



Newsletter 29 June 2005

## **IRD penalties on innocent errors by taxpayers or agents**

**I have given both IRD and ICANZ an opportunity to comment on this newsletter.**

Over the past 3 years I have noticed an increasing tendency for IRD to apply penalties to genuine taxpayer or agent errors.

For nearly four years Inland Revenue has been promoting its compliance model – see <http://www.ird.govt.nz/aboutir/reports/annual-report/annual-report-2004/part3/annual-report-2004-part03-02.html>

This model concludes (inter alia) that:

- when a taxpayer tries to ‘do the right thing’ but doesn’t always succeed, Inland Revenue will assist them to comply, and
- when a taxpayer has decided not to comply, Inland Revenue will use the full force of the law.

However in the past I have notified IRD management of a number of client situations where an error has been made which has not resulted in any gain to the taxpayer or loss of revenue to IRD, but IRD has still insisted on a penalty.

IRD’s response to the issue simply focuses on ensuring that taxpayers do not make mistakes, missing the point that this is an impossible standard, and IRD makes plenty of mistakes itself which of course are never penalised.

Applying an ‘unacceptable tax position’ penalty for genuine errors is a good example of this aggressive attitude.

### **Client experience**

I am keen to hear of any experiences of clients with the penalty for Unacceptable Tax Position, and if there is no sensible progress from IRD in the next few weeks propose to make a submission to the Minister of Revenue along the lines that IRD is undermining the tax system by its actions.

### **Background**

In the 1999 the Finance and Expenditure Committee Inquiry into the Powers and Operations of the Inland Revenue Department recommended (inter alia):

- Shortfall penalties should not be imposed in the case of an inadvertent error.

A 2001 government discussion document on the penalties regime stated

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.

A frequent problem in recent years has been IRD's application of the penalty for 'unacceptable tax position' [UTP] and of its predecessor 'unacceptable interpretation' [UI]. From time to time taxpayers or agents make an error which is generally corrected before any tax is paid or refunded. In the worst example I have seen the matter was corrected by letter before IRD even received the return, but IRD still insisted on a penalty.

I have posted on my website <http://www.jeffowens.co.nz/pubs.htm> a copy of a May 2005 ICANZ journal article on the issue, and also my follow up letter to the Commissioner setting out the background and current concerns.

IRD's reply stated that it is 'aware of the concerns', although doesn't go as far as to say IRD has any concerns. IRD's current and previous responses to this issue indicate that it has no such concerns, and is quite happy to treat penalties on taxpayer errors as a source of revenue.

IRD refers to its draft ruling on the UTP penalty, but we are already aware that the draft released in November 2004 concluded that there is not much room for any concessional operational interpretation of the rules. From long and sometimes bitter experience IRD is generally loathe to change its preliminary views on draft rulings, so I think we can take it as read that IRD will continue to take a narrow view on what errors might escape the UTP penalty.

That apparently leaves only a legislative solution. IRD says that the matter has been referred to the Policy Advice Division for consideration. That is all very well, but Policy has been aware of the problem since it first proposed changing the UI penalty (on which at least we had an argument that an error did not involve an 'interpretation') to the UTP penalty. IRD Policy rejected ICANZ and Law Society submissions in late 2002, and to date has given no indication that it supports a change in 2005. Even if correcting legislation was introduced, in the absence of a change in approach directed from above, we are looking at many more months of inappropriate penalties.

Now if an error is above the applicable threshold, the only argument left is that, as specified in section 141B, a taxpayer does not take an unacceptable tax position merely by making a mistake in the calculation or recording of numbers in a return. In my experience IRD operations universally rejects this, and almost gleefully applies a penalty to every such error.

### **ICANZ response**

I understand the ICANZ tax team has raised the issue with IRD in several forums, but is yet to get any firm commitment from IRD other than that IRD is awaiting a ruling on the existing law. The tax team is continuing to work on the issue and will continue to pursue the matter at both an IRD operational and policy level.

In my view after several years of discussions with IRD there has been no effective progress, and I strongly believe it is time to turn up the heat on IRD. I therefore request your support in this matter.