

Beware, the taxman cometh

Inland Revenue has stepped up the way it goes after tax cheats, catching them the same way that notorious gangster Al Capone was beaten in the US.

BY DEBORAH CODDINGTON

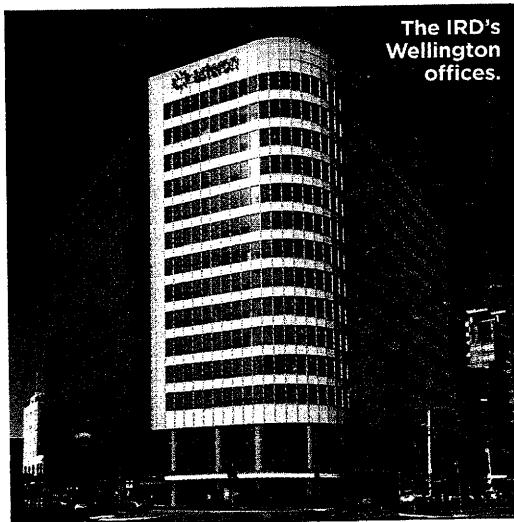
Even on a mild day, the Wellington wind blusters through the cavernous foyer of Inland Revenue's new office tower opposite the Railway Station, a metaphor for the maelstrom in which dishonest taxpayers find themselves when inspectors audit their books. Few wish to dally here, despite welcoming couches. Depending on one's political leanings, the department is either a distributor of wealth or the legalised thief of private property.

Either way, paying tax is generally a low priority. Ninety years ago, federal agents raided Al Capone's gambling dens, brothels and warehouses to seize manual ledgers, but nowadays the IRD can electronically access bank records and Fly Buys membership, clone computer hard drives, get printouts of customers' supermarket purchases, match CCTV footage with cash sales and scrutinise dealings on Trade Me.

The IRD can computer-model what you present as your business performance in your tax returns, and use that model to compare key performance indicators with your competitors'. In Capone's day, what took painstakingly long handwritten calculations now happens in a flash in an Excel spreadsheet, structured by experts in forensic accounting.

Attempts by the Treasury and IRD to reliably estimate the black economy have not resulted in convincing data. In Europe it's thought to be 20% of GDP. Here it may be as much as 10-20% of GDP, which was \$189 billion in 2009/10. Even a much more conservative estimate of 10-20% of New Zealand's core crown tax revenue – \$50.7 billion in 2009/10 – would mean the Government is forgoing \$5.7-11.4 billion a year. If the black economy is much

less than this, it still leaves plenty of scope for the IRD to focus its resources on clawing back lost revenue. That's why in the May 2010 Budget the department was allocated \$84 million to recover \$400 million over 10 years.



The IRD's Wellington offices.

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Not that the clampdown hadn't already started. In February last year a Palmerston North takeaway owner was sentenced to six months' home detention for knowingly evading tax for four years from 2004. Shu Tang Zhi pleaded guilty to 28 charges of evading GST and income tax, after declaring less than 30% of the true profits made by his business, Annie's Fastfood. He was also ordered to repay the \$179,000 tax

plus \$40,000 in penalties and interest.

Zhi, 48, who became a New Zealand citizen in 1986, blamed his problems on a gambling addiction that started while working up to 70 hours a week in the fish and chip shop. He said the antisocial hours and the lack of stimulation at work led him to betting at the TAB and playing pokies.

"This was a case of classic tax evasion, a problem we believe is widespread in the takeaway and restaurant industry," said IRD senior investigations manager Patrick Goggin at the time of Zhi's sentencing. Goggin said the IRD had been targeting the fast-food and restaurant industry for the previous 12 months and would continue to do so.

"Businesses of this type, reporting low profits and low profit margins, are likely to be targeted for investigation and Inland Revenue is able to employ a range of investigation techniques to establish the likely profits being made."

