Owens
Tax Advisors Ltd
Specialist Tax Advice

Web: www.owenstax.com
Email: jeff@owenstax.com
Mobile: +64 29 972 8944
phone: +64 4 972 8944
fax: +64 4 971 8944
PO Box 22052 Wellington NZ

Paper for Conferenz conference

IRD administration of tax system

14 November 2006 (Auckland)

20 November 2006 (Wellington)

In this paper and presentation I raise a number of concerns in respect of IRD's administration of the tax system, particularly in relation to tax disputes

I have included both my own thoughts and IRD's response

Correspondence timeframes

Owens Tax concerns

In our experience it is routine that IRD requires a taxpayer to respond to an 'agreed adjustment' form within two weeks or less, and this time is sometimes truncated further with the time for correspondence to exit the IRD system. This allows very little time to engage a professional and/or to reach a considered position.

We have lodged formal complaints in respect of even worse behaviour, such as

- allowing only seven days to respond, then three or four months passing with no sign of IRD's answer to our explanation, or
- timing a letter so IRD knew the advisor was overseas and giving seven days to respond.

Conversely when a taxpayer or advisor writes to IRD, IRD will often take weeks, months or even longer to reply.

In my view IRD should allow taxpayers and advisors at least four weeks to respond, and a quicker reply being simply a bonus with both parties having an interest in expediting matters by cooperation rather than artificial compulsion.

IRD also needs to tighten up its own procedures so it responds in a more timely manner, and in line with commercial practice and its own demands on taxpayers should be able to provide an estimated time to respond.

I have raised this issue with several parts of IRD and hope to influence some improvement shortly.

Inland Revenue has responded as follows:

The issues referred to here are currently underway via the work senior personnel have undertaken since having these complaints brought to IRD's attention. Regarding the time frames for responding to an agreed adjustment form or requests for information; IRD is working on updating an Inland Revenue 'Best Practice Guide' for Investigators that outlines what is expected as a minimum standard for Taxpayer Contact during all phases of an Audit.

Within this Guide we have a section on 'Setting of Time frames' and it is within this section that we will have a much clearer statement for Investigators to follow on what is a reasonable time frame. You have suggested a minimum of four weeks is reasonable. We are looking at what the impacts of this time frame might mean for the duration of audits as we have some specific public performance standards on which we report to the Government - for example; all general audits will be completed within 6 months.

> Owens further comment: this is all very well, but currently it is often IRD that takes up the lion's share of that time – eg giving the taxpayer two weeks to respond, IRD using another five months, and then imposing another two week response time on the taxpayer]

IRD also intend that the amended best practice statement for customer contact will include a prompt encouraging Investigators to negotiate a suitable time frame if a customer is unable to meet that standard time frame for legitimate reasons. This will mean the customer may contact us and request a further amount of time, or by agreement, agree that the standard time frame is not necessary and return the agreed adjustment form or provide the requested information earlier. In addition, IRD has very recently sent out a reminder about its own standards for responding to customer correspondence and we hope to see an improvement in two way communication in the future.

> Owens further comment: Again I remind IRD that this is a two way process. IRD has the mindset that IRD can set a timeframe (now possibly four weeks), it is up to the taxpayer to 'request' or 'negotiate' a longer timeframe to respond, and only where there are 'legitimate reasons'. Conversely however a taxpayer cannot specify any timeframe for IRD to respond, and indeed in my experience IRD is extremely reluctant to agree to a timetable to respond. However I acknowledge the proposal is a significant step forward.

Electronic Communications

Owens Tax concerns

IRD encourages taxpayers to communicate with IRD electronically – eg lodging tax returns electronically, using IR10 forms in substitution for financial statements etc. However there are areas where IRD will not extend similar convenience to taxpayers and advisors.

IRD will send taxpayer information by post or by fax - either of which can go astray inadvertently or be intercepted. However IRD consistently refuses to send information by email, even though it is quite straightforward to save an attached document with a unique password so that only the intended recipient can open the document.

I have also had situations where IRD has taken a great deal of persuading to release an electronic copy of a NOPA or other large document in Microsoft Word, even by passworded CD. Fortunately recent challenges have been successful so your expectation should be that IRD does provide such documents electronically albeit not currently by email.

