Tax simplification 3

Taxpayer compliance, standards and penalties: a review

A Government discussion document

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The closing date for submissions on the proposals in these chapters (3 and 7) is 21 September. The closing date for submissions on the proposals in other chapters is 21 November.

FOREWORD

The Government is issuing this discussion document as the first part of the post-implementation review of the compliance and penalties legislation contained in the Tax Administration Act 1994.

A new compliance and penalties system was introduced with effect from the 1997-98 year. The legislation encourages voluntary compliance by requiring taxpayers to take their obligations seriously and perform the various tasks required of them honestly, on time and with reasonable care. The objective of penalties is not to raise taxes but to be a cornerstone of an effective tax system.

The need for a review flows from Parliament's Finance and Expenditure Committee's Inquiry into the Powers and Operations of the Inland Revenue Department. The proposals in this document consider the Committee's concerns and respond to them.

The Government proposes a complete replacement of the current rules relating to debt and hardship. The current rules were introduced during the Depression of the 1930s and no longer serve us well.

Ultimately, tax rules must reflect society's standards. Rules that are too penal – or so lenient that revenue to fund health, education and other services is lost – will not be seen as fair. The Government welcomes submissions on whether its proposals will make New Zealand's tax rules fairer.

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Part I

Compliance and penalties: a review

Part I of the discussion document describes the first phase of the post-implementation review of the compliance and penalties legislation. It summarises the proposals put forward in this document, and places the review in context.

Chapter 1

INTRODUCTION

1.1 New Zealand's tax system, being largely one of self-assessment, requires taxpayers to be honest and diligent in meeting their tax obligations. To this effect, a comprehensive system of rules and penalties exists to enforce compliance.

1.2 The compliance and penalties legislation reinforces the obligations on taxpayers under laws enacted by Parliament. The current compliance and penalties legislation, enacted in 1996, was designed to promote effective and fairer enforcement of the Inland Revenue Acts – by providing better incentives for taxpayers to comply voluntarily with their obligations. The legislation came into effect on 1 April 1997.

1.3 The post-implementation review of the current compliance and penalties legislation began in October 1999. Its aim is to benchmark the rules contained in the legislation against the key objectives of fairness, efficiency, clarity, and effectiveness.

1.4 Several developments since the introduction of the legislation make it timely to review these rules. In particular, a number of issues have been identified that suggest that the original policy intent of the legislation in some areas is not being achieved or is ambiguous and needs clarification. There have also been a number of tax reforms since 1997, including the removal of the requirement for many taxpayers to file income tax returns.

1.5 This discussion document reports on the progress of the review, outlining the results thus far. Work to date has involved the consideration of recommendations made on the compliance and penalties legislation by various committees.

SUMMARY OF THE GOVERNMENT'S PROPOSALS IN THIS DOCUMENT

Debt and hardship

The current debt and hardship provisions will be:

- clarified so that Inland Revenue's role is to maximise the recovery of outstanding tax but not if:
    - recovery represents an inefficient use of Inland Revenue's resources; or
    - a taxpayer is placed in serious hardship;

- amended to provide that if Inland Revenue can collect more of the debt over time through an instalment arrangement than from bankruptcy or liquidation, then Inland Revenue would be required to enter the instalment arrangement and any amount not recovered will be written off as unrecoverable;
- amended so that amounts not recovered will be written off permanently and will not be able to be reinstated;
- amended to include fairer instalment arrangements including provision that late payment penalties will stop when a taxpayer contacts Inland Revenue to negotiate payment of the debt;
- amended so that, to clarify its application, the definition of "serious hardship" lists both circumstances which meet that test and circumstances which do not.

Shortfall penalties

- The lack of reasonable care penalty will be reduced to 10 percent if the breach is the taxpayer's first breach of a required standard of behaviour.
- If the taxpayer does not take reasonable care in his or her tax affairs for the following seven years, the shortfall penalty for any subsequent breach will be imposed at 20 percent.
- The legislation will be amended to provide that a shortfall penalty for unacceptable interpretation can be imposed in cases where a tax position taken is unacceptable but the taxpayer has not interpreted the law.
- The first part of the unacceptable interpretation threshold will be increased from $10,000 to $20,000.

Other Finance and Expenditure Committee recommendations

- If a taxpayer proves on the balance of probabilities that the assessment is excessive by a specified amount, the court will reduce Commissioner of Inland Revenue's assessment by that amount.
- Taxpayers who receive a default assessment will be provided with an explanation of what this is, why it has been issued, and what responses are available to them.
- The requirement to pay 50 percent of the tax in dispute will be removed; but Inland Revenue will be given the power to require payment of all the tax in dispute in cases where revenue is at significant risk.
- Performance standards for replying to a Notice of Response will be included in Inland Revenue's purchase agreement with the Minister and in its annual report.
- The proposed performance standards for a Notice of Response will require Inland Revenue to correspond with the taxpayer at least every three months.
- The current use-of-money interest rules are appropriate, and will continue.

- As the use-of-money interest rates are perceived as unfair in some cases, the Government will address this through the simplification measures discussed in the *More time for business* discussion document.

Information-gathering powers

Section 16 of the Tax Administration Act will be amended to:

- allow documents to be removed from premises for copying;
- clarify that third parties can be required to give reasonable assistance in an investigation; and
- clarify who may be given authority to enter a taxpayer's premises.

Section 17 of the Tax Administration Act will be amended to:

- allow Inland Revenue to requisition records held by offshore entities controlled by a New Zealand resident;
- remove the words "necessary or relevant"; and
- give Inland Revenue the discretion to require documents to be sent to a specified Inland Revenue office.

Section 3 of the Tax Administration Act will be amended to make it clear that Inland Revenue can have access to computers and can copy information held on them.

Transfers of excess tax

The legislation will be amended to authorise the transfer of excess tax paid by a taxpayer to another period or tax type of that taxpayer, or to certain other taxpayers – regardless of whether there is an outstanding liability for tax in that period. But the taxpayer must request the transfer, the tax must be refundable, and the tax must not have already been offset by Inland Revenue against an existing tax liability.

Breaches of standards of care

- A shortfall penalty will be imposed in all cases of lack of reasonable care and gross carelessness, irrespective of who breached the standard of care.
- In all cases, the shortfall penalty will be imposed on the taxpayer.
- A $50,000 cap will be introduced on the shortfall penalty for lack of reasonable care, in cases where the shortfall is identified within a two-month period through voluntary disclosure or an Inland Revenue audit.

Promoter penalties

A penalty will be imposed on promoters of investments, in cases where:

- the investment breaches an anti-avoidance provision; or
- the investment leads to the investor having a shortfall penalty for an abusive tax position.

Key questions

1.6 The Government wishes to seek the views of interested people on:

- the findings of the review thus far; and
- other issues that should be considered in this review.

Submissions

1.7 Submissions should be addressed to:

Compliance and Penalties Review
The General Manager
Policy Advice Division
Inland Revenue Department
P O Box 2198
WELLINGTON

Or e-mail: policy.webmaster@ird.govt.nz

1.8 The legislation for the proposals relating to debt and hardship and transfers of excess tax will be included in a taxation bill to be introduced late this year. The closing date for submissions for these proposals is 21 September 2001, so that submissions can be considered before the bill is introduced. The closing date for submissions on all other matters is 21 November 2001.

1.9 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for officials from Inland Revenue to contact those making submissions and to discuss their submission, if required.

1.10 Submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you feel there is any part of your submission that should be properly withheld under that Act (for example, for reasons of privacy), please indicate this clearly in your submission.

Chapter 2

CONTEXT OF THE REVIEW

2.1 A tax system based on self-assessment and voluntary compliance needs to be buttressed by effective compliance and penalties legislation. The compliance and penalties legislation enacted in 1996 was the culmination of a lengthy period of policy development and consultation under the generic tax policy process.

Taxpayer obligations

2.2 Under self-assessment, taxpayers have three key obligations:

- to assess their own tax liability;
- to file a tax return on time; and
- to pay the tax by the due date.

2.3 Because the obligation is on taxpayers to assess their own tax liability, it is necessary to set the standards that taxpayers are to meet in doing so. The standards most taxpayers are required to meet are: to take reasonable care; and to have an acceptable interpretation of the law in relation to larger tax matters.

2.4 These standards are not unreasonable – they do not require taxpayers to be right, but rather to take reasonable care. They also recognise a need for balance between correctness and compliance costs.

2.5 Equally, taxpayers who are required to file returns have a fundamental obligation to do so by the due date. Unless they comply with this obligation, Inland Revenue cannot ensure they are paying the correct amount of tax. Work required to follow up errant taxpayers increases administrative costs, which are ultimately met by all taxpayers.

2.6 Taxpayers are also required to pay their tax on time, to support the efficient collection of revenue by the Government. Taxpayers who do not pay on time, or who renege on their obligations altogether, create administrative costs. Delays and non-payment may also affect government spending, as the Government relies on the prompt payment of taxes to fund a range of social and economic policies.

Weaknesses of the old compliance and penalties legislation

2.7 Before 1997, taxpayer compliance with these obligations was enforced by an ad hoc system of penalties. This resulted in various deficiencies:

- gaps in coverage, where many forms of non-compliance (both deliberate and otherwise) were not subject to direct sanctions;
- a lack of specificity with regard to the minimum standards required for meeting tax obligations;
- a lack of uniformity in the way certain penalties were applied, leading to inadequate incentives for compliance in certain instances;
- flaws in the design of the rules, with sanctions often inappropriate for the offences committed;
- inconsistencies in the application of the legislation, with similar offences receiving penalties of varying size depending on the relevant Revenue Act and the penalty provisions within it; and
- variable imposition of penal taxes by Inland Revenue or the courts, with the level of penalty sometimes being inconsistent.

Principles underpinning the current legislation

2.8 The introduction of a more comprehensive, structured set of penalties was intended to overcome these deficiencies, with the key objective being to encourage voluntary compliance. The rules, therefore, should encourage taxpayers to pay their tax liabilities on time; and penalties are not used as a revenue raising mechanism.

2.9 Four broad principles underpin the design of the current system of penalties: fairness, efficiency, clarity and effectiveness.

Fairness

2.10 Measures are fair if they are consistent with the fundamental rights of New Zealanders and if they treat taxpayers equitably. This means:

- The penalties legislation should recognise that most taxpayers are honest and that they make a genuine attempt to honour their tax responsibilities.
- Penalties should provide incentives to all taxpayers to comply with the law.
- Obligations, standards and penalties should be designed in such a way that they can be imposed impartially and consistently. Taxpayers in similar situations should be treated similarly.
- The standards that taxpayers are expected to meet, and the penalties applied for breaches of those standards, should recognise the differing circumstances and abilities of individual taxpayers.

- Sanctions should be consistent with the seriousness of the offence and the culpability of the offender.
- Penalties should be consistent with the principles of the New Zealand Bill of Rights.

2.11 Voluntary compliance, as well as support for the tax system in general, will be improved if taxpayers perceive that the system of penalties is fair and equitable.

Efficiency

2.12 Penalties legislation and its administration should complement the efficient operation of the tax system, be practicable, and keep compliance and administrative costs as low as possible:

- The legislation should not impose excessive costs on taxpayers.
- Standards should be enforceable, and penalties should be capable of being imposed, without placing undue costs on the tax administration.

Clarity

2.13 Legal process and requirements should be clear and easily understood:

- Sanctions should be consistent across the Inland Revenue Acts and be applied consistently.
- Taxpayer obligations and standards should be clear.
- Penalty measures should be encoded in statute wherever practicable.
- Discretions should be kept to a minimum but be consistent with the need for the system to be fair.

Effectiveness

2.14 The legislation should encourage compliance with the law:

- Penalties should encourage future compliance, both by taxpayers who are penalised and those who are not.
- Standards, incentives and penalties should support the obligations of taxpayers in the self-assessment environment.
- The penalties legislation should be in line with community standards.
- The penalties rules should be comprehensive.
- The design of taxpayer obligations, standards and penalties should recognise the complex nature of transactions occurring in the commercial world.

Civil penalties

2.15 Under the current penalties system, there are three main monetary penalties:

- late filing penalties;
- late payment penalties; and
- shortfall penalties.

Late filing penalty

2.16 The late filing penalty is applied when taxpayers fail to file a tax return by the due date. The penalty, a lump sum amount, is generally imposed after the taxpayer has been notified that a return is required and has not responded to that notification. The dollar amount of the penalty depends on the taxpayer's annual income, and it serves as an incentive for taxpayers to meet their return filing requirements.

Late payment penalty

2.17 The late payment penalty is applied to taxpayers who fail to pay their tax by the due date. From 1 April 2002 the initial penalty will be imposed in two stages: 1 percent of the unpaid tax the day after the due date, and a further 4 percent one week later. There is an additional incremental penalty of 1 percent of any outstanding amount (including previous penalties) applying monthly thereafter.

Shortfall penalty

2.18 The shortfall penalty is applied when taxpayers breach one of five standards of behaviour, which range from not taking reasonable care to evasion, and pay less tax than they are legally required to pay. The magnitude of the penalty (calculated as a percentage of the tax shortfall) depends on the reason for the shortfall:

- a penalty equivalent to 20 percent of the shortfall for not taking reasonable care;
- a penalty equivalent to 20 percent of the shortfall for unacceptable interpretation;
- a penalty equivalent to 40 percent of the shortfall for gross carelessness;
- a penalty equivalent to 100 percent of the shortfall for taking an abusive tax position; and
- a penalty equivalent to 150 percent of the shortfall for evasion.

2.19 Other penalties include a penalty for employers who fail to file their monthly schedules electronically, and an imputation penalty tax and dividend withholding payment penalty tax for companies who have not paid sufficient tax to cover the credits attached to dividends.

Use-of-money interest

2.20 The Government charges use-of-money interest on tax that is overdue, and pays use-of-money interest on overpaid tax. The interest paid on overdue tax is not a penalty – the objective of use-of-money interest is to compensate the party that does not have the use of the money and to encourage taxpayers to pay the correct amount of tax by the due date.

Criminal penalties

2.21 Supporting the civil penalties is a series of criminal penalties which can be imposed for offences such as failing to provide information and evasion.

Scope of the post-implementation review

2.22 This review began in October 1999, with its goal being to focus on how well the objectives of the compliance and penalties legislation were being met. In particular, the review is looking at whether the legislation is:

- effective in deterring non-compliance and encouraging remedial action;
- understandable and fair, and perceived as such;
- appropriately flexible and consistent; and
- consistently administered.

2.23 When the legislation was passed in 1996, the review date was set for October 1999. Even though auditing of tax returns under the new rules would have only just begun, it was considered that the full impact of the legislation would have been sufficiently tested in practice by then. Work to date indicates that in some areas, mainly in relation to shortfall penalties, the legislation has not been in place long enough to be fully tested.

2.24 The large number of issues raised to date, the breadth of issues to be considered, and the degree of technical analysis necessary for each issue has meant that findings of the review cannot be fully outlined in a single discussion document. This discussion document largely concentrates on the recommendations of the Finance and Expenditure Committee from its 1999 inquiry.

Next stage of review

2.25 A follow-up discussion document will:

- consider the changes in taxpayer behaviour resulting from the introduction of the current rules;
- consider whether the current rules maximise voluntary compliance;

- compare New Zealand's rules with those of other countries, including the extent of non-compliance, audit practices and the range and scale of penalties applied in other countries; and
- address a large number of technical matters.

2.26 Submissions on these matters are also welcome at this stage of the review.

Reviews of the tax system and the implications for the penalties legislation

2.27 This review is part of the Government's tax simplification programme. The programme, which includes an objective of "reducing the likelihood of penalties being imposed on small businesses that act honestly and in good faith" has culminated in a series of discussion documents on tax simplification.

2.28 In April 2001, the Government released the first discussion document in its simplification series, *More time for business*, which was aimed at simplifying tax compliance requirements for small businesses. The proposals contained in that document are intended primarily to reduce tax risks for small businesses, including the risk of penalties.

