some definitions are truly definitions. Others form parts of their rules, parts that have been split out in order to simplify the drafting of the rule. The two categories are not precisely distinct. But definitions that fairly clearly fall into the second category should not be moved to definition sections simply because they are drafted in the form of definitions. They make the rules to which they belong more understandable if they remain with those rules. When such a definition is used also in other rules, the definition section can direct users to the section where the term in question is defined. Other examples include definitions that more helpfully fit within the trust regime than in section OB 1, such as ‘beneficiary income’ and ‘qualifying trust’.

2.98 A second problem with definitions has been endemic to income tax legislation for decades, but is exacerbated in the progress of the rewrite so far. This problem is the re-phrasing of rules as definitions. An example is the provision that captures as income the value of employer-provided accommodation. This rule is now part of the definition of ‘monetary remuneration’, in section OB 1. Another example, already present in the legislation before the rewrite, are the rules that tax certain company distributions that are not strictly speaking dividends in the hands of shareholders.

2.99 Generally speaking, where a rule is to provide that a particular receipt is to be taxed, it is better to frame the provision as a rule, rather than to define the receipt as something that it is not, followed by another rule that taxes the item that is defined. The committee **recommends** that these considerations should be borne in mind in the rewriting process.

Broad-brush factual tests and concepts

2.100 The overall impression given by income tax legislation is of a huge fasciculus of one complex rule after another. There is considerable fact behind this impression, but it masks another fact: that within the statutes there are a good many concepts and tests that are framed in very general terms. Examples include ‘capital’, ‘tax avoidance arrangement’, ‘business’ and ‘reasonable’. Section BD 2(1)(b)(ii) permits the deduction of an expenditure or loss to the extent that it is ‘necessarily incurred by the taxpayer in the course of carrying on a *business* for the purpose of deriving the taxpayer’s gross income.’ Section OB 1 defines ‘*business*,’ for most purposes in the Act, as including ‘any profession, trade, manufacture, or undertaking carried on for pecuniary profit.’

2.101 Section BD 2(2)(e) prohibits the deduction of expenditure or loss that is ‘of a *capital nature*’ (unless it is specifically permitted by another section). The words ‘*capital*’ and ‘*capital nature*’ are not defined.

2.102 ‘*Tax avoidance arrangement*’ is defined in section OB 1, in terms of the ‘purpose or effect’ of an arrangement. The definition of ‘*tax avoidance*’ itself is:

‘*Tax avoidance*’, in sections BG 1, EH 1, GB 1, and GC 12, includes -

- (a) Directly or indirectly altering the incidence of any income tax:
- (b) Directly or indirectly relieving any person from liability to pay income tax:
- (c) Directly or indirectly avoiding, reducing, or postponing any liability to income tax:’

2.103 Section 144(4) of the Tax Administration Act 1994 provides:

- (4) No person is to be convicted of an offence under subsection (3) for not presenting an instrument for stamping, if the person can show *reasonable* cause for the person’s failure to present an instrument for stamping within the time specified by the Commissioner under section 53 of the Stamp and Cheque Duties Act 1971.

2.104 Section 141A provides:

- (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 per cent 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.

2.105 The committee considered a suggestion that these kinds of expression should be expanded and made more specific. Just what is meant by 'capital', 'tax avoidance arrangement', 'business', or 'reasonable'? Some of these concepts are defined in the Act, but the definitions are fairly general. The suggestion was that they should be made more specific.

2.106 The committee did not adopt this suggestion. The problem that the suggestion identifies is one that is found throughout law. It is that law often needs to refer to a category of fact or facts by an omnibus term. The core meaning of the term is ordinarily clear enough. The difficulty is to define its boundaries. For example, most activities that might be called 'businesses' clearly are businesses. But there are some activities at the edge of the concept of business where people may reasonably disagree: are they businesses or not? Examples from the cases include carrying on the profession of peripatetic evangelist³⁶ and farming blocks of land of uneconomic size.³⁷

2.107 To define 'business' precisely, it would be necessary to define various categories of activity that amounted to businesses, and perhaps to nominate a number of activities that either are or are not businesses. But this kind of drafting serves only to move the boundaries of the exercise from one point to another. It would not solve generic problems about whether particular activities amount to businesses. In many cases

³⁶ *Graham v CIR* [1961] NZLR 994, McCarthy J

³⁷ *Golightly v CIR* (1972) 1 TRNZ 135, Speight J; *Grieve v CIR* (1983) 6 TRNZ 461 (CA)

it would make the decision more difficult, as particular sets of facts were tested not against a generic concept but against detailed lists.

2.108 The short answer is that when a rule must refer to a category that is extremely broad and that must embrace an unlimited number of factual situations it is ordinarily unrewarding to try to refine the definition of the category beyond a fairly limited point. Moreover, it is almost always bad practice to try to compose a list of definitions that is exhaustive. The result of that exercise is inevitably to leave out of account examples that would have been included had one thought of them in advance. This is particularly true for tax legislation, which is subject to continuous scrutiny by advisers who try to discover routes around rules and definitions. For these reasons, the committee does not accept the suggestion that broad factual concepts within the Act should be made more specific, much less that they should be redrafted to be exhaustive.

2.109 Later in this chapter, at para 2.160 to 2.164, the committee discusses the codification of judicially formulated rules. While in other areas of the law it may make sense to adopt judicial statements, tax law is not so amenable, carrying with it as it does elements of fiscal policy. The committee considers this distinction important, and for this reason cautions against the practice of moving judicial pronouncements directly into tax legislation.

The gross income approach

2.110 The Valabh committee³⁸ identified two approaches to consider in the design of tax legislation: whether the Act should proceed on a 'gross' or a 'net' basis, and whether it should follow a 'global' or a 'schedular' pattern. The 'gross' basis independently calculates gross revenues and gross expenses and offsets the two to produce net income. The net basis calculates net income in accordance with commercial and accounting principles and then modifies the result for tax purposes. The starting point for the statutory calculation is the essential difference. The global pattern calculates either gross revenues or net income (according to which basis is chosen) from all sources, while a schedular pattern does so on a source by source basis. In its *Final Report*,³⁹ the committee recommended the adoption of a global/gross approach.

³⁸ Consultative Committee on the Taxation of Income from Capital, *The Core Provisions of the Income Tax Act 1976*, Discussion Paper, September 1990, para 2.2

³⁹ Consultative Committee on the Taxation of Income from Capital, *Final Report*, October 1992, page 16

2.111 The Working Party on the Reorganisation of the Income Tax Act considered the possibility of retaining some special regimes that would result in net amounts being fed into the calculation of income. However it rejected the idea as being contrary to the general global approach of the Act.⁴⁰

2.112 The consistency described above has not been achieved without cost. Almost by definition, some kinds of income are by nature net, and cannot fit neatly into a legislative plan that is composed on the basis of starting always with gross receipts. Examples are the income of non-resident shipowners and film renters. The drafters' solution has been to create a concept of 'schedular income tax liability', which is reached by several steps that begin with 'schedular gross income', or even with several types of schedular gross income. This elaboration is inevitable, considering the one-size-fits-all basis of the gross approach.

2.113 It is not possible to conclude whether the benefits of the standardised gross/global approach outweigh the costs. To do so, the committee would have needed to go through the provisions of the previous legislation and identify all cases where the term 'income' was used, sometimes in one sense and sometimes in another. The second step would be to inquire which of these different uses caused problems, the third to decide which problems were real and which perceived. Finally, the committee would need to compare problems that arise from inconsistency with problems that arise from the need to legislate around the flanks of the consistency that is now the basis of the legislation. Which problems are worse?

2.114 The exercise described above was beyond the time and resources available, and the committee refrains from judging the merits of the gross approach. On the other hand, the committee is concerned that the switch to the comprehensive gross/global approach was made without the kind of pragmatic testing, described in the last paragraph, that the committee believes was necessary to determine whether the change would be justified. Officials advise that the drafting process and the forthcoming exposure draft of parts C, D, and E of the Income Tax Act will perform this function. The committee is surprised by this news. It entails accepting that one cannot test whether the gross/global approach

⁴⁰ Working Party on the Reorganisation of the Income Tax Act 1976, *Second Report*, Discussion Paper, September 1993, pages 41-45

has more benefits than costs without putting the whole country through the exercise of getting to grips with the core provisions revisions of 1996 and the proposed 1999 revisions of parts C, D, and E.

2.115 Does the foregoing imply that after all this drafting has been done, it is possible that there may be a return to the pragmatic, though occasionally inconsistent, drafting that prevailed before in the 1976 Act? The committee is advised that in fact this idea is not seriously contemplated. The result then is that a rigorous theory of uniformity is being imposed on legislation without prior testing, even though income tax law, the subject matter of the exercise, is by its nature illogical, to a degree unprincipled, and unlikely to be amenable to such an approach.

Gross income and principles of accounting

2.116 The change to gross income as the first step in computing taxable income has entailed moving from business ‘profits’ as the tax base for business income to ‘any amount derived from any business’.⁴¹ The former terminology had been glossed by a great many court judgments, and, in particular, by a number of judgments that explain the extent to which general principles of accounting should determine when income is derived or expenses are incurred for purposes of calculating assessable income.

2.117 As income tax legislation has developed over the decades, the ambit of these judge-declared rules has become gradually more constrained. For example, the introduction in 1986 of the qualified accruals rules to govern financial arrangements brought a large area of timing rules under specific statutory provision. However, there remain areas where timing questions are a matter of judicial interpretation. The leading example is probably profit-recognition in long-term contracts, where the rules were established for New Zealand purposes in *HW Coyle Ltd v CIR*⁴² and *Horizon Homes Ltd v CIR*.⁴³ The problem facing taxpayers is that they are uncertain whether the rules declared in these cases have survived the changes wrought by the ‘gross income’ approach of the rewrite.

2.118 The committee **recommends** that the government should resolve this uncertainty, though it has not been able in the time available to settle

⁴¹ Section CD 3, Income Tax Act 1994

⁴² (1980) 4 TRNZ 1, Holland J

⁴³ (1994) 16 NZTC 11,064, McGechan J

on a firm recommendation as to how the resolution should be achieved. There are four possibilities.

- 1 Enacting a general rule to say that pre-1994 judge-declared timing rules remain in effect unless they are clearly inconsistent with specific timing rules in the Act.
- 2 Doing nothing, and leaving it to the courts to resolve the matter again.
- 3 Identifying specific areas where this kind of problem exists and enacting area-by-area timing rules, leaving unidentified areas to manifest themselves in due course.
- 4 Attempting to construct a statutory general timing rule that would cover all the areas that are now left to the courts. Though theoretically attractive, this approach appears to be impractical.

2.119 The committee leans in favour of the third option. The committee's preference requires evaluative work because it is a matter of judgment and intuition, rather than being based on an in-depth examination of the various possibilities.

The core provisions

2.120 This report explains in para 2.53 that the core provisions as now constituted are not at all as they were proposed in the 1990 report of the Valabh committee.⁴⁴ The original proposal was for the most basic and important rules in the Act to be gathered together as a core from which readers could obtain an overview of the Act's substance.

2.121 This objective is not consistent with the role for the core provisions that has developed during the rewrite process, to provide a series of normative links between the several parts of the Act. The two objectives cannot be pursued together. However, it does not necessarily follow that the first objective should be abandoned. It may be possible to pursue each objective separately, with one part of the Act containing the new-model core provisions, and another part containing the most important rules of the Act.

2.122 The rewrite process has not pursued the strategy described in the last paragraph. Instead, the important rules that were formerly gathered

⁴⁴ Consultative Committee on the Taxation of Income from Capital, *The Core Provisions of the Income Tax Act 1976*, Discussion Paper, September 1990, para 1.3

together as core provisions have been relocated where they seem to fit best in the substantive parts of the Act. The committee does not quarrel with this decision. It has the demerit that the overview envisaged by the Valabh committee is not possible. On the other hand, it avoids having to decide whether an important rule is important enough to be a core provision, or just fails to make the grade. Decisions like that could never be made on a wholly consistent basis. The decision also has the merit of allowing important provisions to join rules of similar kinds, in their appropriate parts and subparts of the Act, though the consequent reordering that is appropriate, to place important provisions first in subparts, has yet to be done.

Alphanumeric section numbering

2.123 Following the recommendation of the Working Party on the Reorganisation of the Income Tax Act 1976,⁴⁵ the 1994 Act renumbered the legislation using an alphanumeric system. This reference system compares with that used in the 1976 Act as shown in Table 2.

TABLE 2: SECTION NUMBERING

	<i>1976 Act reference</i>	<i>1994 Act reference</i>
Part	X11A	ME
Subpart		ME
Section	394D	ME 4
Subsection	394D(2)	ME 4(2)
Paragraph	394D(2)(h)	ME 4(2)(h)
Subparagraph*	394D(2)(h)(ii)	ME 4(2)(h)(ii)

* (often not needed)

2.124 It was expected that the new system would enable a ready identification of the location and function of sections as users became familiar with the new structure of the Act. Part C would deal with income; all sections in the part would begin with a 'C', and so on. It was also expected that the new system would permit the insertion of additional material into the Act without breaking the alphanumeric sequence. This pattern will be an improvement on an Act's standard single series of numbers, which requires either the renumbering of groups of unamended

⁴⁵ Working Party on the Reorganisation of the Income Tax Act 1976, *Second Report*, Discussion Paper, September 1993, pages 14 -18

sections to preserve sequence where new matter is inserted, or gives rise to such numbers as 394ZZZJ to cope with the cumulative effect of relentless amendment. It was recognised that this system had a cost, in that it was not consistent with the numbering of the rest of the statute book. The Working Party believed that the bulk and frequency of amendment of tax legislation placed it, in this respect, in a category of its own where the benefits of the new system outweighed the costs of that inconsistency.

2.125 While the committee considers that the new alphanumeric system is worthwhile, already some symptoms of the old system have re-emerged. The Valabh committee hoped that it would never be necessary to insert sections into subparts, but that they would be added sequentially. However, sections and paragraphs with modifiers 'A' and so on are being added, for example, section DJ 13A, and sections DK 3A to DK 3E, and within sections, paragraphs (1A) and so on. It is not necessary, of course, to insert whole parts between sections, and it is unlikely that the situation will ever get as bad as the previous system, but the impact of the alphanumeric system is not as positive as the committee had hoped. Inserting provisions into subparts and sections will continue to be a necessary part of the amendment process. Balancing that, the system takes users very little time to become accustomed to it, and will pay increasing dividends over the years as the Act is amended and amplified. The alpha-numeric system would have been worthwhile whether it had been decided to retain a regime-based organisational system, or whether the Act adopted its functional organisational scheme, as it has done.

Functional organisation

2.126 The committee's report describes the Act's functional organisation in paras 2.59 to 2.62. The decision to move from the regime-by-regime structure that New Zealand and all other jurisdictions with which the committee is familiar to a functional organisation was both major and brave. There is a very heavy cost, one that can be justified only if there are commensurate benefits.

2.127 The cost is the obvious one: if taxpayers want to discover how a particular regime applies to them it makes sense for them to be able to find the regime set out in one place in the Act. This remark applies equally to regimes that are defined by reference to business form, such as dividend imputation or controlled foreign companies, and to regimes defined by reference to industry segment, such as life insurance or forestry. Indeed, for two or three years now it has become a cliché among

tax advisers that there is a captive and increasingly impatient market waiting for the commercial publisher who will dismember the 1994 Act and reassemble it in a thematic form.

2.128 The committee has no doubt that, other things being equal, a regime-by-regime structure is superior to a functional structure from the point of view of comprehensibility by, and ease of use for, users of the Act. The committee envisages that a regime-by-regime structure would begin, after the core provisions, with a part or parts of the Act that would set out the substantive rules that apply to all forms of income in the absence of special considerations. Later parts would contain regimes that are activity-specific (such as forestry or life assurance), or that are specific to certain investment or trading structures (such as companies or foreign entities).

Claimed advantage of functional structure

2.129 As far as the committee has been able to discover, the only advantage claimed for the functional structure over a regime-based structure is that the former allows to be brought together in one place provisions from different regimes that, within their several dispensations, operate similarly to one another. There are said to be four benefits.

If several rules turn out to contain almost the same language they can be consolidated into an omnibus rule that can be made to apply within a number of separate areas of the Act.

Even if there cannot be consolidation the rules can be rewritten using standardised phraseology.

A functional scheme reduces repetition.

In the view of officials most importantly, a functional scheme will help future policy makers and drafters.

2.130 The committee does not find these benefits compelling. The second can be achieved whether the rules in question are gathered together or scattered. It is simply a matter of applying a common drafting template to rules that operate in a similar manner to one another wherever they may be found in the Act. It is true that common drafting templates have not been applied consistently in the past, but that is more a result of fashions of parliamentary drafting coming and going, rather than of any great difficulty in the task itself.

2.131 At first sight, the first suggested benefit carries more weight. Consolidation of numbers of similarly-phrased provisions into a single

omnibus rule has attractions. However, it is not clear to the committee just how extensive this consolidation will be able to be. There are two or three provisions in subpart GC, being specific anti-avoidance rules, that might be able to be consolidated. Probably, at least some of the associated parties rules in subpart OB could also be consolidated. No doubt there are other examples. However, the committee suspects that, like the examples that it has given, most of the rules that might benefit from consolidation would be discovered to be ancillary rather than substantive provisions. Further, the committee suspects that the total of such provisions would turn out to be a rather small fraction of the whole Act, too small to justify the formalistic rebuilding of the statute in the functional scheme that has taken place.

2.132 Thirdly, although a functional scheme stands to reduce one kind of repetition it increases another. The *reduction* may come about as a result of the consolidation of rules that have similar language, which was described above. As explained by drafters, the *increase* comes from the need in each subpart to reintroduce, at least to some extent, the topic of a rule that, in a functional scheme, is isolated from the other rules that are part of the rule's regime.

Help for policy makers and drafters

2.133 As it was explained to the committee, the functional scheme will help future policy makers and drafters when the Act is amended or when new regimes are added. The segregation into statutory parts of rules that relate to deductions, timing, apportionment, avoidance, and so on is hoped to have the effect of ensuring that each rule of a new regime is placed in its proper context. The statute's parts and subparts will in effect act as guidelines for future drafters, and it will not be necessary to rely on institutional memory. Segregating rules should ensure that inadvertent looseness of drafting will not cause rules to have unintended effects, because, for example, an apportionment rule will find itself in the apportionment part of the Act, and taxpayers will not be able to argue that the rule gives them, say, a timing advantage.

2.134 Elsewhere, the committee's report comments on this 'local context' canon of statutory construction that officials advise is part of the prescribed drafting policy.⁴⁶ If it is to be effective, it needs to be made

⁴⁶ See para 2.36

explicit. There is also the desirability of subjecting this and other changes to existing statutory interpretation practices to the rigours of the generic tax policy process.⁴⁷

2.135 A second benefit is that when drafters add, say, an anti-avoidance provision to the Act they will be able to check on the Act's other anti-avoidance provisions, conveniently gathered in one place, to ensure that the language and approach of the new provision are consistent with what already exists.

2.136 The committee is not persuaded that the help that the Act's organisation is expected to afford to future drafters justifies employing a functional scheme rather than a scheme that is based on substance. Similar guidelines for identifying and segregating rules according to function could operate within regimes, with subparts of regimes dedicated to particular functions. The same idea of having subparts within regimes dedicated to rules of particular kinds could be the basis of an interpretation principle that attempts to confine rules to their own contexts.

Ease of use of the Act

2.137 The most notable feature of the reasons that are advanced to justify a functional rather than regime-based scheme for the Income Tax Act is that all the reasons relate more to the processes of policy-making and of drafting than to the question of ease of comprehension by the user. This feature is particularly true of the last reason.

2.138 One suggestion from officials was that concern about ease of comprehension and about questions of users being sure that they could find all rules relevant to a particular regime that interests them is misplaced, considering people's increasing use of electronic forms of the legislation that are machine-searchable.

2.139 The committee is uneasy about giving much weight to this last suggestion. For a start, the suggestion in a sense confirms the committee's impression that the functional scheme is not friendly to readers, and needs repackaging before it can be used easily. Secondly, while it is true that increasing numbers of tax professionals use electronic versions of the Act, many general practitioners who refer to the Act from time to time do not. Thirdly, the committee has the impression that even those

⁴⁷ For an outline of the generic tax policy process see appendix 2.

who do use electronic versions of the Act tend to do so for references to particular, short passages, but that they turn to paper-based versions to get, for example, an overall understanding of a regime, or to read passages longer than a page or so. Finally, the committee notes that it is currently policy to draft a paper-based statute, not an electronic database.

2.140 The committee understands and sympathises with the concerns of the government as to the policy making and drafting process and understands the perceived benefits that are thought to flow from a functional scheme. However, to put the matter at its lowest, and referring to its terms of reference, the committee is unable to conclude that a functional statutory scheme is likely to make ‘tax laws more coherent and understandable’ than the more intuitively understandable regime-based alternative.

2.141 The logic of the committee’s position is to recommend a change to a regime-based structure. At the present stage of the rewrite that change would be significant shift of direction in terms of design. The committee notes however that the implementation of the original design, in terms of actual redrafting, still has a great distance to go, with drafters still working on the first exposure draft of parts C, D and E at the time of this report. The committee has not enjoyed the time or the resources to examine the Act or the progress of the rewrite process in enough detail to be confident in recommending such a major change. There needs to be an assessment of the value of the benefits to be obtained from continuing on the present course together with an assessment of the work involved in reorganising the statute on a regime by regime basis. The committee **recommends** that the government consider having those assessments done, with a view to deciding whether to persist with the functional organisation of the Act. The committee would be concerned if this recommendation would cause the project to be significantly deferred. An alternative recommendation would be for the government to bear the committee’s comments and recommendations in mind, and to accommodate them as much as possible.

2.142 In making its recommendation, the committee bears in mind that officials advise that the whole rewrite process remains to some degree experimental even at this late stage. It is not clear just which drafting design principles remain experimental, but if the functional structure is one of those principles the committee urges that it should be abandoned.

Ordering of sections

2.143 When the former legislation was split up and sorted into the functional classification that the rewrite follows, sections were often put into appropriate parts and subparts without much concern for logical order within subparts. Subpart CD is a good example. This approach was undertaken wittingly, in order to make progress, and in the knowledge that there would be an opportunity to improve the order later in the rewrite process. In some subparts, logic was further eroded when part B became the more formal structure that it is today, and the substantive rules of the original core provisions were moved to other parts of the Act. The plan is that ordering of sections into logical sequences should occur part by part as rewriting goes on.

2.144 As the committee prepares this part of our report in November 1998 a good deal of the Act remains ordered in a haphazard manner. The committee does not criticise the present ordering, because it appreciates the reasons that have led to the current situation. However, one result is that in evaluating the rewrite the committee cannot comment on the ordering of sections because that exercise is still to be done, except for part B.

2.145 The committee notes with approval, however, that, ordinarily, subparts within parts, and sections within subparts, will start with the important or the general and proceed to the less important or the particular.⁴⁸

2.146 The committee notes that part B, which has been ordered, does not always follow the pattern of more important or general before less important or particular. For example, section BC 2 (non-filing taxpayers) precedes section BC 3 (taxpayer with schedular gross income) which in turn precedes section BC 4 (taxpayers with annual gross income). No doubt the reason was to clear non-filing taxpayers and schedular gross income out of the way before proceeding straight from the annual gross income in sections BC 4 to BC 5 (deductions), BC 6 (net income) and BC 7 (taxable income). The drafters' ordering is appropriate.

2.147 The committee understands that the rewrite and drafting teams agree that, ordinarily, the general should precede the particular and the

⁴⁸ Working Party on the Reorganisation of the Income Tax Act 1976, *Second Report*, Discussion Paper, September 1993, page 4; Parliamentary Counsel Office, *Drafting Manual* (Draft of 16 May 1997) 5.9; NZLC R35, *Legislation Manual Structure and Style*, May 1996, para 144

important the less important, and that the teams already approach their task from this point of view. The committee mentions the ordering question from an abundance of caution, because it is aware of criticisms of the present sequencing. These criticisms fail to take account of the fact that the present order is a temporary parking order, awaiting the next stage of the rewrite.

Principles of drafting

2.148 Legislative drafting should follow a number of reasonably commonsense principles. For example, generally speaking drafters should express the essence of a provision first, separately from limitations or expansions, which follow.

2.149 The committee has not evaluated the rewrite for compliance with this kind of principle. The reason is that so far only the core provisions have been released, and they are unlikely to be typical of the drafting of the Act as a whole. Nevertheless, the Inland Revenue Department has engaged competent staff, one with very long legislative drafting experience, to compose the rewritten statute. The committee has spoken to several members of the drafting team, and is confident that the drafting process is in good hands.

The general income provision

2.150 It is a sensible precaution for drafters to include in income tax legislation an omnibus provision that captures simply ‘income’ according to the ordinary meaning of the word. In Australia, this provision has historically been section 25 of the Income Tax Assessment Act 1936, which simply says that taxpayers’ assessable income includes their gross *income*, without defining the term. The Australian section 25 may be thought of as an umbrella provision: underneath the umbrella, and often extending outside its coverage, later sections capture many other kinds of receipt as assessable income. But section 25 ensures that nothing that is ‘income’ according to the ordinary meaning of the word escapes tax.

2.151 New Zealand has used the opposite structure: a safety net, rather than an umbrella. In the Income Tax Act 1976 section 65(2) there appeared a list lettered from (a) to (ka) of receipts that were deemed to be included in assessable income. The final item in the list was ‘(l) Income derived from any other source whatsoever.’⁴⁹ That is, if any receipt es-

⁴⁹ (l) is the alphabetical letter that follows the letter k, and not the arabic numeral 1.

caped all of paragraphs (a) to (ka), paragraph (l) would catch it if it was income according to the ordinary meaning of the word. In the rewritten statute, the former section 65(2)(l) is replaced by section CD 5. The committee comments on both the drafting and the position of section CD 5.

Drafting of section CD 5

2.152 Section CD 5 reads: ‘The gross income of a person includes any amount that is included in gross income under ordinary concepts.’ This locution appears to have its origin in a dictum of Jordan CJ in *Scott v CT (NSW)*,⁵⁰ where the Chief Justice said: ‘The word ‘income’ is not a term of art, and what forms of receipts are comprehended within it ... must be determined in accordance with the ordinary concepts and usages of mankind ...’ That is, Jordan CJ was explaining how ‘income’ is to be interpreted in a tax statute.

2.153 It is supererogatory for part of Jordan CJ’s explanation to be imported into section CD 5: the purpose of the section is better served by using the word ‘income’ unadorned. In fact, if the adornment has any effect, it must be to qualify rather than to amplify the meaning of ‘income’ when the term is used by itself. That is, logically, the addition of the words ‘under ordinary concepts’ mean that ‘income’ cannot extend to any meanings that it might bear over and above meanings that are ‘under ordinary concepts’.

2.154 A second problem is the word ‘under’. In the English language something can be ‘under’ a rule, but it cannot be ‘under’ a concept. No doubt, ‘under’ supplanted the more usual ‘according to’ by way of an exercise in plain language drafting. Curiously, the title to the section uses ‘according to’, as though the editor was not willing to follow the drafter into the uncharted territory of being under a concept. Good intentions have led the drafting astray.

2.155 For these reasons, the committee **recommends** that ‘under ordinary concepts’ should be eliminated, and section CD 5 should be rephrased using the term ‘income’ without qualification.

⁵⁰ (1935) 35 SR (NSW) 215 at 219

Position of section CD 5

2.156 In some senses, section CD 5 is the most important provision in the Act. It is, after all, the section that captures income in the most general sense of the term. It is for this reason that the committee has devoted a long explanation to its recommendation about the drafting of section CD 5.

2.157 For the position of section CD 5 in the statute, the committee favours the umbrella structure that is employed in Australia over the traditional New Zealand safety net formula. There are two reasons. First, it seems to the committee to be more intuitively reasonable to start with a general taxing provision and then to amplify it with specific rules, rather than to proceed from the particular to the general.

2.158 Secondly, giving section CD 5 primacy of place as the most prominent and most general charging rule should help to minimise the number of occasions when the Commissioner loses a case as a result of relying on the wrong charging rule and discovering the mistake too late to be able to correct it. *VH Farnsworth Ltd v CIR*⁵¹ is an example. If the Act's charging provisions begin with a general umbrella rule the Commissioner's usual practice should become to rely first on this general rule and additionally on any relevant specific rule. The chances of taxable profits escaping through being charged with an incorrect, narrowly focused rule should be minimised.

2.159 As it is currently placed in subpart CD, section CD 5 falls between being an umbrella and being a safety net. That is, some charging provisions precede it, and some (rather more) follow. The committee **recommends** that section CD 5 should be the first charging provision that places 'income' within 'gross income' and, as the calculations are worked through, 'net income' and 'taxable income'. Another possibility would be to weave section CD 5 into section BC 4, where it could act as the core provision that initially captures gross income as annual gross income.

Codification of judicially-formulated rules

2.160 It is a common practice in the codification of laws for Parliament to adopt judicial formulations of rules and to arrange them into a systematic matrix. This approach has carried over into income tax legislation.

⁵¹ (1982) 5 TRNZ 754; 5 NZTC 61,259

For example, for many years New Zealand's test for corporate residence followed passages in *The American Thread Co v Joyce*⁵² and *De Beers Consolidated Mines Ltd v Howe*.⁵³ Even now, as section OE 2 of the Income Tax Act 1994, the test continues to exhibit traces of that early influence. Another example is what is now section CD 4 third limb (the taxation of profit-making schemes), which follows *Ruhamah Property Co Ltd v FCT*.⁵⁴

2.161 When lawyers' law on topics like the sale of goods or the law of partnership is codified, it often makes sense to adopt judicial statements from the cases. The reason is that judges have heard arguments on the relevant issues, and are in a good position to formulate legal principles that take account both of other relevant rules and of competing economic interests.

2.162 These considerations carry over only imperfectly, if at all, to the tax area. Judges are ill-equipped to make fiscal policy, and disavow trying to do so. As a result, judicial statements of tax law will typically be either interpretations of existing statutory rules, or an effort to make sense of what judges believe the law to be. Either way, judicial statements may or may not reflect the law that tax policy makers would formulate if they started from a basis of trying to put into effect the most appropriate fiscal policy for the transaction in question.

2.163 It follows that tax policy makers should not uncritically adopt judicial statements of law as embodying appropriate fiscal policy.⁵⁵ In the opinion of the committee, government tax policy makers and tax law drafters should first determine what the law should be from the point of view of economic policy. If drafters then want help in constructing an elegant formulation it makes sense to turn to judgments to see whether they help. But judgments should not be looked on as a source of economic policy.

2.164 There are sometimes suggestions that New Zealand should continue its former practice of moving judicial pronouncements straight into the Income Tax Act with little or no editing. Something of that nature

⁵² (1913) 6 TC 163 at 165 HL

⁵³ [1906] AC 455 at 458 HL

⁵⁴ (1928) 41 CLR 148 at 151

⁵⁵ Contrast, again, judicial statements on lawyers' law, which should be respected as likely to be of intrinsic merit.

may have happened with section CD 5, discussed in the preceding sections of this report. The committee cautions against that practice.⁵⁶

ASPECTS OF THE REWRITE PROJECT

Ambulatory process

2.165 The process of rewriting the Income Tax Act is expected to last some years. The Act in force today is a mixture of rewritten provisions (the core provisions) and provisions yet to be rewritten. Current plans are for the future results of the exercise to be enacted in two bills that are likely to be a year or more apart. During this time it is inevitable that some provisions will be rewritten or moved several times, as the implications and consequences of later decisions and of changes made to later rewritten provisions are worked through the core provisions and on other provisions enacted earlier. This situation involves an obvious cost to users. If the committee's recommendation elsewhere in this report, that schedule 23 should be continually updated in the manner described in para 2.185 is implemented, that would go some way towards addressing that cost.

2.166 The benefit of adopting this staged implementation of the rewrite is the earlier availability of portions of the Act showing the benefits of the rewriting. An alternative was for rewrite to proceed in parallel with the ordinary annual amendment process, but be enacted only when it was substantially finished.

2.167 The choice between enactment in stages and enactment only on completion of the whole Act involves a difficult judgment, but the committee believes that the government was probably correct to opt for an ambulatory process.

The tandem simplification/substantive improvement programme

2.168 A distinctive feature of the New Zealand rewrite project, in contrast with approaches taken by concurrent rewrite projects in Australia and the UK, is the decision to include within the scope of the project the making of substantive changes in policy and to the the law, as opposed to limiting the project's mandate to re-expressing the status quo. Relatively minor changes, and the resolution of less contentious ambiguities, are able to be undertaken by an accelerated path, under the overview of

⁵⁶ Note the discussion earlier in this report at para 2.160.

an independent advisory panel which reports separately to government. Major changes for which a rewrite bill is expected to be the enactment vehicle are fed through the generic tax policy process in the same manner as other policy initiatives. The broader scope of the New Zealand project, which includes the opportunity to address matters of substance, enhances the chances of the project succeeding in clarifying the legislation. The committee believes this approach is advantageous.

Topics addressed in tandem with the rewrite

2.169 Officials advised the committee that the following substantive topics are being addressed in tandem with rewrite of parts C, D, and E, timing issues, property transactions, death and deceased estates, and self-assessment.

2.170 In addition to matters dealt with as part of the rewrite, the enactment of remedial legislation and government policy initiatives in non-rewrite ‘business as usual’ bills is expected to continue while the rewrite is underway. Two such bills⁵⁷ were introduced and Acts passed in 1998, and a third bill⁵⁸ was introduced. Among topics conspicuous by their absence are apportionment, movement of assets in and out of the tax base, accounting for long-term contracts, and tax avoidance provisions.

2.171 The committee **recommends** that the government should give a higher priority to these topics in the rewrite programme.

Review of compliance-intensive regimes

2.172 The tandem approach affords an opportunity to evaluate existing regimes to see whether the original reasons for the rules still obtain, and whether base-protecting elements can be removed, streamlined, or replaced with less compliance-intensive alternatives.

2.173 Officials have advised that the rewrite process does in fact focus on this kind of issue. The committee notes with approval that as part of the generic tax policy process, the rewrite exercise will include an element of cost/benefit analysis of the balance between compliance costs and the revenue expected to be raised, in respect of the portions of the rewrite exercise that must pass through the generic tax policy process.

⁵⁷ The Taxation (Simplification and other Remedial Matters) Bill; the Taxation (Tax Credits, Trading Stock, and other Remedial Matters) Bill

⁵⁸ The Taxation (Accrual Rules and other Remedial Matters) Bill

2.174 The committee commends the focus on compliance cost reduction and looks forward to seeing the results when the rewritten legislation is progressively released.

2.175 In its *Second Report*, the Working Party in the Reorganisation of the Income Tax Act 1976⁵⁹ noted that it had tested the functional structure that it proposed for the Act. However, as reported by the working party, that testing established two things.

2.176 First, every existing provision of the 1976 Act could be fitted into one of the fifteen strategy parts that the working party proposed, leaving no existing provision without a home. Secondly, all possible additions to the Act would be found an appropriate place. Such possible additions included previous regimes that had been repealed, and regimes that are found in foreign systems but not in New Zealand. The fact that all such regimes that the committee knew about could be accommodated gave the working party confidence ‘that the parts are both robust and durable’.⁶⁰

2.177 The committee does not agree with the working party’s conclusion as far as it goes. However, the committee has in mind deeper and more extensive testing than the working party reported. To pick up several of the committee’s points, the exercise should have tested whether:

It was likely that purpose provisions could usefully redrafted for parts and subparts.

It was feasible to consolidate any significant numbers of similarly worded rules into single omnibus rules.

Eliminating inconsistencies in the use of word ‘income’ by adopting a uniform gross approach is worth the cost of creating the awkward concepts and rules that are a consequence.⁶¹

Adoption of drafting policies without testing

2.178 One of the initial approaches to the rewrite was to adopt firm policies and principles and to attempt to follow these principles rigorously. Two such policies in the rewrite of the income tax legislation were to begin each part of the Act with a purpose subpart, and to collect

⁵⁹ Working Party on the Reorganisation of the Income Tax Act 1976, *Second Report*, Discussion Paper, September 1993, page 10

⁶⁰ See footnote 59

⁶¹ See paras 2.111 to 2.114 of this report.

provisions that function in a similar manner (not necessarily that share a similar function) together, with a view to consolidation.

2.179 As mentioned in para 2.45, it has now become apparent that it is unlikely that part-based purpose provisions can be drafted in any useful manner, assuming the functional structure of the legislation is retained. The Inland Revenue Drafting Unit has advised the committee that it has reviewed the original proposals for the use of purpose provisions in the rewrite, in the light of more recent New Zealand and United Kingdom⁶² discussion of ‘purposive drafting’, and that it now intends to consider the merits of using such provisions on a case by case basis rather than assuming that a global or systematic application of them is appropriate. This development means that it is unlikely that the systematic function originally envisaged for subpart A of the various parts of the Act will be preserved. Secondly, it is far from clear that it will in the end prove possible to consolidate any significant numbers of provisions, even though the prospect of achieving that goal was the major driving force behind the Act’s functional organisation.

2.180 Each of the policies described in the paragraphs above (starting each part of the Act with a purpose provision and gathering functionally similar rules together with a view to consolidation) appears logical and sensible when stated simply as a policy. In most areas of law, it is probably true that these policies could be put into effect when drafting extensive codes. But these policies do not allow for the heterogeneous and often internally inconsistent nature of income tax law.

2.181 The committee believes that before policies such as those described are allowed to govern a major drafting exercise they should be tested empirically. Such testing would require first, the gathering together the component sections of two or three proposed statutory parts (redrafting would not be needed; the sections could be plucked straight from their former contexts). Secondly, drafters could attempt to compose meaningful purpose provisions and effective consolidated sections. Success at these exercises would not establish that they would be successful throughout the Act; nor would failure in respect of any one possible statutory part establish the opposite. The exercise would be more reliable

⁶² Tax Law Rewrite (UK) *Responses to the Second Technical Discussion Document – A Purposive Approach to Rewriting Tax Legislation*, August 1998, <http://www.open.gov.uk/inrev/rewrite.htm>

if repeated for several proposed parts. The results would give an indication of whether the proposed policies could usefully be put into effect.

2.182 The committee notes that the drafting unit has advised that it sees the current drafting process as itself testing some of the detail of the drafting policies originally prescribed, and that it expects comments on the proposed exposure draft to provide it with independent views as to the success or otherwise of drafting policies that are adopted. However, at the same time officials advise that the kinds of relatively structural policies that the committee has discussed, such as the functional scheme of the Act, are unlikely to be subject to review. The committee notes that policies of the kind now under discussion did not originate within the Inland Revenue Department, but were approved by Ministers on the recommendation of consultants. If the Inland Revenue Department has a responsibility, it arises from embarking on the policies without testing them and advising Ministers of the results. Had tests been carried out, the difficulties which have been encountered in the rewrite process may have been avoided.

2.183 The committee **recommends** that statute-wide drafting policies should not be adopted as a matter of principle without reasonably rigorous practical testing. What appear to be significant difficulties in the rewrite process might have been avoided by pre-testing of this nature.

ADDITIONAL RECOMMENDATIONS

Two separate Acts

2.184 The committee considers that there might be some advantage in splitting the Income Tax Act 1994 into two separate Acts. If feasible, such a division could produce an Act of more manageable size for provisions of general application, and remove some relatively complex groups of provisions that concern only a limited number of taxpayers into a second Act. Such a second Act might be used to carry the provisions relating to cross-border transactions and certain industry specific regimes, such as petroleum mining and life assurance. The committee has not worked out the detailed implications of this proposal, and makes no firm determination as to its ultimate feasibility. The committee **recommends** that the government should direct officials to evaluate whether such an approach should be taken.

Schedule 23

2.185 Schedule 23 of the Income Tax Act 1994 contains a series of tables to convert section numbers between 1970s and 1990s legislation.

The schedule is very useful, but its utility is progressively eroded as the rewrite process re-orders section numbers within the 1994 Act. The committee appreciates that as sections are moved from one place to another in the Act it becomes increasingly difficult to compose a table that tracks their history. Designing tables with increasing numbers of columns is only one problem. Nevertheless the committee **recommends** that schedule 23 should be kept under continuous review, and updated whenever there is renumbering, or, at least, whenever there is a reasonably significant renumbering exercise, such as the currently foreshadowed adoption of reorganised parts C, D, and E of the Income Tax Act 1994. The ambulatory nature of the rewrite process has some advantages from the point of view of drafters, but regular changes make the statute difficult for users to follow. Good, up to date, conversion tables can mitigate the problem to some extent.

2.186 The committee considers that it may also be useful if a schedule were to be added to the Act, that listed all the thresholds contained in various places in tax legislation. An example of the kinds of threshold that the committee has in mind is the threshold below which people qualify as cash basis holders under the qualified accruals rules. It would repeat information found in the tax Acts but its usefulness would lie in the collection of all thresholds in one place. If the information was out of step with the substantive provision for any reason, the latter would prevail.

Repairs and maintenance unit

2.187 The committee regards it as inevitable that despite the care taken by officials, and the close scrutiny by tax professionals and taxpayers, the rewritten parts C, D and E (and subsequently, other parts of the Act) will at some stage reveal textual uncertainties and produce unintended outcomes. The committee believes it would be appropriate for the Inland Revenue Department to establish a special 'repairs and maintenance' unit to address promptly any queries raised as to the effect on established principles of the rewritten Income Tax Act, and to deal with any unintended outcomes. Such a unit would provide an administrative mechanism to ensure both that the general body of taxpayers and tax advisers are informed of issues as they arise, and that remedial legislation is developed and introduced at first opportunity. The committee **recommends** the establishment of such a repairs and maintenance unit.

Valuation rules

2.188 The formalistic design structure proposed for the rewritten Act requires that virtually all functional categories have their own part or subpart. As is apparent from this report, the committee favours the organisation of the Act on substantive lines rather than on formal lines. However, if the government determines to adhere to a formalistic organisational structure, the committee **recommends** that it should consider allocating a specific part or subpart to rules about valuation, which at present are not gathered together in the manner that is standard for the rewritten Act.

Apportionment rules

2.189 In *Tax Accounting Issues* and in its *Final Report*,⁶³ the Valabh committee addressed the issue of apportionment. Officials advise that they have not yet had the opportunity to address the Valabh committee's recommendations in depth. That lack of opportunity is regrettable, because it is desirable that the intended policy approach to apportionment issues in general should be settled before or at the time of the release of the rewritten parts C, D, and E of the Act. The reason is that apportionment questions figure largely in the matters that are covered by those parts.

2.190 Even without the benefit of a policy review, the question of apportionment raises a number of important issues that will have an impact on the rewriting of parts C, D, and E. The committee has discussed several of these issues with members of the rewrite team. It is not necessary for the committee to form a view as to the most appropriate approach. Officials are aware of the issues in this area.

Determinations under the qualified accruals rules

2.191 'The qualified accruals rules', as they are labelled in the Act, are more colloquially known as the 'financial arrangements' or 'FA' rules. They occupy subpart EH of the Act. Broadly speaking, their function is to prevent people accelerating expenses or deferring receipts in the context of loans and transactions that from an economic point of view may be partly or wholly equivalent to loans.

⁶³ Consultative Committee on the Taxation of Income from Capital, *Final Report*, October 1992, page 16

2.192 There is an infinite variety of transactions and business structures that have an economic similarity to loans. The qualified accruals rules do not attempt to address each of these possible forms of transactions individually. Instead, the rules adopt a single general principle: for tax purposes, income and deductions related to a financial arrangement must be spread across the duration of the arrangement according to the principle of yield to maturity, which is used in banking circles.

2.193 The yield to maturity principle applies readily enough to a simple loan that lasts for a defined period, but it is not immediately obvious how the principle should apply to more complex transactions. For example, how does a New Zealand borrower take account of exchange rate gains and losses in respect of a loan or of a credit sale where the transaction covers several tax years?

2.194 The solution adopted by the Act is for the Commissioner to issue rulings, in this context called ‘determinations’, that set out how the income and expenditure of identified kinds of financial arrangements may be calculated. For example, for transactions that involve foreign exchange, a determination may sanction one or more of a number of specified exchange rates as allowable for calculation purposes.

2.195 The idea of enacting a general principle in the statute (yield to maturity) and of concretising this general principle in a series of extra-statutory determinations was attractive when the system was established in 1986, and even now retains some attractions. However, it has never worked well. The committee notes that the drafting of determinations has proved a difficult task; the resulting products are often opaque and occasionally almost unintelligible. Most need to be rewritten. The committee’s view is that this redrafting should take place as part of the rewrite of the Act itself.

2.196 The committee **recommends** that in parallel with the rewrite of the Income Tax Act, the department should redraft the existing qualified accruals rules determinations, in an endeavour to publish fresh drafts at the same time as the proposed exposure draft of part E of the Act is published. The committee further **recommends** that the procedure for issuing determinations should take on the basic features of the generic tax policy process. In particular, proposed new determinations should be made available for public consultation as to both substance and clarity. Where possible, each determination should follow one of a limited number of standard templates.

The annual taxing Act

2.197 New Zealand inherited from the United Kingdom the constitutional rule, developed in the seventeenth century, that the Crown does not have the right of its own prerogative to levy taxes. Tax can be levied only by Parliament. Historically, this rule has been emphasised in two ways. First, Parliament confers taxing rights on the Crown only on a year-by-year basis. Secondly, until relatively recently the annual taxing Act has been a separate, readily identified statute, typically called ‘The Income Tax (Annual) Act’, which concisely confers power on the Crown to levy taxes pursuant to the continuing rules of the Income Tax Act.

2.198 Under the Income Tax Act 1994 section OB 1, ‘‘annual taxing Act’ means the provisions of any Act by which the rates of income tax are determined for any year’. This definition was carried forward from section 2 of the 1976 Act, having been inserted in 1987. Before this amendment a separate Act was required each year to determine income tax rates. It is a sensible definition, in that it goes to the substance of the concept that is defined, and does not turn on a particular name for a particular statute. The definition means that the Crown’s annual authority to tax can be conferred simply by including a provision about tax rates for the next twelve months to any tax amendment bill that is before the House, and that there does not need to be a separate bill for this purpose. The committee understands that this amendment was made to save on the additional House time that is required for a separate bill.

2.199 In substance, it is true that so long as Parliament annually passes an Act to empower the Crown to levy tax the name of the statute does not matter, nor does it matter whether the statute deals also with other things. However, the committee regrets that this change has occurred because a separate annual taxing Act reflects the important constitutional principle of parliamentary sovereignty in tax matters.

2.200 The relationship between the Crown and Parliament in respect of taxing powers goes to the heart of New Zealand’s constitution. The committee, therefore, **recommends** that New Zealand should return to separate annual taxing Acts to symbolise this relationship. If there are concerns about the additional pressures on House time that a separate bill may entail, consideration should be given to including the annual taxing Act in a current part of the parliamentary timetable such as the Budget debate. This proposal may require an amendment to Standing Orders.

Relationship between Income Tax Act and rules of criminal law

2.201 There is a belief in some quarters that when taxpayers strictly comply with the requirements of the Income Tax Act, including anti-avoidance provisions, or believe that they have done so, they cannot be described as dishonest, and therefore cannot be guilty of fraud. This belief is mistaken. Strictly speaking, there is no need for a provision in the Income Tax Act to make the point. However, because the belief is so common, and because it leads people astray, the committee **recommends** that the rewrite should include a provision to state the law as to the relationship between the Income Tax Act and fraud, so that there can be no doubt.

2.202 The statement should include specific reference to the relationship between anti-avoidance provisions and criminal fraud. That is, whether a transaction is void by virtue of an anti-avoidance provision does not necessarily shed light on the question of whether the transaction is fraudulent.

Relationship between Income Tax Act and other legislation

2.203 A number of other statutes affect the operation of the Income Tax Act in one way or another. The Diplomatic Privileges and Immunities Act 1968 is an example. The committee considers that such legislation should be listed in a schedule. The objective is that the proposed schedule should not change the law, but that it should act as a useful tool for users of the Act, along similar lines to schedule 23, which contains conversion tables that compare the numbering of the 1994 Act with the numbering of the 1976 Act. The schedule should begin with a statement to the effect that the omission of any legislation does not mean that the omitted Act does not affect the operation of either that Act or the Income Tax Act.

2.204 An additional schedule could list sections of the Crimes Act 1961 that are potentially relevant to income tax fraud. Again, this schedule would not purport to alter the law. Rather, it would bring home to users of the Income Tax Act that the Act is not an isolated edifice that has no relationship to the rest of New Zealand law. The schedule would help people to realise that the criminal law can be as relevant to the income tax area as it can to other areas of economic life. The schedule should begin with a statement to the effect that the rules that it contains are not an exhaustive list of the forms of civil and criminal liability that may arise in connection with tax matters.

2.205 The committee **recommends** that schedules that list legislation which affects the operation of the Act, and relevant sections of the Crimes Act 1961 be added to the Income Tax Act 1994.

CHAPTER 3 – ASPECTS OF THE CAPITAL-REVENUE BOUNDARY

SUMMARY

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Introduction

3.1 The history of tax reform, since the Land and Income Tax Assessment Act 1891, has been punctuated by legislation designed to frustrate attempts by taxpayers to take amounts that are essentially revenue in nature in a capital non-taxable form.

3.2 In this chapter the committee considers certain payments that pose a significant risk to the tax base, because they allow otherwise taxable income to be characterised as non-taxable capital receipts. They are payments for restrictive covenants involving services, inducement payments and certain contributions to capital expenditure. Characterising these payments as capital operates against the government's strategy for a broad-base, low-rate tax system, and creates a risk which is particularly acute in cases of personal exertion, as exemplified by the recent decisions in *Henwood v CIR*⁶⁴ and *CIR v Fraser*.⁶⁵ Such cases seem to afford taxpayers the opportunity to characterise otherwise taxable income from services as tax-free capital receipts. In the government's 1998 *December Economic and Fiscal Update*, the tax treatment of payments for restrictive covenants and lease inducement payments is included in the list of unquantified fiscal risks. It states that the government is considering

⁶⁴ (1995) 17 NZTC 12,271

⁶⁵ (1996) 17 NZTC 12,607

policy measures to ensure that these amounts are treated as taxable income.

3.3 It may not be possible to address the opportunities for characterisation of these payments as capital without modifying the boundary between capital and revenue. This could entail a choice between two policy positions, that is, either maintaining the existing tax base, or maintaining the existing capital-revenue boundary.

3.4 Another aspect of the capital-revenue distinction was raised in submissions by the Investment Savings and Insurance Association of New Zealand, that is, on which side of the capital-revenue boundary do investment gains of collective investment vehicles lie. The committee has had insufficient time to consider the issues raised in these submissions fully, but because of their importance, the submissions themselves appear in appendix 8. The committee **recommends** that Ministers should ask officials to evaluate these submissions, and report on the policy and remedial implications of addressing the concerns raised and the measures that can be implemented to address such matters. The committee considers that the issues identified by the Association are serious. They cause distortions to New Zealand's savings and investment practices, and should be addressed at an early date.

Services-related payments

3.5 This section deals primarily with payments for covenants in restraint of trade in cases involving personal exertion. Because they share some of the same characteristics, inducement payments that are related to status are also discussed in this section.

3.6 People sometimes accept payment in consideration for a restriction on their ability to perform services. The courts have often held that such payments are non-taxable as capital in the hands of the recipient.

3.7 In *Henwood v CIR*,⁶⁶ the taxpayer appeared in two television advertisements for a biscuit manufacturer. He received two payments totalling \$42,500 and did not return either of these payments as taxable income. Following an Inland Revenue Department audit, both payments were assessed as income from acting services. The taxpayer objected, stating that only \$5,000 was income and the remaining \$37,500 was a capital payment in consideration for his agreement to a restraint of trade.

⁶⁶ (1995) 17 NZTC 12,271

The restraint of trade prohibited the taxpayer from promoting any biscuit or confectionery products in competition with the manufacturer during a specified period.

3.8 The Taxation Review Authority found that the taxpayer had received \$5,000 for acting services and \$37,500 for the restraint of trade. On appeal to the High Court, McGechan J held that both payments were received for acting services and were not referable to the restraint of trade. The Court of Appeal, by a majority, restored the decision at first instance, confirming the taxpayer's treatment of the payment. McKay J, dissenting, preferred the approach of the High Court, and considered that the restrictive covenant in the contract was properly to be seen as an essential component of the taxpayer's income-earning process.

3.9 The issue in *Henwood* was whether \$37,500 of the \$42,500 payment (that is, 88 per cent of the total remuneration) was a payment in restraint of trade and as such a non-assessable capital payment, or whether it was a payment for acting services and taxable income. Although the taxpayer was effectively prevented only from making biscuit or sweet advertisements for one other manufacturer of such products in New Zealand, the court found 'a sufficiently substantial intrusion on the future exercise of the appellant's profession to constitute an affair of capital'.

3.10 In *CIR v Fraser*,⁶⁷ the taxpayer agreed to present a series of commercials for a bank. The taxpayer's services were hired through his own company. A payment of \$25,000 was made to induce the taxpayer to enter into the contract, and in addition, payments totalling \$140,000 over a three-year period were made restraining him from advertising or endorsing any other product during the term of the contract or its renewal. The taxpayer treated the inducement and restraint of trade payments as capital receipts. The Commissioner assessed these sums as income and the taxpayer objected.

3.11 The High Court found that the inducement offered and the payments in restraint had caused the taxpayer to leave his position as a current affairs journalist and to take up the bank's advertising campaign. It was imperative for the bank that the taxpayer should be restrained from offering his advertising services to others and from presenting other tele-

⁶⁷ (1996) 17 NZTC 12,607

vision programmes during the advertising campaign. The payments were intended as compensation for the restraint on the taxpayer's activities. The taxpayer had given up a substantial part of his potential income-earning activities in return for the payments, which were classified on capital account and not assessable. This decision was upheld by the Court of Appeal.

3.12 A status-related inducement payment is the consideration paid when a person gives up his or her previous status or position and enters a new contract of or for services. A line of United Kingdom case law holds that such payments are not assessable. For example, a payment made to a barrister to become an employee of a company was held not to be an assessable emolument from employment. Instead, the payment was considered compensation for the barrister giving up his status and position as a practitioner at the Bar.⁶⁸

3.13 In *Fraser*, a payment was made to compensate the taxpayer for the loss of his career opportunities as a result of his entering into the agreement with the bank and for the risk he took in doing so. Such payments are perhaps the only employment-related inducement payments that are not covered by the definition of 'monetary remuneration' in section OB 1 of the Income Tax Act 1994.

3.14 Considerable potential exists for the decisions in *Henwood* and *Fraser* to be exploited to the detriment of the revenue. Some tax advisers have suggested that the decisions provide a precedent for taxpayers to characterise payments for services as non-taxable capital receipts. The payer may also be able to deduct these payments, if they are a regular incident of business, as could be the case with an advertising firm.

3.15 In these cases, taxpayers receive a sum of money in return for entering into a contract that incorporates different elements, such as providing acting services and agreeing to a restraint of trade. Once the total fee for a contract containing both capital and revenue items has been struck, the apportionment of receipts between the different elements can be highly sensitive to tax considerations. Taxpayers will want to maximise tax-free capital receipts, and minimise taxable revenue receipts. At present, the Inland Revenue Department and the courts are poorly placed to respond, except in the most extreme cases.

⁶⁸ *Vaughan-Neil v Inland Revenue Commissioners* (1979) STC 644

3.16 This incentive highlights an issue of enforcement for the Inland Revenue Department. Payments in restraint are prevalent in the entertainment, modelling, sports and advertising industries. If this practice were to spread to other industries, the resources required to determine whether a payment is correctly characterised as a payment in restraint or is merely part of the recipient's ordinary remuneration would have to be increased.

3.17 The decisions in *Henwood* and *Fraser* are likely to promote the use of payments in restraints of trade. This use would pose a significant risk to the tax base representing income from personal exertion, which comprises 75 per cent of the total income tax base.

3.18 In the absence of legislative change, the courts would be left to develop principles through case law. Considering the risk to the income tax base, the committee prefers a legislative solution. This solution would necessarily involve bringing to tax some forms of capital receipts. It is not clear that a legislative response could be limited to restrictive covenants for personal services, because it would be possible to characterise the payment as another form of capital receipt, for example, a payment for the sale of shares in a company which held the restrictive covenant over the taxpayer. Any legislation targeting services-related payments in restraint would need to be buttressed by anti-avoidance rules to prevent it being circumvented by such arrangements.

3.19 A legislative solution would reduce compliance and administrative costs, because taxpayers would have greater certainty in the taxation of income from services. Taxpayers would no longer expend resources on characterising income from services as tax-free capital receipts, and Inland Revenue Department investigators would not incur the costs of identifying such arrangements.

3.20 In the United Kingdom, the legislation treats payments made under restrictive covenants relating to employment contracts entered into after 8 June 1988 as taxable emoluments from employment.⁶⁹ This precedent could be considered for New Zealand, although in the United Kingdom the legislation is supported by the comprehensive taxation of capital gains.

⁶⁹ Section 313, Income and Corporation Taxes Act 1988 (UK)

3.21 In conclusion, the decisions in *Henwood* and *Fraser* illustrate the point that service contracts, both employment contracts and contracts for services, are particularly sensitive to tax considerations. There is an incentive for taxpayers to structure their remuneration so as to maximise tax-free capital receipts and minimise taxable revenue receipts. It is the element of substitutability in service contracts that gives rise to concerns about the protection of the tax base, because existing case law gives taxpayers considerable latitude to characterise otherwise taxable income from services as tax-free capital receipts. Because a payment in restraint of trade and a payment for services are closely substitutable, the capital-revenue boundary that distinguishes these payments, with very different tax consequences, is vulnerable to manipulation. From the perspective of tax policy, it is undesirable to have a boundary between close substitutes.

