Tax penalties, tax agents and disclosures

A government discussion document

Hon Dr Michael Cullen
Minister of Finance

Hon Peter Dunne
Minister of Revenue

First published in October 2006 by the Policy Advice Division of the Inland Revenue Department,
PO Box 2198, Wellington.

Tax penalties, tax agents and disclosures: a government discussion document.
ISBN 0-478-27142-5

CONTENTS

Chapter 1

INTRODUCTION

1.1 Because New Zealand's tax system relies on self-assessment, rules are necessary to encourage taxpayers to file their tax returns on time, to pay on time and, as far as possible, to correctly calculate their tax liabilities. For the system to work, it is vital that those who do not comply with the rules are seen to face the consequences. It is also important that the penalties that result when someone has not complied with the rules are in keeping with the severity of the offence.

1.2 Many taxpayers employ a tax agent to help them in meeting their tax obligations. The services that tax agents provide to their clients have a significant influence on raising voluntary compliance levels and reducing compliance and administrative costs.

1.3 This discussion document examines the current compliance and penalty rules, and identifies several areas where the rules could be clearer, more consistent and better targeted to encourage voluntary compliance. It discusses options for the relaxation of penalties when taxpayers have genuinely and consistently tried to do the right thing. The discussion document also proposes that, in future, in order to recognise a person as a "tax agent" the Commissioner must be satisfied that treating a person as a tax agent is consistent with the protection of the integrity of the tax system.

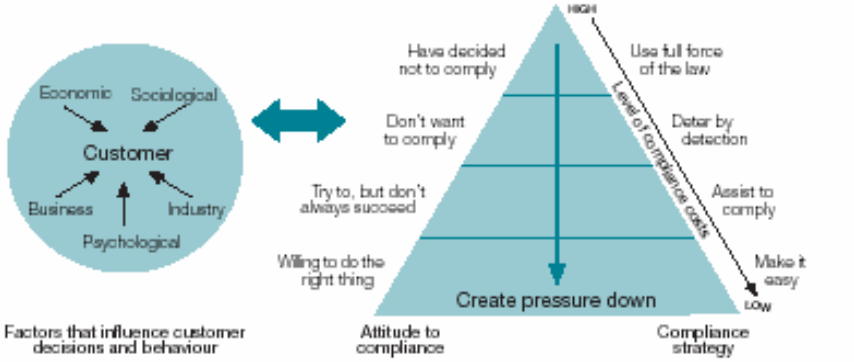
Inland Revenue's compliance model

1.4 Figure 1 illustrates the "compliance model" that Inland Revenue uses to determine how to respond to various levels of compliance and non-compliance.

1.5 Inland Revenue applies this model to promote a tailored response to the way taxpayers behave. It takes into account the external factors that influence taxpayers' attitudes and behaviours, and how these differences direct Inland Revenue's approach to improving compliance.

1.6 A key concept of the model is that most taxpayers are either willing to "do the right thing", or try to comply, but do not always succeed. For these taxpayers the appropriate response is to make compliance easier, or to help them comply. At the other end of the compliance spectrum, when people deliberately do not comply, suitable sanctions are needed. Enforcing the law helps maintain overall taxpayer confidence in the tax system and encourages ongoing compliance. When enforcing the law, the approach taken should encourage taxpayers to comply voluntarily in the future.

Figure 1: The compliance model



Source: Our way forward 2006-2011

1.7 When taxpayers do not file their returns on time, late filing penalties of $50 to $500 may apply. When a payment is not made on time, late payment penalties apply. The initial late payment penalty is imposed in two stages – 1 percent the day after the due date and 4 percent six days later. If payment is not made, incremental late payment penalties of 1 percent are imposed each month that the amount remains unpaid. If taxpayers do not accurately calculate their tax liabilities, shortfall penalties of 20 to 150 percent may be imposed. Shortfall penalties are imposed when a required standard of behaviour has been breached. The basic standard required is that taxpayers must take reasonable care. Use-of-money interest, while not a penalty, also applies to under-payments and over-payments.

Purpose of this discussion document

1.8 This discussion document reviews some aspects of tax penalties and associated legislation, based on the compliance model and the following principles:

- the scope of certain penalties is made clearer, especially those for not taking reasonable care and taking an unacceptable tax position;
- the role of tax agents is clarified in relation to compliance and the tax system generally, both now and in the future;
- there is better recognition of compliant behaviour, including voluntary disclosures; and
- the importance of on-time filing and payment in the compliance model.

Summary of proposals

Tax agents

Currently, anyone can be treated as a tax agent if he or she meets the requirements in the Tax Administration Act 1994 of being "a person who prepares the returns of income required to be furnished for 10 or more taxpayers and who –

(a) Carries on a professional public practice; or
(b) Carries on any business in which returns of income are prepared*;* or
(c) Is the Maori Trustee".

The proposals add a requirement that the Commissioner must be satisfied that treating a person as a tax agent is consistent with the protection of the integrity of the tax system.

Tax agents and the shortfall penalty for not taking reasonable care

The legislation will prescribe the circumstances when a shortfall penalty for not taking reasonable care may be imposed even when taxpayers have used a tax agent. The circumstances will include:

- failing to provide adequate information to the agent;
- failing to provide adequate instructions to the agent;
- unreasonably relying on an agent or advisor; and
- having had a tax shortfall previously which concerned the same error or action.

Refining the scope of the unacceptable tax position shortfall penalty

GST and withholding-type taxes will be removed from the scope of the unacceptable tax position shortfall penalty. The unacceptable tax position shortfall penalty will apply only to tax positions taken in respect of income tax.

The thresholds for assessment of the unacceptable tax position shortfall penalty will be increased. They will apply when the tax shortfall arising from the taxpayer's tax position is more than both $50,000 and 1 percent of the taxpayer's total tax figure for the relevant return period.

Improving recognition of good compliance

Inland Revenue will notify a taxpayer the first time their payment is late rather than imposing an immediate late payment penalty. However, if payment is not made by a certain date the penalty will be imposed.

The late payment penalty legislation relating to the employer monthly schedule will be clarified.

Shortfall penalty for not taking reasonable care or taking an unacceptable tax position will not be imposed when a tax shortfall is voluntarily disclosed (before notification of a pending tax audit or investigation). This proposal will apply to voluntary disclosures made within two years of the tax position being taken.

A new graduated penalty to replace the current shortfall penalty in relation to PAYE will apply when an employer has filed an employer monthly schedule but not paid the PAYE. Inland Revenue will contact the employer and, if payment or an arrangement for payment is not made, a 20 percent penalty will be imposed, reducing to 10 percent if the employer pays the outstanding PAYE within one month of the penalty being imposed. The penalty will not exceed in total any penalty that could be charged under the current rules.

Improving GST filing

The late filing penalty will be extended to GST returns that are not filed by the due date. This will:

- provide an incentive for returns to be filed by the due date;
- reduce the number of default assessments issued to taxpayers and hence reduce potential tax liabilities, which may in some cases bear little resemblance to the amount that should be payable; and
- create more fiscal certainty for the government as a result of fewer default assessments.

Other changes to the penalties rules

The abusive tax position shortfall penalty threshold will be repealed.

For temporary shortfalls to which a 75 percent reduction in the shortfall penalty applies, the legislation will clarify that a tax shortfall has been permanently reversed or corrected if it appears from the taxpayer's actions or through operation of law that the shortfall will be remedied. For a shortfall to be temporary, it must be permanently reversed or corrected within two years of the tax position being taken.

The Commissioner will be able to treat return periods that overlap as the same return period for associated taxpayers, allowing a tax refund to be used to reduce an associated person's tax shortfall.

The proposals outlined in the discussion document *Options for dealing with industry-wide tax evasion* will be dealt with at the same time as the issues in this discussion document.

Application dates

Resulting changes will apply from the date of their enactment, with the exception of those that will require Inland Revenue to alter its electronic systems, in particular, PAYE penalty and the GST late filing penalty.

