

Voluntary disclosures – pleasures and pitfalls

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From time to time, Inland Revenue encourages taxpayers generally to consider making a voluntary disclosure of an error in a tax position taken. In this article we link to IRD's guidance and comment on the advantages, and also important risks and other considerations that need to be taken into account before making a disclosure.

IRD's guidance

IRD's guide and standard practice statement can be accessed through the following weblinks:

<http://www.ird.govt.nz/resources/1/4/145e7e804bbe577dafa3ffbc87554a30/ir280.pdf>

<http://www.ird.govt.nz/technical-tax/standard-practice/shortfall/sps-09-02-voluntarydisclosures.html>

Inland Revenue states:

A voluntary disclosure is when you tell us what is wrong with your tax returns before we find out in some other way. It may involve such things as omitted income or expenses incorrectly claimed. Anyone can make a voluntary disclosure including salary or wage earners, individuals, businesses, trusts and employers and this form enables you to do so

www.ird.govt.nz/forms-guides/title/forms-v/ir281-form-voluntary-disclosure.html

IRD's guide "Putting your tax returns right" states:

If you've made a mistake or filed an incorrect tax return, it's best to tell us about it before we find out in some other way. This guide will help you put your tax returns right.

...

If you tell us about your tax problems, the penalties (if any) will be much lighter than if you wait for us to find out ourselves. Learn here what your obligations as a taxpayer are, what to do if you've made a minor or genuine error, and what a voluntary disclosure is and the benefits of making one.

Comments from Owens Tax Advisors

The key advantage of a voluntary disclosure made before announcement of an IRD audit is that any penalty that the taxpayer may have faced is reduced/remitted to either

- 25% of the applicable penalty (gross carelessness, evasion), or
- zero (lack of reasonable care, unacceptable tax position or unacceptable interpretation)

However there are important risks and other considerations that need to be taken into account.

In the attached appendix we set out some issues based on experiences of our clients and in some cases ourselves, in particular:

1. Cost of VD process
2. A VD will cement in place a tax liability
3. VD should be made before audit notification
4. VD must be 'full and complete'
5. Penalty for gross carelessness or evasion
6. If not subject to reduction, penalty rates and amounts can be excessive
7. Backdated use of money interest
8. VD may trigger an IRD audit

Other long standing issues with IRD administration include:

1. IRD making extremely unrealistic demands for information to be provided in a short period
2. IRD then failing to respond to taxpayer correspondence in a timely manner

These also need to be factored into the decision making process.

Key messages

Before making a voluntary disclosure of a tax shortfall, taxpayers and advisors need to consider the following:

1. Ensure that the shortfall really is a shortfall – for example don't declare a profit on sale of land until you are sure it really is taxable
2. Ensure that you understand the full cost of the disclosure – tax, interest, any potential penalties, and the cost of administering the process
3. Ensure that you have enough information and analysis to make a full disclosure
4. Ensure that should the disclosure trigger an audit, there is nothing more for IRD to find.

You should definitely get assistance from an expert in managing such issues.

Jeff Owens
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Appendix: Potential risks and disadvantages of a voluntary disclosure

1. Cost of VD process

The process of administering and finalising a voluntary disclosure can be expensive and time-consuming – Inland Revenue is renowned for requiring very prompt replies to its correspondence, but being extremely tardy in the other direction.

2. A VD will cement in place a tax liability

The voluntary disclosure does of course cement in place a tax liability. It could be that the liability is open to debate – for example income tax applicable to a capital gain on sale of land – again may legitimately not be subject to income tax in the first place, but having "voluntarily disclosed", it is inevitable that inland revenue will expect tax to be paid.

3. VD should be made before audit notification

The full penalty remission will only apply to a shortfall that has been disclosed prior to Inland Revenue announcing an audit (a pre-notification disclosure). Once Inland Revenue has announced an audit, the penalty remission is reduced to 40%, leaving 60% of the penalty still applicable (post notification disclosure). Once an audit has actually commenced, there is no reduction for voluntary disclosure. Some IRD correspondence makes it clear that an audit has not yet been announced but sometimes IRD demands information, recommends a disclosure, but doesn't give any clue as to whether an audit has commenced or at least been announced.

4. VD must be 'full and complete'

The disclosure must be "full and complete" – in general, sufficient to establish not only the basis that the amount of the shortfall (our strong view is that if the taxpayer makes a voluntary disclosure but has yet to make the calculations, they should be subject to the full penalty reductions). If some shortfalls have been disclosed but IRD finds others in a subsequent audit, the penalty reductions will not apply to the latter.

5. Penalty for gross carelessness or evasion

Because lower level 'shortfalls' may be subject to a full remission for voluntary disclosure, IRD staff may be tempted to impose a higher level penalty

6. If not subject to reduction, penalty rates and amounts can be excessive

If a penalty does apply, and is not subject to a full reduction, that penalty could potentially be as much as 150% of the core tax.

7. Backdated use of money interest

As well as paying the tax shortfall and any penalties, the tax will inevitably be subject to backdated use of money interest at Inland Revenue's above market rates.

8. VD may trigger an IRD audit

A voluntary disclosure may trigger an IRD audit. Our clients are certainly not the only taxpayers to experience these issues – see for example:

www.grantthornton.co.nz/Press/were-from-the-ird-we-appreciate-your-help.html

IRD claims that very few voluntary disclosures are followed by an audit. However in my experience IRD is quick to quote such statistics but they are sometimes incorrect or misleading, and in any case are of no comfort to someone where the process has gone wrong “I’m sorry sir we have amputated the wrong leg, but don’t worry in 99% of cases we get the correct leg”.