3.22 The committee considers that in cases involving personal exertion, all payments in restraint of trade and status-related inducement payments should be taxable and **recommends** that the government should consider legislation to ensure their assessability. These amendments would need to include anti-avoidance rules to prevent their circumvention.

Lease inducement payments

3.23 Lease inducement payments are an example of payments received in business for which claims of a capital character are made. In *Wattie v CIR*,⁷⁰ the court considered whether lease inducement payments are taxable in New Zealand. The issue was whether a cash payment of \$5 million, made as an inducement to an accounting firm to enter into a 12-year lease of new office premises in Auckland, was a capital receipt.

3.24 In the High Court,⁷¹ the Commissioner argued that the receipt was assessable as income from a business on several grounds. First, the receipt was a subsidy against the non-market level of rental which the firm was committed to pay under the lease. Secondly, the receipt was assessable as a gain arising as an incident of the carrying on of the firm's business, on the authority of a line of Australian Federal Court decisions beginning with the decision in *FCT v Cooling*.⁷² Thirdly, the receipt was

⁷⁰ (1997) 18 NZTC 13,297

⁷¹ (1996) 17 NZTC 12,712

⁷² (1990) 22 FCR 42

assessable as a profit-making scheme under the principle laid down by the High Court of Australia in *FCT v Myer Emporium*.⁷³

3.25 In the High Court, Fisher J held in favour of the Commissioner on the first ground. The rental provided for in the lease was purely nominal, and the 'true' rent payable under the composite arrangement represented by the lease and deed collateral documents could be arrived at only by taking into account the \$5 million benefit provided by the lessor to the partnership. Fisher J found as a fact that a market rental for the leased premises was arrived at only if all benefits received by the firm, including the \$5 million payment, were set off against the nominal rental. Applying the test in *Hallstroms*⁷⁴ and *BP Australia*,⁷⁵ Fisher J concluded that the \$5 million was effectively a rent subsidy and, therefore, a revenue receipt. Fisher J did not accept the second of the Commissioner's arguments, declining to follow the Federal Court of Australia in *Cooling*, and did not find it necessary to examine the Commissioner's third submission on *Myer Emporium*.

3.26 By a majority, the Court of Appeal reversed the decision in the High Court.⁷⁶ The Court of Appeal held that the receipt was derived on capital account because it had been received by the partnership in association with its entry into a long-term lease. The lease was on capital account and the receipt took a similar character. The court agreed with Fisher J that the gain did not arise as an incident of the carrying on of the firm's business, and the *Cooling* line of cases, therefore, had no application. The correctness of the decision in *Cooling* was doubted. Finally, the court held that the decision of the High Court of Australia in *Myer Emporium* was no more than a restatement of the principle applying to the assessability of a gain arising from an adventure in the nature of trade. On the facts in *Wattie*, the Court of Appeal held that it was impossible to say that any 'gain' had been derived by the firm. The payment amounted to a negative premium and was a capital item in the same way as a payment by a lessee to obtain surrender of its lease.

3.27 Thomas J, dissenting, held that the sum was paid to the accounting firm to procure the firm's agreement to pay rent at a figure substantially in excess of the market rent. As no capital asset was disposed of by

⁷³ (1987) 163 CLR 199

⁷⁴ *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634

⁷⁵ *BP Australia Ltd v FCT* [1966] AC 224

⁷⁶ (1997) 18 NZTC 13,297

the firm in consideration for the receipt, he considered that any analogy between the receipt and a negative premium was ill-founded.

3.28 On appeal to the Privy Council, the Commissioner sought to reverse the Court of Appeal judgment on two grounds; first, that the receipt represented a subsidy or offset against the above-market level of rental payable by the partnership under the lease and on that basis was assessable income derived from the carrying on of a business. Alternatively, the Commissioner argued that the receipt was assessable as a gain arising from a venture entered into in part for the purpose of profit-making.

3.29 The taxpayer's argument in *Wattie* can be expressed in one proposition, namely, that when a lease is a capital asset, lump sum payments made or received in relation to the acquisition, disposition or modification of that lease, are capital and are neither assessable nor deductible. As the payment received by the taxpayer related to the acquisition of a capital asset of the business, the payment was, therefore, a capital receipt.

3.30 The Privy Council upheld the decision of the Court of Appeal.⁷⁷ Although the payment was commercially, financially and mathematically linked to the rental payments, it was a premium, and premium payments have always been recognised as capital rather than revenue. The court followed the reasoning in *British Insulated and Helsby Cables Ltd*,⁷⁸ that when an advantage for the enduring benefit of the trade is brought into existence, the expenditure is properly attributable to capital.

3.31 As with services-related payments in restraint, the tax-free status of lease inducement payments poses a risk to the tax base. Accepting that lease inducement payments would be deductible to a commercial lessor, as in *Wattie*, there is an incentive for parties to leasing contracts to arbitrage the tax cash value of non-assessable but deductible lease inducement payments. This arbitrage opportunity means that the apportionment of receipts between different but readily substitutable elements, for example, between inducement payment and rent, can be highly sensitive to tax considerations.

⁷⁷ (1998) 18 NZTC 13,991

⁷⁸ [1926] AC 205 at 213

3.32 The committee, therefore, **recommends** that the government should consider legislative reform to make lease inducement payments taxable. Canada has enacted legislation to make lease inducement payments assessable in section 12(1)(x) of its Income Tax Act. This legislation may provide a worthwhile model for New Zealand.

Certain capital contribution payments

3.33 Taxpayers incurring capital expenditure in their business sometimes receive a contribution to that expenditure from another person. Under existing case law, that contribution is not assessable to the recipient. Moreover, the recipient is entitled to full depreciation deductions for that expenditure. For example, say a utility company receives a payment from a major power consumer in return for which it removes an above-ground transmission line supplying that consumer and replaces it with an underground transmission line. Under a separate power supply contract, the consumer is supplied power at a lower price than it would have been charged if it had not made the contribution to the utility company's capital expenditure on the replacement transmission line. For the purposes of the example, the utility company is in the business of supplying power and not in the business of dealing in transmission lines.

3.34 The contribution from the power consumer has the character of capital in the hands of the utility company, and is not taxable under section CD 5 of the Income Tax Act 1994. This treatment is based on the principle established in *Boyce v Whitwick Colliery Company Ltd*,⁷⁹ that a receipt contractually required to be applied by the recipient to a capital purpose has a capital nature. In addition, as the utility company is not in the business of constructing or otherwise dealing in transmission lines, the contribution by the consumer is not taxable under section CD 3.

3.35 In *CIR v City Motor Services Ltd; CIR v Napier Motors Ltd*,⁸⁰ the Court of Appeal found the relevant contribution receipt to be capital. In *City Motors*, the oil company contributed to the cost of constructing the taxpayer's new premises. The money was paid directly to the contractors doing the work. In *Napier Motors*, the oil company paid the taxpayer half the cost of moving petrol pumps inside the taxpayer's premises as required by the city council. In both cases, having regard to the origin and purpose of the contributions voluntarily made by the oil companies

⁷⁹ (1934) 18 TC 655

⁸⁰ [1969] NZLR 1010

towards the cost of improving the capital assets of the taxpayers, the court found that the payments made were not profits or gains derived from the current operation of the taxpayers' businesses and were, therefore, not assessable. Turner J noted that before an amount could be taxable as income from a business there must be something more than merely a receipt arising as a result of the fact that the company was carrying on business. He held that the statutory language 'from the business' must mean 'from the current operations of the business'.

3.36 Case law, then, supports the view that receipts that are contractually required to be expended on capital assets, or which reimburse capital expenditure, are of a capital nature. The factors taken into account are that a benefit accrues to the payer, and that the expenditure incurred is at the request of the payer, even when a benefit also accrues to the recipient. Provided the benefit is not derived from the current operations of business, the receipt will not be on revenue account. With composite agreements, containing both revenue and capital elements, provided an amount can be attributed to the capital component, that amount will be of a capital nature.

3.37 In the example used above, assuming first, that the utility company acquires the transmission lines for the dominant purpose of using them for transmissions as part of its principal business activity, and secondly, that the dominant purpose of devising or entering into the contract is not profit-making, the payment by the power consumer to the utility company will not be taxable under any of the three limbs of section CD 4. The cost price for depreciation purposes for the expenditure incurred by the utility company in relocating its transmission lines is not reduced by the amount of the contribution by the power consumer.

3.38 As with services-related and lease inducement payments, the capital contribution and power supply payments received by the utility company are close substitutes. The fact that placement of these payments falls on either side of the capital-revenue boundary means that taxpayers may approach the issue of apportionment between these items bearing in mind the tax consequences.

3.39 This is an example of what seems to be a general principle that payments for conducting a business in a certain manner are likely to be tax-free. The committee suggests that any legislative reform would need to consider issues in this context.

3.40 The committee notes that contributions of this type would be taxable under section 12(1)(x) of the Canadian Income Tax Act, which

brings to tax all amounts received by a taxpayer in the course of earning income from a business or property as a contribution towards the cost of property or towards an outlay or expense.

3.41 In conclusion, the committee believes that it is not possible to address tax base maintenance concerns without modifying the existing capital-revenue boundary. It could, therefore, be necessary for the government to choose between two positions, that is, either maintaining the existing tax base, or maintaining the existing capital-revenue boundary. The existing tax base is a matter of policy. The boundary between capital and revenue is more a matter of an historical accretion of judicial decisions.

3.42 The committee notes that the Income Tax Act 1994 already taxes a number of payments that are on the capital side of the judicially delineated boundary, such as redundancy payments and consideration received for the sale of patent rights. Reform along the lines proposed would complement the government's commitment to a broad-base, low-rate tax system. The committee, therefore, **recommends** that payments for restrictive covenants involving services, inducement payments, certain capital contribution payments, and other similar payments should be taxable.

CHAPTER 4 – CHARITIES AND OTHER TAX-EXEMPT ENTITIES

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Introduction

4.1 The committee has some concerns regarding tax-exempt organisations. These are first, the appropriateness of the current broad tax exemption for charities and other non-profit organisations; secondly, the ability of tax-exempt organisations to earn business income free of tax, giving them a competitive advantage over other business operators; and finally, the exemption from taxation in certain circumstances of compensation paid to employees of certain charities and tax-exempt organisations. There is a fourth concern: exploitation of the charitable exemption in order to create asymmetrical tax avoidance schemes that permit arbitrage between taxpayers and tax-exempt entities. The committee addresses this concern at para 6.115.

4.2 The government assists some organisations that act for the benefit of the public by exempting them from income tax. These organisations are generally charities under the common law definition, and provide services which would otherwise be under-supplied in a free market, and might need to be supplied directly by the government. Examples include health care and education. In some circumstances, this assistance has been achieved by exempting private sector suppliers from income tax.

Scope of the tax exemption

4.3 The exemption for charitable and other tax-exempt entities is provided largely by section CB 4 of the Income Tax Act 1994. This exemption includes:

Non-business income derived by a trust, society or institution established exclusively for charitable purposes.

Business income derived by such a charitable body, subject to certain exceptions.

Income derived by an amateur sports body.

Income derived by a veterinary club or a herd improvement society.

Income derived by any society or association established substantially or primarily for the purpose either of promoting or encouraging approved scientific or industrial research or for advertising, beautifying, or developing any local areas so as to attract trade, tourists or population.

4.4 The committee has some specific concerns with certain tax-exempt entities, namely sports bodies, and sick, accident or death benefits funds.

Amateur sports bodies

4.5 A principle of income tax law states that taxpayers cannot profit from trading with themselves. This concept, known as the mutuality principle, has been extended to clubs and other associations trading with their members. In keeping with this principle, the taxable income of such bodies should not include receipts from members, such as subscriptions and donations, or income from the sale of goods to members.

4.6 The application of the mutuality principle is, however, affected by statute. Section HF 1 of the Income Tax Act 1994 abolishes this principle unless rebates are provided to the members in proportion to their dealings with the relevant bodies. It is the impression of the committee that tax practice may at times be at variance with this statutory provision.

4.7 Section CB 4(1)(h) provides a tax exemption for income derived by ‘any society or association ... established substantially or primarily for the purpose of promoting any amateur game or sport if that game or sport is conducted for the recreation or entertainment of the general public’. The committee is concerned that this exemption is being applied more widely than would appear to be allowed under the statute.

4.8 Considering that private sporting bodies generally provide a service that benefits only their members rather than the general public as is required under the statute, and that sporting bodies that provide sport for public entertainment are generally commercial and profitable opera-

tions, the committee questions whether the current application of this tax exemption is too wide. The committee notes that a better approach to amateur sports bodies may be to tax them on their net income, subject to the general de minimis rule in section DJ 17, which is designed to reduce compliance costs by providing that those non-profit bodies with net income below \$1,000 need not file a tax return.

4.9 The committee **recommends** that the government should review the law and the practice of granting the exemption and determine whether the practice of granting the exemption is consistent with the law, and whether the law is consistent with the policy intent. If inconsistency is found, the government should rectify the law and the practice in accordance with the policy.

4.10 In other words, if the policy is that the exemption should apply to private sports clubs, as it appears to apply in practice, the law should be redrafted appropriately. If the policy is that the exemption should apply only to organisations providing sport for the benefit of the public, as the law is drafted, the practice of granting the exemption should be applied consistently with that policy.

4.11 The committee also **recommends** that the threshold in section DJ 17 should be reviewed to ascertain whether this threshold is sufficiently high enough to meet its objective of reducing compliance costs.

Sick, accident or death benefit funds

4.12 The committee has concerns with another tax-exempt entity, the sick, accident or death benefit fund (SAD fund). Income derived by a SAD fund is exempt from tax under section CB 5(1)(i).⁸¹ SAD funds are defined in section CB 5(2) as funds established for the benefit of the employees of any employer, or the members of any incorporated society, and the surviving spouses and dependants of any such employees and members.

4.13 The income tax exemption for SAD funds is anomalous in terms of current tax policy. In particular, it provides concessions that are not available for other forms of savings, such as superannuation funds and bank accounts, where tax must be paid on earnings from savings. The exemption for SAD funds is also inconsistent with the treatment of in-

⁸¹ Not being income derived from any business carried on by, or on behalf of, or for the benefit of the trustee.

insurance policies for protection against sickness, accident or death. The earnings on contributions or premiums paid on these insurance policies are taxable.

4.14 The exemption itself is surprisingly open-ended. There is, in fact, nothing requiring a SAD fund to be established for protection against sickness, accident or death. As noted above, the definition of a SAD fund simply refers to any fund established for the benefit of employees or members of an incorporated society including surviving spouses and dependants. The exemption effectively allows earnings on personal savings to be exempt from tax. An investment in a SAD fund, therefore, confers private benefits. There seems to be no public policy justification for the existing exemption of the investment earnings of a SAD fund.

4.15 The committee **recommends** that the income tax exemption in section CB 5(1)(i) for trustees of SAD funds should be repealed.

Business income derived by tax-exempt entities

4.16 Business income derived by charities is exempt from tax under section CB 4(1)(e). However, some charities may engage in business activities unrelated to the charitable purpose for which they are provided a tax exemption. This exemption gives charities a competitive advantage over taxpaying business competitors.

4.17 The committee **recommends** that the government should review the tax treatment of charities and other tax-exempt entities that engage in commercial activities unrelated to their purposes. No reason exists in principle why business income, unrelated to the core purpose, should not be taxed. An unrelated business could include the operation of a manufacturing business, but it would not include such business operations as hospitals, where the business of the charity is central to its purpose, unlike business operations used to fund other charitable activities.

4.18 Contributions, investment income, and income earned from occasional fund-raising activities, even if they are commercial activities should not be affected. The proposal should apply only to continuous

and regular commercial activities that are not related to the charitable or exempt purpose of an entity.⁸²

4.19 The committee notes that the United States taxes ‘unrelated business income’ of exempt organisations. The government may wish to refer to the relevant United States legislation in designing rules for New Zealand.

Compensation of employees of charities and tax-exempt organisations

4.20 The committee notes that, in certain circumstances, the compensation paid to employees of certain charities and tax-exempt organisations is not taxed. These instances are first, fringe benefits provided to the employees of charitable organisations,⁸³ and secondly, the earnings of a superannuation scheme established for the benefit of the employees of certain charities.⁸⁴

4.21 Both circumstances involve tax exemptions for the income earned by, or for the benefit of, employees rather than the tax-exempt organisation itself. Employees of tax-exempt organisations are generally taxed on their monetary remuneration, as they should be, because that is income earned by an individual rather than a charitable organisation. At present, the law exempts benefits provided by a charitable organisation to its employees from fringe benefit tax. This treatment is unjustified because these benefits are a form of compensation to the employees, and fringe benefit tax is intended to be a substitute for the income tax that would otherwise be paid by the employee, if the fringe benefit were taxable as ordinary salary and wages.

4.22 The committee **recommends** that the exemption from the fringe benefit tax in section CI 1(m) for benefits provided by charitable organisations to their employees should be repealed.

4.23 The committee notes that in *Presbyterian Church of New Zealand Beneficiary Fund*,⁸⁵ it was held that income earned on the superannuation scheme of employees of a charity should not be taxed because

⁸² The boundary between what income is taxable and what income remains exempt would need to be carefully drawn to provide certainty and to achieve the policy objective of the reform. In principle, the committee envisages the boundary being drawn between active business income that is unrelated to the exempt purpose of an entity and other income.

⁸³ As defined in section OB 1 (exempt from fringe benefit tax (FBT) under section CI 1 (m)), Income Tax Act 1994

⁸⁴ *Presbyterian Church of New Zealand Beneficiary Fund v CIR* (1994) 16 NZTC 11,185

⁸⁵ (1994) 16 NZTC 11,185

the superannuation scheme furthered the charitable purpose of the employer. The committee considers that the more important consideration in the taxation of superannuation schemes is the fact that income earned by the scheme accrues for the benefit of individual employees, which in principle should be taxable, notwithstanding the tax-exempt status of the employer. As discussed earlier, the government moved some years ago to remove the tax benefit from investment in superannuation schemes to ensure that they are not favoured over other forms of investment or compensation for the benefit of individuals.

4.24 The committee **recommends** that superannuation schemes for the benefit of employees should not have charitable status, and therefore, the earnings of the superannuation scheme should not be exempt from tax.

4.25 In summary, the committee **recommends**:

The law and practice relating to the income tax exemption for amateur sports bodies should be reviewed.

The threshold in section DJ 17 should be reviewed to ascertain whether this threshold is sufficiently high enough to meet its objective of reducing compliance costs.

The income tax exemption in section CB 5(1)(i) for trustees of sick, accident and death benefit funds should be repealed.

Charities and other tax-exempt entities that engage in commercial activities unrelated to their exempt purpose should be taxed on the net income derived from those activities.

The exemption from fringe benefit tax in section CI 1(m) for benefits provided by charitable organisations to their employees should be repealed.

Superannuation schemes for the benefit of employees should not be eligible for charitable status.

4.26 The committee envisages that any initiatives that the government may take would proceed through the generic tax policy process. In this way affected bodies would have the opportunity to comment.

CHAPTER 5 – SOME SPECIFIC CONCERNS

SUMMARY

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Introduction

5.1 In this chapter, the committee makes some recommendations for reducing compliance costs. The recommendations are not intended to be a package of measures, nor to address comprehensively the compliance costs associated with a particular tax regime, but are individual measures that can be undertaken to reduce compliance costs. Important simplification measures, in areas such as tax collection and the issue of disclosure obligations, are dealt with in other chapters. Most of the measures noted here have arisen from submissions received by the committee.

5.2 When the committee began to address tax simplification issues, it was frequently asked: ‘Why doesn’t the tax system just ...’ It is important, therefore, that taxpayers and their advisers have a good understanding of the reasons why some seemingly attractive propositions are unworkable. The answer is to be found in balancing the diverse requirements of a modern tax system, which focuses on more than simplicity alone. It strives also for equity, low deadweight costs of taxation and administrative feasibility. A robust tax system must balance all these considerations effectively. In addition, when compliance costs are reduced in one area, the costs in another area may increase. For example, the PAYE system reduces compliance costs for wage and salary earners, but increases the compliance costs for employers.

5.3 The committee recognises that compliance costs, even those voluntarily incurred, represent a loss of resources that society could employ elsewhere. So, for example, the introduction of complex rules for the valuation of motor vehicles would be welcomed by employers who would likely face a reduced tax bill, because the savings would outweigh the cost of asking a tax adviser to undertake the necessary calculations. But the dollar the employer considers that he or she is losing in this way is of real benefit to society. It is the money used to fund health, education and other government services. Moreover, the amount the employer spends on increased compliance costs, say in hiring an adviser, represents a real loss to society. The employer spends money on an activity that would not have occurred but for the tax system, and moves resources away from more productive activities.

5.4 The need to balance such matters has meant that some suggestions for simplification have had to be rejected. Some of these suggestions are nevertheless considered by the committee in this chapter, as the reasons for their rejection are important, and the committee hopes that its explanation will increase understanding and acceptance of the principles underlying the tax system.

5.5 In addressing concerns on compliance costs, the committee identified measures that could be justified only as part of a wider simplification initiative, with the focus on the collective effect of an overall package of proposals. The committee has noted this point where relevant in this chapter.

The tax treatment of expenditure on motor vehicles

5.6 Taxpayers and their advisers spend considerable time and money trying to identify and implement the most tax efficient structure for the ownership and use of a motor vehicle that is used partly in business, and used, or available for use, partly by a proprietor or an employee for their personal needs. The outcome will be influenced by such factors as the structure used to conduct the business, and the relationship between the owner of the vehicle and the person using the vehicle. The treatment affects the calculation of income tax, fringe benefit tax (FBT), goods and services tax (GST), and, indirectly, the accident compensation levy. Clearly, the fact that there are different ways of doing things adds to compliance costs and also represents a deadweight cost to the economy. The Inland Revenue Department is reviewing this situation at present, and the committee supports this work.

5.7 The committee **recommends** that the government should develop a universal approach to the tax treatment of motor vehicles. The policy that is developed and enacted should balance fiscal needs, equity between taxpayers, and compliance costs. The aim should be to ensure that, regardless of legal structure and ownership, the tax outcome is the same.

Fringe benefit tax

5.8 An employer who provides a motor vehicle for an employee pays FBT on the annual taxable value of a motor vehicle that is used, or is available for use, by that employee. The benefits to the employee lie in both the availability and the use of that vehicle. The value of those benefits is determined at 24 per cent of the GST-inclusive cost of the motor vehicle. When that rate was set,⁸⁶ it reflected the average cost of owning and operating a vehicle. The calculation was based on 16,000 kilometres per annum of vehicle usage over a five-year period.⁸⁷ A range of options was considered and was concluded that a formula-based approach was the most appropriate. The value of the benefits was intended to be based on the costs an employee would have incurred if the employee had bought and run the motor vehicle.

5.9 The submissions made to the committee exemplify that the primary concern is not so much the percentage rate to be applied, although, on occasions, this rate is said to be too high, but the fact that the rate of 24 per cent is applied each year to the original cost of the asset. This fact is perceived by many to be unfair.

5.10 The concerns expressed are largely based on a lack of understanding of the assumptions made in setting the rate. The committee considers that taxpayers need to understand why the present rate continues to apply, and why it remains appropriate to use the cost price of the motor vehicle as the base value each year.

5.11 There are a range of circumstances that could be taken into account in determining the base value of a motor vehicle for FBT purposes. Among these are the annual levels of total mileage, the proportion of business use to private use, the different ratios of vehicle annual oper-

⁸⁶ The rate of 24 per cent was proposed in the *Report of the Task Force on Tax Reform* (the McCaw Report), April 1982, pages 152-160.

⁸⁷ This calculation assumes a depreciating motor vehicle value averaged over the five-year period.

ating costs to vehicle cost prices, the period of vehicle ownership, alteration in the level of expenditure through differing vehicle retention periods or higher or lower usage factors, and the different funding patterns and funding cost structures.

5.12 Taking all such factors into account would significantly increase compliance costs. The tax system would be chasing an increasing accuracy, relevant only to the group of taxpayers that sees the benefit from the additional complexity. Each marginal increase in accuracy achieved by incorporating one of these factors would increase compliance costs for all. While the FBT payable by some would be reduced, the change would increase the tax paid by others.

5.13 The committee considers that a case in equity might possibly be made for a reduction in the value of employee-related benefits from the use of a motor vehicle when the employer could demonstrate that the incidence of private use on particular days, or over time was relatively minimal. However, the committee has noted that under present government policy, 'availability for private use' is one of the criteria. The committee considers that this issue should be absorbed into the department's work on a universal treatment of the private benefits enjoyed by individuals in relation to business motor vehicles.

5.14 Based on Table 3 as shown, the factor of 24 per cent is considered to be in the right order. Overall, the committee finds the global 'percentage of cost' approach a satisfactory compromise, taking into account the fact that the motor vehicle may also be used for business purposes. Table 3 includes an interest charge representing the opportunity cost of the capital committed to the motor vehicle. This charge is calculated on the basis of a capital outlay equivalent to the third year value of the motor vehicle, including charges such as insurance, and the interest the car owner would have received if that money had been invested in a bank. When an employer provides a motor vehicle, the new cost of the vehicle is the more appropriate measure of the capital outlay. This value continues to apply each year because the employee is not contributing to the reduction in the amount borrowed to purchase the motor vehicle. A more appropriate interest charge in this case would be the employee's cost of borrowing to buy that motor vehicle. At present, 10 per cent per annum would not be inappropriate. The results of this approach are displayed in Table 4. Again the results confirm the 24 per cent factor is not excessive.

TABLE 3: CAR RUNNING COSTS
(based on 12,000 kilometres)

(Based on figures from the March 1998 issue of the Automobile Association magazine *Directions*)⁸⁸

Vehicle engine size	to 1300 cc	1300–1600 cc	1600–2000 cc	over 2000 cc
Original cost	\$21,193	\$26,809	\$35,063	\$42,116
Fixed costs per year (incl depreciation)	\$4,588	\$5,639	\$7,176	\$8,484
Running cost per kilometre ¢/l	16.0	17.1	18.9	22.1
<i>Cost per year</i>				
<i>Annual kilometres plus fixed costs</i>				
8,000	\$5,868	\$7,007	\$8,688	\$10,252
12,000	\$6,508	\$7,691	\$9,444	\$11,136
16,000	\$7,148	\$8,375	\$10,200	\$12,020
20,000	\$7,788	\$9,059	\$10,956	\$12,904
24,000	\$8,428	\$9,743	\$11,712	\$13,788
<i>Cost per year cost as a percentage of original cost</i>				
<i>Annual kilometres</i>				
8,000	27.7	26.1	24.8	24.3
12,000	30.7	28.7	26.9	26.4
16,000	33.7	31.2	29.1	28.5
20,000	36.7	33.8	31.2	30.6
24,000	39.8	36.3	33.4	32.7
FBT rate	24%	24%	24%	24%

⁸⁸ 1982 equivalent summarised from *McCaw Report*

<i>Annual kilometres</i>				
16,000	N/A	43.5	40.9	35.6

TABLE 4: CAR RUNNING COSTS INCLUDING FULL FUNDING COST

(Based on figures from the March 1998 issue of the Automobile Association magazine, *Directions*, modified to include full funding cost)

Vehicle engine size	to 1300 cc	1300–1600 cc	1600–2000 cc	over 2000 cc
Original cost	\$21,193	\$26,809	\$35,063	\$42,116
Fixed costs per year (incl depreciation)	\$5,558	\$6,879	\$8,813	\$10,461
Running cost per kilometre ¢/l	16.0	17.1	18.9	22.1
<i>Cost per year</i>				
<i>Annual kilometres plus fixed costs</i>				
8,000	\$6,838	\$8,247	\$10,325	\$12,229
12,000	\$7,478	\$8,931	\$11,081	\$13,113
16,000	\$8,118	\$9,615	\$11,837	\$13,997
20,000	\$8,758	\$10,299	\$12,593	\$14,881
24,000	\$9,398	\$10,983	\$13,349	\$15,765
<i>Cost per year cost as a percentage of original cost</i>				
<i>Annual kilometres</i>				
8,000	32.3	30.8	29.4	29.0
12,000	35.3	33.3	31.6	31.1
16,000	38.3	35.9	33.8	33.2
20,000	41.3	38.4	35.9	35.3
24,000	44.3	41.0	38.1	37.4

5.15 The committee undertook a number of other calculations based on motor vehicle use from 6,000 to 20,000 kilometres per annum to ensure the validity of the 24 per cent rate. These calculations also confirmed the committee's position that the 24 per cent factor is broadly right. Some who made submissions to the committee identified matters for which they considered relief should be available. Even taking these into account, 24 per cent of the cost price remains an appropriate value for FBT purposes.

5.16 The law at present necessarily takes a broad-brush approach, and although not accepted by some, it remains an effective compromise between compliance costs and accuracy. The committee is satisfied that, on the basis of present government policies, the rate of 24 per cent that is applied each year to the original cost of the motor vehicle should not be changed. The committee **recommends** that there should be no change in the present formula for calculating the value of the fringe benefit of a motor vehicle.

5.17 The committee also **recommends** that the Inland Revenue Department should publish in the *Tax Information Bulletin* a full and informative explanation of the rationale underlying the use of the factor of 24 per cent of the original GST-inclusive cost price as a method for determining the base fringe benefit value of a motor vehicle.

GST on fringe benefits

5.18 A common omission made by small businesses is to forget to account for GST on certain fringe benefits, for example, subsidised goods provided to employees. This error is often identified only on audit and it can result in the imposition of penalties. While it may be the taxpayer's fault, the tax system should be designed to minimise the possibility of this type of omission. For this reason, the committee **recommends** that GST on fringe benefits should be returned on the FBT return rather than the GST return.

Use of money interest

5.19 When the annual level of gross tax deductions and specified superannuation contribution withholding tax deductions does not exceed \$100,000, an employer may elect to account annually for FBT. When this measure was enacted the government considered it necessary that the cash flow advantage that had been provided along with the reduction in compliance costs should be balanced by an interest charge. However,

this charge caused many employers with a low annual level of fringe benefits to decline to adopt the option of annual returns.

5.20 The committee considers that taxpayers who pay fringe benefit tax annually should be allowed to prepare an annual FBT return, and to make annual FBT payments without incurring an interest charge on deferred payment.

5.21 Research undertaken by the Inland Revenue Department indicates that taxpayers see the use of money interest provisions as a disincentive to filing annual returns. Of those employers surveyed who were eligible to file annually and did not, 24 per cent indicated that they filed returns quarterly to avoid use of money consequences, 23 per cent said quarterly filing provided a better cash flow and 19 per cent found it suited their accounting system. This research suggests that annual filing would be more favourably regarded if interest were not charged.

5.22 Officials advised the committee that the option to pay FBT annually without incurring an interest charge would reduce compliance costs by approximately \$240,000, mainly through the completion of only one return instead of four returns. They also indicated that administrative savings of approximately \$34,000 per annum would follow, through reductions in the distribution and processing of FBT returns.

5.23 The committee noted that removing the interest charge from annual FBT returns is likely to create timing advantages for employers who file annually. It may also be an incentive to those employers to provide employees with fringe benefits rather than providing monetary remuneration, and could also indirectly affect the government's income support measures.

5.24 Balancing these concerns is the statutory ceiling, which limits the potential for abuse. The overall monetary cost to the government of the deferral associated with annualising FBT payments without interest recompense is, however, moderately significant. The Inland Revenue Department estimates that the removal of the FBT interest charge would cost the revenue approximately \$1.25 million per annum. This estimate is based on the assumption that all taxpayers who are eligible to file annually will do so.

5.25 The committee **recommends** that the matter should be pursued in the context of the comprehensive review of the obligations of business taxpayers being undertaken at present by the Inland Revenue Department. If this review should not result in any reasonable simplification for

small taxpayers who pay FBT, the committee **recommends** that the use of money interest charge should not apply to fringe benefit taxpayers who pay annually.

Provisional tax

5.26 While broadly happy with the provisional tax rules, the committee identified one matter for consideration. Provisional taxpayers who elect to use the safe harbour rules are not charged use of money interest on any underpaid provisional tax. Correspondingly, they are not paid interest on overpaid provisional tax. However, if such taxpayers file an election to estimate their income, they may leave the safe harbour and receive use of money interest on overpaid tax. This election may be made at any time up to and including the third instalment date.

5.27 In the committee's view it is undesirable that the payment of interest on overpaid provisional tax should be determined by such an election. The committee considered the cause of this problem and possible solutions.

5.28 Under the provisional tax rules, a safe harbour is provided for smaller, less sophisticated taxpayers in order to reduce their compliance costs. If the use of money interest provisions applied to them, these taxpayers would probably incur greater compliance costs in estimating their income than the benefit both they and the government would gain from more accurate payment. Because the use of money interest rules do not apply to taxpayers in the safe harbour, prescriptive rules on the amount to be paid at each instalment date are required. Because these rules produce inaccurate results in some individual cases, taxpayers must have an option to leave the safe harbour and to estimate their provisional tax payments.

5.29 One option to deal with this problem would be to restrict taxpayers leaving the safe harbour. However, this restriction would be complex in legislative terms, and would also be administratively difficult. A second option would be to ensure that interest accrued only from the time of making an election to leave the safe harbour. While this option is feasible, it would result in complex interest calculations, which would in turn carry their own administrative and compliance costs.

5.30 A third option would be to pay interest on all overpaid provisional tax. Interest would be paid whether the notice of election to estimate income was filed or not. While this option would benefit taxpayers, it would entail a fiscal cost that would have to be recovered.

5.31 The different treatment of taxpayers who opt out of the safe harbour and those who remain in the safe harbour comes about through the use of two distinct approaches for ensuring payment by provisional taxpayers. Any measures to integrate these approaches would increase compliance costs. Nevertheless, this result is a concern. The committee **recommends** that the government should monitor the number of elections made, and if most taxpayers are found to be opting out of the safe harbour, the government should consider paying interest in all cases of overpayment of provisional tax, thus obviating the need for an election.

Resident withholding tax and back-to-back loans

5.32 Tax issues arise when a taxpayer borrows funds from a financial institution to lend to his or her business or to another entity. The financial institution making the loan may prefer to lend to the individual rather than the company because of the credit risk involved, securing the loan over the individual's private assets. Together, the loan from the bank to the individual and the loan from the individual to the company are known as a back-to-back loan. In these circumstances, resident withholding tax (RWT) can create a cash flow disadvantage for the individual, because the individual is required, in effect, to withhold RWT from interest on the loan to the business, but to make gross interest payments to the financial institution. The individual must top-up the interest paid to the financial institution to the extent of the tax withheld.

5.33 To address the problems arising from back-to-back loans, the legislation at present gives the Commissioner a discretion to provide an exemption from deducting RWT. This discretion imposes compliance costs and is not comprehensive in nature. For example, only taxpayers with RWT credits that are likely to exceed their tax liability by more than \$500 may apply for a certificate of exemption. Moreover, those applying for certificates of exemption must provide comprehensive details on their circumstances and provide accounts.

5.34 Considering this position, the committee was inclined towards some amendment. However, there are practical difficulties in designing such rules, which must at the same time provide the necessary revenue protection. The tax system relies on its withholding taxes, principally PAYE and RWT. Any measure entailing a risk to the integrity of the RWT system must be considered with caution.

5.35 Weighing both the need to pursue reductions in compliance costs and the need to protect the tax base, the committee concludes that suffi-

cient justification exists for retaining the present treatment of back-to-back loans. The committee is unable to recommend a change.

Payment and refunds

Amalgamation of payment dates

5.36 There is a proliferation of due dates for payment of taxes, which particularly affects small employers. The committee saw some merit in considering the amalgamation of due dates.

5.37 PAYE is payable either monthly on the 20th of the month following the PAYE deduction or, if the aggregate of PAYE and specified superannuation contribution withholding tax deductions exceeds \$100,000, on the 20th of the month and the 5th of the following month.

5.38 GST is payable either monthly,⁸⁹ two-monthly, or six monthly.⁹⁰ Payment is due on the last day of the month following the end of the taxable period.

5.39 FBT is payable either quarterly or annually, or is aligned with the taxpayer's balance date. Quarterly payments are due on the 20th of the month following the end of the quarter. Annual payments are due on 31 May following the end of the income year. Taxpayers may also elect to pay by income year, in the case of a close company, in which case payment is due on their terminal tax date.

5.40 Several submissions to the committee identified compliance cost benefits that would arise from amalgamating payments. These benefits would include taxpayers' ability to address all tax obligations at one time, to write one cheque to cover all liabilities, and to exchange less mail with the Inland Revenue Department. Finally, the advantage of having one regular payment date would reduce the likelihood of a taxpayer forgetting to pay and having a late payment penalty imposed.

5.41 However, the committee has identified some disadvantages for businesses. Less frequent, but more significant, tax payments could cause cash flow problems with the possible result that businesses with poor financial management or accounting systems could experience financial difficulties.

⁸⁹ Voluntarily, except in the case of registered persons with turnover exceeding \$24 million.

⁹⁰ Turnover must be less than \$250,000.

5.42 The degree of reduction in compliance costs that would be achieved is also questionable. The situation will differ from taxpayer to taxpayer. Compliance cost savings would be most likely for small, and small to medium businesses which rely heavily on external tax accounting support.

5.43 Many tax calculations occur regardless of the due dates for payment of the tax. For example, employers must deduct PAYE each payday from wage and salary payment, irrespective of the date on which it is paid to the Inland Revenue Department. Furthermore, if payment dates were amalgamated the number of tax returns would be reduced, but each return would be more complex. As an amalgamated return would cover more than one tax type, additional calculations would be required to ensure that the total tax liability equalled the tax payment. The work of preparing this amalgamated return, therefore, is peaked rather than spread.

5.44 Additional complexity would result if different individuals were required to meet the liability, such as the taxpayer, the taxpayer's adviser and a payroll company. Although, if tax accounting personnel are required repeatedly to access documents and files at different times over a period, some additional compliance costs are also incurred.

5.45 Balancing these factors cannot be done on a theoretical basis. It is an exercise that requires consideration of the preferred approach by all those affected – fewer payments but possible cash flow problems against more frequent, smaller payments. The committee considers public consultation is necessary.

5.46 The extent to which the government can separate tax payments from the need for information from tax returns is also a matter for consideration. This separation is easier with small, more stable payment profiles, such as FBT or duties, than with the larger more variable taxes, such as GST.

5.47 The committee has concluded that it is not possible to make a firm recommendation, because of the conflicting factors, but considers that a review of existing payment dates and the separation of the flow of information from the payment of tax has merit. The committee considers that a better overall outcome may be reached by considering the reform of payment dates as part of the comprehensive review of the obligations of business taxpayers. The committee, therefore, **recommends** that the government should publish a discussion document that sets out the de-

bate on amalgamating payment dates and the separation of the flow of information from the payment of tax to allow informed public consideration of the issues and to provide for public submissions. The committee also **recommends** that the discussion document should clearly distinguish the needs and concerns of the small, small to medium, and large businesses.

Treatment of payments that fall due on a non-working day

5.48 Much uncertainty arises over the actual payment date when the payment day falls on a weekend. The exception is payment of GST, for which the legislation provides that the tax is due on the last working day of the month. The committee considers that compliance costs would be reduced if a universal statutory rule specifying the due date for payment of tax on those occasions when the actual due date occurs on a non-business day were clearly expressed.

5.49 The committee considered alternative proposals. First, that for all taxes, when the due date does not fall on a working day, the payment date should be the last working day before the due date for the tax. Secondly, that when the due date does not fall on a working day, the due date for the tax should move to the first working day after the due date.

5.50 The first approach does not meet the objective of reducing compliance costs. The confusion resulting from a rule requiring early payment in some cases could outweigh the benefit of a fixed rule. This approach is also not particularly intuitive: it assists taxpayers who know the legislation, while those unaware of the provision may find themselves liable to late payment penalties.

5.51 The committee considers that the second approach of delayed payment has benefits. While it would raise some cash accounting issues in years when the GST due date for June moves into July, officials have advised the committee that the measure raises no accrual accounting issues. As the government accounts are prepared on an accrual basis, the cash accounting issues are not significant. However, this measure would result in a revenue cost in terms of the time value of money, mostly accounted for by delays in the government receiving GST payments. Officials have advised the committee that this cost would amount to approximately \$1 million per annum. It is not possible to quantify the offsetting compliance costs benefits.

5.52 The committee believes that in the wider scheme of things, the net overall cost of this measure is outweighed by the benefits, and there-

fore, considers that if the due date for any tax falls on a non-business day it should be moved to the next working day.

5.53 One hurdle to implementation of such a change remains. The Inland Revenue Department's computer systems would require relatively complex amendment to reflect the date changes, coming at a time when the department is extensively involved in implementing the government's initiative to remove the need for wage and salary earners to file returns. The committee accordingly **recommends** that the measure should be implemented at the first practical opportunity after completion of the systems changes to accommodate the government's return filing changes. This implementation may coincide with the changes arising from the initiatives focused on reducing compliance costs for businesses.

5.54 In summary, therefore, the committee **recommends** that the government should consider introducing a universal rule that when the due date for the payment of tax falls on a non-business day, the due date moves to the next working day. The committee also **recommends** that this measure should be implemented at the first practical opportunity.

Payment of refunds

5.55 The Inland Revenue Department's systems include a computer program to ensure that overpaid tax is not refunded to a taxpayer if the taxpayer has an outstanding debt in relation to another tax type. However, the transaction entries required by this program can result in compliance costs for taxpayers with different tax types with little, if any, reduction in the risk faced by the Commissioner. This problem mainly affects larger corporations.

5.56 The committee considers that the Commissioner should use some discretion in the application of this policy. The committee understands that the relevant program is fundamental to the system, and that any modification allowing the use of discretion in individual cases would impose administrative costs. Although this may be the case, this system does place a burden on affected taxpayers.

5.57 The committee **recommends** that the Inland Revenue Department should consider this matter with a view to finding and implementing a solution. The committee considers that the resolution of this problem should be addressed as part of the package of tax simplification measures at present under consideration.

5.58 The Commissioner is required by section 6(2)(c) of the Tax Administration Act 1994 to extend equal treatment to all taxpayers. With this in mind, it may be appropriate to amend the law to allow the Commissioner to enter into arrangements with particular taxpayers. For example, in cases where the Commissioner considers that there may be an unacceptable element of risk if the existing policy is not applied, and yet accepts that it makes good sense to address the issue administratively in the interest of reducing compliance and administrative costs, the Commissioner should be able to ask the particular taxpayer to provide an appropriate insurance bond to cover the perceived revenue risk.

5.59 The committee **recommends** that the routine practice of applying refunds to meet outstanding debts should be modified to allow discretion in its application. The committee accepts the recommendation of officials that this change should be considered during the review of the obligations of business taxpayers.

Release of refunds

5.60 The committee considered the issue of the release of a refund when part of that refund relates to an amount not under dispute. Section 174A of the Tax Administration Act 1994, provides that part of a GST refund relating to a non-disputed matter is not held up pending resolution of the dispute. The committee considered expanding this provision to cover all taxes.

5.61 The benefits to taxpayers from extending this approach to taxes other than GST would be significant. It would mean that when disputes arise over possibly minor matters, there would be no impact on a taxpayer's cash flow. Therefore, the committee **recommends** that the government should consider expanding this provision to provide a refund in relation to any tax if:

the Commissioner considers that there is no risk to the revenue in making the refund;

the taxpayer generally complies with all return and payment obligations under the relevant legislation;

the taxpayer is not in material breach of any other tax obligation;

there is likely to be more than a modest delay in resolving the elements of refund subject to dispute;

the taxpayer is not in default in facilitating the resolution of the dispute; and

the taxpayer has paid to the Commissioner the amount which is subject to the dispute.

5.62 Finally, to prevent undue administrative costs the committee considers that an appropriate minimum threshold should be set. In this way, the Commissioner will not be burdened with unwarranted and undeserving requests for an interim refund.

5.63 While supporting the application of the partial refund provision to all taxes, the committee notes that there may be complications for income tax. Typically with individuals, difficulties may arise with the progressive tax rates, varying rebate entitlements, and a range of other elements (perhaps linked to social policy initiatives) which may require separate consideration for any interim refund calculations. For companies, there are other factors that may be relevant, for example, the incidence of group tax losses and foreign tax credits. There may also be consequential impacts on the activities of other entities, such as partnerships, loss transfers from loss attributing qualifying companies and so on.

5.64 Therefore, for income tax, the committee considers that when the other partial refund criteria are met, it would be necessary for the Commissioner to have a discretion to authorise a refund to the extent the Commissioner considers appropriate.

5.65 The committee **recommends** that taxpayers should be able to request a refund of an amount of tax not subject to a dispute provided the criteria set out in para 5.61 are met. For income tax, a refund would be subject to the Commissioner's discretion as to the calculation of the appropriate amount of refund.

Depreciation

5.66 The depreciation rules allow an immediate deduction for property acquired for \$200 or less. However, the property must be capitalised if first, it is purchased from the same supplier at the same time as other property to which the same depreciation rate applies, that is a bulk purchase, unless the entire purchase is less than \$200 or, secondly, it forms part of property that is depreciable, such as refurbishment schemes and other capital improvements.

Increase in low-value asset threshold

5.67 The committee considered whether the threshold below which assets may be written off was too low. The benefit of any increase would be a reduction in compliance costs because taxpayers would not have to

capitalise and depreciate relatively low-value assets. Reducing the compliance costs associated with the depreciation rules would simplify one of the more significant compliance costs associated with preparing an income tax return.

5.68 Some costs would be associated with any increase. First, providing immediate deductibility for assets of some enduring benefit would cause economic distortions. It would result in income being considered too low in the year of purchase and too high in subsequent years. Officials provided the committee with a table, reproduced below, setting out the estimated revenue cost of increasing the present \$200 threshold to \$300 or \$500. The calculations are approximate, having been compiled on the introduction of the present depreciation rules. They also incorporate some transitional effects. These costs represent accelerated deductions, and are equivalent to the government providing a loan at zero interest rate, diminishing in value as the asset should have been correctly depreciated. These fiscal costs are transitional. In the longer term, immediate deductibility would broadly be matched by reductions in depreciation claimed. The economic distortions, however, would continue, as each low-value asset which should be depreciated qualifies for immediate deductibility.

TABLE 5: ESTIMATED REVENUE COST

<i>Write-off threshold</i>	<i>Fiscal year 1</i>	<i>Fiscal year 2</i>	<i>Fiscal year 3</i>
\$300	\$30m loss	\$95m loss	\$41m loss
\$500	\$115m loss	\$405m loss	\$117m loss

5.69 Secondly, an option already exists for assets valued between \$200 and \$2,000. This option is the pool method, which provides simpler depreciation rules and a compliance cost gain without a great revenue cost. However, this gain is less than might first appear, because the rate that is applied is the lowest depreciation rate for any asset in a pool. For this reason, the assistance of a pooling option may do little in some cases to ease the compliance cost burden for low-value items.

5.70 Thirdly, an increase in the threshold means that a greater amount may be deducted immediately, increasing the possibility that the write-off provision may be abused in some way.

5.71 Finally, compliance cost benefits from immediate deductibility would arise only if the taxpayer does not keep a detailed record of the assets for some other purpose.

5.72 Taking into account the revenue cost, it is not clear that the compliance cost savings would be equally significant. Moreover, a viable alternative, the pool account approach, exists. The committee, therefore, **recommends** that, at present, there should be no increase in the \$200 threshold.

Assets purchased at the same time from the same supplier

5.73 The committee considered a possible relaxation in the rules when goods are purchased from the same supplier at the same time as other property, while recognising that any recommendations might entail base maintenance consequences. In recent years, schemes have developed in Australia to exploit more lax write-off provisions than those operating in New Zealand.

5.74 The difficulties the committee identified with the present threshold were, first, when two items are bought at the same time, for example two chairs costing \$135 each, the cost of these items must be capitalised. This rule imposes compliance costs out of proportion to the cost of each chair. Secondly, purchasing one item, and then a short while later, on the same day, purchasing a second item, means the cost of both items can be immediately written off. This position can make the present threshold appear silly, suggesting that amendment is necessary.

5.75 The committee has already noted that an outright increase in the threshold from \$200 to \$300 or \$500 created a large cost to government, and was thus unable to recommend any such increase (see para 5.68). The committee then considered a proposal to allow immediate deductibility if more than two items were purchased, provided the purchase price of individual items did not exceed \$500.

5.76 This threshold is more complex than either the present threshold or a \$500 threshold. However, it brings a degree of common sense to bear. Principally, it substantially reduces the likelihood that a low-value asset purchased at the same time as another more expensive asset which has the same depreciation rate would be required to be capitalised and depreciated.

5.77 The revenue impact of any such change is impossible to quantify without a survey of taxpayers and purchased assets. Before proceeding

with such a change, a survey of this type would be required to allow officials to quantify the impact and the offsetting reductions in compliance costs. However, the committee makes its recommendation subject to the revenue costs of the initiative being sufficiently mirrored by a reduction in compliance costs.

5.78 The committee **recommends** that the threshold should be increased to allow up to \$500 in assets purchased at the same time from the same supplier to be immediately deductible, providing no asset exceeds \$200 in value. The committee considers the recommendation should be costed to ensure matching of the reduction in compliance costs and the foregone revenue.

Safe harbour for assets of similar nature

5.79 The concept of a safe harbour approach to calculating and claiming annual depreciation deductions was suggested to the committee. This proposal could save taxpayers working through complex procedures to identify and apply correct depreciation rates through the creation of 'same genus' pools. The issue is whether the greater accuracy achieved would be in the wider economic interest of both the government and taxpayers.

5.80 The benefits of simplification are clear. At present, the rate and amount of annual depreciation deductions is determined on a line-by-line basis for each individual item of depreciable property, unless the taxpayer has adopted the pool approach for the asset in question. To identify the rate of depreciation applying to each item of depreciable property, taxpayers must work their way through a series of tests to identify which tables and what rate apply. This activity represents a compliance cost.

5.81 Additional issues arise. For example, the application of an incorrect rate could expose a taxpayer to the risk of a shortfall penalty, and even with depreciable property of apparent similar genus, different depreciation rates may apply.⁹¹ A safe harbour for related assets, such as a computer and allied equipment, office furniture and fittings, office equipment other than furniture, fittings and computer related items, and so on would seem to have merit.

⁹¹ For example, desktop PC = 40%; printer = 33%; and so on.

5.82 While the benefits are clear, there are also disadvantages with this approach. The reason for the multiplicity of depreciation rates is that accuracy of depreciation is important in economic decision making. First, to the extent that rates are incorrect, they can cause significant distortions in economic behaviour. Lower than economic depreciation rates may lead to under-investment in capital assets, while higher than economic rates brings about the reverse situation.

5.83 Secondly, a revenue issue arises for the government and a compliance issue arises for taxpayers. Considering the significance of depreciation, it is likely that most taxpayers would have considered both the safe harbour option and the specific depreciation rate for an asset before determining which to apply. In effect, then, this approach increases compliance costs.

5.84 While compliance costs would decrease if taxpayers were required to use general depreciation rates rather than asset specific rates, the committee considers the resulting decrease in accuracy of depreciation rates could not be justified on economic or equitable grounds. Taxpayers would not welcome a measure which provided for a lower than economic depreciation rate in some cases, with the sole resulting benefit being a single reduction in the compliance costs associated with identifying a correct rate of depreciation for that asset.

5.85 The committee considered whether the compliance cost saving objective of any such safe harbour initiative might be met by increasing the threshold for adoption of the 'pooling approach' to depreciation. The committee was mindful that the original reason underlying the adoption of a pooling approach was to address the depreciation issue attendant on ownership and use of multiple assets of relatively low value. The focus of the pooling approach had not been on providing a safe harbour in the context of the general depreciation provisions. However, the committee was not able to identify any reason why the role of the pooling provisions could not be extended to perform much the same role as would safe harbour depreciation rates.

5.86 The committee initially considered proposing a pooling provision threshold increase to, say, \$8,000 to \$10,000. However, it occurred to the committee to ask whether there was a need to have a threshold at all. Moreover, it was unclear if a change were to be made, whether the business community, particularly small businesses, would actually make sufficient use of the pooling rules to provide a depreciation rate safe har-

bour. The committee considered that the matter deserved further analysis, and encourages officials to pursue this matter further.

5.87 The committee accepts that the line-by-line method of depreciating specific assets should continue. The committee recognises that the rules represent a balance between efficiency costs and compliance costs, with an emphasis on minimising efficiency costs. This emphasis is considered appropriate.

5.88 However, the committee **recommends** that the prospective benefits of increasing or even removing the present cost ceiling that limits the application of the pooling approach to depreciation should be evaluated with a view to allowing the methodology to be used as a depreciation rate safe harbour.

Goods and services tax

Threshold for payments basis for accounting for GST

5.89 An issue raised in submissions to the committee concerned the threshold for the automatic right to adopt the payments basis for accounting for GST, and whether it is set too low. Once taxpayers who are registered for GST exceed the threshold, they are required to adopt more complex accounting systems. A consequence of this requirement is a general increase in compliance costs imposed by the GST system.

5.90 The logical solution would seem to be an increase in the threshold. However, an analysis prepared by officials shows that increasing the threshold from \$1 million to \$2 million in turnover would provide a benefit to only 13,000 registered taxpayers, or 3 per cent of those registered. The present threshold allows up to 414,000 registered persons, or 92 per cent, to account for GST on a payments basis. In other words, while this measure would reduce compliance costs, the actual number of taxpayers who would benefit is small. An increase in the threshold would be warranted only with demonstrable compliance cost savings and no sufficient offsetting risk. There may also be a case for a small increase to account for inflation.⁹²

⁹² The threshold was increased from \$500,000 to \$1 million with effect from 1 October 1990. Inflation adjusting the threshold based on September quarter Consumer Price Index information up to September 1998 would increase the threshold to \$1.16 million.

5.91 The committee has identified some real risks associated with an increase in the threshold. Any increase would raise the potential for significant revenue risk through deferred settlement arrangements, that is, when the person acquiring goods or services pays on an invoice basis and the supplier accounts on a payments basis. The risk would be particularly acute with land transactions. The committee has also recognised the availability and sophistication of accounting systems which reduce the compliance costs imposed on people who account on an invoice basis.

5.92 Nevertheless, the committee inclines towards amendment in this area. One possible change that may not increase the risks identified, while still providing a benefit, would be to allow a longer time for the transition to the invoice basis for accounting.

5.93 It is important that people who are registered for GST should not suddenly discover that they have exceeded the statutory threshold for the payments basis for accounting for GST. Once this level is exceeded, taxpayers are no longer eligible to use the payments basis of accounting. Even an inadvertent breach leaves a registered person liable to shortfall penalties. The committee considered that such people should be eligible to continue to use the payments basis for at least a further year, thus recognising that exceeding the threshold might not be immediately obvious. Also, an opportunity should be provided for people to take whatever steps are necessary to decide on and implement the necessary systems changes. While this delay may mean that some people do not move directly to accounting on an invoice basis when they are able to do so, it would provide an appropriate breathing space for most.

5.94 The committee **recommends** that a registered person who is no longer eligible to use the payments basis of accounting should be able to continue accounting in that way for a further year before being required to adopt the invoice basis of accounting. The committee also **recommends** that the government should consider an increase in the threshold to account for inflation.

GST tax invoices

5.95 All small businesses incur compliance costs in ensuring that the documentation they hold to support a GST input tax claim is a tax invoice, as required by section 24 of the Goods and Services Tax Act 1985.

5.96 Evidence shows that a high proportion of the documents held by small businesses which purport to be tax invoices do not meet the statutory requirements. If the recipient of a supply does not take the time to get a proper tax invoice, or to get the supplier's authority to make changes that will convert the existing documentation into a valid tax invoice, he or she risks penalties for making an input tax claim without valid supporting documentation.

5.97 The committee considered ways to reduce this burden. The key constraint is that, for the GST system to work effectively, an audit trail is required. Relaxing the requirements could result in difficulties for the Inland Revenue Department in its audit activity.

5.98 There is an overriding expectation that the issuer of a document purporting to be a tax invoice should ensure that the document meets the statutory criteria. However, the integrity of the system depends in part on the recipient of a supply checking the adequacy of the supplier's documentation. In a self-assessment environment, taxpayers are considered to be responsible for their own affairs. Accordingly, it is appropriate that the responsibility for ensuring an invoice meets the required standard lies with the user of that invoice.

5.99 However, the committee considers that some action is required and, therefore, **recommends** that the Inland Revenue Department should publish a statement on its operational policy on GST tax invoices, identifying errors that are considered significant and errors that are not. This statement would provide recipients of supply with far greater certainty and should emphasise the underlying principle that tax invoices must provide a clear audit trail. A clear establishment of the principles involved would reduce the risks associated with this proposal.

5.100 The committee is also aware of the proposal under the present GST review that the threshold for accepting an abbreviated tax invoice for verifying an input tax credit should be raised to \$1,000. The committee supports this initiative.

Increase in the threshold for tax invoices

5.101 The committee considered whether it should recommend an increase in the \$50 threshold for requiring tax invoices to reduce the compliance costs associated with issuing, ensuring receipt of, and storing documents that meet the requirements for a tax invoice.

5.102 There is a risk to the government of exposure to falsified input tax credit claims. Because of this risk, some countries do not have thresholds at all. The committee considered the balance between reducing compliance costs and a possible increase in tax evasion through claims for fictitious deductions. The committee noted that the relatively low inflation over the last decade has meant little inflationary pressure to increase the threshold. Further, if there were to be an increase, the next logical step would be \$100.

5.103 In the end, the committee steered towards retaining the present threshold because of earlier recommendations on the increased threshold for simplified tax invoices, and because of the potential risk to the revenue resulting from increasing the threshold to the next logical level. The committee **recommends** that there should be no increase in the \$50 threshold for tax invoices.

