Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTOTANGA WHAKATAU Ā-TURE> WHAKAWĀ

Income Tax and GST – Omitted business income and liability for shortfall penalties

Decision date | Te Rā o te Whakatau: 26 May 2023

Issue date | Te Rā Tuku: 29 November 2023

TDS 23/15

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Subjects | Kaupapa

INC/GST: Omitted business income; TAA: Shortfall penalties, onus and standard of proof

Facts | Meka

1. The Taxpayer was an incorporated company that carried on a retail business and was registered for GST. X was the Taxpayer's sole director and shareholder. The Taxpayer had paid wages with PAYE deducted to X and for one income year to Y. X's shareholder current account was also credited with a shareholder salary. X was married to Y.
2. X and Y were settlors, trustees, and beneficiaries of a Trust.
3. Customer Compliance Services, Inland Revenue (CCS) investigated the Taxpayer's income tax and GST affairs and concluded that the Taxpayer had omitted some business income from its income tax and GST assessments. CCS considered that the income had been:
   - deposited into X's and Y's personal bank accounts and the bank accounts of a Trust, used by X and Y and the Trust, and not returned by them for income tax purposes
   - used to pay X's and Y's personal expenses
   - used to fund property purchases made by X and Y and the Trust.
4. CCS also formed the view that the common ownership requirement for a subvention payment made by the Taxpayer to Company A was not met. The New Zealand Companies Register showed Y as Company A's sole director and holding 51% of its shares and X holding the remaining 49%. CCS considered the Taxpayer and Company A were 49% commonly owned, not the required 66%.
5. CCS issued a Notice of Proposed Adjustment (NOPA) to the Taxpayer proposing:
   - income tax and GST adjustments for the applicable years to include the omitted business income in the Taxpayer's income tax and GST returns and disallow the subvention payment

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- consequential adjustments assessing shareholder salary, dividends, or income under ordinary concepts to X, Y, and the Trust
- a shortfall penalty for evasion for each income year and GST taxable period, reduced by 50% for previous behaviour. No shortfall penalty was proposed in respect of the adjustment relating to the subvention payment.

6. The 4-year time bar periods for amending the Taxpayer's income tax and GST assessments had expired in respect of some of the income years and GST taxable periods in dispute. However, CCS considered that exceptions applied to allow the assessments to be amended at any time.

7. The Taxpayer rejected the proposed adjustments, and the matter was referred to the Tax Counsel Office, Inland Revenue (TCO) for adjudication.

Issues | Take

8. The main issues in dispute were:
   - Whether the Taxpayer omitted business income from its income tax and GST assessments (s CB 1 of the ITA 2007 and s 8 of the GSTA).
   - Whether the omitted business income (if any) was assessable to X, Y, and the Trust as shareholder salary, dividends, or income under ordinary concepts (ss CE 1, CD 1, and CA 1(2) of the ITA 2007).
   - Whether the common ownership requirement for the subvention payment was met (ss IA 3 and IC 2-IC 6 of the ITA 2007).
   - Whether the Commissioner could increase the Taxpayer's income tax and GST assessments (ss 108(2) and 108A(3) of the TAA).
   - Whether the Taxpayer was liable for shortfall penalties for evasion, reduced by 50% for previous behaviour (ss 141E and 141FB of the TAA).

9. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

10. TCO decided that:
    - The Taxpayer omitted business income from its income tax and GST assessments.

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- The omitted business income was assessable income of X and Y and the Trust:
  - Employment income in the form of additional shareholder salary for X or, alternatively, dividend income or income under ordinary concepts.
  - Dividend income of Y or, alternatively employment income or income under ordinary concepts.
  - Dividend income of the Trust or, alternatively, income under ordinary concepts.
- The common ownership requirement for the subvention payment was not met.
- CCS's position that the time bar exceptions in ss 108(2) and 108A(3) of the TAA apply was accepted. The Commissioner could increase the Taxpayer's income tax and GST assessments.
- The Taxpayer was liable for evasion shortfall penalties, reduced by 50% for previous behaviour.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary Issue | Take tōmua: Onus and standard of proof

11. 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]

12. 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. Whether the Taxpayer had discharged the onus of proof was considered in the relevant issues.