2.29 Three recent reviews of the tax system have made recommendations relating to the compliance and penalties legislation. These are outlined below.

Commerce Committee Inquiry into Compliance Costs for Business

2.30 Parliament's Commerce Committee reported in November 1998 on its inquiry into compliance costs imposed on business. The Committee made a number of recommendations relating to tax, including the following recommendation on the compliance and penalties legislation:

That Inland Revenue take a more liberal approach when interpreting whether a small to medium size enterprise has breached their obligations or when deciding whether to impose penalties on a small to medium size enterprise.[1]

Committee of Experts on Tax Compliance

2.31 The Committee of Experts on Tax Compliance was established 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 in dealing with avoidance and evasion. The Committee reported in December 1998, making a number of recommendations about what this review should consider. These included:

- reducing the incremental penalty for late payment of tax;

[1] *Inquiry into Compliance Costs for Business: Final Report of the Commerce Committee*, New Zealand House of Representatives, November 1998, Recommendation 3.A, page 32.

- considering whether past good behaviour should be taken into account when deciding to impose penalties; and
- not applying the initial late payment penalty to those who pay their tax a few days late.

Finance and Expenditure Committee Inquiry into the Powers and Operations of the Inland Revenue Department

2.32 In 1999, the Finance and Expenditure Committee held its Inquiry into the Powers and Operations of the Inland Revenue Department. The Committee made a number of recommendations which have implications for the current compliance and penalties legislation, including:

- A taxpayer's past record of "good behaviour" should be taken into account when deciding whether to impose a penalty.
- Greater flexibility should be exercised when deciding whether shortfall penalties should be imposed.
- Shortfall penalties should not be imposed in the case of an inadvertent error.
- The method for determining use-of-money interest rates should be reviewed.
- The area of debt write-offs should be reviewed.

These recommendations have been incorporated into this review, and are discussed in Part II.

Less taxing tax

2.33 Some of the recommendations made by the various committees have already been presented in the discussion document *Less taxing tax*, which was released for public consultation in September 1999. That document was aimed at further reducing compliance costs for taxpayers, particularly businesses. Among the proposals contained in *Less taxing tax* were:

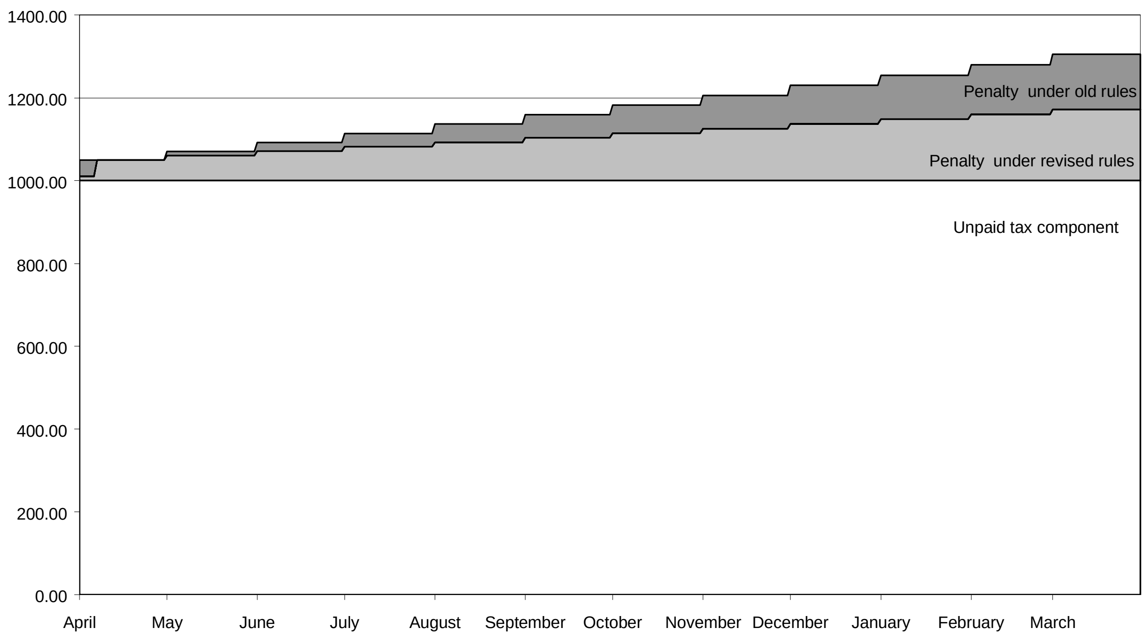
- reducing the incremental penalty for late payment of tax from 2 percent to 1 percent a month;
- applying the initial late payment penalty incrementally – 1 percent on the due date and 4 percent a week later;
- extending (to one month) the 15-day use-of-money interest "grace period" following the issuing of a statement;
- extending the hardship and financial difficulty provisions, which allow Inland Revenue to offer tax relief in certain circumstances to all taxpayers of all tax types;

- extending the instalment arrangement provisions for payment of overdue tax to all tax types; and
- increasing the threshold above which Ministerial approval is required to remit, refund or enter instalment arrangements for outstanding tax.

The threshold for Ministerial approval has subsequently been removed. All other recommendations have been legislated.

2.34 The recent lowering of the late payment penalty rate reflected concerns that the rules in this area were too harsh. Figure 1 shows how late payment penalties previously increased on an unpaid $1,000 debt and how they increase under the revised rules.

FIGURE 1:
THE STRUCTURE OF THE LATE PAYMENT PENALTY: PREVIOUS RULES AND REVISED RULES



Report of the Ministerial Panel on Business Compliance Costs

2.35 In its report to the Government, *Finding the Balance: Maximum Compliance at Minimum Cost*, the Ministerial Panel on Business Compliance Costs stated a number of concerns raised by small businesses:

Many submissions raised the issue that small businesses generally perceive the penalties regime to be harsh and at times stressful…[2]

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[2] *Finding the Balance: Maximum Compliance at Minimum Cost, Final Report of the Ministerial Panel on Business Compliance Costs*, July 2001, page 132.

2.36 The Government acknowledges these concerns and this discussion document makes a number of proposals to address them. The Government is considering the other issues raised in the Panel's report in a separate process.

Part II

Finance and Expenditure Committee recommendations

The aim of the compliance and penalties legislation is to maximise voluntary compliance across all taxpayers. So it is important to have a clear set of compliance and penalties rules which are seen by taxpayers as neither harsh nor lenient.

The Finance and Expenditure Committee made 27 recommendations in its Report on the Inquiry into the Powers and Operations of the Inland Revenue Department. *The Committee's recommendations are comprehensive and are intended to improve the integrity of, and public confidence in, the tax system.*

Part II of this document represents the second part of the Government's response to the Committee's recommendations. Other recommendations made by the Committee have been addressed through the Less taxing tax *discussion document.*

Chapter 3

DEBT AND HARDSHIP

The Government's proposals

The current debt and hardship provisions will be:

- clarified so that Inland Revenue's role is to maximise the recovery of outstanding tax but not if:
  - recovery represents an inefficient use of Inland Revenue's resources; or
  - a taxpayer is placed in serious hardship;
- amended to provide that if Inland Revenue can collect more of the debt over time through an instalment arrangement than from bankruptcy or liquidation, then Inland Revenue would be required to enter the instalment arrangement and any amount not recovered will be written off as unrecoverable;
- amended so that amounts not recovered will be written off permanently and will not be able to be reinstated;
- amended to include fairer instalment arrangements including provision that late payment penalties will stop when a taxpayer contacts Inland Revenue stating they want to negotiate payment of the debt;
- amended so that, to clarify its application, the definition of "serious hardship" lists both circumstances which meet that test and circumstances which do not.

Background

3.1 The current debt and hardship rules date back to the 1930s. They were designed for asset rich but cashflow poor taxpayers of the Depression era, and were not reviewed as part of the introduction of the current compliance and penalty legislation. As a consequence, no significant consideration of their purpose or consequences was undertaken until the Finance and Expenditure Committee's Inquiry into the Powers and Operations of the Inland Revenue Department.

3.2 The current rules are significantly deficient. They provide little guidance to either taxpayers or Inland Revenue on the appropriate treatment of a person in debt.

Current rules

3.3 Inland Revenue has three sets of rules it can use for giving relief to taxpayers who have outstanding tax:

- hardship;

- write-off; and
- instalment arrangements.

Hardship

3.4 The Tax Administration Act contains two hardship provisions: one relating to serious hardship and the other to financial hardship. Both allow taxpayers to be given some relief from their tax liability, with the debt being extinguished in whole or in part. If the debt is extinguished because of financial hardship, then the only ground for its reinstatement is if the information provided by a taxpayer was incorrect, fraudulent or misleading.

3.5 Inland Revenue applies the serious hardship provisions to natural persons. These provisions do not apply to legal entities, as legal entities in themselves cannot suffer "serious" hardship. Instead, the financial hardship provisions apply to them.

3.6 Until April 2001, the legislation restricted the application of both these provisions to income tax and fringe benefit tax. Inland Revenue, however, used the care and management provisions of the Tax Administration Act to apply serious hardship consideration to other taxes.

3.7 Serious hardship and financial hardship are very similar in intent, with the principal difference being that financial hardship allows a taxpayer to retain some assets in order to continue business activity.

3.8 The Government's submission to the Finance and Expenditure Committee's Inquiry highlighted some issues relating to the current hardship rules and stated that they would be considered as part of this review. Although the Committee's response was to await the outcome of the review, it is clear that the Committee was concerned about both the consistency and clarity of the current rules.

"Write-off"

3.9 This is an administrative practice adopted by Inland Revenue in line with the Public Finance Act 1989, a ministerial decision in 1990, and a 1992 Treasury circular.

3.10 "Write-off" means no action is taken to collect a tax debt. The debt, however, still exists – and late payment penalties and use-of-money interest continue to accrue. Inland Revenue can recommence debt collection at any time (except in cases of bankruptcy or liquidation), and usually does so if it discovers that a taxpayer's financial position has improved.

3.11 Many of those who made submissions to the Finance and Expenditure Committee Inquiry were concerned that the term "write-off" was misleading. They believed their debt had been permanently written off and were often unprepared when debt collection subsequently recommenced. One raised the issue of the demotivating effect on taxpayers: if taxpayers know the debt will be reinstated once they are in a better financial position, the incentive to improve their financial position is removed.

3.12 The Committee recommended that the whole area of write-offs be reviewed and that the following issues should be considered:

- *whether there should be a time limit on the reinstatement of a debt;*
- *whether, if the present policy is to continue, the term "write-off" should be replaced by wording that more accurately describes the policy (for example, "provisional write-off");*
- *whether it is necessary for the write-off provisions to be contained in the Inland Revenue Acts.*[3]

Instalment arrangements

3.13 The Tax Administration Act allows taxpayers to pay their overdue taxes in instalments. Until April 2001 the Act limited instalment arrangements to income tax and fringe benefit tax only. For other taxes, the care and management provisions of the Tax Administration Act were used. The two approaches gave slightly varying results.

3.14 The legislation requires Inland Revenue to undertake net present value calculations to ensure returns are maximised when entering instalment arrangements.

Issues

3.15 The Government has concluded that there are a number of significant difficulties with the current debt and hardship rules:

- *Lack of clarity of legislation:* The rules provide little guidance to either taxpayers or Inland Revenue as to when taxpayers should be required to pay tax outstanding and when they should be released from payment.
- *Inconsistent treatment of taxpayers:* The lack of legislative guidance and the general uncertainty as to the purpose of the legislation leads to inconsistent treatment.

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[3] *Inquiry into the powers and operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee,* New Zealand House of Representatives, October 1999, page 5 – recommendation 12, and page 35.

- *High costs imposed:* Write-off, as currently practised by Inland Revenue, reduces incentives for taxpayers to improve their financial situation. Any improvement may be taken to pay an ever-increasing tax debt, as penalties continue to accumulate on the written off, but reinstated, tax liability.

- *Fraudulent behaviour not penalised:* The current rules can result in Inland Revenue being obliged to accept an offer from a person who committed tax fraud simply because the financial return on the overdue amount is greater than that which would be achieved through bankruptcy. The Government considers it appropriate that taxpayers in this circumstance are required to pay their tax debts in full.

Proposed reforms

General principles and scope

3.16 Section 6 of the Tax Administration Act requires Inland Revenue to protect the integrity of the tax system. By clarifying what is expected of Inland Revenue and taxpayers in relation to debt and hardship, the Government's proposals clearly support that requirement. Principally, they clarify taxpayers' rights and provide guidance to Inland Revenue on applying the rules in a fair and impartial way.

3.17 Inland Revenue has an obligation to collect *over time* the highest net revenue that is practicable within the law. In doing so, it must have regard to the level of its resources, the promotion of voluntary compliance, and the compliance costs incurred by taxpayers. The Government's proposals can be seen as codifying the application of that obligation in relation to debt and hardship. These rules recognise, for example, that Inland Revenue has limited resources, that not all debt must be recovered, and that recovering tax owed to the extent of bringing about serious hardship is detrimental to voluntary compliance.

3.18 The Government proposes establishing a legislative framework which provides clarity and certainty about the debt and hardship rules, and which aims for the following outcomes:

- *Fairness of treatment:* Taxpayers who have tax debts and who have approached Inland Revenue with a genuine attempt to arrange payment or request hardship relief are attempting to comply with their obligations. The rules should reflect this.

- *Transparency of treatment:* Both taxpayers and Inland Revenue should understand their roles and their obligations. At all stages of the process, both parties should also have clear guidance as to the options open to them.

- *Consistency of treatment across all taxpayers:* Taxpayers in similar situations should have similar outcomes. Similarity of outcomes cannot be legislated for, but legislation can provide guidance on this. For example, the clearer the definition of the term "serious hardship", the more likely it will be consistently applied.

- *Efficiency of rules:* Issues should be resolved as promptly as possible. Taxpayers who do not qualify for serious hardship should have this determined as quickly as possible, so that they can organise their affairs to make payment. Correspondingly, taxpayers who do qualify for serious hardship should also have that decision made promptly.

3.19 A tax system based on voluntary compliance depends on taxpayers perceiving that others pay their fair share of tax. This maintains both the equity and efficiency of the tax system. For example, businesses that do not pay their taxes have an unfair economic advantage over their tax paying competitors. Therefore, in relation to debt, Inland Revenue's role will be to maximise the amount of debt recovered.

3.20 However, it is generally accepted that there should be limitations on the enforcement of tax payments. Payment of a tax debt will not be enforced when:

- the payment will cause an unacceptable level of hardship to the taxpayer involved; and
- the cost of enforcement, in terms of the use of Inland Revenue's administrative resources, is greater than the return.

3.21 Further, tax which is not recoverable will be written off by Inland Revenue and that write-off will be permanent.

3.22 Inland Revenue will have regard to whether the taxpayer is a beneficiary of a trust. The support or likely level of support that the taxpayer may be provided by the trust is relevant in considering repayment options.

3.23 The Government's proposals will apply to all taxes except child support, which may be passed on to the custodial parent. The special rules reflecting this will continue to apply.

3.24 Child support arrears are not written off for either hardship or bankruptcy reasons because child support is money paid for the support of children. If liable parents were able to have child support debt written off, the children involved would suffer, and the principles of the scheme would be undermined. Child support payments are made to the Government if the custodial parent is a welfare beneficiary. Writing off arrears for hardship or bankruptcy in these cases would result in inconsistent treatment between liable parents based on the status of the custodial parent.

3.25 The proposals for writing off arrears will not apply to tax that has been evaded or tax that is the subject of an abusive tax position. Such taxpayers would still be able to enter instalment arrangements, however.

