Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTOTANGA WHAKATAU Ā-TURE > WHAKAWĀ

“Negative income” adjustment

Shortfall penalties

Decision date | Te Rā o te Whakatau: 1 February 2022

Issue date | Te Rā Tuku: 16 June 2022

TDS 22/12

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Subjects | Ngā kaupapa

Income tax: Whether the Taxpayer was correct to include the negative income adjustment in its income tax return to prevent income being taxed twice. Whether the Taxpayer is liable for shortfall penalties.

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer & Compliance Services, Inland Revenue
Commissioner	Commissioner of Inland Revenue
ITA 2007	Income Tax Act 2007
TAA	Tax Administration Act 1994

Taxation laws | Ngā ture tāke

All legislative references are to the Income Tax Act 2007 (**ITA 2007**) unless otherwise stated.

Facts | Ngā meka

The Taxpayer's business

1. The Taxpayer is a company. The Taxpayer conducted a consulting business.
2. Subsequently, over a period of two decades, the Taxpayer's business was transferred between a number of different ownership entities. During this time, the Taxpayer had no direct ownership interest in the consulting business.
3. The business income of each of those different ownership entities was reassessed to another person under an avoidance reconstruction. This reconstruction was made under provisions in earlier legislation corresponding to what is now s GA 1.
4. The reconstruction of the income to the other person was disputed. The dispute was finally resolved when the reconstruction was approved by the Court of Appeal.

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The Taxpayer's self-assessment

5. The Taxpayer filed its income tax return for the income tax year in question (the income year) and included a negative income amount as other income.

6. The Taxpayer included this negative income amount as an adjustment to remove income that the Taxpayer argued was both returned by the Taxpayer and reconstructed to another taxpayer as part of the reconstruction of a tax avoidance arrangement. The Taxpayer argued the adjustment is required to avoid taxing the same income in the hands of two taxpayers (s GA 1(6)).

7. Customer & Compliance Services, Inland Revenue (**CCS**) did not accept the negative income adjustment was correct or necessary. Therefore, CCS proposed to adjust the Taxpayer's income tax return by removing the negative income amount from the assessment for the income year.

Shortfall penalty adjustments

8. CCS also proposed the following shortfall penalties as alternatives (in order of priority):
   - Abusive tax position shortfall penalty
   - Gross carelessness shortfall penalty
   - Unacceptable tax position shortfall penalty
   - Not taking reasonable care shortfall penalty

9. Shortfall penalties are calculated based on a tax shortfall amount. The tax shortfall used by CCS for the proposed penalties did not include the tax effect of deductions claimed by the Taxpayer that were the subject of a voluntary disclosure.[1]

10. For all penalty types, CCS proposed a reduction of 50% for previous behaviour (s 141FB of the TAA). Further, in the case of the unacceptable tax position and not taking reasonable care penalties, the penalty is proposed to be at the cap of $50,000 (s 141JAA of the TAA).

[1] The Taxpayer voluntarily disclosed that legal fees had been incorrectly claimed in the income year.

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Issues | Ngā take

11. The issues considered in this dispute were:

    - Whether the Taxpayer was correct to include the negative income adjustment in its income tax return for the income year to prevent income being taxed twice.
    - Whether the Taxpayer is liable for the shortfall penalties proposed by CCS.

Decisions | Ngā whakatau

12. The Tax Counsel Office reached the following decisions on the issues:

    - It was not correct for the Taxpayer to include the negative income amount in its return.
    - The Taxpayer is liable for a shortfall penalty for taking an abusive tax position, reduced by 50% for previous behaviour as proposed by CCS.

Reasons for decisions | Ngā take mō ngā whakatau

Issue 1 | Take tuatahi: Negative income adjustment

13. There is no dispute that when challenging a tax avoidance arrangement the Commissioner is allowed to pursue assessments of different taxpayers for the same income. However, ultimately, once the challenge to the tax avoidance arrangement is complete, the Commissioner is required under s GA 1(6) to ensure that the same income is not taxed to more than one person.[2]

14. The Taxpayer argued the same income has been taxed twice, once to the Taxpayer and again to the other person. For an adjustment to be required to the Taxpayer's assessment under s GA 1(6), the Taxpayer would need to establish that it did, in fact, return this income. The Taxpayer argued it has filed income tax returns in the relevant periods that included its share of the amounts.

15. CCS argued the Taxpayer has not paid any income tax in relation to the amount that the Taxpayer argued must be reversed, not during the income year or any earlier year.