Two months after that case, Wellington property developer Lance Christopher James was jailed for two years for evading \$356,000 of tax. James was found guilty of eight charges of evading income tax – he had failed to provide tax returns between 1998 and 2005 involving \$174,000 when

he was self-employed as a director for a number of property development companies – and admitted a further 11 charges of PAYE evasion.

"This is a clear case of a businessman who knew exactly what his tax obligations were, but deliberately set out to ignore them," Goggin said. "Others who are tempted to cheat on their taxes should take note of this sentence and be left in no doubt of the very serious consequences if

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they choose that path."

James sought to be sentenced to home detention rather than prison but Judge Chris Tuohy said allowing him to stay in his \$1.8 million Eastbourne home, bought in part with money from unpaid taxes, "offended the perception of justice".

James was involved in a number of developments that struck trouble. Finance company Lombard sold up his Brooklyn Rise housing development, leaving one of James's companies owing \$5 million of GST.

A development on Wellington's expensive Oriental Parade is subject to a leaky building claim as well as a dispute with neighbours. Excavation for another project, also on Oriental Parade, resulted in a neighbour's yard collapsing onto the building site.

Last June, when a Wellington owner of two seafood restaurants, Yong Rong Zhi, was convicted on 26 charges of evading \$158,000 of tax, Goggin pointed out it was another case of a business reporting low profits and low profit margins, which made it likely the IRD would target it.

The court was told that despite low returns, Zhi was able to buy his business outright and buy the property in which the business was housed, then sell them for substantial profits. During this period he evaded \$43,555 of GST and unlawfully obtained \$15,585 of Working for Families tax credits because he managed to depress artificially his income.

These are a sample of results, but what is the modus operandi? And if the surprise element is disclosed, how will successful prosecutions ensue?

Meet the IRD's two top sleuths: national investigations manager assurance Tony Morris and Wellington legal and technical services manager assurance Colin Hutchins.

After the last Budget, Morris took responsibility for leading the nationwide hunt for the hidden economy. The extra funding means in the year ending June 30 he needs to return \$90 million from tax evasion and fraud activities - by February his team had already recovered more than \$100 million.

Morris and Hutchins attribute this success to attitude. Aforementioned cases notwithstanding, the IRD is more concerned about compliance than prosecution; it would rather not have customers be very afraid. The department's philoso-

phy is, like its name, to gather revenue, not plunge taxpayers into financial ruin.

In their business suits and shirts, the two men don't look fierce, and most taxpayers will never blip onto the radar of their investigative team. Yet your armpits can prickle slightly in their company and your heartbeat speed up a little as you realise it's woe betide the tax evader who underestimates their bloodhound skills.

"We don't want people stumbling into serious offending," says Morris. "A lot of

our work is about encouraging them to get it right from the start so we don't have to investigate. If people go bankrupt, they can lose their homes, their livelihoods, their reputations. Our objective is generally to keep people in business when we can, so we work towards that."

Hutchins: "If a number of business people read your article and think, 'I'd better put my affairs right with the IRD', they could make a disclosure to us, they won't be prosecuted

for tax evasion and they'll get substantial reductions in penalties because they've come clean unprompted."

Since July 2010, following the Budget directive, the IRD has targeted till-tickers mainly in the hospitality industry - owners of cafes, restaurants and takeaway shops who don't declare cash income. And just like Al Capone, a taxpayer's lavish lifestyle is often a dead giveaway that taxes are being evaded.

From May 1927 when the US Supreme Court ruled all income, legitimate or not, was subject to taxation, the Inland Revenue Service went after Capone for tax evasion, because federal agents had had no success catching him for bootlegging, prostitution rackets, gambling or gruesome murders such as the St Valentine's Day massacre.