3.26 In cases of tax evasion and abusive tax positions, the Government believes that the goal of maximising compliance amongst the tax paying public should have a higher priority than that of maximising the revenue that is collected. So, for example, Inland Revenue could bankrupt a tax evader, even though it resulted in less revenue, if that action would send a message to the community about the importance of complying with the law.

3.27 The rules will be supported by appropriate accountability and performance measures to ensure that Inland Revenue is administering them as intended.

3.28 To the extent that a debt is written off on the basis of incorrect or misleading information from the taxpayer, the debt would be able to be reinstated.

Details of the proposed reforms

Maximising the amount recovered

3.29 Inland Revenue's role will be to maximise the recovery of outstanding tax as this maintains both the equity and efficiency of the tax system.

3.30 This means Inland Revenue will be required to adopt the approach which maximises the amount collected. If Inland Revenue can collect more of the debt over time through, for example, an instalment arrangement, than from bankruptcy or liquidation then Inland Revenue would be required to enter an instalment arrangement. Any amount not covered by this instalment arrangement will be written off as unrecoverable.

Net present value calculation

3.31 The requirement for Inland Revenue to undertake net present value calculations will be removed. Currently, legislation requires Inland Revenue to complete this informationally demanding and time-consuming calculation. The Government's proposals do not remove the obligation on Inland Revenue to maximise outstanding tax recovered (in fact, this obligation is made clearer). It is the obligation to undertake the calculation itself that is removed. In some cases where the repayment options are very similar, the net present value calculation is still likely to be used in determining which repayment option is preferable.

Serious hardship clarified

3.32 Inland Revenue will be prevented from recovering tax if the recovery places the taxpayer in serious hardship. Obviously, tax should not be paid if it results in the taxpayer being unable to afford food or accommodation. Conversely, taxpayers should not be released from a tax obligation if that obligation is simply viewed as burdensome – for example, when a tax debt requires the taxpayer to sell an expensive car and replace it with a vehicle of lesser value.

3.33 Recovery of a debt will continue until the point where further recovery would place a taxpayer in serious hardship. This ensures that taxpayers are not seen as being rewarded, or unduly punished, for failure to make payment. Any debt that cannot be recovered will be written off.

3.34 The current legislation provides no guidance as to what constitutes serious hardship, and this raises concerns about unfairness and inconsistencies of treatment. The Government proposes to remedy this problem by defining "serious hardship".

3.35 "Serious hardship" will be defined to include:

- deprivation of necessities according to normal community standards; or
- not being able to acquire a basic standard of food, clothing, medical supplies, accommodation, education for children or dependants, and other basic requirements.

3.36 "Serious hardship" will also be defined to exclude:

- the mere imposition of an obligation to pay tax;
- the prospect (or likelihood) of bankruptcy or liquidation;
- the limitation of social activities and entertainment; and
- the loss of access to goods or services of an expensive nature or standard.

3.37 The point at which a taxpayer begins to suffer serious hardship is one of judgment. The Government therefore welcomes submissions on the definition outlined above, especially on whether the definition is too harsh or lenient.

3.38 Consideration of serious hardship would be limited to people. Legal entities, such as companies, cannot suffer hardship. The Government is concerned, however, that the recovery of the full amount of tax from a company may cause serious hardship for a shareholder owning 50 percent or more of that company. Inland Revenue will have discretion to look through the company and examine the effect of its actions on such a shareholder.

Example

A company owes $100,000, with the only asset in the company being a debit balance in the principal shareholder's current account of $100,000. If the company were placed into liquidation, the $100,000 in the current account would be called up. The shareholder's assets are a house valued at $90,000 and a car with a value of $5,000. The Government recognises that any action taken to liquidate this company could impose serious hardship on the shareholder. Under these proposals, the taxpayer arranges with Inland Revenue that $70,000 raised by way of mortgage will be paid to Inland Revenue and the balance of the debt will be written off as collection would cause serious hardship.

Recognition of the administrative costs of collection of tax

3.39 Recovering overdue taxes uses administrative resources. Inland Revenue will have a clear discretion allowing for effective use of administrative resources. Debt will be written off if the administrative costs of recovering the debt outweigh the amount collected.

"Write-off"

3.40 The current meaning given to "write-off" – in effect "parking" a debt which may be reinstated at a later date – will be removed, as it can be a source of considerable inequity and economic cost. In its submission to the Finance and Expenditure Committee, the Government stated:

This measure could have an adverse economic impact because incentives to earn future income may be reduced as a result of the prospect of the outstanding debt being reinstated.[4]

3.41 For clarity, the proposed legislation will detail a number of circumstances in which tax may be genuinely written off:

- bankruptcy;
- liquidation;
- a company being struck off the Companies Office register;
- confirmation of the distribution of a deceased taxpayer's estate;
- a taxpayer cannot be found;
- the debt relates to a taxpayer that cannot be identified;
- administrative error; and
- situations where Inland Revenue considers there is a limit on the amount recoverable.

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[4] *Government Response on Policy Issues and Inland Revenue Response on Administrative Issues*, August 1999, paragraph 391.

3.42 The final criterion includes debts written off if this would result in serious hardship for the taxpayer or it is not practicable to collect the full amount. Amounts will also be written off if Inland Revenue considers the tax unrecoverable.

3.43 The Finance and Expenditure Committee requested the Government to consider whether it is necessary for the write-off provisions to be contained in the Tax Administration Act. The Government has concluded that there are benefits from all the rules being clarified and in one place.

Instalment arrangements

3.44 The recovery of most debts involves the consideration of serious hardship, the writing off of tax, or the use of Inland Revenue's administrative resources. It also involves taxpayers trying to comply with their tax obligations but facing cashflow problems. One option, an alternative to applying whatever recovery action is considered appropriate, is for the taxpayer and Inland Revenue to enter an instalment arrangement.

3.45 The Government proposes a clearer and more flexible instalment arrangement process which will ensure that taxpayers who are attempting to comply voluntarily can quickly resolve their problems.

3.46 Taxpayers will need to initiate an instalment arrangement by telephone or in writing. On receipt of a request for an instalment arrangement, Inland Revenue will suspend any late payment penalties and recovery action currently under way. The use-of-money interest, however, will continue to apply: this ensures that the taxpayer is not rewarded for any delay in payment.

3.47 To prevent abuse of the suspension of late payment penalties, Inland Revenue will decline requests if it considers:

- the taxpayer is being frivolous;
- the purpose of the request for an instalment arrangement is simply to stop the imposition of a late payment penalty or recovery action; or
- the taxpayer has other tax amounts outstanding, or has not complied with a previous instalment arrangement.

3.48 Inland Revenue requires clear authority for declining instalment arrangements and imposing full late payment penalties on those who simply use instalment arrangements as a way of deferring payment.

3.49 In relation to a request for an instalment arrangement, Inland Revenue can:

- require additional information to determine whether an arrangement is appropriate;

- outline a possible arrangement, or make a counter-offer if the taxpayer has offered an arrangement (for example, Inland Revenue may consider the payment can be made in a more timely way);
- decline the offer of an arrangement, if it considers the taxpayer is in a position to pay the outstanding tax without serious hardship;
- decline the arrangement on the basis that an agreement cannot be reached;
- accept an arrangement offered by the taxpayer; or
- accept the taxpayer's agreement to an arrangement offered by Inland Revenue.

3.50 Inland Revenue must not knowingly place a taxpayer in serious hardship and use administrative resources inefficiently. These requirements will override any instalment arrangement. For example, taxpayers may consider that they can pay back the tax owed, and they may be willing to incur serious hardship to do so. Nevertheless, they should not be required to do so. Another example is where the taxpayer is initially in a position to pay but the taxpayer's financial affairs worsen during an instalment arrangement, to the extent that serious hardship applies. At this point, part of the taxpayer's debt would be written off and the rest would be subject to a new instalment arrangement.

Response periods

3.51 The proposed legislation will not specify a time period in which Inland Revenue must respond to a request for an arrangement. If a taxpayer enters an instalment arrangement late payment penalties will cease applying when the taxpayer contacts Inland Revenue (as explained further in paragraph 3.58). Ensuring a timely response can best be addressed by establishing appropriate standards as part of Inland Revenue's annual reporting process.

3.52 In circumstances where Inland Revenue requests more information or makes a counter-offer, the legislation will provide that the taxpayer should be given at least ten working days from the date of Inland Revenue's response to provide any financial or other information required by Inland Revenue or consider the counter-offer. If the circumstances warrant, however, Inland Revenue will have the authority to set a longer period.

3.53 If the information or response is not provided within the standard ten-day period (or the longer period set by Inland Revenue), the late payment penalties will recommence as if no application had been made.

3.54 If Inland Revenue and the taxpayer cannot agree as to the terms of an instalment arrangement, late payment penalties and recovery action will recommence as if no application had been made.

3.55 If an agreed instalment arrangement involves Inland Revenue writing off part of a taxpayer's outstanding tax and the taxpayer making payment of the remainder, then default by the taxpayer in their payment will not result in reinstatement of the amount already written off.

3.56 Taxpayers will have the option to renegotiate an instalment arrangement if their financial situation changes. Inland Revenue will not have the option to renegotiate an arrangement in cases where a taxpayer's financial situation improves, because having this option discourages taxpayers from earning more income.

3.57 Inland Revenue may overturn an instalment arrangement if the arrangement is based on information which is later found to be misleading or fraudulent. Penalties would then apply, as if the instalment arrangement had not been reached.

3.58 As is current practice, the initial late payment penalty will be reduced from 5 percent to 1 percent if a taxpayer requests an instalment arrangement before the due date for payment of the tax. This provides an incentive for taxpayers to contact Inland Revenue before administrative costs are incurred.

Flexibility in the application of debt and hardship provisions

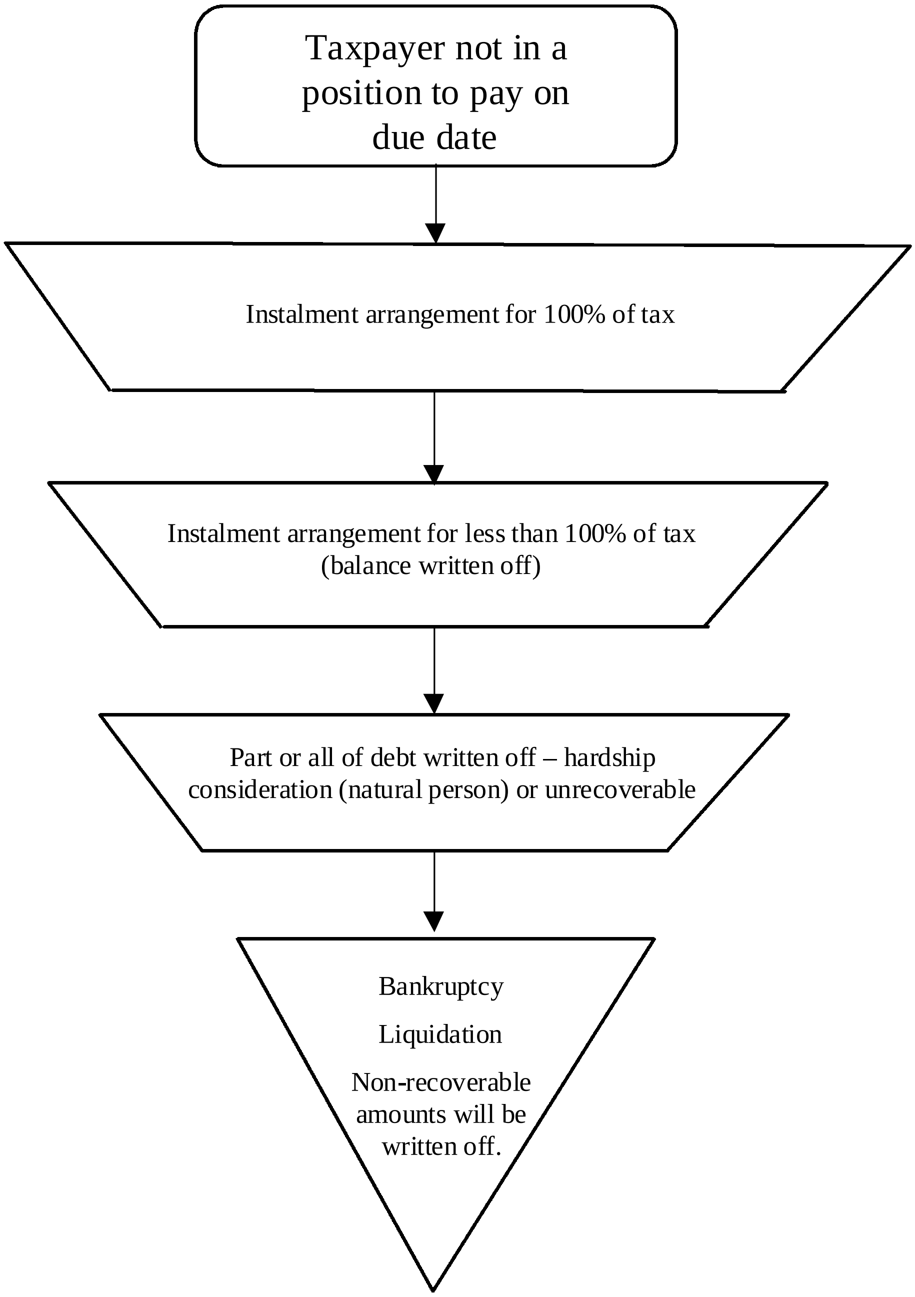
3.59 The rules allow for flexibility so that any or all of the following may occur, in relation to a single debt:

- The taxpayer may agree to pay part or all of the tax, either in one lump sum or over time, in accordance with an instalment arrangement with Inland Revenue.
- Inland Revenue may agree that part or all of the outstanding tax was not recoverable, and so the unrecoverable component may be written off.
- Inland Revenue may agree that recovery of part or all of the outstanding tax would cause serious hardship, and so the tax may be written off.
- Inland Revenue may consider that recovery of part or all of the outstanding tax would not reflect an efficient use of administrative resources and that tax would be written off.

3.60 The debt recovery process is summarised in Figure 2. Most taxpayers should be able to have their situation resolved by way of an instalment arrangement, with or without partial write-off of outstanding tax. The number of bankruptcies is expected to be very low.

3.61 The effectiveness of these proposals relies on, and encourages, taxpayers to contact Inland Revenue with their debt problems as early as possible. The rules provide Inland Revenue with considerable flexibility. The outcome of early discussion is more likely to be positive, with reduced stress and cost for taxpayers. The need for other approaches to debt recovery, measures of last resort such as bankruptcy, will reduce.

FIGURE 2:
PROCESS FOR RECOVERY OF DEBT



EXAMPLES

Example one

Facts: A taxpayer operates a meat processing business. Thirty people are employed. The taxpayer has arrears of PAYE and GST totalling $400,000 which are unable to be paid in full. The taxpayer makes an offer of $250,000 to settle the arrears in one sum. Inland Revenue considers that bankruptcy would yield $100,000.

Outcome: Inland Revenue accepts the taxpayer's offer of $250,000 and writes off the balance.

Example two

Facts: Another taxpayer operates a bakery. The taxpayer has arrears of $80,000, and makes an offer of $60,000 to settle the arrears over three years. Inland Revenue considers that bankruptcy would yield $40,000.

Outcome: Inland Revenue would write off $20,000 and enter an instalment arrangement over three years for $60,000.

Example three

Facts: A candlestick-making company employs four staff and has arrears of $80,000. It makes an offer of $30,000 to settle the arrears over three years. Inland Revenue considers that bankruptcy would yield $40,000 but would make the staff redundant.

Outcome: The existing offer would result in liquidation and the write-off of $40,000. Given this outcome, Inland Revenue would discuss the situation with the taxpayer to see if the taxpayer could make an improved offer exceeding $40,000. If the taxpayer made such an offer, an instalment arrangement would be agreed.

Example four

Facts: A computer repairman has arrears of $150,000 and has assets including a freehold home of $120,000 (which includes a workshop) and a work van worth $10,000.

