TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTOTANGA WHAKATAU Ā-TURE> WHAKAWĀ

Quantum of suppressed income and whether it is dividend or employment income

Decision date | Te Rā o te Whakatau: 22 December 2021

Issue date | Te Rā Tuku: 15 June 2022

TDS 22/08

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This document is a summary of the original technical decision so it may not contain all the facts or assumptions relevant to that decision.

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Subjects | Ngā kaupapa

Quantum of suppressed income; Nature of income, employment or dividend; Treatment of reparation order payments

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer and Compliance Services, Inland Revenue
Commissioner	Commissioner of Inland Revenue
GST	Goods and services tax
TRA	Taxation Review Authority
SOP	Statement of Position
TCO	Tax Counsel Office, Inland Revenue

Taxation laws | Ngā ture take

All legislative references are to the Income Tax Act 2007 unless otherwise specified.

Facts | Ngā meka

1. This TDS relates to two separate Adjudication decisions for two taxpayers (**Taxpayers**) who were co-directors and 50/50 shareholders in a company. Because the facts, decisions, and reasons for the two decisions were the same for both taxpayers, except in respect of a matter relating to a reparation order, the two decisions have been combined into one technical decision summary. The issue relating to the reparation order that only relates to one taxpayer is dealt with in issue 3 in the technical decision summary.
2. The Taxpayers, who are individuals, were both directors in the Company which operated three retail establishments. The Taxpayers worked in the businesses.

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3. Customer and Compliance Services (**CCS**), Inland Revenue conducted a risk review which led to an audit of the Taxpayers and the Company including searches of the business premises and the seizure of business records. Several voluntary disclosures of omitted income were made on the Company's behalf during this process.

4. The Commissioner formed the view that the Company had been involved in fraudulent activity by suppressing cash sales and under returning GST and income tax. The Commissioner also formed the view that the Taxpayers had been involved in fraudulent activity by suppressing dividend income received from the Company and under returning income tax. Amended assessments were issued accordingly for the Company and for each of the Taxpayers.

5. The Commissioner laid criminal charges against one of the Taxpayers and following a jury trial they were convicted, and a reparation order was made as part of the sentence.

6. The Taxpayers each issued a Notice of Proposed Adjustment to commence the disputes process. In their individual Statements of Position (**SOP**), the Taxpayers rejected the Commissioner's assessments as arbitrary and demonstrably unfair. The Taxpayers also argued the assessments should be cancelled as they incorrectly assessed the omitted income as dividend income rather than employment income. The Taxpayer concerned also submitted that payment of the reparation order should be deducted from the Taxpayer's core tax liability.

7. The Commissioner in her SOP rejected the Taxpayers' positions, arguing that the Taxpayers had not proved that the Commissioner's assessments were wrong and by how much they were wrong. The Commissioner maintained that the omitted income derived by the Taxpayers from the Company was dividend income.

8. The matter was referred to the Tax Counsel Office (**TCO**), Inland Revenue for adjudication.

Issues | Ngā take

9. The main issues considered in this dispute were:

   - Whether the quantum of the Commissioner's assessments was wrong. This involves two subsidiary issues of:
     - Whether the assessments were arbitrary or demonstrably unfair.
     - Whether the Taxpayers had proved the Commissioner's assessments were wrong.

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- Whether the additional income derived from the Company in the disputed periods was employment or dividend income.

10. Another matter that arose was how the Court ordered reparation should be dealt with.

Decisions | Ngā whakatau

11. TCO decided that:

- The Taxpayers have not shown that the quantum of the Commissioner's assessments was wrong.
- The Taxpayers have not shown the additional income they received from the Company was employment income and not a deemed dividend.

12. In relation to the reparation order made by the Court, CCS has stated that if the Taxpayer pays the reparation payment, the Commissioner will credit the payment to the Taxpayer's core tax liability.

Reasons for decisions | Ngā take mō ngā whakatau

Issue 1 | Take tuatahi: Quantum of income

13. The Taxpayers argued the methodology used by the Commissioner to calculate the Company's omitted income (and as a consequence of that, the Taxpayers' omitted income) had limitations and uncertainties which meant that the Taxpayers' assessments were arbitrary and unfair. The Taxpayers also argued that the Commissioner's assets accretion analysis had failed to identify assets or expenditure matching the alleged omitted income. The Taxpayer asserted that calculations done by a forensic accountant they engaged properly represented the amount of omitted income for the Company.