13. An assessment made by the Commissioner cannot be arbitrary. He must make the best judgement he can on the information in his possession as to the amount of taxable income and the amount of tax payable. In some cases, a taxpayer may be able

[1] Challenge proceedings (ie, the proceedings that would follow if a 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.

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to discharge the onus of proof by showing that the assessment is arbitrary or demonstrably unfair.[5]

Issue 1 | Take tuatahi: Whether the Taxpayer omitted business income from its assessments

14. It was not in dispute that the Taxpayer was carrying on a business and an amount that a person derives from a business is income of the person (s CB 1 ITA 2007). It was also not in dispute that the Taxpayer was carrying on a taxable activity and that GST was charged on its taxable supplies under s 8 of the GSTA.

15. Under s 22 of the TAA, a taxpayer carrying on a business dealing in goods is required to keep sufficient records to enable the Commissioner to ascertain their assessable income. Similarly, under s 75 of the GSTA a GST registered person must also keep sufficient records to enable the Commissioner to ascertain their liability to tax.

Application

16. TCO concluded that the Taxpayer had omitted business income from its income tax and GST assessments.

17. The proposed adjustments by CCS were not arbitrary. Evidence of CCS's investigation into, and analysis of, the Taxpayer's income tax and GST affairs shows that it:
    - undertook a comprehensive investigation and analysis of the Taxpayer's tax affairs
    - exhausted most, if not all, lines of inquiry
    - found a factual basis for the proposed adjustments
    - gave the Taxpayer adequate opportunities to provide explanations and supporting documentation
    - considered and accepted explanations and supporting documents the Taxpayer provided and made consequential adjustments to reduce the adjustments originally proposed, including some adjustments where supporting documentation was incomplete.

[5] *Lowe v CIR* (1981) 5 NZTC 61,006 (CA); *CIR v Canterbury Frozen Meat Co Ltd* (1994) 16 NZTC 11,150 (CA); *CIR v New Zealand Wool Board* (1999) 19 NZTC 15,476 (CA).

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18. The Taxpayer had not shown the proposed adjustments were incorrect:

- It had not provided any or sufficient evidence and records to show the amounts making up the proposed adjustments were anything other than business income it had omitted from its income tax and GST assessments
- It had not shown CCS failed to exclude drawings, tax-paid salaries and wages, loans, proceeds from capital disposals, and business income returned by Company A for tax purposes from the proposed adjustments.

Issue 2 | Take tuarua: Whether the omitted business income is assessable to X, Y, and the Trust

Employment income

19. Section CE 1 provides that salary or wages derived by a person in connection with their employment or service is income of the person.

20. Under s RD 5, "Salary or wages" means a payment of salary, wages, or allowances made to a person in connection with their employment. It includes a bonus, commissioner, gratuity, or pay of any other kind.

21. An amount will be derived in connection with a person's employment or service if it was received because the person was an employee or because of the service they provided. The amount need not be paid under a contract of employment.[6]

22. Generally, salary and wages are "PAYE income payments" taxable under the PAYE (pay as you earn) rules. If certain requirements are met, a person who is a shareholder and an employee of a company can elect that salary and wages the company pays them is treated as income not subject to PAYE.

Dividends

23. Under s CD 1 a dividend derived by a person is income of the person. Under s CD 4, a dividend is a "transfer of value" from a company to a person if the cause of the transfer is a shareholding in the company.

[6] *Shell New Zealand Limited v CIR* (1994) 16 NZTC 11,303 (CA), at 11,304 and 11,306.

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24. Section CD 5 provides that a transfer of value occurs when a company provides money or money's worth to a person.

25. Under s CD 6 a transfer of value to a person is caused by a shareholding in the company:

   - if the person:
     - holds shares in the company, or
     - is associated with a shareholder, and
   - the company makes the transfer because of the shareholding of the relevant person.

26. Associated persons include:

   - A company and a person (not a company) with a 25% or more interest in the company.
   - Two persons connected by marriage.
   - A trust and a person who is a beneficiary in the trust.
   - A trust and its settlor.
   - Two persons associated to the same third person.