Outcome: On contacting the taxpayer to recover the debt, Inland Revenue concludes the taxpayer could face serious hardship if the debt were fully repaid. The outcome is that the taxpayer mortgages the home for $100,000. This $100,000 is paid to Inland Revenue, and the additional $50,000 is written off. An instalment arrangement is considered, but is rejected because income in excess of that needed to maintain the business is committed to repaying the mortgage.

Other measures

Tax losses

3.62 As part of the determination of a taxpayer's assets, Inland Revenue will take into account the tax losses of a taxpayer. If any tax revenue is written off, Inland Revenue will have the authority to extinguish part or all of the taxpayer's tax losses commensurate with the amount written off.

Hardship rebates

3.63 A number of tax rebates are available to taxpayers in serious hardship – for example, there is a rebate of $60 for solo parents with dependants. The rebates are applied only in cases of hardship relief. The rebates are historical, and are irrelevant to the wider tax issues facing a person in serious hardship. Their application creates more compliance and administrative costs than benefits. The Government proposes that they be removed.

Specific issues for consultation

- What factors should be taken into account when considering serious hardship?
- Should taxpayers who evade tax or take an abusive tax position be eligible to have their debt written off on the grounds of hardship?
- Should the hardship rebates be removed?

Submissions on this chapter are required by 21 September 2001.

Chapter 4

SHORTFALL PENALTIES

The Government's proposals

- The lack of reasonable care penalty will be reduced to 10 percent if the breach is the taxpayer's first breach of a required standard of behaviour.
- If the taxpayer does not take reasonable care in his or her tax affairs for the following seven years, the shortfall penalty for any subsequent breach will be imposed at 20 percent.
- The legislation will be amended to provide that a shortfall penalty for unacceptable interpretation can be imposed in cases where a tax position taken is unacceptable but the taxpayer has not interpreted the law.
- The first part of the unacceptable interpretation threshold will be increased from \$10,000 to \$20,000.

4.1 A tax shortfall is the difference between the tax liability established under the tax legislation and the position a taxpayer took in their tax return. When a shortfall results from a breach or default on the part of a taxpayer, a shortfall penalty is imposed. There are five categories of breach or default, with a specified penalty rate (set as a percentage of the shortfall) for each category:

- lack of reasonable care 20 percent
- unacceptable interpretation 20 percent
- gross carelessness 40 percent
- abusive tax position 100 percent
- evasion 150 percent.

4.2 The penalty rates are non-negotiable: if a breach or default occurs, the applicable penalty must be imposed. If there is a tax shortfall but no default or breach, then no shortfall penalty is imposed.

4.3 The compliance and penalties legislation is aimed at encouraging taxpayers to comply voluntarily with their tax obligations, and is not intended to be onerous. Taxpayers are expected to take care and, if there is a significant amount of tax at stake, to take extra care in interpreting the legislation.

4.4 The cornerstone of the legislation is the standard of reasonable care. This is a fluid concept which recognises the distinct characteristics of individual taxpayers and the different burdens placed on them. Applying a standard of reasonable care does not require that a taxpayer actually foresaw that the breach or default would cause a shortfall; it simply requires that a reasonable person in those circumstances would have foreseen the shortfall as a reasonable probability.

4.5 This chapter discusses the shortfall penalty issues raised by the Finance and Expenditure Committee. Other shortfall penalty issues will be considered in the next stage of the review, the scope of which is referred to in paragraph 2.25.

Past record of good behaviour

Background

4.6 The Finance and Expenditure Committee recommended that:

> *…a past record of "good behaviour" be taken into account when deciding whether to impose a penalty*[5]

4.7 The Committee of Experts on Tax Compliance also considered this issue. Their report recommended 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;…*[6]

4.8 This matter was also considered by the Ministerial Panel on Business Compliance Costs. In its report it stated:

> *The policy of imposing tax collection obligations on employers/small businesses, and then punishing them with penalties for getting it wrong builds strong resentment from those that have good 'track records'.*[7]

Issue

4.9 The Finance and Expenditure Committee's recommendation was not confined to a particular penalty, but the Government considers the issue is of relevance only to the lack of reasonable care shortfall penalty. It is not relevant to late filing penalties, late payment penalties, non-electronic filing penalties, and other shortfall penalties:

- *Late filing penalty* – This penalty is imposed if taxpayers do not file their tax return in the required time frame. Taxpayers generally receive a letter warning them that their return is late *before* the late filing penalty is imposed. The Government considers that because a taxpayer receives such a notice a past record of good behaviour should not be taken into account when imposing this penalty.

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[5] *Inquiry into the powers and operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee*, New Zealand House of Representatives, October 1999, page 4 – recommendation 7 and page 27.

[6] *Tax Compliance*, Committee of Experts on Tax Compliance, December 1998, paragraph 12.7.

[7] *Finding the Balance: Maximum Compliance at Minimum Cost, Final Report of the Ministerial Panel on Business Compliance Costs*, July 2001, page 121.

- *Late payment penalty* – The legislation imposing this penalty was recently amended. The initial late payment penalty is now imposed in two stages: 1 percent on the day after the due date; and another 4 percent a week later. The aim of this penalty is to encourage taxpayers to pay the correct amount of tax at the correct time, and the amendment was aimed at reducing the penalty on taxpayers whose payment is only a few days late. The two-step penalty encompasses the concept of taking good behaviour into account.

- *Non-electronic filing penalty* – The information provided in the employer monthly schedule is of key importance and is required to be provided in a timely manner. Good behaviour should not be taken into account when imposing this penalty.

- *Other shortfall penalties* – A past record of good behaviour should not be taken into account when considering the imposition of shortfall penalties for unacceptable interpretation, gross carelessness, abusive tax position, or evasion. Taxpayers who have breached these standards should not be considered to have a past history of good behaviour, given the culpability associated with the breach.

4.10 Some flexibility has already been built into the reasonable care standard. For example, individual taxpayers following the steps set out in the tax pack will be considered to have taken reasonable care, whereas a large business taxpayer will be required to have systems in place to ensure that the business's income and expenditure is properly recorded.

Proposed reform

4.11 The purpose of the compliance and penalties legislation is to encourage voluntary compliance. The legislation recognises that taxpayers may make mistakes but that most of them are fundamentally honest and are doing their best. Taking into account a taxpayer's past record of good behaviour creates goodwill and encourages future compliance, whereas, on the other hand, imposing the full shortfall penalty may be seen as unfair and actually reduce voluntary compliance.

4.12 The Government is committed to taking into account good behaviour when considering the shortfall penalty for lack of reasonable care. But the issue is more complex than simply providing that the penalty not apply if a taxpayer has a past history of good behaviour. If the penalty did not apply in these cases, then the "norm" for taxpayers could become one of only taking care after having been audited, or one of breaching the standard now and then but not sufficiently to be seen as a "bad" taxpayer. This approach would be seen as inequitable by those taxpayers who do maintain compliance standards. It would also introduce a risk of significant reduction in voluntary compliance.

4.13 Applying a test for good behaviour and determining whether a taxpayer had met that test would incur considerable compliance and administrative costs. There is no objective measure of good behaviour – for example, a taxpayer who always pays tax on time but lies about the amount due may meet a "good behaviour" test while a taxpayer who pays late now and then may not.

4.14 As a way to take account of good behaviour but at low compliance and administrative costs, the Government proposes that the lack of reasonable care penalty be reduced to 10 percent if the breach is the taxpayer's first breach of a required standard of behaviour. If the taxpayer subsequently does not take reasonable care across their tax affairs within seven years, the shortfall penalty for any subsequent breach would be imposed at 20 percent. But if they repeat the original breach, then the subsequent breach is most likely to be treated as gross carelessness, resulting in a 40 percent shortfall penalty.

4.15 The seven-year period provides a clear rule for the good behaviour test. It allows scope for taxpayers to make a one-off breach of the standard of care – but it ensures that those who make frequent breaches face the full force of the shortfall penalty for lack of reasonable care.

4.16 The reduction in penalty would apply to all lack of reasonable care offences identified during an audit. The concept of a taxpayer being a complying taxpayer does not cease at the first breach, but rather at the point at which the breaches are identified.

4.17 This measure should also address the concerns of both the Committee of Experts on Tax Compliance and the concerns of the Ministerial Panel on Business Compliance Costs.

Flexibility in the application of shortfall penalties

Background

4.18 The Finance and Expenditure Committee recommended that:

> *…the Inland Revenue Department exercise a greater degree of flexibility when applying shortfall penalties*[8]

4.19 The Committee's concern was that shortfall penalties were being imposed in all cases where a tax shortfall arose.

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[8] *Inquiry into the powers and operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee,* New Zealand House of Representatives, October 1999, page 4 – recommendation 7 and page 27.

Issue

4.20 It was never intended that a shortfall penalty be imposed in all cases where a tax shortfall occurred. As outlined above, there must be a tax shortfall and a breach of a required standard of behaviour before a shortfall penalty would be imposed. Statistics kept by Inland Revenue indicate that shortfall penalties are imposed in approximately 14 percent of cases where there is a tax shortfall.

4.21 There are a number of reasons why shortfall penalties are not imposed, including:

- The tax shortfall is the result of an inadvertent error by the taxpayer or the agent.
- The tax shortfall arose as the result of an incorrect, but not unacceptable, interpretation by the taxpayer or the agent.
- As set out in chapter 8 of this discussion document, the tax shortfall arose as the result of a breach of a standard of care by an agent.

4.22 The Government is committed to ensuring there is flexibility in the application of shortfall penalties. Shortfall penalties were designed specifically to take into account the circumstances of each taxpayer. The penalties recognise that taxpayers are not expected to get everything right, but that they should at least take care.

Inadvertent errors

Background

4.23 The Finance and Expenditure Committee recommended that:

…shortfall penalties should not apply where it is determined that a taxpayer has made an inadvertent error.[9]

Issue

4.24 It was never intended that a shortfall penalty be imposed when a taxpayer makes an inadvertent error. The Standard Practice Statement *Shortfall penalties – not taking reasonable care* (INV-200) states:

The purpose of the not taking reasonable care shortfall penalty is to increase voluntary compliance with the system. The standard is the cornerstone of the penalties regime which requires all taxpayers to act reasonably in the conduct of their tax affairs. It is a fluid concept which recognises the distinct characteristics of particular obligations and the different burdens placed on various taxpayers.

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[9] *Inquiry into the powers and operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee*, New Zealand House of Representatives, October 1999, page 4 – recommendation 7 and page 27.

The standard recognises taxpayers' varying abilities and reflects a balance between the need for returns to be correct and the recognition of the difficulties that taxpayers may face in ensuring that they are correct.

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

The reasonable care test is not intended to be overly onerous and does not mean perfection. The effort required of the taxpayer is commensurate with the reasonable person in the taxpayer's circumstances. Ordinarily what is expected is the achievement of a standard appropriate to the category of taxpayer, rather than that of the individual taxpayer involved.

4.25 The option of amending the legislation to specifically state that "shortfall penalties will not be imposed in cases of inadvertent errors" was considered. Inadvertent error, however, is already covered by the concept of negligence – which is well tested and well understood. Currently, the reasonable care test equates with the concept of negligence in the civil law of torts, and the jurisprudence is well established. "Negligence is to be measured objectively by ascertaining what in the circumstances would be done or omitted by the reasonable man" *(Meulan's Hair Stylists Ltd* v *CIR* [1963] NZLR 797).

Consistency in applying shortfall penalties

Background

4.26 The Finance and Expenditure Committee also indicated its concern that shortfall penalties were not being applied consistently.

Issue

4.27 When the current compliance and penalties legislation was introduced, Inland Revenue set up procedures and processes to ensure that shortfall penalties would be applied fairly and consistently. Regional consistency committees within Inland Revenue review a percentage of completed audits, including audits where no shortfall penalty has been imposed, to ensure that the penalties legislation is applied consistently. These consistency committees also meet on a periodic basis at a national level, to discuss penalty cases of technical interest.

Specific issues for consideration

- Are the mechanisms for ensuring consistency effective?
- Can they be improved?

Taxpayers taking reasonable care

Background

4.28 The Finance and Expenditure Committee recommended that:

The Inland Revenue Department develop a systems audit methodology in order to assess whether taxpayers are adopting a reasonable standard of care.[10]

Issue

4.29 As noted in the Government's response to the report of the Finance and Expenditure Committee, Inland Revenue is currently reviewing its audit function to determine ways in which its audit methodologies can be further improved. The Committee's recommendation ties into a number of projects that are intended to improve the quality of technical decision making and audit activity. Work has begun on the development of processes to ensure that investigators take adequate account of the reasonable care taken by taxpayers.

4.30 The extent to which shortfall penalties have affected compliance is difficult to determine. This is partly because of an absence of data on pre-1997 shortfalls. Furthermore, the penalty has not been in existence for long enough to enable repeat audits of taxpayers who have had a penalty applied, with the possible exception of those who have filed GST returns. Therefore it is not possible to determine whether there has been a significant change in taxpayer behaviour.

4.31 The number of shortfall penalties that are applied can vary significantly depending on Inland Revenue's audit activity. It is expected that, over time, the number and value of shortfall penalties imposed will plateau and possibly diminish as taxpayer behaviour changes in response to the penalties legislation.

4.32 Anecdotal evidence suggests that the introduction of shortfall penalties may be affecting some taxpayers' decisions, particularly those of taxpayers with more complex tax affairs. Inland Revenue believes that, in cases where taxpayers may have taken aggressive stances in the past, they are now avoiding this because of the risk of being considered to have taken an unacceptable interpretation.

4.33 Inland Revenue will continue to monitor the imposition of shortfall penalties, and will discuss this issue in its follow-up compliance and penalties issues paper (due to be released next year). Information on the number and amount of shortfall penalties imposed is included in Inland Revenue's annual report.

[10] *Inquiry into the powers and operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee*, New Zealand House of Representatives, October 1999, page 4 – recommendation 8 and page 27.

Penalties for taxpayers who have not interpreted the legislation

Background

4.34 The Finance and Expenditure Committee recommended that:

> *The Inland Revenue Department reinforce both publicly and internally that if a taxpayer or adviser has not interpreted legislation a penalty for unacceptable interpretation cannot apply.*[11]

Issue

4.35 The shortfall penalty for unacceptable interpretation is intended as a signal to taxpayers who take tax positions where there is a significant amount of tax at stake. It indicates that they should take extra care and that, when viewed objectively, their interpretations should be likely to be correct.

4.36 This penalty applies only where there is a significant amount of tax at stake, as it would be unduly onerous to apply this test to all tax shortfalls. Clearly, many taxpayers lack a comprehensive understanding of tax law, and tax knowledge comes at a cost which is at times high. If the amount of tax at stake is not significant, then taxpayers should not be penalised for failing to meet the standard.

4.37 The current interpretation of the legislation allows taxpayers to avoid making reasonable efforts to determine what the law is. A taxpayer could choose not to interpret the legislation on a complex tax issue, as a means of avoiding possible shortfall penalties. This is contrary to the original intention – which was that taxpayers should endeavour to take a tax position that is "at least about as likely as not correct". It therefore weakens the standard that larger taxpayers are required to meet, and makes a penalty more difficult to impose in cases where it is fair that it be imposed.

Proposed reforms

4.38 Legislation will provide that a shortfall penalty for an unacceptable interpretation can be imposed in cases where a tax position taken is unacceptable but the taxpayer has not interpreted the law.

4.39 A taxpayer is currently liable to pay the shortfall penalty only if the shortfall exceeds *both* $10,000 *and* the lesser of $200,000 and 1 percent of the taxpayer's total tax figure for the relevant return period. To ensure that this penalty only applies in cases where there are significant tax consequences, and to balance the proposed change outlined above, the first part of the threshold will be increased from $10,000 to $20,000.