14. CCS argued the Commissioner's basis for calculating the assessments was fair and produced the most accurate assessment of the Taxpayers' income. CCS argued that the approach taken by the forensic accountant was inaccurate as it ignored evidence of cash sales found by the Commissioner in her search of the business premises.

15. To address these arguments, TCO considered the following points:

- who must prove a matter (the onus of proof);

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- to what standard the person must prove the matter (the standard of proof);
- the basis on which the assessments are made (the threshold onus);
- credibility.

Onus of proof

16. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]

Standard of proof

17. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is more probable than not.

Threshold onus

18. From an examination of the relevant case law[5], the following principles may be derived in relation to the Commissioner issuing an assessment:

- An assessment cannot be arbitrary.
- The Commissioner must have some information on which to base an assessment.
- The Commissioner may base an assessment on the information in the Commissioner's possession and need not seek further information from other sources.
- The Commissioner cannot act in disregard of the law or facts known to her.

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[1] Challenge proceedings (i.e., the proceedings that would follow if this dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

[2] Section 149A(2) of the TAA.

[3] *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

[4] Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

[5] See *Lowe v CIR* (1981) 5 NZTC 61,006 (CA); *CIR v Canterbury Frozen Meat Co Ltd* (1994) 16 NZTC 11,150 (CA); *Golden Bay Cement Co Ltd v CIR* (No 1) (1995) 17 NZTC 12,253 (HC), a decision confirmed by the Court of Appeal: *Golden Bay Cement Company Ltd v CIR* (1996) 17 NZTC 12,580 (CA); *CIR v Dandelion Investments Ltd* (2001) 20 NZTC 17,293 (HC); *Dandelion Investments Ltd v CIR* (2003) 21 NZTC 18,010 (CA).

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- There is no overriding duty on the Commissioner to fully resolve the taxpayer's affairs before assessing.
- An assessment remains valid even if the Commissioner believes further enquiries may be required to arrive at the correct tax payable.
- The Commissioner may properly make an assessment which the Commissioner believes is not necessarily correct, or even probably wrong to some extent. This is so long as the Commissioner believes the assessment to be the best the Commissioner can do until further information is obtained.
- Precision or mathematical certainty may be unattainable.
- The Commissioner must make an honest judgment as to what the correct figure should be on the information available to the Commissioner.

Credibility

19. TCO adjudicates disputes solely on the documentary evidence provided by the parties to the dispute. It does not see or hear taxpayers give evidence and so is not able to assess their credibility first hand.
20. Sometimes CCS assesses credibility based on its dealings with the taxpayer. When adjudicating a dispute, TCO will consider any assessment made by CCS as to a taxpayer's credibility. All the parties' arguments and the available evidence will also be considered.
21. A taxpayer will have the opportunity in any later challenge proceedings to have their credibility assessed by the TRA or a court.

Application to the facts

22. TCO considered the arguments presented by the Taxpayer and CCS and answered two related issues:
    - Were the Commissioner's assessments arbitrary or demonstrably unfair?
    - If not, did the Taxpayers prove that the assessments were wrong, why they were wrong and by how much they were wrong?

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Were the Commissioner's assessments arbitrary or demonstrably unfair?

23. The Commissioner relied on the evidence of cash sales found at the business premises to calculate the income omitted by the Company and made available to the Taxpayers. She was able to verify information and also make reasonable inferences. Cash sales percentages and gross profit margins calculated by the Commissioner were then compared with data from similar businesses and found to be consistent.

    TCO concluded the methodology adopted by CCS involved the exercise of judgment and consideration of relevant facts and information. The Commissioner made the best assessments possible on the available evidence. The assessments were not arbitrary or demonstrably unfair.

Did the Taxpayers prove the assessments were wrong?

24. The Taxpayers asserted that the assessments made by the Commissioner were wrong and the correct amount of omitted income was submitted in the Taxpayers' voluntary disclosures as adjusted by the forensic accountant they engaged.