27. Case law shows that company money taken and retained by a shareholder, whether deposited in their bank account or used for their personal expenditure, can be dividends under s CD 1.

Income under ordinary concepts

28. Section CA 1(2) provides that an amount is income of a person if it is their income under ordinary concepts.

29. The phrase "income under ordinary concepts" is not defined in the ITA 2007. However, income has been described as a flow of money or money's worth arising from the ownership of property or capital, from labour, or from a combination of those things.[7]

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[7] *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at 13,355. See also *Tennant v Smith* [1892] AC 150 (HL) and *CIR v Parson* (No 2) [1968] NZLR 574 (CA).

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30. Regular recurrent payments on which the recipient depends to meet living expenses may be income under ordinary concepts.[8]

Application

31. TCO concluded that the omitted business income was assessable income of X, Y, and the Trust in the following ways:

   - Employment income in the form of additional shareholder salary of X or, alternatively, dividend income or income under ordinary concepts.
   - Dividend income of Y or, alternatively employment income or income under ordinary concepts.
   - Dividend income of the Trust or, alternatively, income under ordinary concepts.

32. The relevant amounts were employment income of X, and Y if the income was not assessable to Y as dividend income, because there was a connection between the income and their employment or service.

33. The relevant amounts were dividend income of Y and the Trust, and X if the dispute proceeded to challenge stage and it was found the business income was not X's employment income, because:

   - The Taxpayer made transfers of value when it deposited and otherwise made available money to X, Y, and the Trust.
   - The transfers of value were caused by X's shareholding in the Taxpayer:
     - X held shares in the Taxpayer.
     - Y and the Trust were associated with X.
     - There did not appear to be any reason for the Taxpayer to have made the transfers of value to X and Y and the Trust other than because of X's shareholding.

34. If not employment or dividend income, the relevant amounts were assessable to X and Y and the Trust as income under ordinary concepts. This was because:

   - Money was made available to X and Y and the Trust regularly and, or, recurrently over the income years in dispute.

[8] *Reid v CIR* (1985) 7 NZTC 5,176 (CA) at 5,183.

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- X and Y and the Trust used the money for their own purposes, including regular expenses.
- The Taxpayer had not explained the reason why the money was made available to X and Y and the Trust or otherwise disproved that it arose from the ownership of property or capital, from labour, or from a combination of those things.

Issue 3 | Take tuatoru: Whether the common ownership requirement for the subvention payment was met

35. A company may make a tax loss available to another company to subtract from their net income if certain requirements are met. One of the requirements is that the companies are at least 66% commonly owned. To be 66% commonly owned, a group a group of persons must hold common "voting interests" in both companies that add up to at least 66%.

36. If a "market value circumstance" exists, the group of persons must hold common "market value interests" adding up to at least 66%. In the dispute there was no suggestion that any market value circumstance existed. Accordingly, only common voting interests were relevant in determining whether the common ownership requirement was met.

37. If all relevant requirements are met, the other company can use the loss by making a subvention payment to the loss company.

38. Common voting interests are measured by determining the percentage of a person's "voting interests" in each company. A person's "voting interest" in a company equals the percentage of the total "shareholder decision-making rights" for the company carried by shares or options held by the person. "Shareholder decision-making rights" are rights to vote or participate in decision-making concerning company dividends or distributions, the company's constitution, variations in its capital, or the appointment of directors (ss IC 3, YA 1 and YC 2).

39. For income tax purposes, a person holds or does something as a nominee for another person if they act on the other person's behalf. Where a person holds or does something as a nominee for another person, the other person is treated as doing or holding the thing and the nominee is ignored (s YB 21).

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40. How s YB 21 applies where a person holds shares as a nominee for another person is considered by the Commissioner in an Interpretation Statement.[9] In summary:

- A person who holds shares as a nominee for another person:
  - is registered as the holder of the shares, but holds them for another person and has no beneficial interest in them
  - must deal with the shares and exercise voting and other rights attached to them as directed by the other person.
- Evidence of a trust or another similar arrangement or agreement is required to prove a person holds shares on behalf of another.