Private use adjustments

5.104 Many businesses, being GST registered activities, own and use assets which also are used in part by the proprietors for their own requirements. Similarly, many proprietors use their own personal assets for business purposes. While GST adjustments for this secondary use are required in each taxable period, the level of adjustment is almost always minor. For accounting purposes, more often than not, the corresponding adjustments are calculated or implemented after year end, as part of the annual accounting wrap-up after balance date. Having two different adjustments, one during the year and one at year end, seems to impose unnecessary compliance costs.

5.105 The committee considered whether registered persons should be allowed to make private use adjustments on an annual basis in the GST return corresponding with the date of the annual income tax return.

5.106 There is no question that secondary use adjustments should be part of the GST system, but the compliance costs that would be involved in monthly adjustments seems unduly high when compared with the resulting benefit. A precedent is available for moving private use adjustments to the period in which the annual income tax return is filed. The annual adjustment for GST on entertainment costs is made in this way.

5.107 While the committee considers this measure would not be subject to abuse, the possibility does exist, and the committee considers that an appropriate limit could be introduced to apply in cases where the collective annual adjustment exceeded a threshold, say \$5,000.

5.108 The committee **recommends** that GST secondary use adjustments for private or exempt use should be moved to the period in which the annual income tax return is filed except when the adjustment involves the procedures available for acquisitions of items under \$10,000.

Unit trusts

5.109 Unit trusts are trusts, but are treated by the tax system as companies. While legally trusts in form, the relationship between unit trust and beneficiary is very similar to the relationship between company and shareholder, as the trust units are purchased from the trust in the same way as company shares are purchased from companies. Thus, the two entities are closely substitutable.

5.110 In the case of ordinary trusts, the beneficial interests are created upon settlement, and the settlor and beneficiaries are different, that is, the trust corpus is contributed by someone other than the beneficiaries.

5.111 Tax treatment favours ordinary trusts because trust income is only taxed at one level in either the trustee's or the beneficiary's hands.⁹³ Company income is generally taxed at two levels, first, to the company as it is earned and, secondly, to the shareholders when it is distributed, with the imputation system preventing double taxation. However, when the company has not paid tax, it cannot attach imputation credits, and tax is then imposed on the distribution. Ordinary trusts are not taxed on the foreign-sourced income of non-resident beneficiaries. The scope of this relief is greater than the conduit tax relief recently enacted for companies.

5.112 It is because unit trusts have a commercial nature, and because they can generally be substituted for companies, that the government has chosen to apply the company tax rules to them to maintain the integrity of those rules, and to define exactly what tax treatment will apply when income interests, whether shareholder or beneficiary, are created by purchase or by capital contribution. Nevertheless, this treatment has created problems for managed funds, which face practical difficulties in applying company tax rules.

⁹³ If trust income vests in a beneficiary in the income year in which it is earned by the trust or within six months after the end of the year, it is taxed to the beneficiary. All other trust income is taxed to the trustee. Subsequent distributions to beneficiaries of income which has been taxed to the trustee are generally not taxed.

Foreign unit trusts

5.113 Difficulties arise in relation to foreign unit trusts. It may be suggested that New Zealand should apply the trust rules to unit trusts that have all non-resident beneficiaries and earn only foreign-sourced income. The trust income would not be taxed, as it should not be, because it is all foreign-sourced income earned on behalf of non-residents. Such treatment would act as an incentive for unit trusts to be managed in New Zealand.

5.114 While this may be the case, the system would then be faced with the difficulty of having to differentiate between unit trusts and companies. The pure flow-through treatment could raise the concern of New Zealand's tax treaty partners that New Zealand was being used as a tax haven, particularly if such unit trusts sought to use tax treaty benefits. This concern could affect New Zealand's negotiating position in tax treaties. While the committee accepts there are some potential benefits in using trust tax treatment for unit trusts, it also recognises that a legitimate concern arises with this approach in the terms of the integrity of the company tax rules and the reaction of tax treaty partners.

Financial arrangements

5.115 The qualified accruals rules are extremely important. However, for most people, they have proved very difficult to comprehend and apply. While changes to make the rules more accessible were included in the Taxation (Accrual Rules and other Remedial Matters) Bill, the committee considered two issues aimed at simplifying these rules.

Alternative approach to valuing financial arrangements

5.116 The committee was advised that work had been undertaken by officials on a year-end based valuation approach to accounting for financial arrangements, similar to the approach taken for trading stock. Under this approach, the valuation of financial arrangements would be based on the discounted value of future cash flows, with the income or expense for a given period based on the difference between opening and closing values adjusted for acquisitions and disposals.

5.117 The analysis of this option by officials found that substantial changes would be required to the Income Tax Act to accommodate this approach. On this basis it was concluded that the costs outweighed the benefits of a possible change in approach to accounting for financial arrangements. Officials were also concerned about the delays that any detailed analysis of this option would cause. This concern among other

matters unfortunately meant that this issue could not be considered for inclusion in the Taxation (Accrual Rules and other Remedial Matters) Bill which was introduced in November 1998.

5.118 The complexity of the issues involved and the time available to the committee restricted its consideration of this approach to valuing financial arrangements. However, on the face of it, this approach may have merit. The committee **recommends** that this approach to valuing financial arrangements should be considered as part of the rewrite of subpart IH of Income Tax Act 1994.

Priority for the rewriting of accrual rules determinations

5.119 The committee in paras 2.191 to 2.196 considered the role of the accrual rules determinations under the qualified accrual rules. The committee concluded there that most determinations need to be rewritten.

5.120 When considering possible simplification measures for inclusion in this chapter, the committee identified the fact that the recommended rewriting of the determinations would represent a significant simplification measure. The committee therefore **recommends** that rewriting the accrual rules determinations should be given a high priority. While it recognises that the government must prioritise the use of its resources, the committee concludes that the determinations should be rewritten in the same style as the accruals legislation recently introduced into the House.

Administrative issues

Readability of customer assessments and statements

5.121 To address an often-stated concern about the readability of Inland Revenue forms, the committee sought information on taxpayers' assessments of the readability and comprehensibility of statements and notices. The committee was particularly concerned about the quality of the existing statements of account. These statements can be confusing even for tax practitioners who frequently use them.

5.122 The information provided by the Inland Revenue Department gave the committee some confidence that the department is actively working to improve its statements and notices. A guide to the preparation of Inland Revenue forms is attached at appendix 4. The committee considers the list in that guide has merits, and that the Inland Revenue Department should apply these principles to all statements as soon as possible.

5.123 The reverse page of the statement of account should provide meaningful information on what taxpayers can or should do if they do not understand or agree with the position disclosed. Although not all matters in dispute will necessarily come within the disputes resolution process, the information should include some cautionary note about the time frames required in that process.

5.124 The committee **recommends** that priority should be given to the redesign of statements of account, the nature of the data disclosed, and the manner in which it is disclosed.

Internet access to Inland Revenue Department forms

5.125 The committee considered whether Inland Revenue forms should be made available on the department's website. The benefits of being able to download the forms when required would be considerable. The Inland Revenue Department has begun work on this goal, and the committee supports this work.

5.126 Some forms, however, such as the new employer monthly schedule and the various tax returns, require an actual Inland Revenue form to be filed for smooth administrative processing. For these forms, special inks and pre-coded items are used to facilitate electronic processing.

Taxpayer education

5.127 The committee considers that the Inland Revenue Department should publish more tax booklets targeted at specific industries,⁹⁴ and at specific common transactions.⁹⁵ Under self-assessment, this detailed information must be provided to taxpayers if they are to meet the standards of behaviour required by the rules governing compliance and penalties.

5.128 The committee **recommends** that Inland Revenue Department should publish booklets for specific industry groups, advising taxpayers of their tax obligations and the tax treatment of specific transactions.

⁹⁴ For example, the restaurant trade, the building industry, the publishing industry and the retail sector.

⁹⁵ Such as investing in a property offshore.

Part II

Robustness Against Avoidance and Evasion

CHAPTER 6 – TAX MITIGATION, AVOIDANCE AND EVASION

SUMMARY

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Introduction

6.1 Two general points can be made about tax avoidance. First, tax avoidance occurs across the tax spectrum and is not peculiar to any tax type. Secondly, legislation that addresses avoidance must necessarily be imprecise. No prescriptive set of rules exists for determining when a particular arrangement amounts to tax avoidance. This lack of precision creates uncertainty and adds compliance costs.

6.2 This chapter focuses primarily on income tax avoidance. However, this focus does not imply that the same concerns do not apply in the context of other taxes. Indeed, section 76 of the Goods and Services Tax Act 1985 provides an anti-avoidance provision that was drafted broadly along the lines of section 99 of the Income Tax Act 1976.

6.3 The committee did not have the time or resources to consider issues of tax avoidance outside those provisions applying to income tax. However, where the corresponding anti-avoidance provisions that relate to other taxes draw on similar principles, it may be taken that the committee's views are likely to extend to that context. This statement, however, should not be understood to mean that the committee has reviewed section 76 of the Goods and Services Tax Act 1985, nor that it has reached any conclusions on its current drafting.

Income tax avoidance

6.4 In the Income Tax Act 1994, tax avoidance is an imprecise and difficult concept. This chapter focuses on aspects of that concept, the way it is interpreted, and the way it is enforced.

6.5 The first part of the chapter describes the distinctions drawn by the courts between tax mitigation, avoidance and evasion. The committee then presents a policy framework for considering issues relating to tax avoidance, and proposes some amendments clarifying the operation of the general anti-avoidance rule in sections BG 1 and GB 1 of the Income Tax Act 1994. The committee discusses the department's policy statement (published in 1990) on the general anti-avoidance provision, and then turns to a more general consideration of departmental public statements, focusing on the exposure draft on form and substance in taxation law. In the next section, the committee looks at the use of the loss attributing qualifying companies rules for tax planning purposes. The intention of the rules was to eliminate tax considerations as an element in determining the appropriate structure for closely held businesses, but their use appears to have been extended beyond this purpose. A particular type of scheme is then examined involving contrived depreciation deductions, which can take advantage of the loss attributing qualifying companies rules. The committee evaluates the scheme as it provides an excellent example of the general points made in the report.

DEFINITIONS OF TAX MITIGATION, AVOIDANCE AND EVASION

6.6 It is impossible to express a precise test as to whether taxpayers have avoided, evaded or merely mitigated their tax obligations. Tax avoidance is described in the Income Tax Act 1994 by reference to its intended fruits, but giving meaning to the terms of the description is ultimately a matter of judgment for the courts. As Baragwanath J said in *Miller v CIR*; *McDougall v CIR*:

What is legitimate 'mitigation' and what is illegitimate 'avoidance' is in the end to be decided by the Commissioner, the Taxation Review Authority and ultimately the courts, as a matter of judgment.⁹⁶

⁹⁶ (1997) 18 NZTC 13,001

Tax mitigation

6.7 Taxpayers are entitled to mitigate their liability to tax and will not be vulnerable to the general anti-avoidance rule in section BG 1 if they do so. A description of tax mitigation was given by Lord Templeman in *CIR v Challenge Corporate Ltd*:

Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section 99 [section BG 1] does not apply to tax mitigation because the taxpayer's tax advantage is not derived from an 'arrangement' but from the reduction of income which he accepts or the expenditure which he incurs.⁹⁷

6.8 Tax mitigation is, therefore, behaviour which, without amounting to tax avoidance, serves to attract less liability than otherwise might have arisen.

Tax avoidance

6.9 The general anti-avoidance rule in section BG 1 provides that a tax avoidance arrangement is void for income tax purposes. Tax avoidance, as Lord Templeman has pointed out, is not mere mitigation.⁹⁸

6.10 The term is described in section OB 1 as, directly or indirectly:

- 1 altering the incidence of any income tax,
- 2 relieving any person from liability to pay income tax,
- 3 avoiding, reducing or postponing any liability to income tax.

On an excessively literal interpretation, this approach could conceivably apply to mere mitigation, for example, to an individual's decision not to work overtime, because the additional income would attract a higher rate of tax. However, a better way of approaching tax avoidance is to regard it as an arrangement that, unlike mitigation, yields results that Parliament did not intend, unless nullified by section BG 1.

⁹⁷ (1986) 8 NZTC 5,219 at 5,225

⁹⁸ *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,219

6.11 In *Challenge Corporation Ltd v CIR*, Cooke J described the effect of the general anti-avoidance rules in sections BG 1 and GB 1 in these terms:

[It] nullifies against the Commissioner for income tax purposes any arrangement to the extent that it has a purpose or effect of tax avoidance, unless that purpose or effect is merely incidental... Where an arrangement is void... the Commissioner is given power to adjust the assessable income of any person affected by it, so as to counteract any tax advantage obtained by that person.⁹⁹

6.12 As Baragwanath J noted in the *Miller* case, 'Parliament has deliberately left [section BG 1] open textured'.¹⁰⁰ Woodhouse J commented on the breadth of the general anti-avoidance rule in the *Challenge Corporation* case, noting that Parliament had taken:

The deliberate decision... that... because the problem of definition in this elusive field can not be met by expressly spelling out a series of detailed specifications in the statute itself, the interstices must be left for attention by the judges.¹⁰¹

Tax evasion

6.13 Mitigation and avoidance are concepts concerned with whether or not a tax liability has arisen. With evasion, the starting point is always that a liability has arisen. The question is whether that liability has been illegitimately, even criminally, left unsatisfied. In *CIR v Challenge Corporation Ltd*, Lord Templeman said:

Evasion occurs when the Commissioner is not informed of all the facts relevant to an assessment of tax. Innocent evasion may lead to a re-assessment. Fraudulent evasion may lead to a criminal prosecution as well as re-assessment.¹⁰²

6.14 The elements which can attract the criminal label to evasion were elaborated by Dickson J in *Denver Chemical Manufacturing v Commissioner of Taxation (New South Wales)*:

⁹⁹ (1986) 8 NZTC 5,001 at 5,013

¹⁰⁰ (1997) 18 NZTC 13,001

¹⁰¹ (1986) 8 NZTC 5,001 at 5,007

¹⁰² (1986) 8 NZTC 5,219 at 5,225

An intention to withhold information lest the Commissioner should consider the taxpayer liable to a greater extent than the taxpayer is prepared to concede, is conduct which if the result is to avoid tax would justify finding evasion.¹⁰³

6.15 Not all evasion is fraudulent. It becomes fraudulent if it involves a deliberate attempt to cheat the revenue. On the other hand, evasion may exist, but may not be fraudulent, if it is the result of a genuine mistake. In order to prove the offence of evasion, the Commissioner must show an intent to evade by the taxpayer. As with other offences, this intent may be inferred from the circumstances of the particular case.¹⁰⁴

6.16 Tax avoidance and tax mitigation are mutually exclusive. Tax avoidance and tax evasion are not: they may both arise out of the same situation. For example, a taxpayer files a tax return based on the effectiveness of a transaction which is known to be void against the Commissioner as a tax avoidance arrangement.

6.17 A senior United Kingdom tax official recently referred to this issue:

If an 'avoidance' scheme relies on misrepresentation, deception and concealment of the full facts, then avoidance is a misnomer; the scheme would be more accurately described as fraud, and would fall to be dealt with as such. Where fraud is involved, it cannot be recharacterised as avoidance by cloaking the behaviour with artificial structures, contrived transactions and esoteric arguments as to how the tax law should be applied to the structures and transactions.¹⁰⁵

TAX AVOIDANCE IN A POLICY FRAMEWORK

6.18 This chapter now turns from the existing legal framework in the context of income tax to a possible policy framework for considering issues relating to tax avoidance generally. The questions considered relevant to a policy analysis of tax avoidance are:

- 1 What is tax avoidance?
- 2 Under what conditions is tax avoidance possible?

¹⁰³ (1949) 79 CLR 296

¹⁰⁴ As to using inference to prove intent, see paras 13.55 to 13.80.

¹⁰⁵ Gribbon J, *Taxation*, 13 November 1997, page 157

- 3 When is tax avoidance a 'policy problem'?
- 4 What is a sensible policy response to tax avoidance?
- 5 What is the value of, and what are the limitations of, general anti-avoidance rules?

What is tax avoidance?

6.19 Finance literature may offer some guidance to what is meant by tax avoidance in its definition of 'arbitrage'. Arbitrage is a means of profiting from a mismatch in prices. An example is finding and exploiting price differences between New Zealand and Australia in shares in the same listed company. A real value can be found in such arbitrage activity, since it spreads information about prices. Demand for the low-priced goods increases and demand for the high-priced goods decreases, ensuring that goods and resources are put to their best use. Tax arbitrage is, therefore, a form of tax planning. It is an activity directed towards the reduction of tax.

6.20 It is this concept of tax arbitrage that seems to constitute generally accepted notions of what is tax avoidance. Activities such as giving money to charity or investing in tax-preferred sectors, would not fall into this definition of tax arbitrage, and thus would not be tax avoidance even if the action were motivated by tax considerations.

6.21 The committee has noted that financial arbitrage can have a useful economic function. The same may be true of tax arbitrage, presuming that differences in taxation are deliberate government policy furthering economic efficiency. It is possible that tax arbitrage directs resources into activities with low tax rates, as intended by government policy. It is also likely to ensure that investors in tax-preferred areas are those who can benefit most from the tax concessions, namely, those facing the highest marginal tax rates. If government policy objectives are better achieved, tax arbitrage is in accordance with the government's policy intent. Tax avoidance, then, can be viewed as a form of tax arbitrage that is contrary to legislative or policy intent.

What makes tax avoidance possible?

6.22 The basic ingredients of tax arbitrage are the notion of arbitrage, and the possibilities of profiting from differentials that the notion of arbitrage implies. This definition leads to the view that three conditions need to be present for tax avoidance to exist.

- 1 A difference in the effective marginal tax rates on economic income is required. For arbitrage to exist, there must be a price differential and, in tax arbitrage, this is a tax differential. Such tax differences can arise because of a variable rate structure, such as a progressive rate scale, or rate differences applying to different taxpayers, such as tax-exempt bodies or tax loss companies. Alternatively it can arise because the tax base is less than comprehensive, for example, because not all economic income is subject to income tax.¹⁰⁶
- 2 An ability to exploit the difference in tax by converting high-tax activity into low-tax activity is required. If there are differences in tax rates, but no ability to move from high to low-tax, no arbitrage is possible.
- 3 Even if these two conditions are met, this does not make tax arbitrage and avoidance possible. The tax system may mix high and low-rate taxpayers. The high-rate taxpayer may be able to divert income to a low-rate taxpayer or convert highly-taxed income into a lowly-taxed form. But this is pointless unless the high-rate taxpayer can be recompensed in a lowly-taxed form for diverting or converting his or her income into a low-tax category. The income must come back in a low-tax form. The benefit must also exceed the transaction costs. This is the third necessary condition for tax arbitrage.

6.23 Since all tax systems have bases that are less than comprehensive because of the impossibility of defining and measuring all economic income, tax arbitrage and avoidance is inherent in tax systems.

Examples of tax arbitrage/avoidance

6.24 The simplest form of arbitrage involves a family unit or a single taxpayer. If that family unit or taxpayer faces differences in tax rates (condition 1 above), and condition 2 above applies, then the third condition automatically holds. This conclusion follows because people can always compensate themselves for converting or diverting income to a low tax rate.

6.25 An example of such simple tax arbitrage involving a family unit is income splitting through, for example, the use of family trust. An example of simple tax arbitrage involving a single taxpayer is a straddle

¹⁰⁶ Some forms of capital gain may escape, as is the case in New Zealand.

whereby a dealer in financial assets brings forward losses on, say shares, and defers gains while retaining an economic interest in the shares through use of options. Transfer pricing and thin capitalisation practices through which non-residents minimise their New Zealand tax liabilities are more sophisticated examples of the same principles.

6.26 Multi-party arbitrage is more complex; the complexity is made necessary by the need to meet condition 3 above, that is, to ensure a net gain accrues to the high-rate taxpayer. In the simpler cases of multi-party income tax arbitrage, this process normally involves a tax-exempt (or tax-loss or tax-haven) entity and a taxpaying entity. Income is diverted to the tax-exempt entity and expenses are diverted to the taxpaying entity. Finally, the taxpaying entity is compensated for diverting income and assuming expenses by receiving non-taxable income or a non-taxable benefit, such as a capital gain.

6.27 New Zealanders over the years have indulged in numerous examples of such tax arbitrage using elements in the legislation at the time. Examples are finance leasing, non-recourse lending, tax-haven 'investments', redeemable preference shares, assignments of income using section FC 11, and lease inducements.

Is tax arbitrage a policy problem?

6.28 In theory, cases may arise where tax arbitrage is in accordance with the policy intent of tax rules. It might, for example, ensure that the desired high level of investment is diverted to a tax-preferred activity. However, in most cases, it is contrary to the policy intent, which is to provide favourable tax treatment to a specified class of taxpayer. Tax arbitrage gives access to this preference to a much larger class of taxpayer. When taxpayers outside the specified class can access the tax preference in a way that is inconsistent with the policy intent, it is tax avoidance and thus a policy problem.

6.29 Tax incentives, concessions and loopholes in tax legislation create intended and unintended tax consequences for certain types of economic activity. Initially, this result increases the after-tax rates of return from those activities above the 'normal' after-tax rates of return produced by other activities, increases the value of those assets that are used by those concessionally taxed activities, and introduces inequities into the tax system by conferring windfall gains on the existing owners of those assets. However, subsequent investors in concessionally taxed activities will have to pay higher prices for those assets, and this result reduces the after-tax rates of return they earn from those activities.

6.30 This process of arbitrage will continue until the after-tax rate of return produced by the concessionally taxed activity is driven back down to the normal after-tax rates of return available from other activities. It is important to note, however, that this process of arbitrage may take some time to occur, during which taxpayers can earn higher than normal after-tax rates of return.

6.31 In other words, tax arbitrage continues until the value of the tax concession is capitalised into the price of those assets that produce the concessionally taxed income. Eventually, this process removes the initial inequities in the tax system created by those concessions. In so doing, however, it also results in a long-term over-investment in the assets required by the concessionally taxed activity. Tax arbitrage, therefore, results in inefficient patterns of investment. Ideally, anti-avoidance rules should act as a deterrent to tax avoidance arrangements.

What is a sensible policy response to tax avoidance?

6.32 The most sensible way to reduce tax avoidance is to target the conditions that make tax arbitrage possible. This approach means broadening the tax base and lowering the variability of tax rates. A number of policy considerations may make variability of rates a continuing feature of aspects of New Zealand's tax system. As the committee noted earlier, all taxes have less than comprehensive bases. The approach that has been adopted in New Zealand has been to move as far as possible towards a broad-base, low-rate system, in particular, targeting areas in which tax arbitrage is most evident.

6.33 Examples of such measures and the tax avoidance activity they were designed to counter have been:

Thin capitalisation rules – non-residents minimising their New Zealand tax liabilities through thin capitalisation practices.

Transfer pricing rules – non-residents minimising their New Zealand tax liabilities through transfer pricing practices.

Specified lease rules – finance leasing.

Accrual rules – pre-paid interest schemes.

Controlled foreign company and foreign investment fund rules – tax haven 'investments'.

Inter-corporate dividend exemption (removed) – redeemable preference share schemes.

Section FC 11 (repealed) – assignments of income using section FC 11 in conjunction with tax-exempt entities.

Measures relating to films and petroleum mining in the Taxation (Accrual Rules and Other Remedial Matters) Bill introduced on 17 November 1998 – film and petroleum mining investors receiving two tax deductions for, in effect, one amount of expenditure.

6.34 This legislation is a relatively detailed response to tax arbitrage. An alternative response could be to rely instead on the general anti-avoidance provisions, such as sections BG 1 and GB 1 of the Income Tax Act 1994 and section 76 of the Goods and Services Tax Act 1985. The New Zealand approach has been to rely upon the general anti-avoidance rules only as a backstop to the substantive legislation. Some commentators have argued that there is no place for general anti-avoidance provisions.

The value and limitations of general anti-avoidance rules

6.35 The argument sometimes advanced against adopting general anti-avoidance rules is that, because tax bases are less than comprehensive, tax law does not apply to theoretical concepts, but applies to detailed prescriptions of what is taxable and what is not. Income tax, for example, is not applied to ‘income’ in either an accounting or economic sense, but to what the Income Tax Act 1994 sets out to be income. If the Act does not bring something into taxable income, deriving non-taxable income cannot be said to be tax avoidance.

6.36 While this argument has a theoretical attractiveness about it, it assumes that tax policy makers can identify and deal with all the various arbitrage opportunities inherent in the tax system or live with the results of such opportunities. When this issue was previously considered,¹⁰⁷ the response was to acknowledge the practical need for anti-avoidance provisions.

6.37 This approach is consistent with the government’s strategy of broadening the tax base and reducing the variability of rates. The committee **recommends** that the government should continue to restrict the

¹⁰⁷ By the Consultative Committee on the Taxation of Income from Capital in *Key Reforms to the Scheme of Tax Legislation*, Discussion Paper, October 1991 and *Final Report*, October 1992

conditions that make tax avoidance possible by continuing its broad-base, low-rate tax policy.

INCOME TAX: THE GENERAL ANTI-AVOIDANCE RULE

6.38 In this part of the chapter, the committee proposes several amendments to the general anti-avoidance rule in sections BG 1 and GB 1 of the Income Tax Act 1994. The amendments generally clarify only and do not make any substantive changes to the ambit of the general anti-avoidance rule.

Nature of the general rule

6.39 It is uncertain whether the general anti-avoidance rule in sections BG 1 and GB 1 can be regarded as a code, so ousting common law anti-avoidance rules, such as the fiscal nullity doctrine. This doctrine has developed in the courts in the United Kingdom over the last two decades. In broad terms, it provides that any steps inserted in a related series of transactions for the purpose of avoiding tax can be disregarded by the revenue authorities, and the related transactions can be viewed as a whole.

6.40 The doctrine was first expounded in the judgment of Lord Wilberforce in *Ramsay v Commissioners of Inland Revenue*.¹⁰⁸ It is an example of the court applying a purposive approach to construing tax legislation, and allows the court and the Inland Revenue Department to ‘see through’ a preordained series of transactions. In *Ramsay*, Lord Wilberforce identified three key features of avoidance schemes which earmarked them as such: their self-cancelling structure, their non-commerciality, and the expectation that all the consecutive steps in the exercise would be performed even though there was no contract stipulating that they would be.

6.41 In a later case, *Inland Revenue Commissioners v Burmah Oil Co Ltd*, Lord Diplock said:

It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax avoidance schemes to assume, that *Ramsay’s* case did not mark a significant change in the approach adopted by this House in its judicial role to a preordained series of transactions (whether

¹⁰⁸ [1981] STC 174

or not they include the achievement of a legitimate commercial end) into which there are inserted steps which have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable.¹⁰⁹

6.42 The committee considers that the general anti-avoidance rule in sections BG 1 and GB 1 should not have the effect of ousting common law anti-avoidance rules, such as the fiscal nullity doctrine. The committee **recommends** an amendment to provide that the general anti-avoidance rule in sections BG 1 and GB 1 does not affect the application of any principles of common law. The amendment would, therefore, ensure that the courts in New Zealand would not be precluded from applying common law anti-avoidance rules, such as the fiscal nullity doctrine. A precedent for this approach is contained in section 75 of the Defamation Act 1992 which provides that nothing in the provisions dealing with absolute privilege affects any other rule of law relating to absolute privilege.

Application of the rule

6.43 The committee considers that the general anti-avoidance rule should apply automatically to any arrangement involving tax avoidance. In other words, the application of the rule should not depend on the Commissioner invoking it. The wording of the provisions makes this clear, and the judicial authority for this view is the Privy Council decision in *Newton v FCT*.¹¹⁰

6.44 Nevertheless, it is a common belief among tax advisers that section BG 1 is not self-actuating, and operates only if and when the Commissioner invokes it. In the committee's opinion, people should be disabused of this belief. Accordingly, the committee **recommends** an amendment to make the position absolutely clear.¹¹¹

6.45 The automatic application of the general anti-avoidance rule is also consistent with self-assessment of tax obligations. It would provide

¹⁰⁹ [1982] STC 30 at 32

¹¹⁰ [1958] AC 450 at 469

¹¹¹ While the general anti-avoidance provisions operate of their own force, at a practical level an arrangement will be treated as void only when the Commissioner so determines. In all cases, where the section applies, the arrangement is void for tax purposes from the outset. The Commissioner also needs to decide whether any reconstruction is required to counteract more appropriately the tax avoidance, and to issue an assessment accordingly.

an effective deterrent to taxpayers entering into tax avoidance arrangements and therefore help to preserve the robustness of the tax system.

Reconstruction

6.46 The committee takes the view that when the reconstruction provisions in section GB 1 are applied by the Commissioner, the effect of the section is that the reconstruction applies from the date of the original transaction that is void against the Commissioner for income tax purposes under section BG 1. The committee again considers that this current position should be made clear in the legislation, and **recommends** that an amendment to the legislation should be made.

Scope of the rule

6.47 If a general anti-avoidance provision is to be effective, it cannot be precise. Although this feature of an anti-avoidance provision means less certainty for taxpayers, the committee believes that this cost is outweighed by the benefit provided by the flexible wording of the general anti-avoidance rule, allowing the court to address new and different types of tax avoidance arrangements. Again, this helps to preserve the robustness of the tax system.

6.48 There is a danger, then, in being overly precise in defining the term ‘tax avoidance’, as this precision could restrict the flexibility of the courts in addressing particular tax avoidance arrangements.

6.49 The committee does not favour adopting the 1992 Valabh committee recommendations¹¹² on the general anti-avoidance rule, which sought to define its scope more precisely. The committee considers that these recommendations would make the general anti-avoidance rule less effective and less robust. In particular, the committee considers it preferable to keep the current objective nature of the general anti-avoidance rule, rather than making it more subjective as contemplated by the Valabh committee. A subjective test would make the provision too difficult for the Commissioner to apply. The committee does not endorse the benchmark criteria suggested by the Valabh committee for testing whether an arrangement constitutes tax avoidance, because this proposal

¹¹² Consultative Committee on the Taxation of Income from Capital, *Final Report*, October 1992, pages 20-33 and *Key Reforms to the Scheme of Tax Legislation*, Discussion Paper, October 1991, pages 6-53

could result in the courts having less flexibility to deal with particular cases, even if non-exclusive language were used in the enactment.

6.50 The committee notes that the ‘incidental’ exception in the general anti-avoidance rule did not mean minor in a quantum sense.

6.51 The committee did not identify any readily apparent way of improving the drafting of the general anti-avoidance rule apart from the clarification recommended earlier in this chapter. As discussed in para 6.34, the general anti-avoidance rule is a necessary, but not a sufficient protection of the tax base. It will continue to be necessary to counter particular types of tax avoidance by enacting legislation to address the underlying conditions that make tax avoidance possible. For example, the repeal of the inter-corporate dividend exemption in 1992 put an end to schemes involving redeemable preference shares, which had effectively allowed the trading of company tax losses between unrelated parties.

6.52 Other than amendments to clarify aspects of the present legislation, the committee favours keeping the drafting of the general anti-avoidance in substantially its present form. The committee acknowledges a trade-off in a lack of certainty for taxpayers in knowing when the boundary of acceptable tax behaviour has been crossed. However, the committee notes that this lack of certainty is partly addressed by the binding rulings system, which provides taxpayers the opportunity to obtain certainty.

6.53 In summary, therefore, the committee **recommends** that first, the general anti-avoidance rule in sections BG 1 and GB 1 should be clarified to ensure that it is not interpreted to preclude the application of common law anti-avoidance rules, such as the fiscal nullity doctrine. Secondly, for the avoidance of doubt, the general anti-avoidance rule should be clarified to ensure that it applies automatically, and does not depend on action by the Commissioner. Finally, an amendment should be made to clarify that any reconstruction under section GB 1 applies from the date of the original arrangement.

INTERPRETATION STATEMENTS, PUBLIC RULINGS, AND PRODUCT RULINGS

Introduction

6.54 The general anti-avoidance rule, among others in the Income Tax Act 1994, is broadly framed. As the committee has noted in para 6.47, it is a necessary feature of the rule that its precise scope is not clear. How-

ever, the Inland Revenue Department must apply the legislation, and to this end, from time to time, the Commissioner issues interpretation statements, interpretation guidelines, and public rulings. Incidentally to its deliberations on another topic, the committee had occasion to consider a group of several such statements of law, one of which is as yet only an exposure draft. The statements considered by the committee related broadly speaking to avoidance matters. The committee was concerned about the quality of the analysis in the statements, analysis that no doubt has an impact on decisions made within the Inland Revenue Department. The committee explains its concerns about the statements that it examined in the paragraphs that follow.

Policy statement on section 99 of the Income Tax Act 1976

6.55 The committee begins with a departmental policy statement published in 1990 on the application of section 99 of the Income Tax Act 1976, the general anti-avoidance section. This statement seems to have governed much of the department's approach to tax avoidance since it was published.

6.56 Section 99 was last amended as to substance in 1974. The 1974 wording was carried forward into the 1976 Act. The section was disaggregated into several components in the 1994 Act. It is now found in section BG 1, section GB 1, and in a number of definitions in section OB 1. However the essential terminology remains as it was in 1974, and the 1990 statement continues to apply to it.

6.57 The committee understands that the department now intends to withdraw the statement. However, withdrawal depends on a substitute statement being completed; until that is done the statement remains extant.

Objective/subjective test

6.58 The committee was concerned about a number of passages in the policy statement, in particular passages that have the effect of imposing burdens on Inland Revenue officers who try to deploy section 99 where those burdens are not inherent in the text of the section itself. Correctly, the statement recognises that the section 99 test is objective. The test is: 'Does the impugned arrangement avoid tax?' not, 'Did the parties try to avoid tax?' However, some of the text of the statement is framed in terms that could be interpreted as employing a subjective test. An example is, 'The evaluation will be with a view to concluding whether one can predicate whether the arrangement was implemented in its particular

way so as to achieve an income tax advantage.’ This passage is apt to take investigators’ attention away from arrangements themselves, and to encourage them to seek a tax avoidance purpose entertained by the people responsible for implementation. However, the anti-avoidance section does not require the Commissioner to establish such a purpose.

Four-step analysis

6.59 Secondly, the statement sets out a four-step analytical framework that is said to be required by ‘the Commissioner’s approach’ to section 99 cases. One problem with the four steps is that their phraseology seems to accept that the Commissioner has the burden of proof, which is not so. A second problem is that step (d) asks whether an arrangement that may already have been determined to involve more than merely incidental tax avoidance at step (c) ‘frustrates the underlying scheme and purpose of the legislation’.

6.60 The underlying scheme and purpose of the legislation is not mentioned in section 99. That is not to say that underlying scheme and purpose are irrelevant to a section 99 inquiry. In fact, whether an arrangement frustrates the underlying scheme and purpose of the legislation can be relevant to whether the arrangement entails tax avoidance, which is a question that the statement poses at an earlier step in its analytical framework. Tax inspectors accept too heavy a burden if they are required to elevate underlying scheme and purpose to an independent test, that is, to establish that an arrangement involves both tax avoidance and frustration of the Act’s scheme and purpose.

Practical example

6.61 Thirdly, the policy statement contains an annex that gives several examples of arrangements that might be avoidance, and blesses some of them. The committee will mention only one example of the arrangements that the statement accepts as not involving avoidance. This is example 4, an arbitrage scheme that contrives to grant a tax preference to foreigners when acquiring shares in petroleum mining companies, even though section 160A of the 1976 Act in terms awarded the preference to New Zealand residents only. Alternatively, depending on the price at which New Zealand residents sell their shares to foreigners, the scheme involves not arbitrage but New Zealand residents obtaining a preference for investing in petroleum mining shares that they own for only two weeks.

6.62 On the basis of a formalistic analysis, the policy statement determines that the scheme in example 4 is not vulnerable to attack under section 99. The Commissioner may be correct, but the committee is doubtful. At any rate, if the example is correct it follows that section 160A did not achieve its intended effect. If so, the section should have been amended. If section 160A was deficient in the manner that the Commissioner explains in the statement then, of course, the Commissioner had no option but to assess people on the basis of section 160A's correct, though deficient, meaning. However, the committee doubts the merits of publishing a statement that highlights this assumed deficiency and that invites taxpayers to exploit it.

6.63 Since it was published, the 1990 policy statement seems to have had considerable influence. It may be part of the explanation for the infrequency with which the Commissioner has invoked section 99/BG 1 from the time that it adopted its present terms in 1974. However, the committee is pleased to note the increased use of section 99/BG 1 that is recorded in para 13.51.

Interpretation guideline exposure draft on form and substance in taxation law

6.64 Issues of form and substance are different from questions of avoidance, but in practice they are often closely related. The committee discussed the Inland Revenue Department's 1998 exposure draft of an interpretation guideline, *Form and Substance in Taxation Law*. As the draft explains:

Interpretation guidelines are intended to clarify general points of interpretation that are causing, or may cause, difficulty for practitioners, taxpayers, and Inland Revenue. An interpretation guideline is Inland Revenue's opinion as to the better view of the law. That view is developed from an appreciation and assessment of the law on a particular topic, as gleaned from the cases.¹¹³

6.65 The draft finishes with this warning:

Draft items produced by the Adjudications and Rulings Business Group represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

¹¹³ New Zealand Inland Revenue Department document reference IG9703 (1998)

In draft form these items may not be relied on by taxation officers, taxpayers, and (sic, or?) practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

6.66 Although the document is an exposure draft with the qualifications outlined above, the committee understands that the document describes the manner in which the department is interpreting the law. For the reasons given in paras 6.72 to 6.88, the committee disagrees with the approach that the exposure draft reveals.

6.67 The exposure draft suffers from a shortcoming in that it employs an analytical framework that is not refined enough for the purposes of its subject matter. It says, ‘The [courts’] only significant departure from [a formalistic] approach is when the essential genuineness of a transaction is challenged [by alleging that the transaction is a sham].’ However, when a transaction is challenged as a sham and not genuine, or as being in substance something different from what its form suggests, the courts have essentially one response. This response is to seek the true legal obligations and rights that the transaction imposes or confers on the parties to it.

6.68 Courts often explain this exercise by adopting one of two bipartite frameworks. The first is the form/legal substance dichotomy. Where the form of a transaction, or the label that the parties give to the transaction, is different from the true legal substance of the transaction, then the courts construe the transaction according to the true legal rights and obligations that it creates, that is, according to its true legal substance. An example is *Ensign Tankers (Leasing) Ltd v Stokes*.¹¹⁴ In that case, the House of Lords held that a transaction that was constructed as a non-recourse loan was in legal substance a partnership, and that it should be treated as a partnership for tax purposes.

6.69 The second bipartite framework entails distinguishing between a transaction’s true legal substance and its economic effect. A recent example is *Wattie v CIR*.¹¹⁵ In that case, the Privy Council held that a payment that the Commissioner of Inland Revenue argued was a rent subsidy was in legal substance a premium paid by a landlord to attract a tenant, notwithstanding that in economic effect the payment was just the

¹¹⁴ [1992] 1 AC 655

¹¹⁵ (1998) 18 NZTC 13,991

same as a rent subsidy. Being a premium, the payment was a non-taxable capital receipt, whereas a rent subsidy would have been a revenue item.

6.70 Two features of these alternative bipartite frameworks require noting. First, the concept of legal substance is common to each framework. Secondly, whichever framework is appropriate to the case at hand, the correct answer is always the same: the court must analyse the transaction according to its legal substance and the true legal rights and obligations that it creates. If the first framework is used, the courts reject form in favour of true legal substance. If the second framework is used, the courts reject economic substance in favour of legal substance.

6.71 The result is that a conspectus of both types of case, that is, cases like *Ensign Tankers* and cases like *Wattie*, reveal three relevant categories: form, legal substance, and economic substance. The courts reject the first and third in favour of the second. This principle does not mean that the first and third categories are never correct. Rather, they are correct only if they happen to coincide with legal substance, with the parties' true rights and obligations. Thus, in *Wattie* legal form (a premium) did in fact coincide with legal substance (a premium) and the Privy Council rejected analysis according to economic substance that would have led to classifying the payment as a rent subsidy. In *Ensign Tankers*, economic substance (a partnership) did in fact coincide with legal substance (a partnership) and the House of Lords rejected form (a non-recourse loan).

6.72 It is an important shortcoming of the exposure draft that its analytical framework fails to identify the three categories of form, legal substance, and economic substance, and instead relies on a formulaic division between form and substance. In the context of a particular case, that distinction can sometimes be enough. But in the context of an interpretation guideline about form and substance that attempts a comprehensive coverage of the relevant elements of the whole field this failure is misleading.

Discussion of judicial dicta in the exposure draft

6.73 The exposure draft quotes two judicial statements of principle that are notoriously difficult to reconcile, without apparently recognising their inconsistency. The first is the 'no taxation on substantial or economic or business character of what was done' statement from *CIR v*

Europa Oil (No 1),¹¹⁶ and the second is Dixon J's emphasis that tax analysis 'depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed, or exhausted in the process' in *Hallstroms Pty Ltd v Federal Commissioner of Taxation*.¹¹⁷

6.74 The draft cites *Attorney-General v Barker Bros Ltd*¹¹⁸ and other cases on contract formation (that is, on the question of whether or not a contract exists) as helpful cases for analysing contracts that, *ex hypothesi*, do exist. The committee is not aware of tax cases, apart from cases of alleged shams, where there was any issue as to whether the contract in question existed. It is hard to see how the *Barker Bros* case can shed any light on the apparent conflict between *Europa Oil* and *Hallstroms*.

6.75 The conflict between *Europa Oil* and Dixon J in *Hallstroms* is resolved, however, when one remembers that there are three relevant categories. When Dixon J rejects a 'juristic classification of legal rights' in favour of 'what the expenditure is calculated to effect from a practical and business point of view' he must not be interpreted as embracing taxation by economic substance. He must be taken as rejecting the pure juristic form of a transaction if this form does not reflect the true legal rights of the parties. He is not saying, as *Europa Oil* says he must not, that people should be taxed according to the economic substance of their transactions.

Committee's reservations

6.76 The committee hesitated before recording its reservations about a document that is, as yet, only an exposure draft. At the same time, the draft has now been extant since 4 June 1997 and there have been only five submissions on it, none of which has made the points made by the committee. It may be unrealistic for the department to rely on voluntary public comment to correct this kind of document. The committee suspects that, had the draft not come to its attention, the points that it makes

¹¹⁶ [1971] NZLR 641 at 648 (PC)

¹¹⁷ (1946) 72 CLR 634 at 648

¹¹⁸ [1976] NZLR 495 (CA)

would never have come to light; nor are they the committee's only reservations about the draft.¹¹⁹

6.77 The committee is concerned about the likely use of the draft. The document is in essence a text on how to approach transactions by using a form/substance analytical framework. But in status, and in some of its language, the document is a draft statement of the law as the Commissioner understands it. There are several problems here. They stem from the fact that the form or substance question is more a tool of argument or analysis than it is a statement of law. Moreover, it is a deceptive tool, in that judges often state it in firm, almost dogmatic terms, whereas in fact it is infinitely flexible and elusive. In this respect, it has some similarity to the rules of statutory interpretation, which the committee discusses earlier in this report.¹²⁰

Assessment of the interpretation guideline

6.78 The matters discussed in the last paragraph give cause for concern about the users of the interpretation statement. If people are knowledgeable about tax law, they will understand that, despite its form, the statement can in only a limited sense function as a statement of the Commissioner's view of the law. But these people will already know enough about tax law that they will either not need to use the statement, or, worse, they will be able to use it against the Commissioner, picking on passages that can be deployed against him.

6.79 If people's knowledge of tax law is such that they need the statement to inform them about the form/substance distinction there is a risk that they may be misled. In difficult cases, the form/substance distinction is a matter of shadings of grey. The draft statement does not paint a picture that is purely black and white, but it does give an impression of much more certainty and logic than in fact exists. An Inland Revenue officer relying on the statement to help in analysing and categorising a difficult transaction could well come to the wrong conclusion.

6.80 Issuing the guideline in a form consistent with the committee's views may not be the answer. The guideline is not really an interpreta-

¹¹⁹ Another is the draft's discussion of a practical example formed by a pair of opposing transactions that balance one another in both legal and economic substance. The draft specifically denies the possibility of considering the transactions together as a self-cancelling matrix even though this is a standard analytical approach. See below paras 6.82 to 6.88.

¹²⁰ See paras 2.7 to 2.91

tion of a difficult or ambiguous rule of tax law, and hardly qualifies to be called an ‘interpretation’. As mentioned earlier, it is more in the nature of instruction in the use of a particular analytical technique. Because the technique is a tool, in close cases it can be used to argue for either side. Publishing an explanation of such a technique as a formal statement of the Commissioner’s view of the law can inadvertently give tax advisers in the private sector an argument that, in substance, does not exist. Further, it can cause officers to reach incorrect conclusions.

6.81 The committee bears in mind that there are many tax professionals who do not have a formal legal training. For them, guidelines can serve a very useful purpose. Indeed, the draft statement under discussion was developed with the encouragement of the accounting profession. If the requirements of such people are to be met, then there is a need for finalising and issuing the draft guideline in the respects outlined.

Transactions that balance one another

6.82 An example discussed in the exposure draft is a case in point. The example involves a pair of transactions that balance one another as to subject matter and parties. The example is:

P purchases some assets from M for \$100,000. P and M then enter into a simultaneous put and call option agreement under which:

- M has the right to buy the assets back for for \$110,000 (call option);
- P has the right to sell the assets to M, also for \$110,000 (put option).

6.83 The draft states that these options must necessarily be treated as separate transactions, even though they are part of a single agreement. It is possible that there are circumstances where the opinion in the draft would be correct. However, there are not enough secondary facts in the example to decide whether a court would consider each transaction separately and give each transaction full effect, or whether it would conflate the transactions into a single, self-cancelling matrix. Indeed, there are no secondary facts given in the example.

6.84 Inland Revenue officers faced with cases where the primary facts match the balancing transactions in the example could be forgiven for following the analysis in the draft and assuming that the law will inevitably require each transaction to be given separate effect.

The Magnum case and balancing transactions

6.85 Interestingly, some people seem to have adopted that approach in analysing the Magnum scheme in the Winebox papers. It may be recalled that the core transactions in the Magnum scheme were an agreement to sell a promissory note, and another agreement to buy the same note. The Magnum scheme's pair of transactions were, if anything, less closely interrelated than the put and call options in the exposure draft's example. The differences are first, that the Magnum transactions were not formally part of a single agreement, and secondly that, while one party was the same in both Magnum transactions, the second parties to the two transactions were not identical but were related companies in the same group.

6.86 On their facts, and to put the matter at its lowest, there is a tenable argument that the Magnum transactions were self-cancelling and did not have the effect that was purported by their authors. In fact, in *European Pacific Banking Corporation v Television New Zealand*,¹²¹ the Court of Appeal went further, and, taking into account the secondary facts of the Magnum scheme, held that Television New Zealand had established a seriously arguable case that the whole scheme was iniquitous. In the recent case of *Peters v Davison*,¹²² the Court of Appeal confirmed its earlier opinion that the Magnum promissory note transaction could be ineffectual because of cancellation of one leg of the transaction by the other.

Difficulties of form/substance analysis

6.87 Comparing the exposure draft's example with the Magnum scheme illustrates that form/substance analysis is much more subtle, elusive and impressionistic than would appear to be the case to a reader of the draft. The committee is concerned that, although the draft purports to be no more than a draft, and is subject to correction, the ordinary course of events would not necessarily see the necessary corrections made. If there is reliance on the period of exposure of the draft to provoke professional comment that would identify errors, that reliance may well be misplaced. Frequently, the view that the draft espouses will suit the taxpayer rather than the Commissioner. It would be a most altruistic practitioner from the private sector who would seek to correct the draft.

¹²¹ [1994] 3 NZLR 43

¹²² Unreported, Court of Appeal, CA 72/98, 17 November 1998

6.88 A further cause of the committee's concern is that, although the draft is subject to revision after exposure, at the moment it states the Commissioner's current 'considered views'. Have those views affected any private binding rulings that have been issued in the last few years? Have they influenced decisions about completed transactions that have come to the attention of Inland Revenue investigators? The committee cannot answer these questions, because private rulings are not published, and because decisions about individual taxpayers are confidential.

Interpretation guideline on shams

6.89 Like issues as to form and substance, questions of sham are in practice closely related to questions of avoidance, often arising in the same case. The committee considered an interpretation guideline entitled *Sham – Meaning of the Term*, that was published in 1997 in the *Tax Information Bulletin*,¹²³ and that remains in force. The guideline is an item of three or four pages much along the lines of a short expository article that one might find in a professional or scholarly journal or as part of a chapter in a text book.

6.90 The guideline mentions relevant law, draws certain conclusions, and gives some examples. However, it suffers from the same analytical shortcoming as the exposure draft on form and substance that the committee has discussed, in that the discussion takes place within an analytical framework that is not adequate. The guideline adopts a simplistic form/substance dichotomy. It does not make the point that in order to discover the true legal rights and obligations that a transaction creates courts may ask two, separate, questions, each apt for a different kind of case: form/legal substance, relevant in cases like *Ensign Tankers Ltd v Stokes*,¹²⁴ and legal substance/economic substance, relevant in cases like *Wattie v CIR*.¹²⁵

'No half-way house'

6.91 A second difficulty is that the guideline keeps to the framework, 'There is no half-way house between a sham and an effective transaction.' There are plenty of dicta in the cases that appear to support this principle, and it is accurate as far as it goes. But the principle must be understood within a wider context. That context is that, above and be-

¹²³ Volume 9, No 11, page 7

¹²⁴ [1992] 1 AC 655, discussed in para 6.68

¹²⁵ (1998) 18 NZTC 13,911, discussed in para 6.69

yond the doctrine of sham, the courts do in fact decline to accord to certain categories of genuine, non-sham, transactions the effect that those transactions purport to have. In strict logic, these impugnable transactions are sub-categories of genuine transactions. However, their legal effect is such that they are no more effective in achieving their hoped-for tax result than if they were shams. For practical purposes, these transactions do constitute a quasi-half-way house between sham and genuine transactions.

6.92 The main inhabitants of this quasi-half-way house are: mislabelled transactions, self-cancelling transactions, and transactions that, when interpreted in context, have an effect different from the initial impression that the reader gains from one or more of the documents.¹²⁶

6.93 The difficulty with the department's interpretation guideline is that most readers would take it to be comprehensive in scope, (in the sense of covering or referring to the whole relevant field, rather than in the sense of being a fully detailed analysis). The guideline reinforces this impression by quoting the 'no half-way house' principle, which has misled a good many readers of judicial judgments in the past. The problem is compounded by the fact that the guideline appears to be a general, authoritative statement. In contrast, reported judgments can be misleading enough, but at least most readers of law reports appreciate that statements of principle in judgments can be taken as generally authoritative only within limits.

Interpretation guidelines about legal reasoning

6.94 The committee concludes its discussion of the section 99 statement, the draft interpretation guideline on form and substance, and the guideline on shams, by reflecting on the purpose of guidelines and statements that set out not interpretations of law but, in effect, instructions or information on how to go about methods of legal reasoning. To the extent that users are Inland Revenue Department staff, the purpose is commendable and necessary: it is most important for staff to be educated in methods of legal reasoning. But interpretation statements are an awkward vehicle for such education.

¹²⁶ See Prebble J, 'Criminal Law, Tax Evasion, Shams, and Tax Avoidance: Part II – Criminal Law Consequences of Categories of Evasion and Avoidance' (1996) 2 *New Zealand Journal of Taxation Law and Policy*, 59, pages 63-66. The interpretation guideline mentions this third category by implication in its discussion of Richardson J's judgment in *Re Securitibank (No 2)* [1978] 2 NZLR 136, but it does not explore the implications of the category in a manner that is sufficiently informative.

6.95 If interpretation statements and guidelines are to fulfil the function that their name implies, they must be reasonably concise and dogmatic. Legal reasoning has many characteristics, but concise dogmatism is not one of them. Where it is a question of education or instruction of officials on methods of legal reasoning, the conventional vehicles of text books, articles, and class instruction may be more appropriate. However, as the committee discusses below, resource constraints make this strategy not altogether practical.

6.96 The committee is also concerned about directing interpretation statements of the kind under discussion to taxpayers and practitioners. Non-specialists who do not know how this kind of statement fits into the total context of the law may be misled. Specialists do not need them, and are apt to turn them against the Commissioner.

Merits of interpretation statements and guidelines

6.97 As is apparent from the foregoing paragraphs, the committee's discussion reflected grave misgivings about interpretation statements and guidelines that involve approaches to lines of legal reasoning rather than statements of law. The committee considered a recommendation that the Commissioner should not issue such statements and guidelines. In the end, the committee did not follow this course, for three reasons.

6.98 First, there is the question of Inland Revenue officers. The Commissioner will always have to rely on officers who do not have a deep knowledge of tax law and of legal analysis. It will never be practical or economical wholly to remedy this problem by providing enough education to train all, or even most, staff of the Inland Revenue Department as tax specialists. In the end, the committee was persuaded that non-specialists are better off with guidelines, even over-simplified and sometimes misleading guidelines, than with no guidelines at all.

6.99 Secondly, in modern public administration, New Zealanders' expectations are such if such guidelines are published they must be made available to the public, and not kept within the department, as was the case until the enactment of the Official Information Act in 1982. If guidelines are available, particularly if they contain examples, tax advisers will sometimes rely on them to make arguments detrimental to the tax system.

6.100 Thirdly, tax law, particularly income tax law, will always have areas of uncertainty. This is particularly so for cases that depend on the application of a somewhat flexible form of reasoning rather than on

relatively black letter law. Examples of such flexible forms of reasoning include: applying the principles of statutory interpretation; analysing facts according to the form/substance distinction; drawing the line between capital and revenue items; and applying the statutory anti-avoidance rule. Both taxpayers and tax advisers welcome succinct guidelines that try to reduce this uncertainty, even (or especially, depending on one's point of view) if the reduction of uncertainty is at the expense of some erosion of the tax base.

6.101 Bearing in mind the difficulties with the interpretation statements and guidelines that it has studied, the committee **recommends** that the government draws to the Commissioner's attention the committee's view that the department should:

Review existing interpretation statements, interpretation guidelines and public rulings that depend on high-level legal analysis in order to determine whether these statements should be revised.

Immediately withdraw any such statements that are found to be deficient, without waiting until replacement drafts are available.

In particular, immediately withdraw the 1990 policy statement on section 99 of the Income Tax Act 1976.

Where appropriate, and especially for issues involving complex reasoning, seek external expert input into interpretation guidelines and interpretation statements before they are released for public consultation.

Take particular care when including in such statements generic examples that do not incorporate contextual facts, and, in general, incorporate contextual facts in examples so that examples do not inadvertently apply to wider areas than officials intend.

Reconsider and refine the department's apparent view on how form/substance and sham/genuine analysis should be approached.

LOSS-ATTRIBUTING QUALIFYING COMPANIES

Introduction

6.102 Having examined the general anti-avoidance rule and the department's approach to problems of interpretation, the committee now turns to the use of some particular rules, the loss attributing qualifying companies rules, for tax planning purposes.

6.103 The qualifying companies rules form a subset of the company tax regime. The rules address a problem faced by small businesses: if they wish to obtain the benefits of limited liability and perpetual succession that are afforded by the corporate form, they lose the tax benefits of sole traders and partnerships. The qualifying companies rules allow closely held companies to be treated more or less as partnerships for tax purposes. That is, profits may be attributed directly to shareholders, without the need to go through the imputation system. In order to prevent avoidance, the qualifying companies rules are hedged around with certain formalities and anti-avoidance rules.

6.104 Loss-attributing qualifying companies are a further subset of qualifying companies. Standard qualifying companies permit profits to pass through directly to shareholders, but carry losses forward within the company. Loss attributing qualifying companies permit losses to be passed into shareholders' personal accounts. Because of the potential for abuse, there are additional formal and anti-avoidance rules associated with loss attributing qualifying companies.

Loss attributing qualifying companies as tax planning vehicles

6.105 Tax planning structures that are marketed to the public tend to take one of a relatively small number of basic forms. One of these constitutes structures that offer clients an opportunity to take advantage of accelerated deductions. Many such structures are efficient only if there can be a number of participants. They therefore require a scheme with two characteristics: first, people can combine in groups for investment purposes; secondly, the combination can pass losses through to individual members of the group. Companies have the first characteristic, but not the second. Partnerships have the second, but, because of joint and several liability, have limited appeal for people who need to combine with strangers to join together for investment.

6.106 In the past, New Zealand taxpayers turned to the special partnership, which offered the best of both worlds: limited liability, and the ability to pass losses through to members. During the 1980s, special partnerships were popular structures for investors in films, livestock, and other investments that appeared to offer opportunities from accelerated

deductions. People's ability to use special partnerships in this manner was foreclosed from the start of the 1986-87 income year.¹²⁷

6.107 Nowadays, partnerships formed of numbers of loss attributing qualifying companies fill the gap left since the demise of special partnerships. This structure can offer investors both limited liability and the pass-through of losses. They can also be large enough to gather together enough investors to obtain sufficient economies of scale to make loss-generating investments worthwhile. Two areas where they are used are forestry and intangible property depreciation schemes. There may be other areas.

6.108 Towards the end of its term, the committee became aware of an aggressive tax shelter scheme that involved the depreciation of intangible property. The marketers of the scheme recommend that customers should invest via loss attributing qualifying companies. This structure is not essential to the scheme's operation, but there is little doubt that investing via a loss attributing qualifying company makes the scheme more attractive to participants.

Forestry

6.109 At present, in New Zealand, forestry investment enjoys a tax preferred status. That status is a matter of government policy and specific Parliamentary enactment and not an accident. The tax-preferred status is unusual, and perhaps close to unique in the current New Zealand tax system. Loss attributing qualifying companies enable middle-income people to pool funds to invest in forestry, and to take advantage of the tax preference. Without pooling funds, middle income people would find it hard to attain the economies of scale that are needed before one goes into forestry.