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[11] *Inquiry into the powers and operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee*, New Zealand House of Representatives, October 1999, page 4 – recommendation 9 and page 28.

Chapter 5

OTHER FINANCE AND EXPENDITURE COMMITTEE RECOMMENDATIONS

The Government's proposals

- If a taxpayer proves on the balance of probabilities that the assessment is excessive by a specified amount, the court will reduce Commissioner of Inland Revenue's assessment by that amount.
- Taxpayers who receive a default assessment will be provided with an explanation of what this is, why it has been issued, and what responses are available to them.
- The requirement to pay 50 percent of the tax in dispute will be removed, but Inland Revenue will be given the power to require payment of all the tax in dispute in cases where revenue is at significant risk.
- Performance standards for replying to a Notice of Response will be included in Inland Revenue's purchase agreement with the Minister and in its annual report.
- The proposed performance standards for a Notice of Response will require Inland Revenue to correspond with the taxpayer at least every three months.
- The current use-of-money interest rules are appropriate, and will continue.
- As the use-of-money interest rates are perceived as unfair in some cases, the Government will address this through the simplification measures discussed in the *More time for business* discussion document.

5.1 This chapter discusses:

- the time bar;
- burden (onus) of proof;
- time limit for responses to Notices of Response; and
- rates for use-of-money interest.

Time bar

Background

5.2 Under the Tax Administration Act, Inland Revenue's power to issue an amended assessment is limited to four years from the end of the income year in which the taxpayer provides the return. This limit is known as the time bar.

5.3 The time bar does not apply if Inland Revenue considers that the taxpayer's return:

- is fraudulent;
- is wilfully misleading; or
- does not mention gross income of a particular nature or from a particular source, in respect of which a tax return is required to be provided.

5.4 In relation to the time bar, the Finance and Expenditure Committee recommended that:

The Tax Administration Act 1994 (TAA) be amended to provide a clear four-year time bar in relation to all taxes except where the Commissioner of Inland Revenue has reasonable grounds to suspect a return to be fraudulent or wilfully misleading.[12]

Issue

5.5 As noted in *The Government's Response to the Report of the Finance and Expenditure Committee*, this recommendation restates the current law in relation to assessments raised by Inland Revenue. The *Response* also noted the Government's concern that, if an assessment or amended assessment is issued just before the expiry of the four-year time bar, the time in which a taxpayer can discuss that assessment is truncated.

5.6 This issue was intended to be considered in this review. As the issue directly relates to the disputes process, however, its consideration has been deferred and included in the post-implementation review of the disputes resolution process (which has begun). A discussion document on the disputes resolution process is due to be released in the first half of 2002.

Burden of proof

Background

5.7 In disputes between Inland Revenue and taxpayers, the onus of proof depends on the issue involved. It is up to taxpayers to prove their tax liability, especially where this involves a lower-level penalty. The only exception is in transfer pricing, where the onus of proof is on Inland Revenue because of the subjective nature of transfer pricing and the need to provide certainty in such a complex area. The onus is on Inland Revenue in the case of evasion, obstruction and criminal penalties.

[12] *Inquiry into the powers and operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee*, New Zealand House of Representatives, October 1999, page 4 – recommendation 1 and page 15.

5.8 The onus of proof applies to the facts, not the law. The key reason for the onus of proof being on taxpayers is that facts about the tax positions they take are primarily within their knowledge. Moreover, it is the taxpayer who exercises primary control over record-keeping, and over the extent to which there is full and honest disclosure to Inland Revenue.

5.9 The Finance and Expenditure Committee recommended that:

The burden of proof remain with the taxpayer, but that consideration be given to establishing a "test" for the Inland Revenue Department to meet to ensure that only properly calculated and substantiated amended assessments are issued to complying taxpayers.[13]

Issue

5.10 In all cases except those involving a minor error, the original assessment is based on information contained in returns furnished by taxpayers. Any amendments to these assessments are issued on the basis of an agreement between the taxpayer and Inland Revenue, or after the resolution of a dispute. The disputes resolution process provides a "test" to ensure that assessments are properly calculated and substantiated.

Proposed reforms

5.11 The Committee of Experts on Tax Compliance also considered where the onus of proof should lie. It concluded that the onus of proof in all civil proceedings should remain with the taxpayer – except for civil penalties for evasion (as is currently the case).

5.12 The Committee noted that a taxpayer who wishes to challenge an assessment is required to prove not only that the Commissioner of Inland Revenue's assessment is wrong, but also by how much it is wrong. It recommended that the law be clarified to provide that if a taxpayer proves, on the balance of probabilities, that the assessment is excessive by a specified amount, then the court should reduce Inland Revenue's assessment by that amount.[14] The Government agrees with this recommendation.

Default assessments

5.13 Of particular concern to the Finance and Expenditure Committee was the issue of default assessments. A default assessment is issued if a taxpayer does not file a tax return. In the case of income tax, it is generally issued after a late filing penalty has been imposed – and this in turn can only be imposed after a letter requesting the return has been issued.

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[13] *Inquiry into the powers and operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee*, New Zealand House of Representatives, October 1999, page 4 – recommendation 2 and page 16.
[14] *Tax Compliance*, Committee of Experts on Tax Compliance, December 1998, paragraphs 10.12 and 10.13.

5.14 Default assessments are calculated in a variety of ways:

- previous year's assessment plus a growth factor of 10 percent;
- current year's provisional tax plus a growth factor of 10 percent;
- current year information held (that is, actual earnings for the relevant year);
- payments made during the year;
- GST/PAYE history;
- average self-employed income profile; or
- audit information.

5.15 Goods and services tax default assessments are based on the taxpayer's filing history:

- if the taxpayer's history includes debit returns, the default assessment is based on the monthly average of debit returns for last 12 months or more;
- if the taxpayer's history includes no debit returns, the default assessment is based on the latest default assessment plus a growth factor of 10 percent; or
- if the taxpayer has no filing history, then the default assessment is based on a pre-set fallback figure.

5.16 For fringe benefit tax, the previous period assessment plus a growth factor of 10 percent is used. If no details are available, a pre-set figure is used as the default assessment amount.

5.17 For ACC residual claims levies, the default assessment is calculated on the actual gross wages paid by the employer during the year multiplied by the ACC levy rate applicable to the employer's industrial activity.

5.18 Once a taxpayer files the return for which the default assessment has been issued, the default assessment is replaced with the taxpayer's assessment.

5.19 The Government concludes that the process for determining the amount of a default assessment is robust. Nevertheless, the information provided with the default assessment should be improved. The Government therefore proposes that taxpayers should always receive an explanation of what the default assessment is, why it has been issued, and what responses are available to the taxpayer.

Not requiring payment of tax in dispute

5.20 A related matter of concern is where a taxpayer disputes the amount of tax to pay. Here the Tax Administration Act requires that the taxpayer pay the non-deferrable tax relating to the amount in dispute – that is, 50 percent of the amount of tax that is being disputed. The justification for requiring this, however, was significantly diminished by the introduction of use-of-money interest. The requirement to pay 50 percent of the tax in dispute will be removed.

5.21 To balance this, Inland Revenue will be given the power to require payment of all the tax in dispute in those rare cases where there is revenue at significant risk – that is, where there is a risk that the amount in dispute might never be paid.

Time limit on Inland Revenue for responding to a Notice of Response

Background

5.22 A new disputes resolution process was introduced in October 1996. It changed the focus of the disputes process to ensure that the facts, evidence and issues are disclosed between Inland Revenue and taxpayers in a way designed to promote the early resolution of disputes.

5.23 The first step in the disputes resolution process is for the party requesting the adjustment (usually Inland Revenue) to issue a Notice of Proposed Adjustment to the other party (usually the taxpayer). The Notice of Proposed Adjustment sets out the facts, the relevant legislation, any issues arising from the proposed adjustment, and any propositions of law supporting the proposed adjustment.

5.24 If the taxpayer issues the Notice of Proposed Adjustment and Inland Revenue does not accept this, then Inland Revenue must issue a Notice of Response within two months. This Notice of Response outlines the reasons why Inland Revenue rejects the proposed adjustment. The taxpayer then has two months to reject the arguments in the Notice of Response – and if the taxpayer does this, the issue will progress to the conference phase. If the taxpayer does not reject the Notice of Response within two months, it is deemed to have been accepted.

5.25 On the other hand, if Inland Revenue issues the Notice of Proposed Adjustment and the taxpayer does not accept this, then the taxpayer must issue a Notice of Response to Inland Revenue within two months. If Inland Revenue rejects the arguments in the taxpayer's Notice of Response, the issue will progress to the conference phase. However, there is no time limit on Inland Revenue for responding to the taxpayer's Notice of Response.

5.26 The Finance and Expenditure Committee recommended that:

The Government review the process by which assessments can be challenged, placing particular emphasis on assessing the merits of establishing a time limit on the Commissioner of Inland Revenue when addressing a taxpayer's Notice of Response.[15]

Issue

5.27 Taxpayers have the full facts of their own affairs at hand, and are likely to be in a position to respond within two months. Inland Revenue, however, usually has little information available and may need more than two months to investigate the dispute, which may be one of many. The disparity between the information available to the two parties is the key reason for the current position.

5.28 It is essential to successful dispute resolution that both parties "lay all cards on the table" in respect of their position. If the taxpayer does not provide information voluntarily, Inland Revenue will be required to use statutory powers to obtain the information.

5.29 If a two-month time limit was imposed on Inland Revenue, there would be cases where Inland Revenue would not be able to obtain the necessary information. It would then have to accept the adjustment proposed by the taxpayer without all the facts and without being able to determine the accuracy of the adjustment. This would reduce the equity of the tax system, by encouraging taxpayers to enter disputes and then to delay providing information.

Proposed reform

5.30 The Government does not recommend a limit on Inland Revenue's response period. Nevertheless, it recognises that Inland Revenue should be held responsible for its performance. Performance standards for responding to a Notice of Response will be included in Inland Revenue's purchase agreement with the Minister of Revenue, and in its annual report. The proposed standards will also require Inland Revenue to correspond with the taxpayer at least every three months as to progress.

Specific issue for consultation

To ensure that the letter from Inland Revenue is useful to the taxpayer, submissions are requested on the information Inland Revenue should be required to include in any interim response.

[15] *Inquiry into the powers and operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee,* New Zealand House of Representatives, October 1999, page 4 – recommendation 10 and page 29.

Rates for use-of-money interest

Background

5.31 In 1994 the Government moved to market-based use-of-money interest rates in order to discourage deferral of provisional tax payments and to introduce fairer rules. This allowed the removal of the much disliked underestimation penalty, with reliance predominantly placed on the use-of-money interest rules to ensure provisional tax is paid on time.

5.32 The move to market-based use-of-money interest rates has resulted in concerns about the fairness of the margin between the overpayment and underpayment rates. The Finance and Expenditure Committee recommended that:

The method by which use of money interest is calculated be reviewed to determine whether changes to the interest rates for overpayments and underpayments to reduce the differential between the rates are appropriate.[16]

5.33 Prior to the Finance and Expenditure Committee's recommendation, the Committee of Experts on Tax Compliance considered this issue and noted that:

…even though a rational basis for setting the use of money interest rates exists 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.[17]

5.34 The Committee of Experts recommended that questions about relief from the use-of-money interest rules should be addressed as part of this review.

How the rates are set

5.35 The formula for calculating the use-of-money interest rate on underpayments is based on the Reserve Bank business base lending rate series. This series tracks the base rate that major banks charge good corporate customers. For other customers, banks generally add a margin of between 2 and 5 percentage points, depending on the individual characteristics of that customer. The formula for calculating the use-of-money interest rate on tax underpayments adds a margin of 2 percentage points to the published business base lending rate. Currently, the rate on underpayments is 12.62 percent. The rate ensures that smaller businesses have an incentive to pay the correct amount of tax on time.

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[16] *Inquiry into the powers and operations of the Inland Revenue Department: Report of the Finance and Expenditure Committee*, New Zealand House of Representatives, October 1999, page 5 – recommendation 11 and page 31.
[17] *Tax Compliance*, Committee of Experts on Tax Compliance, December 1998, paragraph 11.35.

5.36 The formula for calculating the use-of-money interest rate on overpayments is based on the Reserve Bank 90-day bank bill rate. The formula reduces the rate by 1 percentage point, to discourage taxpayers from using Inland Revenue as an investment opportunity. The 1 percentage point margin also reduces the likelihood that the overpayment rate will exceed the fluctuating 90-day bank bill rate. Currently, the rate on overpayments is 5.74 percent.

5.37 The existing rates reflect that the Government is an involuntary borrower if taxpayers overpay, and an involuntary lender if taxpayers underpay.

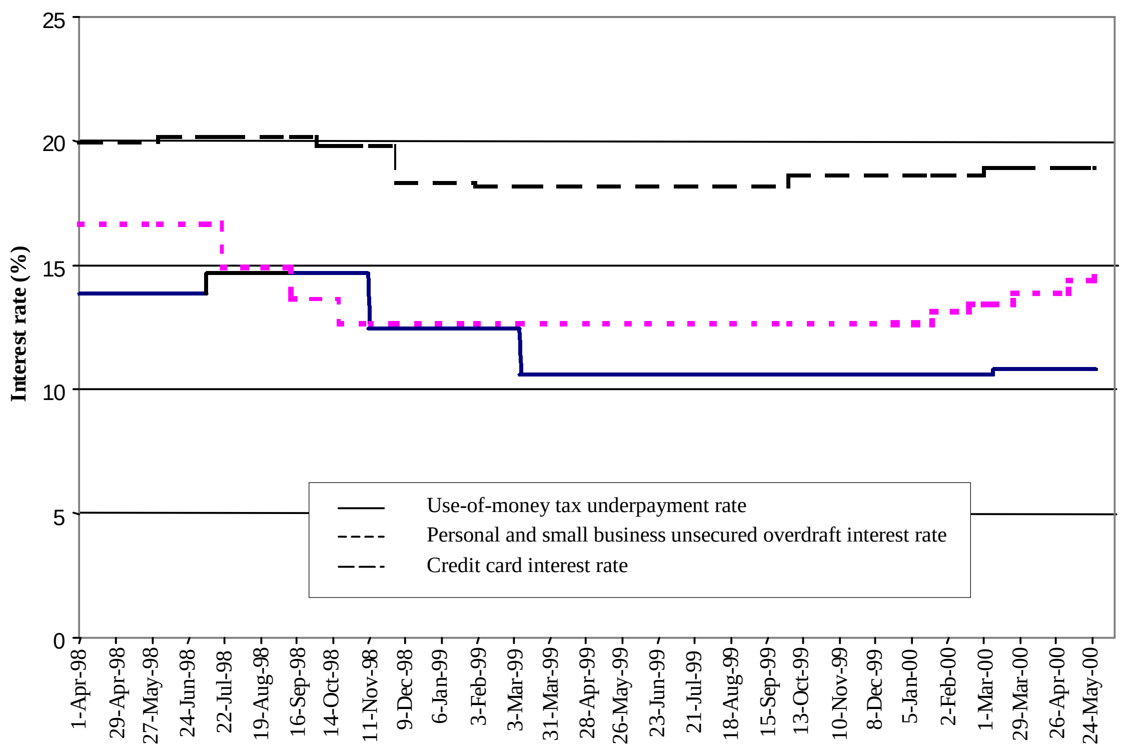
5.38 Increasing the overpayment rate to reduce the margin between the two rates would place the Government in the position that taxpayers would have a real choice to lend to the Government through provisional tax payments rather than through the appropriate channel of Government stock.

Issue

Re-examination of the interest setting process

5.39 The Government has reviewed the method by which use-of-money interest rates are set.

FIGURE 3:
COMMERCIAL INTEREST RATES VS USE-OF-MONEY INTEREST RATE
ON UNDERPAYMENTS



5.40 The Government has compared the rates it charges on tax underpayments with those charged by other lenders. Figure 3 shows that the Government charges:

- less than lenders who provide unsecured credit by way of credit card; and
- less than a bank's unsecured small business and personal borrowing rate.