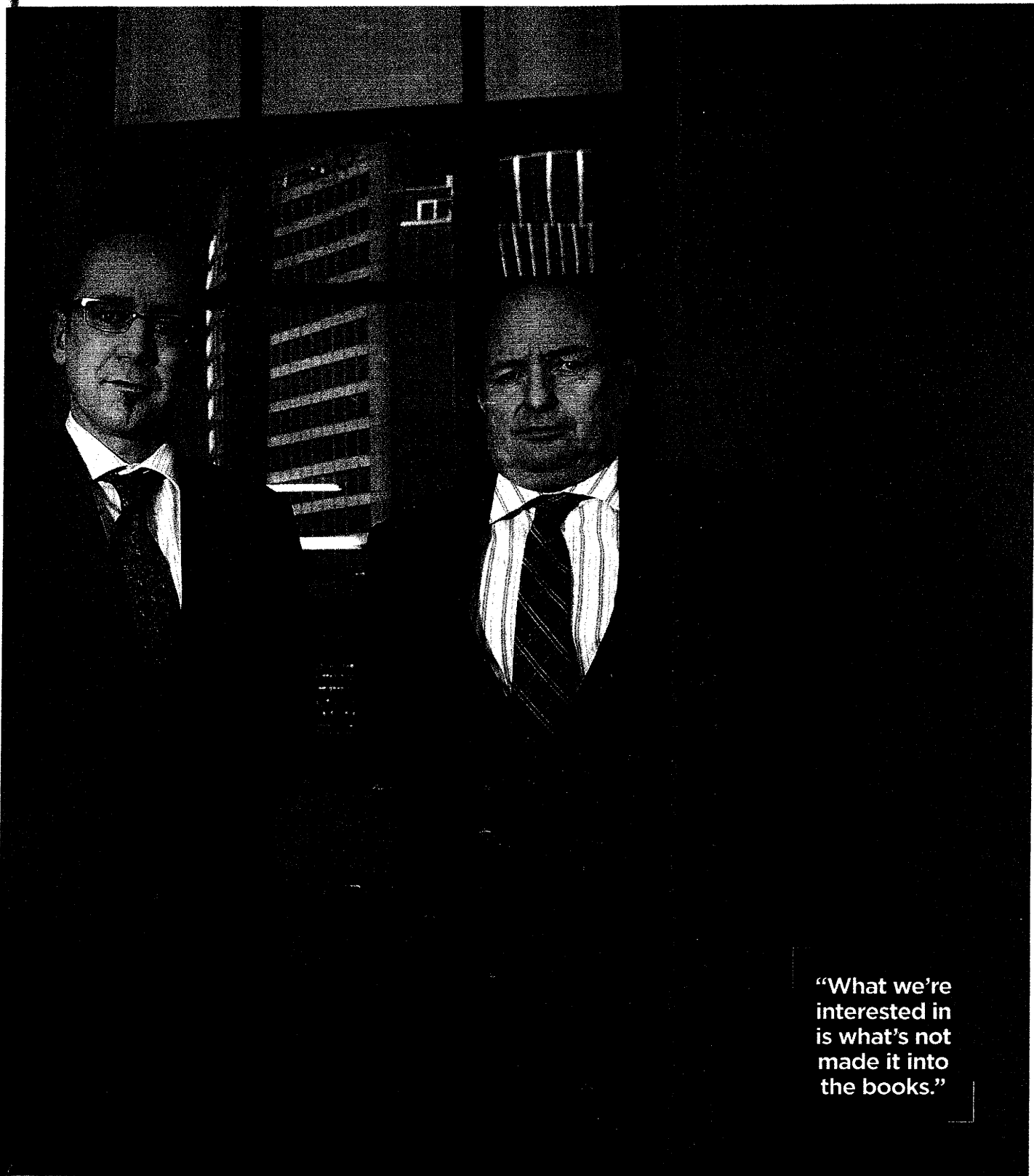
It took years to untangle the complex and hidden financial details of Capone's empire, but he was eventually undone when his lavish lifestyle was unpicked, despite his claims of little personal income. Laurence Bergreen's biography of Capone describes how his wife, Mae, tossed cash around like confetti. In one day's shopping in Miami Capone bought "over \$1000 in merchandise, all paid in cash", a considerable amount in 1929. He wanted to look like a tourist, "with one exception - he was wearing a belt with a diamond-studded buckle", also bought with cash.