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[2] *Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 316 (PC) at [33], *Russell v CIR* (2012) 25 NZTC ¶20-120; [2012] NZCA 128 at [84].

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16. The available evidence indicated the amount assessed to the other person was made up of income and losses of the different ownership entities. The amount did not include any income of the Taxpayer. In other words, the Taxpayer has not provided any evidence that it returned amounts that were reassessed to the other person.

17. Therefore, the Taxpayer had not satisfied the onus of proving that it had returned income that was reassessed to the other person.

18. It did not assist the Taxpayer that the Taxpayer owned the consulting business before it was transferred to the different ownership entities, or that the Taxpayer later reacquired the business. Income tax is assessed to a person who derives income from a business, not to the business itself. Further, income is assessed for particular years. The Taxpayer did not own the business during the relevant income years and did not derive (or return) the income that was assessed to the other person.

19. For the above reasons, the Tax Counsel Office concluded that it was not correct for the Taxpayer to include the negative income adjustment in its own assessment.

Whether the income year would have been the correct year to make an adjustment

20. The Taxpayer argued the income year was the correct income year to include the negative income adjustment. This is because this was the year in which the other person's challenge proceedings were finally resolved.

21. CCS argued that if an adjustment was required, it would need to be made in the periods in which the income was originally returned.

22. The Tax Counsel Office considered that, if an adjustment was required (it was not), the adjustment would need to have been made in the periods in which the income was originally included. This is because the allocation of income to a particular year (required under s BD 3) and, by extension, the reversal of such allocation, has important implications within the scheme of the income tax legislation. For example, tax rates may be different between different years and the availability of losses or imputation credits can differ between different years. An adjustment in a different income year may not have the same effect. There is also no provision authorising the making of adjustments in a later income year.

23. The definition of "day of determination of final liability" referred to by the Taxpayer does not assist the Taxpayer. That term is relevant to the timing of the refund, payment, or application of tax that has been paid by a disputant, following a successful challenge by the disputant (s 138I of the TAA). This dispute concerned an adjustment to the allocation of income to an income year, not a payment, refund or application of tax that might flow from such an adjustment.

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24. These are further reasons why it was not correct for the Taxpayer to include the negative income adjustment in its income tax return for the income year.

Conclusion

25. The Tax Counsel Office concluded that it was not correct for the Taxpayer to include the negative income adjustment in its income tax return for the income year.

Issue 2 | Take tuarua: Shortfall penalties

26. Legislative references in Issue 2 are to the TAA unless otherwise stated.

27. CCS proposed the following penalties as alternatives (in order of priority):[3]

    - Abusive tax position shortfall penalty
    - Gross carelessness shortfall penalty
    - Unacceptable tax position shortfall penalty
    - Not taking reasonable care shortfall penalty

28. Shortfall penalties are calculated based on a tax shortfall amount. For all penalty types, CCS proposed a reduction of 50% for previous behaviour (s 141FB). Further, in the case of the unacceptable tax position and not taking reasonable care penalties, the penalty was proposed to be at the cap of $50,000 (s 141JAA).

29. In this case the Tax Counsel Office considered:

    - The Taxpayer took a tax position by including a negative amount as "other income" in its tax return for the income year. This resulted in a higher tax loss amount available to carry forward to the subsequent income year.
    - The correct tax position was that no negative income adjustment should have been made.

Abusive tax position shortfall penalty

30. The abusive tax position shortfall penalty in s 141D was considered in the Interpretation Statement "Shortfall Penalty for Taking an Abusive Tax Position".[4]

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[3] If the requirements of more than one penalty are satisfied, the highest shortfall penalty will apply (s 149(2) and (3)).

[4] Published in *Tax Information Bulletin* Vol 18, No 1 (February 2006) at 24.

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Despite later case law, the Tax Counsel Office considered the Statement correctly stated the law in relation to the penalties.

31. Section 141D imposes a shortfall penalty on a taxpayer if the following requirements are satisfied:

- The taxpayer has taken a "taxpayer's tax position".
- The taxpayer's tax position has led to a tax shortfall.
- The tax position is an "unacceptable tax position". A tax position will be an unacceptable tax position if:
  - the tax position, viewed objectively, fails to meet the standard of being about as likely as not to be correct, and
  - none of the exceptions in s 141B(1B) to (1D) apply.
- The tax position is an "abusive tax position". This means that, in addition to being an unacceptable tax position, viewed objectively, the tax position must be one the taxpayer takes:
  - in respect, or as a consequence, of an arrangement entered into with a dominant purpose of avoiding tax (s 141D(7)(b)(i)), or
  - where the tax position does not relate to such an arrangement, with a dominant purpose of avoiding tax (s 141D(7)(b)(ii)).