6.110 It may be, therefore, that, in the field of forestry, loss attributing qualifying companies are promoting government policy, though if this is so the situation has evolved rather than come about by design. The position is almost certainly otherwise in any other areas where loss attributing qualifying companies are being used to gain access to tax benefits. That is particularly so in respect of schemes that rely on claiming depreciation in respect of intangible property.

¹²⁷ By the Income Tax Amendment Act (No 4) 1986

The intended role

6.111 Officials were not able to tell the committee the extent of the use of loss attributing qualifying companies for conventional, non-tax shelter purposes. However, the committee is aware that loss attributing qualifying companies do play a useful role, particularly for start-up ventures. In this context, they permit initial year losses to be transferred to business proprietors, which is an example of the reason for establishing this category of taxpayer in the first place.

Simplicity

6.112 In chapter 1 of this report, the committee explained the phenomenon that it has called the 'fiscal paradox'. This paradox is that the more people try to make tax systems equitable, the more they make them complex. Loss attributing qualifying companies are an excellent illustration. Their objective is to eliminate tax considerations as an element in determining the appropriate structure for closely held businesses, whether company, partnership, or sole tradership.

6.113 The cost in statutory terms is a whole subpart of the Income Tax Act 1994, subpart HG, which occupies 25 pages in the 1998 reprint, not including definitions. The provisions of subpart HG show an instructive contrast to the Act's next subpart, HH, which covers the taxation of trusts, conceptually a more complex topic, in only 15 pages. From the point of view of simplicity alone, eliminating loss attributing qualifying companies would clearly be a positive step.

6.114 The committee **recommends** that the government should examine loss attributing qualifying companies to determine:

whether the use of loss attributing qualifying companies as tax avoidance vehicles is a threat to the tax base;

whether the use of loss attributing qualifying companies promotes a government policy of preferring forestry investment, assuming that there is such a policy;

whether, taking into account the factors listed and any other matters that appear to be relevant, the provisions as to loss attributing qualifying companies should be amended in order to prevent these companies being used as vehicles for tax shelters or, if necessary, be repealed.

CONTRIVED DEPRECIATION SCHEMES

6.115 The committee is aware of a tax shelter scheme that offers generous depreciation deductions to participants for a modest price. The scheme depends for its effect on three elements: claiming depreciation on fixed life intangible property; an asymmetry between participants, being on the one hand ordinary taxpayers and on the other hand a tax-exempt charity; and the use of a syndicate of loss attributing qualifying companies as the investment vehicle. Loss attributing qualifying companies are not essential to the operation of the scheme, but make it more attractive for participants.

6.116 The scheme provides an excellent illustration of several of the general points made in this report. First, it shows how loss attributing qualifying companies, a concept created to promote equity as to tax between sole traders and closely held companies, can be employed to facilitate the marketing of tax shelters.

6.117 Secondly, it illustrates both in this respect and in respect of fixed life intangible property the operation of the fiscal paradox.¹²⁸ In 1993, Parliament amended the Income Tax Act to enable people to claim depreciation allowances for fixed life intangible property in order to promote equity between businesses that use tangible (and thus depreciable, assets) and businesses that use intangible assets, which were formerly non-depreciable. Parliament's well-intentioned measure forms the fulcrum for achieving arbitrage between the charity and scheme participants.

6.118 Thirdly, the scheme illustrates how standard approaches to statutory interpretation allow a measure that is enacted for one purpose (here, to promote horizontal equity between taxpayers) to be used for another purpose (in this scheme, to create a tax shelter). The committee discusses officials' concern about such unintended effects in para 2.38.

6.119 Fourthly, the scheme illustrates the way in which people can take advantage of the tax exemption that is enjoyed by charities.¹²⁹ Indeed, the scheme constitutes a more dramatic illustration of this point than the committee had in mind when writing the part of this report that relates to tax-exempt institutions. The committee is not aware of schemes that turn

¹²⁸ See paras 1.3 to 1.5

¹²⁹ See para 4.1

on arbitrage between charities and taxpayers being marketed in New Zealand in the past, though this activity has occurred in Australia.¹³⁰

6.120 Fifthly, the scheme may illustrate an unexpected problem with the rewrite's adoption of the gross receipts approach, discussed by the committee in para 2.110 to 2.119. The problem is that section EG 1(1) allows a deduction for depreciation of 'depreciable property'. Section OB 1 relevantly defines 'depreciable property' to include property that people use 'in deriving gross income'.

6.121 Before the gross income approach was adopted, arguably entitlement to deduct depreciation allowances turned on at least an intention to derive net assessable income, even though the intention might have been unrealistic from an objective point of view. Now, it seems that an intention to derive gross income is sufficient, even though the taxpayer never expected the venture in question to result in net income that is taxable.

6.122 Sixthly, the scheme is a good example of the archetypal form of tax arbitrage between taxpaying and tax-exempt entities that is mentioned in para 4.1.

6.123 The committee was informed that the department is aware of arrangements of this type and that they are already under investigation.

¹³⁰ See, for example, Prebble J, *Criminal Law, Tax Evasion, Shams, and Tax Avoidance: Part II—Criminal Law Consequences of Categories of Evasion and Avoidance* (1996) 2 *NZ Journal of Taxation Law and Policy* for a discussion of an Australian scheme.

CHAPTER 7 – TAX EVASION AND THE HIDDEN ECONOMY

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Introduction

7.1 New Zealand, like many other jurisdictions, relies on a tax system based on voluntary compliance. Taxpayers are expected to understand and comply with their tax obligations.

7.2 Under such a tax system, it is inevitable that some taxpayers will fail to comply with their tax obligations. For example, some people will seek to evade tax by submitting false tax returns that conceal taxable activities from the Inland Revenue Department. Other taxpayers will evade tax unintentionally because they do not understand their obligations. In this case, the taxpayer does not deliberately set out to submit a false return. However, such taxpayers will still file a false return if they are not reminded of their tax obligations either in their tax return, or in supplementary information provided by the Inland Revenue Department.

7.3 Although it is not feasible to eliminate tax evasion completely, it is important to keep the level of evasion under control. Increases in the level of evasion can threaten the integrity of the tax system. In particular, tax evasion undermines the ability of the government to raise revenue in an equitable and efficient manner. Individuals and businesses that evade tax in effect shift their tax burden onto those taxpayers who comply with their tax obligations. This shift results in an inequitable distribution of the tax burden, and disadvantages those businesses that choose to comply with their tax obligations.

7.4 In practice it is extremely difficult to monitor the level of tax evasion in New Zealand. This difficulty arises because tax evasion in-

volves economic activities that are part of what is usually referred to as the 'hidden' economy.

7.5 This chapter begins with a discussion of what is meant by the hidden economy and explains how estimates of the size of the hidden economy in New Zealand have been used to obtain an indication of the overall level of tax evasion. This introduction is followed by a discussion of what is being done to reduce the level of tax evasion. The chapter concludes with a description of the committee's recommended approach to reducing tax evasion.

What is meant by the hidden economy?

7.6 As noted above, tax evasion involves economic activities that are hidden from Inland Revenue. In the course of evading tax, taxpayers either intentionally or unintentionally fail to take into account certain taxable activities when completing their tax returns. These hidden economic activities comprise part of what is usually referred to as the hidden or black economy.

7.7 The hidden or black economy comprises economic activities that are not measured in official statistics, including both legal and illegal activities.

7.8 For example, national statistics exclude certain legal market transactions that have deliberately hidden from authorities, such as the income that taxpayers have failed to declare to the Inland Revenue Department. Certain legal non-market activities, such as the unpaid housework, are also excluded because they are difficult to measure.

7.9 National statistics also exclude certain unreported illegal market activities, such as the trade in illegal drugs, as well as illegal non-market activities, such as drugs produced for personal consumption.

7.10 Tax evasion typically involves a range of hidden economic activities, including both legal and illegal transactions, as well as market and non-market transactions. For example, the total level of tax evaded in New Zealand includes the tax evaded on income from unreported legal activities such as income earned from cash jobs, as well as income from unreported illegal activities such as prostitution, illegal gambling, and trade in illicit drugs.

7.11 Not all of the economic activities that comprise the hidden economy involve taxable transactions. For example, unpaid housework does not give rise to assessable income.

7.12 As a result, the total value of taxable economic activity on which tax is evaded will be less than the total size of the hidden economy. This feature means that estimates of the size of the hidden economy need to be adjusted in order to obtain estimates of the level of tax evasion. This result can be achieved either by excluding the value of non-taxable activities from estimates of the size of the hidden economy, or by adopting a narrower definition of the hidden economy that excludes non-taxable transactions.

Research on the estimated size of the hidden economy

7.13 The Inland Revenue Department commissioned three papers on the hidden economy from Professor DE Giles of the University of Victoria in British Columbia. The papers comprise the first serious attempt to estimate the size of the hidden economy in New Zealand and its interaction with the tax system.¹³¹ The study covered the years 1968 to 1994.

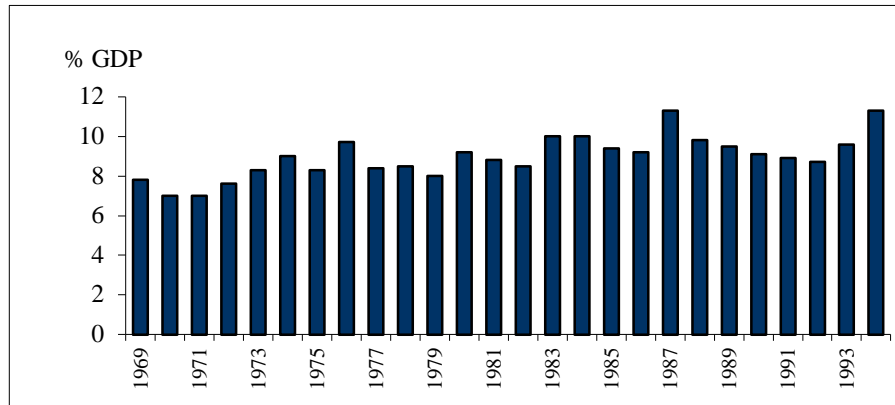
7.14 The commissioned work estimated the economy-wide level of unmeasured market activity. This measure excluded non-market activities such as housework that are not subject to tax.

7.15 Officials advised the committee that the estimated long-run average size of the hidden economy was 8.8 per cent of GDP, while in 1994 it was 11.3 per cent. For 1994 the level of tax evasion was estimated to be \$3.2 billion. A casual examination of the time series reveals that the size of the hidden economy fluctuates over time with a rising trend, as shown in figure 1. The research established a positive correlation between the business cycle and the hidden economy, so it is not surprising that the hidden economy was large in 1994 when the business cycle was near its peak, as it was in 1987.

7.16 No estimates exist of the size of the hidden economy or the level of tax evasion in New Zealand after 1994. Providing a reliable estimate would entail re-estimating the model using data for the years after 1994. Any attempts to estimate the size of the hidden economy after 1994 without re-estimating the model would require an assumption as to the proportionate size of the hidden economy. This assumption would affect the reliability of the figures, given the fluctuations shown in figure 1.

¹³¹ The most recent available information on Professor Giles' research on the hidden economy can be found on his website http://web.uvic.ca/econ/economet_he.html.

FIGURE 1: HIDDEN ECONOMY AS PERCENTAGE OF GDP



SOURCE: INLAND REVENUE (NZ)

7.17 Professor Giles also investigated the relationship between the level and mix of taxation (that is, direct and indirect taxation as a share of total taxation) and the size of the hidden economy. The studies found that:

A decrease in the tax/GDP ratio from its current level slightly reduces the hidden economy/GDP ratio.

An increase in the proportion of indirect tax to direct tax from its current proportion reduces the hidden economy.

The introduction of GST in 1986 had a noticeable impact in reducing the size of the hidden economy relative to GDP.

If the government were to reduce tax rates to zero, the hidden economy would still remain at 4 per cent – 4.5 per cent of GDP.¹³²

The rate of economic growth, unemployment, inflation and government regulation were found to be significant contributors to the size of the hidden economy.

7.18 These results point to some interesting conclusions. First, on its own, reducing the tax/GDP ratio is not particularly effective as a means of minimising the hidden economy given the substantial tax revenue foregone for only slight gains in reducing the hidden economy. Several

¹³² See para 7.19

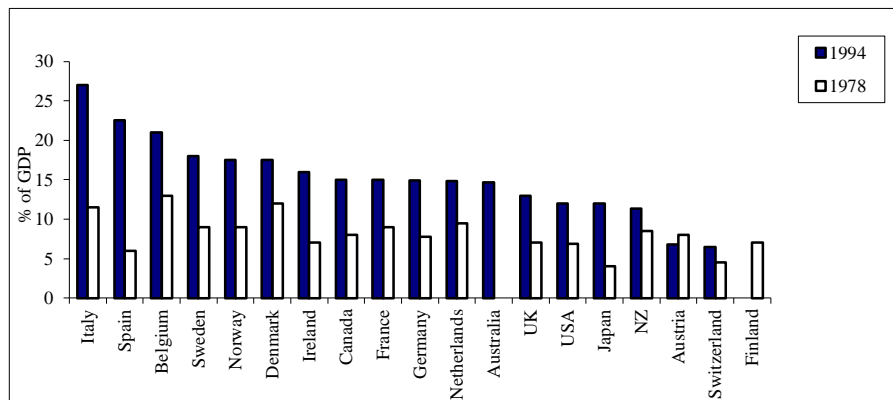
reasons exist for modifying the statutory tax rates and the tax bases to which they are applied. These reasons include lessening the economic distortions caused by taxes and redistributing income. It follows that reductions in the size of the hidden economy caused by lower tax levels are best seen as a beneficial side effect of such a policy, rather than a prime reason for their introduction.

7.19 Secondly, getting rid of taxation does not get rid of the hidden economy. This finding implies that a significant proportion of income is unreported for reasons other than taxation, such as criminal activity or avoiding other forms of government regulation.

7.20 Finally, many other influences on the size of the hidden economy proved significant in the research. Aside from the rate of economic growth, unemployment, inflation and government regulation were found to be significant contributors to the size of the hidden economy. The government addresses these issues as part of its wider economic policy.

7.21 Internationally, New Zealand's hidden economy is in line with most OECD countries in terms of both the 1994 estimate of 11.3 per cent of GDP and the long-run average of 8.8 per cent of GDP. The estimates range from approximately 27 per cent of GDP for Italy to 6 per cent of GDP for Switzerland for 1994. Generally, the hidden economy has been growing in most OECD countries.

FIGURE 2: SIZE OF HIDDEN ECONOMY AS PERCENTAGE OF GDP IN VARIOUS COUNTRIES



SOURCE: GILES, D 1998 'THE UNDERGROUND ECONOMY: MINIMIZING THE SIZE OF GOVERNMENT' IN GRUBEL H, ED, *HOW TO SPEND THE FISCAL DIVIDEND: THE OPTIMAL SIZE OF GOVERNMENT*, FRASER INSTITUTE, VANCOUVER (FORTHCOMING).

7.22 Officials cautioned the committee about comparisons between studies and across countries. There is wide variation in estimates of size of the hidden economy depending upon the country concerned, the availability of data and the method employed in estimating it. Park (1979) and Feige (1982), for example, estimated the size of the hidden economy in the United States at 4 per cent and 33 per cent of GDP respectively for 1978.¹³³ These results show, as noted by Professor Giles in his paper, that not only does the evidence ‘suggest variation over time and across countries for the relative size of the hidden economy, but it is also rather imprecise’.¹³⁴

What is being done to reduce the level of tax evasion?

7.23 Since 1984, successive governments have introduced a range of initiatives that have reduced the scope for tax evasion in New Zealand.

7.24 For example, reductions in the rates of income tax, in combination with the introduction of the GST regime, significantly reduced both the incentive and opportunities for many taxpayers to evade tax. In particular, these changes discouraged the willingness of businesses registered for GST purposes to pay cash to suppliers of their inputs, as this would result in the loss of their input tax credits.

7.25 The broadening of the tax base, and reduction in tax rates, also enabled a significant extension of withholding tax regimes. This extension included the introduction of the dividend imputation regime, and the subsequent introduction of a resident withholding tax on interest and dividend income. These measures significantly reduced the scope for individuals to evade tax on their interest and dividend income.

7.26 More recently, the Inland Revenue Department has been seeking to encourage compliance by simplifying the tax system. This process involves a range of activities including:

The implementation of phase one of the project, Directions: Customer Requirements. This project improved the accuracy of

¹³³ Feige E, 1982 “A New Perspective on Macroeconomic Phenomena: The Theory and Measurement of the Unobserved Economy in the United States: Causes, Consequences and Implications”, in Walker M, (ed) *International Burden of Government*, Vancouver, pages 112-136. Park T, 1979 “Reconciliation Between Personal Income and Taxable Income 1947-77” mimeo, Bureau of Economic Analysis, Washington DC.

¹³⁴ Giles D, 1996 “Measuring the Size of the Hidden Economy and the Tax Gap in New Zealand: an Econometric Analysis”, Working Paper 5a, Inland Revenue Department (NZ).

the resident withholding tax system in order to reduce the number of taxpayers required to file tax returns.

The beginning of phase two of the project, which is directed at reducing compliance costs for businesses, especially small businesses.

The rewriting of the Income Tax Act to improve the ability of taxpayers to determine, calculate and satisfy their income tax obligations.

The introduction of a system of binding rulings to help taxpayers determine how the tax system applies in particular circumstances.

The planned introduction of legislation to codify the practice of self-assessment.

7.27 In addition, the Inland Revenue Department has been pursuing a range of initiatives aimed at discouraging non-compliance. These initiatives include:

introducing more effective penalty provisions;

making more effective use of information provided through the binding rulings system to identify potential threats to the tax base;

implementing legislation to ensure that stolen money is taxable;

implementing a wide range of compliance improvement initiatives.

7.28 The department's compliance improvement strategy is designed to identify key risks and compliance improvement opportunities and to maximise net revenue over time. The factors considered in the assessment of risk include the revenue at risk, the number of taxpayers involved, the opportunity for non-compliance, and the likelihood of the risk continuing.

7.29 Under the compliance improvement strategy, the Inland Revenue Department has planned the following initiatives.

Improving society's compliance attitudes toward tax compliance by promoting to the community the consequences to the evader and to society generally of people cheating on their tax obligations. The nature of such community awareness programmes is discussed in more detail in the committee's recommendations at the end of this chapter, as well as in chapter 16.

Improving Inland Revenue presence by, for example, co-locating staff with other agencies and enabling staff to work from home in areas where there is no office presence by the department.

Improving detection capability and investigating the effectiveness of conducting random audits.

Utilising intelligence collected from the several customer segments of the department.

Conducting research into the compliance of immigrants who have English as their second language by testing the extent to which their businesses are included in the tax system.

Improving staff capability by training new staff and retaining those audit staff with existing experience and by being more competitive in the employment market for these skills.

7.30 The audit selection process complements the compliance improvement strategy by a continuous review of large corporations and by individually selecting taxpayers for audit. The selection criteria include abnormal financial ratios or trading results, prior audit results and selected industry audits based on risk.

7.31 The Special Audit section of the department audits illegal activities, such as drug dealing and white-collar crime. This work is difficult and often dangerous. The committee commends the work done by the Special Audit staff and recognises the valuable contribution they make. The committee notes that the resources of Special Audit doubled in 1996 and a review of those resources is being conducted at present with a view to an increase.

7.32 As shown in Table 6, the Inland Revenue Department collects considerable revenue from its audit activities. Officials advised the committee that much of the revenue identified by Special Audit in the 1997-98 period was deferred for assessment pending the introduction of legislation making stolen money assessable.

TABLE 6: REVENUE FROM AUDIT ACTIVITIES

	<i>Special Audit</i> (\$NZ million)	<i>All Other Audit areas</i> (\$NZ million)	<i>Total Audit</i> (\$NZ million)	<i>Total Audit as a % of Total Tax Revenue collected by Inland Revenue</i>
1995/96	\$17.6	\$436.8	\$454.4	1.7
1996/97	\$35.3	\$528.6	\$563.9	2.1
1997/98	\$15.2	\$569.6	\$584.8	2.1

NB: 'All Other Audit Areas' is all audit functions except Special Audit. The Special Audit figure is for additional tax assessed, measured on a cash basis, while the figure for all other audit areas is for non-compliance detected, which is measured on an accruals basis, and omits taxpayer errors, voluntary disclosures and objections and cases stated.

Committee's recommended approach to reducing tax evasion

7.33 Although the estimated size of the hidden economy in New Zealand is around the lower to middle level for OECD countries, this is not a reason to be complacent. There is little doubt that the level of tax evasion in New Zealand would have been much higher now had previous governments not decided to broaden the tax base, reduce tax rates, and extend withholding tax regimes to cover a wider range of income.

7.34 These measures were implemented as part of the programme of tax reform that New Zealand has pursued since the mid-1980s. It seems likely that an inadvertent by-product of this major programme, and of the restructuring of the Inland Revenue Department that followed, may have been that the department was left with insufficient resources to tackle residual areas of tax evasion, particularly where the essential problem is non-declaration of income. In this connection, there are two factors to bear in mind.

7.35 First, measures to reduce tax rates, to broaden the tax base and to introduce withholding taxes chiefly involve changes in the law, followed by appropriate systemic changes to the department's administration. Attacking non-declaration of cash receipts or, say, discovering undeclared income kept in bank accounts in foreign countries, require other techniques: skilful auditing, careful detective work, and so on.

7.36 Secondly, tax evasion in the form of simple non-declaration of income appears nowadays to be concentrated in some relatively specific areas of the economy. The committee reaches this conclusion by setting to one side areas of the economy and types of transaction that do not lend themselves to evasion. Wages and salaries are the prime example. The PAYE system means that it is likely to be rare for wage and salary earners to evade tax simply by means of suppressing receipts. The same consideration applies to taxpayers who derive interest or dividends. Withholding tax that is now applied at source makes the non-declaration of interest or dividends an unpromising evasion strategy.

7.37 Different considerations that lead to a similar conclusion apply to large businesses that must entrust the preparation of accounts and tax returns to employees, and to businesses whose main sales are to other businesses, and not to retail customers. Tax evasion needs secrecy, which cannot be guaranteed if a firm's tax affairs must be known to employees, or if customers or suppliers are themselves in business and, therefore, have a duty to keep records of transactions for tax purposes. On the other hand, undertakings where evasion is a practical proposition

include owner-operated businesses, businesses whose customers buy on private or capital account, and businesses that take some or all of their receipts in cash. The problem is exacerbated in such businesses by the factor of competition. If a few businesses evade tax, they are able to reduce prices. Often, competitors will feel obliged to follow suit in order to meet the market. Tax evasion by one can thus breed tax evasion by others.

7.38 Several conclusions follow from these considerations. First, although, like a number of other countries, New Zealand has a hidden economy estimated at about 10 per cent of GDP, in specific sectors it is likely that the proportion of receipts that are suppressed, and of tax that is evaded, is very much higher. Secondly, there are few, if any, broad-brush legislative responses. Rather, the Commissioner must rely on administrative measures, such as better taxpayer intelligence and better audit techniques. Like any tax authority, the New Zealand Inland Revenue Department keeps these matters in mind. However, as mentioned, it may be that in recent years the department has not kept evasion as much in mind as desirable.

7.39 One reason is that the attack on tax aspects of the hidden economy must differ from other fiscal measures. Major reforms, such as adopting a company imputation system or enacting withholding taxes, take a long time to plan; once in place, however, they can often be left to carry out their tasks. For the hidden economy, major systemic reforms are seldom feasible. Each improvement of audit technique or accretion to information about taxpayers is relatively small in the total scheme of the tax system. It follows that to be effective, such improvements must be regular and inexorable; Inland Revenue management should not implement some reforms to combat evasion and then turn its attention elsewhere, intending to return to evasion in some years' time. Rather, anti-evasion strategy should follow the "Kaizen" theories pioneered by the American philosopher of management, Edwards Deming.¹³⁵ This strategy is the committee's major recommendation for tax evasion. Below, the committee considers a number of more specific measures.

¹³⁵ See, for example, Deming, W Edwards, 1982, 1986, *Out of the Crisis*, Massachusetts Institute of Technology; Kaizen, M I, 1986, *The Key to Japan's Competitive Success*, Random House. Of Deming's celebrated, if somewhat ponderous, '14 Points for Management', the most relevant in the present context is number 5: 'Improve constantly and forever the system of production and service, to improve quality and productivity...' (at page 23).

7.40 Deming argued that good management requires businesses to strive constantly for improvements in systems and techniques. Deming deplored the spasmodic improvements that he saw in many American businesses, which would invest heavily in planning and implementing new systems or plant, but then leave those systems or plant to operate unrefined for some years before circumstances forced another review. Deming advocated keeping systems constantly under review and making small regular improvements as opportunities offered. In the committee's opinion, this approach should be used in attacking the hidden economy. Major systemic successes are elusive, though they are most welcome when they occur. The committee **recommends** that an appropriate goal should be a sustained accretion of improvements, that steadily whittle away at the amount of tax that is evaded and that enable the department to respond quickly to new business techniques or to new systems of concealment that offer opportunities for new methods of evasion.

7.41 In order to maintain a strategy of a sustained, always improving attack on tax evasion, there is a need to ensure that the Inland Revenue Department keeps up to date with recent literature on anti-evasion measures, gathers and exchanges information about administration from and with foreign tax departments, and gathers information from the field in New Zealand. The objective must be to move smoothly to the next stage of the process, namely, to deploy this information in an anti-evasion strategy that is continually reviewed, tested, and updated. Tax departments need a formalised and regular means of bringing international experience and scholarly writings to bear on their attack on tax evasion. The committee understands that the activities that it has in mind are divided between the department's Policy Advice and Operations divisions. However, the committee does not have a grip on the methods that the New Zealand Inland Revenue Department employs for planning and executing anti-evasion strategies, nor, in particular, whether there is a unit dedicated to the task or whether this work is shared by a number of units. The committee leaves it to the Commissioner to decide whether policy formation and strategic planning as to the hidden economy and tax evasion should take place within the Policy Advice division or the Operations division or within a unit that draws personnel from each division. But the committee has no doubt that there should be a rationalisation and coordination of departmental expertise and focus in this area.

7.42 In addition, the committee **recommends** that the targeting of audits should not be based solely on the amount of tax being evaded by a particular taxpayer. Rather, the Inland Revenue Department should also

target types of tax evasion that involve many taxpayers evading tax on small amounts of income. This approach would provide a more effective deterrent to tax evasion by drawing the attention of a wider range of tax evaders to Inland Revenue's audit activities.

7.43 Exactly what level of resources should be devoted to audit activity is not a straightforward matter. At first sight, it appears that the solution is to keep increasing the amount spent on audit until the marginal increase in revenue raised equals the marginal cost to the Inland Revenue Department associated with conducting that audit.

7.44 On closer inspection, however, this approach may result in an over-investment in audit activity because the benefits of increased audit activity are not equal to the amount of revenue raised. That revenue is simply a transfer from one group in the community (those not previously paying tax) to another (the recipients of government spending financed by that revenue). By reducing the expected rewards that taxpayers gain from investing resources in evasion activities, auditing lessens the extent to which taxation distorts taxpayers' decisions. The real benefits of audit activity are the reductions in those distortions to economic decision making and the more equitable distribution of income that results from improved compliance.

7.45 As outlined below, the committee also **recommends** that the Inland Revenue Department should:

continually identify opportunities for tax evasion;

continually look for new opportunities for the efficient operation of withholding tax methodologies, whether of existing or new design;

develop a strong community awareness of the cost to the community of tax evasion in terms of facilities, benefits and opportunities foregone, and the increased cost of existing services and facilities;

review the law relating to non-cash transactions, and effectively communicate the law to those sectors of the community where non-cash transactions are prevalent.

Identifying opportunities for tax evasion

7.46 By focusing on situations that provide opportunities for tax evasion, the Inland Revenue Department can more effectively target its audit activities. The department needs formally to evaluate the range of opportunities that taxpayers have for non-compliance with the tax sys-

tem, and the circumstances in which the reporting of income may be avoided.

7.47 The incentive to evade taxation arises, for example, when the payer incurs a cost on a private account, such that the service provider is taxable and has to account for GST on the consideration for supply, and the payer obtains no relief for income tax or GST on the outgoing payment.

7.48 Tax evasion, however, is not solely the province of those involved in cash transactions. The Inland Revenue Department has in place methodologies for drawing its attention to tax evasion in many sectors of the economy. It is also improving both the way and speed with which it makes use of that information. However, the department must continue to focus on the opportunities for accessing and analysing useful information, to make the information available to those who are responsible for remedial and investigative actions, and to encourage the expectation that such actions be done promptly.

Withholding tax systems

7.49 The Inland Revenue Department should continue to look for new areas to apply withholding tax systems, taking into account their effectiveness in reducing the scope for tax evasion. This approach implies not only applying existing withholding tax systems to other areas, but also developing new systems. Such withholding systems should not, however, impose additional costs on those people who are responsible for making deductions, or who must disclose their income to the Inland Revenue Department. The committee discusses withholding tax systems in more detail in chapter 11.¹³⁶

Community awareness programmes

7.50 The committee supports the Inland Revenue's decision to investigate the development of an integrated programme to alter community perceptions of the acceptability of tax evasion, and to promote voluntary compliance. Such community awareness programmes are also discussed in chapter 16 of this report.¹³⁷

¹³⁶ See paras 11.1 to 11.28

¹³⁷ See paras 16.32 to 16.36

7.51 To this end, the committee **recommends** that the department should work closely with community groups, tax practitioners and particularly with specialists in public awareness campaigns to develop industry profiles and more effective compliance at all levels. In developing a community awareness programme, the focus should be on:

- the costs of the cash economy to the community;
- the fact that there is no excuse for the non-declaration of income;
- the introduction of an awareness programme of tax obligations and moral attitude in school education curricula;
- the seriousness of the consequences of detection;
- the details of the department's initiatives on the cash economy, including community presence;
- the publication of instances of evasion that have been identified and, where appropriate, the actions taken.

7.52 Other community initiatives might include the development, implementation and promotion of a programme about keeping good records and getting professional advice, and the development of 'industry tool-kits' to enhance tax agents' attention to tax matters of relevance for industry clients. The Inland Revenue Department could also introduce non-financial sanctions, such as educational measures, when a default is the result of lack of understanding rather than an intentional default.

7.53 The department could also consider the programmes recommended by the Australian Task Force on the Cash Economy, such as the community communication programme and the government agency co-ordination.

Review of the law relating to non-cash transactions

7.54 The law in relation to bartered goods and services is somewhat unclear. The courts have at times relied on the convertibility principle, which says that goods supplied to another person constitute income only if they can be converted into money.¹³⁸

7.55 While benefits in kind to employees are taxed under the fringe benefit tax rules, uncertainty remains when people who are not in an employment relationship exchange goods and services. The committee

¹³⁸ See, for example, *Tennant v Smith* (1892) 3 TC 158

recommends that the law should be clarified so that such transactions do give rise to taxable income even when they cannot be converted into cash. This clarification still leaves the issue of how to value these goods and services. The only practical measure appears to be the market value of the goods or services supplied. The committee **recommends** that the government should review the law surrounding barter transactions.

7.56 The committee also **recommends** that the department should effectively communicate a suitable explanation of the tax law relating to barter transactions to those sectors of the community where barter transactions are prevalent.

CHAPTER 8 – DISCLOSURE

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Introduction

8.1 In this chapter, the committee looks at the role of disclosure in a self-assessment environment. Self-assessment relies on taxpayers voluntarily meeting their tax obligations. This concept is recognised in section 15B of the Tax Administration Act 1994, which sets out taxpayers' primary obligations, and clearly spells out that taxpayers are required to determine the amount of tax payable correctly and to pay it on time.

8.2 Disclosure in this context serves two main purposes. First, it is necessary to provide information for audit selection. Secondly, disclosure is relevant to the issue of the abatement of penalties.

8.3 Taxpayers have a statutory obligation to disclose to the Commissioner in a timely and useful way all information required to be disclosed under the tax laws.¹³⁹ Disclosure here covers items specifically required to be disclosed by statute,¹⁴⁰ and items for which disclosure is required by the Inland Revenue Department. For income tax, under section 33 of the Tax Administration Act 1994, the department requires a complete statement of the taxable income of the taxpayer for the preceding year, together with such other particulars as may be prescribed. The department's disclosure expectations cover any requirements set out in a particular tax return, in the guide accompanying a particular tax return, or

¹³⁹ Section 15B(e), Tax Administration Act 1994

¹⁴⁰ For example, statutory elections required to be disclosed and details of subvention payments.

matters for which a specific disclosure form is prescribed. The Commissioner can also require specific taxpayers to disclose particular information under provisions such as section 17 of the Tax Administration Act 1994. These categories are referred to below as required disclosures.

8.4 The committee **recommends** that section 15B(e) of the Tax Administration Act 1994, which states that taxpayers must disclose to the Commissioner in a timely and useful way all information required to be disclosed under the tax laws, should be amended to identify the different categories of required disclosures: information specifically required by statute, information required by the department in a prescribed form, and information requested by the department from specific taxpayers.

8.5 Generally, apart from required disclosures, taxpayers are not obliged to disclose information, but anything that is disclosed must not be misleading. Sanctions may be imposed for deliberately misleading disclosures, and taxpayers open themselves up to the risk that a deliberately misleading disclosure could suggest tax evasion on their part.

8.6 An intent to evade may also be inferred from a failure to disclose relevant information to the Commissioner.¹⁴¹ The risk also arises that defaults of this nature may preclude the application of a time bar.

8.7 Even for required disclosures, some real issues arise, including the way in which the obligations to disclose are affected by e-filing procedures, and the use of e-filing under self-assessment. In practice, under e-filing, it appears that the Inland Revenue Department accepts that if the approved software does not ask for the information, it is sufficient that the information is on the taxpayer's own files and available for examination by the department.

8.8 This acceptance leaves open, however, whether, and to what extent, availability must be within a reasonable proximity to the taxpayer's own tax-file. Many advisers insist on forwarding to the Inland Revenue Department hard copies of documents making any required disclosures not accommodated by the e-filing software, to avoid any risk the department will state later that disclosure was not made as required. Clearly, that taxpayers and their advisers consider they may have to act

¹⁴¹ An intent to withhold information lest the Commissioner should consider the taxpayer liable to a greater extent than the taxpayer is prepared to concede may constitute evasion: *Denver Chemical Manufacturing v Commissioner of Taxation (New South Wales)* (1949) 79 CLR 296.

in this way is unsatisfactory, as it defeats the benefits in efficiency contemplated by e-filing.

Disclosure in the self-assessment environment

8.9 Disclosure requirements must be consistent with self-assessment. Generally, at the time the return is filed, the Commissioner will be given only information that is necessary for the Inland Revenue Department's audit selection process. The committee recognises, therefore, that business taxpayers should keep information on file to assist Inland Revenue Department investigators if they are selected for audit.

8.10 The requirement for disclosure differs between groups of taxpayers. For example, before the recent reforms, only minimal disclosure was necessary for wage and salary earners, because the department already had the necessary information about this group from their employers. Audits of large corporations are ongoing and, therefore, for the purposes of audit selection, disclosure is not necessary. Disclosure mainly affects small and medium-sized business enterprises.

8.11 The committee has no doubt that with the introduction of full self-assessment procedures the government will address issues of disclosure. However, the committee would encourage the department to focus not only on the information that it needs to process tax assessments, but also on ways in which the department can be kept informed of issues relating to individual taxpayers that may be relevant to its audit selection, and on ways in which the department might assist taxpayers in suitably recording all key information on tax positions taken.

8.12 The committee considers that the government should recognise, when developing new disclosure requirements, that the move to self-assessment places significant obligations on taxpayers, the importance of which are reinforced by the penalties provisions. The government should also recognise that if the Inland Revenue Department wishes to be informed of particular situations, arrangements, or matters affecting the tax position of a taxpayer, under modern assessment processing procedures the department must use specific disclosure requests or pursue specific initiatives.

The tax return

8.13 The Organisational Review of the Inland Revenue Department in 1994 identified that the tax system in New Zealand already operated substantially by means of self-assessment by which individual taxpayers

are required to determine their own tax liabilities and account for them to the Commissioner.

8.14 In many situations, however, the law is drafted in such a way as to require the Commissioner to make the assessment. This system requires taxpayers to provide information that is then used to assess their liability. The key difference under self-assessment is that taxpayers are required to interpret the law, apply that law to their circumstances, and assess their own liability.

8.15 The government is considering the introduction of a comprehensive self-assessment system. As a result, it is timely to consider the purpose of the tax return in a self-assessment environment.

8.16 An annual tax return can be viewed as having one main purpose – it is the method by which taxpayers inform the Commissioner how much tax they are required to pay. This return allows the Commissioner to check that that stated amount of tax has been paid and, if not, to impose a late payment penalty.

8.17 Beyond this, a tax return can be a method of communicating with taxpayers, allowing taxpayers to update their personal details, and collecting information for forecasting and audit purposes. Also, tax returns, as they are designed at present, may educate taxpayers by leading them through the steps required to determine their tax liability.

8.18 A final indirect purpose of the tax return is to provide information for statistical purposes. This purpose is likely to become increasingly important as the emphasis on reducing compliance costs across the public sector places pressure for information to be collected only once.

8.19 The committee **recommends** that the department should consider reviewing each of the purposes of the tax return to decide whether the return remains the most appropriate vehicle for these functions. It may be that the tax return could simply be a pay-in slip, with the other purposes of a tax return being dealt with independently.

8.20 The committee looked at whether different levels of disclosure could be applied to different classes of taxpayer. For example, for large taxpayers with more sophisticated systems, disclosure of accounting information may involve little more in compliance costs than limited disclosure. Therefore, the committee considers that the review suggested should be coupled with a consideration of the application of increased use of technology. Technology provides many opportunities for low-cost high-volume transfer of information. The committee **recommends** that

the Inland Revenue Department should examine the application of technology to its disclosure requirements.

Information retention under self-assessment

8.21 If the government adopts the recommendation to review each of the purposes of the tax return, this review should be undertaken in conjunction with a consideration of the records that taxpayers must keep under self-assessment. Otherwise the risk arises that the information required by the Commissioner to verify an assessment made by a taxpayer will not be available. The committee **recommends** that such a review should be undertaken at the same time as the review of return filing obligations.

8.22 The committee also considers that if record-keeping requirements are increased, taxpayers should receive some education on the necessity for those requirements. To help in this matter, the committee notes that it would be eminently worthwhile to encourage taxpayers on their own initiative to record relevant information considered by them in adopting a particular tax position.

8.23 The committee suggests that the Inland Revenue Department should prepare forms designed to help taxpayers focus on the right issues, thereby reducing the risk of inadvertent error or omission. It remains for the Inland Revenue Department to identify the areas of tax compliance where the use of prescribed forms may yield the greatest dividends both for taxpayers and government. However, three areas which immediately suggest themselves as candidates for prescribed information forms include the approaches taken to tax aspects of the valuation of trading stock, the disposal of real property, and the disposal of shares. The committee considers the benefits of this concept apply more broadly and similar forms should be developed for all taxes, where such a need arises.

8.24 The committee envisages that these forms would be used by small taxpayers, mainly those without a tax agent. These forms would both guide taxpayers through the activities outlined above and would, if retained as the committee hopes, provide a permanent record, should the taxpayer be audited. Many tax agents may also find it prudent to complete and retain these forms as part of their evidence of having taken reasonable care. The committee considered recommending legislating for the preparation and retention of these forms, but taking into account the diversity of taxpayers' accounting systems and approaches, the committee concluded that the best approach was to consider methods of encour-

aging the use of the forms. The committee notes that failure to maintain on file either prescribed information forms or forms setting out tax positions would not imply lack of reasonable care of any other tax default. Retaining these records would reduce uncertainty, which might otherwise arise as to taxpayers' actions.

8.25 The committee, therefore, **recommends** that the Inland Revenue Department should prepare and send out to taxpayers, or where appropriate their agents, forms which guide them through their key annual income tax activities, and also act as a record for audit purposes. In forwarding the forms to taxpayers, the Inland Revenue Department should inform recipients of the benefits of completing and retaining the forms in fulfilment of expectations as to the exercise of reasonable care and other taxpayer performance standards.

Reduction of penalties for disclosure

8.26 As the committee has noted, proper disclosure is fundamental to the tax system. Limitations on the time and resources available to the committee precluded it making a detailed examination of this area. However, the disclosure expectations required by the tax system have to be married with the features and needs of the self-assessment process.

8.27 The whole issue of disclosure is of sufficient importance to be a matter for informed public debate. As the matter is one which is all-pervasive, the committee **recommends** that the issue should be considered as part of the review of penalties to be conducted in 1999. This review will involve public consultation.

8.28 The committee notes that under the law at present, different levels of culpability lead to different penalties. Significant reductions in penalties occur where taxpayers disclose their tax positions to the Commissioner before the tax shortfall is identified on audit or otherwise. Shortfall penalties are reduced by 75 per cent for voluntary disclosure before notification of an audit, and by 40 per cent for voluntary disclosure after notification of an audit but before the audit starts.¹⁴² A shortfall penalty payable by a taxpayer for having an unacceptable interpretation or having taken an abusive tax position is reduced by 75 per cent if adequate disclosure is made at the time of filing the tax return.¹⁴³

¹⁴² Section 141G, Tax Administration Act 1994

¹⁴³ Section 141H, Tax Administration Act 1994

8.29 The committee favours increasing the incentives in the penalties provisions for taxpayers to disclose information as this seems the best way to encourage taxpayers to disclose doubtful positions before they are audited. This proposal may involve both greater reductions in penalties and increased levels of penalties in certain cases, for example, when a taxpayer takes an abusive position. The committee concluded that the best way to encourage taxpayers to be open about their tax affairs would be to develop the penalties provisions further by providing relief from shortfall penalties when appropriate disclosures are made by taxpayers.

8.30 In principle, a self-assessment system focuses on taxpayers making their own decisions on the tax positions they take. An objective is to avoid deluging the Inland Revenue Department with information which it does not need in order to carry out its functions. However, it remains appropriate that taxpayers are open about the tax positions that they take, particularly when they may be uncertain.

8.31 A compromise appears necessary. That compromise must focus on the need for the Inland Revenue Department to be made aware of matters of real potential significance, and for other information to be held on file for ready examination by the Inland Revenue Department during any audit or inquiry. The catalyst for achieving the objective would be the provision of further relief from penalties in situations where the taxpayer has taken all steps reasonably required in a self-assessment system.

Public discussion on disclosure

8.32 As the committee has noted, proper disclosure is fundamental to the tax system. The issue is of sufficient importance to be a matter for informed public debate. The committee has not had the opportunity to develop its ideas to the extent it would have liked. However, the committee believes that the principles it has outlined form the basis for developing a workable solution to the important matter of disclosure by taxpayers. The issues should be considered as part of the planned penalties review in 1999.

8.33 The committee **recommends** that, among other issues, the penalties review should include consideration of:

The concept of encouraging the retention on file of particulars of tax situations and their rationale if some uncertainty is involved.

The issue of requiring disclosure if the tax at risk in a tax position exceeds a specified threshold. Such disclosure would be re-

quired to be accompanied by sufficiently informative statements on the tax situation at issue and the tax position taken.

The role of record-keeping versus disclosure to the Commissioner and the appropriate treatment of such disclosure.

CHAPTER 9 – COMMISSIONER’S INFORMATION-GATHERING POWERS

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ACCESS TO PREMISES AND REQUISITIONS FOR INFORMATION

Introduction

9.1 Sections 16 and 17 of the Tax Administration Act 1994, relating to access to premises and requisitions for information, constitute the Commissioner’s main information-gathering powers. In this chapter, the committee identifies a number of deficiencies in these provisions and recommends remedial amendments.

9.2 In a self-assessment environment, the provision of accurate and timely information in response to the Commissioner’s requisitions becomes very important, as the Inland Revenue Department places increased emphasis on the post-assessment phase of tax collection.

9.3 In order to achieve an equitable levying of taxes, the Inland Revenue Department should, in principle, possess or have access to all information which might affect a taxpayer’s liability to tax. The department’s resources should be focused on ensuring that all taxpayers pay the correct amount of tax on time. Its resources or energy should not be dissipated in disputes over whether or not it is entitled to have access to a particular item of information.

9.4 Information is the lifeblood of the department’s taxpayer audit

activity. The Privy Council in *New Zealand Stock Exchange and National Bank of New Zealand v CIR*,¹⁴⁴ confirmed the wide ambit of the Commissioner's information-gathering powers and related those powers to the Commissioner's public duty of correctly assessing the taxable income of all taxpayers.

By accident or design, a taxpayer may default in his obligation to furnish a return or to disclose all his assessable income. In order to discharge his duty of assessing and recovering tax on all taxable income, the Commissioner must discover the names of the taxpayers and the respective sources and amounts of their assessable income.¹⁴⁵

Information-gathering powers

9.5 The Commissioner's main information-gathering powers are contained in sections 16 and 17 of the Tax Administration Act 1994, and relate generally to access to premises and to requisitions for information. The major exception to these powers is legal professional privilege which is the subject of the next part of this chapter.¹⁴⁶

9.6 Under section 16, the Commissioner, or an authorised officer, has at all times full and free access to all places to inspect any books, documents or any matter which the Commissioner considers necessary or relevant for tax purposes. The words 'books' and 'documents' are defined very widely to include records stored electronically and any other type of record. The owner or manager of any property or business which is being investigated may be required to give all reasonable assistance when the Commissioner is exercising his right of access, and to answer all proper questions relating to the investigation either orally, in writing, or by statutory declaration. The Commissioner may also make extracts from or copies of any books or documents which are inspected.

9.7 This general right of access to premises is subject to specific provisions governing access to private dwellings. Entry to private dwellings is not permitted unless the departmental officer has obtained the consent of the occupier, or a judicial warrant has been obtained authorising such entry; the judicial officer issuing such a warrant must be satisfied that it is necessary or relevant for tax purposes.

¹⁴⁴ (1991) 13 NZTC 8,147

¹⁴⁵ (1991) 13 NZTC 8,147 at 8,148

¹⁴⁶ Section 20, Tax Administration Act 1994

9.8 Under section 143H of the Tax Administration Act 1994, it is an offence for anyone to obstruct an officer of the department in the exercise of his or her statutory powers. Therefore, it is an offence to refuse an officer access to premises contrary to section 16, including access to private premises when the officer has a judicial warrant authorising entry. The penalty on conviction for such an offence is a fine of up to \$25,000 on the first occasion, and up to \$50,000 on any subsequent occasion.

9.9 Under section 17, the Commissioner can require anyone to furnish in writing any information, or produce for inspection any books or documents in their knowledge, possession, or control, which the Commissioner considers necessary or relevant for tax purposes. Written information may have to be verified by statutory declaration. The Commissioner may also remove and retain any books or documents produced for inspection for so long as is necessary for a full and complete inspection of them.

9.10 The Commissioner is not required to identify particular taxpayers when requisitioning information under section 17, and is entitled to requisition information about a class of unidentified taxpayers from third parties, such as banks. This interpretation was confirmed by the Privy Council in *New Zealand Stock Exchange*.¹⁴⁷ With the exception of legal professional privilege, section 17 overrides any contractual duty of confidence, such as that arising from the relationship of banker and customer. The Privy Council in *New Zealand Stock Exchange* said:

The whole rationale of taxation would break down and the whole burden of taxation would fall only on diligent and honest taxpayers if the Commissioner had no power to obtain confidential information about taxpayers who may be negligent or dishonest.¹⁴⁸

9.11 It has been held that section 17, by necessary implication, abrogates the right not to answer questions that tend to incriminate: *Singh v CIR*;¹⁴⁹ *Commissioner of Customs v Ingram*.¹⁵⁰ No one can, therefore,

¹⁴⁷ *New Zealand Stock Exchange and National Bank of New Zealand v CIR* (1991) 13 NZTC 8,147

¹⁴⁸ (1991) 13 NZTC 8,147 at 8,149

¹⁴⁹ (1996) 17 NZTC 12,471

¹⁵⁰ [1949] 1 All ER 896

refuse to provide information under a section 17 requisition on the ground of self-incrimination. In *Singh*, the court stated:

The purpose of the enquiry is to further an investigation initiated because of suspected breaches of the Inland Revenue Department Act. That purpose would be defeated if a taxpayer or other person to whom the request were directed were able to decline to answer on the grounds that the information or material may do exactly what the Commissioner is seeking to do, namely to find evidence relating to possible enforcement proceedings.¹⁵¹

9.12 Under section 143 of the Tax Administration Act 1994, it is an offence to fail to provide information to the Commissioner when required to do so by a tax law. The penalty on conviction for such an offence is a fine of up to \$4,000 on the first occasion, \$8,000 on the second occasion and \$12,000 on any subsequent occasion.

9.13 The importance attached to the Commissioner's power to obtain information under section 17 is reflected in the statement of taxpayers' primary obligations in section 15B of the Tax Administration Act 1994. Disclosure of all information that the tax laws require the taxpayer to disclose must be made to the Commissioner in a timely and useful way.

Remedial amendments to sections 16 and 17

9.14 In this chapter, the committee recommends some remedial amendments to correct deficiencies identified in sections 16 and 17. Several of these deficiencies were highlighted in the evidence given on specific investigations by the Inland Revenue Department to the Davison Commission.¹⁵² In its evidence, the department also outlined the barriers frequently encountered in investigations, providing examples of the way in which Inland Revenue Department investigators were hindered in obtaining information.

Records of offshore entities controlled by New Zealand residents

9.15 Under section 17, the Commissioner can require a person to produce for inspection any records in the possession or under the control of that person. Can the section be used to require New Zealand residents

¹⁵¹ *Singh v CIR* (1996) 17 NZTC 12,471 at 12,477

¹⁵² For a brief outline of the work of the Davison Commission, see appendix 2.

who control offshore entities to produce for inspection the records of such entities which are held offshore?

9.16 The answer turns on the meaning of ‘control’, in particular, whether documents can be regarded as being under the control of a person because that person controls a company which controls those documents. In substance, a New Zealand parent company does have ultimate control over the records of its offshore subsidiaries. However, the records of an offshore subsidiary of a New Zealand company are strictly under the legal and direct control of the offshore subsidiary and its board of directors.

9.17 The Davison Commission considered this issue. Some companies responded to section 17 requisitions for the records of their offshore subsidiaries by saying that the information was the property of the subsidiary company, and it was the decision of the directors of that company either to provide or withhold the information. In its evidence to the Davison Commission, the Inland Revenue Department stated that such responses were an example of the way in which its auditors were often hindered in obtaining all relevant records. The department also cited the delay in obtaining access to such offshore information, which took months, and sometimes years. In principle, section 17 should apply to the records of offshore subsidiaries. The corporate veil can be used too readily to frustrate legitimate investigations of entities which are, in substance, under the control of New Zealand taxpayers.

9.18 The committee favours an amendment to section 17 to ensure that the section can be used to require New Zealand resident individuals and companies to produce for inspection in New Zealand the records of their offshore subsidiaries, which are held offshore. The amendment could involve deeming such records to be under the control of the New Zealand resident.

9.19 For the purposes of determining whether an offshore entity is under the control of a New Zealand resident, any voting interests in that offshore entity held by persons associated with that New Zealand resident should be aggregated with the voting interests held by the New Zealand resident. Such an aggregation rule,¹⁵³ would be necessary to prevent taxpayers circumventing the provision by fragmenting their in-

¹⁵³ Similar to that used in the controlled foreign company regime.

terests among associated parties. Also, any nominal shareholding held for the purposes of compliance with company law requirements should be disregarded.

9.20 The amendment could provide that any foreign secrecy laws that purportedly restrict the production of any records should be ignored. This measure would preclude any defence of foreign state compulsion, and would be appropriate because an important reason for companies establishing subsidiaries in certain countries in the first place is to take advantage of their secrecy laws. The Australian provision, section 264A(12) of the Income Tax Assessment Act 1936, which relates to requisitions for information held offshore, provides that no account is to be taken of foreign secrecy laws. The United States also has several provisions which provide that the fact that a foreign jurisdiction may impose a civil or criminal penalty for disclosing the information sought, is not reasonable cause for failure to comply with the request. Such a provision would be declaratory of the existing legal position, following the decision of the Privy Council in *Brannigan v Sir Ronald Davison*.¹⁵⁴

9.21 Apart from imposing penalties for non-compliance with a section 17 requisition, the Commissioner can make assessments based on the information available to him, including drawing reasonable inferences from a taxpayer's failure to provide evidence.¹⁵⁵

'Necessary or relevant'

9.22 Information can be sought under section 17 only if the Commissioner considers it is 'necessary or relevant for any purposes relating to the administration or enforcement of any of the Inland Revenue Acts'. This requirement has in practice been used by some taxpayers to frustrate legitimate investigations by the Inland Revenue Department. The problem was highlighted in evidence given by the department to the Davison Commission. Some aggressive taxpayers, often acting on professional advice, tested the department on every section 17 requisition, requiring reasons why the department considered the information sought was necessary or relevant. Investigations were slowed down as a result. The Inland Revenue Department also gave evidence that some corporations took the approach first, that an item of requisitioned information

¹⁵⁴ [1997] 1 NZLR 140

¹⁵⁵ See paras 13.54 to 13.80

was not necessary or relevant in terms of section 17, then subsequently stated that they did not have that information.

9.23 The committee considers that the words ‘necessary or relevant’ in section 17 encourage taxpayers to raise spurious arguments and **recommends** that these words should be removed from this section. Because the Commissioner must always act in good faith, removing the phrase from the section would not alter this requirement. As long as the Commissioner has, in good faith,¹⁵⁶ reached the view that an item of information is necessary or relevant for tax purposes, it is a valid requisition.

Sending documents to an Inland Revenue office

9.24 A minor deficiency in section 17 appears in the requirement that a person produce documents for inspection at the person’s premises. The section does not allow the Commissioner to require that the documents are sent to an Inland Revenue office: *Green v Housden*.¹⁵⁷ The committee **recommends** that an amendment should be made to section 17 to give the Commissioner a discretion to require documents requisitioned under the section to be sent to an Inland Revenue office. The discretion could be exercised if the taxpayer’s records were in a remote location and it would be more convenient for any requisitioned documents to be sent to the department. Such an amendment might be achieved by amending the phrase ‘when required’ in section 17(1) to ‘when and where required’.

Removing documents for copying

9.25 Section 16 confers on the Commissioner full and free access to all premises to inspect any books, documents or anything else which the Commissioner considers necessary or relevant for tax purposes. While officers can make extracts from or copies of any books or documents, the Commissioner has no power to remove any books or documents from the premises for the purpose of making copies. The absence of such authority could be problematical in cases where it is not possible or practicable to make copies of documents on the taxpayer’s premises, and a risk arises that the documents might be altered or destroyed if a requisition under section 17 were to be made. This shortcoming seems to be a

¹⁵⁶ Which may include an honest mistake.

¹⁵⁷ (1993) 15 NZTC 10,053

gap in the legislation and the committee, therefore, **recommends** that an amendment should be made to give the Commissioner this authority under section 16.

9.26 Any power to remove and retain books or documents for the purpose of copying them should be accompanied by a requirement for the documents to be returned as soon as practicable to ensure that the exercise of the power does not unduly disrupt a taxpayer's business or activity. This objective should be expressed in the amending legislation so that the positions under section 16 and 17 are the same.

9.27 A precedent for such an amendment is contained in section 165 of the Customs and Excise Act 1996, which authorises a Customs officer to remove from any place any documents for the purpose of making copies. The documents must be returned as soon as practicable after copies of them have been taken. Similarly, section 206 of the Fisheries Act 1996 enables a fishery officer, in the exercise of the officer's other powers under that Act, to remove for a reasonable time any documents for the purpose of taking copies.

Assistance from third parties

9.28 Section 16(2) confers on the Commissioner the power to require the owner or manager of any property or business which is being investigated under section 16, or anyone employed or previously employed in connection with the property or business, to give reasonable assistance in the investigation, and to answer questions relating to the investigation either orally, in writing, or by statutory declaration.

9.29 Exactly who may be required to give reasonable assistance or answer questions under section 16(2) is uncertain. This uncertainty applies particularly to third parties. For example, take the case where an Inland Revenue Department investigator exercises his or her right of access to the records of a bank of which the taxpayer who is being audited is a customer. Some doubt arises whether the bank manager can be required to give the investigator assistance. On one hand, the taxpayer, and not the bank, is the subject of the investigation, so arguably the bank manager cannot be required to give assistance. On the other hand, the right of access to the bank is given to the investigator under section 16(1), so that, for the purposes of section 16(2), it is the bank that is being 'investigated', and the bank manager can be required to give the investigator assistance.

9.30 In principle, third parties should be required to give reasonable assistance to an investigator or to answer an investigator's questions during an inspection of premises under section 16 because the information can be requisitioned under section 17. For example, if an investigator can have access to a bank, he or she should be able to require the bank manager to identify the safety deposit box of the taxpayer who is being audited. A statutory requirement for third parties to give assistance or to answer questions would also protect them from actions for breach of confidence or infringement of the Privacy Act 1993. The committee, therefore, **recommends** that the uncertainty over the ambit of section 16(2) should be resolved by clarifying that it does apply to third parties.

9.31 Ensuring that section 16(2) can apply to third parties could be achieved by replacing the references to 'investigation' and 'investigated' with the words 'inspection or investigation' and 'inspected or investigated' respectively. This amendment would remove any doubt that a third party could be subject to section 16(2).

9.32 An alternative approach would be to adopt the terminology of section 263 of the Australian Income Tax Assessment Act 1936, the equivalent provision to section 16. The relevant parts of this provision are set out below:

(1) The Commissioner, or any officer authorised by him in that behalf, shall at all times have full and free access to all buildings, places, books, documents and other papers for any of the purposes of this Act, and for that purpose may make extracts from or copies of any such books, documents or papers.