5.41 This analysis shows that the interest rates the Government charges are appropriate for small businesses.

5.42 To look at this issue another way, if the underpayment rate applying to provisional taxpayers was excessive, the Government would expect provisional taxpayers to aim to overpay tax (to the extent that they have funds available).

5.43 Inland Revenue has analysed the provisional tax paid by those whose turnover is less than $1.3 million:

ANALYSIS OF PROVISIONAL PAYMENT
PROFILE FOR 1998/99 INCOME YEAR

Turnover less than $1.3 m	*Payments*	*Interest*
Overpayment	$265.3m	$4.5m
Underpayment	$371.0m	$37.1m

This shows:

- Underpayments are 1.4 times the current level of overpayments.
- Interest charged on underpayments exceeds interest paid on overpayments by a factor of eight. Only half of this variation is accounted for by the difference in interest rates.
- Underpaid provisional tax is not being paid until terminal tax. Therefore businesses are choosing not to correct their underpaid tax when they receive an assessment.

5.44 The analysis above suggests that the current use-of-money interest rates on underpayments may, in fact, be too low.

5.45 A further way of looking at whether the underpayment rate is appropriate would be to examine the implications of reducing that rate. This could:

- Reduce the efficiency of the provisional tax rules, and raise the possibility that the unpopular and now repealed underestimation penalty would have to be reinstated.

- Lead to the imposition of lack of reasonable care shortfall penalties on estimates which are obviously low (and have been set low so that the taxpayer can defer some of their provisional tax).
- Increase compliance and administrative costs, if processes to enforce payment are put in place. Detailed rules outlining how taxpayers determine the amount of tax they pay during the year would be needed if the interest rate on underpayments was lowered and the incentive to comply was reduced.

5.46 The application of multiple use-of-money interest rates has also been considered. As this approach would necessarily be based on Inland Revenue's judgment of the taxpayer's creditworthiness, it is not considered feasible. There is a real risk that Inland Revenue would make incorrect judgments about the rate to be applied. Further, multiple rates may also be seen as unfair. For example, a medium-sized business and a smaller business underpaying provisional tax by the same amount would be charged different amounts of interest – even if both paid the outstanding tax and interest on the same day.

5.47 The Government concludes that the use-of-money interest rates on underpayments are not inappropriately high. They are, in fact, lower than what the market charges for unsecured lending. There would be significant risks from reducing the margin between the two sets of rates.

Reducing the cases where use-of-money interest applies

5.48 While concluding that the process for setting the rates is correct and that the results are not inappropriate, there is still the issue of the application of the rates themselves and the view that they are unfair. Underlying the concerns of the Committee of Experts on Tax Compliance is a clear perception that, just as the Government can be an involuntary lender, taxpayers can be involuntary borrowers – and at rates at which they would not have otherwise borrowed.

5.49 Reducing the need to use use-of-money interest to ensure compliance is one of the goals of the recently released *More time for business* discussion document. The document includes the following proposals:

- a voluntary withholding tax (via the banking system) on business income as a substitute for provisional tax, with taxpayers who used this option not facing use-of-money interest if they underpaid their tax during the year;
- provisional tax payments based on business turnover and made via the GST system, with no use-of-money interest applying; and
- allowing taxpayers to pool their provisional tax payments in a way that avoids penalties and reduces interest costs.

Remission of use-of-money interest

5.50 In rare circumstances, use-of-money interest can be remitted. Broadening the existing remission provisions is not feasible. There are considerable compliance and administrative costs associated with remission, and the effectiveness of the interest rules could be undermined if the remission provisions were extended. Remission of use-of-money interest should remain limited.

Part III

Other issues

Part III covers other significant issues identified in the current compliance and penalty rules.

Firstly, it discusses the recommendations made by the Committee of Experts on Tax Compliance on Inland Revenue's information-gathering powers.

It then looks at transfers of excess tax, breaches of standards by taxpayers with agents, capping the penalty for lack of reasonable care in some circumstances, and promoter penalties.

Chapter 6

INFORMATION-GATHERING POWERS

The Government's proposals

Section 16 of the Tax Administration Act will be amended to:

- allow documents to be removed from premises for copying;
- clarify that third parties can be required to give reasonable assistance in an investigation; and
- clarify who may be given authority to enter a taxpayer's premises.

Section 17 of the Tax Administration Act will be amended to:

- allow Inland Revenue to requisition records held by offshore entities controlled by a New Zealand resident;
- remove the words "necessary or relevant"; and
- give Inland Revenue the discretion to require documents to be sent to a specified Inland Revenue office.

Section 3 of the Tax Administration Act will be amended to make it clear that Inland Revenue can have access to computers and can copy information held on them.

Background

6.1 The information collected by Inland Revenue during normal return-processing activities is mainly designed for audit selection purposes but is inadequate for confirming a taxpayer's assessment or tax position. It is therefore necessary for Inland Revenue to gather more specific information for audit purposes. The Privy Council in *New Zealand Stock Exchange and National Bank of New Zealand* v *CIR*[18] confirmed the wide scope of Inland Revenue's information-gathering powers in relation to Inland Revenue's duty to ensure that assessable income is assessed and the relevant tax is paid.

6.2 Inland Revenue collects information from both the taxpayer who is under audit and from third parties who have information about the taxpayer or the taxpayer's business. Both taxpayers and third parties will necessarily incur some compliance costs as part of that information-gathering process. The Government aims to minimise costs arising from uncertainty and delay, by ensuring that the legislation clearly specifies Inland Revenue's powers to gather information.

[18] (1991) 13 NZTC 8,147.

6.3 A significant part of Inland Revenue's resources are devoted to audit. The Government is also concerned that uncertainty in legislation does not cause those resources to be wasted.

6.4 As pointed out in December 1998 by the Committee of Experts on Tax Compliance:

> *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.*[19]

6.5 Inland Revenue's main information-gathering powers are set out in sections 16 and 17 of the Tax Administration Act. They relate to powers to gain access to premises and to request information. Under the Act, it is an offence:

- to fail to provide information to Inland Revenue when required to do so by a tax law; and
- to obstruct an officer of the department in the exercise of his or her statutory duty.

Proposed reforms

6.6 The Committee of Experts made a number of recommendations to correct deficiencies in sections 16 and 17 of the Tax Administration Act. They noted that several of those deficiencies were highlighted in the evidence given at the Commission of Inquiry into Certain Matters Relating to Taxation (the Winebox inquiry).

6.7 The Government agrees with the recommendations made by the Committee of Experts. It proposes to enact those recommendations. It also proposes to clarify Inland Revenue's powers to enter a taxpayer's premises and the definition of "book and document".

Removing documents for copying

6.8 While section 16 confers on Inland Revenue full and free access to all premises to inspect and copy any books, documents or anything else that Inland Revenue considers necessary or relevant for tax purposes, it has no authority to remove documents for copying elsewhere.

[19] *Tax Compliance*, Committee of Experts on Tax Compliance, December 1998, paragraph 9.3.

6.9 The Committee of Experts noted that the current wording of section 16 could create problems in cases where it is not possible or practicable to make copies of documents on the taxpayer's premises, and that requisitioning them under section 17 raises a risk that the documents might be altered or destroyed. The Committee recommended that this be rectified by giving Inland Revenue the power to remove documents for copying.

6.10 Section 165 of the Customs and Excise Act 1996 and section 206 of the Fisheries Act 1996 are precedents for this type of power. Customs officers are permitted to remove documents for the purpose of making copies, and must return them as soon as practicable after copies have been made. Fisheries officers are permitted to remove documents for a reasonable time for the purpose of making copies.

6.11 To minimise disruption on those being audited, the Committee also recommended that documents removed for copying should be returned as soon as practicable.

Assistance from third parties

6.12 Under section 16(2), Inland Revenue has the authority to require the owner, manager, and current or former employees of any business that is being investigated to give reasonable assistance in an investigation or to answer questions relating to an investigation. There is uncertainty, however, over whether third parties – for example, a taxpayer's bank manager – are required to give reasonable assistance or answer questions.

6.13 The Committee recommended that section 16(2) be clarified. It commented that, in principle, third parties should be required to give reasonable assistance and answer questions because the information being sought can be "requisitioned" under section 17. Such a statutory requirement would also protect third parties from actions for breach of confidence or infringement of the Privacy Act 1993.

6.14 The Committee outlined two possible ways of clarifying section 16. The first is to replace the references to "investigation" and "investigated" with the words "inspection or investigation" and "inspected or investigated" respectively. The second option is to adopt the terminology used in the equivalent Australian legislation – that is, section 263 of the Australian Income Tax Assessment Act 1936. The Government prefers this latter option because it is concise and clear and unambiguously applies to third parties. The relevant Australian legislation is set out in appendix 2.

Authority to enter a taxpayer's premises

6.15 This issue was not raised by the Committee of Experts on Tax Compliance. It is included here as a result of the Government's own concerns.

6.16 It is necessary to obtain the taxpayer's consent or a judicial warrant before Inland Revenue officers can enter a taxpayer's private dwelling. Warrants specify the individual investigator who may enter the premises. Practical difficulties can arise if the investigation requires the involvement of other investigators or other parties, such as computer programmers or police. For example, a new investigator may be needed if the original investigator becomes ill.

6.17 One solution is to amend section 16 to allow warrants to authorise Inland Revenue officers, in general, and other persons, such as the police, whose assistance is considered necessary, to enter the taxpayer's dwelling. This solution would be consistent with the corresponding provisions in the Customs and Excise Act 1996 and the Fisheries Act 1996.[20]

6.18 The assistance of other persons (such as the police) may also be required during investigations on premises other than private dwellings. Although section 16 gives Inland Revenue or an authorised officer full and free access to these places for tax purposes, it is not clear whether the access extends to other persons. As a matter of practice, Inland Revenue officials will provide their name and verification of identity if asked.

6.19 Amending these provisions so that they are consistent with each other would reduce uncertainty and delay in the completion of audits.

Records of offshore entities controlled by New Zealand residents

6.20 A question arose during the Commission of Inquiry on whether section 17 could be used to require New Zealand residents who control offshore entities to produce the records belonging to those entities and held offshore for inspection.

6.21 Ordinarily, under section 17, Inland Revenue can require a person to produce for inspection any records under the control of that person. But there is uncertainty over the meaning of "control" and, in particular, over whether documents can be regarded as being under the control of a New Zealand resident simply because that resident has control of an offshore company which has those documents in its possession.

[20] See section 167 of the Customs and Excise Act 1996 and section 200 of the Fisheries Act 1996.

6.22 The Committee of Experts recommended that section 17 be amended to ensure that New Zealand resident individuals and companies can be required to produce such records for inspection in New Zealand. Although some parties at the Commission of Inquiry argued that these records were the property of the subsidiary company and that it should be the decision of the directors of that company whether or not to provide the records, the Committee of Experts reasoned that the overseas entities are under the control of New Zealand residents. In particular, the Committee noted that:

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.[21]

6.23 The Committee recommended that an aggregation test be used to determine whether an offshore entity is under the control of a New Zealand resident. The voting interests in the offshore entities held by persons associated with the New Zealand resident would be aggregated with the voting interests held by the New Zealand resident. This is similar to the test used to determine income attribution for controlled foreign companies.

6.24 To prevent foreign secrecy laws restricting the production of records in New Zealand, the Committee of Experts also recommended that those laws be ignored. They noted that such laws are an important reason for companies establishing subsidiaries in certain countries, and that Australia and the United States already have provisions for ignoring foreign secrecy laws.

"Necessary or relevant"

6.25 Information sought under section 17 must be "necessary or relevant for any purposes relating to the administration or enforcement of any of the Inland Revenue Acts". The Committee of Experts noted that this requirement is unnecessary because Inland Revenue must always act in good faith – and that removing the words "necessary or relevant" would not alter the principle behind this.

6.26 The Committee also noted that the wording in section 17 encouraged taxpayers to raise spurious arguments and to hinder legitimate investigations by Inland Revenue. It pointed to evidence, given at the Commission of Inquiry, of aggressive taxpayers slowing investigations by firstly asking why Inland Revenue considered certain information necessary or relevant and then stating that they did not have that information.

[21] *Tax Compliance*, Committee of Experts on Tax Compliance, December 1998, paragraph 9.17.

Sending documents to an Inland Revenue office

6.27 Section 17 does not allow Inland Revenue to require that documents be sent to a particular Inland Revenue office. The Committee of Experts noted that this was a minor deficiency, and recommended that it be rectified because it could be more efficient in some cases for documents to be sent to a particular Inland Revenue office.

Definition of book and document

6.28 The Committee of Experts suggested that the phrase "book and document" is defined in section 3 of the Tax Administration Act very widely and includes records stored electronically. The Government considers, however, that this should be made unambiguous.

6.29 Both the Customs and Excise Act 1996 and the Serious Fraud Office Act 1990 contain more up-to-date definitions of the word "document" which clearly include computers.[22] It is proposed to amend the definition of book and document in section 3 of the Tax Administration Act so that it is along the lines of these two other Acts. Inland Revenue would then have clear authority to access or remove computers for the purpose of copying the information they contain.

Specific issues for consultation

- Are restrictions needed on the power to remove documents for copying (other than returning them as soon as practicable)?
- What problems would New Zealand residents face in providing Inland Revenue with records held by their overseas companies?
- Is there a better test than the aggregation test (currently used for controlled foreign companies) to determine whether an offshore entity is under the control of a New Zealand resident?
- Are there any reasons for retaining the explicit requirement that information sought under section 17 should be "necessary or relevant"?
- Would a requirement that documents be sent to a particular Inland Revenue office create significant compliance costs?
- Are books and computers sufficiently different to require special conditions on Inland Revenue's powers to access or remove computers?

[22] "Document" is defined in section 2 of the Serious Fraud Office Act 1990 and section 2 of the Customs and Excise Act 1996.

Chapter 7

TRANSFERS OF EXCESS TAX

The Government's proposals

The legislation will be amended to authorise the transfer of excess tax paid by a taxpayer to another period or tax type of that taxpayer, or to certain other taxpayers – regardless of whether there is an outstanding liability for tax in that period. But the taxpayer must request the transfer, the tax must be refundable, and the tax must not have already been offset by Inland Revenue against an existing tax liability.

Background

7.1 Taxpayers who have overpaid their tax and are entitled to a refund may seek to have the excess credited against a past or future liability (of their own, or of another taxpayer) rather than having the excess refunded. This is commonly done to reduce exposure to use-of-money interest on underpayments of tax. Use-of-money interest on underpaid tax is currently payable by the taxpayer at the rate of 12.62 percent, whereas use-of-money interest is payable by Inland Revenue in respect of overpaid tax at the rate of 5.74 percent.

Issue

7.2 The legislation contains no comprehensive set of rules governing the transfer of overpaid tax by a taxpayer. In the absence of clear legislative rules, Inland Revenue has developed administrative guidelines. But there has been some inconsistency and confusion in the application of these as tax legislation has changed and the guidelines have become outdated.

7.3 In order to address this, Inland Revenue last year issued a draft practice statement which set out its administrative practice. This was later withdrawn, as submissions on the draft statement indicated that there was considerable disagreement about existing law. A number of the submissions complained about the lack of legislative clarity and proposed that matters such as the effective date of transfers be set out in legislation.

Proposed reform

7.4 The Government proposes that the legislation authorise Inland Revenue to transfer tax which has been overpaid by a taxpayer, and which is refundable. This excess tax will be able to be transferred to another period or tax type of that taxpayer, or to certain other taxpayers, provided that the taxpayer requests this and the tax has not already been offset by Inland Revenue against an existing tax liability.

7.5 Such transfers would be permitted regardless of whether there is an existing liability for unpaid tax. There is no reason to restrict these transfers.