How to make a submission

1.9 Submissions on the proposed changes close on 30 November 2006.

1.10 Submissions should be sent to:

Compliance and penalties project
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
P O Box 2198
Wellington
New Zealand

1.11 Alternatively, submissions can be made in electronic form, in which case "Compliance and penalties project" should appear in the subject line. The electronic address is policy.webmaster@ird.govt.nz

1.12 Please note that submissions may be the subject of a request under New Zealand's 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 there is any part of your submissions that you consider could properly be withheld under that Act (for example, for reasons of privacy), please indicate this clearly in your submission.

Chapter 2

TAX AGENTS

Summary of proposals

Currently, anyone can be treated as a tax agent if he or she meets the definition in the Tax Administration Act 1994 of being "a person who prepares the returns of income required to be furnished for 10 or more taxpayers and who –

(a) Carries on a professional public practice; or
(b) Carries on any business in which returns of income are prepared; or
(c) Is the Maori Trustee".

The proposals add a requirement that the Commissioner must be satisfied that treating a person as a tax agent is consistent with the protection of the integrity of the tax system.

2.1 Many taxpayers employ a tax agent to help them in meeting their tax obligations. The services that tax agents provide to their clients have a significant influence on raising voluntary compliance levels and reducing compliance and administrative costs. Currently, more than 4,500 tax agents are registered with Inland Revenue, representing more than 1.7 million taxpayers.

2.2 The current legislation recognises the importance of this role by providing tax agents with an extended period of time in which to file their clients' income tax returns and extending by two months the terminal tax date for taxpayers linked to a tax agent. In addition, Inland Revenue provides a range of services specifically for tax agents and their clients.

2.3 For example, all tax agents have an agent account manager who is responsible for monitoring their performance and who serves as the agent's primary contact with Inland Revenue. A dedicated telephone service also provides tax agents with a convenient channel for communicating with Inland Revenue, and "The Look at Account Information" service provides tax agents with secure online access to client information such as account balances, transaction details, earnings information and some tax return details.

2.4 As part of a strategy to optimise the relationship between Inland Revenue and tax agents, Inland Revenue is considering a range of initiatives to ensure that its interactions with tax agents are efficient, tailored for individual tax agents and that they positively influence compliance behaviour.

2.5 In particular, Inland Revenue is exploring a number of initiatives aimed at simplifying existing services and processes for tax agents through greater use of technology and a greater range of self-service options. The initiatives being considered focus on providing tax agents with greater direct access to client and technical information held by Inland Revenue and on enabling agents to update client records themselves. For example, the options may include changing a client's address details or transferring credits. While access to the administrative services provided by Inland Revenue is currently available to all tax agents, Inland Revenue may, in the future, look to target particular services towards the needs of particular groups of tax agents.

The issue

2.6 In this context, the government believes that the rules relating to tax agents need updating.

2.7 A tax agent is defined in the Tax Administration Act 1994 as "a person who prepares the returns of income required to be furnished for 10 or more taxpayers and who –

(a) Carries on a professional public practice; or
(b) Carries on any business in which returns of income are prepared; or
(c) Is the Maori Trustee".[1]

2.8 To be recognised as an agent, a person must apply to Inland Revenue by returning an "Application to be a tax agent or agency". Provided that an agent meets the very limited criteria required, Inland Revenue cannot refuse to register the entity as a tax agent even if, for example, that person has a long record of non-compliance in their own tax affairs or those of their clients, or they have been convicted of offences involving serious dishonesty.

2.9 As Inland Revenue continues to provide tax agents with a greater range of self-service options and greater online access, the ability to place a high level of trust in tax agents assumes much greater importance.

2.10 The current ability of an individual or an entity to engage with Inland Revenue and taxpayers as a tax agent with very limited restrictions is inconsistent with similar positions of trust which have strict criteria on who can be considered eligible. In tax legislation, for example, the Income Tax Act contains comprehensive rules on who may be accredited as a PAYE intermediary.

[1] Section 3(1) of the Tax Administration Act 1994.

Proposed reform

Integrity of the tax system

2.11 To deal with these concerns, the government is proposing to add a requirement to the definition of "tax agent" that the Commissioner of Inland Revenue must be satisfied that listing a person as a tax agent is consistent with the protection of the integrity of the tax system.

2.12 This will provide the Commissioner with the discretion to withhold recognition, or remove a person as a tax agent when the Commissioner thinks the action is necessary to protect the integrity of the tax system.

2.13 Operational guidance will be provided on the circumstances in which the Commissioner's discretion might be exercised. Potential factors that might be taken into account, while not necessarily definitive, might include:

- whether a person has been found guilty of an offence or breach by the disciplinary body of a professional organisation of which they are a member – for example, the New Zealand Institute of Chartered Accountants;
- whether the person is an undischarged bankrupt or an insolvent entity;
- whether the person is an individual or a body corporate that has been convicted of a crime involving dishonesty (within the meaning of section 2(1) of the Crimes Act 1961) and has been sentenced for that crime within the last seven years;
- whether an individual is prohibited from being a director or promoter of, or taken part in the management of a company under section 382, 383 or 385 of the Companies Act 1993;
- whether a person has been convicted of an offence under the Tax Administration Act 1994; and
- the tax agent's compliance history – including both their own tax affairs and their level of compliance as an agent.

2.14 It is envisaged that the discretion not to grant, or remove tax agent status would be exercised only in a very small number of cases. In the majority of cases it is not anticipated that this discretion will have any significant impact on the level of information required of applicants seeking tax agent status, or on any compliance costs incurred in applying.

2.15 The proposed solution seeks to strike a balance between the reality that the vast majority of tax agents provide a very valuable service to taxpayers and that their continued ability to do so should not be unduly restricted.

Entities other than natural persons

2.16 Currently, tax agent status is not limited to natural persons, and includes individuals, partnerships, companies and other entities. Entities comprise more than half of all agents registered with Inland Revenue.

2.17 However, the proposed test of protecting the integrity of the tax system relates to the behaviour of individuals rather than entities. Under the proposed rules, individuals who were unable to gain tax agent status in their own right could operate as a tax agent under the guise of a company or other entity.

2.18 While the government does not wish to disrupt current practice more than is necessary, enabling only individuals and not entities to list as tax agents could significantly increase the number of tax agents dealing with Inland Revenue. This could, in turn, result in higher administrative and compliance costs.

2.19 Therefore, the government proposes that entities will continue to be recognised as tax agents along with individuals, provided that the entity supplies Inland Revenue with the names of:

- each individual acting as a director, secretary or statutory officer if the entity is a body corporate;
- all shareholders of closely held companies;
- all partners if the entity is a partnership; and
- all individuals who are members of the entity, if the entity is an unincorporated body.

2.20 The Commissioner must be satisfied that the involvement of these individuals is consistent with the protection of the integrity of the tax system for the entity to have agency status.

2.21 This information will allow the Commissioner to decide not to grant agency status to a particular entity, or to remove agency status from an entity if, in protecting the integrity of the tax system, the decision was necessary as a result of the involvement of particular individuals in controlling the business or managing clients connected with it.

2.22 If the entity is registered as an agent, the risk is that the whole entity could lose its agency status, although there may be just one individual who is of concern to Inland Revenue. If the entity did not want this risk, the individuals involved in the entity could apply to be listed as agents in their own right.

Consequences of not meeting the definition of being a tax agent

2.23 Under the proposed rule, the Commissioner will be required to give a tax agent notice of the intention to revoke the agent's listing and give reasons for the intended revocation. If the agent does not resolve the matters listed in the notice of intended revocation to the satisfaction of the Commissioner, their agency status will be revoked and the agent and the taxpayers linked to that agent advised accordingly.

2.24 Providing notice is of particular importance to entities, as the removal of agency status will affect the other members of the entity and potentially a much larger group of client taxpayers.