25. TCO concluded that the approach taken by the forensic accountant ignored the only direct evidence of sales for the disputed periods and used a cashflow and assets accretion analysis that assumed all the money received from the Company was spent on assets retained by the Taxpayers. On this basis, the accountant concluded that a lesser sum had been received from the Company by the Taxpayers. While there was evidence that the Taxpayers used some of the undisclosed cash to acquire assets such as an overseas rental property, it was also noted that the Taxpayers travelled regularly overseas. If the Taxpayers had physically taken New Zealand currency to an overseas destination or spent the cash on consumables such as travel or other living expenses, the accountant's methodology would not capture those amounts.

26. The Commissioner must determine as best she can on the information available the amount on which tax is payable and what is the amount of that tax. TCO considered that she had done so with the assessments which were based on the available evidence. The Taxpayers had not shown that the calculations of the forensic accountant should be preferred to the approach followed by the Commissioner.

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Issue 2 | Take tuarua: Nature of income

27. The issue is whether the additional income derived by the Taxpayers from the Company in the tax years in dispute was dividend or employment income.

28. The Taxpayers argued the income derived from the Company was taken in the form of drawings in their capacity as employees and was properly regarded as salary and wages, not dividend income. This was on the basis the Taxpayers worked in the business 24/7 operating the three establishments and had historically received regular monthly drawings and/or a shareholder salary. The Taxpayers argued that to treat the income as unimputed dividend income was unlawful as it denied the Company a deduction for the expense of remunerating the Taxpayers and effectively amounted to double taxation. The Taxpayers argued the assessments were not made on an intelligible basis and should be cancelled as incorrectly assessing the omitted income as dividend rather than employment income.

29. CCS argued that the Taxpayers had already received shareholder salaries for their services. The significant amounts of cash transferred to the Taxpayers in addition to that salary were not for any services provided but were a transfer of value caused by a shareholding relationship and, therefore, a dividend.

Employment income

30. Section CE 1 states that certain amounts derived by a taxpayer in connection with their employment or service are income of that taxpayer. Some key principles from the analysis on employment income are:

- Employment income includes salary, wages, or allowances relating to the employment of a person (s CE 1(1)(a)).
- Employment income includes "expenditure on account of an employee", which is where an employer pays for expenditure that is incurred by the employee or is to be incurred (s CE 1(1)(b)).
- Employment income includes "any other benefit in money" in connection with their employment or service. This is intended to be a catch-all with broad application (s CE 1(1)(g)).

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Dividend income

31. Section CD 1 provides that a dividend derived by a person is income of that person. Section CD 3 states that ss CD 4 to CD 21 define what a dividend is. Some general principles can be drawn from analysis of the legislation and case law:

- A dividend derived by a person is income to them (s CD 1).
- A dividend is a transfer of company value from a company to a person caused by a shareholding in that company (ss CD 4(1) and CD 6). A transfer of company value occurs where a company provides money or money's worth to a person where the market value of this is more than the market value of money or money's worth the person provides (s CD 5(1)).
- One indication that a transfer of company value is caused by a shareholding relationship is if the terms of the arrangement that results in the transfer are different from the terms for a similar arrangement where no shareholding is involved (s CD 6(2)).
- Dividends under tax law do not have to reflect the character of dividends as generally understood. There is nothing in the ITA 2007 stating that dividends must be paid out of company profits. Where companies incur expenditure for the benefit of a shareholder there may be a dividend under tax law to that shareholder.[6]
- Drawings (that is, payments made by a company to a shareholder in reduction of the shareholder's current account with the company) are not regarded as income of the shareholder but as non-assessable loan repayments.
- For a payment to a shareholder to be drawings there must be some evidence to show that the company was aware of, and acquiesced in, the making of the payment as a reduction in the shareholder's current account.[7]
- In the absence of contemporaneous evidence, such as book entries showing debits to a shareholder's current account with a company, it may be difficult for a person to show that the receipts are non-assessable drawings.[8]

[6] *McIlraith v CIR* (2007) 23 NZTC 21,456 (HC) at [29].

[7] *Case Q6* (1993) 15 NZTC 5047 at 5,049, 5,050 and 5,051.

[8] *Case 12/2015* [2015] NZTRA 12, (2015) 27 NZTC 3,011 at [57]-[58].

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Application to the facts

32. TCO considered the parties' arguments about whether the additional income derived by the Taxpayers from the Company in the disputed periods was employment or dividend income of the Taxpayers. The Taxpayers' view was that the additional income was employment income. The Commissioner maintained her view that the additional income was a deemed dividend.