32. The amount of the penalty is 100% of the resulting tax shortfall.

Unacceptable tax position

33. For an abusive tax position shortfall penalty to apply to a tax position, the tax position must be an "unacceptable tax position".

34. A taxpayer's tax position will be an unacceptable tax position if, viewed objectively, the tax position:

- fails to meet the standard of being about as likely as not to be correct, and
- none of the exceptions in s 141B(1B) to (1D) apply.

35. The application of s 141B(1B) to (1D) were not raised and do not appear to be relevant in this case.

36. The Tax Counsel Office summarised that a tax position will be "about as likely as not to be correct" if:

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- the tax position is close to or around 50% likely to be correct[5]
- the merits of the arguments supporting the tax position are substantial[6]
- on balance, the tax position is one that, while wrong, could be argued on rational grounds to be right[7]
- there must be room for a real and rational difference of opinion[8]
- the taxpayer's tax position is one about which "reasonable minds could differ".[9]

Determining whether a tax position is "about as likely as not to be correct"

37. Section 141B(1) states that a taxpayer takes an unacceptable tax position if, viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct. Applying the standard objectively means that whether the taxpayer believed its tax position was "about as likely as not to be correct" is not relevant.[10]

38. The fact that a taxpayer may have received positive advice concerning the tax position taken is not relevant in determining whether the tax position was about as likely as not to be correct. The correctness of a tax position must be viewed objectively. Advice may affect a taxpayer's belief in the correctness of a tax position, but not the actual correctness. This is confirmed in *Alesco* at [142] and [143].[11]

39. The matters that must be considered in determining if the taxpayer's tax position is about as likely as not to be correct include (s 141B(7)):[12]

    - The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions).
    - Decisions of a court or a TRA on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).

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[5] *Case U47* (2000) 19 NZTC 9,410.

[6] *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, (2009) 24 NZTC 23,188.

[7] *Ben Nevis*, *Walstern v FCT* [2003] FCA 1,428.

[8] *Walstern*.

[9] *Walstern*, *Case X25* (2006) 22 NZTC 12,303.

[10] *Ben Nevis*.

[11] *Alesco New Zealand Ltd v CIR* [2013] NZCA 40, (2013) 26 NZTC 21-003.

[12] Whether there is an unacceptable tax position is determined at the time the taxpayer's tax position is taken (s 141B(5) and (6)).

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40. In *Case U47* Judge Barber commented that s 141B(7), in effect, affirms and endorses the criminal maxim that ignorance of the law is no excuse.

41. CCS argued the tax position taken by the Taxpayer was not about as likely as not to be correct because the income that the Taxpayer purported to adjust in its return was not the Taxpayer's income in the first place.

42. The Tax Counsel Office considered that the Taxpayer had not established the negative income amount was included in the Taxpayer's income in the first place. As noted earlier, the available evidence indicated the amount assessed to the other person was made up of income and losses of the different ownership entities. The amount did not include any income of the Taxpayer.

43. Given the lack of evidence, the Tax Counsel Office considered that the tax position taken by the Taxpayer does not have substantial merit and could not be argued on rational grounds to be right. Therefore, the tax position was not about as likely as not to be correct and, therefore, was an unacceptable tax position.

Dominant purpose of avoiding tax

44. To be liable for an abusive tax position shortfall penalty a taxpayer must take an "abusive tax position" (s 141D(2)). "Abusive tax position" is defined in s 141D(7).

45. Section 141D(7)(a) requires that the tax position be an unacceptable tax position. As noted above, the Tax Counsel Office concluded that there was an unacceptable tax position.

46. Section 141D(7)(b) requires that the tax position taken by the taxpayer involves a dominant purpose of avoiding tax.

Purpose of an arrangement or of the taxpayer

47. Section 141D(7)(b)(i) and (ii) indicate that the dominant purpose can be that of an arrangement or of the taxpayer.

48. In the present case, the tax position taken (claiming the negative income adjustment) was not part of an arrangement. The tax position was one taken by the Taxpayer in reliance on s GA 1(6). An adjustment made under s GA 1(6) is made as a consequence of a tax avoidance reconstruction. Although there is a connection to a tax avoidance arrangement, the adjustment made by the Taxpayer was not part of the arrangement, ie it wasn't part of the plan.