(3) The occupier of a building or place entered or proposed to be entered by the Commissioner, or by an officer, under subsection (1) shall provide the Commissioner or the officer with all reasonable facilities and assistance for the effective exercise of powers under this section.

9.33 It is immediately apparent that the Australian provision is more concise than its New Zealand equivalent. It undoubtedly applies to third parties. The main difference between section 16(2) and the section 263 is that the latter does not require that the investigator's questions are answered. However, it is arguable that the requirement to answer questions set out in section 16(2) is redundant, because the Commissioner must be given all reasonable assistance and has other information-gathering powers. Answering questions orally would generally come within the ambit

of the requirement to give the investigator all reasonable assistance. As well as not obstructing the investigator and providing such things as sufficient light, air, and space for an inspection, reasonable assistance would extend to answering questions on the precise location of an item. For example, a bank manager would be required to identify the taxpayer's safety deposit box in a vault. The committee notes that in practice, the Commissioner would not rely on section 17 for answers to such questions, because that section requires information to be furnished only in writing and not orally. Such an approach would not be practical when conducting a search of premises for particular items. Section 17, of course, could be relied on if the investigator wanted written answers to any questions.

9.34 The Australian section 263 also differs in that it applies only to the current occupier of the place being inspected, whereas section 16(2) can apply to former employees, for example, a former bank employee who handled the taxpayer's transactions with the bank. If investigators had to rely on the wording in the Australian provision, they would need to use section 17 to extract written answers from the ex-employee. If investigators wanted oral answers from the ex-employee, they could use section 19 of the Tax Administration Act 1994, which gives the Commissioner the power to conduct an inquiry for the purpose of obtaining information by requiring people to attend before the Commissioner and answer questions.

9.35 In summary, then, the committee **recommends** that the following amendments should be made to sections 16 and 17 of the Tax Administration Act 1994:

Section 17 should be amended to deem the records of an offshore entity controlled by a New Zealand resident to be under the control of that New Zealand resident.

Section 17 should be amended to remove the words 'necessary or relevant'.

Section 17 should be amended to give the Commissioner the discretion to require that documents requisitioned under that section should be sent to an Inland Revenue office.

Section 16 should be amended to allow documents to be removed from premises for copying and to be returned as soon as practicable.

Section 16(2) should be amended to clarify that it applies to third parties.

LEGAL PROFESSIONAL PRIVILEGE

Introduction

9.36 The main limitation on the Commissioner's information-gathering powers is legal professional privilege. Legal professional privilege can attach to both communications in which legal advice is sought and given, and also to communications in the context of litigation. This common law doctrine is embodied in section 20 of the Tax Administration Act 1994.

9.37 In this chapter, the committee considers whether the ambit of legal professional privilege preventing disclosure of information to the Commissioner is too wide, and makes some recommendations limiting the scope of legal professional privilege and its abuse. Two distinct issues arise: first, the abuse of the privilege, and secondly, the Inland Revenue Department's challenges of that abuse.

9.38 Section 20 was originally enacted in 1958 as section 16A of the Inland Revenue Department Act 1952 in response to the Court of Appeal's decision in *CIR v West-Walker*.¹⁵⁸ The enactment was an attempt to express that decision in statutory form, while preventing its application to certain financial records, such as trust accounts. In *West-Walker*, the court held that a solicitor was entitled to decline to furnish to the Commissioner information protected from disclosure by legal professional privilege without the prior consent of the client.

9.39 Section 20 provides that any information or book or document is privileged from disclosure in the following circumstances:

If it is a confidential communication passing directly or indirectly between a legal practitioner in his or her professional capacity and a client, or between legal practitioners in their professional capacity; and

If it is made for the purpose of obtaining or giving legal advice; and

If it is not made for the purpose of committing some illegal or wrongful act.

9.40 Section 20 probably constitutes a code for legal professional privilege to the extent that it applies to communications between a law-

¹⁵⁸ [1954] NZLR 191

yer and a client. A claim for privilege in relation to such communications does not lie apart from the privilege permitted by the section. However, the section is silent on the application of legal professional privilege to protect communications with third parties relating to actual or contemplated litigation. If anyone refuses to disclose information to the Commissioner on the ground that it is privileged under section 20, an application can be made to a District Court Judge to determine whether the claim of privilege is valid.

9.41 The New Zealand courts have followed the approach taken in the United Kingdom and have held that privilege applies if the dominant purpose of the communication relates to the provision of legal advice: *Guardian Royal Exchange v Stewart*.¹⁵⁹ In contrast, the High Court of Australia has adopted a sole purpose test: *Grant v Downs*.¹⁶⁰ However, in practice this approach, as illustrated in *FCT v Citibank Ltd*,¹⁶¹ has not significantly assisted the Australian Tax Office in preventing its investigations being hindered by privilege claims.

9.42 If documents are merely lodged with a lawyer for safe custody, they are not privileged from disclosure: *CIR v West Walker*.¹⁶²

9.43 In *Leary v Federal Commissioner of Taxation*,¹⁶³ a decision of the Australian Federal Court, it was held that a lawyer acting primarily in the role of a promoter of a scheme was unable to rely on legal professional privilege. Brennan J explained that:

[The] activities of an entrepreneur in the promotion of a scheme in which taxpayers would be encouraged to participate fall outside the field of professional activities; those activities are not pursued in discharge of some antecedent professional activity. Entrepreneurial activity does not attract the same privilege nor the same protection as professional activity; and the promotion of a scheme in which particular clients may be advised to participate is pregnant

¹⁵⁹ [1985] 1 NZLR 596

¹⁶⁰ [1976] 135 CLR 674

¹⁶¹ (1989) 89 ATC 4268

¹⁶² [1954] NZLR 191

¹⁶³ (1980) 80 ATC 4438

with the possibility of conflict of entrepreneurial interest with professional duty.¹⁶⁴

9.44 In *Miller v CIR*,¹⁶⁵ the High Court held that legal professional privilege extends to communications between salaried solicitors and their employer clients, if the solicitor is acting in his or her capacity as a legal adviser, and not in some other capacity, such as an executive capacity. The case involved discovery of legal opinions prepared by Inland Revenue solicitors. Baragwanath J applied the main Commonwealth precedent of *Alfred Crompton v Customs and Excise Commissioners (No 2)*.¹⁶⁶

9.45 In *Dinsdale v CIR*,¹⁶⁷ the High Court has also recently held that legal professional privilege does not extend to the notes of interviews conducted with a number of third parties by auditors of a bank on instruction from the bank's solicitors. The notes were not communications between a lawyer and client, so section 20 did not apply. The High Court's decision was upheld by the Court of Appeal.¹⁶⁸

Hindrance of investigations

9.46 There is ground for arguing that legal professional privilege is being used to obstruct the Inland Revenue Department whose auditors are obliged at present to allow taxpayers the opportunity to claim privilege for any requisitioned documents: *FCT v Citibank Ltd*.¹⁶⁹ In evidence before the Davison Commission, legal professional privilege was cited by the Inland Revenue Department as:

... one of the biggest obstacles to the Inland Revenue Department when it is conducting large corporate investigations. ... The veil of privilege weakens the department's ability to carry out its [revenue collection] duty because of the opportunity it provides for exploitation.¹⁷⁰

9.47 The following examples of where the Inland Revenue Department considers that its investigations have been hindered, and which

¹⁶⁴ (1980) 80 ATC 4438 at 4452

¹⁶⁵ (1997) 18 NZTC 13,001

¹⁶⁶ [1972] 2 QB 102

¹⁶⁷ (1997) 18 NZTC 13,244

¹⁶⁸ (1998) 18 NZTC 13,583

¹⁶⁹ (1989) 89 ATC 4268

¹⁷⁰ Nash, July 1995, Supplementary Brief of Evidence, page 19

mainly concern privilege claims, were given by the department in its evidence to the Davison Commission:

Claiming privilege for materials held on a solicitor's file but clearly not involving matters of legal advisory nature.

Taking a restrictive interpretation of the word 'control' over information held by a corporation's solicitors, when faced with a wide-ranging Inland Revenue Department information request.

Removing documents from files made available for inspection and not informing the Inland Revenue Department that legal professional privilege has been claimed.

Mixing documents relating to transactions with, or not separating them from legal advisory papers, and claiming a blanket privilege for all documents.

Including transaction details in the document containing legal advice to hide them from the Inland Revenue Department.

Preventing access to offices where important records may be retained without giving the owner sufficient notice that a claim of legal professional privilege can be made.

Claiming privilege through accountants and officers of companies holding legal practising certificates.

9.48 Some of these practices seem to the committee so clearly outside the scope of any valid claim to privilege that they are clearly beyond the limits of acceptable professional behaviour.

9.49 As well as severely limiting the Inland Revenue Department's powers to obtain information, such broad claims for legal professional privilege provide lawyers with a competitive advantage vis-à-vis other tax advisers. Privilege may be claimed for tax advice from a lawyer when advice of exactly the same nature provided by an accountant, would not be privileged. Accounting professionals have expressed their concern, although their preference is to widen professional privilege to include advice from accountants.

9.50 It is well established that no privilege exists against self-incrimination in relation to the Commissioner's information-gathering powers: *Singh v CIR*; ¹⁷¹ *Commissioners of Customs and Excise v In-*

¹⁷¹ (1996) 17 NZTC 12,471

gram.¹⁷² Lord Goddard CJ stated that such privilege would ‘stultify the whole purpose’ of the revenue’s information-gathering powers.

9.51 It seems to the committee that the existence of legal professional privilege in tax matters, other than litigation-related privilege, is inconsistent with the absence of any privilege against self-incrimination on tax matters. In his dissenting judgment in *CIR v West-Walker*¹⁷³ which led to the original enactment of section 20, Stanton J wrote:

I cannot think that the rules of evidence relating to the protection of privileged communications is of any higher status than the similar rule against requiring a witness to incriminate himself.

9.52 The committee regards the privilege against self-incrimination as more fundamental than legal professional privilege. Considering the former privilege no longer applies in tax cases, there is a strong argument that the latter privilege should also not apply in tax cases. Therefore, on the issue of the application of legal professional privilege, other than litigation-related privilege, tax cases can be distinguished from other cases.

Future of privilege in tax matters

9.53 The Organisational Review Committee considered the issue of legal professional privilege.¹⁷⁴ It stated that it might be appropriate to reconsider legal professional privilege generally in relation to tax matters, noting a growing trend in litigation to place all cards on the table. This statement was made following submissions by the New Zealand Society of Accountants that privilege should be extended to tax advice given by its members.¹⁷⁵

9.54 The committee notes that it was the view of the Davison Commission¹⁷⁶ that legal professional privilege in all tax matters should be

¹⁷² [1948] 1 ALL ER 927

¹⁷³ [1954] NZLR 191

¹⁷⁴ Organisational Review Committee, *Report on the Organisational Review of the Inland Revenue Department*, April 1994, para 9.52

¹⁷⁵ Arguments for extension are mainly based on accountants achieving horizontal equity with lawyers in the area of tax advice.

¹⁷⁶ Commission of Inquiry into Certain Matters Relating to Taxation, *Report of the Winebox Inquiry*, August 1997

abolished. The Commission itself experienced considerable difficulties with privilege claims during the course of its investigations.¹⁷⁷

9.55 The Law Commission has also considered the issue of legal professional privilege in tax matters. If the Commission proceeds in the way the committee understands is likely, its approach will solve a number of the problems that have arisen in the tax area.

9.56 The committee understands that the Law Commission is to recommend the abolition of privilege for tax advice. The proposal is intended to allow the Commissioner to have access to all communications between a lawyer and client which are generated before the filing of the taxpayer's return. The New Zealand Law Society has opposed this change. The Law Commission's rationale for the exclusion of tax advice from privilege is based on a strong public interest in keeping the Commissioner fully informed. It considers that because tax collection is dependent on disclosure, there must be full disclosure.

9.57 The Law Commission proposes an amendment to section 20(1)(b) of the Tax Administration Act 1994, so that privilege would be available only for confidential communications with legal advisers when those communications are brought into existence for the purpose of obtaining or giving legal advice or assistance in relation to the subject matter of an income tax return that at the time of obtaining the legal advice or assistance, has been or ought to have been furnished.

9.58 The Law Commission's proposals remain in draft form and have not been published. The committee would have no quarrel with what the Law Commission is proposing.

9.59 The committee does not make any final recommendation on the scope of the existing legal professional privilege rule applying in tax matters, because it would prefer the government to refer to the more detailed work undertaken by the Law Commission, which has had more time to consider this issue than has the committee.

9.60 However, apart from any consideration of the wider issue of whether the rules of privilege applying in tax matters should be relaxed, the committee **recommends** that two specific amendments should be made to section 20. The committee supports an amendment to ensure the physical protection of documents once a claim for privilege is made, and

¹⁷⁷ See pages 1:5:26-1:5:31

pending the determination of its validity by a District Court Judge under section 20(5) of the Tax Administration Act 1994. If claims for privilege are made, procedural rules would be necessary to safeguard documents by, say, ensuring they are placed in a package which is sealed and delivered to the nearest District Court registrar for safe custody. Such rules would be necessary to protect documents from abusive practices such as removal, destruction or tampering. A precedent for such protective procedures is contained in section 232 of the Canadian Income Tax Act.

9.61 The committee also favours an amendment to section 20 to make conditions of privilege the identification of the document and the ground on which privilege is claimed. At present, section 20 contains no such requirement. This deficiency was reflected in the evidence of the Inland Revenue Department to the Davison Commission which referred to the practice of documents being removed from files made available for inspection and Inland Revenue Department not being informed that privilege had been claimed for them.

9.62 The rules used for identifying documents for which privilege has been claimed for discovery purposes in civil litigation proceedings could form the basis of such an amendment. Those claiming privilege would be required to identify the documents and state the grounds for privilege by affidavit.

9.63 In summary, the committee **recommends** that the government should await the outcome of the Law Commission's study of legal professional privilege before making any decisions on the scope of this privilege. In the interim, the committee **recommends** two specific amendments to section 20:

An amendment should be made to ensure the physical protection of documents for which legal professional privilege is claimed pending judicial determination of the claim's validity.

An amendment should be made to require the identification of documents for which privilege is being claimed as a condition of obtaining privilege.

CHAPTER 10 – ASSESSMENTS AND DISPUTES RESOLUTION

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SUSPENSION OF TIME BAR

Introduction

10.1 In this section, the committee considers whether the time bar in section 108 of the Tax Administration Act 1994 for the amendment of assessments by the Commissioner should be suspended when a section 17 notice has been issued, or when judicial review proceedings have been instigated. Moreover, when the time bar is suspended, whether the period for retaining records should be extended.

10.2 Section 108 provides that when a taxpayer has provided a tax return and has been assessed, the Commissioner may not amend the assessment to increase the tax liability once four years have passed from the end of the year in which the tax return was provided. However, this time bar does not apply if the Commissioner considers that a tax return provided by a taxpayer is fraudulent, or wilfully misleading, or omits mention of gross income of a particular nature, or from a particular source. Section 108 represents a compromise between the correct determination of tax liabilities, and the desirability of achieving finality in the tax affairs of honest taxpayers.

10.3 Clause 30 of the Taxpayer Compliance, Penalties, and Disputes Resolution Bill introduced in 1995 would have suspended the time bar for amendment of assessments for the period between the issue of a section 17 notice and the taxpayer's compliance with it, and for the period

of any judicial review proceedings. This amendment was deferred pending release of the Davison Commission's report.

Suspension of time bar for requisitions under section 17

10.4 Although the committee generally supports the compromise between accuracy of assessment and certainty for honest taxpayers, it considers that it would be desirable to suspend the time bar when the Commissioner issues a section 17 notice in which the taxpayer is advised that non-compliance will result in such suspension. The committee favours the suspension of the time bar for the period between one month after the issue of a section 17 notice and the taxpayer's compliance with the notice. Any reassessment made during the period following the normal time bar, which is equal to the period of suspension, should affect only matters based on or related to the information sought in the section 17 notice. Such a suspension would provide an additional incentive for taxpayers to comply with section 17 requisitions in a timely manner.

10.5 The committee does not consider it necessary for the time bar to be suspended for the period of any judicial review proceedings. Generally, the instigation of judicial review proceedings should not prevent the Inland Revenue Department from continuing its normal investigative activities. If the department has any doubts on this matter, it should seek directions from the court. If problems arise because time is running out, the proper approach is for the department to make sure the court is aware of the time bar. Although interim injunctions affecting the department can be granted *ex parte*, motions to rescind them can be heard by the courts very quickly.

Extending period for record-keeping

10.6 Associated with the Commissioner's powers to obtain information under section 17 is the statutory requirement for taxpayers to retain information about their income tax affairs for a specified period. The importance placed on this requirement is shown in the statement of taxpayers' primary tax obligations in section 15B of the Tax Administration Act 1994: taxpayers must keep all necessary information and maintain all the necessary records required under the tax laws. The main record-keeping requirement for business taxpayers is contained in section 22 of the Tax Administration Act 1994, that business records must be kept for seven years after the end of the income year to which they relate.

10.7 The committee considers that any statutory minimum record-keeping period should be extended by any period for which the time bar

is suspended. If not, any suspension of the time bar could be futile, if the records that the Commissioner needed for reassessment had been disposed of because the period for retaining records had expired during the course of obtaining information by requisition under section 17.

10.8 The committee **recommends** that the time bar for amending assessments should be suspended for the period between one month after the issue of a section 17 notice in which the taxpayer is advised that non-compliance will result in such suspension, and the taxpayer's compliance with the notice. Any reassessment made during the period following the normal time bar, which is equal to the suspension period, would affect only matters based on or related to the information sought in the section 17 notice. The committee also **recommends** that the statutory minimum periods for keeping records should be extended by the period the time bar is suspended.

ONUS OF PROOF IN CIVIL PROCEEDINGS

10.9 Section 149A of the Tax Administration Act 1994 places the onus of proof in all civil proceedings on the taxpayer.¹⁷⁸ This section corresponds to section 18 of the Taxation Review Authorities Act 1994 which relates to the former objection procedures. If a taxpayer disputes an assessment, the taxpayer must prove on the balance of probabilities that the assessment concerned is incorrect.

10.10 The main justification for placing the onus of proof on the taxpayer is that matters concerning the tax position taken by a taxpayer are primarily within the knowledge of the taxpayer. It would be very difficult and costly for the Commissioner to discharge the onus of proof. This approach is consistent with the rationale for self-assessment, that is, taxpayers have more information about their tax liabilities and are, therefore, in a better position to assess their own tax liability than the Commissioner. In *Buckley & Young v CIR*, the court said:

The Commissioner could not sensibly be expected to bear the onus of proof of matters which originate with the taxpayer and which usually are peculiarly within his knowledge and power. Thus there are sound if not compelling practical reasons why the legislation requires him to pro-

¹⁷⁸ Except for civil penalties for evasion under section 141E.

vide satisfactory evidence to support his calculation of his assessable income.¹⁷⁹

10.11 Placing the onus of proof on taxpayers is also consistent with the primary obligation of taxpayers to determine correctly the amount of tax payable.¹⁸⁰ The committee agrees with these reasons and considers that the onus of proof in all civil proceedings, except for civil penalties for evasion, should lie with the taxpayer.¹⁸¹

10.12 A taxpayer who wishes to challenge an assessment made by the Commissioner is required to prove not only that the Commissioner's assessment is wrong, but by how much it is wrong.¹⁸² The committee considers that if a taxpayer is able to prove on the balance of probabilities that the Commissioner's assessment is excessive by at least a certain amount, the court should be able to reduce the Commissioner's assessment by that amount. This point has not been tested in the courts, and the law is not clear on it. As the committee considers that, in principle, a taxpayer should succeed with this argument, it considers that the law should be clarified.

10.13 The committee, therefore, **recommends** that first, the onus of proof in civil proceedings, except for civil penalties for evasion, should continue to lie with the taxpayer, and secondly, that the law should be clarified expressly to provide that if a taxpayer is able to prove on the balance of probabilities that the Commissioner's assessment is excessive by at least a certain amount, the court should reduce the Commissioner's assessment by that amount.

JUDICIAL REVIEW

10.14 Taxpayers may instigate judicial review proceedings either to restrain the Commissioner from taking certain action, or to have the court declare invalid an action that has been taken. However, section 109 of the Tax Administration Act 1994 is a major obstacle to such pro-

¹⁷⁹ (1978) 3 NZTC 61,271 at 61,283

¹⁸⁰ Section 15B(a), Tax Administration Act 1994

¹⁸¹ The committee is aware of the reform enacted this year in the United States which has reversed the onus of proof in relation to small taxpayers in certain circumstances so that it now lies on the tax administration. However, for the reasons given above, the committee has declined to recommend this approach for New Zealand.

¹⁸² *Aspro Ltd v C of T* [1932] AC 683; *C of T v McCoard* [1952] NZLR 263; *Babington v CIR* [1957] NZLR 861; *Europa Oil (NZ) Ltd (No 2) v CIR* (1974) 1 NZTC 61,169; *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271

ceedings. The section expressly precludes taxpayers disputing an assessment outside the objection or challenge procedures contained in Parts VIII and VIIIA of the Tax Administration Act 1994. Section 109 also deems an assessment to be correct for all purposes except in relation to a challenge to the assessment under the statutory appeal procedures.

10.15 Recent cases show that judicial review is appropriate in only limited cases in challenging the conduct and decisions of the Commissioner. Section 109 has been held not to preclude the court from entertaining judicial review applications, but recourse to such proceedings is generally available only in exceptional circumstances, such as cases alleging an abuse of process.

10.16 In *Golden Bay Cement Company Ltd v CIR*,¹⁸³ the Court of Appeal held that section 109 precluded any challenge to the correctness of an assessment outside the specific statutory appeal procedures in the Tax Administration Act 1994, but did not preclude judicial review proceedings challenging the process followed by the Commissioner in the exercise of the statutory power to make assessments. McKay J, delivering the judgment of the court, stated:

Once an assessment has been made, then whether or not it is correct it can only be challenged in proceedings on objection. Where the issue is not the correctness of an assessment, but the very existence of the power to make it, [section 109] will not prevent the court from determining whether the purported assessment is in fact an assessment in terms of the Act. As was pointed out by Richardson J in this court in *CIR v Canterbury Frozen Meat Co Ltd* (1994) 16 NZTC 11,150, there is a distinction between challenging the correctness of an assessment on the one hand, and the process followed and the character of the resulting decision on the other.¹⁸⁴

10.17 The court reviewed Commonwealth authority and, following the reasoning of the Privy Council in *Harley Development v CIR*,¹⁸⁵ commented that when specific statutory appeal procedures are already available, such as those under the Tax Administration Act 1994, it will only

¹⁸³ (1996) 17 NZTC 12,580

¹⁸⁴ At page 12,584

¹⁸⁵ [1996] STC 440

be in exceptional cases, typically involving an abuse of powers, that the courts will entertain an application for judicial review of a decision that has not been appealed through those specific statutory procedures. The court rejected the argument that the ‘validity’ of an assessment was distinct from its ‘correctness’ (which counsel for the taxpayer conceded could be challenged only under the specific statutory appeal procedures) and that matters going to ‘validity’ were properly amenable to challenge through judicial review proceedings. McKay J stated:

Once the taxpayer has been notified in proper form that an assessment has been made in purported exercise of the Commissioner’s powers, that assessment will be treated as valid until a court rules otherwise. Until then it has at least a de facto operation, and cannot be treated as if non-existent: *Love v Porirua City Council* [1984] 2 NZLR 308 (CA) at p 311. Section 30 [Income Tax Act 1976] is intended to provide the primary means by which an assessment or apparent assessment can be challenged. If the taxpayer wishes to challenge it, whether as to its correctness or as to its validity, he is able to do so by the objection procedure.¹⁸⁶

10.18 If the courts did not adopt a presumption of validity of assessments made by the Commissioner, every assessment could be open to attack by way of judicial review. The reasoning of the Court of Appeal on this aspect is consistent with case authority on judicial review proceedings outside the tax arena: official decisions must be presumed to be valid and legitimate until declared invalid by a court.

10.19 The approach taken by the Court of Appeal in *Golden Bay* was endorsed by the court in its subsequent decisions in *BNZ Finance Ltd v Holland*¹⁸⁷ and *New Zealand Wool Board v CIR*.¹⁸⁸ When an assessment has been made and notified in proper form to a taxpayer, both ‘validity’ and ‘correctness’ can be challenged only under the specific statutory appeal procedures, unless exceptional circumstances exist.

10.20 However, in *BNZ Finance*, the court noted that the restriction imposed by section 109 on judicial review proceedings is triggered only

¹⁸⁶ (1996) 17 NZTC 12,580 at 12,585

¹⁸⁷ (1996) 17 NZTC 12,658

¹⁸⁸ (1997) 18 NZTC 13,113

when an assessment has been made. Judicial review proceedings therefore, could be more easily undertaken in the pre-assessment stage. *Golden Bay* involved an assessment that in the opinion of the Court of Appeal could and should have been pursued under the specific statutory appeal procedures. But in *BNZ Finance*, the Commissioner had not yet purported to make an assessment. The statutory appeal procedure was, therefore, not available. Consequently, nothing in the *Golden Bay* decision, and nothing in the income tax legislation, in particular, section 109, precluded an application for judicial review.

10.21 The Court of Appeal in *BNZ Finance* noted that under section 4 of the Judicature Amendment Act 1972, an application for judicial review may be made in relation to the proposed or purported exercise of a statutory power, as well as to the actual exercise of such power. It is not necessary for an applicant to wait until a body or person does something outside its jurisdiction before seeking relief. Richardson P, delivering the judgment of the court, stated that:

The intention to make an assessment does not have the presumption of validity which attaches to an apparent assessment until such time as the apparent assessment is declared invalid.¹⁸⁹

10.22 The court, therefore, held that the general immunity from judicial review for assessments does not extend to the proposed exercise of the Commissioner's statutory power to make assessments.

10.23 The committee understands that recently the number of judicial review proceedings brought against the Commissioner has decreased. This reduction could be due to two factors. First, recent Court of Appeal decisions indicate that judicial review is available only in a limited number of cases. Secondly, the use of money interest provisions apply from the original due date. Before the 1996-97 income year, in the absence of use of money interest, taxpayers had an incentive to apply for judicial review, because even if the application were unsuccessful, the taxpayer had the use of the Crown's money during the period of the proceedings. This incentive has now been removed.

10.24 The committee considers that the present availability of judicial review generally represents a proper equilibrium between the taxpayer

¹⁸⁹ (1996) 17 NZTC 12,658 at 12,660

and the Commissioner, and is sensible and rational, considering the specific statutory appeal procedures in the tax legislation.

CHAPTER 11 – TAX COLLECTION

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WITHHOLDING PAYMENT REGULATIONS

Introduction

11.1 New Zealand operates a tax system based on voluntary compliance. A key component of this system is the removal, where possible, of opportunities for non-compliance through the use of a comprehensive system of withholding taxes. Withholding systems play an important role in the tax system, ensuring that tax is paid on income that might otherwise not be reported.

11.2 The Income Tax (Withholding Payments) Regulations were introduced in 1957 as part of the PAYE legislation. They were intended to complement the PAYE system for income from salary and wages by applying withholding taxes to certain classes of payments which were neither business income nor salary or wages. The regulations generally cover situations where no true master-servant relationship exists.

11.3 Although the scope of the regulations and the tax rates have been reviewed from time to time, the regulations have evolved through piecemeal extension, rather than as a result of a fundamental review of

the type of tax deduction system needed to complement the PAYE system. The regulations were last reviewed in 1979.

11.4 The regulations apply to payments for a defined list of activities, for example, certain labour-only services, game hunting and sphagnum moss collection. Some payments are excluded from the regulations, including salary and wages, payments to a Maori authority, a public authority, or a company (not being a non-resident entertainer or a non-resident contractor), and any payments exempted by certificate.

11.5 The person making the withholding payment (the payer) is required to deduct tax from the gross GST-exclusive amount of the payment, if the payee is GST registered and provides a tax invoice. If the payee is not GST registered, tax must be deducted from the amount paid. Deductions must be made at the set rates at the time the payment is made, the rates varying between categories of payments. The payee generally receives no allowance for expenses in calculating the amount of tax deduction, but can claim for expenditure incurred during the year in their annual return. Failure to deduct withholding tax and to pay it to the Inland Revenue Department by the due date renders the payer liable to penalties and prosecution.

Key principles underlying withholding systems

11.6 The increasing use of and reliance on withholding systems in the tax collection process recognises several advantages of these systems. The first is that collecting tax at the source of the income reduces the scope for tax evasion and reduces debt recovery work for the Inland Revenue Department. Secondly, if there are a small number of payers and a large number of payees, it is more efficient to impose a withholding obligation on payers rather than collecting tax directly from payees. Finally, the tax system can be greatly simplified by reducing the number of provisional taxpayers.

11.7 The committee believes that the ideal withholding tax system should, as far as possible, eliminate the scope for tax evasion while not imposing additional costs on people who are responsible for making deductions, or who must disclose their income to the Inland Revenue Department. Such a system provides an efficient means of collecting income tax by ensuring that some tax is collected at the point of transaction.

11.8 The committee recognises that in practice, however, this ideal is impossible to achieve because it is necessary to take into account com-

pliance and administrative costs, and to consider the incentives that must be provided to those who are being asked to withhold tax.

11.9 In terms of compliance costs, even the simplest withholding tax system imposes costs on both payers and payees. But at the same time, withholding taxes permit a reduction in other compliance costs, such as those arising from the provisional tax system. High administrative costs are incurred by the Inland Revenue Department in running a withholding tax system. However, other possible sources of administrative costs, such as audit and recovery costs, may be reduced. As a third consideration, if those who are being asked to withhold have no incentive to deduct payments, both compliance and administrative costs tend to increase. Designing a withholding tax system requires the careful balancing of these considerations to achieve the greatest possible reduction in tax evasion at the lowest possible cost.

A withholding tax for services

11.10 A comprehensive withholding payments system for resident contractors was proposed in the government's economic statement of 17 December 1987, and the proposal was revisited in 1991. However, the proposal did not proceed because of the compliance costs that would be imposed.

11.11 The committee has identified that introducing a withholding tax on the labour income received by resident contractors could reduce the scope for resident contractors to evade income tax by failing to declare the income they received. It would also provide a more efficient means of collecting tax on that income, and by reducing the number of provisional taxpayers, it would simplify the tax system.

11.12 However, the committee acknowledges that extending the withholding system to payments made to resident contractors would be likely to increase the compliance costs incurred by both the people who would be required to deduct the withholding tax, and the resident contractors from whom tax would be withheld. In addition, implementing this system would entail considerable administrative costs for the Inland Revenue Department. The committee, therefore, does not support this approach unless or until technological advances are available to reduce these costs so as to make this option viable.

A reporting system

11.13 The committee considered the suggestion that regulations should be geared towards reporting of recipient details by the payer, and conse-

quent disallowance of deductions for unreported payments. Payers would not be required to deduct withholding tax, but would be required to report the recipient's name, the amount of the payment and other details. The reporting requirement would apply only in relation to payments over a specified threshold. If payers did not comply with this requirement, they would be denied a deduction for their payments.

11.14 The main advantages of this approach would be first, lower overall compliance costs in comparison with the costs of withholding systems. The costs of collecting and accounting for withholding tax would be eliminated. Secondly, there would be better integration with normal business practices. Because of this integration, reporting systems would generally be more acceptable. Thirdly, in terms of flexibility, reporting systems are more easily introduced or removed as required for particular industries and classes of payers and payees.

11.15 There are, however, some disadvantages with this approach. The first and main disadvantage would be the risk that income might not be reported to the Inland Revenue Department. Although denying deductions for expenses associated with withholding payments would provide sufficient incentive for business taxpayers to report their payments, it generally would not work for the household sector, because deductions in that sector are not permitted. Withholding systems ensure that at least some tax is paid, even if comprehensive matching is not undertaken. A further disadvantage would be that additional administrative costs would be incurred by the Inland Revenue Department in ensuring that taxpayers declared the income they received. Debt recovery work would also increase.

11.16 The committee believes that the current withholding system should continue to apply if, and to the extent, there is a risk that the business to which the withholding system applies may not be in a position to meet its income tax liability. Smaller businesses, irregular activities, or infrequent activities, such as sphagnum moss collection, game hunting and certain labour-only services, which are activities specifically covered by the regulations, are more likely to run this risk. Therefore, subject to the committee's comments on exemptions from withholding tax in paras 11.18 to 11.28, the committee **recommends** the continued application of a withholding tax system in these cases.

Deficiencies

11.17 The committee noted the concern in submissions that the impact of the new compliance and penalty provisions has caused taxpayers and

their advisers to take a fresh look at some long-standing practices that developed in the absence of an effective system of enforcement and, as a result, appear to be inconsistent with the law. The principal submission to the committee asked it to address several deficiencies in the existing regulations, in particular, in relation to payments made to GST registered contractors, and to payments made by the household sector.

Payments made to GST registered contractors

11.18 Some businesses pay GST registered contractors without deducting the required withholding tax and, as a result, they may be liable for penalties. It is assumed that because the contractors are GST registered, they also have a certificate of exemption from withholding tax, but this is not always the case. The committee is aware of the practice of GST registered contractors presenting tax invoices to contracting businesses, indicating that on that basis they are not subject to the withholding requirements. Administratively, on occasions the Inland Revenue Department has accepted this practice. Although it may be expedient, it appears to be inconsistent with the law.

11.19 This problem could be addressed by amending the regulations to exclude from the definition of ‘withholding payment’, payments made to GST registered contractors for their taxable activities. Such payments then would not be subject to withholding tax. Restricting the exclusion to payments made for a person’s taxable activity would ensure that hobbies, which are not taxable activities under the GST legislation, would not be excluded from the regulations. Contracting businesses would be required only to hold a tax invoice disclosing the GST-inclusive value of the supply of services.

11.20 The committee considers that this amendment would simplify the obligations for contracting businesses, and would reduce their compliance costs. The amendment would also reduce administrative costs for the Inland Revenue Department by removing the need for annual applications for exemption certificates for this class of payee.

11.21 It is possible that removing these payments from the scope of the regulations might have the effect of undermining the withholding system and increasing the risk of non-reporting of income. The committee considers, however, that if the contractors are GST registered, then bearing in mind both the penalties provisions and Inland Revenue’s audit programme, it is most unlikely that these contractors would not return the income they receive. Requiring a tax invoice also creates an audit trail

which the Inland Revenue Department could use as a cross-check against the contractors' receipts.

11.22 The committee therefore **recommends** that payments to a GST registered person for a supply services should be excluded from the definition of 'withholding payment', if the payer holds at the time a GST tax invoice disclosing the GST-inclusive value of that supply, except in areas of revenue risk.

Payments made by the household sector

11.23 Whether the household sector is required to deduct withholding tax from payments made for services carried out for their private residences is uncertain. At present, householders do not have to deduct withholding tax from payments they make to private domestic workers, such as nannies, gardeners and other home-helpers.¹⁹⁰ Private domestic workers are required to account for their own tax.

11.24 The definition of 'private domestic worker' seems to include some people who are covered by the regulations. For example, a householder would be required to deduct withholding tax from payments to freelance musicians hired to play for a private party at a private house. In such cases, deductions are not in fact made, and it would be idle to insist on their being made.

11.25 To provide greater certainty in this matter, the committee **recommends** that the regulations should be amended to exclude payments made by people in the household sector from the requirement to withhold tax to the extent that the payments relate to their private residences, or otherwise are of a private nature.

11.26 The committee believes that both measures, if adopted, would improve the consistency and efficiency of the regulations, while at the same time minimising opportunities for non-compliance. Both measures highlight the trade-off between encouraging compliance by taxpayers and minimising compliance costs.

11.27 The effect of the double amendment would be that only payments made by GST registered persons to the extent that those payments relate to a taxable activity, or payments made by non-registered persons

¹⁹⁰ Section OB 1, Income Tax Act 1994 defines 'private domestic worker' as being a person who is employed by another person to perform part-time work in or about that person's private residence.

if the payments are not of a private nature, would be subject to the deduction of withholding tax.

11.28 In summary, then, the committee **recommends** that the regulations should be amended to exclude from the definition of ‘withholding payment’:

payments made to a GST registered person for the supply of services when the payer holds at the time a GST tax invoice disclosing the GST-inclusive value of that supply, except in specific areas of revenue risk; and

payments made by people in the household sector to the extent that the payments are of a private nature.

INTEREST ON UNDERPAYMENTS

Introduction

11.29 Part VII of the Tax Administration Act 1994 provides for the payment of interest on underpayments and overpayments of tax. This payment is generally known as ‘use of money interest’. It applies to both overpaid and underpaid tax from the due date for payment of that tax until the day that the tax is paid. Different rates of interest are paid on overpaid and underpaid tax.

11.30 Submissions to the committee raised concerns about both the levels of interest charged and the disparity between the overpayment and underpayment rates for use of money interest. In addressing these concerns, the committee believes it is important that taxpayers understand how these rates are set. The twin objectives of the rates are first, to compensate fairly the party (either the Crown or the taxpayer) who has lost the use of their money, and secondly, to encourage taxpayers to pay the right amount at the right time.

Rates

11.31 To some extent these objectives conflict. No single interest rate can both compensate the ‘lender’ fully, and also ensure that overpayments of tax are minimised. The government wants to minimise overpayments of tax by setting the interest slightly lower than the rate taxpayers would normally receive on short-term deposits for two reasons. First, because the government’s procedure for changing rates in response to changes in market interest rates is relatively slow, the government does not want inadvertently to be in the position of being the best source of short-term finance if market rates were to fall quickly. Secondly, the

government wants to avoid introducing additional uncertainty in its revenue forecasts. Uncertainty would occur if the overpayment rate was more generous than that offered by financial institutions, so encouraging overpayments of tax. In practice, the rates must recognise that the taxpayer and not the department ultimately chooses whether taxes are underpaid or overpaid. Further, the rates need to be set having regard to the borrowing rates for taxpayers in general, and not the circumstances of individual taxpayers. This broad-brush approach means that the rates may result in some inequities for individual taxpayers.

11.32 Taking these objectives into consideration then, the rates must be, for underpayments, close to, but more than what taxpayers generally would pay for unsecured borrowing from another source; and, for overpayments, close to, but less than what taxpayers generally would receive on short-term deposits of similar risk.

11.33 The criteria to be considered for changing the rates are as follows:

- 1 Both rates should be adjusted following:
 - (a) an increase or decrease of 2 per cent in the Reserve Bank business base lending rate, the base rate for the underpayment rate; or
 - (b) an increase or decrease of 1 per cent in the Reserve Bank 90 day bank bill rate, the base rate for the overpayment rate.
- 2 Adjustments in the underlying market interest rates should be measured from the date the rates were last set.
- 3 The rates should be reset to underlying market interest rates if the rates have not been adjusted during any 12-month period, with consultation on whether the misalignment of rates is sufficient to require a change.
- 4 When an adjustment is proposed, the government should consult with interested parties concerning timing, on the basis that:
 - (a) as a general principle, adjustments should apply from the next standard provisional tax payment date (7 March, 7 July or 7 November), but
 - (b) if consultation suggests an earlier change is required, the adjustment should take effect from the 7th of the next month, which would be a non-standard provisional tax payment date.

11.34 The use of money interest rules are generally well understood and are operating efficiently. The committee considers that the process of setting rates is efficient, and that the existing consideration of the compliance cost impact of any change in the interest rates is appropriate.

11.35 However, the committee considers that even though a rational basis for setting the use of money interest rates exist, and even though an efficient administrative system calculates taxpayer liabilities, it does not necessarily follow that the rules are seen by taxpayers as operating equitably. There are many circumstances when it may reasonably be argued that there is inequality in the imposition of interest, or in the level of interest. Some examples of perceived inequities occur to the committee, and others have been suggested in submissions, including the following cases.

If the department issues a non-binding ruling on an expected tax treatment, no interest or penalties should result for any tax position subsequently assessed because of a changed departmental stance.

If no shortfall penalty has been attracted by the taxpayer's actions, use of money interest should perhaps be wholly or partly relieved.

If the taxpayer had no reasonable expectation of having to pay interest at the time of making provisional tax payments, an unexpected breach of the interest thresholds should perhaps find relief from use of money interest.

The examples are illustrative only. The committee notes that other situations may deserve consideration for possible relief.

11.36 The use of money interest rules compensate both taxpayers and the government when incorrect payments of tax are made, regardless of the reason. Without the use of money interest provisions, a taxpayer who pays tax correctly would be in a worse position than a taxpayer who defers a payment by taking an incorrect tax position but one which does not incur a shortfall penalty. Taxpayers who accurately forecast their income and paid tax accordingly would be treated less favourably than taxpayers who made no effort to forecast their income.

11.37 This most important topic – one which generates considerable dissatisfaction with the tax system – should be investigated further. The committee is aware that the penalties provisions are scheduled for a full review in 1999 and, therefore, the committee **recommends** that ques-

tions about relief from the use of money interest rules should be fully addressed then.

Late payment penalty and use of money interest

11.38 The late payment penalty comprises an automatic 5 per cent penalty on underpayments not paid by the due date, and an additional 2 per cent penalty charged for each month until the tax is paid. Use of money interest also applies to outstanding balances (not including penalties) until such amounts are paid. The combined impost is intended to reinforce a fundamental obligation of the tax system – the requirement to pay taxes by the due date. The committee considers that the late payment penalty appears to be overly punitive, when combined with use of money interest on underpayments.

11.39 The committee accepts that the due date would be meaningless if some sort of penalty did not apply for late payments. The initial 5 per cent penalty is intended to provide sufficient incentive to pay on time, without being overly punitive. Previously, the penalty was 10 per cent.

11.40 The committee considers that the government should consider reducing the 5 per cent penalty for taxpayers who fail to pay on time, but who correct that error within a few days of the due date for payment of the tax. In these cases, the late payment penalty is significant, even if the taxpayer did not have a reasonable cause for failing to pay on time.

11.41 The additional 2 per cent monthly penalty combined with use of money interest ensures a continual incentive to pay, or to apply to the Inland Revenue Department either for remission or to pay by instalment. If the penalty were a single occurrence, without an additional incremental penalty, taxpayers would lack any incentive to pay once the initial late payment penalty was incurred. Interest would be charged, but this charge is intended to be neutral in effect, approximately equalling the benefit to the taxpayer of retaining the tax. The incremental penalty provides a continuing incentive for the taxpayer to pay the tax as soon as possible.

11.42 The committee endorses the reasons for the late payment penalty, and considers it inappropriate to depart from giving taxpayers incentives to pay their tax on time. However, the penalty should have less of an impact. Although previously, the late payment penalty on income tax amounted to 10 per cent every six months, and also a lesser overall penalty is now imposed in the cases of short-term failure to pay, the new rules provide a more significant penalty after the first two months. The

committee notes that the combined late payment penalty and use of money interest could impose an overall impost in excess of 50 per cent over a 12-month period.

11.43 In summary, therefore, the committee **recommends** that the 5 per cent penalty should not apply to taxpayers who fail to pay on time, but who correct that error within a few days of the due date for payment. The committee also **recommends** that the government should consider reducing the incremental late payment penalty of 2 per cent per month to 1 per cent per month.

TAX RECOVERY

Introduction

11.44 This part of the chapter considers the effectiveness of the tax recovery provision, section HK 11 of the Income Tax Act 1994. The section provides that directors and shareholders of a company are liable in certain circumstances for tax payable by the company if it is left with insufficient assets to meet its tax liability.

11.45 Section HK 11 is directed at arrangements which deplete a company's assets so that it is unable to meet its tax liabilities. The company itself is often liquidated as part of the arrangement, or simply because after a transaction is completed, the company serves no useful purpose. Such arrangements were a feature of transactions considered by the Davison Commission.

Operation of the section

11.46 The tax recovery provisions in section HK 11 apply when an arrangement has the effect of leaving a company unable to satisfy an existing or future tax liability, and it is reasonable to conclude that if a director of the company had made all reasonable inquiries into the affairs of the company at the time it entered into the arrangement, the director would have anticipated that the tax liability would be required to be met by the company, and that a purpose of the arrangement was to avoid meeting the tax liability.

11.47 Directors or controlling shareholders at the time the arrangement was entered into, or non-controlling shareholders at that time, if it was reasonable to conclude, having regard to any benefit derived by the shareholder, that the shareholder was a party to the arrangement, may be liable as agents of the company under section HK 11.

11.48 Certain statutory defences are provided. For example, directors are not liable if they can satisfy the Commissioner that they were not involved in the executive management of the company, and had no knowledge of the arrangement at the material time. If none of the statutory defences applies, the directors of the company are jointly and severally liable for the full amount of the tax liability. Shareholders who come within the ambit of section HK 11 are liable for the recovery of tax to the extent of the greater of the market value of their direct and indirect shareholding in the company, and the value of the benefit they derived from the arrangement, and the relevant proportion of any late payment penalty or interest.

Purpose of tax avoidance

11.49 The committee is concerned with one aspect of subsection (1) of section HK 11, namely, its requirement that a purpose of the arrangement must be to avoid tax. This provision is set out below:

This section shall apply where –

- (a) Any arrangement has been entered into in relation to a company; and
- (b) An effect of that arrangement is that the company is unable to satisfy under this Act a liability for income tax (referred to in this subsection as the ‘tax liability’) of the company, whether the tax liability exists at the time of entry into the arrangement or arises subsequently; and
- (c) It can reasonably be concluded that –
 - (i) A director of the company at the time of entry into the arrangement who had made all reasonable inquiries into the affairs of the company would have anticipated at that time that the tax liability would be, or would be likely to be, required to be satisfied by the company under this Act; and
 - (ii) A purpose of the arrangement was to have the effect specified in paragraph (b).

11.50 The committee considers that the requirement in subsection (1)(c)(ii), that a purpose of the arrangement was to have the effect of tax avoidance, makes the tax recovery provision too difficult to apply because it requires the Commissioner to show subjective intent. A court would be unlikely in all but the most blatant circumstances to conclude

that a purpose of the impugned arrangement was to avoid payment of tax. This purpose would have to be a foreseen and intended consequence or a goal of the arrangement.

11.51 In addition, the second limb of paragraph (c) seems to frustrate the objective component of the first limb, which sets out the test of a director who had made all reasonable enquiries into the company's affairs and what he or she would have anticipated as likely. This first limb seems to be designed to target recklessness, negligence or oversight on the directors' part. However, if the directors have not made all reasonable enquiries, and therefore do not know of the looming tax liability, how can they be said to have a purpose of avoiding tax under subsection (1)(c)(ii)? It follows that the second limb would always rule out recklessness, negligence, or oversight.

11.52 The committee **recommends** that the government should amend section HK 11 to make the tax recovery provisions more effective by changing the requirement for an avoidance purpose in subsection (1)(c)(ii) so that it is an alternative or disjunctive requirement only. The effect of such an amendment would be to make the requirement for reasonable enquiries by a director the main test for determining the application of section HK 11. The committee does not propose any amendment to subsection (4), which lists classes of shareholders who can be made liable for the unpaid tax of a company. Section HK 11 will continue to apply primarily to controlling shareholders. It will apply to non-controlling shareholders only when it is reasonable to conclude, having regard to the materiality of any benefit derived by such shareholders, that they were a party to the arrangement which left the company unable to satisfy its tax liability.

CHAPTER 12 – PENALTIES

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Role of the penalties provisions in a self-assessment environment

12.1 The tax system involves the participation of hundreds of thousands of taxpayers, their agents and advisers. It is not practical for tax administrators to scrutinise and assess every individual tax return received each year and, like other modern tax administrations, the Inland Revenue Department has begun to rely increasingly on self-assessment to administer tax collection. The movement towards self-assessment of tax liabilities reflects the view that taxpayers are in a much better position than tax administrators to assess their tax liabilities, so long as they are given sufficient assistance and incentives to comply.

12.2 A self-assessment system relies heavily on taxpayers, who must take their obligations seriously and perform the various tasks required of them honestly and with reasonable care. Although most people do their best to comply voluntarily with their tax obligations, some do not. Taxpayers may fail to meet their obligations in many ways, ranging from honest mistakes through to negligence, tax avoidance and tax evasion.

12.3 Some administrative measures have improved compliance. New disputes resolution procedures aim to provide prompt and efficient resolution of disputes and to avoid expensive litigation. The design of withholding systems is intended to limit the potential for non-compliance. There is an increased Inland Revenue focus on education of taxpayers. Clear laws should help ensure that obligations are well understood. Improved audit strategies aim to increase the likelihood of detecting non-compliance.

12.4 Although the committee accepts that these measures all contribute to the success of a system based on voluntary compliance, the committee does not consider that they are sufficient by themselves. They

must be reinforced by an effective statutory system of penalties, which provides taxpayers with the appropriate incentives.

12.5 The committee has reviewed the findings of the penalties study commissioned by the United States Internal Revenue Service in 1989.¹⁹¹ The key findings of the study highlight the importance of penalties in a self-assessment environment. The study found that penalties can encourage those taxpayers who do not comply to do so, and can encourage those taxpayers who do comply to continue to do so, first, by setting and validating ‘standards of behaviour’ expected of taxpayers, secondly, by deterring departures from these standards, and, finally, by providing taxpayers who depart from these standards with their just deserts.

Evaluation of the current penalties provisions

12.6 The committee received a number of submissions on the penalties provisions. One submission suggested that the new penalties provisions should be allowed to operate for some time before consideration is given to changing them. As the government intends to undertake a post-implementation review of the penalties provisions in 1999, after they have been sufficiently tested in practice, the committee considers that it should not make any major recommendations for change. The review will be of great interest and importance to taxpayers and their advisers. The committee would, therefore, like to take this opportunity to raise a number of issues which it believes should be considered by the government as part of the proposed review.

12.7 The committee **recommends** that the government should specifically require the review team to report on:

whether the government’s performance expectations of taxpayers are reasonable;

whether, and to what extent, a past record of ‘good behaviour’ should be taken into account in deciding to impose penalties or to escalate enforcement;

whether the fairness of the penalties provisions is apparent to all taxpayers, and whether taxpayers who comply can see that those who do not comply are adequately punished.

¹⁹¹ United States Internal Revenue Service, *Report of the Commissioner’s Executive Task Force on Civil Penalties*, February 1990

12.8 The committee envisages that the review team's report will be backed up by substantive evidence from behavioural scientists on the expected impact of alternative approaches. The report should canvas the views across the spectrum of taxpayers, and tax and accounting professionals. The committee also encourages the government to invite one or more tax professionals from the private sector to join the review team.

12.9 In the light of the government's intention to review the operation of the penalties provisions in 1999, after it has been sufficiently tested in practice, the committee **recommends** that no major changes should be made to the penalties provisions before this review. The committee hopes that the discussion in this chapter will raise public awareness of the penalties provisions and its importance in a self-assessment environment. For this purpose, an outline of the penalties provisions is included at appendix 6.

CHAPTER 13 – APPLYING THE LAW

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Introduction

13.1 A central focus of the committee’s terms of reference is to report on the robustness of the tax system. A robust tax system requires, in addition to robust tax laws, robust administration by the revenue authority – in New Zealand’s case, the Inland Revenue Department. This chapter considers the robustness of New Zealand’s tax administration, where it may have been deficient, and where it can be improved.

13.2 Maintaining a robust tax administration is not just an obviously desirable objective of a revenue authority. In New Zealand, it is a statutory duty imposed on the Commissioner of Inland Revenue and all departmental staff. Under sections 6 and 6A of the Tax Administration Act 1994, the Commissioner and his staff are charged with the task of care and management of the tax system and upholding the integrity of that system.

13.3 Encouraging voluntary compliance with tax laws is the strategy adopted by Inland Revenue to maintain the integrity of the tax system. This approach is an orthodox one that has also been adopted by comparable overseas tax authorities – the Australian Tax Office, the United Kingdom Board of Inland Revenue, Revenue Canada and the United

States Internal Revenue Service. Encouragement of voluntary compliance involves a number of aspects. One is that those who set out not to comply with the tax laws must be brought to account in an appropriate way. If people see some sections of society being able to escape their legal tax obligations, the tax system will be seen to be unfair and voluntary compliance will be undermined.

13.4 Taxpayers are entitled to consider the tax consequences when deciding whether and how to act or to refrain from acting, so that no more tax is paid than the law requires.¹⁹² Moreover, it can be the duty of company officers and directors to ensure that no more tax is paid than the law requires.

13.5 The incentive to create schemes intended to test the boundaries of the legislation is high. So also is the temptation to devise schemes, often deliberately complex, in an attempt to confuse the department and so, to fail to meet legal obligations. The tax system needs to be robust if it is to cope.

13.6 In these circumstances, proper enforcement of the law requires the Inland Revenue Department to:

invoke general anti-avoidance laws where they apply;

invoke the criminal law where fraud and not just avoidance is involved;

use other legal means available to it, including the use of injunctions and declaratory judgments, to ensure that the tax system is not undermined for the benefit of a few.

13.7 This chapter sets out the committee's views on these issues for the future guidance of the department, tax advisers and taxpayers.

Background

13.8 Until the 1970s the tax scene in New Zealand was relatively peaceful. After that time, however, a number of New Zealand companies and advisers took a more aggressive approach to reducing their tax liabilities. In the committee's view, the Inland Revenue Department

¹⁹² *Re George Inglefield Ltd* [1993] Ch 1 at 26: 'If a man so conducts his affairs that he places himself outside the operation of an Act of Parliament, he cannot be said to be either evading it or defeating it. He has done nothing that is unlawful, and he has done nothing that calls for adverse comment from the court.'

seemed slow to react to the possibility of harm to the system. It fell behind this more aggressive approach to the law by elements in the business and tax community.

13.9 The department, realising its operational deficiencies, has since restructured to become more responsive to taxpayers, and as part of this restructuring, has ensured that more legal advice is available to it.

13.10 The committee has found much to admire in the way the department is handling the challenges facing it in the present economic and social environment. Although the task is far from over, determined and, in many ways already successful, efforts are being made to produce a streamlined, coherent, comprehensible and efficient system with the lowest economic costs. These steps include the restructuring of the department and the development of the generic tax policy process to enable consultation on proposed legislation. The changes the Inland Revenue Department is making places very heavy demands on it. The standards expected by the Tax Administration Act 1994 are very high, and although the committee considers that the department should aspire to the highest standards, it recognises that this aspiration needs to be balanced by practical hindrances to the achievement of those standards.

13.11 There are, nevertheless, some core requirements that the Inland Revenue Department must always meet. The department should never:

fail to assess the revenue that is lawfully due otherwise than in accordance with the care and management requirements set out in the Tax Administration Act 1994;¹⁹³

yield to pressure for favourable treatment;¹⁹⁴ or

grant amnesties from prosecution that could and should be brought.¹⁹⁵

13.12 The committee notes a related requirement: that officials must be alert not to overlook the possibility that an arrangement may be fraudulent, and the possible need to obtain the appropriate legal advice.

13.13 In general, maintaining the robustness and integrity of the tax system requires the Inland Revenue Department to apply the law without

¹⁹³ For example, *W & A McArthur Ltd v Federal Commissioner of Taxation* (1930) 45 CLR 1 at 9, Isaacs CJ

¹⁹⁴ [1994] 1 All ER 769 at 790

¹⁹⁵ Declared in cases such as *Czarnikow v Roth Schmidt & Co* [1992] 2 KB 478 at 488, Scrutton LJ

fear or favour. This principle was laid down by the Court of Appeal in *Reckitt & Colman (NZ) Ltd v Taxation Board of Review and the Commissioner of Inland Revenue* where it stated:

Every taxpayer shall be treated exactly alike, no concession being made to one to which another is not equally entitled... Where there is no express provision for discretion... and none can be properly implied from the tenor of the statute, the Commissioner can have none; he must with Olympian impartiality hold the scales between the taxpayer and the Crown giving to no one any latitude not given to others?¹⁹⁶

13.14 The committee understands that the department accepts this approach. An example of the implementation of this approach is the department's new Adjudication & Rulings unit, the mandate of which is to use its best endeavours to reach a conclusion that it consider the courts would reach on technical issues before it.

13.15 The committee considers that in carrying out its responsibilities the department has taken too restrictive a view of the secrecy provisions. The department should follow the more liberal interpretation recently adopted by the courts.¹⁹⁷ In addition, the legislation should be amended to clarify that the secrecy provisions are not intended to, and do not in fact prevent the department from taking action, such as providing information leading to criminal prosecutions, to protect the integrity of the tax system.

13.16 Finally, the committee recognises that the onerous duties placed on department also fall on its individual officers. In any large organisation disagreements over how particular matters should be handled will inevitably arise. In the department's case, these disagreements can go to the heart of how best to protect the integrity of the tax system. That being the case, and considering the need to protect the confidentiality of individual taxpayer affairs, the department needs to be especially vigilant in establishing satisfactory procedures for resolving internal disagreements over the handling of individual taxpayer's cases.

¹⁹⁶ [1996] NZLR 1032 at 1042

¹⁹⁷ See the Court of Appeal decisions in *Knight v Barnett* (1991) 12 NZTC 8,014; *CIR v ER Squibb & Sons Ltd* (1992) 14 NZTC 9,146; *Fay Richwhite & Co Ltd v Davison* (1995) 17 NZTC 12,011

Historical perspective

13.17 In the *Commissioner's Comment* column in the department's newspaper, *Revenews*, the present Commissioner said:

There is no denying that public attitudes towards the integrity of the tax system and the fairness of the department have suffered during the course of the [Winebox] hearings... The perception that customers hold concerns us all because, if it is negative, it can harm voluntary compliance and make it more difficult for us to achieve our overall objective of maximising revenue.¹⁹⁸

13.18 The committee agrees with this conclusion. Every New Zealander has a real interest in the proper and impartial administration of the tax laws.¹⁹⁹ The damage to public attitudes towards the integrity of the tax system, and towards perceptions of fairness of the department, must be cured, and must be seen to have been cured, before the tax system can be considered fully robust. The committee believes that that damage will be cured only when it has become apparent to all citizens of New Zealand that the department is able to match the ingenuity of the most powerful. Two examples from the past illustrate this point.