2.25 If, because of a revocation of tax agency status, a taxpayer fails to meet a filing deadline the legislation will provide that penalties are not imposed.

Transitional issues

2.26 Individual agents currently registered as tax agents will not be required to reapply for their agency status.

2.27 For entities currently listed as an agent, entities will continue to be listed as tax agents provided they supply Inland Revenue with the names of:

- all individuals who are members of the entity, if the entity is an unincorporated body;
- each person acting as a director, secretary or statutory officer if the entity is a body corporate; and
- all partners if the entity is a partnership.

2.28 This information will be required within 12 months of the enactment of the new rules. The information is necessary to enable the Commissioner to be satisfied on an ongoing basis that, given the involvement of these individuals, it is consistent with protection of the integrity of the tax system for the entity to have agency status.

Secrecy

2.29 Professional bodies such as the New Zealand Institute of Chartered Accountants and others with a significant function of providing tax advice have their own membership criteria based on standards of integrity. The proposals in this chapter will be enhanced if Inland Revenue is able to provide information to these bodies about the agency listings it has revoked. An exception to Inland Revenue's secrecy obligations, along the lines of the non-disclosure right exception, is proposed as part of the legislation.

Other options

2.30 The government has considered whether more regulated tax agent rules such as Australia's would be beneficial to New Zealand. On balance, it appears that any benefit from such rules would be outweighed by higher compliance and administrative costs.

2.31 Providing the Commissioner with the discretion recommended in this chapter is considered sufficient to ensure that agents who operate outside the principles of the tax system are identified and have their agency status removed. Inland Revenue will, however, monitor this situation and may in the future propose more robust measures for screening tax agents should these be seen to be required.

Chapter 3

TAX AGENTS AND THE SHORTFALL PENALTY FOR NOT TAKING REASONABLE CARE

Summary of proposals

The legislation will prescribe the circumstances in which a shortfall penalty for not taking reasonable care can be imposed, even when taxpayers have used a tax agent. The circumstances will include:

- failing to provide adequate information to the agent;
- failing to provide adequate instructions to the agent;
- unreasonably relying on an agent or advisor; and
- having had a previous tax shortfall penalty imposed for the same error or action.

Role of tax agents

3.1 Tax agents[2] are responsible for a large percentage of the tax returns filed with Inland Revenue. The services they provide have a significant influence on voluntary compliance levels and minimise compliance and administrative costs.

3.2 It is important that the penalty rules adequately recognise the important role of agents and, consistent with the compliance model in figure 1, that the rules continue to encourage agents to help their clients to be compliant.

Background

3.3 Taxpayers who have relied on the advice of tax agents will usually be considered to have exercised reasonable care. This principle is not set out in the legislation but has developed over time through practice.

3.4 The legislation does not define what "reasonable care" is. When the shortfall penalty for not taking reasonable care was introduced, it was considered flexible enough to reflect a wide range of circumstances as well as changes to the tax system over time. The government of the day was concerned that to define it further would have substantially duplicated the common law understanding of the term "reasonable care" and could have unduly constrained the flexibility of the standard.

[2] In this chapter reference to tax agent also includes reference to tax advisors.

3.5 Currently, taxpayers who use agents may still be exposed to a penalty for not taking reasonable care if they:

- fail to provide adequate information when seeking advice;
- fail to provide reasonable instructions to a tax agent; or
- unreasonably rely on a tax advisor or on advice (when they have reason to believe that the advice is not correct).

3.6 Outside these exceptions, the shortfall penalty for not taking reasonable care is generally not incurred if the taxpayer has used a tax agent. This does not apply to the unacceptable tax position shortfall penalty, which occurs if the tax position taken does not meet the standard of "being about as likely as not to be correct" and the tax shortfall is greater than the prescribed thresholds. In this case, the penalty may be assessed, irrespective of whether an agent is used.

3.7 This highlights the need to clarify the scope of the penalty for not taking reasonable care. The government has therefore recommended that the unacceptable tax position shortfall penalty be refocused so that it applies to income tax only, and that the threshold for its application be increased. (See chapter 4.)

3.8 The standard of "reasonable care" is not excessive and does not require perfection. However, many taxpayers use agents because agents have more knowledge about the requirements of the tax system.

3.9 The government wants to ensure that there is a better balance between recognising that tax agents are not infallible, while providing a greater incentive for them to, as far as possible, "get it right".

Proposed reform

3.10 The legislation will prescribe the circumstances when a shortfall penalty for not taking reasonable care can be applied and taxpayers have used tax agents. The circumstances will include those currently in practice, including:

- failing to provide adequate information to the agent;
- failing to provide adequate instructions to the agent; and
- unreasonably relying on an agent or advisor or on their actions.

3.11 These are all circumstances in which the taxpayer's actions might be regarded as having contributed to the lack of care.

3.12 The proposed reform will extend these circumstances to include whether the taxpayer has had a tax shortfall previously and whether the same error or action has been repeated.

3.13 In this situation the taxpayer should have been aware that there was a known risk associated with a particular action. Depending on the facts, a reasonable person in the taxpayer's circumstances would check that the correct tax position had been taken in the second instance. For example, an agent completes a taxpayer's income tax return. There are losses to carry forward (which are correctly calculated) but, owing to a computer systems error, the amount of the loss carried forward is substantially overstated. The first time this tax shortfall occurs no shortfall penalty is imposed. However, in a subsequent period, for the same taxpayer, the amount of the losses carried forward is again incorrect as a result of the same error. In this second instance a shortfall penalty for not taking reasonable care should be considered; it would be reasonable to expect that the taxpayer would have checked the amount of the loss carried forward.

3.14 By not checking that the tax position is correct it could be argued that neither the taxpayer nor the agent have taken reasonable care.

3.15 The standard reductions for voluntary disclosure, temporary shortfalls and previous good behaviour would still apply in the example.

3.16 It can be argued that the proposal will treat taxpayers who use a tax agent more leniently, as the taxpayer may not be penalised the first time a tax shortfall occurs. A taxpayer who does not use an agent may, in the same circumstances, be penalised. However, by choosing to use an agent, the first taxpayer has demonstrated a willingness to take reasonable care.

3.17 The proposal will also apply to taxpayers who change agents. If the taxpayer is aware of what is required because the shortfall has occurred before, it is reasonable to expect the taxpayer to check that the correct tax position has been taken.

Chapter 4

REFINING THE SCOPE OF THE UNACCEPTABLE TAX POSITION SHORTFALL PENALTY

Summary of proposals

- GST and withholding-type taxes will be removed from the scope of the unacceptable tax position shortfall penalty. The unacceptable tax position shortfall penalty will apply only to tax positions that relate to income tax.
- The thresholds for the assessment of the unacceptable tax position shortfall penalty will be increased. They will apply when the tax shortfall arising from the taxpayer's tax position is more than both $50,000 and 1 percent of the taxpayer's total tax figure for the relevant return period.

4.1 An unacceptable tax position shortfall penalty of 20 percent of the shortfall is assessed if, viewed objectively, a taxpayer's tax position fails to meet the standard of being "about as likely as not to be correct". The penalty is applied only in cases where the tax shortfall is significant – a shortfall of more than $20,000 and the lesser of either 1 percent of the total tax figure or $250,000. The penalty does not apply to tax shortfalls that arise from mistakes in the calculation or recording of numbers in a return.

4.2 The shortfall penalty for an unacceptable tax position is intended as a signal to taxpayers who take a particular tax position in which there is a significant amount of tax at stake. It does not require that the treatment a taxpayer gives to a particular matter must be the better view, or must be more likely than not the correct treatment. Rather, it must be a position to which a court would give serious consideration, but not necessarily agree with. The taxpayer's argument should be sufficient to support a reasonable expectation that the taxpayer could succeed in court.