Application

41. CCS argued that the common ownership requirement was not met. It argued that the Taxpayer and Company A were commonly owned as to 49%, not the required 66%. The Taxpayer argued that the common ownership requirement was met. It argued that X held 50% of their shares as nominee for Y, making the Taxpayer and Company A 99% commonly owned.

42. TCO concluded that the common ownership requirement for the subvention payment was not met. This was because from the evidence presented:

- Y held 51% of Company A's shares and X held the remaining 49%.
- X held 100% of the Taxpayer's shares in their own right. The Taxpayer had not shown that X held half of the Taxpayer's shares as nominee for Y.

43. Accordingly, the common voting interests in the Taxpayer and Company A were 49%, not the required 66%.

Issue 4 | Take tuawhā: Whether the Commissioner could increase the Taxpayer's income tax and GST assessments

44. Generally, under s 108 TAA the Commissioner may not amend an assessment to increase the amount assessed if:

- the taxpayer has furnished an income tax return

[9] IS 12/01 Income tax: timing of share transfers for the purposes of the continuity provisions.

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- an assessment has been made, and
- four years have passed from the end of the tax year in which the taxpayer provides the tax return.

45. However, under s 108(2) TAA, the Commissioner may amend an assessment at any time if the Commissioner is of the opinion that a tax return provided by a taxpayer is fraudulent or wilfully misleading or does not mention income of a particular nature or derived from a particular source.

46. An income tax return is misleading if:
    - it includes something which gives the Commissioner a wrong impression, or
    - it does not include something, the omission of which gives the Commissioner a wrong impression as to the taxpayer's true income tax position.

47. An income tax return will be "fraudulent or wilfully misleading" when the taxpayer:
    - filed it knowing that it did not reflect their true income tax position, or
    - was recklessly careless as to whether the return was wrong.

48. To be "fraudulent or wilfully misleading", the filing of the incorrect return must be deliberate and intentional. Inadvertently filing an incorrect return or filing a return which the taxpayer honestly believes to be correct will not constitute filing a "fraudulent or wilfully misleading" return.

49. Where the taxpayer is not a natural person, the issue will be whether the person signing the return wilfully filed a misleading return.

50. Generally, under s 108A TAA, the Commissioner may not amend a GST assessment to increase the amount assessed if four years have passed from the end of the GST return period in which the taxpayer provides their GST return.

51. However, under s 108A(3) TAA, the Commissioner may increase a GST assessment at any time if the Commissioner considers that a taxpayer has knowingly or fraudulently failed to disclose all material facts necessary for determining the amount of GST payable.

52. In regard to the application of s 108A(3):
    - For a person knowingly to fail to disclose all material facts the person must have knowledge or be aware of the failure.

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- For a person to fraudulently fail to disclose all material facts, the person must deliberately fail to disclose the facts knowing they are acting in breach of a legal obligation.
- Knowledge can be established by inference, recklessness, and wilful blindness.
- In the case of a company, the knowledge of a responsible officer or officers of the company may be attributed to the company.
- Disclosure is not limited to what is contained in the GST return. Regard should be had to the whole of the information that the Commissioner may be expected to treat as made available, including information disclosed in other documents.
- "All of the material facts" include all facts which a person knows or is capable of knowing that are material to determining the correct tax payable. The Commissioner must be given an adequate opportunity to consider whether a particular receipt was assessable income or a particular outgoing was an allowable deduction.

Application

53. CCS argued that ss 108(2) and 108A(3) of the TAA applied to allow the Commissioner to amend the Taxpayer's income tax and GST assessments. CCS argued that this was because:
    - It was of the opinion that the Taxpayer's income tax returns for the income years in dispute were fraudulent or wilfully misleading (s 108(2) of the TAA).
    - It considered the Taxpayer knowingly or fraudulently failed to disclose to the Commissioner all material facts necessary for determining the amount of GST payable for each GST period in dispute (s 108A(3) of the TAA).
54. TCO concluded that the Commissioner could increase the Taxpayer's income tax assessments. This was because CCS was of the opinion the Taxpayer's tax returns were fraudulent or wilfully misleading. There was evidence supporting CCS's opinion, including evidence showing the Taxpayer's income tax returns were filed deliberately and intentionally. X, as the Taxpayer's responsible officer, knew that they did not reflect the Taxpayer's true income tax position. There was nothing to suggest CCS did not hold the opinion or that the opinion was not honestly held.
55. TCO also concluded that the Commissioner could increase the Taxpayer's GST assessments. This was because CCS considered that the Taxpayer knowingly or fraudulently failed to disclose to the Commissioner all material facts necessary for