33. The additional income will be a dividend under s CD 4(1) if:

- there is a transfer of company value from a company to a person; and
- the cause of the transfer is a shareholding in the company.

34. TCO considered whether the income was employment income as part of its discussion of the cause of the transfer of value to the Taxpayers.

Was there a transfer of company value?

35. TCO concluded that there had been a transfer of value from the Company to the Taxpayers. The Taxpayers voluntarily disclosed that cash from the sales income of the Company's businesses was deposited into the personal bank accounts of the Taxpayers and was not returned as income by either the Company or the Taxpayers. The Commissioner's audit found evidence that cash sourced from the businesses and not deposited into bank accounts was provided to the Taxpayers.

Was the transfer of value due to the Taxpayers' shareholding?

36. CCS argued the only reason the cash amounts were paid to the Taxpayers was because of the shareholding relationship and that the amounts were dividend income. The Taxpayers argued that the amounts were employment income and not dividend income.

37. TCO found that the Taxpayers did not provide any documentary evidence to support their view that the omitted income should properly be regarded as salary and wages (e.g. shareholder current accounts or evidence such as a board resolution to pay additional salary). Although the Company allocated a modest shareholder salary to the Taxpayers each year, without further evidence this does not necessarily mean that the nature of substantially larger amounts provided to the Taxpayers would also be treated as employment income. No documentation was provided to suggest the Company intended to treat the omitted income as drawings and convert it to a shareholder salary. On the contrary the income was

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suppressed by the Company and omitted from the Taxpayers' income tax returns which suggests there was no intention at the time to treat it as drawings and shareholder salary.

38. Since the Taxpayers have not proved the omitted income is employment income then the only reason for the Company to have made transfers of value was because of the Taxpayers' shareholding in the Company. On this basis the omitted income is a dividend.

39. This outcome is supported by s CD 6(2) which provides that an indicator that a transfer of value is caused by a shareholding relationship is if the terms of the arrangement that result in the transfer are different from the terms for a similar arrangement where no shareholding is involved.

40. The Taxpayers argued that any employed manager of such an operation would have received a regular salary just as the Taxpayers did and it was not a transfer of value due to a shareholding but a regular payment for the personal exertion of the employees.

41. The Taxpayers did not provide any evidence of a documented regular salary for themselves therefore it was assumed that by a regular salary the Taxpayers meant the cash that was taken from the till on a regular basis. It is considered unlikely that a person employed by the Company as a manager of the establishments (and not a shareholder) would receive their salary by taking regular amounts from the till without documentation or oversight. It also seems unlikely that the Company would pay that person such a substantial amount if they were not a shareholder.

42. For those reasons TCO considered the Company allowed the Taxpayers to take regular income from the till without documentation or oversight because of their shareholding in the Company rather than because of the services they performed. This indicated that the transfer of value was caused by a shareholding relationship and that the omitted income is a deemed dividend.

43. Although the imputation credit account regime, in general terms, seeks to avoid double taxation between a company and its shareholders, double taxation does occur in some circumstances, including the circumstances of the Company and the Taxpayers where it has been concluded that the amount is a dividend. Further, the Company has been removed from the Companies Register and CCS notes that it is unlikely that it has the means to pay its tax liability.

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Issue 3 | Take tuatoru: Application of the reparation order

44. The Commissioner laid criminal charges against one of the Taxpayers and following a jury trial they were convicted, and a reparation order was made as part of the sentence. The treatment of the reparation payment was raised.

45. TCO considered the Court of Appeal case *R v Allan* and in particular the statement in the decision that reparation is not a tax collecting mechanism.[9] From this it concluded that it is not clear that reparation payments are tax payments. TCO made the observation that unlike the normal situation where an assessment is issued by the Commissioner and there is a liability to pay the tax, where a reparation order is made, the offender is to pay the reparation to the Ministry of Justice. The Ministry of Justice must then pay this money to the person who is the recipient under the reparation order.

46. Regardless of this, CCS stated that if the Taxpayer in question pays the reparation payment, the Commissioner would credit the payment to the Taxpayer's core tax liability.

47. Given that no payment of reparation has been made, the existence of an order to make payment cannot be taken into account to reduce the Taxpayer's income tax liability.

[9] *R v Allan* [2009] NZCA 439, (2009) 24 NZTC 23,815.

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