4.3 An aim of the shortfall penalty is to encourage taxpayers to get their tax position correct in terms of the law. This can be compared with the shortfall penalty for not taking reasonable care, which applies to a more general set of actions. When looking at whether a tax position is acceptable or not, the subjective elements, such as the effort the taxpayer went to, are not considered. In relation to the penalty for not taking reasonable care, taxpayers can argue that reasonable care has been taken by simply using a tax agent. This is not the case with the penalty for an unacceptable tax position – the penalty applies if the tax position taken fails to meet the required standard, irrespective of whether the taxpayer has engaged an agent.

The issue

4.4 Taxpayers who make and acknowledge errors in taking a particular tax position cannot be regarded as having met the standard of being "about as likely as not to be correct". If the standard is not met, unacceptable tax position shortfall penalties may apply. The government's view is that the penalty should be better targeted.

4.5 Current legislation has had an adverse effect on taxpayer behaviour by making them less inclined to disclose errors to Inland Revenue. To counter this problem, a recent amendment, new section 141KB, provides the Commissioner with the discretion either to cancel or not impose the unacceptable tax position shortfall penalty. The discretion applies in cases when the Commissioner is satisfied that:

- the tax position taken is the result of a clear mistake or simple oversight;
- the shortfall arising from the tax position is or would be subject to a reduced penalty because the shortfall was voluntarily disclosed before notification of a pending tax audit or investigation, or is a temporary shortfall; and
- it is appropriate that the taxpayer not be liable to pay an unacceptable tax position shortfall penalty in relation to the tax position taken.

4.6 The new section applies retrospectively from 1 April 2003 and has already been applied in numerous cases. The discretion was, however, signalled as a short-term solution only. The Commissioner's discretion is not considered to be a long-term solution because:

- it increases administrative and compliance costs;
- it does not fit well with the self-assessment environment; and
- using the words "clear mistake and simple oversight" in the penalties context is inherently uncertain and may create a revenue risk if the term becomes more broadly interpreted over time.

4.7 For these reasons, it is proposed to repeal the discretion and instead refocus and narrow the provisions relating to the unacceptable tax position shortfall penalty.

Better focusing the penalty

4.8 There are three options for better focusing the unacceptable tax position shortfall penalty:

- returning to the pre-2003 "unacceptable interpretation" wording;

- limiting the application of the unacceptable tax position shortfall penalty to income tax; or
- increasing the thresholds at which the shortfall penalty is assessed.

4.9 The three options are discussed below.

Return to the "unacceptable interpretation" wording

4.10 In 2003 a change was made from the original and narrowly defined term "unacceptable interpretation" to the currently used "unacceptable tax position". The change was necessary because under the earlier term taxpayers could, and did argue, that because they had not made an interpretation the shortfall penalty could not be assessed.

4.11 For example – two taxpayers operate in a similar industry; one taxpayer becomes aware that the other taxpayer is claiming deductions for expenses that the first is not currently claiming, talks to their agent and starts claiming deductions for similar expenses. It is strongly arguable, if not clear in law, that these expenses are not deductible under income tax law. No interpretation was made, so an unacceptable interpretation shortfall penalty cannot be imposed and, as the taxpayer has used the services of an agent, the penalty for not taking reasonable care does not apply.

4.12 If the "unacceptable interpretation" position were to be reinstated, there would still be cases where no shortfall penalty could be assessed, although a penalty would be appropriate in the circumstances.

Limit the application of the unacceptable tax position shortfall penalty to income tax

4.13 Many of the examples where the assessment of an unacceptable tax position shortfall penalty appears overly harsh involve GST. Often GST returns are completed by taxpayers themselves rather than by an agent. This is because GST returns are completed more frequently than income tax returns and tend to involve similar transactions in each period.

4.14 Often an unacceptable tax position shortfall penalty is assessed when the incorrect tax position relates to a one-off transaction. For example, a taxpayer purchases a major asset and inadvertently claims an input tax credit in an earlier period. In this case, it would be more appropriate to base any consideration on whether the taxpayer had taken reasonable care.

4.15 In general, structures adopted to minimise GST payments are not as elaborate as those developed for income tax purposes.

4.16 In Australia, the "reasonably arguable position" standard on which the New Zealand penalty is based applies only to income tax.

Proposed reform

4.17 Under the proposals, GST and withholding-type taxes will be removed from the scope of the unacceptable tax position shortfall penalty so that the unacceptable tax position shortfall penalty will apply only to tax positions relating to income tax.

4.18 For other types of tax, the shortfall penalty for not taking reasonable care will apply in appropriate cases. The standard of reasonable care requires that taxpayers exercise the degree of care that a reasonable person would be likely to exercise in the taxpayer's circumstances. This means that for most taxpayers, following Inland Revenue's instructions when completing a tax return would be sufficient to meet the "reasonable care" test.

4.19 However, if the tax position involves a significant amount of tax relative to the size of the taxpayer's business, it may be reasonable to expect the taxpayer to seek the input of a tax professional or enquire about the correct tax treatment. If expert advice was not sought, depending on the facts, the taxpayer may not have taken reasonable care.

4.20 In cases not involving income tax and when taxpayers have taken reasonable care and there are tax shortfalls, penalties for not taking reasonable care would not be imposed. However, Inland Revenue could use this opportunity to inform the taxpayer what is required if a similar situation occurs in the future.

4.21 The proposal does not apply to the abusive tax position shortfall penalty. While an abusive tax position is also an unacceptable tax position, an abusive position is taken with the dominant purpose of reducing or removing a tax liability, or receiving a tax benefit. It is appropriate that this penalty remains in relation to all tax types.

Increasing the thresholds

4.22 The unacceptable tax position shortfall penalty is only assessed when there is a significant amount of tax at stake.

4.23 Currently taxpayers are liable to pay the shortfall penalty if they take an unacceptable tax position and the tax shortfall arising from their tax position is more than both:

(a) $20,000; and
(b) the lesser of $250,000 and 1 percent of the taxpayer's total tax figure for the relevant return period.[3]

[3] Section 141B(2) of the Tax Administration Act 1994.

Proposed reform

4.24 The thresholds above which the unacceptable tax position shortfall penalty is assessed will be increased. Under the proposed changes, the penalty will apply when the tax shortfall arising from the taxpayer's tax position is more than both:

(a) $50,000; and
(b) 1 percent of the taxpayer's total tax figure for the relevant return period.

4.25 As well as increasing the minimum threshold to $50,000, the upper threshold of $250,000 will be removed, thus significantly further increasing the thresholds. Removing the $250,000 limit ensures that the penalty does not apply to what may be regarded as everyday transactions for some large corporations.

4.26 This proposal will remove many cases from the scope of the penalty. It also ensures that the policy underlying the penalty is reinforced so that the penalty applies only when there is a substantial amount of tax at stake.

Chapter 5

IMPROVING RECOGNITION OF GOOD COMPLIANCE

Summary of proposals

- Inland Revenue will notify a taxpayer the first time their payment is late rather than imposing an immediate late payment penalty. However, if payment is not made by a certain date the penalty will be imposed.
- The late payment penalty legislation relating to the employer monthly schedule will be clarified.
- Shortfall penalty for not taking reasonable care or taking an unacceptable tax position will not be imposed when a tax shortfall is voluntarily disclosed (before notification of a pending tax audit or investigation). This proposal will apply to voluntary disclosures made within two years of the tax position being taken.
- A new graduated penalty to replace the current shortfall penalty in relation to PAYE will apply when an employer has filed an employer monthly schedule but not paid the PAYE. Inland Revenue will contact the employer and, if payment or an arrangement for payment is not made, a 20 percent penalty will be imposed, reducing to 10 percent if the employer pays the outstanding PAYE within one month of the penalty being imposed. The penalty will not exceed in total any penalty that could be charged under the current rules.