Inland Revenue has responded as follows:

Inland Revenue works in a unique environment within which the secrecy of taxpayer information is paramount. Section 81 does not give us a choice as to whether we protect our customer's information or not. Should that information be given to the wrong person because we did not have appropriate processes and controls in place Inland Revenue would rightly be heavily criticised. Such events also erode the general trust people have in giving commercially sensitive and personal information to the Department. Inland Revenue, therefore, clearly has a much higher standard of responsibility to ensure appropriate standards of security of information are in place than say, you as a small business.

> Owens further comment: This is ignoring the point that an electronic document protected by a password is far more secure than a letter or fax.

Putting that to one side, we do agree that being able to communicate effectively via electronic means is a highly desirable form of communication for many tax practitioners and businesses when dealing with us. As a central Government agency, Inland Revenue is taking a leading role in many e-Govt initiatives to ensure the benefits of developing technology are fully adopted within Government. The Department's recent success in gaining an award for our Internet site is a reflection of the work we are doing in this area.

To ensure we are responsive to our customer's needs and the changing ways of doing business, we are committed to becoming a more "e" friendly Revenue agency. One proposal that may be of interest to you is to open up email communications with the top 50 corporate customers and tax agents. We recognise that these two groups of customers will generally have the appropriate amount of "e" security for us to be confident we can transmit sensitive information electronically. This proposal is being evaluated and we have some further work to do before adoption. But I can assure you the Department is genuinely committed to exploring ways in which we can safely benefit from e communication so that we find an efficient user friendly approach that does not compromise our legislative obligations and general public trust.

> Owens further comment – IRD's words indicate a willingness to improve communications process but it still seems to be heavily hedging its bets. IRD was researching security of email more than five years ago and there seems to have been little progress to date. I repeat – a word document protected by password is much safer than a fax or a letter sent by mail or courier, and I see no reason whatsoever that IRD shouldn't join the 20th century and cooperate with taxpayers in the way IRD wants taxpayers to cooperate with IRD.
>
> There is no legitimate reason to restrict this to 'top 50' customers – the security issues are at IRD's end not the customer. If the customer (taxpayer or agent) requests or agrees to receive documents electronically there is no reason to not implement that.

IR10 accounts information form

Owens Tax concerns

IRD encourages taxpayers to lodge IR10 forms in substitution for financial statements.

In July 2003 IRD stated[1]:

> **E-Filers, IR10 and disclosure obligations**
>
> The IR10 is an integral part of Inland Revenue's E-File system. We use it for providing information to Statistics New Zealand and to build up data for audit case selection.
>
> Tax agents and taxpayers who file returns manually may either send in an IR10 or a set of financial statements with tax returns. However, we are encouraging tax agents to use both the E-File system and the IR10 instead.

[1] Agents Answers [Issue 47 - July 2003]

> **Concerns about lack of information disclosure on an IR10**
>
> There has been some concern about the lack of information disclosure when using an IR10 compared with the information disclosed in the financial statements, which could affect how section 108 of the Tax Administration Act 1994 applies to reassessments after the four-year time limit has passed.
>
> There is a perception that a taxpayer who filed an IR10 instead of financial statements could be disadvantaged if an investigation of back-year returns reveals a discrepancy. If the discrepancy is in an item that is recorded in the financial statements (obtained during the investigation), but which did not need to be recorded on the IR10, section 108 could be used to reopen the statute-barred assessment with the argument that full disclosure was not given in the return for that particular item.
>
> This problem does not exist when financial statements are filed with the tax return. If a reassessment is not issued for the item before the four-year time limit has passed, Inland Revenue is statute-barred from reopening that assessment because full disclosure was made to us with the return.
>
> Because of these concerns some E-Filers and other agents choose to send paper returns so they can attach more disclosure information. We'd like to assure agents that this is not necessary and that they can continue to use the IR10 and E-File returns confidently.
>
> It's our policy not to disadvantage taxpayers and their agents who use the IR10.

The IR10 Guide explicitly states that “Completing an IR 10 form helps speed up the processing of the tax return. If an IR 10 is completed, financial records don’t have to be included, although they may be requested later”.

Similar statements have been made in 1998 and 1993.

I am aware however of situations where IRD has set aside information included in financial statements, including an example where IRD claimed that a return was not statute barred because of lack of disclosure, even though a relevant capital gain was clearly disclosed in financial statements.