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determining the amount of GST payable for each GST period in dispute. There was evidence supporting CCS's opinion including:

- the Taxpayer failed to disclose material facts in its GST returns, namely the true consideration it received for making taxable supplies, and
- X, as the Taxpayer's responsible officer, knew the Taxpayer was acting in breach of a legal obligation.

56. Further, there was nothing to suggest CCS did not honestly hold the opinion or that CCS misdirected itself as to the legal basis on which the opinion was to be formed.

Issue 5 | Take tuarima – Whether the Taxpayer was liable for shortfall penalties for evasion

57. Section 141E(1)(a) imposes a shortfall penalty for evasion on a taxpayer if the following requirements are satisfied:[10]

- The taxpayer has taken a tax position. A tax position is a position or approach to tax under a tax law as taken in or in respect of a tax return, income statement, or due date.[11]
- Taking the tax position has resulted in a tax shortfall. A tax shortfall is the difference between the tax effects of the correct tax position and the tax effects of the taxpayer's tax position.[12]
- The taxpayer has evaded the assessment or payment of tax. Evasion requires an intention to avoid the assessment or payment of tax known to be chargeable:
    - The element of intention will be satisfied if the taxpayer knows that their action or omission will breach a tax obligation. There must be some blameworthy act or omission on the part of the taxpayer. The required intent for evasion can be inferred from surrounding circumstances and conduct.[13]

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[10] The shortfall penalty for evasion or a similar act is considered in the Interpretation Statement: Shortfall Penalty—Evasion as published in *Tax Information Bulletin* Vol 18, No 11 (December 2006).

[11] Definitions of "tax position" and "taxpayer's tax position" in s 3 of the TAA.

[12] Definition of "tax shortfall" in s 3 of the TAA.

[13] *Taylor v Attorney-General* [1963] NZLR 261 (SC); *Lloyds Bank Ltd v Marcan* [1973] 2 All ER 359; *Case H90* (1986) 8 NZTC 619; *Case N47* (1991) 13 NZTC 3,388; *R v G* [2013] NZCA 146.

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- Recklessness can amount to evasion and involves the conscious taking of risk. Recklessness will be proven where: [14]
  - Facts actually known to the taxpayer were such that they must have put the taxpayer on inquiry that a tax obligation may not be met.
  - The taxpayer made a conscious decision to ignore the facts without making further inquiry.

58. The penalty payable for evasion or similar act is 150% of the resulting tax shortfall.

59. The onus of proof rests with the Commissioner to show that a taxpayer is liable for a shortfall penalty for evasion under s 141E.[15] This is different from the other shortfall penalties where the onus of proof is on the taxpayer. The standard of proof is the balance of probabilities.[16]

Application

60. TCO concluded that the Taxpayer was liable for evasion shortfall penalties (reduced by 50% for previous behaviour) because:
    - They took tax positions that resulted in tax shortfalls.
    - In taking the tax positions, the Taxpayer evaded the assessment or payment of tax. There was evidence a responsible officer of the Taxpayer, X, knew that omitting to include business income in the Taxpayer's income tax and GST returns breached its tax obligations.

61. The imposition of shortfall penalties for evasion was appropriate given the seriousness of the Taxpayer's non-compliance. This occurred recurrently over the income years and taxable periods in dispute, involved substantial amounts and was not voluntarily disclosed.

[14] *Case H90* (1986) 8 NZTC 619; *R v Harney* [1987] 2 NZLR 576 (CA); *Case P29* (1992) 14 NZTC 4,213; *Case S100* (1996) 17 NZTC 7,626; *R v G* [2013] NZCA 146.

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

[16] Section 149A(1) of the TAA.

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