Current incentives to comply

5.1 One of the purposes of the compliance and penalties rules is to provide incentives for taxpayers to comply voluntarily with their tax obligations. The legislation does this by penalising non-compliance on the one hand, and by recognising taxpayers' previous good compliance on the other. This is achieved by:

- reducing shortfall penalties for voluntary disclosures and previous compliant behaviour;
- warning taxpayers who have not filed their tax returns on time that if they do not file by a certain date a late filing penalty will be assessed; and
- imposing the initial late payment penalty in two steps – 1 percent the day after the due date and 4 percent six days later.

Late payment penalty

5.2 One of the basic obligations for taxpayers is to pay their taxes on time. To encourage taxpayers to do this, those who pay late face late payment penalties.

5.3 The late payment penalty is imposed in two stages: the initial late payment penalty and the incremental late payment penalty.

5.4 The initial late payment penalty is applied in two steps – the first being a 1 percent penalty imposed the day after the due date and the second being a 4 percent penalty imposed at the end of the sixth day if the tax owing remains outstanding.

5.5 An incremental late payment penalty of 1 percent is imposed each month the tax remains outstanding.

The issue

5.6 The government is concerned that taxpayers who are usually compliant but have inadvertently missed a payment have late payment penalties imposed on them. In some cases, the penalty can be disproportionately high compared with the severity of the breach. There should also be some consideration given to the taxpayer's previous record of compliance before imposing the late payment penalty.

Proposed reform

5.7 Inland Revenue will notify taxpayers the first time their payment is late.

5.8 The notification will explain that if the payment is not made by a certain date, late payment penalties will be imposed. The notification will also state that if taxpayers make late payments in the future, further leniency will not be granted. Inland Revenue will not send the taxpayer any further notifications for two years, and the initial late payment penalty will be imposed in the normal manner.

5.9 If the warning does not result in payment, the late payment penalty will be imposed in the normal manner at 1 percent the day after the initial due date and 4 percent six days later.

5.10 On the date of introduction of this proposal, all taxpayers will start with a clean slate.

5.11 The first time a taxpayer pays late (irrespective of whether he or she has paid late in the previous two years) a warning will be given. This will allow the new provision to apply immediately. It also allows the provision to apply in cases where a new business which does not have a compliance history is starting up. In this case, the added benefit is that the provision will allow Inland Revenue to inform taxpayers of their payment obligations before a more serious level of default occurs.

Late filing penalty

5.12 The government has considered whether a similar amendment should be made to the late filing penalty rules to take into account previous good compliance. However, a change is seen as unnecessary for two reasons: the penalty is a fixed amount, and before a late filing penalty is imposed Inland Revenue generally notifies taxpayers that their returns are late and that late filing penalties will be imposed if their returns are not filed immediately.

5.13 The legislation applying to employer monthly schedules will be clarified to reflect the current practice of warning employers when a schedule is filed late, and imposing penalties on subsequent cases.

Penalty reductions for voluntary disclosures

5.14 Currently, shortfall penalties reduce if taxpayers voluntarily disclose tax shortfalls. Penalties are reduced by:

- 75 percent if the disclosure is made before the taxpayer is notified of a pending tax audit or investigation; or
- 40 percent if the disclosure is made after the taxpayer is notified of the pending tax audit or investigation but before the audit or investigation starts.

5.15 The penalty reduction reflects the lower administrative cost of having the tax shortfall identified before resources are committed to an investigation. It also recognises the taxpayer's intention to comply and co-operate with Inland Revenue.

The issue

5.16 The compliance and penalty rules should provide sufficient incentives for taxpayers to comply voluntarily with their tax obligations. However, the current rules do not encourage taxpayers to disclose a tax shortfall.

5.17 Imposing shortfall penalties in cases when taxpayers voluntarily disclose tax shortfalls, even though the penalties are reduced, reduces the incentives for taxpayers to make voluntary disclosures. This is because taxpayers know that the consequence of making voluntary disclosures is the assessment of shortfall penalties.

Proposed reform

5.18 To increase the incentives for taxpayers to comply voluntarily, shortfall penalties payable when tax shortfalls are voluntarily disclosed before taxpayers are notified of pending tax audits or investigations will not be imposed. The proposal will be subject to the disclosure being made within two years of the relevant tax position being taken.

5.19 The two-year period will allow taxpayers to reconcile their GST returns with their income tax return and/or their annual accounts. It also allows for two income tax returns to be filed, which will give taxpayers sufficient opportunity to identify tax shortfalls in the first return when they complete the second return.

5.20 If taxpayers voluntarily disclose tax shortfalls before Inland Revenue notifies them of a pending tax audit or investigation more than two years after taking the tax position, the existing 75 percent reduction will apply.

5.21 Given the more serious concern with tax shortfalls arising from gross carelessness, abusive tax positions and evasion, the proposal will apply only to the shortfall penalties for "not taking reasonable care" and "unacceptable tax positions". Voluntary disclosures made before the notification of a pending tax audit or investigation of these more serious actions will still qualify for the reduction of 75 percent.

Temporary shortfalls

5.22 Consideration has been given to whether the penalty reduction given for temporary shortfalls should also be increased from 75 percent to 100 percent.

5.23 One of the reasons a reduction is given for voluntary disclosures is because it forestalls the administrative costs of an investigation. Another reason is that, in making a voluntary disclosure, the taxpayer is signalling a wish to comply. These arguments are not so apparent in the case of temporary shortfalls.

5.24 For these reasons the government has decided not to increase the temporary shortfall reduction.

Late payment of PAYE

5.25 One of the basic tax obligations for employers is to withhold PAYE tax on behalf of their employees and pay the PAYE to Inland Revenue by specific dates. If the employer fails to pay Inland Revenue on time, penalties will apply. In practice, non-payment of PAYE is treated more seriously than failure to pay other taxes, as PAYE places a special responsibility on the employer to effect payment on behalf of the employee.

5.26 The current penalties that apply in relation to PAYE obligations include:

- *Late payment penalty*: The penalty is applied at the rate of 1 percent on the due date, 4 percent seven days later and 1 percent each month the tax is outstanding.
- *Late filing penalty:* $250 is applied to each employer monthly schedule filed late.

- *Shortfall penalty for evasion*: A shortfall penalty of 150 percent is imposed on taxpayers who knowingly apply or permit the application of PAYE deductions for any purpose other than for payment to the Commissioner.[4] An amount is considered to have been applied for a purpose other than in payment to the Commissioner if the amount is not paid to the Commissioner by the due date.[5]

- *Prosecution:* The extent of the penalty is decided by the courts but can include a monetary penalty, periodic detention, or imprisonment in extreme cases.[6]

The issue

5.27 When considering non-compliance in relation to PAYE obligations there are a number of possible scenarios, including:

- employers who have some or all of their employees outside the PAYE system;
- employers who pay the PAYE to Inland Revenue but do not file the employer monthly schedule; and
- employers who file the employer monthly schedule but do not pay the PAYE to Inland Revenue.

5.28 In relation to the first scenario, the government considers that the current penalty rules should continue to apply. In the second scenario, penalties are limited because the tax is paid. In the third situation, where the employer files the schedule but does not pay the PAYE, the government considers that the current rules give rise to a number of concerns:

- *Distortionary outcomes in different fact situations:* A taxpayer with a good record of tax compliance incurs the same (or higher) level of penalty as a taxpayer with a record of non-compliance. An employer who fails to file an employer monthly schedule could be eligible for a 75 percent reduction for voluntary disclosure, while an employer who files an employer monthly schedule, but no payment, is not eligible for any voluntary disclosure penalty reduction. This is effectively providing a disincentive for employers to file.
- *A lack of opportunity for taxpayers to correct non-compliance*: The shortfall penalty for evasion can be imposed the day after PAYE has not been paid to Inland Revenue, leaving taxpayers with little opportunity to address non-payment.
- A *perception that the current rules may be harsh*: In theory, taxpayers could incur shortfall penalties for evasion (150 percent of the unpaid PAYE) plus the initial late payment penalties, even if payments are made only a few days late.