I urge you to be wary of this, notifying NZICA of any such attempts by IRD to set aside a legitimate statute bar. If IRD will not give a clear undertaking that it will respect its own advice in this regard, then it may be necessary to encourage all taxpayers to lodge financial statements and refuse to use IR10 forms.

NZICA has followed this up with an email to members and is not aware of any other examples, so this may be an isolated instance.

However in a related matter, IRD has also disallowed a livestock election by a taxpayer because the taxpayer had not filed a separate letter in accordance with IRD policy. I believe that the requirement to file a letter is a fiction dreamed up by IRD – the legislation only provides that the election be made 'in writing', other legislation provides that an electronic document satisfies this requirement, the relevant information is clearly included in the financial statements, and in accordance with IRD policy the taxpayer filed an IR10 in substitution.

In my view there is absolutely no legitimate policy reason why IRD should not accept the IR10 (and supporting financial statements) as a valid election,

What is particularly insidious in this case is that

- primary sector taxation experts have encouraged their clients and colleagues to not file a separate document
- we believe that the majority of NZICA members have followed that recommendation
- IRD has to date accepted those elections, including by explicit ruling in 2004
- IRD even provided my client an article supporting that position
- as a result we believe that there will be hundreds if not thousands of farming taxpayers potentially facing the same issue

In respect of the IR10, Inland Revenue has responded as follows:

As you have pointed out, Inland Revenue will not re-open any stature-barred tax returns unless there is a genuine belief and sufficient evidence of a return being fraudulently or deliberately misleadingly filed.

If you come across cases where we are attempting to re-open any legitimately statute-barred returns for investigation, we would encourage you to take this up with the investigator and/or his or her Team Leader. In addition, there is a proposal to review the IR10 with a view to assessing how well it meets both the needs of our customers and the department. Should the review be undertaken, tax practitioners, as well as other customer groups will form an important part of the consultation process.

However in respect of the livestock election, at time of writing senior IRD personal are adamant that the law is clear, IRD requires a 'letter' and we should test the matter through a Notice of Response, adjudication and the courts.

I think this is a despicable example of IRD writing new policy at a local office level in order to achieve an inappropriate tax grab, and has singled out one or two taxpayers to dump the full cost of a dispute against IRD's far larger resources.

This is a repeat of IRD's decision (also made at a district level) to require farmers to capitalise the cost of re-sowing grass, a matter that required urgent dialogue with the Commissioner to resolve.

Including penalties in agreed adjustments

Owens Tax concerns

IRD published practice is to reach agreement with the taxpayer on any shortfall penalties at the same time as other tax adjustments and to include these shortfall penalties on the agreed adjustment form unless the taxpayer advises otherwise, or circumstances exist where it is inappropriate to do so, eg prosecution - refer TIB Vol 13:9 (September 2001). However I am aware of examples where IRD has neglected to do that and reserves the ability to add penalties later.

Thus a taxpayer may accept a position they think is incorrect after weighing up the cost of defending it, and then find that the actual tax charge has doubled or worse.

If you receive an 'agreed adjustment' form (a badly misnamed document in the first place) you should immediately check that IRD has disclosed any proposed penalties, and also insist on a reasonable amount of time in which to respond.

Inland Revenue has responded as follows:

It is Inland Revenue policy to have any shortfall penalties included in the agreed adjustment form when it is presented to the customer for consideration. If this does not occur, please send the agreed adjustment back to the Investigator and ask for them to include the penalties (if any) in the agreed adjustment form. A reminder for all investigations staff is being prepared to ensure our staff are aware of this requirement. This may also be included with an update on the best practice statement for customer interaction.

Complaints Management Service and the Investigations segment are working together to ensure these issues are picked up at a national level and communicated to all investigations staff to ensure consistency across the board.

> Owens further comment: I am pleased with IRD's response and look forward to more appropriate policing of this within IRD. It certainly should not be up to taxpayers and advisors to police this.

Making voluntary disclosures to Inland Revenue

Owens Tax concerns

Section 141G provides a 75% reduction in penalty for disclosing an error to IRD, but where the shortfall is temporary (eg many GST or PAYE errors) the comparable section 141I 75% reduction is not in addition to that for disclosure, so in effect the taxpayer is gets no credit for disclosing the error.