7.6 The key issue in relation to transfers of excess tax is the effective date of transfer. This is because the effective date has an impact on the transferee's liability for use-of-money interest on underpayments of tax. It is proposed that the date of transfer differ, depending upon the person to whom the transfer is made.

Effective date (for transfers to other periods or taxes of the same taxpayer)

7.7 Taxpayers may ask that the excess tax be offset against a past underpayment to eliminate or reduce use-of-money interest that has already accrued on the underpayment. Alternatively, they may request Inland Revenue to apply the excess against some unspecified future liability that might arise – for example, underpayment of tax discovered on audit.

7.8 The Inland Revenue Acts, including the use-of-money interest rules, generally apply on an individual basis. A taxpayer who has paid the correct amount of tax overall should not be subject to use-of-money interest. Therefore no taxpayer should be required to pay use-of-money interest at 12.62 percent on underpaid tax while receiving use-of-money interest on overpaid tax at 5.74 percent. A taxpayer should be able to offset the excess tax against the underpayment to reduce exposure to interest at the higher rate.

7.9 For all excess tax paid directly by the taxpayer to Inland Revenue, the appropriate effective date for transfer will be any date the taxpayer chooses, but no earlier than the date the excess tax was paid. Taxpayers may then choose the date most advantageous to them.

7.10 "All excess tax paid directly by the taxpayer" includes overpayments of provisional and terminal tax, GST, fringe benefit tax, specified superannuation withholding tax, taxes deducted at source on behalf of another taxpayer (such as PAYE and resident withholding tax), and duties. It does not include excess tax deducted at source by a third party on their behalf.

Example

If a taxpayer overpays the 7 July provisional tax instalment, and the overpayment is not discovered until year end, the taxpayer can choose 7 July or any date after that as the effective date of transfer. If this taxpayer has underpaid GST on 31 July, then 31 July could be chosen as the effective date (in order to cancel use-of-money interest on the GST underpayment).

7.11 A refinement of the effective date rule is required for the two situations in which a taxpayer does not pay the tax directly to Inland Revenue. These are GST refunds and over-deduction of income tax at source. In the case of GST refunds, the taxpayer would choose the effective date – but the earliest possible effective date would be the first day after the end of the GST period in which the refund arose. In the case of income tax over-deducted at source on behalf of the taxpayer, the effective date would be the first day after the end of the relevant income year of the taxpayer.

Effective date (for transfers to other taxpayers)

7.12 A taxpayer may want to transfer excess tax to another taxpayer, rather than having it refunded. A common reason for this will be to reduce use-of-money interest that has already accrued in relation to an underpayment of tax by the other taxpayer.

7.13 As noted earlier, the Inland Revenue Acts generally, and the use-of-money interest rules in particular, apply to taxpayers on an individual basis. Taxpayers should, in principle, not be able to transfer an excess to cancel use-of-money interest payable by another taxpayer. In addition, to enable all taxpayers to do this would impose high administrative costs on Inland Revenue, as it would need to action requests and reissue statements of account to reflect the transfers and resulting cancelled interest.

7.14 A departure from the "individual" approach has been proposed for pragmatic reasons in the discussion document *More time for business*. The pooling proposal contained in that document enables taxpayers who have underpaid their provisional tax to offset the underpayment by utilising the excess provisional tax of another taxpayer. This may, however, be done only through a third party: this minimises the administrative costs that Inland Revenue would otherwise incur if taxpayers were able to transfer excess tax directly to other taxpayers. One intended benefit of pooling is to provide relief for businesses who are concerned about exposure to use-of-money interest on underpayments of provisional tax.

Other "related" taxpayers

7.15 A further departure from the "individual" approach is justified in circumstances where the inability to transfer tax to reduce exposure to use-of-money interest is widely perceived to be unfair. From discussions with interested parties, it has become clear this inability to transfer excess tax is considered to be unfair in two circumstances.

7.16 The first of these circumstances is where taxpayers are, or consider themselves broadly to be, one economic entity. Included here are companies in the same group, and family members within one degree of relationship (husband and wife, parent and child).

7.17 The second circumstance is where taxpayers share in an income stream and allocate income amongst themselves after the end of the income year. These taxpayers include shareholder/employees and companies, partners in a partnership, and family trusts and beneficiaries.

7.18 The effective date for transfers to another taxpayer will therefore be the same as that proposed in paragraphs 7.9 to 7.11, in circumstances where there is a transfer of excess tax between:

- family members within one degree (for example, husband and wife);
- companies in the same group (where the members of the group are at least 66 percent commonly owned);
- shareholder/employees and companies;
- partners in the same partnership; or
- family trusts and beneficiaries.

7.19 Family trusts would be defined as trusts established primarily to benefit:

- natural persons for whom the settlor has natural love and affection; or
- charities.

Other "unrelated" taxpayers

7.20 The effective date for transfers to all other taxpayers will be able to be chosen by the transferor – but this date must be on or after the later of:

- the date of the request; or
- the date on which the relevant return is filed.

7.21 It is appropriate to allow taxpayers to transfer to unrelated parties provided the proposed effective date applies. In these cases a transfer to another taxpayer is simply a short-cut for what would otherwise happen: a refund of tax to the overpaying taxpayer, and then a transfer of funds from that taxpayer to a person who uses them to pay tax that is due or may become due. Allowing such transfers to be made reduces taxpayers' compliance costs, ensures the Government receives the tax, and does not increase administrative costs of Inland Revenue.

Application

7.22 If the proposed rules are supported in submissions they will apply to transfers of:

- excess income tax (including provisional tax) paid for the 2002-03 and subsequent income years;

- excess tax paid for earlier income years where the excess is discovered on an assessment made after the date of enactment of amending legislation;
- excess GST on supplies made in taxable periods beginning on or after 1 April 2002; and
- excess fringe benefit tax and excess duties paid on or after 1 April 2002; and
- tax deducted on behalf of another taxpayer and paid on or after 1 April 2002.

Specific issue for consultation

The Government welcomes submissions on its proposals – and, in particular, on whether there are other taxpayers who should be included in the list of those able to transfer excess tax as at the dates referred to in paragraphs 7.9 to 7.11.

Submissions on this chapter are required by 21 September 2001.

Chapter 8

TWO FURTHER ISSUES RELATING TO SHORTFALL PENALTIES

The Government's proposals

- A shortfall penalty will be imposed in all cases of lack of reasonable care and gross carelessness, irrespective of who breached the standard of care.
- In all cases, the shortfall penalty will be imposed on the taxpayer.
- A $50,000 cap will be introduced on the shortfall penalty for lack of reasonable care, in cases where the shortfall is identified within a two-month period through voluntary disclosure or an Inland Revenue audit.

Taxpayers with agents and breaches of standards of care

Background

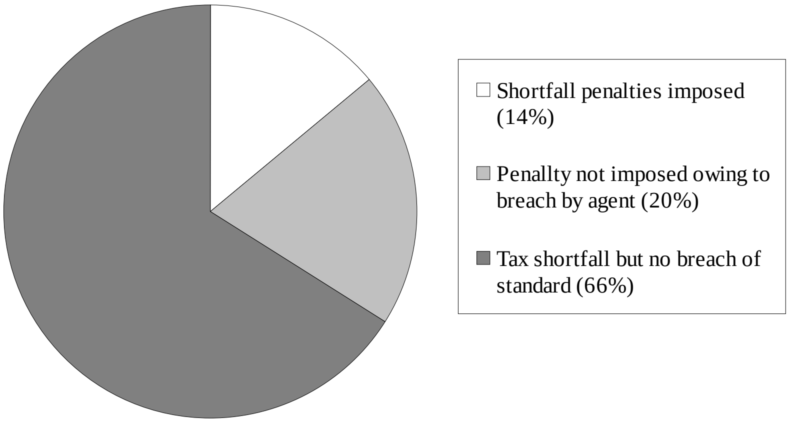
8.1 The cornerstone of the compliance and penalties legislation is a standard of reasonable care. A taxpayer who has relied on the advice of a tax agent will usually be considered to have taken reasonable care, regardless of the care taken by the tax agent. In other words, if a tax agent does not take reasonable care and this results in a tax shortfall, then no shortfall penalty is imposed on either party. This is also true if a tax agent is grossly careless.

8.2 Legislation does not, and should not, require taxpayers or their agents to be right in everything they do. The current approach, however, clearly allows agents to take less than reasonable care in a client's tax affairs. Inland Revenue statistics show that, for audits completed in the 2000-01 year, for approximately 20 percent of tax shortfalls no penalty was imposed solely because that shortfall was attributed to a tax agent's lack of reasonable care or gross carelessness. (By comparison, penalties are imposed in approximately 14 percent of shortfalls, and there is no penalty imposed in the remaining 66 percent of shortfalls.) These statistics are illustrated in Figure 4.

8.3 The issue does not extend to breach of standards through an abusive tax position or evasion because these breaches require intent on the part of the taxpayer. Nor does it extend to unacceptable interpretation: a recent decision by the Taxation Review Authority confirms this.[23]

[23] Case U47 (2000) 19 NZTC.

FIGURE 4:
TAX SHORTFALLS



Issue

8.4 The current position clearly has problems. Not penalising these instances of lack of reasonable care and gross carelessness is unfair on taxpayers and agents who do manage their tax responsibilities correctly. It also means there is little incentive for tax agents to take care – so that those who currently breach standards have no reason to improve their performance. Furthermore, the current approach encourages less honest tax agents to report errors by their clients as their own, thus ensuring that their client avoids a shortfall penalty. The overall effect is to erode the standards expected of taxpayers, endanger voluntary compliance, and decrease revenue.

8.5 One of the advantages to a taxpayer from employing a tax agent should be a significantly reduced risk of penalties as a result of the care and skill of that tax agent. In fact, the reverse is true: there is an incentive to employ tax agents who take less care and so can offer a lower (but incorrect) tax liability.

8.6 Many agents are members of professional organisations that require their members to maintain certain minimum professional standards – so these standards and the professional integrity of the organisations' members should mitigate such concerns. But not all tax agents are members of professional organisations, and the Government wants to ensure that the accountability practised by responsible tax agents is extended to all tax agents. Tax agents who incur costs to maintain standards should see that those who do not are penalised.

Reasonable care by agents is not an excessive standard

8.7 The standard of reasonable care has been designed so that it is not excessive for taxpayers or their agents. Not every tax shortfall by a tax agent arises from lack of reasonable care. But if, for example, an agent preparing a taxpayer's accounts was given two cashbooks but included the entries from only one of those cashbooks in the taxpayer's accounts, a shortfall penalty should be imposed.

8.8 Nor does repeating the same error necessarily indicate a lack of reasonable care. This would depend on – for example – the size of each error, the type of error, and whether the errors are simultaneous or consecutive.

Options

8.9 The Government has identified four possible ways of ensuring that agents have incentives to take care:

- Inland Revenue makes a determination as to who is responsible for the breach of the standard of care and therefore on whom the penalty should be imposed;
- the penalty is imposed on taxpayers if either they or their tax agent breaches a standard of care;
- the penalty is imposed on agents if either they or their client breach a standard of care; or
- half the penalty is imposed on the taxpayer and the other half imposed on the agent.

8.10 All these options have advantages and disadvantages. There is no clear and easily identified best option.

Option one: Determination of liability by Inland Revenue

8.11 This would appear to be the fairest solution, but it has some practical difficulties: Inland Revenue may be unable to determine who was at fault, or the taxpayer or the agent may disagree with Inland Revenue's finding. For example, if trading stock of significant value is not included in a taxpayer's tax return at year end, the taxpayer may argue that the information was provided to the agent and the agent may argue that it was not. Moreover, there is an incentive for the agent and taxpayer to disagree, as the penalty would not be imposed until there is agreement on the facts.

8.12 It may be impossible for Inland Revenue to determine fault in a case like this. So there is a significant risk that, under this option, a tax shortfall arising from lack of reasonable care or gross carelessness may go unpenalised.

8.13 This option is not practical.

Option two: Taxpayer liable in all cases

8.14 The second option makes the taxpayer liable for all shortfall penalties, even if the tax position giving rise to the penalty relates to failure by the agent.

8.15 This option recognises that the error relates to a tax shortfall of the taxpayer, not the agent. The fact that the tax position arose from a breach by the agent does not change that. So it is consistent with the treatment in all other instances of non-compliance – that is, the taxpayer is penalised.

8.16 Furthermore, this approach is administratively much simpler. It does not require Inland Revenue to have information about the agent's tax advice or the taxpayer/agent relationship. The penalty can be included in the taxpayer's tax liability and can be paid through existing payment mechanisms.

8.17 Imposing the penalty on the taxpayer has a number of disadvantages:

- It may penalise a taxpayer for an agent's breach over which the taxpayer may have no practical control. The reason the taxpayer has employed an agent is often the taxpayer's lack of tax knowledge, which means they are often in a poor position to identify where an agent has not taken reasonable care or has been grossly careless.
- It is costly and difficult for taxpayers to take legal action against a negligent agent. This acts as a disincentive for taxpayers to gain compensation from their agent (unless the size of the penalty is very large). It also reduces the incentives on an agent to take care – which is the reason the penalty is imposed in the first place.
- The possibility exists for agents to contract out of liability for their own negligence. Thus the taxpayer would have no opportunity to pass on any of the penalty.

8.18 The principal risk with this option is that taxpayers may bear the cost of an agent failing to take care. This undermines the incentive for agents to maintain reasonable standards. To counter this, the option may need to be strengthened: the taxpayer could be given an explicit right to sue the agent in cases where a penalty results from the agent's negligence. This would override any contract between the taxpayer and the agent.

8.19 Australia has such a provision, which states that an agent is liable for any fine or penalty incurred by the taxpayer through the negligence of the agent and that the taxpayer is entitled to sue for the amount of the penalty. The provision also confirms that the taxpayer is not exonerated from the original liability for the penalty.

8.20 Even if the legislation confirmed the right of the taxpayer to take legal action, it is costly for taxpayers to do this. Therefore this option may only be feasible if reputable and professional tax agents accept the liability for penalties when they are at fault. The Government recognises that a willingness to accept liability may take time to develop and it welcomes submissions on this matter.

8.21 This is the Government's preferred option.

Option three: Agent liable in all cases

8.22 Under this option, a shortfall penalty would be imposed on the tax agent in all cases – even if the taxpayer was the one not taking care.

8.23 The advantages of imposing the penalty on the agent are:

- Agents would be penalised for their own breaches.
- The agent has the knowledge and ability to determine who was actually responsible for the breach and, if necessary, could sue the taxpayer in cases where the taxpayer was responsible.
- A focus on the agent may lead to better-targeted Inland Revenue education and enforcement efforts, as one agent represents many taxpayers.

8.24 The disadvantages of imposing the penalty on the agent are:

- Agents would be penalised for taxpayers' breaches – although, to some extent, the tax expertise of an agent allows that agent to monitor clients and minimise this risk.
- It would be inconsistent with common law, which requires that responsibility for an agent's actions lies with the principal.
- Agents may no longer wish to deal directly with Inland Revenue on behalf of their clients, because doing so will risk a penalty being imposed. The removal of the close relationship between tax agents and Inland Revenue would significantly increase compliance and administrative costs.
- It would be inconsistent with the penalty for unacceptable interpretation (which is currently imposed on the taxpayer where the breach is the result of an agent's incorrect advice). But this is not a significant disadvantage: consistency could instead be achieved by making agents responsible for any shortfall penalties for unacceptable interpretations.
- Penalties are regarded as tax. Imposing the penalty on the agent would therefore require a separate system for billing and for policing non-payment.

- Difficulties could be experienced in attributing responsibility for the breach. If an agent is an employee of a large firm, who should be penalised – the firm or the individual employee?

8.25 On balance, the Government considers the net benefits of this option are less than the benefits of imposing penalties on taxpayers. This, however, is the Government's second most preferred option.