[4] Section 141E(1)(b) Tax Administration Act 1994.
[5] Section 4A(2)(c) of the Tax Administration Act 1994.
[6] Section 143A(8)(d) Tax Administration Act 1994.

Proposed reform

5.29 To deal with these problems a new penalty will be introduced to replace the current shortfall penalty in relation to PAYE. The new rules will better reflect the degree of seriousness shown by employers in meeting their PAYE obligations, while adopting a more graduated approach to the shortfall penalty will provide better opportunities to correct any non-compliance.

5.30 Under the proposal, shortfall penalties for evasion will not be imposed if the employer files the employer monthly schedule but does not pay the PAYE. Instead, Inland Revenue will contact the employer to establish the reason for the non-payment and offer to liaise with the employer to establish or enhance its systems to ensure future compliance. The legislation will require that the Commissioner warn the employer that a 20 percent PAYE shortfall penalty will be imposed if payment, or an arrangement for payment, is not made.

5.31 If the employer does not make the payment or enter an instalment arrangement the employer will receive instruction requesting payment within 30 days. On the expiry of 30 days, the PAYE shortfall penalty of 20 percent of the unpaid PAYE will be imposed. If the PAYE is paid within 30 days of its imposition, the penalty will be reduced to 10 percent. If the payment is not made, the process will repeat itself – that is, another 20 percent penalty will be imposed, which will reduce to 10 percent if payment is made within 30 days. The penalty will not exceed in total any penalty that could be charged under the current rules.

5.32 This proposal is aimed at encouraging employers to pay the outstanding PAYE and giving them an incentive to comply. Compliance includes entering into an instalment arrangement. If the employer enters an instalment arrangement the new penalty will not apply unless the employer defaults on an instalment arrangement. In this case, the penalty will be imposed at 20 percent, with no reduction to 10 percent.

5.33 The normal late payment penalties, use-of-money interest and ability to prosecute will continue to operate as they do at present.

Chapter 6

IMPROVING GST FILING

Summary of proposals

A late filing penalty will be introduced for GST returns that are not filed by the due date. This will:

- provide an incentive for returns to be filed by the due date;
- reduce the number of default assessments issued to taxpayers and hence reduce potential tax liabilities, which may in some cases bear little resemblance to the amount that should be payable; and
- create more fiscal certainty for the government as a result of fewer default assessments.

6.1 When taxpayers fail to file their GST returns, the principal mechanism available to encourage the filing of the return is for Inland Revenue to issue a default assessment. A default assessment is an estimation of tax liability and remains in place until the taxpayer files the return. A default assessment is likely to present a slightly larger debt than a self-assessment, and thereby encourage taxpayers to file returns.

6.2 The default assessment is seen by some taxpayers as an excessive response to non-filing. The government considers that a more appropriate response would be to impose a late filing penalty, with the default assessment reserved for significant or ongoing non-compliance.

6.3 Consistent with the proposals outlined in chapter 5, a late filing penalty would not be imposed the first time a taxpayer fails to furnish a return, but would instead result in a warning.

Background

Late filing penalties

6.4 Late filing penalties were introduced in 1997 on income tax returns, and on employer monthly schedules in 1999. The purpose of the penalty is to encourage returns to be filed on time. Late filing penalties were not introduced for GST returns because default assessments were considered a sufficient mechanism to encourage compliance with GST filing obligations.

Employer monthly schedule

6.5 For the purposes of comparison, Inland Revenue currently uses a two-step process to encourage timely filing of the employer monthly schedule. The first time an employer fails to file employer monthly schedules, Inland Revenue issues warning notices advising that penalties will not be imposed, provided the schedules are filed immediately. If a further default in filing occurs within 12 months of the first default, a late filing penalty of $250 is imposed.

6.6 If taxpayers file their employer monthly schedules on time for 12 months, the process is reset and any future initial default results only in a warning, with no late filing penalty. (As discussed in chapter 5, the legislation will further clarify this process.)

GST default assessment

6.7 The default assessment system is very similar to the late filing penalty process for employer monthly schedules. If taxpayers fail to furnish returns they are issued warning letters requesting that the GST returns are filed.

6.8 If the returns are not furnished, default assessments are issued. If the outstanding returns are not furnished by the next filing date the same process is repeated, with the amounts that are default-assessed increasing by a predetermined rate.

6.9 If taxpayers do file the required returns, the amounts owed are reassessed.

Current position

6.10 A default assessment can impose unnecessary stress on taxpayers and create a degree of fiscal uncertainty for the government.

6.11 The goal is to increase the number of returns filed on time. The same, or better, taxpayer compliance can be achieved with a late filing penalty, and with lower levels of stress and anxiety for taxpayers than by using default assessments.

6.12 The government is concerned that the number of default assessments is growing. Although the number of GST registrants increased between 2001 and 2005, the relative increase in default assessments has risen from 5.3 percent to 6.2 percent of outstanding returns.

6.13 By comparison, the percentage of employer monthly schedules outstanding has decreased since 2000. While the compliance incentives may differ, evidence would suggest that the imposition of a late filing penalty on GST returns would achieve better results, while also ensuring that government debt figures are not inflated.

6.14 Introducing a late filing penalty on late GST returns will also ensure consistency in the tax filing incentives between the two main taxes paid by small to medium–sized enterprises – GST and PAYE.

Role of default assessments

6.15 The ability to issue a default assessment in relation to GST will not be removed from the legislation as it is expected that Inland Revenue will continue to use them in cases of ongoing non-compliance.

Proposed reforms

6.16 As with the late filing penalty for an annual imputation return, reconciliation statement, employer monthly schedule or an annual tax return with a net income of between $100,000 and $1,000,000, a late filing penalty of $250 will be imposed for failing to file a GST return on time.

6.17 Consistent with the proposals in chapter 5, the legislation will require Inland Revenue first to issue a warning. The warning notification will request that taxpayers file their returns, and that they do so within the time specified.

6.18 If the return is still outstanding, a reminder will be given to taxpayers advising that they have not filed their return. It will also warn them that failure to file any further GST return within 12 months of the date of the reminder will result in the imposition of a late filing penalty.

6.19 If, within this 12-month period taxpayers again fail to furnish another GST return, a combined warning and notification will be issued. This will inform them of the imposition of a $250 late filing penalty, and warn them of the pending imposition of a default assessment.

6.20 If the second return remains outstanding, a default assessment will be issued.

6.21 If taxpayers file their GST returns on time for 12 months or longer and then default, the process starts again and warning notifications will be issued. Further defaults within 12 months of the warning will be penalised.

6.22 Introducing the late filing penalty and using default assessment in cases of continuing non-compliance will:

- be a better tool to encourage on-time GST filing;
- reduce taxpayer stress by a reminder being initially given instead of a debt figure; and
- allow the government to ensure that the GST debt levels are not overstated.

Chapter 7

OTHER CHANGES TO THE PENALTIES RULES

Summary of proposals

- The abusive tax position shortfall penalty threshold will be repealed.
- For temporary shortfalls to which a 75 percent reduction in the shortfall penalty applies, the legislation will clarify that a tax shortfall has been permanently reversed or corrected if it appears from the taxpayer's actions that through operation of law the shortfall will be remedied. For a shortfall to be considered temporary it must be permanently reversed or corrected within two years of the tax position being taken.
- The Commissioner will be able to treat return periods that overlap as the same return period for associated taxpayers, allowing a tax refund to be used to reduce an associated person's tax shortfall.
- The proposals outlined in the 2004 discussion document, *Options for dealing with industry-wide tax evasion,* will be dealt with at the same time as the issues in this discussion document.

Abusive tax position shortfall penalty

7.1 An abusive tax position shortfall penalty of 100 percent of the tax shortfall applies when the tax position taken is an unacceptable tax position that has a dominant purpose of reducing or removing a tax liability or giving tax benefits.