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Hutchins and Morris: about to focus on fishing, aquaculture, the scrap-metal industry and tourism.

On October 24, 1931, "Scarface" Capone was sentenced to 11 years' jail, not for murder or illegal booze-running, but for tax evasion.

In Wellington 80 years later, Hutchins agrees the IRD's methods of investigation are the same. "We look at the taxpayer's lifestyle and spending requirements and patterns, their asset position and



“What we’re interested in is what’s not made it into the books.”

how those assets were funded, the taxpayer and their immediate family’s bank accounts – we can go to the bank and ask for all statements that go to a taxpayer’s addresses.

“We examine credit cards and loyalty programmes, like Fly Buys. Loyalty programmes are widespread these days and people like to accumulate points and

get the benefits, rewards and discounts these create. But notably, membership of these programmes creates an electronic trail of spending patterns, including cash expenditure, of which there would otherwise be no record.

“The loyalty programme and other records can supply two useful insights. First, they may identify substantial cash

expenditure that the taxpayer cannot adequately explain; and second, they demonstrate a propensity to spend and the nature of that spending, which may not otherwise be evident and from which appropriate inferences can be drawn.”

So when a business owner files his tax returns showing only a modest profit or none at all, and the taxman drives

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past that taxpayer's residence and sees a couple of late-model European cars parked in the driveway registered to the taxpayer and his wife, the taxman says aha. And if the children are then found to be attending an expensive private school, the IRD will probably, Morris says, "make third-party" inquiries. As Hutchins says, "That's what they did with Al Capone on a grand scale."

So how do the IRD inspectors know what they don't know?

Hutchins: "It's a misunderstanding to think the IRD will only investigate what's on the books. We already know what's in the books. What we're interested in is what's not made it into the books. We investigate the financial affairs of the taxpayer, so we investigate what's not in the books and make a comparison."

"You can only do a certain number of things with money. You can save or invest it. You can buy assets or repay debt. You can spend it on consumables and maintaining a certain lifestyle. And sadly, sometimes you can fritter it away on addictions like alcohol or gambling."

And it's not just the owner's lifestyle that is given the once-over. In any investigation, the IRD looks into the business – not just the profitability, but also its performance against industry norms, what's going on with the cash handling and record-keeping.

But there's no random targeting of tax returns going on here. In a kind of triage system, the IRD's intelligence unit profiles all tax returns from the hospitality industry, categorising them low risk – compliant and/or high-quality returns generating a sensible profit margin – medium risk and high risk – a return with low profits. The unit then looks at the ratio of cash received to Eftpos and credit card sales, the number of staff needed to run the business compared with the number disclosed on the payroll, how much liquor is sold and the types of drinks sold. If aberrations are obvious, then an audit follows.

Morris concedes that sometimes a restaurant that at first glance might appear to be dodgy might simply be badly run. "Quite often when we go in, we find things are okay, there's no dishonesty."

But even when there has been evasion, if the taxpayer immediately admits he or

she has, as Hutchins puts it, "been a bit naughty", the IRD does have the discretion to reduce the penalty – prosecution is not automatic.

But once first interviews are over, it's goodnight nurse. "That's why people need to be very careful about drifting into serious tax problems," says Hutchins.

"A takeaway proprietor pocketing \$50 a

drawings or Eftpos – then it must be cash. The taxpayer then needs to be able to point to a source of cash income other than the business. When taxpayers continue to lie and deny buying any goods with cash, the IRD has produced CCTV footage matching them with cash receipts from supermarket checkouts, plus footage matching them claiming Fly Buy points.

So why do they think they can get away with it?