Option four: Both parties liable in all cases

8.26 A final option would be to hold both taxpayer and tax agent liable for 50 percent of any penalty imposed for lack of reasonable care or gross carelessness.

8.27 The principal advantage of this option is its apparent fairness. The two parties who work together in preparing the tax return would have a penalty imposed.

8.28 The disadvantage of this approach is that it encompasses all the disadvantages of options two and three. A further disadvantage arises from the likelihood that, in cases of a large shortfall penalty, both parties would commence litigation as both would consider the imposition of the penalty inequitable.

Proposed reform

8.29 In all cases where a standard of care is breached, a shortfall penalty should be imposed. The principal issue is on whom the penalty should be imposed.

8.30 Determining on whom the shortfall penalty should be imposed is a difficult issue. On balance, it would appear that a better outcome would be achieved by imposing the penalty on the taxpayer (option two) rather than on the agent (option three). The sustainability of this option, however, depends on agents taking responsibility for their actions. If this is not the case, the Government considers the next best option is seeking to hold the agent directly responsible (option three).

8.31 Options one and four are not seen as feasible.

8.32 Option two is consistent with the application of other penalties, and has low compliance and administrative costs. Consultation with tax practitioners indicated that reputable agents currently accept culpability for late payment penalties, late filing penalties and use-of-money interest, and this practice would naturally extend to penalties for shortfall penalties.

Specific issues for consultation

- If a taxpayer employs an agent and a standard of care is breached, on whom should the shortfall penalty be imposed?
- If option two is taken, how likely is it that the penalties will be borne ultimately by the culpable party?
- Given that reputable agents currently resolve issues of culpability for other penalties and use-of-money interest, is an amendment to provide taxpayers with a right to sue necessary?

Additional issue: A cap on the penalty for lack of reasonable care

Background

8.33 Where a tax shortfall is large, the corresponding shortfall penalty is also large. In most cases this is appropriate – but the Government is concerned about the application of the lack of reasonable care penalty to very large errors which are speedily identified and corrected. For example, a business taxpayer under-calculates their GST outputs by $45 million and, because no systems were in place to identify this shortfall, the under-calculation results in unpaid GST of $5 million. Inland Revenue identifies the shortfall and determines a lack of reasonable care: the penalty is $1 million.

8.34 Given the nature of the breach, the Government considers the size of the penalty in such cases to be excessive.

Proposed reform

8.35 A monetary cap on the shortfall penalty for lack of reasonable care will be introduced. Such a cap would ensure that the penalty for such breaches is not out of step with other monetary penalties imposed under the Tax Administration Act. In addition, a cap is likely to reduce compliance and administrative costs as taxpayers will have less incentive to dispute the imposition of a penalty they consider unfair.

8.36 The cap will be set at $50,000 per tax position, which equates to the maximum criminal penalty imposed under the Income Tax Act. Taxpayers who deliberately attempt to abuse the existence of this cap will risk incurring the uncapped gross carelessness penalty (set at 40 percent of the shortfall). To ensure that taxpayers still have an incentive to take reasonable care over very significant tax positions, the cap will be limited to those shortfalls identified through voluntary disclosure or Inland Revenue audit within two months of filing the return.

Chapter 9

PROMOTER PENALTIES

The Government's proposals

A penalty will be imposed on promoters of tax investment schemes, in cases where:

- the investment breaches an anti-avoidance provision; or
- the investment leads to the investor having a shortfall penalty for an abusive tax position.

Background

9.1 If a taxpayer becomes a party to a tax investment scheme offered by a promoter and the scheme is considered by Inland Revenue to constitute tax avoidance, then a shortfall penalty (for abusive tax position) is imposed on the taxpayer. No penalties are imposed on promoters of the scheme. The compliance and penalties legislation therefore provides no incentive for investment promoters to ensure that the tax effects they claim for their schemes are correct. Furthermore, offer documents in some cases restrict taxpayers from taking legal action against the promoter.

Issue

9.2 Promoters of tax avoidance schemes should be held clearly accountable for their actions.

9.3 The promoter is usually the party with the greater knowledge of the scheme's tax effects. Often, the true tax impact of a scheme may be determined by features that the promoter is aware of but the investor is not. These undisclosed features may mean the scheme constitutes tax avoidance, and may place the investor at risk of significant penalties.

9.4 This chapter outlines measures aimed at reducing both the marketing of, and investment in, tax avoidance schemes. Although the discussion here focuses on income tax, the measures will apply to all taxes.

Options

9.5 The Government has identified three ways of amending the current penalty rules:

- increasing the penalty on investors in tax avoidance schemes;

- imposing a penalty on promoters of tax avoidance schemes; and
- combining the above – that is, imposing a penalty on promoters *and* increasing the penalty on investors.

9.6 In considering these options, the Government has taken into account the following:

- that one party – the promoter – is better placed to know whether a scheme constitutes tax avoidance;
- that those who participate in tax avoidance should be in no doubt that tax avoidance is not acceptable, and that penalties must be imposed at the minimum level necessary for achieving this outcome; and
- that compliance and administrative costs must be minimised.

Option one: Increasing the penalty on investors

9.7 The advantages of increasing the penalty on investors are that it further discourages investors from engaging in tax avoidance, and that it uses existing penalty mechanisms to do this.

9.8 There are, however, a number of disadvantages with this option:

- The investor may not be aware of the features in the scheme that constitute tax avoidance. Increasing the penalty does not give the investor the information necessary for distinguishing between a tax avoidance scheme and a legitimate investment.
- An increased penalty increases the risk that investors will shun legitimate schemes if they are unable to discern which schemes are legitimate and which are not. This creates inefficiencies in the economy.
- Penalties must be commensurate with the level of offence committed. The shortfall penalty for an abusive tax position is currently 100 percent of the tax shortfall. Increasing this rate could result in penalties not being applied, or in a lesser penalty (such as unacceptable interpretation) being imposed in the place of the correct penalty.

9.9 Increasing the level of the penalty on investors would result in investors facing penalties in excess of their offence. Furthermore, enforcement of these increased penalties is likely to be unacceptable to society. This option is not feasible.

Option two: Introducing a penalty on promoters

9.10 Currently, the Tax Administration Act penalises taxpayers for failure to meet certain standards. The concept of penalising a promoter as well as a taxpayer represents a significant shift in the approach of the current penalty rules.

9.11 Nevertheless, the option of penalising the promoter should be considered, for the following reasons:

- Such a penalty is practical and feasible. The promoter is usually in a position to determine both the quantum of the investment and the tax impact of that investment.
- The introduction of penalties for a group which currently faces no penalties is more likely to lead to improvements in voluntary compliance than an increase in penalties for another group which already faces penalties.
- Schemes designed by promoters typically involve many taxpayers. Penalising a scheme's promoter has the potential to reduce tax avoidance across many taxpayers. A promoter penalty is an "efficient" and well targeted way of discouraging tax avoidance.
- The promoter plays a much more significant role than an advisor does. That role is sufficient to move a promoter from simply "advising": the promoter becomes an active participant in tax outcomes.

9.12 The advantages of this option are:

- As the promoter is usually more aware than the investor of the tax effects of the scheme, imposing a penalty on promoters is more likely to result in improvements in compliance.
- A penalty on promoters will give the promoter of a scheme an incentive to ensure that the scheme does not constitute tax avoidance. This is likely to have two effects:
  - The number of schemes promoted simply for tax reasons rather than for any true economic benefits would reduce. Voluntary compliance would therefore be increased. In addition, investments would be made on the basis of their true economic return rather than their putative tax advantage.
  - Promoters would be encouraged to take more care in determining the tax impact of their schemes. For example, they could make increased use of binding rulings to provide more certainty about the tax effects of the scheme. A request for a binding ruling would give the Government the opportunity to amend legislation, and so close any loopholes more quickly than it can now.

9.13 The disadvantages of introducing a penalty on promoters are:

- It may be seen as weakening the principle that taxpayers have sole responsibility for their tax return. However, it is worth noting that this responsibility would not diminish and that promoters and investors often "act as a team" in exploiting tax avoidance opportunities.
- The penalty may not be able to be enforced in situations where a promoter uses a "straw man" or becomes non-resident.

Option three: Introducing a penalty on promoters and increasing the penalty on investors

9.14 For the reasons outlined earlier, the Government does not consider it equitable to increase the penalties on investors. Those same reasons still apply even if the penalties are increased to a lesser extent, or if matching penalties are also imposed on promoters of tax avoidance schemes. This option is therefore not acceptable.

Proposed reform

9.15 The Government has concluded that the introduction of a penalty on promoters of tax avoidance schemes is the best way to ensure that they are held clearly accountable for their actions.

9.16 The penalty would apply if a scheme breaches an anti-avoidance provision or if it results in an investor having a shortfall penalty for an abusive tax position.

9.17 Imposition of the penalty would not, however, depend on the successful imposition of a penalty on the investor. So, if a taxpayer disputed the imposition of a shortfall penalty, imposition of the promoter penalty would not be delayed.

9.18 The promoter penalty would generally be imposed as one penalty – but if additional taxpayer shortfalls were detected, further penalties would be imposed. In effect, the penalty on the promoter would be based on the extent of tax shortfalls generated by the scheme. This would ensure that the promoter faced a penalty that reflected the total tax impact of the scheme.

9.19 To prevent disputes about the rate of tax to be used to determine the tax shortfall, a flat rate of 39 percent would be used. Investors in these schemes are typically high-income earners, and so the use of the 39 percent rate would be appropriate. The penalty imposed would depend on the standard breached by the taxpayer. For example, if shortfall penalties were imposed because of an abusive tax position on the part of the taxpayer, then the promoter would be treated as committing the same offence.

9.20 The reductions that apply to voluntary disclosures of shortfalls would apply.

9.21 A fixed penalty was considered and rejected. For larger schemes, a fixed penalty would simply be treated as part of the expenses of the scheme – and so would neither increase voluntary compliance nor adequately penalise the promoter. Setting a very high fixed penalty (to ensure that the penalty would be effective even in the most blatant cases of avoidance) would result in excessive and unfair penalties in most instances.

Specific issues for consultation

- Is a new penalty on promoters of tax avoidance schemes (rather than increased penalties on investors) the best way of combating such schemes?
- Should the penalty on promoters be proportionate to the total tax impact of the promoter's scheme?

Appendices

Appendix 1

TERMS OF REFERENCE FOR THE REVIEW OF THE COMPLIANCE AND PENALTIES LEGISLATION

The review is to assess how well the compliance and penalties legislation is achieving its objectives, which encompass being:

1. effective in deterring non-compliance and encouraging remedial action;
2. understandable and fair, and perceived as such;
3. appropriately flexible and consistent; and
4. consistently administered.

The review will identify areas where improvements can be made to better achieve the objectives of the compliance and penalties legislation.

In relation to the objectives above, the review will consider the following issues:

Effective in deterring non-compliance and encouraging remedial action

- Whether there has been any change in compliance behaviour caused by the new legislation.
- Whether a past record of "good behaviour" should be taken into account when deciding whether to impose a penalty, and if so how; whether the Inland Revenue Department needs to exercise a greater degree of flexibility when applying shortfall penalties; whether shortfall penalties should apply when it is determined that the taxpayer has made an inadvertent error.
- Whether the legislation sets standards clearly. For example, what constitutes "lack of reasonable care" or "unacceptable interpretation"? How late filing penalties, late payment penalties and shortfall penalties are applied, including whether the levels of late filing penalty are appropriate given the different taxpayer groups. Whether the rates of shortfall penalties are appropriate, by being fair while deterring non-compliance and encouraging remedial action. Whether the standards imposed on agents are appropriate.
- In relation to sections 16 and 17 of the Tax Administration Act 1994, whether:
    - 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.

- The method by which use-of-money interest is calculated to determine whether changes which can be made to the interest rates for overpayments and underpayments in order to reduce the differential between the rates are appropriate.
- Whether there are circumstances that require relief from the use-of-money interest rules.
- In relation to write-offs, whether there should be a time limit on the reinstatement of a debt; whether, if the present policy continues, the term “write-off” should be replaced by wording that more accurately describes the policy (for example, “provisional write-off”); whether it is necessary for the write-off provisions to be contained in the Inland Revenue Acts.
- Whether there should be no penalties for voluntary disclosures.
- The criteria for entering into instalment arrangements, reporting to the Government on the matter.
- Whether there should be the option of having an annual GST return based on figures from the financial statements, with GST payments during the year being regarded as provisional. In the case of GST returns it may only be when the annual accounts are completed that GST errors are identified. Taxpayers are potentially exposed to penalties.
- Whether Inland Revenue should be required to reinforce internally and publicly the principle that if a taxpayer (or advisor) has not interpreted the legislation a penalty for unacceptable interpretation cannot apply.
- Whether there should be penalties on temporary shortfalls.
- The wider remission powers of the Commissioner in respect of use-of-money interest to cover the situation where the taxpayer did not have the benefit of the use of the funds or no economic benefit was gained; the Commissioner's split rate approach and its validity.

Understandable and fair, and perceived as such

- Whether the fairness of the penalties provisions is apparent to all taxpayers, and taxpayers that comply can see that those who do not comply are adequately penalised.
- Whether the Government's performance expectations of taxpayers are reasonable.
- Whether the debt hardship and instalment arrangement provisions are adequate and the rules for offsetting overpayments or tax credits against underpayments or tax debits are adequate.

- Whether the Tax Administration Act 1994 should be amended to provide a clear, four-year time bar in relation to all taxes except where the Commissioner of Inland Revenue has reasonable grounds to suspect a return to be fraudulent or wilfully misleading.
- The process by which assessments can be challenged, in particular considering whether a time limit should be placed on the Commissioner of Inland Revenue when addressing a taxpayer's Notice of Response.
- 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 required 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.
- Whether incentives could be provided to taxpayers to ensure that they pay off their debt in the shortest timeframe they can afford. For example, the use-of-money interest rate could reflect the term of the instalment arrangement.
- Whether the remission provisions can be applied to companies.

Appropriately flexible and consistent

- Whether the legislation minimises compliance costs where possible and is consistent with the proposals in the discussion document *Less taxing tax.*
- The extent of any lack of consistency in the application of the compliance and penalties legislation, owing to unclear or uncertain legislation.
- Whether there should be more flexibility in considering remission and hardship.
- Whether Inland Revenue should be required to develop an administrative solution to the problem whereby a taxpayer claiming GST in the wrong entity may be harshly penalised, despite there being no economic disadvantage to the Government (or advantage to the taxpayer); whether such administrative measure then requires to be embodied in the law by a suitable legislative change.

Consistently administered

- Whether the penalties legislation and administrative practices complement the efficient operation of the tax system, are practicable and aim to keep compliance and administrative costs as low as possible; whether the compliance and penalties legislation is integrated with various initiatives such as Inland Revenue's Audit 2000 and self-assessment projects.
- The extent of any lack of consistency in Inland Revenue administration. A separate report from the Operations Group will be sent to the Government outlining any administrative issues identified and the priorities in finding solutions.

Appendix 2

AUSTRALIAN INFORMATION-GATHERING POWERS

The Australian equivalents of Inland Revenue's information-gathering powers are sections 263, 264 and 264A of the Income Tax Assessment Act 1936. Section 263 relates to access to books and premises, section 264 relates to information and evidence, and section 264A is about related international issues.

It is proposed in chapter 6 that section 16 of the Income Tax Act 1994 be amended to adopt the terminology used in the equivalent Australian legislation – section 263 of the Income Tax Assessment Act 1936.

Section 263 of the Income Tax Assessment Act 1936 (Australia)

(1) The Commissioner, or any officer authorized 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.

(2) An officer is not entitled to enter or remain on or in any building or place under this section if, on being requested by the occupier of the building or place for proof of authority, the officer does not produce an authority in writing signed by the Commissioner stating that the officer is authorized to exercise powers under this section.

(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.