Certain tax loss schemes

13.19 Since the late 1970s, one New Zealand tax agent has been offering a 'service' involving the use of tax loss companies. In *Miller v CIR; Managed Fashions Ltd v CIR*,²⁰⁰ the Court of Appeal has held that the schemes were void as tax avoidance. Considering the ubiquity of these schemes, the department should have been aware of them from an early stage.

13.20 Although this scheme is now a matter of history, the proliferation of such schemes was such that their cumulative effect on the revenue of New Zealand apparently reached tens of millions of dollars of tax. It has been only since the 1990s that cases involving those schemes have been brought before the courts, which have consistently held that they were void as tax avoidance.

¹⁹⁸ Issue 15, September 1997

¹⁹⁹ In *New Zealand Insurance Company v Commissioner of Stamp Duties* [1954] NZLR 1011 at 1018, Barrowclough CJ declared that: 'Every person in New Zealand is interested in seeing that all taxation which Parliament has authorised is, in fact, levied and collected.'

²⁰⁰ (1998) 18 NZTC 13,961

13.21 It appears that this episode is now being brought to a satisfactory conclusion. However, this result was not achieved without a significant delay and cost. It is imperative that in the future such aggressiveness should be dealt with swiftly and efficiently.

Tax shelter schemes

13.22 Film tax shelters offer another example from the past where the Inland Revenue Department seemed to struggle with a change to a more aggressive environment.

13.23 Although, over the past decade, a concerted and successful effort has been made to achieve neutrality in the tax system and to prevent tax preferences driving investment and commercial decisions (see para 6.21), calls are sometimes made for the restoration of some such preferences with a view to both encouraging businesses and offsetting preferences said to be enjoyed by trading competitors of New Zealand enterprises. Some arbitrage opportunities, which caused the department problems during the 1980s,²⁰¹ seemed to enable, in some cases, multiple approaches to the padding of allegedly deductible expenses claimed for schemes involving goat raising, apricot growing, film making, bloodstock breeding, garlic production, game bird breeding, and other schemes.

13.24 Many advisers had no doubt that there was substance to the notion that some schemes were illegal and fraudulent. They raised three particular concerns, first, that the schemes were starkly uncommercial; secondly, that the purported costs of goods and services were falsely inflated; and finally that, in so far as they had been falsely inflated, costs simply could not have been deductible for tax purposes, even though, on the advice of the promoters of the schemes, taxpayers were claiming that they had been incurred.

13.25 The decision of the House of Lords in *Ensign Tankers (Leasing) Ltd v Stokes*,²⁰² shows the English judges dismissing claims for deductions for expenditure on a film-making scheme not essentially different from dozens of New Zealand schemes, some relating to films and some focused on other investments. In the course of reported judgments on various pro-

²⁰¹ The report of the Davison Commission pointed out 'the Commission not having investigated many of the allegations made... which are outside the scope of its inquiry, it is not to be taken as in any way saying that there is or is not any substance in them'.

²⁰² [1994] 1 All ER 769

cedural matters arising from an inquiry into certain New Zealand films, Judge Barber held those schemes to have been frauds on the revenue.²⁰³

13.26 A civil suit against a promoter, by investors who claimed to have been defrauded, was settled this year for a payment of the investors' entire losses together with all their legal costs.

13.27 The healthy scepticism required to deal with such schemes can be illustrated by the workings of a typical film scheme. When any such scheme is considered, it is unsurprising that they can have seemed fraudulent. The schemes were usually touted to investors on the basis that the investors would be required to put up only, perhaps, one third of the alleged costs of making the film. The remaining 'costs' were supposed to be met from 'advances' made by companies which were located in jurisdictions not noted for welcoming inquiries from tax authorities, or indeed from investors.

13.28 On the strength of the proposition that these additional 'costs' were genuine, and were being genuinely borrowed by the investors, the promoters advised the investors to claim the whole of the 'costs', and not just the one-third which they were paying with their own real money. The tax relief that they stood to obtain often exceeded the amount they were putting at risk. So even if the film made nothing at all, the investors would have been much better off than if they had never invested and lost their money in the film in the first place.

13.29 But the genuineness of the 'costs' which were being 'funded' by the offshore 'borrowing' was far from apparent. For one thing, the offshore 'lenders' generally had little capital and lacked any visible means of support, let alone the resources to 'lend' millions of dollars for film making.

13.30 Another reason for doubting the genuineness of the claims was that the sums being 'funded' by the offshore companies were to be repayable *only* out of the profits of the films. In its judgment in *Mirage Entertainment Corp Ltd (In Receivership) v Arthur Young*,²⁰⁴ the High Court found that it was well known, at that time, in the film industry in New Zealand, Australia and the United States 'that only one in ten films covers its costs ... [and that] on average New Zealand films have only recovered

²⁰³ See *Re an Inquiry into [A] Films Limited (No 1)* [1993] DCR 686, and *Re an Inquiry into [A] Films Limited (No 2)* [1993] DCR 970.

²⁰⁴ (1992) 6 NZCLC 68,213

30 to 40 per cent of their costs.’ In a number of films scrutinised in that case, only four films recovered any of their cost. That there were almost never any profits made it essential to view with the greatest scepticism any claim that offshore ‘financiers’ were intent on throwing away millions of dollars just so that investors in New Zealand could claim tax deductions in New Zealand in excess of true costs.

13.31 The committee is aware that, in April 1987, the Minister of Revenue published an estimate of the tax loss that related only to the film schemes. That estimate was \$56 million.

13.32 To the extent that revenue loss was due to inflated expenses, the deductions should have been disallowed. Provided it had reasonable grounds for challenging the deductions, the department did not have to prove that they were not legitimate. The law places the burden of proof on those who wish to dispute the correctness of the department’s decision in such cases to prove that the expenses were costs incurred within the principle laid down by the House of Lords in *Ensign Tankers*.

13.33 From the evidence, it seems that the Inland Revenue Department in common with many advisers and investors had difficulties in understanding some of the film transactions. While not all film investments were of the type described, and many that were of this type were successfully challenged by the department, it appears that the department was unable to take the swift and decisive action that could have been taken. The issue is whether this situation persists.

Improvements in the Inland Revenue Department

13.34 In the light of events of the past, the committee sought information from the department to help it form a view on whether the public is now entitled to take a more positive view of the integrity and robustness of the system.

13.35 The committee has been advised that the department has taken steps since the time these schemes were developed. Along with the restructuring of the department, and the introduction of the generic tax policy process, a new disputes resolution procedure has been put in place. Under parts IVA and VIIIA of the Tax Administration Act 1994, inspectors faced with similar situations to those described above, would now issue a notice of proposed adjustment, and the disputes procedure involving the department’s Adjudication unit then would proceed.

13.36 The department clearly is resolute that such questions will not be permitted to arise again. In August 1998 it issued Standard Practice

Statement INV-350 on *Finalising Agreements in Tax Investigations*. Among the many valuable points it made, the department said:

There are circumstances or situations where Inland Revenue will not enter into negotiations. These [include] not assessing an amount which is clearly assessable, or allowing a deduction... that is clearly not allowable.

13.37 The committee is pleased to record this approach. However, those new procedures, of themselves, do not overcome any past inadequacies in the quality of the legal advice relied on by the department. The committee has been informed that an objective of departmental restructuring has been to ensure that appropriate legal skills are available at all stages of the process involving audit, investigation, assessment, dispute resolution and litigation. Barristers and solicitors are employed in the technical and legal support groups in service centres throughout the country (20), by Corporates segment (10), by Adjudication & Rulings unit (27), by Litigation Management (12). In addition, the department has access to the Solicitor-General and barristers and solicitors employed as Crown counsel or Assistant Crown counsel by the Crown Law Office and by Crown Solicitors offices throughout the country, and by barristers who are instructed pre-litigation by the department, or post litigation by the Crown Law Office.

13.38 The committee has found it very difficult to assess the quality of legal knowledge and analysis within the Inland Revenue Department. A major impediment is that most Inland Revenue decisions are confidential between the department and the taxpayers. This consideration applies in particular to almost all decisions in favour of the taxpayer, because a taxpayer who has the benefit of a favourable decision has no reason to appeal to the courts. Moreover, even if the committee had had access to files within the Operations group of the department, it did not have time or resources to assess decisions recorded in those files. As a second best option, the committee has examined a number of Inland Revenue Department decisions of recent years that are public knowledge.

13.39 This chapter mentions decisions that relate to Winebox transactions and to certain widely marketed tax shelters. Chapter 6 discusses three interpretation statements where departmental legal decision making has been set out and published. The committee found shortcomings there and

in the other legal analyses that it examined.²⁰⁵ The committee put to officials a number of questions that the committee hoped would discover whether past shortcomings had been rectified. Officials answered these questions by reference to the systemic changes that the committee records in paras 13.35 to 13.37 of this report.

13.40 The committee cannot say whether these systemic changes have had the necessary effect. The committee is concerned that of necessity it has been left in this state of uncertainty. Very many Inland Revenue officers make essentially legal decisions every week. Often, the transactions in question require the decision maker to have a basic knowledge of the legal system, some grasp of the rules of evidence, and some knowledge of criminal law, to say nothing of the knowledge of tax and business law that people expect of Inland Revenue officers in any event. The committee is not in a position to say whether New Zealand officers in general have these skills at the levels that are necessary for the complexities of the tasks that they severally face.

13.41 The skills of Inland Revenue Department staff are crucial to the integrity of the tax system. The committee cannot assure the government that the Inland Revenue staff as a body have the expertise that they need. Further, the committee has the impression that at the moment the government is not certain about the level of competence that it should require of the department, nor, which must follow, whether the department meets that level. The committee **recommends** that the government should ensure that the Inland Revenue Department reviews staff skill levels, and further, that the department should ensure that recruitment, retention, and continuing education policies are fully adequate to establish and maintain the staff skill levels that are necessary.

Applying the general anti-avoidance provisions

13.42 In order to match aggressive tax behaviour, it is essential that the department should invoke the general anti-avoidance provisions when appropriate. Some of the film investment schemes considered in the first part of this chapter were ineffective because, once properly analysed and understood, they often did not meet the statutory criteria upon which tax relief depended.

²⁰⁵ See the discussion that follows in paras 13.47 and 13.48

13.43 In some cases, taxpayers might find ways in which to structure arrangements which apparently or actually comply with the detailed provisions of the Act, but in so doing, they cause the law to operate in a way which Parliament could not possibly have intended. As the committee has pointed out in chapter 7, the common law can neutralise that result in many cases of apparent compliance. If the common law fails to have that effect, sections BG 1 and GB 1 act as a backstop to protect the integrity of the tax system. When the arrangement is of the type contemplated by the anti-avoidance provisions, the arrangement is void for tax purposes from the outset (see the discussion in paras 6.38 to 6.53).

13.44 When confronted by ingenious schemes that otherwise appear to comply with the Act and with the common law, but which appear to do so in a way that is likely to undermine the integrity of the tax system, the first resort of the Inland Revenue Department, therefore, must be to a competent analysis and application of these backstop provisions. The department's task is not to consider whether to apply the provisions. They apply of their own force. The duty is to consider whether they do apply, and, if so, to assess accordingly.

13.45 Mr David Russell QC, of Queensland, in his paper on *Substance v Form – the ATO Approach*,²⁰⁶ prefaced his remarks with this comment:

The necessity for some form of protection of the Revenue from artificial, blatant and contrived tax avoidance schemes will be self-evident. No objection could be taken to legislation whose effect was that identified in [those passages from the reasons of the majority in] *Challenge*.

13.46 In his address, he said that 'you could have no complaint with a provision like s 99 [now s BG 1] as construed by the Privy Council in *Challenge*'.

13.47 The committee believes that the issue is not so much the deficiencies in the anti-avoidance provisions, as in the Commissioner's past understanding and application of those provisions. This view is echoed in the report of the Davison Commission,²⁰⁷ where the observation was made that the Inland Revenue Department had adopted a 'conservative inter-

²⁰⁶ To the 13th National Convention of the Taxation Institute of Australia in Melbourne on 21 March 1997. At pages 9-10 he set out the views of the majority of their Lordships in *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,219.

²⁰⁷ At page 3:1:50

pretation' of the general anti-avoidance provision on the tax avoidance issue,²⁰⁸ and that 'the weakness exposed by the Winebox deals is not the legislation itself ... but the use of it by the Commissioner'.

13.48 The department has published a statement on the approach to be taken to the interpretation of the anti-avoidance legislation.²⁰⁹ The committee considers the statement to be unsatisfactory and inaccurate. The committee understands that the department finds the statement inadequate, and intends to withdraw it. As outlined in para 6.101, the committee considers that the statement should be withdrawn immediately without waiting for a replacement.

13.49 As the committee observed in para 6.43, section BG 1 of the Income Tax Act 1994 applies by force of the statute. It is not intended by Parliament to be applied at the discretion of the Commissioner. This intention makes it imperative that this provision must not be undermined. The committee believes that the department should move quickly to apply section BG 1 to any scheme that displays an evident tax avoidance purpose or effect, to disallow any challenge that is not compelling, and, relying on the taxpayer bearing the onus of proof, to attempt to obtain a speedy judgment on the case.

13.50 During that process, the committee expects that the department would use its powers to inquire of the responsible advisers whether the scheme was being applied or recommended in other cases. If it were, the committee would expect that the revenue also would move swiftly to halt any proliferation of the scheme.²¹⁰ The department should never act so slowly or indecisively so as to expose the revenue to any unnecessary risk or shortfall.

13.51 The committee was advised by the Inland Revenue Department that it has, in recent years, been making assessments on the basis of section BG 1 a great deal more frequently, and that, since January 1994, it has done so in 352 cases. In 223 of these cases, the person assessed has conceded, or the court has ruled in favour of the department. In 45 cases, the department has either lost or conceded to some extent. The remaining

²⁰⁸ At page 3:1:41

²⁰⁹ *Tax Information Bulletin*, volume 1, No 8, February 1990.

²¹⁰ By appropriate public statements, concerted investigation and fast-tracking dispute resolution procedures.

84 cases remain unresolved at this time. These figures emphasise the value of section BG 1 to the tax system.

13.52 Officials also advised the committee that there is a process for identifying schemes that pose a potential threat to the tax base and quantifying the associated fiscal risk. This process means that Ministers are advised periodically of those fiscal risks so that they can be incorporated in the government's fiscal forecasts. This in turn means that as well as investigating these schemes, the need for a policy response is considered. This consideration has resulted in base protection measures being included in three recent tax Acts and a current tax bill.²¹¹

13.53 The committee **recommends** that, in addition to the recommendations in chapter 6, the department should remove from its internal practices and procedures and from public statements any suggestions that section BG 1, as interpreted by the Privy Council in *Challenge*,²¹² should be read restrictively rather than liberally.

Applying the criminal law

13.54 In some cases, the aggressiveness of taxpayers can lead them to go beyond avoidance and commit fraud on the revenue. In such cases, it is important that the department brings criminal charges against those involved, including those who promote such activities. In the past, it seems that some officers of the Inland Revenue Department were under the mistaken belief that fraud could be proved only by direct evidence. While it is true that the onus of proof is on the prosecution in criminal cases, it is also true that this burden can be met in some cases by circumstantial evidence, that is, by inference from the facts.

13.55 Inference is the standard means of proof of intentional acts. Some examples may assist. In his closing argument on 27 August 1971, in the trial of Lieutenant William Calley for murder at My Lai in Vietnam, counsel for the United States told the Court Martial and the jury:

Now we have an additional element that we must satisfy as to all of the specifications: did the accused have the required criminal state of mind at the time he killed these individuals. To be guilty of premeditated murder, gentlemen,

²¹¹ 1998 No 7, 1998 No 101, 1998 No 107 and Bill 1998 No 241

²¹² (1986) 8 NZTC 5,219

you have to intend to kill the victim. You have to intend that he die...

How does the government perceive what a man is thinking? What Lieutenant Calley was thinking on the day in question? How do we show you that? First of all, we rely on your own common sense and understanding and recognition of the way the human mind functions, recognition of the way people think and act. We rely upon the fact that you can take these facts, you can take his acts, his conduct, the observations of others, and find what he was thinking. We can prove it to you. We have proved it to you, because what is the evidence of a man's intent, what he intends to do? A man's actions are the mirror of a man's mind. You can prove intent two ways, just as you can any other element of an offense, or any other fact. You can prove it by direct evidence, and what is that? When a man tells you what he's thinking. You can prove it by circumstantial evidence; even though he doesn't tell you, you know by what he does what he intended.²¹³

13.56 By way of further recent example, the summing up in May 1995 of Williamson J, in the trial in Dunedin of David Bain for murder included this passage:

As a jury you are entitled to draw inferences. Inferences are not guesses. They are logical, reasonable, fair deductions from facts which have been proved. It is important in this case, as in most criminal cases, because the Crown is asking you to draw the inference from the combination of a number of different circumstances that the accused did shoot each of the victims, although he may now be blanking it out of his mind. It is for you to decide whether that is the appropriate and reasonable conclusion to come to from all the evidence that you have heard. Evidence by way of inference is often referred to as circumstantial evidence. It is evidence of facts from which the jury may infer the existence of the vital fact in issue. Circumstantial evidence is often contrasted with direct evidence such as eye-witness

²¹³ Lief et al, 1998, *Ladies and Gentlemen of the Jury*, pages 368-369

evidence. Usually circumstantial evidence derives its force from the fact that it consists of a number of items all pointing to the same conclusion. It is really a process of reasoning. Because crimes, if premeditated, are usually committed by stealth or in secrecy, it is not uncommon that there is no direct evidence. Sometimes when facts are just taken one by one, item by item, they don't have a strong probative value but when they are considered together, they do. So you must weigh the combined effect of all the circumstances which have been proved in this case to decide whether you are satisfied beyond reasonable doubt of the accused's guilt.²¹⁴

13.57 When no signed confession or incriminating document that admits the offence is available, so that a fraud cannot be proved by direct evidence, there are well-settled circumstantial elements that can justify the inference of fraud nonetheless. For example, there may be a lack of reasonable ground for taking a particular course of act or omission. In *R v Waterfall*, the English Court of Appeal ruled that 'the absence of reasonable ground may point strongly to the fact that the belief is not genuine'.²¹⁵

13.58 In *R v Mackinnon*, another English judge put it in this way:

Often in the case of alleged fraudulent statements the only evidence of dishonesty consists of evidence that no grounds exist on which any reasonable man could have believed in the truth of the statement. In my experience, juries are not slow in a proper case to draw the inference of fraud.²¹⁶

13.59 In *Westminster City Council v Croyalgrange Ltd*, the House of Lords made the following findings:

Such [guilty] knowledge may be proved either by proving actual knowledge or by showing that the defendant had deliberately shut his eyes to the obvious or refrained from inquiry because he suspected the truth but did not want to have his suspicions confirmed; furthermore [per Lord Brightman], if all the other ingredients of the offence are proved, if the defendant chooses not to give evidence of his

²¹⁴ McNeish J, 1997, *The Mask of Sanity: The Bain Murders*, page 262

²¹⁵ [1970] 1 QB 148 at 151

²¹⁶ [1959] QB 150

absence of knowledge, the court may infer that the defendant did have the requisite knowledge.²¹⁷

13.60 In the Equiticorp criminal trial in 1992, *R v Adams*,²¹⁸ some of the counts revealed offshore company structures of what Tompkins J described as ‘impressive complexity’. One structure comprised 50 companies in Hong Kong, five companies in the Turks and Caicos Islands and one in Vanuatu, all purchased at once. Every one of these companies had a bank account opened for it. ‘The whole edifice was in reality an elaborate facade, set up to pass Equiticorp funds’ to another company in loans each of which would be below the limit at which board approval would have been required.

13.61 Another loop of companies in three offshore jurisdictions was set up in order to make transactions in three currencies, and in order that the owners of the structure could not be able to be detected.²¹⁹ In the circumstances before him, Tompkins J found that the purpose of the setting up and use of the loop was clear beyond reasonable doubt.

It was expensive to set up and use. A clear example of this is transaction 4 where the money travelled from [the solicitors’] trust account, through the Yeoman Loop, back to [the solicitors’] trust account at a cost of \$37,000. When regard is had to those costs, if the use were legitimate, an explanation of that legitimate use could be expected ...

It was set up and used in order to conceal the payments that were intended to be, and were, made, and to make it difficult for any person who had cause to inquire, to find out what they were, and their source. The cumulative effect of [the complexity of the scheme and the absence of any legitimate tax or other explanation] leads to the clear conclusion that the only reasonable inference that can be drawn is that the concealment was dishonest – that is, with intent to defraud. Concealment for innocent purposes is not a reasonably possible inference.

Was anyone defrauded?

²¹⁷ [1986] 2 All ER 353

²¹⁸ Unreported, High Court, Auckland, T240/91, 18 December 1992

²¹⁹ *Maxwell v Commissioner of Inland Revenue* [1959] NZLR 708 is another New Zealand case in which attention was drawn to the centrality of any explanation which may be given by the defendant.

If the purpose of the structure were dishonest concealment, the question answers itself. The persons the conspirators intended to defraud were those from whom it was intended to conceal. It is not necessary that these be specifically identified. But it is easy to see that they would embrace... the Revenue, and enforcement agencies.

13.62 References in documents to avoiding possible ‘detection’ by the Commissioner, to attempts being made to ‘confuse the enemy’ [apparently the Commissioner], to an arrangement by the taker of a put option that ‘should the structure ever be contested by the New Zealand Inland Revenue that we run with the objection procedure for as long as possible’, although only ‘until the issue becomes too hot to handle’ were found by the Court of Appeal, in *European Pacific Banking Corp v TVNZ*, to justify its finding that:

There may also be room for the inference that those transactions were conceived and documented as they were in order to conceal any connection with the contemporaneous payment of tax in the Cook Islands.²²⁰

13.63 On the basis of that inferred intent, the court was able to find that the TVNZ had made out an arguable case that European Pacific Banking Corporation were guilty of iniquity. That finding justified the court declaring that the company could run a programme based on those documents notwithstanding the otherwise confidential nature, and notwithstanding the fact that it was claimed that the documents had been stolen. ‘Why conceal?’ the court effectively asked, ‘unless because one knows that the tax credit claim at least ‘may be’ in contravention of the law.’

13.64 As the House of Lords held, in *Wai Yu-tsang v R*:

‘intent to defraud’ [can] exist where there was no other intention than to deceive a person responsible for a public duty from doing something, or failing to do something, which he would not have done, or failed to have done, but for the deceit.²²¹

13.65 In other words, when it lacks the convenience of a signed confession, the Crown sets out to prove all the known circumstances. It then in-

²²⁰ [1994] 3 NZLR 43 at 46

²²¹ [1991] 4 All ER 664 at 668

vites the court to draw from them the necessary inference that wilful fraud has been committed by the taxpayer. In *Spies v United States*, the United States Supreme Court made an expressly non-exhaustive list of the badges of fraud:

[W]e would think affirmative wilful attempt may be inferred from conduct such as keeping a double set of books,²²² making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal.²²³

13.66 Another circumstance that can point strongly to wilfulness is the sheer size of deficiencies, which can be such that the court will infer that the taxpayer did not believe that his return was honest.²²⁴ Repetition of substantial deficiencies year in year out is another circumstance from which such an inference can be drawn in appropriate cases.²²⁵ The use of dummy names is yet another example.²²⁶ So, also, is lying to the revenue about why one has not filed past due returns.²²⁷

13.67 If breaches of penal provisions of the taxation laws, which the taxpayer claims were not wilful, were to have arisen in the course of transactions or arrangements which included deliberate breaches of other statutes or of the general law, the taxpayer's claim that the taxation breaches were unintentional or inadvertent may meet a sceptical reception from the court.

13.68 Thus, during the 1980s, section 62 of the Companies Act 1955 was regarded as an irritating obstacle to corporate takeovers and to the accessing – often as part of tax schemes which relied on deception – of corporate assets. It forbade the provision by a company of financial assistance for the purpose of purchases of shares in its capital. Because the

²²² As in *Petera Pty Ltd v Federal Commissioner of Taxation* (1985) ATPR 46,884, where a restaurateur who kept one set of books for his own purposes, and one for his tax accountant, understated his income in one year alone by \$90,000.

²²³ 317 US 492 (1943)

²²⁴ *McGovern v Galt* [1948] VLR 285, O'Brien J; *Commissioner of Inland Revenue v Parisienne Gown Co Ltd* [1956] NZLR 442, McGregor J

²²⁵ *Commissioner of Inland Revenue v Frethey* [1961] NZLR 245, McCarthy J

²²⁶ *McGovern v Carra* [1950] VLR 454, Sholl J

²²⁷ *United States v Goodyear* 649 F 2d 226 (1981) [4th cir]

sanction was a fine of only \$200, there were those who were prepared to disregard the prohibition, and treat the fine as, in effect, a licence fee.

13.69 Such an argument was run and rejected in the prosecution of the former chief executive officer of the Australasian Investments Corporation Group. Temm J held:

While the penalty is minimal, the purpose of the section is plain. Any person who deliberately embarks upon a course of conduct, whether in the market place or anywhere else, in deliberate defiance of the provisions of the section must take the consequences. Where a person breaks the law knowingly and deliberately, that can be strong evidence of dishonest intention.²²⁸

13.70 Some transactions may be so large, so questionable, so complex, or so adverse in their potential effect on the revenue, that failure to obtain expert advice, or expert advice independent of the in-house advice, also may be a factor assisting the court to infer a dishonest intention.

Dealing with schemes hard to find

13.71 In *Inland Revenue Commissioners v Stype Investments (Jersey) Ltd* the English Court of Appeal said of a transfer by executors of £20 million out of the United Kingdom to Jersey within two months of the death of the deceased:

It does not seem credible that no discussion took place or that no investigation was made of the capital transfer tax position. Despite the magnitude of the sum involved, no evidence has been produced that the advice of English counsel was sought after the death of Sir Charles. In these circumstances there is a grave possibility that the object of directing the Prudential to pay £20m in Jersey was to evade tax on £20m. If this was in fact the object, it may have been the product of a criminal conspiracy to defraud the Revenue. This court feels very strongly that the Inland Revenue should ask the Director of Public Prosecutions to investigate.²²⁹

²²⁸ In *R v Rodney Hamish Worn* (unreported, T135/91) page 11

²²⁹ [1982] 3 All ER 419 at 430

13.72 Running tax driven transactions offshore can be undertaken to disable the revenue authorities from doing their duty, namely, considering whether, on all the true facts, there is any matter requiring consideration in connection with the liability to tax of anyone who is resident in, or who is deemed to be resident in, New Zealand; or with the liability to tax of anyone who may have derived income from New Zealand. The Commissioner has the right to know, and the duty to find out.

13.73 The operations of tax haven entities, which are bona fide, are not concealed from the revenue. Examples are the Netherlands Antilles subsidiary of the New Zealand company which figured in *New Zealand Forest Products Finance NV v CIR*,²³⁰ and Pan Eastern Refining Company Ltd, the Bahamas subsidiary of the objector in *Europa Oil (NZ) Ltd v CIR*.²³¹

13.74 As a percentage of the total company registrations in tax havens, the number of non-puppet companies would be very small. In most tax haven companies, there will be the usual puppet structure, and the whole object of the exercise is to see that the Commissioner does not get the necessary full disclosure.

13.75 Credible reasons for legitimate use of secrecy in this context will rarely, if ever, suggest themselves. In the absence of a credible alternative explanation, the secrecy will point to illegitimate obstruction of the Revenue authorities. At first instance in *Agip (Africa) Ltd v Jackson*,²³² Sir Peter Millet observed that ‘secrecy is the badge of fraud’.

13.76 The following year, reviewing a book on money laundering, Sir Peter wrote:

Giving evidence before me in the course of civil proceedings last year, a Swiss fiduciary agent who had actively assisted his clients to launder their funds was indignant at the suggestion that he had done anything wrong. ‘I never suspected for a moment’, he told me. ‘that the money represented the profits of drug-trafficking’ (which it did not) ‘or the proceeds of fraud’ (which it did). When asked what he thought the money was, he told me that he assumed that it was ‘merely’ the proceeds of tax evasion or breaches of ex-

²³⁰ (1995) 19 TRNZ 452

²³¹ [1970] NZLR 321

²³² [1992] 4 All ER 385 (affd ibid 451)

change control, or a bribe. 'It is usually a bribe', he explained, in tones which suggested that that made everything above board. When asked what steps he had taken to satisfy himself that the money did not represent the proceeds of criminal activities, whether drug-trafficking or fraud, he admitted that he had taken none; it was simply not practicable to do so.

International fraud is a huge and growing business. Electronic transfer of funds, the widespread use of nominee companies and offshore funds and the existence of havens like Panama and D'jibouti, where investigation is impossible, all contribute to the ease with which fraudsters can transfer substantial sums instantaneously from one country to another and conceal their source and ownership. They are significantly assisted by the reluctance of banks and professional men to enquire into their clients' affairs, and by the attitude of mind displayed by the Swiss fiduciary agent. In his case, wilful blindness was a positive virtue; it was part of his job description.²³³

13.77 In *R v Jones*,²³⁴ the defendant was found guilty of a number of counts of fraud, including the use of a document to obtain a pecuniary advantage, which had cost the Revenue more than \$800,000. He was sentenced to four years' imprisonment. While it was the jury that decided guilt, one of the important indicia undoubtedly would have been the factor noted by Judge Deobhakta in his sentencing, namely that the defendant had utilised:

several companies in order to avert any attention by the Inland Revenue as to what was happening in connection with these series of transactions that were entered into. ... [T]hese are serious offences. They are calculated offences and they occurred over a period. The scheme involved was such that it would have been pretty difficult for an ordinary investigator to notice them on the face of it.

13.78 When matters which could be consistent with wilful concealment are nonetheless claimed to have been legitimate and bona fide, it is rea-

²³³ In *Lloyd's Maritime and Commercial Law Quarterly*, 1993, page 415

²³⁴ Unreported, District Court, Auckland, T 65/94

sonable to expect that those responsible for the arrangements will explain to the court the bona fide use of the complex web of offshore companies. In *R v Adams*, Tompkins J held on this issue:

Nominee companies and off-shore companies are commonly used for reasons, amongst others, of secrecy. Such uses may not of themselves be dishonest. They only become dishonest if it can be shown that their use was known to those setting up and using them to be for a dishonest purpose, such as dishonest concealment. However, when they are legitimately used, those responsible should be able to give credible reasons for the secrecy.²³⁵

13.79 In the absence of credible and honest commercial explanation, concealment generally leaves little room for doubt that the schemes are fraudulent. The committee considers it important to highlight the possible criminal consequences of concealment from the Commissioner as these may not be fully appreciated by taxpayers and their advisers. A taxpayer who is confident that an arrangement is effective for tax purposes but who takes active steps to conceal the arrangement from the Commissioner may be guilty of conspiracy to defraud, even if the arrangement is in fact effective: *O'Donovan v Vereker*,²³⁶ and *R v Forsyth*.²³⁷ In the former case, Northrop J said that even 'an honest belief that the scheme is effective... does not prevent the finding of a criminal intent'.²³⁸

13.80 A robustly-managed tax system would not permit those involved in the promotion of fraudulent schemes to escape investigation and prosecution simply because they were so well-masked that it took years to expose them. For a tax system to permit that possibility would be for it to send all the wrong signals to those intent on such fraud.

Delay in prosecution

13.81 Section 10B of the Crimes Act 1961 provides that, after 10 years from the date of commission, certain offences cannot be prosecuted under that Act without the prior consent of the Attorney-General. The justification for that is readily apparent. The relevant offences are only those punishable by maxima of less than \$2,000 in fines or 3 year's jail. The provi-

²³⁵ Unreported, High Court, Auckland, T 240/91, 18 December 1992

²³⁶ (1987) 76 ALR 97, Full Fed Ct

²³⁷ (1990) 20 ATR 1818

²³⁸ At page 116

sion is a way of preventing the relatively trivial from accumulating and threatening the investigation of the very serious.

13.82 That is the only statutory limitation period relating to the prosecution of offences under the Crimes Act 1961. It cannot, for example, apply to provisions such as section 257 of the Crimes Act 1961, which creates the offence of conspiracy to defraud the revenue. There is also a 10-year limitation on some, but not all, tax offences under section 150A of the Tax Administration Act 1994.²³⁹

13.83 Apart from those express statutory limitations the principles are set out in *Halsbury's Laws of England*:

Except where there are statutory provisions to the contrary, criminal prosecutions may be commenced at any time after the commission of the offence.

Prolonged delay in starting or conducting criminal proceedings may be an abuse of process as, for example, where substantial delay has been caused by some improper use of procedure by, or inefficiency on the part of, the prosecution and the accused has not himself caused or contributed to it and has been prejudiced by it. The jurisdiction to decline to allow criminal proceedings to continue should be used sparingly.²⁴⁰

13.84 In the Equiticorp criminal trial, having found that a complex offshore structure had been used in that case to conceal from legitimate inquiry transactions known to be unlawful, the judge ruled that:

A person who conceals a dishonesty to avoid it being detected has an intent to defraud. An intention to obstruct anyone who might be called upon to investigate a transaction if dishonesty can be shown is itself a fraud.²⁴¹

13.85 Tax fraud is an area in which the courts speak always with a strong voice. It is 'a very grave offence' said Lord Salmon in *Inland*

²³⁹ The form of this legislation creating, and dealing with, offences is unhelpful and unfriendly. It is, for example, not user friendly in its extensive cross-referencing without each cross-reference carrying with it an indication of its subject matter. There is thus required a great deal of cross-referencing in order to see just what the applicable provisions might be.

²⁴⁰ Volume 11(1) *Halsbury's Laws of England*, 4ed, para 786

²⁴¹ *R v Adams*, (unreported, High Court, Auckland, T 240/91, 18 December 1992, pages 37-40)

Revenue Commissioners v Rossminster Ltd,²⁴² echoing Lord Denning in the same case who held tax evaders to be ‘parasites who suck out the life-blood of society’.²⁴³

13.86 The New Zealand courts, likewise, treat tax fraud with the greatest seriousness. In its decision in *R v Petherick*,²⁴⁴ the Court of Appeal endorsed the views that, where large tax fraud is concerned: Prosecution under the Crimes Act 1961 is the proper approach. Imprisonment is the normal punishment. This echoed a similar finding by that court in *R v Fuller*.²⁴⁵

13.87 In *Maxwell v CIR*, tax fraud was described as:

a deliberate evasion of one’s duties as a citizen, while at the same time advantage is taken of the rights of citizenship. Through such action added burdens are thrown on those members of the community who with integrity face their proper obligations, obligations which at no time are light. This class of offence is usually born of greed and should be seen in that light. ...[I]n those cases where the offence is deliberate and substantial as to amount there is much to be said for the view that imprisonment is the punishment which really fits.²⁴⁶

13.88 The message the courts are sending is not restricted to taxpayers. It is applicable with equal force to the Inland Revenue Department. If the department fails to recognise the need for, and the bases of, prosecution, it will undermine the robustness of the tax system. It also will undermine the express intent of section 6(1) of the Tax Administration Act 1994.

13.89 The court has expressed its views strongly that tax fraud is very serious and is appropriate to be dealt with by the Crimes Act 1961. The committee is concerned that officers in the department may not be sufficiently aware of this view, nor of the established principles of evidence. The committee **recommends** that the department should be always alert to the possibility of criminal fraud by taxpayers. When fraudulent activity is

²⁴² [1980] 2 WLR 1 at 52

²⁴³ At page 19

²⁴⁴ (1994) 18 TRNZ 662 at 666

²⁴⁵ [1991] 1 NZLR 323

²⁴⁶ [1959] NZLR 708 at 714

detected, the department should ensure that its officers are aware that the Crimes Act 1961 is the appropriate vehicle for prosecution.

Corporates segment

13.90 The committee notes that the perception of the public is that big corporations do not run the same risk of prosecution as smaller enterprises and individuals. While fraud may be rare in this area, such businesses are not immune from charges of fraudulent activity.

13.91 Officials provided a table showing penal action undertaken by the Corporates segment from 1994 to 1997.

TABLE 7: NUMBER OF PENAL ACTIONS UNDERTAKEN

<i>Year</i>	<i>1994-95</i>	<i>1995-96</i>	<i>1996-97</i>
Asked for a letter of explanation	1	3	0
Issues with a warning/obligation letter	1	2	0
Prosecuted, convicted, and or charged with penal tax	0	0	0
Charged with penal tax	0	1	0
Amount of penal tax charged	\$0	\$7,330	\$0

13.92 Outside the corporate sector shown in table 4, the average number of cases where penal tax was charged between 1994 and 1997 was 128 per annum. The committee was concerned that the comparison between this figure and that in the table showed a low level of evasion and fraud being detected in the corporate sector. However, officials informed the committee that Corporates segment handles only 1,900 head files, and the group comprises mainly large companies for which the normal penal offences such as GST fraud, non-accounting for PAYE and suppressed sales would be uncommon.

13.93 In addition, the department has advised that there is a large increase in proportional terms expected in the 1998-99 year, with requests for letters of explanation sent to, and other penal action expected to be taken against five companies and five individuals. It was pointed out that with such a small sample, statistical variation of this magnitude can be expected. The committee was also advised by officials that data from the new penalties regime shows that the likelihood of penalties being imposed increased with the size of the organisation. This point is illustrated in Table 8. This shows, for example, that 1 per cent of business taxpay-

ers have a turnover exceeding \$10M, while 2 per cent of taxpayers on whom shortfall penalties were imposed fell into this category.

TABLE 8: NUMBER OF PENALTIES IMPOSED

<i>Annual turnover</i>	<i>% of total business taxpayers</i>	<i>% of cases of shortfall penalties imposed</i>
\$0–\$100,000	60	35
\$100,001–\$250,000	19	21
\$250,001–\$500,000	10	15
\$500,001–\$1M	5	13
\$1M–\$10M	5	14
Over \$10M	1	2
Total	100	100

Injunctions and declaratory judgments

13.94 The committee also considers that the department should make greater use of injunctions and declaratory judgments than it seems to have done in the past. If the evidence establishes a risk that a scheme may be applied in other cases as well, and if there is great potential for damage, other measures are available to the department. For example, it may be open to the department to apply for an injunction to limit the proliferation of a tax avoidance scheme.

13.95 In the recent past, in the United States of America, a firm of accountants was allegedly operating a scheme which it described as ‘expanding’ the use of a statutory tax credit for property used in manufacturing. The ‘expansion’ comprised misdescribing²⁴⁷ various items so that the credit would be claimed, and, in the absence of a building inspection by the revenue, would be allowed unchecked. This activity was not tax avoidance but tax fraud. The accountants were touting for business on the basis that they offered this ‘service’. They were advising prospective clients that they could help them claim more of a credit than allowed under ‘traditional methods’.

13.96 The United States Internal Revenue Service sought an injunction to prevent the accountants from any further promotion of their ‘service’, from advising clients to use deceptive terminology, from creating false

²⁴⁷ For example, the firm would describe ineligible concrete-block walls as ‘knock-out panels’; fixed walls as ‘moveable partitions’; and doors as ‘moveable partitions-wood’.

documentation to support improper claims to the tax credit, and from hindering the efforts of the revenue to discover the identities of all taxpayers who had used the 'service'. The injunction was granted by the Eleventh Circuit Court of Appeals *United States v Ernst & Whinney*.²⁴⁸ While it relied on various express provisions of the Internal Revenue Code of the United States, which conferred injunctive power on the District [ie trial] Court, the Court of Appeals made clear that those provisions were subject to the usual rules of equity.

13.97 The inherent jurisdiction of the High Court of New Zealand, and the tenor of the Commonwealth authorities,²⁴⁹ mean that such relief is arguably available in New Zealand, and an application for it should be seriously considered in an appropriate case.

13.98 In addition, the court can declare whether, on a true construction, a statute applies to the facts of a particular case. Section 3 of the Declaratory Judgments Act 1908 provides that:

Where any person... desires to do any act, the... legality... of which depends on the construction... of any statute,... such person may apply to the High Court... for a declaratory order determining any question as to the construction... of such statute.

13.99 The committee considers that the department should make greater use of the resources that exist in the legal system to enhance its position when it is confronted by aggressive tax planning.

The requirement of secrecy

13.100 As the committee has discussed above, prosecution under the Crimes Act 1961 is the proper way to deal with major tax fraud. In the past, the Inland Revenue Department staff seem to have viewed the statutory secrecy obligation imposed on them by section 81(1)(a) of the Tax Administration Act 1994 as an obstacle to prosecution of income tax delinquency under the Crimes Act 1961. The department construes the exemptions in the section narrowly.

²⁴⁸ 735 F 2d 1296 (1984)

²⁴⁹ Referred to in, for example, Meagher et al, 1992, *Equity*, 3d ed, para [2135] pages 562-563

13.101 As recorded by the Court of Appeal, counsel for the Crown in *R v Petherick* gave as a reason for prosecution delays in that case, that:

It is the department's view that the secrecy requirements of s 13 of the Inland Revenue Department Act 1974 preclude it from instituting prosecutions under the Crimes Act, and that this may be done only by the Serious Fraud Office.²⁵⁰

Even as late as July 1998, the department seemed to be adopting the same approach.²⁵¹

13.102 The committee believes that this provision is not the obstacle the department perceives it to be. By its very terms, the statutory obligation is subject to an express exception for disclosure that is required 'for the purpose of carrying into effect' the Inland Revenue Acts.

13.103 The possibility of prosecution under a provision of the Crimes Act 1961, aimed at securing a conviction and a possible sentence of imprisonment, is likely to be a very effective means of securing compliance with, and therefore 'carrying into effect', the Income Tax Act 1994. In this respect, the committee cannot see any requirement in section 81 that the 'carrying into effect' cannot occur when the prosecution is brought by another agency of the Crown rather than the Inland Revenue Department itself.

Effect of the exceptions

13.104 If the committee's view is correct, then disclosure to the police, or to a court, for the purpose of prosecuting, say, a charge of conspiracy to defraud the revenue contrary to section 257 of the Crimes Act 1961, would fall squarely within the express exception of disclosure for the purpose of 'carrying into effect' the Inland Revenue Acts.

13.105 It is true that, in subsection (4) of section 81, Parliament has enacted a number of specific instances in which 'nothing in' the enactments requiring secrecy save for the purpose of 'carrying into effect the Inland Revenue Acts' shall be 'deemed to prohibit' the Commissioner from disclosure in specified circumstances.

²⁵⁰ (1994) 18 TRNZ 662 at 665

²⁵¹ *Police v van der Bosch* (unreported, District Court, Dunedin, Judge Saunders, 6 July 1998) where, in a prosecution for GST fraud, a departmental officer refused to testify on the question of GST registration because the prosecution, being a police prosecution, was considered not to be for the purposes of carrying into effect the Inland Revenue legislation.

13.106 But whatever the scope of subsection (4), the primary focus of section 81 is clear. It is subsection (1), and only that subsection, which enacts the requirement of secrecy. The important feature of this requirement of secrecy in subsection (1) is that it is not absolute. The secrecy requirement is a qualified one only. That is to say, it is a requirement to maintain ‘the secrecy of all matters relating to... the Inland Revenue Acts... except for the purpose of carrying [them] into effect’. The section contains within itself a critical exception that appears to the committee to be all the authority the department needs in order lawfully to lay an information with the police for a charge under the Crimes Act 1961 relating to the Income Tax Act 1994.

13.107 The President of the Court of Appeal appears to have read it that way in *Knight v Commissioner of Inland Revenue*:

Parliament has also provided that the basic principle is itself subject to the ‘carrying into effect’ exception. The list in section 13(4) does not help in determining the true scope of that exception. It may well be that some of the matters specifically listed could also fall within the exception but have been included in the list to avoid doubts.²⁵²

13.108 The committee is aware that section 143 of the Tax Administration Act 1994 imposes a liability to fine and imprisonment for ‘knowing contravention’ of section 81. For that reason alone, its officers must take care. But by section 6(1), officers must take care also to ‘protect the integrity of the tax system’.

Maintaining the integrity of individual departmental officials

13.109 As mentioned previously, section 6(1) of the Tax Administration Act 1994 imposes on all officers of the Inland Revenue Department the duty ‘at all times to use their best endeavours to protect the integrity of the tax system.’

13.110 Officers of the Inland Revenue Department who are solicitors are also officers of the High Court. As such they are under the professional obligation identified by Temm J in an address to newly-admitted solicitors in June 1993:

²⁵² [1991] 2 NZLR 30 at 36

Sometimes lawyers think that their duty to their clients is their first responsibility. That is not right... The desire to do one's best for one's client is commendable, but there are limits... [The lawyer] has an overriding duty to the court, to the standards of his profession, and to the public, which may and often does lead to a conflict with his client's wishes or with what the client thinks are his personal interests.... You will prosper wherever you be if you give good service, tell your client what the law says he should know and never, never, tell a client only what he wants to hear.²⁵³

13.111 These dual professional and statutory obligations at times may require officers of the Inland Revenue Department to express reasoned disagreement with views they see being relied on if they think those views to be contrary to the law. This is an issue that creates difficulties for all large organisations. In all such organisations differences of views will inevitably occur. The problem is that any large organisation, especially a law enforcement agency, needs to be able to reach consistent views on important issues. It would not be acceptable, for example, for different officers of the department to apply tax law differently according to their own personal views. On the other hand, individual officers can be placed in an invidious position if they see decisions being taken in relation to individual taxpayers that do not appear to accord with the tax law enacted by Parliament.

13.112 As noted above, the need to resolve internal disagreements is common to all large organisations. In the Inland Revenue Department's case, such disagreements can go to the heart of the integrity of the tax system. While this indicates that the issue is a fundamental one for the department, it is also worth bearing in mind that it can be equally fundamental to the core functions of other organisations, especially government bodies in areas such as health care and education.

13.113 The best way to resolve this issue is to have appropriate procedures in place to ensure that Inland Revenue officers can raise these issues in full confidence that any concerns will be seriously considered without fear of recrimination or victimisation. In fact, the reporting of any such issues should be considered the duty of Inland Revenue em-

²⁵³ *Law Talk*, June 1993, page 3

ployees. Inland Revenue's *Code of Conduct* for employees reflects this. It states:

If you believe in good faith that you have evidence of wrongdoing or misadministration in the department, your first step would be to take the matter up with a senior manager. If it is a serious wrongdoing, or you feel unable to discuss the matter with senior management, or that the matter has not progressed, you may report it directly to the Commissioner by notifying the National Advisor Fraud Prevention and Investigations within Internal Audit, National Office. The wrongdoing will then be investigated in terms of the Internal Audit investigations procedures.²⁵⁴

13.114 In normal circumstances, this procedure should ensure that departmental employees feel able to raise issues of concern to them. However, it still leaves open the possibility that an employee could identify wrongdoing without recourse if senior management of the department do not take action. The common law principle of iniquity would protect an employee who makes disclosure to the proper authority of any fraud or criminal activity within the department. This gap in procedures would also be covered by the Protected Disclosures Bill, which is before Parliament, sponsored by the Minister of State Services.

Protected Disclosures Bill

13.115 In summary, provided they are made in accordance with the provisions of the Bill, disclosures of information of serious wrongdoing in an organisation are protected and anyone making such a disclosure is granted immunity from civil and criminal proceedings. If any retaliatory action is taken against anyone disclosing such information, a personal grievance action under the Employment Contracts Act 1991 is available, and protection is also given under the Human Rights Act 1993.

13.116 Serious wrongdoing is defined to include the unlawful, corrupt or irregular use of public funds or public resources, acts constituting either an offence or maladministration by a public official, or constituting a serious risk to public health or safety, to the environment, or to the maintenance of law. 'Maladministration' is 'an act, omission, or course

²⁵⁴ At page 22

of conduct that is unlawful, oppressive, improperly discriminatory, or grossly negligent’.

13.117 Under the Bill, public sector organisations are required to set up internal procedures for receiving and dealing with information about serious wrongdoing. Disclosures follow these procedures unless the person to whom the disclosure is to be reported is, or may be, involved in the wrongdoing, or is associated with someone who is. Disclosure may then be made to the head of the organisation or to an appropriate authority in certain circumstances.²⁵⁵

13.118 An ‘appropriate authority’ is a defined term. As well as public sector organisations, it includes ‘a private sector body which comprises members of a particular profession or calling and which has power to discipline its members’. The Bill also provides for a second level of disclosure, to a Minister of the Crown or the Chief Ombudsman, if the matter has not been investigated or if no action has been taken. The Ombudsman is not given any additional powers.

13.119 Although nothing in the Bill explicitly sets out the action that the person or organisation receiving the disclosure is required to take, it is implicit that an investigation, and appropriate action, is to be undertaken. It seems to the committee that any concerns it has in this area would be met by the enactment of this Bill.

Summary

13.120 In summary, the committee noted its concerns that, in the past, officers of the department may not have been sufficiently alert to the possibility that particular arrangements may have been fraudulent, and may not have obtained the appropriate legal advice. It also noted that in carrying out its responsibilities, the department may have taken too restrictive a view of the secrecy provisions of the Tax Administration Act 1994. A mistaken view of the secrecy provisions seems sometimes to have led the department to fail to initiate prosecutions under the Crimes Act 1961. Officials informed the committee that since the time of the events that led to the committee’s concern, the department has been restructured, and the generic tax policy process and the new disputes

²⁵⁵ Where the person making the disclosure has reasonable grounds for believing the head of the organisation is, or may be, involved in the wrongdoing, or that urgency, or some other exceptional circumstances, justifies that action or that, despite two written requests for information on a disclosure, no action has been taken on that disclosure within a reasonable timeframe.

resolution procedures have been introduced. Along with these changes, officials advised that the attitude of the department has altered.

13.121 However, some concerns remain as to the quality of legal knowledge and analysis within the department, and the committee **recommends:**

The government should ensure that the department reviews the skill levels of its employees to determine their adequacy, and should ensure that recruitment, retention and continuing education policies are adequate.

The department should remove from its internal practices and procedures and from public statements any suggestion that section BG 1 should be read restrictively.

The department should be always alert to the possibility of criminal fraud activity by taxpayers, and should ensure that officers are aware that the Crimes Act 1961 is the appropriate vehicle for prosecution, and that the secrecy provisions of the Tax Administration Act 1994 are not an obstacle to such prosecution.

CHAPTER 14 – THE TAX IMPLICATIONS OF ELECTRONIC COMMERCE

SUMMARY

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Introduction

14.1 Electronic commerce is a generic term used to describe a variety of new forms of commerce, such as smart cards, electronic cash, electronic banking and the internet.

14.2 Electronic commerce is not a new phenomenon. It has existed since the use of telegraphic transfers by financial institutions. However, the rapid growth in technological developments in the communication industry over the last two decades has been facilitated by the following factors:

The deregulation of telecommunications sectors by approximately one third of OECD member countries.

The improvements of telecommunication infrastructures such as high speed modems, satellite and terrestrial broadcast.

A fall in the price of accessing the internet.

14.3 The main concerns raised by the growth of electronic commerce are first, whether existing tax policy is sufficiently robust to address any new and existing issues, and secondly, whether such activities pose a threat to the revenue base through avoidance and evasion.

14.4 Many of the tax policy issues concerning electronic commerce can be split into two groups – issues for the taxation of income and is-

sues that affect the taxation of consumption. Some alarmist comments have been made to the effect that electronic commerce will remove the ability of countries to levy tax. The committee considers that such comments are too extreme. Electronic commerce does not require immediate fundamental changes to tax policy. The conclusion drawn by the committee is that this issue needs to be followed and reacted to, but it does not raise new tax policy issues. However, it does make more acute many existing problems faced by those designing tax policy. For tax administrations the growth of electronic commerce creates both opportunities and problems.²⁵⁶

Implications for the taxation of income

14.5 The communications revolution undoubtedly makes it easier for non-residents to conduct substantial business activities and derive substantial income without having a fixed place of business in New Zealand. This ability has implications for many of the concepts embodied in international tax rules, which were developed at a time when operating a business commonly required a physical presence. For example, under many double taxation agreements, a resident of one state is required to have a permanent establishment in the other (source) state, before that source state is able to impose tax on the non-resident's business profits. A permanent establishment requires a physical presence if it is to exist. With telepresence technologies,²⁵⁷ a physical presence is no longer needed in many jurisdictions to conduct business. However, even if a physical presence were to be established in New Zealand, modern technology has made it relatively straightforward to ensure that the bulk of the value-adding activities is left outside New Zealand. In that case, New Zealand would not be able to sustain the attribution of any significant share of the overall profits to that physical presence.

14.6 The communications revolution poses two important questions in relation to the taxation of income. First, do governments need to redefine existing terms to accommodate the change to business practices caused by the communications revolution? Perhaps more fundamentally, however, the question arises on the extent to which source-based taxation is the appropriate policy strategy for governments in the future.

²⁵⁶ This approach has been endorsed at a recent OECD ministerial conference: *A Borderless World – Realising the Potential of Global Electronic Commerce*, Ottawa, October 1998.

²⁵⁷ Use of computer based synthesis of remote sensor input to give the user the appropriate sound/sight cues, as if they were present.

New Zealand's application of residence and source principles

14.7 New Zealand imposes tax on the worldwide income of its tax residents. This approach is referred to as the residence principle of taxation. However, New Zealand also imposes tax on all income sourced in New Zealand, whether it is derived by resident or non-resident taxpayers (the source principle). The application of these principles can be modified by New Zealand's double tax agreements.

14.8 Both the residence and source principles have difficulties in definition that may be exacerbated by the communications revolution. The discussion below focuses on the implications of the communications revolution for the source and permanent establishment definitions (affecting the source principle) and for the centre of management concept (affecting the residence principle).

14.9 The main challenge of the communications revolution is to the source rules, that is, the statutory provisions defining income that is sourced in New Zealand, especially business income. From a New Zealand perspective, the provisions are mainly relevant to the New Zealand taxation of non-residents, particularly residents of double tax agreement countries, as the requirement for a permanent establishment for source country taxation presents a higher threshold for business income than New Zealand's normal legislative source rules. Consider an analyst living in Switzerland who is contracted to design a database for a New Zealand bank, and conducts all of his or her development from a terminal in Switzerland. Under New Zealand's double tax agreements with Switzerland, the definition of permanent establishment would require the Swiss analyst to have an actual place of business in New Zealand before New Zealand could tax the income. New Zealand could not, therefore, tax the business income of the analyst. Similar protection would apply to most non-residents engaging in electronic commerce with New Zealand from a double tax agreement country.

14.10 In the case of non-residents from non-double tax agreement countries engaging in electronic commerce with New Zealand, their business profits would not have tax treaty protection. It is arguable that if the analyst in the example above were from a non-double tax agreement country, he or she would be deriving New Zealand-sourced business income, by virtue of the fact that business is being partly carried on in New Zealand.

14.11 It may be appropriate to consider whether the concept of a permanent establishment enshrined in double tax agreements needs to be

updated to reflect developments in the global trading environment. However, regardless of the definitions of source and permanent establishments, the committee notes that the government should not lose sight of the basic policy debate on the extent to which it is appropriate to tax non-residents under the source principle. This policy debate is discussed further below.

Central management as basis for corporate residence

14.12 The communications revolution does not present the same challenge for the residence rules. It is not as easy to change residence as it is to change the jurisdictional source of income, particularly in New Zealand, where individual residence is determined primarily by reference to a person's permanent place of abode, rather than by a test of length of presence alone. The communications revolution should not, therefore, make it any easier for individuals to circumvent this definition. What it means, in practice, is that if a New Zealand resident does not return income from electronic commerce, the issue is essentially one of evasion, rather than one of a deficiency in New Zealand tax rules.

14.13 Electronic commerce may, however, affect the determination of corporate residence. A company will be resident in New Zealand if it is incorporated or has its head office in New Zealand. A company will also be resident in New Zealand if it has its centre of management in New Zealand, or if control of the company by its directors is exercised in New Zealand. It is these latter tests to which the communications revolution presents a challenge.

14.14 The centre of management test is one of the primary international tests of corporate residence. The international norm appears to be that the centre of management is where the directors' meetings are held. If directors hold their meetings using telepresence technologies, the question arises whether there is no centre of management, or alternatively whether the company could be argued to have a centre of management in each of the countries in which the directors are present. The committee considers, therefore, that the concept of a centre of management and the tie-breaker rules for dual residence in double tax agreements should be reviewed as a result of the electronic revolution.

14.15 The committee considers that perhaps the trend should be towards tax systems that treat companies purely as agents for shareholders. To some extent, New Zealand has already put this policy into effect. For example, even if a company that is owned by New Zealand residents is non-resident, New Zealand's comprehensive controlled foreign company

and foreign investment fund rules require the company's income to be attributed back to its New Zealand resident shareholders on a current basis.

Source-based taxation

14.16 Many of the specific tax issues the committee has discussed above, such as the concepts of source and permanent establishment, would be superseded by a shift to a residence-only basis for taxation. The committee considers that it is worth noting in this regard that double tax agreements commonly trade away source rights of non-residents for lower taxation of foreign-sourced income of residents. Put another way, source rights are often traded for more effective residence taxing rights.

14.17 The globalisation of world trade may lead to continuing pressure to minimise source-based taxation, because it presents some difficulties in enforcement. Unless a non-resident has a physical presence in the source country, it can be difficult to collect the prescribed tax liability. This feature is a primary reason for the existence of non-resident withholding tax systems, which permit tax to be deducted at source, and recovery of the same to be sought from the resident payer of the income.