49. Where the tax position does not relate to an arrangement, the tax position must be one that the **taxpayer** takes with a dominant purpose of avoiding tax (s 141D(7)(b)(ii)).

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Although this appears to require a subjective inquiry as to the taxpayer's purpose, the words "viewed objectively" in s 141D(7)(b) indicate that the taxpayer's purpose must be determined objectively. The Tax Counsel Office considered that determining the purpose of the taxpayer objectively can be achieved by testing the taxpayer's statements as to their purpose by reference to objective factors.[13]

Avoiding tax

50. The term "avoiding tax" is not defined in the TAA.

51. The Tax Counsel Office considered that "avoiding tax" includes tax avoidance to which the anti-avoidance provisions of the Act would apply. However, it also includes the avoidance of tax in a broader sense under general tax laws. This is supported by s 141D(6), which states that a tax position can be an abusive tax position under a general tax law or an anti-avoidance tax law.[14]

Dominant purpose

52. The abusive tax position shortfall penalty only applies when there is a dominant purpose of avoiding tax. "Dominant purpose" is not defined in the TAA.

53. The Concise Oxford English Dictionary defines "dominant" as "Exercising chief authority or rule: ruling, governing, commanding; most influential".[15] The same dictionary defines "purpose" as the "reason for which something is done, or for which it exists; the end to which an object or action is directed; aim…".

54. Case law has interpreted the term "dominant purpose" as the most influential, important, prevailing, or ruling purpose.[16]

55. Indicators of a dominant purpose of avoiding tax may include artificiality, contrivance, circularity of funding, concealment of information and non-availability of evidence, and spurious interpretations of tax laws.[17] A spurious interpretation covers situations where a tax position taken has no or very little basis at law or in the interpretation made or position taken is frivolous.

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[13] *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346 (CA).

[14] Taxpayer Compliance, Penalties, and Disputes Resolution Bill: Commentary on the Bill (September 1995) at 15 and 16, *Honk Land Trustees Ltd v CIR* (2016) 27 NZTC ¶22-055 at [63].

[15] *Oxford English Dictionary* (Online ed, Oxford University Press, 28 January 2022).

[16] *FCT v Spotless Services Ltd* 96 ATC 5,201 at 5,206, *National Distributors* at 6,350.

[17] Taxpayer Compliance, Penalties, and Disputes Resolution Bill: Commentary on the Bill (September 1995).

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56. Given the lack of evidence provided by the Taxpayer it returned any of this income (eg, income tax returns or financial statements), the Tax Counsel Office considered the tax position taken by the Taxpayer did not have substantial merit and could not be argued on rational grounds to be right. Therefore, the tax position was not about as likely as not to be correct and, therefore, was an unacceptable tax position.

57. Viewed objectively, based on the Taxpayer's current director's experience, their role with the Taxpayer, and the available information it is considered that Taxpayer's current director would have known there was no basis for the negative income adjustment. Given this, the Tax Counsel Office concluded that the Taxpayer's current director took the tax position with a dominant purpose of avoiding tax.

58. In summary, the Tax Counsel Office concluded that the taxpayer is liable for an abusive tax position shortfall penalty. As proposed by CCS, this penalty was reduced by 50% for previous behaviour (s 141FB).

The other penalties proposed as alternatives

59. CCS also proposed alternative shortfall penalties (including the gross carelessness, unacceptable tax position, and not taking reasonable care penalties). The Tax Counsel Office decided that the requirements of these penalties were also satisfied. However, under s 149(3) of the TAA, where the requirements of more than one penalty are met, the highest penalty applies (in this case, the abusive tax position shortfall penalty).

60. In brief summary, the Tax Counsel considered:

Gross carelessness

- A reasonable person in the Taxpayer's circumstances would have foreseen a high risk of a tax shortfall occurring as a result of claiming the negative income adjustment. In other words, a reasonable person would have checked to make sure that it was correct to make the negative income adjustment (including checking that the amount had been returned by the Taxpayer in its returns).

Unacceptable tax position

- Unacceptable tax position was considered above at [33]-[36] and it was concluded there that the position taken by the Taxpayer was unacceptable.[18]

[18] As proposed by CCS, this penalty would be capped at $50,000 under s 141JAA.

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Not taking reasonable care

- For the same reasons as given above for the gross carelessness shortfall penalty, it was also concluded that the Taxpayer did not take reasonable care in taking its tax position.[19]

[19] As proposed by CCS, this penalty would also be capped at $50,000 under s 141JAA.

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