7.2 As noted in the *Commentary on the Taxpayer Compliance, Penalties and Disputes Resolution Bill*, September 1995:

> Indicators of a dominant purpose of avoiding tax may include artificiality, contrivance, circularity of funding, concealment of information and non-availability of evidence, and spurious interpretations of tax laws.

7.3 For an abusive tax position shortfall penalty to be imposed the tax shortfall must be greater than $20,000.[7] Despite differing slightly from the unacceptable tax position shortfall penalty threshold (in that the materiality threshold does not apply), it appears that this threshold has been carried over from the unacceptable tax position shortfall penalty.

[7] Section 141D(4) of the Tax Administration Act 1994.

7.4 While it is appropriate that the unacceptable tax position shortfall penalty has a threshold, as it would be overly onerous to apply this standard to all tax positions, this does not hold true for abusive tax positions. Although an abusive tax position is an unacceptable tax position, it is also at the more aggressive end of the non-compliance scale.

Proposed reform

7.5 The threshold for the imposition of the shortfall penalty for having an abusive tax position will be repealed.

Temporary shortfalls

7.6 A shortfall penalty is reduced by 75 percent if the tax shortfall is temporary.[8] The legislation sets out what is meant by "temporary".

7.7 The reduction recognises that there is a difference in the tax revenue effect between a temporary and permanent shortfall. The amount of the reduction is in line with the penalty rate currently applied to voluntary disclosures before notification of a pending tax audit or investigation (75 percent of the shortfall penalty). This is because a temporary shortfall is very similar to a voluntary disclosure, as the shortfall is rectified after the shortfall is identified by the taxpayer.

The issue

7.8 When the compliance and penalty rules were first introduced, there was considerable criticism relating to the imposition of shortfall penalties in cases where there had been little or no fiscal risk. This problem was particularly obvious when a GST refund check was made by Inland Revenue and a timing difference was detected.

7.9 The rules reducing the penalty for temporary shortfalls require the taxpayer to permanently reverse or correct the situation in a subsequent tax-return period. However, in some cases, there is little or no opportunity for this to occur.

7.10 Inland Revenue's *Standard Practice Statement INV-231*, released in May 1998, dealt with this concern. The legislation requires that the temporary shortfall is:

> … permanently reversed or corrected before the taxpayer is first notified of a pending tax audit or investigation.[9]

[8] Section 141I of the Tax Administration Act 1994.
[9] Section 141I(3)(d) of the Tax Administration Act 1994.

7.11 However, the *Standard Practice Statement* states that the:

> …. Commissioner will accept that a tax shortfall has been permanently reversed or corrected if:
>
> - it appears from the taxpayer's actions that steps taken will remedy the tax shortfall; or
> - through operation of law or circumstances, the matter will reverse itself.

Proposed reform

7.12 The legislation will be amended to better reflect the Standard Practice Statement. This will give taxpayers the opportunity to benefit from the reduction for a temporary shortfall if the taxpayer has taken steps to address the tax shortfall, even though the opportunity has not yet arisen to deal with it in a subsequent return.

7.13 The Standard Practice Statement currently provides no time limit within which the temporary shortfall must be permanently reversed. The proposed legislation will require the temporary shortfall to be permanently reversed or corrected within two years of the tax position being taken. If the temporary shortfall is permanently reversed or corrected outside of the two-year period, any shortfall penalty will not qualify for reduction under the temporary shortfall provision.

7.14 This proposal should further encourage taxpayers who identify tax shortfalls to correct them.

Associated persons filing returns with differing balance dates

7.15 Occasionally, taxpayers include transactions in the wrong entity's return – for example, in an associated person's return. Because they do not know they have included the transaction in the wrong return, the tax shortfall does not show up when a reconciliation is undertaken. These shortfalls are often not voluntarily disclosed because the taxpayer is unaware they have occurred and, therefore the shortfall cannot be considered "temporary".

7.16 Currently, if there is a tax shortfall in one taxpayer's return and, as a result an associated taxpayer's return is adjusted, resulting in an entitlement to a refund or an increased refund, the refund may be used to reduce the tax shortfall of the associated taxpayer. The returns must, however, be for the same tax type and return period.

7.17 Problems arise when the return periods are not the same – for example, when one associated taxpayer files the GST return on odd months and the other associated taxpayer files on even months. Because the return periods are not the same, the refund cannot be used to reduce the tax shortfall.

Proposed reforms

7.18 Under the proposed changes, the Commissioner will be able to treat return periods that overlap as the same return period for the purposes of this provision. This discretion will not apply when the tax shortfall arises as the result of an abusive tax position or evasion – for example, if a taxpayer deliberately claims an input tax credit in the wrong entity in order to claim the refund earlier.

7.19 The current provision also applies only when adjustment results in creating a refund or an increased refund for the second taxpayer. The proposed provision will also apply where the adjustment results in less tax to pay for the second taxpayer.

Tax compliance initiative

7.20 The discussion document, *Options for dealing with industry-wide tax evasion,* was released in August 2004.

7.21 The discussion document noted that New Zealand's tax laws contain severe penalties for evasion. This can make it difficult for people who have evaded tax in the past and who want to comply with the law to come forward and sort out their tax affairs. The document also noted that existing rules do not deal with the problem of industry-wide tax evasion because the rules are designed to apply to individual businesses. This means that a different approach to promoting compliance is required when evasion becomes commonplace within an industry.

7.22 The discussion document recommended that Inland Revenue be given the power to offer limited amnesties to specific industries in which tax evasion is widespread. Following the amnesty, the targeted industry would be subject to increased audit, and any tax shortfalls detected would face the full range of penalties and other sanctions provided for in the legislation.

7.23 The discussion document also recommended the introduction of a special voluntary disclosure rule. For people who came forward, the core tax amount would be limited, but normal penalties and interest would apply.

7.24 As a result of the submissions received on the options outlined in the discussion document, the limited amnesty proposal has been developed on the basis of a two-year amnesty option.

7.25 Under the proposed rules, a tax evader who comes forward will have to pay tax on previously undisclosed income for two years (covering the current filing year and the year before that). Use-of-money interest, shortfall penalties (currently reduced by 75 percent for voluntary disclosure before notification of a pending tax audit or investigation) and any consequential effects of disclosing two years' income for family assistance, student loans and child support liabilities will be included in the overall assessment of a person's liability

7.26 The Commissioner will offer a limited amnesty to a specific targeted industry or activity. The terms of the offer will specify the taxes that are included in the amnesty and a period in which the tax evader can come forward under the amnesty. It will also be clearly communicated that after the amnesty offer expires, intensive investigations and audits of the targeted industry will begin. Tax evaders will qualify under an amnesty if they have undisclosed income earned from the targeted industry. Upon qualifying for the amnesty, they must fully disclose their income from all sources for a two-year period. The two-year period will cover the current filing year and the year before that.

7.27 Limited amnesties will not affect existing tax debts or provide immunity from prosecutions under other legislation such as the Crimes Act or the Serious Fraud Act.

7.28 These proposals, which were first outlined in the discussion document, have to date not been included in a tax bill. The government has decided to progress them at the same time as the proposals in this discussion document.

Chapter 8

OTHER INITIATIVES CONSIDERED AND REJECTED

8.1 In developing the proposals in this discussion document, a number of issues were considered which will not, at this stage, be progressed.

Shortfall penalties

8.2 In 2003 the new section 141FB was inserted into the Income Tax Act. The section takes into account taxpayers' previous compliance. Under its provisions, taxpayers receive a 50 percent reduction of the shortfall penalty if, within the previous two years, in the case of GST, fringe benefit tax, PAYE and resident withholding tax, or four years in the case of all other taxes, they have not been liable to pay a shortfall penalty on a tax shortfall identified during an audit. The exception to this general rule is the shortfall penalty for tax evasion, where there is no probation period.