14.18 However, economic theory suggests that the minimisation of source-based taxation may not actually be bad for two reasons. First, it is not clear where the incidence of source taxation is actually borne, but there is some suggestion that it is often borne by the country imposing the tax, rather than the entity on which the tax is imposed. For example, before New Zealand introduced the approved issuer levy regime in 1991, it was common for non-residents to gross-up the amount of interest payable by the amount of non-resident withholding tax imposed. Thus, if the world rate of interest was 8.5 per cent, New Zealand companies would be charged 10 per cent (assuming a 15 per cent rate of non-resident withholding tax). The effect was that the full incidence of the tax was borne by the New Zealand borrower, rather than the non-resident on whom the tax was formally imposed. Many other countries have also eliminated non-resident withholding tax imposed on interest, in response to the increased mobility of capital and responsiveness to interest rates over the last decade.

14.19 Secondly, economic literature suggests that the optimal tax system for a small country is one applying a pure residence-based system,²⁵⁸ with income earned by non-residents being exempt from tax. The requirement under various double tax agreements and unilateral decisions made by many countries to provide a credit for foreign taxes means that this optimal solution cannot be achieved in the present global environment.

14.20 The difficulties in applying source-based taxation are not restricted to the communications revolution, and are a broader consequence of the increasing globalisation of world trade. Some of the taxation issues raised by electronic commerce are not really new. Rather, they represent an extension of existing problems. The committee believes that perhaps the key consideration here is that governments should not be rushed into taking piecemeal measures in response to the effects of the communications revolution on existing international tax concepts.

Implications for goods and services tax

14.21 The aim of a value added tax is to impose a tax on final consumption. The issue for tax policy makers around the world is whether to place the economic incidence upon the consumer or the supplier. An important consideration is the practicality of the options.

14.22 The aim of New Zealand's GST is to impose a uniform tax on final consumption in New Zealand. GST is based on the 'destination' principle, that is, tax is charged according to the destination of goods and services, as opposed to the 'origin' principle, that is, the supply of goods and services is taxed according to the source of that supply. GST is imposed on what New Zealand consumes, rather than what it produces.

14.23 The European Union has adopted a reverse charge mechanism, which requires domestic taxpayers to pay value-added tax on receipt of imported services in their jurisdiction. The reverse charge ensures that services, like goods, are taxed when they are consumed in the relevant jurisdiction. A reverse charge in New Zealand's GST would impose an obligation on a New Zealand recipient of an imported service to levy GST. In the development stages of the GST system, it was considered that the administration and compliance costs associated with a reverse

²⁵⁸ With a deduction, rather than a credit, for foreign taxes.

charge were too high in comparison with the expected revenue that would result.

Place of supply rules

14.24 The Goods and Services Tax Act 1985 imposes tax on the supply of services in New Zealand. Relying on the notion of physical performance creates economic distortions for imported services. If the service is physically performed outside New Zealand, it is not subject to GST. Electronic commerce has aggravated these distortions by simplifying the means by which suppliers may locate themselves offshore.

14.25 If the rules did not rely on physical performance, it would be necessary to prescribe particular tax treatments for particular supplies. This method of determining the impost of GST is used in the European Union, where the basic place of supply for services is the place where the supplier is established. However, in the context of electronic commerce where the service suppliers are often non-resident, this method for determining the place of supply would accentuate the extent to which supply is treated as taking place outside New Zealand.

Imported goods and services

14.26 Another issue that concerns the committee is the treatment of the growing volume of goods that are purchased and supplied electronically from the internet.²⁵⁹ This problem is just a variant of the existing 'mail order' problem. That is, such imported goods are subject to GST, but administrative difficulties are associated with levying and collecting that tax. To reduce those costs, New Zealand Customs Service at present, does not collect duties and GST, unless they are amounts above \$50.

14.27 It is important to note, however, that services traded over the internet are not physically cleared by New Zealand Customs Service as they are delivered straight to the consumer's personal computer. Because no adequate audit methodologies exist, even if a reverse charge did apply, the Inland Revenue Department could find it difficult to collect GST from individual consumers.

The post-implementation review of GST

14.28 As part of the post-implementation review of GST, an analysis is to be undertaken of the current treatment of internationally traded goods

²⁵⁹ For example, software, music, books, information services.

and services. That analysis will consider the existing policy framework against the changing market for these supplies. This review may also involve a reconsideration of the place of supply rules upon which the GST regime is based. The original policy decision not to implement a reverse charge on imported services will also be considered.

Implications for tax administration

14.29 The growth in usage of the internet creates challenges for tax administrations. The committee considers that, although many of these challenges are not new to tax authorities, the rate of technological progress to date suggests that these issues should be considered sooner rather than later. Some of the emerging issues resulting from the increase in electronic transactions are listed below.

Audit trails – The lack of any central control of the internet and the ease of cross-jurisdiction transactions will make tracing complex arrangements difficult.

Verification of identity and residence – Taxpayers can establish and operate from an internet address in any jurisdiction, even though they effectively reside elsewhere.

Documentation – The growth in internet commerce will make obtaining information necessary for enforcement difficult, particularly when transactions involve jurisdictions with which no tax treaty exists and, therefore, no exchange of information between the tax authorities is possible.

Removal of convenient taxing points – With fewer intermediaries in the distribution of goods and services, and producers selling directly to consumers, some consumption taxes may become less viable sources of revenue.

Accessibility of offshore banking – The increasing ease of shifting funds offshore to tax havens, together with secrecy laws in tax havens providing anonymity, and low transaction costs, will make countering international tax evasion difficult.

14.30 Electronic commerce does, however, offer tax administrations an opportunity to make tax collection more efficient through lower administration and compliance costs. Electronic technology can provide more accurate tax data, and faster processing of returns at a lower cost to the tax authority and the public. Ways of achieving this include:

electronic filing – allowing taxpayers to file encrypted returns themselves or through a tax professional;

direct deposit programs – providing opportunities for prompt and time-saving means to pay and refund;
automated deductions of taxes – allowing employers required to withhold PAYE deductions to file them directly with any other required deductions;
automatic matching of data; and
improved technology – facilitating and accelerating the exchange of information between tax authorities.

OECD initiatives

14.31 The growth in internet transactions has not so much created new problems for taxation, as caused a significant increase in the size of existing problems. The growth in the volume of sales of goods and services over the internet has prompted the OECD to re-examine how effectively current tax policy is at taking into account such commerce.

14.32 Many tax jurisdictions are looking for solutions that can be implemented unilaterally. History is full of examples where the ill-considered implementation of a tax by one jurisdiction has resulted in the departure of an industry from that jurisdiction. Indeed, it is this fear of capital flight that appears to have prevented some countries from implementing new technology based taxes.²⁶⁰

14.33 The OECD has become a key forum for countries to discuss and consider the tax implications of commerce through the internet. Four OECD committees are addressing the problems posed by the internet. Briefly:

Working Party 1 is looking at whether a vendor trading through the internet falls within the existing international framework concerning source and income allocation. The Working Party is also considering whether the principle of ‘permanent establishment’ should be revised.

Working Party 6 is looking at the impact that electronic commerce will have on the transfer pricing rules.

Working Party 8 is looking at developing audit-orientated solutions to electronic transactions and making recommendations on

²⁶⁰ Commonly referred to as ‘bit’ taxes.

issues such as compliance, audit, encryption, and tax evasion and avoidance.

The Special Sessions on Consumption Taxes Committee is discussing a variety of VAT/GST issues, including the appropriateness of the existing place of supply rules and the appropriate treatment of commodities acquired directly from the internet, such as software and digitised music, literature and video.

The Inland Revenue Department is often represented on Working Party 1 and meetings held by the Special Sessions on Consumption Taxes.

14.34 The Commissioner of Inland Revenue recently attended, as part of a New Zealand delegation led by the Hon John Luxton, an OECD conference in Ottawa 'A Borderless World – Realising the Potential of Global Electronic Commerce'. Specifically, the Commissioner participated in a roundtable discussion on taxation and electronic commerce. The principle conclusions from the discussion were:

that the existing principles of neutrality, efficiency, certainty, simplicity, fairness and flexibility should apply to the taxation of electronic commerce;

that the framework for the taxation of electronic commerce should be guided by the existing principles that guide governments in relation to conventional commerce;

that electronic commerce offers tax administrations the potential to simplify tax systems and enhance service.

14.35 The committee **recommends** that the government should monitor and continue to participate in the efforts of the OECD in developing tax policy on electronic commerce, and should seriously consider any recommendations that are proposed. This recommendation recognises that any changes to tax policy as a result of the growth in electronic commerce will require international co-ordination.

Part III

Tax Advisers

CHAPTER 15 – TAX ADVISERS

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Introduction

15.1 Tax advisers have an important role in the tax system. Professional assistance with tax matters is required except in the most straightforward situations because of the complexity of the tax system. As tax advisers generally assist taxpayers in preparing tax returns and represent and advise taxpayers in their communications with the Inland Revenue Department, they are, in effect, intermediaries between the taxpayers and the department. The quality of their advice, their professionalism and ethics play a central role in the tax system.

Is there a problem?

15.2 The assistance provided by professional tax advisers ought to result in better quality of the tax return and tax compliance generally. However, empirical studies in the United States have found that while professional tax advisers have increased compliance with unambiguous law, they have decreased compliance with ambiguous law.²⁶¹ In other words, if the law can be interpreted in various ways, professional tax advisers will encourage their clients to adopt tax positions which they would not otherwise take to minimise their declared tax liabilities.

²⁶¹ Steven and Nagin, 'The Role of Tax Preparers in Tax Compliance,' *Policy Sciences*, vol 22(2), May 1989, pages 167-194

15.3 Tax advisers are duty bound to advise their clients on how to pay no more than the law requires. But their behaviour causes concern if they advise their clients to engage in transactions that purport to be effective to avoid tax, but in fact are not. In these cases, the proper assessment of their client depends on detection by the Inland Revenue Department. It is also a matter of concern if they advise their clients to engage in tax evasion, or otherwise not to comply with their obligations, or if they hinder, delay or obstruct tax investigations. The committee is aware of instances in which tax advisers in New Zealand appear to have behaved in such ways. The evidence given in the Davison Commission inquiry suggested this behaviour.

Registration of tax advisers

15.4 Some countries require registration of tax agents. The rules vary in scope, as the following instances show. In Germany, only those people are allowed to engage in commercial tax practice. Australia allows a taxpayer to deduct fees paid for tax advice or preparation of returns only if the fees are paid to an authorised person. In the United States, anyone may prepare returns and represent taxpayers in audit. However, only lawyers, accountants and registered agents may represent the taxpayer before the Internal Revenue Service in more substantial proceedings, such as appeals against assessments and tax court proceedings. The Service may prohibit anyone from representing a taxpayer in audit if that person engaged in conduct that, had he or she been an enrolled agent, would have meant disbarment.

15.5 New Zealand does not require registration of tax advisers. Tax practitioners often choose to register with the Inland Revenue Department as tax agents, which allows them an extension of time for filing their clients' tax returns and to receive standard communications from Inland Revenue. However, people do not have to register in order to practice as a tax agent in New Zealand.

15.6 Three general reasons are given for registration. First, protection of the public: registration may be desirable if the benefit of maintaining competency standards outweighs the costs of administering the system and restricting membership in the profession. Secondly, administrative efficiency: the tax administration may operate more efficiently if tax officials are dealing with people of a certain level of competency. Thirdly, the integrity of the tax system: people who engage in unethical conduct should not be allowed to practice, and allowing them to continue to practice harms the integrity of the system.

15.7 Disadvantages of registration are said to be, first, restriction of competition: if only a limited number of practitioners are authorised to engage in an activity, that will reduce consumer choice and competition and increase the cost of the service. This concern is greater for the full registration model, as exemplified by Australia and Germany, than the partial registration model used in the United States. Secondly, capture by the profession: if tax agents must be registered and the profession regulates itself, tax agents may create barriers to entry and exacerbate the problem of restriction of competition. Thirdly, administrative costs: the costs of administering the system by the tax authority are high.

Regulation by professional societies

15.8 In New Zealand, most professional tax advisers are either accountants or lawyers, and are members of their respective professional societies. Those societies are responsible for regulating the professional behaviour of their members. Both the New Zealand Law Society and the Institute of Chartered Accountants of New Zealand (ICANZ) have codes of professional responsibility which apply to all of their professional services, including tax work. ICANZ is at present finalising tax practice guidelines which are intended to provide guidance on the application of the ethical guidelines to tax practice.

15.9 While professional bodies have the power to discipline members for breaching ethical standards, the committee is not aware of this power being used in relation to tax services. This fact may simply reflect the emergence of issues arising from ‘aggressive’ tax advising, which in some circumstances would, more appropriately, be called fraud, and is a relatively recent phenomenon in New Zealand. Whatever the reason, it is clear to the committee that the professional bodies have statutory obligations. These obligations exist when councillors and executives become aware of possible impropriety, irrespective of whether formal complaints have been made. Failure by those bodies to discharge those obligations diligently can damage society and the economy, and could require the introduction of rules to subject the members of those bodies to external regulation.

15.10 In the case of the legal profession, every member of the New Zealand Law Society has an obligation to make a formal complaint to the society on any matters of possible misconduct which come to their attention. Failure to discharge that obligation may itself be professional misconduct by the person in default. The ICANZ code of ethics does not at present contain a similar requirement, except in relation to defalca-

tions. The committee understands that the Institute's code of ethics is scheduled for a thorough review in 1999. The committee expresses the hope that ICANZ will recognise the requirement that all instances of fraud, dishonesty and similar disreputable behaviour give rise to the need for members to report it to ICANZ executive. Further, the committee expresses the hope that the executive would take reported breaches seriously and initiate appropriate actions in the protection of its reputation.

15.11 Whether or not they are members of either body, officers of the Inland Revenue Department who encounter misconduct by tax advisers should be able to have it drawn to the attention of the appropriate professional body. Because of the secrecy requirements in section 81 of the Tax Administration Act 1994, the first step should be internal to the department. Section 81 would need to be amended to allow the department then to report such misconduct. The committee **recommends** that the government should consider such an amendment.

15.12 If the adviser's conduct amounts to criminal misconduct, then it should in any event be reported to the police or the Serious Fraud Office in the ordinary way.

Civil penalties

15.13 Another arm of regulation is the possible sanction of civil penalties for misconduct. The penalties provisions in the Tax Administration Act 1994 provide for civil penalties when taxpayers fail to meet their tax obligations. Some countries, such as the United States, have a system of penalties that apply specifically to tax advisers. When New Zealand was developing its current penalties rules, such a system was considered, but the government chose not to adopt it. It noted that standard civil law principles would allow the amount of the penalty to be recovered from a tax adviser when the adviser's wrongful conduct had caused the penalty to be imposed. For example, suppose a tax adviser negligently advised a client to take a tax position that was not 'reasonably arguable', and did not inform the taxpayer of the risk of penalty. If the taxpayer was subsequently penalised by the Inland Revenue Department, the taxpayer could seek recovery from the tax adviser on the grounds of professional negligence. While this may occur in some cases, the committee notes that attempting to recover the penalty in this way would be very costly, and could be used only in a few cases when the amount of the penalty is very high.

15.14 The committee is aware that the new penalties provisions have been in place for only a short period of time. The committee **recom-**

mends that the provisions should be allowed to operate for some time to gauge their effect in practice with a later review, if necessary, to consider the desirability of having penalties apply directly to tax advisers. The committee hopes that the standards of performance of tax professionals and the vigilance and the enforcement rates of the key professional bodies will render it unnecessary to enact specific penalties for tax agents.

Criminal penalties

15.15 Section 148 of the Tax Administration Act 1994 provides that it is an offence to aid and abet a person to commit an offence, such as evading tax or obstructing officers of the Inland Revenue Department. This provision could obviously apply to a tax adviser who assists a taxpayer to commit such an offence. The penalty is the same as that which may apply for the principal offence, for example, up to five years imprisonment for tax evasion.

15.16 Section 66 of the Crimes Act 1961 provides that people who aid or abet anyone to commit an offence under that Act are themselves a party to that offence. Some examples of offences under the Crimes Act 1961 are destroying and fabricating evidence, attempts to commit offences, and conspiracy to defraud the revenue, both in New Zealand and elsewhere. These offences are set out in appendix 7. In the recent United Kingdom case of *R v Charlton*,²⁶² several tax advisers who devised a 'dishonest avoidance scheme' were jailed after being convicted of cheating the public revenue. It is, therefore, apparent that the aiding and abetting provisions in the Tax Administration Act 1994 are not the only penalties that can be imposed on defaulting tax advisers.

Administrative disbarment

15.17 Another option for regulating repeated or serious misconduct is administrative disbarment, where the tax administration permanently or temporarily prohibits certain tax advisers from representing their clients in official matters, such as audits, before the tax department. The United States Internal Revenue Service provides for such regulation in *Circular 230*. Disbarment can result from behaviour such as facilitating fraud or evasion, repeatedly being rude and abusive to tax administration officials, and delaying or obstructing tax investigations. This sanction is serious, and administrative procedures would be necessary to implement it

²⁶² (1996) STC 1418

fairly. Judicial review proceedings would be available if a tax adviser thought a decision to disbar was unfair.

15.18 If New Zealand were to adopt a system of administrative disbarment, the United States provides a format for its design. The system there provides that the hearings to determine the facts and make an order of suspension or disbarment are before an administrative law judge. A tax administration official, called the Director of Practice, is responsible for acting on complaints and investigating misconduct of which he or she becomes aware. As with a court proceeding, a formal hearing for suspension or disbarment begins with a complaint issued by the Director to the person who is the subject of the complaint detailing the allegations of misconduct.

15.19 Once an adviser has been disbarred or suspended, the revenue is not able to accept tax returns or objections prepared by the adviser; nor is the adviser allowed to represent a client in audits, objection proceedings or tax court proceedings. Taxpayers may recover from the disbarred adviser any additional costs that they incur as a result of using the adviser, if the adviser did not disclose the disbarment. If this system were adopted in New Zealand, it would be possible to have as an additional consequence, that it would be an offence if such a person practised as a tax adviser.

15.20 This procedure would be costly and time-consuming. Because it would place a major administrative obligation on the Inland Revenue Department, the committee does not recommend that it be adopted unless future cases of undisciplined misconduct of tax advisers makes such a system desirable.

15.21 For the present, the committee considers that professional bodies should continue to have the responsibility for regulating the ethical conduct of their members. The Inland Revenue Department should assist in this process by referring cases of misconduct to the bodies when appropriate.

15.22 However, the committee considers that the matter should be kept under review. If the professional bodies should be found wanting in diligence, then consideration of a possible administrative disbarment system will become essential.

Part IV

Operational Issues

CHAPTER 16 – RELATIONSHIP WITH TAXPAYERS

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Introduction

16.1 During its deliberations and while considering submissions made to it, the committee studied several matters that relate to the part of the relationship between the Inland Revenue Department and taxpayers that could loosely be called ‘public relations’. For convenience, the committee has gathered its comments on those matters into this chapter.

16.2 Two corporate communications specialists, Mesdames Carole Hartney and Catherine Judd, both of Jacques Martin Consulting, a division of Jacques Martin New Zealand Ltd, kindly advised the committee and assisted with its research for this chapter. The committee very much appreciates receiving this help in what is a rather specialised area. The committee records its grateful thanks to Mesdames Judd and Hartney.

BRANDING AND SLOGANS

16.3 Since 1995, proceeding from the Organisational Review of the Inland Revenue Department that took place between 1993 and 1994, the department has tried to alter the way in which staff interact with taxpayers. A core aspect of this change has been an instruction to refer to taxpayers as ‘customers’ with ‘needs’ rather than as taxpayers with duties.

16.4 The object is to improve the department's service to taxpayers and its relationship with taxpayers. It is hoped that the best-practice private-sector processes and standards that the term 'customer' implies will encourage staff to achieve this improvement. In turn, it is anticipated that improved levels of service to 'customers' will lead to better levels of voluntary taxpayer compliance. The committee sympathises with the department's aspirations, but has some concerns about the process.

Re-branding

16.5 A change from 'taxpayers' to 'customers' entails a significant psychological shift, on the part both of departmental staff and of taxpayers. In commercial terms, the closest analogy involved in the process of moving to a customer focus is perhaps the re-branding of a product or service. It is not inapt to use the term 're-branding' for the department's change from taxpayers to 'customers' because of the implication of private-sector service levels and relationships that 'customer' conveys.

16.6 From its own knowledge, which has been confirmed by advice from private sector corporate communications consultants, the committee would expect that such a significant re-branding of its service delivery methods by an organisation as large as the Inland Revenue Department would have been preceded by extensive research. In the private sector, this research is conducted in the relevant market. For the department, the research would be both among taxpayers and among its own staff.

16.7 The research would try to answer questions such as these: Does the term 'customer' appeal to taxpayers? Does the re-branding proposal seem genuine and sincere, considering that in the end the department's 'customers' first, cannot take their business elsewhere, and secondly, must disgorge cash rather than receive benefits? If despite the very inexact parallel between a true commercial customer and a taxpayer the change of nomenclature is or could be fundamentally sound, how should it be put into effect to achieve maximum benefits?

16.8 Officials told the committee that this re-branding was a result of the Organisational Review and that the department did not undertake preliminary 'market' research before the re-branding exercise, nor has there been research into the effectiveness of the re-branding or into taxpayers' reactions since. This omission is a matter for regret for two reasons. First, as mentioned, the department has not had the benefit of advice on how best to proceed with the re-branding exercise. Secondly, the department has foreclosed the possibility of measuring the results of the

change. A commercial organisation engaging in a comparable exercise would ordinarily conduct before and after surveys to determine whether the change had been beneficial.

16.9 Be that as it may, the kind of research that the committee has in mind remains worthwhile now, if less so than if it had been carried out earlier. The department's re-branding is still continuing, and as departmental processes are changed during the implementation of, for example, self-assessment, the department will need to examine the implications of its customer service focus in new circumstances. Research into taxpayers' responses would be worthwhile.

Consideration of the 'customer needs' model

16.10 There appears to be a growing, but still slight, literature on the merits and practicalities of government departments adopting a customer needs model for their relations with citizens. The most penetrating study that the committee has found is an article by Mr Ron Hikel, director and partner in charge of the KPMG Centre for Government, Toronto, Canada, with the title 'Real Customer Service in Government: is it Possible?'²⁶³

16.11 Hikel points out the contradictions between the concept of a customer of a private enterprise firm, and the concept of a citizen with rights vis-à-vis a government department. The committee notes that these contradictions intensify when the primary relationship of the citizen to the department in question is one of duties (such as the duties of a taxpayer) rather than of rights.

16.12 As Hikel explains, great problems arise in transferring the ideal of customer service to the public sector. In most public sector areas, there neither is nor can there be a true equivalent to such fundamentals of customer relations as 'satisfaction or your money back' or 'the customer is always right'. In the private sector, true customers are always individuals, but in the public sector, governments must deal with people as categories, according to the stipulations of the law.

16.13 Private sector concerns make large and continuing investments in reading (as Hikel puts it) potential and actual customers, and then re-designing their products to make them more appealing. The ability of

²⁶³ Available at http://www.kpmg.ca/centre/vl/cg_view.htm, originally published in the KPMG periodical *Executive's Digest*. See also Will Hutton, *The State We're In*, Vintage, 1996.

public sector organisations to conduct the same exercise is severely constrained, because major modifications of operating systems require changes in policy, regulations, or legislation. Hikel explains:

No one doubts the need for governments to improve service delivery. But the central trouble with this ‘citizen as customer’ image is that it rests on a fundamental misunderstanding of the present role of government in society. The customer image implies that, in effect, governments wish to please – much as any private retail business. But this is obviously wrong. At their most fundamental, governments exist to use the authority ceded to them by each citizen, to establish and enforce rules of conduct. Further, these rules are backed – at least in Canada [and we would add New Zealand] – by a more or less exclusive monopoly on the use of armed force and other sanctions.

To equate the concepts of ‘citizen’ and ‘customer’, is to both diminish and misunderstand the obligations of citizenship and the role of government.

Many government ‘consumers’ come to be across the counter from public servants because they are compelled by laws, backed by the threat of retribution. For example, they are required to obtain a license before driving, register any motor vehicle they own, and pay a variety of related taxes. Failure to comply with these laws can result in legal punishment. This compulsion exists because citizens have permanent obligations. Customers shop in a more or less free market. Citizens do not. Few of our relationships with government are purely voluntary, contrary to the norm between consumers and private sector services.

[M]any public servants do not in any sense serve ‘customers.’ Standing before a ... Customs Inspector, you are in no sense a customer. The purpose of the encounter is to ensure that you are paying tax or duties on any taxable items being brought into the country. Government is not a business. It may go bankrupt, but it won’t hold a fire sale, cancel the lease, take down the sign, and shove off for Palm Springs.

Government claims of concern for ‘clients’ often aren’t credible because, as long as their mandate lasts, we cannot

withhold our patronage. Customers by definition have no permanent obligations – except to pay for what they wish to use or own. Satisfying them is the key because otherwise their business is lost. Mostly, as a recent study has shown, customers don't complain; they go elsewhere. But in much of our dealings with government, we cannot go to another provider.

There is, in short, a severe limit on the use of the customer model to define the actual nature of the relationship between government and citizen. 'Customer' is an incomplete, faulty and essentially deceptive description of the typical transaction between governed and government.

16.14 Hikel's article concludes:

Eventually the preferences of citizens as individual 'customers' coming to government for services will clash with routinized and authorized responses, sanctioned by Parliament, Legislature or Council. How far can the public sector go using customer preference data to reform delivery systems, without running into constitutional issues about the relative importance of satisfying individuals, as against compliance with collective norms and rules set by legislation? The answer is that no one knows because no one has yet taken the notion of customer service far enough to find out.

The 'customer needs' model in action

16.15 Hikel's article is not wholly pessimistic. He allows that if governments are able to bring the customer paradigm into their delivery of services, citizens' satisfaction with the government certainly should improve. He points out, however, that in order to make this change effective, major institutional changes are required within government departments. Depending on their functions, some departments are better placed to make these changes than others. For example, a postal service can more readily adapt to the customer mode than a tax department. The list below of necessary changes adapts and paraphrases Hikel's article:

Real customer service needs local autonomy, shorter decision lines, and reorganized delivery units set up for the convenience of customers, if necessary with changed hours of operation and office lay-out.

Better backup to support the front line.

Good monitoring to enforce service standards.

Quicker response times to resolve issues.

Direct supervision of those dealing with customers.

Better training by people who know something about service.

Local budgets and some autonomy in spending them.

Rewards/compensation for those who are the better service providers.

All of which will ordinarily entail major departmental reorganisation and reconceptualising of the department's relationship with citizens.

16.16 It is fair to say that following its Organisational Review in 1994, the New Zealand Inland Revenue Department has adopted, at least in part, most of this list. However, there are several sticking points. First, the department's duty is to collect tax that is lawfully owing. Rewarding officials for being effective tax collectors is not an unreasonable proposal, but could taxpayers be persuaded to see such rewards as 'compensation for those who are the better service providers'? Secondly, the department is subject to budgetary constraints that are imposed on the civil service as a whole, which limit scope for local budgetary autonomy. The committee considers these constraints later in this report.²⁶⁴

16.17 Thirdly, as Hikel points out, the whole customer needs paradigm makes sense only when there really are customers, that is, people who themselves can initiate a request for some service, perhaps pay a fee, are able to express some judgment over the quality of what they receive and exercise some action if they do not like it. It is true that within the operations of the Inland Revenue Department there are a number of situations that, taken in isolation, exhibit some or, at a stretch, all of these features. But they are hardly endemic to the role of a tax collecting agency. Although retailers can hope that their customers will be completely satisfied, this complete satisfaction is an improbable state of mind for a taxpayer.

²⁶⁴ See chapter 18

The committee's concern

16.18 The committee's major concern with the customer needs model is that the Inland Revenue Department's excellent intentions could rebound. Indeed, in the absence of something in the nature of market research we cannot know whether taxpayers' reactions are favourable or unfavourable.

16.19 The inherent contradictions between the status of customer and the status of taxpayer are unlikely to be lost on taxpayers. In claiming to treat taxpayers as customers, tax inspectors risk encouraging expectations that cannot be fulfilled. They risk seeming to be insincere. Who would not look sideways at a 'provider of customer needs' who points out that if taxes are not paid by the due date, there is an automatic penalty, followed by non-negotiable interest, no matter how politely and sympathetically this message is communicated?

16.20 The committee cannot emphasise too strongly that it sees great merit in the department's efforts to minimise taxpayer compliance costs, to eliminate as much frustration and unpleasantness as possible from the experience of being a taxpayer, to make telephoning for information easier and more rewarding, to train front-line officers so that they can increasingly operate as one-stop suppliers of information, and so on. What the committee does question is the merit of using the terms 'customer' and 'needs' to refer to a process that is ultimately coercive. A velvet glove on an iron hand is commendable, but calling the iron hand by another name is not so clearly a good idea.

16.21 Among Inland Revenue staff, too, the customer needs model could lead to an uncertainty of role. How can an official deal firmly with a taxpayer who is reluctant to pay tax or to disclose relevant information while at the same time trying to satisfy the 'needs' of that taxpayer as a 'customer'?

16.22 For both taxpayers and Inland Revenue staff, is it desirable or possible to achieve the improvements of relationships and methods of working that the department seeks without using the term 'customer'? Intuitively, the answer should be yes. At least theoretically, it is possible to treat the taxpaying public with care and solicitude without calling them customers, useful shorthand though the word may be.

16.23 The logical consequence of the committee's concerns is to recommend that the department discontinue the use of 'customer' to mean 'taxpayer'. However, the committee is not sufficiently informed to make that recommendation. As mentioned, no marketing-like studies have

been done among either taxpayers or Inland Revenue staff to identify and evaluate the merits and demerits of the customer needs model. Accordingly, the committee **recommends** that thorough surveys should take place, to determine whether the department should continue to use the model and, if so, whether any measures are necessary to deal with the contradictions between the roles of taxpayer and customer that the committee has identified.

INLAND REVENUE DEPARTMENT MOTTO

‘It’s our job to be fair’

16.24 Some years ago, the Inland Revenue Department adopted the motto ‘It’s our job to be fair’. On the face of it the motto is unexceptionable. In practice, it creates difficulties. The problem is that the motto is inevitably understood differently by two groups of people: on the one hand lawyers and officials who act under the law, and on the other hand taxpayers in general.

16.25 To a lawyer, the motto means: ‘The department must observe and enforce the law, and must not allow personal or other non-legal considerations to interfere.’ The committee agrees with this point of view. Many people, on the other hand, would take the motto to mean something else. Although they might not formulate it in this way, they would take the motto to mean that if the result of applying the Income Tax Act is to impose a burden on a taxpayer that appears to be harsh from the viewpoint of a bystander (or, possibly, even from the subjective viewpoint of the taxpayer in question), then it is the job of the department to reduce that burden.

16.26 This conception of the task of the Inland Revenue Department is incorrect. Moreover, it should never be correct. The general principle that government administration should operate according to the rule of law is nowhere more important than in the tax system. The Commissioner’s discretion to make allowances for hardship is appropriately limited. It is true that the rigidities of tax law lead to complaints, but these complaints are nothing to the dissatisfaction and disaffection that would be the result of a flexible system with discretionary adjustments according to taxpayers’ personal circumstances.

Reason for misconception

16.27 Taxpayers’ misconception of the meaning of ‘it’s our job to be fair’ is an example of a common error that comes about from mixing the relative certainty of legal norms with the subjective flexibility that is

characteristic of people's attitudes to morality. Law is heavily influenced by morality, but non-lawyers often fail to appreciate that while both are normative systems they are separate normative systems. The leading American jurist, Richard A Posner, explained the problem in his Oliver Wendell Holmes Lectures in 1997. Judge Posner said:

A potent source of confusion is the law's frequent borrowing of moral terminology, of such terms as 'fair' and 'unjust' and 'inequitable' and 'unconscionable,' a borrowing that reflects in part the ecclesiastical origins of the equity jurisdiction, and that [misleads people] into believing that law is suffused with moral theory. Holmes warned long ago of the pitfalls of misunderstanding law by taking its moral vocabulary too seriously; it is the major theme of his great essay *The Path of the Law*.²⁶⁵ ... The law uses moral terms in part because of its origins, in part to be impressive, in part to speak a language that the laity, to whom the commands of law are addressed, is more likely to understand – and in part, I admit, because there is considerable overlap between law and morality.²⁶⁶

16.28 Posner's remarks are addressed to lawyers who are trying to grapple with the vexed question of the degree to which law embodies morality. But at least that debate takes place, as it were, within the parameters of law as a discipline. The New Zealand Inland Revenue motto, 'It's our job to be fair,' gives rise to a much more frustrating discussion, where the participants cannot even engage one another in a sensible dialogue, because officials must speak of legal duties while taxpayers understandably believe that the motto shifts the dialectic into some overarching realm of fairness. To a lay person, the motto brings into play a whole matrix (albeit an ill-defined matrix) of norms that are not necessarily legal at all.

16.29 In practice, as the officials advised the committee, 'it's our job to be fair' is often a focus of taxpayer complaint. How, taxpayers ask, is the department acting fairly when the application of the law to their circumstances is so manifestly unfair? People use the motto to give complaints a legitimacy that is spurious. The situation is further inflamed because

²⁶⁵ (1897) 19 *Harvard Law Review* 447 at 457-464

²⁶⁶ Posner R A, 'The Problematics of Moral and Legal Theory' (1998) 111 *Harvard Law Review* 1637 at 1695

complainants are ignorant of this spuriousness. As Posner reminds us, Holmes warned 100 years ago against lawyers taking the moral vocabulary of law too seriously. How much more seriously does the aggrieved non-lawyer taxpayer take the moral vocabulary of the Inland Revenue motto.

Conclusion on the motto

16.30 Having inherited ‘it’s our job to be fair,’ the Commissioner is in a cleft stick. Although the motto misleads taxpayers and although it is more apt to inflame than to satisfy complainants, the department can hardly be criticised for adhering to it. This kind of motto is much easier to adopt than to abandon. It is for this reason that the committee has explained the motto’s logical and philosophical problems at some length.

16.31 The committee emphasises that the motto is simply not appropriate for a tax department that has the task of applying the law. This inappropriateness cannot be remedied by operational adjustments here or there. It is dangerous to encourage officials to take the motto more seriously, in case they interpret the encouragement as licence to exercise unauthorised discretions. It is impractical and would no doubt be counter-productive to try to explain to disgruntled taxpayers the true jurisprudential meaning of ‘it’s our job to be fair’ in the context of a modern government that is administered according to the rule of law. The only solution, albeit a difficult one, is to abandon the motto. The committee so **recommends**. If consideration is given to adopting a replacement motto, the committee **recommends** that it should be tested carefully, not only by research to discover taxpayers’ reactions, but also by measuring the motto against the legal and administrative duties of the Inland Revenue Department.

ATTITUDE-FORMING MEDIA CAMPAIGNS

16.32 A number of New Zealand government agencies engage extensively in media campaigns that are designed to influence the behaviour of citizens. Campaigns against dangerous driving and the misuse of drugs come to mind. The Accident Rehabilitation and Compensation Insurance Corporation runs safety campaigns on a lesser scale. The committee raised with officials the question of whether such campaigns would be useful for the Inland Revenue Department.

16.33 The department already conducts some campaigning, notably to encourage people to file their returns and to pay due tax on significant dates. However, the committee had in mind deeper campaigns designed

to encourage overall taxpayer compliance and to engender a sense of responsibility and duty when it comes to paying taxes.

16.34 The committee understands that the department has done preliminary work in this area, but has not yet made a decision whether attitude-forming campaigns in the tax area are a good idea. One difficulty is that promoting positive attitudes by this kind of campaigning is a relatively difficult exercise, with the risk that even a well-planned campaign can inadvertently intensify existing negative attitudes.

16.35 Officials advise that the department is at present collating information about attitude-forming media campaigns from other tax administrations, and is finding what it can from other New Zealand government agencies about their knowledge and experience in the area. In due course, the department will decide whether to embark on this activity.

16.36 The committee endorses the department's decision to investigate the possibility of attitude-forming campaigns, and believes that the department is correct to approach the idea cautiously. However, the committee **recommends** that the department should make progress in the area more rapidly than is currently proposed. If attitude-forming campaigns prove to be feasible, even minor changes in taxpayer attitudes and behaviour could have significant impacts on tax collections and on the department's workload, impacts that will be increasingly important with New Zealand's move to self-assessment. Secondly, the committee **recommends** that the department obtain consultants' advice. Attitude formation is a difficult art, and one would not expect the necessary knowledge or experience to reside permanently within the government sector. It is a task where engaging consultants is not only justifiable but advisable.

RESPONSE TO PUBLICITY

16.37 During the term of the committee, several cases arose involving complaints about the Inland Revenue Department that received extensive media coverage. Much of this media coverage tended to be highly critical of the department and presented only one side's view because the secrecy requirements in the Tax Administration Act 1994 place constraints on the department responding publicly.

16.38 If the Commissioner cannot respond publicly in cases where the taxpayer goes to the media with complaints about the department, the public perception of what occurred in the particular case may not necessarily be correct.²⁶⁷ It seemed to be a common feature in these highly publicised cases that they were initiated by the taxpayer going to the media with complaints about the department.

16.39 Highly publicised complaints about the department which are not in fact correct can adversely impact upon the integrity of the tax system, because public perceptions play an important role in maintaining the integrity of the tax system. To allow unfounded allegations to go without response could adversely affect taxpayers' perceptions about the tax system, and thereby undermine the system's integrity.

16.40 The committee considers that the Commissioner should be entitled to respond publicly in serious cases when publicity threatens the integrity of the tax system in terms of section 6 of the Tax Administration Act 1994, which requires that the best endeavours of the Commissioner must be used to protect that integrity. Importantly in this regard, this concept includes taxpayers' perceptions of that integrity. Section 6 should allow the administration exception in the secrecy provisions in section 81(1) of the Tax Administration Act 1994 to apply, because 'carrying into effect the Inland Revenue Acts', which is the formulation of the administration exception in section 81(1), should include the Commissioner protecting the integrity of the tax system under section 6 of the Tax Administration Act 1994. Obviously, any decision of the Commissioner to respond publicly requires a careful balancing of the need to protect the integrity of the tax system against unfounded allegations, and maintaining confidentiality of taxpayers' affairs, an important value in New Zealand's tax system, and one included in the definition of the integrity of the tax system in section 6(2) of the Tax Administration Act 1994.

²⁶⁷ The main secrecy provision is contained in section 81(1), Tax Administration Act 1994 which imposes an obligation on officers of the department (including former officers) to maintain and aid in the secrecy of all matters which come to their knowledge relating to the Inland Revenue Acts (and certain other Acts). Section 81(3) gives officers of the department immunity from having to disclose in any judicial proceedings any matters that come to their notice in the performance of their duties. Section 81(1) and (3) are subject to what is commonly termed the 'administration exception', which allows disclosure by officers of the department when it is necessary for the purpose of carrying into effect the Inland Revenue Acts (and certain other Acts).

16.41 The committee **recommends** that section 81(1) of the Tax Administration Act 1994 should be amended to clarify that the administration exception in that provision permits the Commissioner to disclose taxpayer affairs for the purpose of responding to publicity about the department's activities when the Commissioner considers in good faith that such disclosure is necessary to safeguard the integrity of the tax system.

CHAPTER 17 –THE RULINGS PROCESS

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Introduction

17.1 Part VA of the Tax Administration Act 1994²⁶⁸ provides for the Commissioner to issue binding rulings. There are three types of binding rulings, namely public rulings,²⁶⁹ private rulings²⁷⁰ and product rulings.²⁷¹ Each states how the Commissioner considers that a taxation law applies in relation to a particular ‘arrangement’ or (in the case of product rulings) type of ‘arrangement’.

17.2 A public ruling binds the Commissioner to assess in accordance with its terms if the ruling reflects a taxpayer’s circumstances and the taxpayer applies the taxation law in the way stated in the ruling. Similarly, a private ruling binds the Commissioner to assess a taxpayer in accordance with the terms of the ruling if that ruling is strictly applicable and the taxpayer applies the taxation law in the way stated in the ruling. The same is true for product rulings, where the Commissioner is required to follow the ruling if it applies in a particular taxpayer’s circumstances and that taxpayer adopts the approach set out in the ruling.

²⁶⁸ Sections 91A to 91I

²⁶⁹ Sections 91D to 91DE

²⁷⁰ Sections 91E to 91EJ

²⁷¹ Sections 91F to 91FJ

17.3 Public rulings are published by the Commissioner, and are freely available. Private rulings are confidential between applicants and the department. Product rulings are confidential until they are issued, but the legislation then requires the Commissioner to notify the making of a product ruling in the *Gazette* and to make a copy of the ruling available to anyone who may request it.

17.4 Because the system of binding rulings is limited to ruling upon ‘arrangements’, and because many of the topics upon which clarification is sought are broader or raise factual variations, the department frequently issues other public statements which are not formally binding rulings. Usually these are described as ‘interpretation statements’, although where they cover a general area of taxation or related law they may be termed ‘interpretation guidelines’. These are not formally binding on the Commissioner, but they will generally be followed administratively. The processes for research, analysis and consultation adopted for interpretation statements and interpretation guidelines are identical to those followed for public binding rulings. Over and above the rulings, statements, and guidelines mentioned so far, the Inland Revenue Operations business group produces ‘standard practice statements’, which are public statements regarding the administrative practices of the department or exercises of particular discretions vested in the Commissioner. The committee did not have time to review standard practice statements as to quality or coverage.

17.5 When the Rulings unit begins work on any ruling, three people are identified in relation to the project – the analyst (who is the principal researcher and author for the project), the manager (whose role is to assist the analyst and provide guidance throughout the research and analysis), and the sign-off (whose function is to challenge and be satisfied as to the robustness of the technical reasoning and logic contained in the background issues report). A directions meeting is held at the beginning of a project to identify issues, suggest relevant research sources and (when required by the legislation) to set recommended timeframes and fee estimates. Subsequent meetings will be held between the three officials during the project. Before a ruling or statement is produced, a detailed issues report will be prepared by the analyst. The process provides for conclusions to be agreed by the manager and approved by the sign-off. In some projects where specialised issues arise, an additional member of the Adjudication and Rulings business group may be nominated as ‘adviser’ in relation to the project where he or she has relevant expertise or background.

17.6 All public rulings, interpretation statements and interpretation guidelines are subject to an extensive consultation process, both within and outside the department. (Consultation includes circulation to professional bodies and industry groups, advertising the drafts for comment in the *Tax Information Bulletin* and placing a copy on the department's website.)

17.7 Upon receipt of a private or product ruling application, copies of the application are automatically forwarded to the Policy Advice Division of the Inland Revenue Department and to the Operations segment that is responsible for the particular applicant. In that event, a summary memorandum is prepared in order to seek relevant input from other analysts within Adjudication and Rulings. A copy of the memorandum also goes to the Policy Advice Division and to National Operations Policy. Before an issues report is completed in relation to any private or product ruling, the analyst is required to provide an opportunity for both Policy Advice Division and the relevant Operations segment to provide comments and/or technical submissions concerning the matters raised in the application. The ultimate decision on the ruling application, however, rests with the Rulings unit, which attempts to apply an objective interpretational approach, rather than a policy-based or revenue protective one, in reaching its conclusions.

17.8 At the conclusion of every rulings project, the file goes through a post-issue review process, where it is checked by a different person within Adjudication and Rulings to ensure that relevant processes have been correctly followed and that the conclusions and recommendations are appropriately analysed and sustainable.

17.9 The committee considered two aspects of rulings that are issued by the Inland Revenue Department: quality, and the relationship between rulings and policy making.

Quality of private binding rulings

17.10 Most binding rulings are private. By section 91EH(2) of the Tax Administration Act 1994 the Commissioner notifies the existence of a private ruling by sending a copy to the applicant. This is the only notification. There is no publicity unless the applicant chooses, which rarely if ever happens.

17.11 Before part VA of the Tax Administration Act 1994 established binding rulings in 1995 there was a lively debate about whether private rulings should be confidential, or whether they should be disclosed,

though rendered anonymous if the applicant wished. The principal argument for disclosure is that binding rulings are in a sense delegated legislation, and, being akin to law in a manner similar to court judgments, they should not be secret. Against disclosure it was argued that the contents of a ruling would be likely to identify the taxpayer involved, and that rendering rulings anonymous would not be enough to protect taxpayer identity in New Zealand's relatively small marketplace.

17.12 The second argument won the day. One result is that, probably, more private rulings are issued than might otherwise have been the case. Since 1995 the numbers of private rulings issued are: 1995, 168; 1996, 176; 1997, 302; 1998, until 6 October, 153. The committee has no reservations about this result. The certainty offered by the rulings process is a good thing, and, since applicants pay a full price for the work involved in issuing rulings, there is no reason to limit numbers.

Quality control and utility of the rulings process

17.13 A second result that is less immediately obvious is that there is no quality control of rulings that is external to the Inland Revenue Department. Such an absence of quality control is unusual in respect of law. Legislation, court judgments, and public interpretation statements of the Commissioner are all subject to scrutiny by members of the public who are affected and by their advisers. Legislation and interpretation statements are also likely to be scrutinised by the courts, as are judgments, in the context of appeals and later cases.

17.14 As will be understood by the last paragraph, the quality control that the legal process ordinarily applies to law is informal and sporadic, but it is nonetheless real. For example, the statute book is replete with rules that have been amended and improved after the courts found something wanting in their earlier form.

17.15 As a matter of principle, the committee is concerned that, external to the Inland Revenue Department, there is no control over private binding rulings by way of independent scrutiny of this growing body of quasi-law. The department strives to overcome this problem by ensuring that rulings are checked at several levels of seniority before they are issued.

17.16 Counterbalancing this lack of external quality control of rulings is the consideration that the ruling process has a very useful role in the administration of the tax system. Through people applying for rulings, the Commissioner receives early notice of business and tax planning

structures. The rulings process can therefore give the Commissioner notice of matters that he could draw to Parliament's attention if legislative countermeasures are needed.

Conclusion as to private rulings

17.17 The department is aware of the importance of maintaining the highest of standards in the operation of the rulings process. It tries to ensure that Rulings unit staff are of very high calibre. Moreover, every six months the department estimates for the Minister of Revenue the amount of tax that is at risk because of rulings that have been issued (that is, tax that will erroneously be foregone should it turn out that one or more rulings are wrong).

17.18 The committee considered whether private rulings should be required to be published in an anonymous form. This step would have the merit of permitting public scrutiny of rulings and of allowing public access to a growing body of quasi law. But it would result in fewer rulings. On balance, the committee decided that the advantages of the rulings process (certainty for the taxpayer and intelligence for the Commissioner) outweigh the advantages of publication. The committee therefore does not recommend a change.

Interpretation statements, interpretation guidelines, and public rulings

17.19 From time to time, the Commissioner issues statements that, in contrast to private rulings, are for the guidance of taxpayers in general. In chapter 6 of this report, beginning at para 6.54 the committee considers several of such statements that concern tax avoidance and related matters.

Rulings and principles of tax policy formation

17.20 In principle, tax policy should be driven by economic policy, not by legal policy. When Parliament translates economic policy into law by passing tax legislation, the legislation becomes the vehicle for carrying economic policy into effect. Legal rules or principles cannot tell us what tax law should try to achieve: that is a matter of economic policy and of government objectives. Nevertheless, drafters of tax legislation must take general legal rules and principles into account in the drafting process, because these rules and principles influence the way in which statutory law is interpreted and takes effect.

17.21 Broadly speaking, New Zealand's tax policy formation and execution take account of the factors that are explained in the last paragraph.

The government's generic tax policy process starts with asking what is to be achieved from an economic point of view, and finishes with tax law that is enacted to put that objective into effect. Along the way, the policy is tested from both economic and legal points of view within both the Treasury and the Inland Revenue Department, and by consultation with the public and with professional groups.

17.22 The processes of composing and issuing private rulings and product rulings do not observe these principles. Private and product rulings are composed within the Rulings unit of the Inland Revenue Department. Like courts, the unit's brief is to issue rulings that state the current law, not to consider whether the unit's view of the law promotes or frustrates fiscal policy. That is, the unit starts by treating law as a base of accepted correct principle, whether the law is found in statute or in judicial decisions. In contrast, tax policy formation, and in particular New Zealand's generic tax policy process, start one stage earlier, by looking at economic principle.

17.23 Where the law (or the unit's interpretation of the law) correctly states economic policy, there is no cause for concern: that is, whether new law is created by general legislation or by a binding ruling the result is what Parliament would have laid down had Parliament thought about the matter.

17.24 On the other hand, where the law as interpreted by the Rulings unit does not reflect economic principle (either economic principle that Parliament has considered, or principle that Parliament would support if it considered the matter) the ruling that is issued may well be contrary to good tax policy. This matter is not one to be laid against the door of the Rulings unit. Its task is not to make policy but to work out the law and to state that law in rulings. Indeed, the unit would be acting unlawfully if it issued rulings according to economic policy rather than according to law.

17.25 The situation described in the last paragraph, of having binding rulings that may be contrary to good tax policy when the policy is measured according to economic principle, carries a cost. In deciding to adopt procedures for issuing binding rulings, New Zealand has decided to bear this cost. The benefit is that binding rulings can give taxpayers certainty about the fiscal consequences of their transactions. On an individual taxpayer basis, that certainty is worth having, and in many cases the cost to society will not be great, or there may be doubt whether there is any cost. For example, in some cases it would be hard to decide whether rulings

that draw the line between capital and income are right or wrong from an economic point of view, because the very distinction between capital items and revenue items, which is fundamental to New Zealand income tax law, often makes little sense when it is examined in the light of economic principle. For the reasons just described, one can justify the idea of binding rulings. So long as rulings are issued to taxpayers on an individual basis, benefits appear to outweigh costs.

17.26 The considerations just described do not apply to public rulings. Public rulings are much closer to ordinary delegated legislation than are private rulings: anyone who wishes may take advantage of a public ruling. Government policy makers have recognised this implication of public rulings. For this reason, among others, section 91D of the Tax Administration Act 1994 provides that it is discretionary rather than compulsory whether the Commissioner issues public rulings. Secondly, the Commissioner has adopted the practice of notifying proposed public rulings to the Treasury (as well as other parties) before issue, which permits consideration of whether any change to the law is required. The committee endorses both measures.

17.27 When it comes to product rulings, there is a seeming weakness in the system. By section 91F (1) it is not in terms compulsory for the Commissioner to make product rulings. Although in drafting terms that sits uncomfortably with an apparently unfettered discretion in section 91F (1), section 91F (3) may limit the Commissioner's power to decline applications to the fairly limited circumstances set out there. More importantly, there is no provision for proposed product rulings to be examined for consistency with fiscal policy. Despite this lacuna, a product ruling, or a series of product rulings, can have an effect similar to public rulings.

The passive fund rulings

17.28 A good example is the series of product rulings issued between 1996 and 1998 that relate to passively managed investment funds. These rulings state that capital gains derived by passive funds are exempt from tax. To understand the importance of these rulings it is necessary to have some knowledge of their context.

17.29 The context of the 1996 to 1998 rulings starts with *Californian Copper Syndicate Ltd & Reduced v Harris*.²⁷² *Californian Copper* involved the boundary between capital gains and income profits. It dealt with the tax consequences of the sale of assets that for most people are classified as being on capital account. At the risk of over-simplification, the case held that when a taxpayer's business involves selling such assets, even if only once, then profits that the taxpayer derives are taxable as income.

17.30 Throughout this century, the *Californian Copper* principle has had a steadily increasing impact on the finance sector. Progressively, courts have decided that the principle applies to the profits from increasing numbers of transactions. In the present context, the Australian High Court case of *London Australia Investment Co Ltd v FCT*²⁷³ was a watershed. Again at the risk of over-simplification, that case held that, in general, profits that investment companies make when they realise investments in order to buy other investments are taxable as income. This is so even though such profits would ordinarily not be income for people who happen to be, as individuals, shareholders in investment companies, if these individual shareholders had directly bought and later sold the same investments. That is, the taxable status of certain transactions changes from capital to revenue if people undertake these transactions via investment companies. For present purposes, mutual funds and investment unit trusts are in the same position as investment companies.

Product rulings in respect of passive funds

17.31 The 1996 to 1998 rulings that are the subject of this part of the committee's report hold that passive funds that simply track the stock market, or a fraction of it, are not affected by the *Californian Copper* principle. The fundamental approach of these funds is that they hold shares in, say, companies listed on the New Zealand stock exchange in proportion to the respective market capitalisation of those companies. For example, if company A's capitalisation represents four per cent of the capitalisation of all listed companies, a passive fund that covers the whole sharemarket will ensure that four per cent of its funds are invested in company A. Typically, passive funds invest in only part of the market, say the leading 20 or 40 companies.

²⁷² 5 TC 159, Court of Session

²⁷³ 138 CLR 106

17.32 As the relative capitalisation of listed companies changes, so does the portfolio of a passive fund. If the shares of company B go down in value relative to the value of shares in other companies, a passive fund sells some of its shares in company B and buys shares in the appropriate proportions in other listed companies.

17.33 The 1996 to 1998 rulings protect the fund from paying tax on any gain in the value of company B shares that it may realise in the course of this transaction. This result contrasts with the position of an ordinary fund that manages its investments actively and that, say, quits shares in company B because it calculates that they are overvalued or because the dividend yield is too low, or for any of the other reasons that might cause a fund manager to change an investment. For ordinary funds, the *Californian Copper* principle as understood nowadays says that gains on the sale of company B shares are taxable as income.

Implications of passive fund product rulings

17.34 For New Zealand investors nowadays the contrast is between the tax positions of passive funds and active funds. A second contrast is between cases where the *Californian Copper* principle operates and cases where it does not operate. The outcomes of those contrasts include:

Generally, if funds take care over their investments, they suffer a harsher tax regime than funds that follow the market automatically.

Passive funds cannot act to protect their investors by quitting even the most unpromising of stocks, for fear of rendering themselves liable to tax on all profits derived on investment switches.

Generally, the bigger and more diversified an investment portfolio, no matter who holds it, the more chance there is that the *Californian Copper* principle applies.

The fiscal advantages of passive funds have resulted in a major shift of New Zealand investment patterns to the benefit of these funds. In fact, one investment adviser, argues that these fiscal advantages are so significant that it is unethical except in rare circumstances for advisers to recommend actively managed investment funds to New Zealand taxpayers.²⁷⁴

²⁷⁴ Sunday Star-Times, Auckland 18 October 1998, page E2

17.35 The 1996 to 1998 rulings are not the only cause of the shift to passive funds on the New Zealand stockmarket. Another factor is investors' increasing disillusionment with the performance of actively managed funds. In recent years, the press has published survey after survey to show that when management fees are taken into account (and sometimes even when they are not) the performance of actively managed funds over time often does not even match the market. The committee is advised that throughout the world there is a trend for investors to move from active to passive funds.

17.36 The impact of this trend in New Zealand more or less coincided with the 1996 to 1998 rulings. As a result, it is not possible to disentangle the effects on the New Zealand stock market of these two separate influences. Be that as it may, there can be little doubt that the rulings had a very significant impact, not only on investment advisers but also on investors. Until the rulings were issued, passive funds hardly existed in New Zealand. The following table shows the increase in investment in New Zealand passive funds since the 1996 to 1998 rulings.

TABLE 9: RETAIL INVESTMENTS IN NEW ZEALAND PASSIVE FUNDS

<i>Asset class</i>	<i>September 1996 (\$NZ million)</i>	<i>March 1998 (\$NZ million)</i>
NZ equities	38.45*	157.62
International and Australian diversified	0	133.69
All retail funds	38.45*	291.31
<i>For comparison:</i>		
NZSE top 40 index	2192.70	2289.29

* all in the New Zealand Stock Exchange TeNZ fund established in June 1996

Policy and the passive fund rulings

17.37 Some people have reservations about the way in which the *Californian Copper* principle is applied to actively and passively managed funds, and whether nowadays that application is correct in law. However, these reservations may be put to one side. The more important issue concerns the fiscal effect of the 1996 to 1998 product rulings. They have had a major effect on the managed fund industry. On the face of it, the effect may be detrimental, in that the rulings encourage people to invest via vehicles that calculatedly do not manage investments for the best yield, if one ignores tax considerations. On the other hand, the overall effect of the passive fund rulings may be beneficial to the economy. That is so if managed funds in general are indeed an inefficient invest-

ment vehicle, as some disillusioned investors suspect. In the present context, however, the important consideration is that the factors that caused the change are questionable, in that one factor with at least some responsibility was an announced change in tax treatment of investments.

17.38 For some years, New Zealanders have become increasingly aware that it is bad policy for the tax system to drive business and investment decisions. This thought is fundamental to many of the tax reforms that have occurred since the mid-1980s. Elsewhere in this report the committee has noted its concern that, despite policy makers' best efforts, some lack of neutrality remains within the tax system.²⁷⁵ But, at least, to the extent that there is a lack of neutrality, this position is ordinarily a function of the Income Tax Act.

17.39 To have product rulings on income tax law contributing in a major way to the structure of New Zealand's investment market is questionable. The present shape of the market may or may not be optimal. The government would no doubt reject any suggestion that it should directly regulate the stock exchange in a manner that promotes one investment vehicle at the expense of others. Nevertheless it is achieving the same result indirectly by tax legislation.

17.40 The committee endorses the current rulings process. It **recommends** that the issuing of product rulings should clearly be discretionary, as is already the case with public rulings. In exercising its discretion to issue public and product rulings the policy implications of such rulings should be taken into account.

²⁷⁵ See chapter 1

CHAPTER 18 – THE INLAND REVENUE DEPARTMENT’S BUDGET

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Introduction

18.1 The Commissioner of Inland Revenue exercises independent statutory functions under the revenue Acts. Thus the Inland Revenue Department’s existence could be said to spring from those Acts. The Inland Revenue Department is, in fact, a department of state. The Commissioner is its Chief Executive under the State Sector Act 1988.

