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Dear David

## **Penalty for Unacceptable Tax Position**

I read with dismay the article on page 48 of the May 2005 Chartered Accountants Journal: Unacceptable Tax Position – is it time for a change? The article highlights a number of issues of concern.

In particular I note the closing paragraph:

Inland Revenue's Rulings Unit have issued a draft interpretation statement, IS0055, that indicates there is not much room for any concessional operational interpretation of the rules and it seems that the only avenue is a legislative change.

### **Application of penalty to errors**

From time to time Chartered Accountants in Public Practice bring to me examples where a taxpayer or their advisor has made an unintentional error involving a GST timing issue, ie one which will automatically reverse itself in the next period (one month, two months or six months).

If the IRD has identified the error there seems to be a preconceived assumption that a 20% penalty must apply in every case, either for 'lack of reasonable care' [LORC] or for an unacceptable tax position [UTP]. Sometimes IRD does not distinguish between the two – simply stating that a 20% penalty applies.

The 20% penalty is often subject to a possible 75% reduction for disclosure and a possible further 50% for 'good behaviour.'

However while the reductions are welcome, when the core tax is significant, the penalty can run to many thousands of dollars, when in most cases there is no economic loss to the IRD and no potential economic gain to the taxpayer from their error.

In my view this is clearly a fault in the legislation, and in that regard I agree that the only solution appears to be legislative change.

However IRD's actions in this regard seem to be to be particularly unhelpful.

### **Prior commentary on penalties regime**

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 government discussion document on the penalties regime stated (inter alia)<sup>1</sup>:

- 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.

However when an error is more than the UTP threshold IRD seeks to apply a penalty in every case. This is in direct contradiction to the earlier undertakings by government and FEC, and indeed by the IRD itself.

Where a taxpayer discovers an error that is above the UTP threshold, then by disclosing it to IRD they are guaranteeing a penalty or a dispute. Consequently, taxpayers are forced to weigh up the costs of the penalty and/or the dispute against the risks of disguising or self-correcting the error in the immediately subsequent period and hope that IRD does not pick it up.

In the mean time, IRD frequently makes errors in administration and tax assessments, but all it does is apologise (sometimes) and continues on without sanction. Of significance is the fact that IRD does not apply a similar standard to its own actions as it requires of taxpayers.

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<sup>1</sup> [2001] TAXPAYER COMPLIANCE, STANDARDS AND PENALTIES: A REVIEW

## **Change from Unacceptable Interpretation**

As you are aware, the UTP penalty replaced the penalty for Unacceptable Interpretation [UI] in 2003.

The UI penalty had its own problems, in particular with IRD staff assuming that if an agent is involved there must have been an 'interpretation' in every case, and with IRD staff treating the LORC and UI penalties as interchangeable.

However submissions were strongly against the change to UTP that was proposed and in fact enacted.

ICANZ submitted:

We strongly disagree with the proposal to change the shortfall penalty for "unacceptable interpretation" to "unacceptable tax position". Where a taxpayer has not interpreted the tax law but there is a significant amount of tax at stake and a shortfall results, then the lack of reasonable care penalty is the appropriate penalty to consider.

The NZ Law Society submitted:

The New Zealand Law Society is concerned that if the amendments are enacted, the Inland Revenue Department will wield section 141B each time a major taxpayer, even if inadvertently or with the best care possible, gets it wrong. It will be too easy for the Inland Revenue to impose shortfall penalties on significant taxpayers who are, for instance, late in complying with filing and paying obligations or who transpose figures in their returns or who, through the confusing and unclear nature of certain tax forms, simply complete them incorrectly.

Other submissions were on similar lines.

IRD was clearly on notice that this penalty was encroaching into the area of inadvertent taxpayer errors.

Subsequently in October 2004 ICANZ conducted a survey of its members and provided a number of examples to IRD..

## **What should IRD do**

For nearly four years Inland Revenue has been promoting its compliance model, which as you are aware 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.

I have identified many situations when the taxpayer falls into the first category but Inland Revenue applies the provisions of the penalty rules as though they were in the second. The UTP legislation forces this result.

The situation is unacceptable. The penalty rules are having the opposite effect to encouraging compliance. That is, they are forcing taxpayers to stay outside the confines of the law because of the high costs of making a disclosure to IRD.

IRD should support legislative change as a matter of urgency, and in the interim encouraging an approach by staff that has regard to the commercial realities of the fact that taxpayers do not live in a world of perfection – sometime, despite the best efforts of taxpayers mistakes are made. Penalising, or threatening to penalise such errors is not constructive and promotes non-compliance.

At a minimum temporary shortfalls must be removed from this regime, and there must be no penalty where a taxpayer has voluntarily disclosed an error.

If things stay as they are then it would seem that IRD is treating the penalties regime as a revenue gathering mechanism, in direct contradiction to the original design of encouraging compliance.

I trust that ICANZ and IRD can work together to ensure this is not the outcome. I would welcome your comments.

Yours sincerely

**Jeff Owens**  
Director