Hutchins reckons most people don't believe they'll be selected for an audit; if they haven't been selected in the past 10 years, they think they're safe, or if they do get investigated, "the mischief won't be found".

The IRD's research shows that "habitual non-compliers" consistently and deliberately fail to keep, maintain or provide documents and tax returns, don't pay tax, commit tax fraud and manipulate family or personal circumstances to reduce tax liabilities or to access payments they're not entitled to.

Other small and medium-sized owner/operator industries have already been flagged for a future focus. Hutchins says the traditional corner dairy is a

prime suspect for undeclared cash takings – "a truckload of lollies and a box next to the till ..."

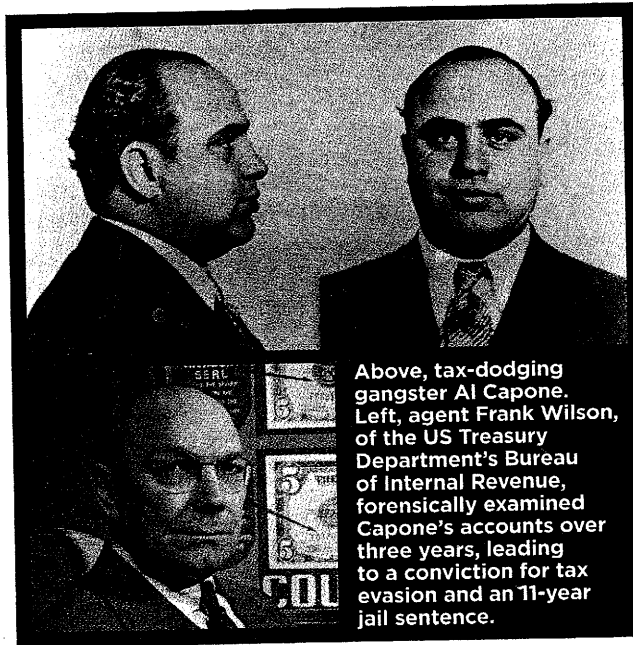
Then there are the online traders who think they're invisible. "We're not interested in people selling old clothes out of their wardrobe, but people using it regularly as a venue for commercial outlets. We've got a lot better at our intelligence and third-party data. We get information on millions of transactions, and that's analysed."

The team will be moving on to fishing, aquaculture, the scrap-metal industry and tourism – watch out bed-and-breakfast operators renting out spare bedrooms when the kids leave home.

And along with everyone else in New Zealand, the IRD is gearing up for the Rugby World Cup. Just as Capone got done

for not paying tax on his ill-gotten gains in the 1930s, if anyone here makes substantial profits from illegal ticket scalping, then Morris makes it clear where people stand.

"We will make sure people are aware of their obligation to pay tax on any profits from ticket scalping, and if they fail to meet their obligations and the amounts involved are significant, we will consider penalties or prosecution." ■



Above, tax-dodging gangster Al Capone. Left, agent Frank Wilson, of the US Treasury Department's Bureau of Internal Revenue, forensically examined Capone's accounts over three years, leading to a conviction for tax evasion and an 11-year jail sentence.

day from the till may pay scant regard to the fact that income tax and GST will not be accounted for on that money. But \$50 a day is almost \$20,000 a year or \$80,000 in four years. An \$80,000 omission is a significant issue.

"However, we are encountering situations where it is not \$50 a day, but \$500. In four years that's \$730,000. That sum could result in a tax bill of \$215,000 of income tax and \$80,000 of GST, interest and penalties of another \$200,000 and potentially a criminal prosecution."

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COLIN HUTCHINS

But if I'm a cafe owner not declaring, say, 10% of daily takings, and I use those takings to purchase groceries, food and entertainment, how can the IRD possibly trace this money?

Easily, and it's how Morris's team nails small and medium-size business owners who evade PAYE, GST and income tax.

Everyone has to spend money to support themselves and their families and if the spending isn't traceable – cheques,