18.2 Funding of the department’s operations is, therefore, governed by the Public Finance Act 1989. Under that Act, the Minister of Revenue, on behalf of the Crown, purchases outputs from the Commissioner in return for sums appropriated by Parliament. These outputs are the visible operations of the department: audits, return processing, policy advice and so on.

18.3 The total level of appropriations in Vote: Revenue is set each year in the annual Estimates legislation, which also sets out in broad terms (referred to as output classes) the outputs to be purchased by the Minister. More details of the outputs purchased are set out in the annual purchase agreement between the Minister and the Commissioner. This agreement sets out, in significant detail, the individual outputs to be supplied and specifies the quantity, quality and timelines of each output. The agreement also specifies the amount the Minister will pay for each output.

18.4 This approach finds expression in section 6A of the Tax Administration Act 1994, where the Commissioner is charged with the duty of raising the ‘highest net revenue’ that is practicable under the law, having regard to, among other things, the level of resources available to the

Commissioner. For a deeper description of the rationale underlying section 6A, see the report of the Organisational Review of Inland Revenue.²⁷⁶

18.5 The committee reviewed the basis for the output class structure of the Inland Revenue Department to ascertain whether the current structure impinged upon the efficiency of tax administration. In particular, the committee questioned why departmental outputs were divided by functions rather than by customer segments, and whether this classification interfered with internal management, which is based on customer segments. The functional approach for defining output classes is consistent with the fundamental principles of public sector financial management in New Zealand, and with the Public Finance Act 1989 in particular.

Provisions of the Public Finance Act 1989

18.6 Section 4(1) of the Public Finance Act 1989 provides that:

- (1) No expenditure of public money shall be made other than in accordance with an appropriation by an Act of Parliament.

Section 4(3) requires that a separate appropriation shall be made for each class of outputs contained in the Estimates in accordance with section 9(2A)(c) or section 9(2A)(d) of the Act.

18.7 Section 9(2A) of the Act provides that the Estimates shall, in relation to each Vote, identify a range of information. For the purposes of the current discussion, the most important are:

- (c) Identify, for each class of outputs to be supplied by the department or Office of Parliament, the proposed costs or expenses to be incurred.
- (e) Include a description of each class of outputs to be purchased by the Crown.
- (f) Identify the link between the classes of outputs to be purchased by the Crown and the Government's desired outcomes.

²⁷⁶ Organisational Review Committee, *Report on the Organisational Review of the Inland Revenue Department*, April 1994. For some details of the review, see appendix 2.

- (o) Comparative figures for each of the five financial years before the financial year to which the Estimates relate for total expenses incurred in relation to classes of outputs.

18.8 Section 2 of the Act defines 'class of outputs' to mean 'a grouping of similar outputs' and 'outputs' as 'the goods or services that are produced by a department, Crown entity, Office of Parliament, or other person or body'.

18.9 The Public Finance Act 1989 does not go further in terms of providing a legal basis for defining output classes. The development of the principles of public sector financial management was undertaken in the reports of the Working Party on Output Definition in 1992. Cabinet subsequently adopted the recommendations of the reports of the Working Party on Output Definition. That decision confirmed the basis for the functional approach for defining output classes. The functional approach for defining output classes was intended to enable effective parliamentary scrutiny while retaining internal management flexibility.

18.10 An output class structure based on customer segments or business lines within a department would require a fundamental reassessment of the principles of public sector financial management over the whole public sector. It would also not comply with Cabinet's decision of 1992. The committee was advised by Treasury that the government has no plans to carry out such a reassessment or a review of the Act. As a result, it is not feasible to suggest that Inland Revenue outputs should be redefined in terms of its current customer segments: business direct, business link, corporates and so on.

18.11 The definition of output classes²⁷⁷ was predicated on grouping similar activities that can be subject to common performance measures, in a sensible way from the purchaser's perspective. The idea was that Parliament could then evaluate the purchase of and retain control over the specific services being delivered. Output classes which were structured in this functional-based way would provide a degree of comparability between departments and over time. It was thought a segment-based structure would contain dissimilar activities, hindering parliamentary scrutiny, and would need to change in line with internal structures, losing comparability.

²⁷⁷ Such as taxpayer information services, taxpayer audit, management of overdue tax and returns.

18.12 There can be some tension between effective parliamentary control and flexibility of management. The priority is the former under a Westminster parliamentary system. If departmental managers were to have effective decision-making authority for both inputs and outputs, then it could be more difficult to hold departments accountable. The primary intent of the Public Finance Act 1989 in aggregating outputs by nature was to ensure that decision rights as to output mix rested with Ministers rather than with managers. The objective is that Parliament should make its appropriations on a basis that is transparent and enforceable.

18.13 In principle, flexibility of management is not seriously compromised because departmental managers have flexibility in what inputs they purchase and in how they structure their operations. They can also regroup outputs within internal accounting systems to create internal reporting structures that match their changing business organisation, while simultaneously meeting parliamentary scrutiny. Departmental management in the public sector is also normally focused at the more detailed output level.

18.14 In practice, the need to seek approval for changing a department's mix of outputs appears to be a constraint on management, albeit that there are procedures for urgent approvals when the situation demands an immediate response.

18.15 Ministers seek appropriation from Parliament to deliver classes of outputs. Ministers are responsible to Parliament for the overall performance of departments, but are not involved in day-to-day management of their departments. Parliamentary Select committees report to Parliament on each Vote within two months of the presentation of the Budget and again following the tabling of the Supplementary Estimates. Select committees also carry out financial reviews of departments before the first sitting day in each financial year. Parliamentary scrutiny is based on reviewing classes of similar outputs using common performance measures.

18.16 Departmental chief executives are responsible for the delivery of the outputs that Ministers have agreed to purchase from them. Purchase agreements specify what outputs Ministers are buying and how delivery will be measured. The committee notes that, generally, there is some scope within the system of Parliamentary appropriations to redirect resources during the course of a year. However, it would be desirable to look for ways to improve the flexibility available to departmental man-

agers to respond to variations in demands for outputs within a financial year, consistent with requirements of accountability. The committee understands that the budget processes are intended to facilitate such changes, within the overall level of funding, and that proposals to do this are rarely declined. The committee did not have the time or resources to inquire into whether this flexibility within the government's budget processes is fully utilised.

18.17 The public is often heard to say 'Why can't the Inland Revenue Department behave more like a company in the commercial world?' Also, one hears statements like 'Surely common sense dictates that one just direct resources from area A to area B' or other such observations founded in commercial responses.

18.18 The Inland Revenue Department is not a private sector firm, with the management flexibilities available to such firms, seeking to maximise profits. It is a department of state, carrying out a range of functions. It is appropriate, therefore, that it should be subject to the same budgeting and accountability arrangements that apply to other departments.

18.19 In the private sector, managers typically have some discretion to vary outputs to reflect market demand. Managers' accountability is measured by profitability. In the public sector, where profit is not available as a measure, there must be other ways of holding managers to account. In New Zealand, as the committee has explained, public sector accountability is by control over outputs exercised by Ministers, on behalf of Parliament.

18.20 Nevertheless, the public sector experiences changes in demands that are analogous to changes of market demand in the private sector. Under New Zealand's system, if managers wish to change outputs in the order to meet changed demand they must seek ministerial approval. Parliament later analyses this approval by the supplementary estimates process. The need to seek these approvals means that public sector managers ordinarily cannot respond to changes in demand as quickly as managers in the private sector. The committee does not criticise the system. It is a function of the democratic process and of parliamentary accountability. In short, the public should not expect government departments to operate with the flexibility of the private sector.

18.21 There is merit in keeping this issue under review. In short, there is scope within the system of parliamentary appropriations to redirect resources during the course of a year. However, it is desirable to look for

ways to improve the flexibility available to departmental managers to respond to variations in demands for outputs within a financial year.

18.22 The committee **recommends** that the government should encourage the Commissioner fully to utilise the scope for flexibility within the government's budget processes. The government should also keep the whole issue of management flexibility under review.

Part V

Appendices

APPENDIX 1

THE COMMITTEE'S GUIDELINES

Guidelines to interpreting the terms of reference of the committee of experts:

GENERAL GUIDELINES

The committee should take into account the following guidelines in its deliberations:

The committee's work should be consistent with the general direction of the government's tax policy as set out in the government's revenue strategy and in the Coalition Agreement.

The overall aim of the committee is to consider future policy issues for promoting better compliance by taxpayers with their tax obligations.

The committee's terms of reference are broad. However, the committee should consider itself bound as follows in implementing the terms of reference:

- it is not to consider the government's general tax policy (that is, tax base and rates), except in so far as it impacts on compliance; and
- it is not to consider the recommendations of the Commission of Inquiry into Certain Matters Relating to Taxation.

The committee's focus should be on legislation. Given the limited time the committee has to consider the terms of reference, it should not focus on major organisational issues, or on the details of Inland Revenue's administration. However, administration may be considered insofar as the committee may recommend a change to legislation that would assist Inland Revenue in administering the tax laws.

Any recommendations which the committee makes and the Government wishes to pursue will be subject to the generic tax policy process.

SPECIFIC GUIDELINES INTERPRETING THE TERMS OF REFERENCE

The committee is to consider and make recommendations on:

1. *Tax compliance costs, including how tax laws may be simplified and made more coherent and understandable while ensuring an appropriate balance between the levels of complexity, fairness, accuracy and economic efficiency.*

The committee should comment on the extent to which the rewrite and simplification projects are achieving this term of reference.

Rewrite

Comment

The Income Tax Act is being rewritten to strengthen the logical and conceptual structure of the Act and to express the law in plain language in order to minimise compliance and other costs resulting from the way the Act is structured and expressed. Reducing ambiguity in the Act is also intended to improve compliance and enforcement.

Guidelines

Are there changes to the Rewrite project which would enable it to better achieve the Term of Reference? In particular, is the rewritten Act:

appropriately structured;
with an appropriate level of detail; and
expressed in plain language

given:

the complexity of the policy expressed in the Act; and
the ability of taxpayers to exploit lack of detail.

Simplification and compliance costs

Comment

The simplification and self-assessment projects aim to reduce compliance costs.

The tax system imposes compliance costs by:

requiring business taxpayers to understand their obligations, which results from:

- reading and understanding:
 - the Income Tax Act,
 - relevant regulations, determinations, and tax treaties, and

- case law,
- or employing professional advisers for this;
- requiring taxpayers to gather information necessary to determine their tax liabilities and fulfil reporting obligations;
- requiring taxpayers to calculate their income tax liabilities;
- requiring taxpayers to report information to Inland Revenue (for example, file tax returns);
- requiring persons to report information (to Inland Revenue and others) and make payments on behalf of others (for example, PAYE, RWT and NRWT);
- requiring taxpayers to retain information; and
- requiring taxpayers to assist Inland Revenue in audits and other administrative matters.

Guidelines

Are there changes to the simplification project that would enable it to better achieve the term of reference? For example:

Can income tax calculation methods be modified to be simpler, while preserving the policy of how taxable income is intended to be determined?

Can reporting and record retention requirements be simplified while preserving the interests of having an effective tax administration?

2. *How to make the tax system more robust against avoidance and evasion (identifying and bearing in mind the underlying causes of such activity), with particular regard to:*

a. *The use of tax-driven structures lacking business reality*

Comment

This term of reference refers to transactions using structures (entities and arrangements) which lack business reality (which do little economic activity other than facilitate a transaction which has the effect of reducing tax liabilities, or earning income in a way which attracts no or little tax).

Boundaries

The income tax system has boundaries, that is, distinctions between items of income or expenditure that are taxable/exempt or deducti-

ble/non-deductible, depending on how they are classified. These boundaries normally result from policy decisions, for example:

it is government policy that capital gains are generally not taxed but income generally is taxed;

expenditure incurred for private or domestic purposes is non-deductible; and

foreign-sourced income is treated differently from domestic-sourced income, because of international obligations (to provide foreign tax credits), and practical difficulties in measuring and taxing foreign-sourced income (for example, income earned through foreign entities).

While there are policy rationales for each of these boundaries, they are often exploitable in that taxpayers can reclassify income or expenditure into categories that give a more favourable tax result. This can be done by structuring their affairs to achieve a more favourable tax result, or exploiting boundaries in a way that amounts to tax avoidance.

Guidelines

How significant is this issue?

Given the government's general tax policy (that is, tax base and rates), how do current tax boundaries affect the risks of taxpayers using tax-driven structures lacking business reality?

What are examples of structures that have been used for tax avoidance?

b. Abuse or complicity by tax advisers

c. Standards of conduct for tax advisers

Comment

Professional advisers on tax matters are usually lawyers or accountants belonging to their respective professional bodies. These bodies have ethical standards which must be complied with. The bodies are empowered to sanction members that violate the standards, including suspension or expulsion from the bodies.

In addition to the ethical standards of the professional bodies, the legal system imposes constraints on the activities of advisers. If a taxpayer engages in activity that is considered tax evasion, criminal principles of extended responsibility (such as conspiracy and accessory) could potentially apply to advisers who advised or assisted the

taxpayer in the activity. If a taxpayer suffers monetary loss from engaging in tax avoidance (for example, the taxpayer is subject to tax avoidance penalties), the taxpayer may have the right to seek compensation from the adviser under civil law standards of professional responsibility (eg, if a taxpayer was not advised that a transaction was tax avoidance and was potentially subject to penalties). The legal structure imposes a discipline on the activities of tax advisers.

The recent changes to the compliance and penalties regime establish a crime of aiding and abetting principal tax offences.

The government considered the role of tax advisers in the review of taxpayer compliance, standards and penalties in 1995. It decided to introduce an offence in the Tax Administration Act 1994 of aiding and abetting another person to commit a criminal offence, but not to proceed with proposals to:

- clarify in legislation the right of taxpayers to sue advisers or limit advisers' ability to contract out of liability if they have been negligent; or

- introduce an offence of aiding and abetting the putting into place a (non-criminal) abusive avoidance arrangement.

Guidelines

Are professional advisers in general behaving according to appropriate ethical standards?

What should the ethical standards for tax advisers be?

Do the professional bodies have appropriate ethical standards for advisers?

Are there appropriate sanctions for breach of ethical standards and are these enforced? What role should civil and criminal law have in maintaining ethical standards for professional advisers? Consider the new offences of aiding and abetting tax offences which resulted from the review of taxpayer compliance, standards and penalties.

Does the committee have any recommendations to make on standards of conduct for tax advisers resulting from the review of taxpayer compliance, standards and penalties in 1995?

d. Concealment and other tax related offences, and the possibility of confiscating concealed profits

Guidelines

Does failure to disclose information currently unduly hinder the Commissioner from accurately determining an assessment?

How much should taxpayers be required to disclose? What objective standards can define this?

Is the current law on concealment and tax-related offences appropriate?

e. The lack of prosecutions to prevent harmful tax practices and schemes

Guidelines

Audits

Are the information disclosure rules for cooperation with audits adequate?

Are changes desirable to laws to enable the Inland Revenue Department to access information kept in offshore companies, particularly in countries with secrecy laws?

Prosecutions

Are law changes desirable to improve the extent to which harmful practices are prosecuted?

Is judicial review being abused by taxpayers and, if so, what legislative changes are desirable to prevent such abuse.

f. The adequacy of the current penalties regime, including criminal penalties

Comment

The penalties regime has been substantially changed under the compliance and penalties legislation. This will add new penalties to enforce the higher standards of compliance needed for a self-assessment tax system. These include:

penalties for errors arising for lack of reasonable care;

penalties for taking legal positions that constitute an unacceptable interpretation;

penalties for engaging in 'abusive tax avoidance';

penalties for evasion; and

criminal penalties for tax evasion.

There are also penalties for 'knowledge' offences (such as wilfully not paying withheld PAYE); and knowingly failing to comply with information reporting requirements.

These new penalties are intended to act as incentives for taxpayers to accurately determine their tax liabilities under a self-assessment system, and to provide the Commissioner with sufficient information to enforce the tax law.

Guidelines

Are the new penalties sufficient to discourage taxpayers from engaging in tax avoidance and tax evasion?

g. How to achieve disclosure of tax schemes affecting the instance of tax payable by greater than \$100,000

Guidelines

This is a specific proposal which the committee is being asked to consider.

What are the current disclosure requirements? How does disclosure fit into the current filing rules and the move towards self-assessment?

Is requiring such disclosure desirable?

If desirable, how would you define a 'scheme' that can be isolated so it can be determined that it has a tax impact of more than \$100,000?

How much disclosure of the scheme would be required?

h. The possibility of treating the failure to disclose (or falsification of material facts) by a person experienced in tax matters as a serious criminal offence, and establishing it as punishable by a maximum penalty of 10 years imprisonment where more than \$5 million in tax revenue is involved

Comment

The recent changes to the compliance and penalties regime includes criminal offences for not disclosing information required to be disclosed, and for tax evasion. These offences currently carry penalties of up to five years imprisonment.

Guidelines

Is a change in the law along these lines necessary and desirable?

If yes, is a 10-year imprisonment period appropriate given that tax evasion carries a penalty of up to five years imprisonment? What other offences carry penalties of 10 years' imprisonment?

What level of disclosure would be required? Should the standard disclosure (ie, filling out the questions on the tax return) or a greater level of disclosure be required?

How would a person experienced in tax matters be defined?

i. The possibility of recovering from large-scale, tax evasion schemes (say \$100,000 and over) and those who aid them, profits attributable to the use of unpaid tax (unjust enrichment)

Comment

Recent changes to the compliance and penalties regime provide that late payments of tax attributable to earlier income years carry interest from the original due date of the tax, even if the tax was not assessed until later.

Guidelines

Is a change in the law along these lines necessary and desirable?

j. The internationalisation of the economy, including electronic commerce and how the taxation collection base can be maintained

Comment

The growing use of electronic communications (the internet) provides a new means of transacting cross-border commerce (for example, a consumer in New Zealand ordering via a computer in New Zealand goods that are sent to the consumer from offshore). This use raises a number of tax policy issues, for example:

What is the source of the income?

Does the supplier have a taxable presence (fixed establishment) in New Zealand?

How does this effect current laws on the income tax source rules and GST rules?

Guidelines

What is the significance of internet commerce for tax policy, now and in the next few years?

Are there changes to GST rules or the income tax source rules that are necessary and desirable?

APPENDIX 2

SOME TERMS USED IN THE REPORT

SUMMARY

Organisational review	307
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Organisational review

The term ‘organisational review’ refers to the work and recommendations of the organisational review committee, chaired by the Rt Hon Sir Ivor Richardson. The committee reported in April 1994, having conducted a fundamental, strategic review of the Inland Revenue Department and its activities. The committee was asked by the then government to ‘investigate and recommend the optimal organisation arrangements for the tax assessment and collection system, and other activities that are currently a part of the tax system, the provision of taxation policy advice, legislative management and ministerial servicing’.

The main recommendations made by the organisational review committee concerned the structure of the department, tax policy advice, resolution of tax disputes, technical quality, subcontracting and the roles of the Commissioner of Inland Revenue and Chief Executive.

These recommendations have largely been or are in the process of being implemented. In particular, the Inland Revenue Department’s service delivery has been restructured from a functional basis to one based on customer segments. The department has moved from a field delivery structure based on four regions and 26 district offices, to six service centres (‘hubs’) and smaller branch offices and customer service offices (‘spokes’). Under this new structure, national office managers responsible for the design of services in their customer segments, work with service centre managers who have responsibility for delivery in their ar-

eas. The distinction between design and delivery has ensured clearer accountabilities for managing performance at national and local levels.

A generic tax policy process was introduced following the Organisational Review. This process is discussed separately below. New disputes resolution procedures took effect on 1 October 1996 and included the establishment of a new adjudication function and also a litigation management unit within the Inland Revenue Department. The new adjudication unit ensures that a separate structural focus is given to the adjudication of the department's final quantification of a taxpayer's liability. Section 6A of the Tax Administration Act 1994 gives explicit recognition of the obligation on the Commissioner to operate within limited resources in the care and management of the tax administration functions.

Generic tax policy process

The generic tax policy process was introduced as a result of the organisational review. It is intended to improve the process by which tax policy is developed. The organisational review committee found that at both ministerial and departmental levels, the roles and accountabilities at each stage of the tax policy development process needed to be more clearly and formally defined. The committee thought that the tax policy process had not been clearly specified or agreed and had not ensured that strategic issues and issues of detail were dealt with in an appropriate sequence at the appropriate level or in the appropriate forum.

In order to address these problems, the organisational review committee recommended introducing a generic tax policy process to clarify the process of policy development and the respective roles played by Treasury and the Inland Revenue Department in that process. In particular, the committee considered that the Inland Revenue Department's policy advice function should be more prominent and should be strengthened.

The main objectives of the generic tax policy process are to:

- encourage earlier, explicit consideration of key policy elements by Ministers;
- provide opportunities for substantial external consultation in the tax policy development process, which is intended to increase transparency and improve the quality of advice at both the conceptual and detailed design stages; and
- clarify the responsibilities and accountabilities of participants in the process.

The generic tax policy process has five distinct phases:

- 1 Strategic phases – the development of an economic strategy, a fiscal strategy, and a three-year revenue strategy.
- 2 Tactical phases – the development of a three-year work programme and an annual resource plan.
- 3 Operational phases – the detailed policy design, formal detailed consultation, and ministerial and cabinet approval of detailed policy recommendations.
- 4 Legislative phases – the translation of detailed policy recommendations into legislation.
- 5 Implementation and review phases – the implementation of legislation, the post-implementation review of legislation, and the identification of remedial issues.

A key feature of the generic tax policy process is the emphasis it places on consultation at each of the main stages of the process with taxpayers, their advisers and professional and industry bodies.

Directions: Customer Requirements

Directions: Customer Requirements is a major project, the primary objective of which is to reduce compliance costs for taxpayers. It is the current major strategic project being conducted by the Inland Revenue Department. This project is explained further in appendix 5.

Davison Commission and the Winebox papers

The term ‘Davison Commission’ refers to the Commission of Inquiry that was set up in September 1994, presided over by Rt Hon Sir Ronald Davison, formerly Chief Justice of New Zealand, to examine transactions referred to in papers presented, by leave, to the House of Representatives by the Hon Winston Peters on 16 March 1994. These papers are referred to as the Winebox papers. The terms of reference of the Commission of Inquiry required it to report upon whether the Inland Revenue Department and the Serious Fraud Office had acted in a lawful, proper and competent manner in dealing with the relevant transactions, and to examine whether any changes to the criminal or tax laws should be made for the purpose of protecting New Zealand’s income tax base from the effects of fraud, evasion and avoidance.

The Davison Commission reported in August 1997,²⁷⁸ and found that the Inland Revenue Department had acted in a lawful, proper and competent manner in dealing with the Winebox papers. The findings of the Davison Commission are subject to judicial review proceedings.

²⁷⁸ Commission of Inquiry into Certain Matters Relating to Taxation, *Report of the Winebox Inquiry*, August 1997

APPENDIX 3 OMITTED TOPICS

Introduction

The committee's terms of reference are broad. In one respect or another, they cover the whole of New Zealand's tax system. At the same time, the committee's time and resources have been constrained. One consequence is that the committee has had to omit from its scrutiny a number of significant areas of the tax system.

The committee has addressed other areas only partially. The committee lists some of these omitted or partially omitted areas in this appendix. While all these matters are important, the committee draws the government's attention to the items in the first list below as requiring early attention. The committee expresses no view on whether the matters in the other lists require attention, but records there are items the committee would have discussed if it had time.

Matters requiring early attention

Lack of neutrality in taxation of different investment structures; see the submission from the Investment Savings and Insurance Association of New Zealand Incorporation in appendix 8 on page 326

Education and training of Inland Revenue staff

Recruitment and retention of Inland Revenue staff

Matters partially considered

The company tax system

The international tax rules

Trust taxation

Matters not considered

The FIRST computer system, and other departmental computer systems

Departmental methods of measuring and upgrading the quality of work in the service centres

Goods and Services Tax in general, and section 76, the anti-avoidance provision of the Goods and Services Tax Act 1985 in particular

Interest deductibility (the subject of a discussion document planned for publication in 1999)

Penalty level (to be reviewed according to the generic tax policy process in 1999)

The status and work of the Taxation Review Authority²⁷⁹

A post-implementation review of the Organisational Review's recommendations on tax policy advice

²⁷⁹ The committee includes the Taxation Review Authority in the third category for completeness only. The committee does not suggest and has heard no suggestion that the Authority needs review or evaluation. The committee understands that there are some cases where the Authority would welcome a discretion to award costs. The Authority would also be assisted by better facilities for the recording of evidence.

APPENDIX 4

GUIDE FOR INLAND REVENUE FORMS

DO LIST

Use plain English.

Where jargon needs to be used provide clear explanations, for example, for 'reassessments', 'balance brought forward', 'credits' and 'debits'.

Amount and date to be paid needs to be clear.

The pay-in slip should specify date payment is due – not 'immediately'.

Need to clearly differentiate between revenue types.

Transfers – clearly state where transfer has been made to/from (which revenue or period).

Provide information on a more timely basis.

Provide clear explanation when the reassessment shown on the notice of assessment differs from that on the return. Must be clear how calculations have been derived.

Be clear about why penalties/interest is being charged, and how this is calculated.

Be clear what year/period the information relates to.

Be clear about the period covered by the statement.

DO NOT LIST

Do not issue pay-in slip or envelope if there is nothing to pay.

Do not use multiple sheets when the information could fit on one piece of paper.

Do not repeat information in a statement or a notice that was on a previous one.

Do not provide information from back years.

APPENDIX 5

DIRECTIONS: CUSTOMER REQUIREMENTS

The committee has been briefed on the work being undertaken by the Inland Revenue Department on reducing compliance costs for taxpayers. This work is known by its project name, *Directions: Customer Requirements*. It has two phases, the first resulting in the removal of the need for wage and salary earners to file tax returns. The second involves simplification for business taxpayers, and in some cases, the issues considered by the committee have overlapped with initiatives being proposed under the second phase. In these cases, the committee has mainly recommended simultaneous implementation of its proposals along with any outcomes of the second stage review.

This appendix was provided by the Inland Revenue Department in order to provide a short history of compliance cost reduction in the first phase of the project and to summarise the features of the second phase.

Strategic direction for the Inland Revenue Department

Since implementing its new organisational structure in 1996, Inland Revenue has been looking at measures to improve its performance by focusing on areas of compliance risk. This focus has resulted in a strategic direction based on five broad aims:

- to encourage compliance with the aim of maximising net revenue;
- to reduce to a minimum and to simplify the information requirements the department places on taxpayers;
- to conduct business in a way that suits taxpayers;
- to develop a workforce that is respected for its professionalism, knowledge, ability and willingness to meet taxpayers' needs;
- to develop an organisational infrastructure and information systems that support a taxpayer-focused compliance improvement strategy.

The strategic direction is being implemented in two linked phases.

The first phase of Directions: Customer Requirements

In August 1996, the government released the discussion paper,²⁸⁰ which put forward proposals for reducing the requirement for saving and wage earners to file IR 5 returns. The discussion paper also proposed simplifying the labyrinth of rules, thresholds, penalties, and interest provisions in the provisional tax regime.

These proposals were developed as part of a strategy in the project *Directions: Customer Requirements* which is aimed at simplifying and reducing to a minimum the information requirements the Inland Revenue Department places on taxpayers.

Under the old system of filing returns, IR 5 taxpayers were required to file a tax return annually showing income received throughout the year and rebates claimed. Approximately, 1.2 million taxpayers filed an IR 5 return. Under the new system, the Inland Revenue Department will provide an income statement to those with whom annual contact is required for a social policy or other reason. Approximately 300,000 of these statements are expected to be issued by the Inland Revenue Department, with a further 300,000 being requested, mainly to claim a tax refund.

Employers had certain responsibilities, including furnishing an annual reconciliation to balance the PAYE deductions made during the year. Approximately 200,000 reconciliations were filed each year. A number of amendments, principally the introduction of an employer monthly schedule removed these obligations.

The second phase of Directions: Customer Requirements

The second phase of the project is to examine further minimisation of the requirements placed on business taxpayers, particularly small businesses. The goal of the review is to reduce tax compliance costs for businesses by minimising return filing and other tax administration requirements when possible and by simplifying the remaining requirements, and by improving the Inland Revenue Department's service. The review will also identify opportunities to rationalise the information needs across government agencies. This process will involve reviewing cases of duplication, either in the information collection process or in the collection of data.

²⁸⁰ *Tax Simplification Issues*, Government Discussion Paper, August 1996

The Inland Revenue Department recognises that in order to identify practical solutions to reduce compliance costs, it is important to have regard to the way businesses are run, and to consider the impact that tax obligations and other government requirements have. Wide consultation with businesses and their representatives will be required, to be facilitated by the publication of a discussion document. Inland Revenue will complete a scoping report to the Minister of Revenue by 30 May 1999.

The impact of the department's strategic vision

In simplifying the tax system to make it easier for taxpayers to comply with their obligations, the Inland Revenue Department will be concentrating its resources on those areas of compliance risk, for example, evasion and the underground economy. The implementation will significantly affect the Inland Revenue Department's business processes. The department will change from a large, process-focused organisation to one that is technically specialised and geared to areas of greatest compliance risk. This process will shift the focus of the department's resources away from the bulk processing of low value-added transactions. By removing the need for taxpayers to file wage and salary tax returns if the amount of tax involved is small, the department can target its resources in other directions, for example, towards ensuring compliance.

In the future, the Inland Revenue Department's core business will be audit, policy, litigation management, adjudication and rulings, child support, and some return and debt management processing. Targeting resources to these higher value-added functions will in turn require review to ensure the new resources are used efficiently. A major initiative in the second phase of the project is Audit 2000, intended to improve audit methodologies and tools to address areas of risk. In order to make this transition, the Inland Revenue Department recognises that the department will need to invest in its management resources and infrastructure.

The Inland Revenue Department considers technical training and management development are a primary focus. Technical competence is a core skill required to ensure that Inland Revenue Department staff are kept up-to-date with developments and legislative change. New performance management and remuneration systems are being implemented to ensure that the department can compete in the limited labour pool for tax professionals, policy analysts and customer service staff. This emphasis will be supported by more flexible employment contracts. A new financial management system has already been introduced and provides

Inland Revenue managers with access to world-class integrated financial tools.

Inland Revenue has a large integrated information base of income data which provides an integrated picture of each taxpaying entity, and the department is committed to using new technology for efficiency and more importantly, to keep pace with taxpayers' service expectations and the new ways in which they are doing business. Examples are call centre technology, electronic commerce and computer-based auditing.

The next stage of the department's technology plan is to develop data warehousing and decision support tools that can access the information collected for compliance analysis. Other technology projects include making greater use of specialised tools, such as a technical reference system and audit tools for field use.

APPENDIX 6

THE PENALTIES PROVISIONS

In 1994, the government identified that the prevailing system of penalties did not address comprehensively the different ways in which taxpayers failed to meet their obligations. Some sanctions were overly punitive and some were costly to administer. As an example, the only sanction available for failure to file a return was prosecution. There were also inconsistencies in the application of some penalties. The courts and the Commissioner had considerable latitude when considering the level of penalty to impose.

These deficiencies made the previous rules unfair to taxpayers who complied with the law, because those taxpayers who did not comply were not always adequately penalised. The government considered that if these problems were allowed to persist, they would undermine public confidence in the tax system, and would reduce voluntary compliance by the majority of taxpayers, such compliance being an integral feature of an effective self-assessment tax system.

It was, therefore, considered that the standards that taxpayers were expected to meet in interpreting and applying tax law needed to be clarified.

The government enacted the new compliance and penalties legislation in 1996, generally with application from the 1997-98 income year. The legislation is intended to signal clearly what is expected of taxpayers and their agents, to improve compliance with tax laws by clearly linking obligations with sanctions for non-compliance, and to increase the effectiveness of incentives to comply with tax laws and impose costs on those who do not comply.

Penalty for failure to file returns

The late filing penalty recognises that taxpayers have a fundamental obligation to file their return by the due date. Unless taxpayers comply with this obligation, revenue streams to meet Crown commitments may arrive late. Recovery work is expensive and all of these costs have to be met by taxpayers. The government considered it unfair that taxpayers who meet

their tax obligations should have to carry these extra costs. Previously, the only option available to the Commissioner was to prosecute, and this is a time-consuming and expensive procedure.

The standard penalty for late filing is \$50. This penalty rises to \$250 if the net income exceeds \$100,000, and to \$500 if the income is higher than \$1,000,000. A penalty of \$250 applies if a PAYE or ACC reconciliation is filed late.

The penalty is imposed only after prior warning from the Inland Revenue Department that the return is overdue. This measure recognises that some taxpayers may file their returns late for reasons beyond their control. On receipt of notification, taxpayers have an opportunity to apply for an extension of time to file their returns. Remission is possible when late filing is caused by factors beyond a taxpayer's control.

Late payment penalties

The late payment penalties apply from the due date for a tax, or, in the case of a reassessment, from the new due date for payment of reassessed tax. The sole objective of these penalties is to encourage payment of tax by the due date.

A 5 per cent penalty applies if the due date for the payment of the tax is missed. Previously, the rate was 10 per cent. After the due date, however, incremental penalties of 2 per cent of the tax outstanding are charged monthly.

The previous initial penalty of 10 per cent for late payment of tax was reduced to reflect the automatic imposition of this penalty and its incremental scale, the relative culpability compared to other actions, and the availability of other, more significant sanctions when late payment occurs as a result of lack of reasonable care.

The committee has already considered amendments to the late payment penalty in paras 11.38 to 11.43.

Shortfall penalties

The fundamental standard expected from taxpayers in meeting their tax obligations is the standard of reasonable care. This standard is breached by lack of reasonable care, taking an unacceptable position, gross carelessness, abusive avoidance and tax evasion. Sanctions apply according to the seriousness of the offence and the amount of revenue at stake. The penalty rates applying are:

lack of reasonable care	20 per cent of the tax shortfall
unacceptable interpretation	20 per cent of the tax shortfall
gross carelessness	40 per cent of the tax shortfall
abusive avoidance	100 per cent of the tax shortfall
tax evasion	150 per cent of the tax shortfall

The level of penalty may be adjusted up or down to take account of matters such as hindrance or voluntary disclosure.

The standard of reasonable care is the basic standard that all taxpayers must exercise in fulfilling any tax obligation. The term ‘reasonable care’ is not defined in the legislation. The government considered the concept of reasonable care was sufficiently well established in the commercial world and in common law as to not require definition. Also, by not defining the term, it remains adaptable to changing perceptions of what constitutes reasonable care. The concept also is sufficiently flexible to reflect a wide range of circumstances as well as changes over time in the tax system.

The test of an unacceptable interpretation applies if the tax at stake exceeds the greater of \$10,000 or 1 per cent of the income tax returned in the relevant period. The test applies in all cases if the tax at stake exceeds \$200,000.

An ‘unacceptable interpretation’ is defined in the legislation as an interpretation that does not meet the standard of being ‘about as likely as not’ to be correct. Effectively, ‘about as likely or not’ creates an expectation that the interpretation must be one that the courts might regard as worthy of consideration, even if it is not one that they will adopt. The decision as to whether or not an interpretation is unacceptable takes into account all the provisions of the relevant legislation, including the likelihood of the application of a general or specific anti-avoidance provision.

If an arrangement fails the unacceptable interpretation test, and its dominant purpose is determined to be tax avoidance, it constitutes ‘abusive avoidance’, the penalty for which is 100 per cent of the tax shortfall. If an arrangement is not abusive, but fails the unacceptable interpretation or reasonable care tests, the lower shortfall penalties will apply.

Abusive avoidance occurs if arrangements have as their principal purpose the gaining of a tax advantage, and the taxpayer’s interpretation was not ‘more likely than not’ to be correct. Such arrangements are defined by characteristics such as artificiality, contrivance and lack of commerciality. They might also involve concealment of information.

The names of those who have taken a position of abusive avoidance are published in the *New Zealand Gazette*.

Imposing a heavy penalty when the dominant purpose of an arrangement is to avoid tax sends a clear message from the government that the manipulative and aggressive interpretation of tax laws is unacceptable behaviour.

Criminal penalties

Under the previous rules, the provisions in the Inland Revenue Acts relating to criminal penalties were at times illogical and inappropriate. Some duplicated one another and treated breaches of similar magnitude inconsistently. Some contained ineffective and inconsistent penalties, which were confusing, and did not reflect the severity of the offence. Criminal penalties are now grouped into the following classes:

Information offences: The provision of accurate information is fundamental to the effective operation of the tax system. The Income Tax Act 1994 contains absolute liability offences for failure to provide information, keep records and provide returns. These statutory offences ensure that the burden of meeting these fundamental obligations rests firmly on the taxpayer.

'Knowledge' offences: Taking into account the seriousness of criminal prosecutions, knowledge of breach of an obligation is a minimum requirement. These offences include knowingly failing to provide information or books and documents, and providing false, incomplete or misleading information.

Evasion: There are a number of particularly serious defaults which involve the evasion of tax. For this purpose the meaning of evasion is well established, and involves an act done with the intention of not paying tax which is payable. Intent is critical to this offence.

Other offences: This covers such matters as aiding and abetting, and obstruction.

The names of taxpayers who commit these offences are published in the *New Zealand Gazette*.

Remission of penalties

Provisions for remission to allow the Commissioner of Inland Revenue to take into account circumstances when a penalty is not appropriate, such as:

Remission for reasonable cause: The late payment penalty and the late filing penalty can be remitted if failure to pay or file was brought about by a reasonable cause beyond the taxpayer's control, and the taxpayer remedied the default as soon as practicable. Remission under this provision will occur only if the taxpayer was not in control of the event that caused the failure to comply.

Remission consistent with collecting the highest net revenue over time: The Commissioner may remit penalties if satisfied that remission is consistent with the obligation to collect the highest net revenue over time. It may apply, for example, when a late payment or late filing penalty was imposed on a taxpayer who failed to comply as a result of an honest oversight.

Remission of late payment penalty by way of an instalment arrangement: Taxpayers may negotiate with the Commissioner to pay their overdue tax by instalments over an agreed period. Incremental late payment penalties will be remitted if taxpayers have adhered to the terms of the arrangement. If taxpayers arrange to pay a tax debt by instalment before the due date for payment of the tax, knowing they are in financial difficulty, the initial penalty for late payment will also be reduced from 5 per cent to 2 per cent.

No specific remission criteria are required for shortfall penalties. The requirement for reasonable care covers all situations contemplated by the provisions for remission.

APPENDIX 7 CRIMINAL OFFENCES

The offences under the Crimes Act 1961 of potential application to tax advisers include:

Destroying evidence, section 231:

‘Every one who destroys, cancels, conceals, or obliterates any document for any fraudulent purpose is liable to the same punishment as if he had stolen the document, or to imprisonment for a term not exceeding three years, whichever is the greater.’

Fabricating evidence, sections 113 and 229A:

For example, backdating documents, or creating documents with intent to mislead the court or a Taxation Review Authority. Section 113 which makes fabricating evidence with intent to mislead any tribunal holding any judicial proceeding an offence and which carries a seven year maximum term then could become relevant.

Or obtaining a foreign tax certificate with intent fraudulently to use it in order to obtain a reduction in New Zealand tax payable or a refund of New Zealand tax paid. Section 229A then could become relevant:

‘Every one is liable to imprisonment for a term not exceeding seven years who, with intent to defraud,—

(a) ... obtains any document that is capable of being used to obtain any privilege, benefit, pecuniary advantage, or valuable consideration; or

(b) Uses or attempts to use any such document for the purpose of obtaining, for himself or for any other person, any privilege, benefit, pecuniary advantage, or valuable consideration.’

Attempts, section 72:

Taking a step in the direction of an intended offence against the Crimes Act 1961 is, within s 72(1), to be ‘guilty of an attempt to commit the offence’. Where the enactment creating the intended offence does not specify the penalty attaching to an attempt, the

maximum penalty is half the maximum term which would have applied had the attempt to commit the offence been successful: section 311(1).

Conspiracy to defraud the revenue in New Zealand, section 257:

‘Everyone is liable to imprisonment for a term not exceeding five years who conspires with any other person by deceit or falsehood or other fraudulent means to defraud ... any person ...’

‘Person’ is defined, by s 2(1) to ‘include the Crown’.

In this context, the relevant intent is an intent, dishonestly, either

‘to get out of the revenue something that was already in it, or to prevent something from getting into the revenue which the revenue was entitled to get:’ *Parker v Churchill* (1986) 65 ALR 107 at 121, Jackson J (Fed Court: Full Court). See also *R v Kidman* (1915) 20 CLR 425 at 437, Griffith CJ (Full High Court);

or

‘to deceive a person [such as the Commissioner of Inland Revenue] responsible for a public duty into doing something, or failing to do something, which he would not have done, or failed to have done, but for the deceit.’ *Wai Yu-tsang v R* [1991] 4 All ER 664, 668c.

Suppose a transaction is devised with an intent of either sort, but is thwarted at the last minute. Even though it did not go ahead in the end, the people who agreed or who agreed to procure a taxpayer to carry out the scheme have already committed the offence of conspiracy to defraud. This is because the offence is completed on the making of their agreement: *R v Cuthbertson* [1981] AC 470 at 481, Lord Diplock; *R v Doot* [1973] AC 807 at 825-827. In *Liangsiri-prasert v United States Government* [1990] 2 All ER 866 at 873, the Privy Council adopted a statement that ‘the gist of the offence [is] the agreement whether or not the object is attained.’

Conspiracy to defraud the revenue of another country, section 310:

Under s 310, up to seven years’ jail can be the lot of the person who conspires ‘to do or omit, in any part of the world, anything of which the doing or omission in New Zealand would be an offence,’

unless that person can prove

‘that the doing or omission of the act to which the conspiracy relates was not an offence under the law of the place where it was, or was to be, done or omitted.’

So, whereas an agreement to defraud the revenue in New Zealand will be a crime under section 257, an agreement to defraud the revenue of a foreign state will be a crime under section 310 save in the unlikely event that such defrauding is not criminal in the place in which the fraud was intended to be carried out.

APPENDIX 8
INVESTMENT SAVINGS AND INSURANCE
ASSOCIATION OF NEW ZEALAND
INCORPORATION SUBMISSION

8 July 1998

The Secretary of the Committee of Experts on Tax Compliance
P O Box 2198
Wellington

REDUCING TAX COMPLIANCE COSTS – SAVINGS VEHICLES

1. ISI Background

- 1.1 The Investment Savings and Insurance Association of New Zealand Inc. (ISI) is an industry organisation which represents the vast bulk of the providers of collective investment savings vehicles in New Zealand. Members manage over \$20 billion in savings on behalf of more than 1.5 million New Zealand investors and policy holders.
- 1.2 ISI recommends that the Committee of Experts on Tax Compliance should review the host of different tax regimes applying to savings vehicles with a view to reducing both compliance costs and the unnecessary level of tax complexity. This would increase the economic efficiency of such vehicles and as a result increase the savings of New Zealanders, without decreasing total tax revenue.

2. Summary of tax regimes for investment vehicles and other means of investment for the public

- 2.1 At present there is a multiplicity of different tax regimes for investment vehicles and other methods of investment. ISI

members as financial services enterprises utilise many of these vehicles or methods for their clients and/or are constantly migrating their clients from one vehicle or method to another with decisions in many cases being tax driven.

- **Life Insurance regime** – all gains on revenue account, taxed at a flat 33%, proceeds received exempt by investors;
- **Superannuation** – status of investment gains determined by common law, employer contributions taxed, income taxed at a flat 33% and distributions not assessable to investors;
- **Tax Credit System** – draft legislation to introduce a tax credit mechanism to reduce the rate of tax on savings via superannuation and life insurance products to the marginal tax rate of investors who are on less than 33% – structure seen as likely to provide little direct benefit to electors over and above the cost of compliance to providers who are obliged to pass on that cost to electors;
- **Unit Trusts** – modified corporate regime with a flat 33% tax and imputation, status of investment gains determined by common law, no refund available for surplus imputation credits on distributions only on other income;
- **Category A GIFs** – regime as for unit trusts;
- **Category B GIFs** – qualifying trust regime with concessional treatment for certain trusts, charities and superannuation funds, (Note the Taxation Simplification and Other Remedial Matters Bill intends removing this concession for superannuation funds from 1/4/99), as well as concessions for certain investments restricted to New Zealand and Australian government bonds, money market instruments and first mortgages, investment gains determined by common law, no ability to retain income and therefore a necessity for expenses to be charged outside the fund by way of deduction from distributions;
- **Index equity funds** – typically either category B GIFs or wholesale superannuation funds with binding rulings confirming investment gains on capital account, and otherwise treated as qualifying trusts for superannuation

- funds (to 1/4/99) charities and certain trusts but as companies for direct investors, (i.e., category A GIFs);
- **Master funds** – either superannuation or unit trust vehicles with a range of different risk portfolios which in turn invest in specific investment risk situations using a series of unit trusts, superannuation funds or GIFs (as the case may be) no tax concessions facilitate their tiering;
 - **Wrap account** – bare trusts for investors with an administrator and custodian and a menu of products (being typically collective investment vehicles both in New Zealand, Australia and UK) taxed to the investor like direct investment;
 - **Foreign Investment Vehicles**
 - Grey list countries (e.g., UK Investment Trusts and Australian unit trusts) treated as companies in New Zealand with distributions treated as foreign dividends to New Zealand investors;
 - Non grey list – (i.e., FIF's) taxed on an accrued gain/loss basis typically by marking to market at balance date bringing to account all gains and losses on revenue account;
 - **Direct investment** – status of investment gains determined by common law but rarely are individuals in business. Taxed at investor's marginal rate;
 - **Wholesale pools** – no tax exemption, currently inefficiently taxed as unit trusts or GIF's unless direct tracing occurs (which is not economic to perform).

3. Tax compliance

- 3.1 There are two broad compliance issues which deserve detailed consideration. The complexity of having a number of different tax regimes for pooled investment and the costs and risks within each of those regimes.
- 3.2 These complexities have arisen as a consequence of the applicable of purist economic tax theory without regard to the purposes of collective investment, e.g., the application of the corporate tax model to unit trusts and as a consequence of adhoc piece-meal legislation reacting to product development, for example, the difference between category A and B GIFs.

- 3.3 Over time investment dollars will always flow to the vehicles which are most tax efficient. Consequently in recent years we have seen a proliferation of passive index funds, a substantial increase in GIFs, and an ongoing inflow of investment dollars into foreign trusts which roll up income in 'grey list' countries.
- 3.4 Investment dollars have constantly moved out of insurance savings products because they have the least flexible tax regime with all investments being on revenue account. Currently unit trusts have a slight preference over superannuation funds and insurance savings products, which are themselves disadvantaged over direct investment given the bulk of assets are on revenue account.
- 3.5 The financial services industry in New Zealand is essentially characterised by too many different funds with overly complicated different tax regimes, relatively high administration costs (on an international comparative basis), few economies of scale and broad tax disadvantages over direct investment. This situation is contributing to New Zealand's low rate of savings and the low average return on savings.
- 3.6 Product providers spend enormous resources complying with all these different tax regimes and that cost is directly passed on to savers thereby reducing economic efficiency and discouraging collective investment as a choice ahead of direct investment.
- 3.7 A major disparity and inconsistency is the treatment of investment gains and the retention of common law as the means of determining tax treatment, rather than clear concise legislation at the capital/revenue boundary. This has led to the distortion of tax-exempt index funds at one extreme and the taxation of all gains in relatively passive unit trusts and superannuation funds on the grounds that they are carrying on a business at the other extreme, whilst direct investors largely do not pay tax on investment gains.
- 3.8 The GST exemption for financial services has not kept up with the expansion of products in the financial services sector. The definition of 'financial services' singles out the management of superannuation funds as GST exempt and leaves management of the remaining investment products with little clarity. This inconsistency cannot be defended on policy grounds and increases compliance costs for no discernible purposes.

- 3.9 Accurate measurement of 66% continuity for imputation credit carry forward is required in unit trusts and GIF's. In volatile markets investment cash flows move quickly often threatening continuity. Unlike companies these vehicles are open ended so investors move in and out freely. The effect is felt most dramatically in wholesale vehicles which target specific risk situations where changes in asset allocation can result in massive unit holder changes in short periods of time. The 66% requirement is totally punitive and unreasonable at this level and demands time wasting tracking to be carried out on a daily basis with no concessions, purely to replicate the corporate regime.
- 3.10 Wholesale pools are used as a means of asset allocation into discrete investment risks for retail products. No accommodating tax regime exists for these vehicles. If they could be treated as pass through entities on the basis of fully distributing all income (i.e., a qualifying trust regime) there would be no reduction in tax take, but a substantial cost saving would pass through to retail investors. See attached article from the Independent dated 10 October 1997 by Paul Baker of National Mutual.
- 3.11 The need for considerable simplification while at the same time achieving broad tax neutrality between collective savings vehicles and as against direct investment should be legislative guideline.

4. ISI's recommendations

With a view to reducing tax compliance and eliminating tax distortions between collective savings vehicles, and as against direct investment, ISI recommends as follows:

- Roll up vehicles, such as superannuation trusts and life insurance saving products, should be dealt with under a tax regime which is a proxy for investors;
- Distributing vehicles such as GIFs and unit trusts can be accommodated with either a qualifying trust regime as the preferred alternative or an imputation regime, but it should be just one regime;
- The introduction of legislation or other methods to clarify the capital/revenue boundary for investment gains with a view to introducing certainty and neutrality;

- Wholesale investment pools for taxed savings vehicles should not be taxed on income distributed, (i.e., qualifying trust status should be available and this would require amendments to the definition of 'unit trust' in the Income Tax Act).
- The definition of financial services in the GST Act should be clarified to include the administration and management of all collective savings vehicles;
- The requirement for 66% continuity to carry forward imputation credit balances in savings vehicles needs to be relaxed because of their open ended status (i.e., no restriction on the amount of units issued or redeemed unlike a company). At the very least wholesale vehicles should enjoy the same concessions as widely held trusts as they are most affected by volatility.

Yours faithfully

Tony Lines
Convenor
ISI Tax Policy Committee

APPENDIX 9

LIST OF REPORTS ON THE TAX SYSTEM

KEY TAX REFORM DOCUMENTS 1982 TO 1997

In this appendix, the committee lists the major tax reform documents that have been issued since 1982. Documents in italics are reports of external committees. All other documents were government statements of one kind or another.

- 1982 *Report of the Task Force on Tax Reform* (the McCaw report)
- 1984 Goods and Services Tax
- 1985 White Paper on Goods and Services
GST: The Key to Lower Income Tax
Benefits, Taxes and the 1985 Budget – Discussion Paper
Statement on Taxation and Benefit Reform
- 1986 Consultative Document on Primary Sector Taxation
Benefits, Taxes and the 1985 Budget: A Review and Summary
Statement on Government Expenditure Reform
Report of the Consultative Committee on Primary Sector Taxation
Discussion Paper on Taxation of Bloodstock Breeders
Consultative Document on Accrual Tax Treatment of Income and Expenditure
- 1987 Consultative Document on Petroleum Mining Taxation
Final Report on the Accrual Taxation System
Consultative Document on Full Imputation
Consultative Document on International Tax Reform
Further Report to the Minister of Finance of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure on Comprehensive Tax Reform and Possible Interim Solutions
Discussion Paper for Review of Excise Duties on Alcoholic Beverages and Tobacco Products
- 1988 *International Tax Reform – Part I of the Report of the Consultative Committee*

- Consultative Document on Superannuation and Life Insurance
Full Imputation – Report of the Consultative Committee
Report to the Minister of Customs on the Review of Excise Duties on Alcoholic Beverages and Tobacco Products (the Sullivan Committee)
International Tax Reform and Full Imputation – Part II – Annex: Draft Legislation – Report of the Consultative Committee
Tax Treatment of Superannuation – Report of the Consultative Committee
- Discussion Document on Domestic Interest Withholding Tax
Report of a Committee of Consultants to the Minister of Revenue and Commissioner of Inland Revenue on the Effect of the Accruals Regime on Property Transactions
- 1989 *Report of Consultative Committee on Life Insurance and Related Areas*
Report to Minister of Finance and Minister of Social Welfare by Working Party on Charities and Sporting Bodies (the Russell report)
- Consultative Document on Tax Simplification
- Consultative Document on the Taxation of Income from Capital
- 1990 *Interim Report of Tax Simplification Consultative Committee*
 Definition of Dividends under the Income Tax Act 1976 – A Discussion Document
Final Report of Tax Simplification Consultative Committee
Core Provisions of the Income Tax Act 1976 (Report of the Consultative Committee on the Taxation of Income from Capital – the Valabh committee)
The Taxation of Distributions from Companies (the Valabh committee)
- 1991 *Tax Accounting Issues* (the Valabh committee)
 Taxing Income Across International Borders: A Policy Framework
Taxation of Distributions from Companies – Final Report (the Valabh committee)
Operational Aspects of the Accrual Regime (the Valabh committee)
Key Reforms to the Scheme of Tax Legislation (the Valabh committee)

- Discussion Paper on Livestock Valuation
- 1992 *Final Report of the Livestock Valuation Consultative Committee*
Final Report of the Consultative Committee on the Taxation of Income from Capital (the Valabh Committee)
- 1993 *Working Party on the Reorganisation of the Income Tax Act 1976 – First Report of the Working Party*
Working Party on the Reorganisation of the Income Tax Act 1976 – Second Report of the Working Party
 The Taxation Implications of Company Law Reform: A Discussion Document
- 1994 Taxpayer Compliance, Standards and Penalties: A Discussion Document
 Resolving Tax Disputes: Proposed Procedures – A Government Consultative Document
 Rewriting the Income Tax Act: Objectives, Process, Guidelines
 Business Compliance Cost Reduction – A Government Policy and Discussion Paper
- 1995 International Tax – A Discussion Document
 Taxpayer Compliance, Standards and Penalties 2: A Discussion Document
 Core Provisions: Rewriting the Income Tax Act – A Discussion Document
- 1996 Tax Reduction and Social Policy Programme: Details
 Tax Simplification Issues – A Government Discussion Paper
- 1997 The Design of a Possible Low-Level Carbon Charge for New Zealand
 Trading Stock Tax Rules – A Discussion Document on Government Proposals for Change
 The Taxation of Conduit Investment – A Government Discussion Document
 The Tax Credit System: Taxing superannuation funds and life office savings through tax credits – A Government Discussion Document
 Rewriting the Income Tax Act: Parts C, D and E – A Discussion Document
 Simplifying Taxpayer Requirements – A Government Discussion Paper on Proposals for Change

- The Taxation of Financial Arrangements – A Discussion Document on Proposed Changes to the Accrual Rules
- 1998 Legislating for Self-assessment of Tax Liability – A Government Discussion Document

APPENDIX 10
RECOMMENDATIONS OF THE FINAL REPORT OF
THE CONSULTATIVE COMMITTEE ON THE
TAXATION OF INCOME FROM CAPITAL
(VALABH COMMITTEE)

GOVERNMENT ACTIONS UP TO DECEMBER 1998 IN RELATION TO THE
VALABH COMMITTEE'S RECOMMENDATIONS

The Valabh committee made 148 separate recommendations in its *Final Report*, the majority of which have been acted on. The following sets out the status of these recommendations, cross-referenced to the chapters in the committee's *Final Report*.

Chapter 2 – Core Provisions

All of these recommendations were considered and discussed in the lead-up to the various 'Rewrite' discussion documents. New core provisions were enacted by the Income Tax Amendment Act 1996 (No 67).

Chapter 3 – Taxation Avoidance

The government has not adopted the redrafted general anti-avoidance provision proposed by the committee. When the committee's report was released, the government stated its concern to ensure that the general anti-avoidance provision was not weakened. The issue has since been under consideration by the Davison Commission and the Committee of Experts.

Chapter 4 – Scheme and Drafting of Legislation

The government established a working party chaired by Arthur Valabh. Its recommendations resulted in the reordered Income Tax Act 1994.

Chapter 5 – Partnerships

The government did not agree with the committee's detailed recommendations. However, it did agree to a general review of the tax laws relating to partnerships, but as a non-priority issue. Other matters continue to have a higher priority on the government's tax policy work programme.

Chapter 6 – Administration Aspects

The committee's observations on advance rulings, the assessment and dispute resolution process and penalties have been incorporated in the reviews of these areas. The recommendation on the criteria that should govern the Commissioner's discretions is being included in the project the department is undertaking on legislating formally for self-assessment. A discussion document on legislating for self-assessment has been released. The recommendation on adjustments required consequent upon incorrect accounting practice has yet to be acted upon.

Chapter 7 – Interest

Consideration of the committee's recommendation to allow non-private or domestic interest costs to be deducted was deferred until the Davison Commission had reported. This issue has now a high priority on the tax policy work programme.

Chapter 8 – Tax Accounting Issues

The government has introduced legislation covered by the committee's recommendations on trading stock reform. The committee's other recommendations covering: cost apportionment, non-market transactions, asset classification, isolated transactions, land transactions and long-term construction projects are being considered as part of, or in tandem with, the rewrite of parts C, D and E of the Income Tax Act 1994.

Chapter 9 – Operational Aspects of the Accruals Regime

The government has carried out a comprehensive review of the accrual rules, which included consideration of the Valabh committee recommendations. This review resulted in a public discussion document and a bill which is currently before the House.

Chapter 10 – Debt Remission and Bad Debts

The recommendations on debt remission were rejected at the time the Valabh committee made its recommendations, and were rejected again in the recent public discussion document on the accrual rules. However, the bill proposing the revised accrual rules, which is currently before Parliament, contains some minor provisions relating to debt remission that have the objective of closing down some tax avoidance opportunities.

The bill does not contain any provisions relating to bad debts. Bad debts were discussed in the public discussion document, which highlighted the difficulty of making significant changes without a broader review of bad

debts throughout the Act. Such a broader review is not currently on the government's work programme.

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