8.3 The government has considered increasing the reduction for previous good behaviour from 50 percent to 100 percent but has decided against this change because it could provide an incentive for taxpayers to ensure that their tax positions were correct only after they had been audited, or to breach the required standards of behaviour every now and then but not sufficiently to be seen as a non-compliant taxpayer. Increasing the reduction could reduce the incentives for taxpayers to comply with their obligations.

8.4 The government considers there are more effective ways of promoting voluntary compliance, as outlined in chapter 5.

Taxpayers who file early and correct their tax positions before the due date

8.5 Under the current rules, if a taxpayer files a tax return before the due date, discovers an error in the return and tries to correct the error, the correction is treated as a voluntary disclosure. If a tax shortfall penalty applies, the 75 percent reduction for voluntary disclosure applies, provided the error was identified before a pending tax audit or investigation.

8.6 To encourage voluntary compliance, Inland Revenue previously took a liberal approach under the provisions of *Standard Practice Statement INV 570*, and did not impose shortfall penalties if a taxpayer independently and voluntarily filed an amended return before the due date.[10] However, this Statement has been withdrawn.

[10] *Standard Practice Statement INV 570 Shortfall penalties* – application where returns are amended before due date. This practice did not apply to income tax.

8.7 Chapter 5 proposes that when voluntary disclosures of tax shortfalls that arise from the taxpayer not taking reasonable care or taking an unacceptable tax position are made before the notification of an audit, no shortfall penalty should be imposed. Therefore when the taxpayer files the return early and corrects the tax position before the due date, the penalty will not be imposed.

8.8 There may be a small number of cases when the voluntary disclosure is made after taxpayers are notified of a pending audit and before the due date. However, because many of these tax shortfalls result from innocent mistakes and taxpayers have taken reasonable care, a shortfall penalty would not be assessed.

8.9 There will be other cases when taxpayers have taken abusive tax positions. In these circumstances it would be inappropriate for a shortfall penalty not to be assessed merely because the taxpayer is notified of a pending tax audit or investigation before the due date.

8.10 For these reasons, no amendments to prescribe that taxpayers may correct their returns before the due date for filing without facing a shortfall penalty are proposed.

The time at which taxpayers take their tax positions

8.11 Several commentators have recommended that if taxpayers correct their return and pay the correct amount of tax on time, no shortfall penalty should be assessed. They argue that because there is no loss of revenue there should be no penalty. Alternatively, they suggest that the tax position is taken when the tax is payable not when the return is filed.

8.12 Shortfall penalties are intended to encourage taxpayers to take correct tax positions. There is a range of instances when a tax shortfall may occur without loss of revenue – for example, where the taxpayer has losses carried forward and there is a tax shortfall in the calculation of the loss. Not assessing a shortfall penalty because there is no loss of revenue reduces the incentives on taxpayers to ensure that their tax positions are correct.

8.13 It is appropriate to consider the tax position at the time the return is filed because the position is based on the law as it stands at that time. If the tax position was taken when the tax was paid there could be amendments or cases overturned that affect the tax positions taken and which could not be reflected in the return filed.

8.14 For these reasons no changes are proposed.

Capping penalties and interest

8.15 Currently, there is no cap on the amount of late payment penalties or use-of-money interest that can accumulate on an outstanding tax debt.

8.16 While the government would prefer taxpayers to pay their debts on time, it appreciates that some circumstances may prevent a taxpayer from doing so. In such cases a taxpayer's best option is to contact Inland Revenue and enter into instalment arrangements.

8.17 There will, however, always be taxpayers who disagree with paying tax. It is important that these taxpayers see the consequences of their non-compliance through the appropriate imposition of penalties.

8.18 The government has considered whether there should be a cap on the amount of late payment penalty that accumulates. For example, a cap could be set at three times the amount of the core tax debt.

8.19 However, capping tax debts could result in taxpayers no longer paying small to medium-sized debts. For example, if a cap of three times the core tax was set, a $100 debt would grow to $300. The probability of Inland Revenue prosecuting the taxpayer because of non-payment of the debt would be low and the incentive to pay would therefore be reduced.

8.20 There is also a risk that once the cap had been reached, taxpayers would pay creditors who charge ongoing interest or penalties for late payment in preference to Inland Revenue.

8.21 The proposals in this document are aimed at encouraging taxpayers to come forward and pay their debts as early as possible – for example, the new PAYE penalty outlined in chapter 5. The government considers that proposals aimed at encouraging taxpayers to voluntarily comply is a better option than capping penalties once they have reached a certain level.

Appendix

OUTLINE OF THE CURRENT PENALTIES AND USE-OF-MONEY INTEREST STRUCTURE

Shortfall penalties

There are five shortfall penalties. The penalties (only one of which will apply to a tax shortfall) are applied as a percentage of the tax shortfall:

- Evasion (150%)
- Abusive tax position (100%)
- Gross carelessness (40%)
- Unacceptable tax position (20%)
- Not taking reasonable care (20%)

For an unacceptable tax position or abusive tax position shortfall penalty to be imposed the tax shortfall must be in excess of both:

- $20,000; and
- the lesser of either 1% of the total tax figure and $250,000.

Shortfall penalties imposed

The extent of each penalty imposed by Inland Revenue is shown in the following table:

Shortfall category	2000-01		2001-02		2002-03		2003-04		2004-05	
	Number	$000	Number	$000	Number	$000	Number	$000	Number	$000
Lack of reasonable care	5,164	3,689	2,935	8,548	1,422	4,229	1,385	3,721	1,002	2,624
Gross carelessness	2,343	3,134	927	9,328	148	1,192	471	3,089	691	4,645
Unacceptable tax position	125	695	232	1,208	438	4,380	311	1607	410	3,930
Abusive tax position	22	1,156	155	8,757	45	4,909	73	2,515	86	7,200
Evasion	1,081	4,482	402	19,297	222	14,136	282	18,061	304	10,480
	8,735	**13,156**	**4,651**	**47,138**	**2,275**	**28,846**	**2,522**	**28,993**	**2,493**	**28,879**

Penalty reductions

The legislation provides for the following reductions in shortfall penalties:

- Good previous behaviour (50%)[11]
- Voluntary disclosure
  - Prior to notification of a pending tax audit or investigation (75%)
  - After notification and before the beginning of audit (40%)
- Disclosure of an unacceptable tax position (75%)
- Temporary shortfall (75%)

[11] This reduction may be given on its own, or in addition to any of the other reductions listed.

Limit on the amount of the penalty

A cap of $50,000 applies on shortfall penalties for not taking reasonable care and taking an unacceptable tax position, in cases where the shortfall is identified either by the taxpayer or Inland Revenue within a certain period from the due date of the return, being the later of:

- the date that is three months after the due date of the return to which the shortfall relates; and
- the date that follows the due date of the return to which the shortfall relates by the lesser of –
  - 1 return period; and
  - 6 months.

Increased penalty

A shortfall penalty may be increased by 25 percent if the taxpayer obstructs the Commissioner.

Late filing penalties

If taxpayers do not file their returns on time, late filing penalties apply. The amount of the penalty depends of the type of return not filed and in some cases the net income of the taxpayer.

The late filing penalty for an annual tax return for a taxpayer with net income:

- below $100,000 – $50;
- between $100,000 and $1,000,000 (both figures inclusive) – $250; and
- above $1,000,000 – $500.

For annual imputation returns or reconciliation statements or employer monthly schedules the penalty rate is $250.

Late payment penalties

If a payment is not made on time late, payment penalties apply.

The initial late payment penalty is imposed in two stages, 1 percent the day after the due date and 4 percent six days later.

If payment is not made incremental late payment penalties of 1 percent are imposed each month the amount remains unpaid.

Use-of-money interest

Use-of-money interest, while not a penalty, also applies to under payments and overpayments.