While the NZICA code of ethics requires Chartered Accountants to recommend that a client error is disclosed to IRD, it can result in an audit of issues of which IRD may have remained unaware, and an inordinate amount of time defending the client's position whether successfully or otherwise. You need to keep this in mind and weigh up the consequences when making such a decision.

A press release by the Institute of Chartered Accountants (18 October 2006) states:

> "Inland Revenue's schoolboy-like enthusiasm for imposing penalties, as well as the breadth of the shortfall penalty regime, seriously compromises people's perception of the tax system's fairness, which consequently undermines voluntary compliance,"

The media release was in response to the October government discussion document Tax penalties, tax agents and disclosures:

The document proposes:

> "As a further incentive, shortfall penalties for not taking reasonable care or for taking an unacceptable tax position would not be imposed if the taxpayer concerned made a voluntary disclosure of the shortfall before being notified of a pending tax audit or investigation. That would have to occur within two years of the taxpayer taking the position."

This is a very welcome change, albeit in response to five years of lobbying by NZICA and other prominent commentators

Section 141KB relief from shortfall penalties

Owens Tax concerns

I have written several times on this issue. A recent letter from the Minister of Revenue advised that as of early June IRD had ruled on 11 applications for such relief, accepting 10 and rejecting one. I am aware however that as at the date of that letter two such applications had been declined by IRD and it is possible there may be more.

I urge members to forward details of such applications to NZICA, especially where IRD has turned them down.

All such applications had to be lodged with IRD by 1 October 2006.

I am aware of several examples where IRD has rejected 141KB relief on the grounds that the given error was ”not a simple error’ or that the taxpayer ‘deliberately took the position’ or even ‘deliberately made the error’.

IRD in the field seem to be vigorously undermining the spirit of the relief, in the same way as IRD fought against providing the relief in the first place.

The document proposes (inter alia) that:

- 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.
- UTP or LORC penalties will not apply if shortfall disclosed before notification of a pending tax audit or investigation

Owens comment:

These proposals are very welcome – GST and timing shortfalls have definitely caused the most problems in the penalties system

I am very disappointed that it took the best part of five years for the government to properly acknowledge the concerns raised by NZICA and others over the way IRD vigorously applied penalties where the risk to the revenue was minimal or non existent, and especially where the taxpayer had voluntarily disclosed a mistake.

Application date of proposed changes

The discussion document proposes:

> 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.

Owens comment: The changes are clearly an acknowledgement, not that there will be problems with the penalties regime in future, but that there are serious problems with the penalties regime now and in the past. In particular this has arisen since in the face of overwhelming submissions to the contrary IRD changed the penalty for 'unacceptable interpretation' to 'unacceptable tax position, which as predicted led to many innocent mistakes being heavily penalised in contradiction to the 1994 design of the current penalties regime.

The relief proposed MUST be backdated to the introduction of the Unacceptable Tax Position legislation in late 2002/early 2003.

We acknowledge that this will be an administrative headache for IRD, where taxpayers relitigate harsh and inappropriate penalties that were imposed by IRD in the last five years. This is a problem that IRD has brought upon itself by rejecting the majority of 2002 submission on the UTP proposals, and by continuing to rail against subsequent improvements.

Cost of addressing IRD behaviour

When IRD exhibits inappropriate behaviours as set out above, especially in conjunction, the financial and personal costs imposed on taxpayers and their advisors can be very significant.

I believe that when IRD behaviour steps outside acceptable boundaries, taxpayers need to challenge IRD and claim compensation for unnecessary cost.

Challenging such behaviours often lead to stonewalling by IRD. There are official escalation processes, including to IRD complaints management, Minister of Revenue, Ombudsmen etc, but it is very difficult to get a meaningful outcome.

In a recent tax dispute I documented eleven examples of inappropriate IRD behaviour ranging from the mundane (misspelling the taxpayers and advisors names) to quite serious – deliberately misquoting legislation, charging a penalty four times as large as available in legislation, withholding a legitimate refund.

Even then IRD's response was to simply apologise and undertake to do better in future.

Taxpayers are afraid to challenge IRD because the cost of doing so often exceeds the tax and penalties at stake. Maybe this is deliberate on IRD's part, but it is certainly not the way to run a tax system

Challenging IRD can be expensive and frustrating but it is the only way to encourage improvement.

Nil illegitimus carborundum.