Tax administration and practice – part one

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> Liability for tax is imposed by the charging sections . . . of the . . . Act. The Commissioner acts in the quantification of the amount due, but it is the Act itself which imposes, independently, the obligation to pay. The assessment and objection procedures are merely machinery for quantifying; they do not cast liability.[1]

This we were taught and this some of us, in turn, taught and for a time believed.

Those of us who practise in the area on a day to day basis probably appreciate more than most that the tax system and even the liability to tax itself depends not only upon the rules in the Income Tax Act 1976 but on a matrix of conventions, practices, discretions, judgments, procedures, rights and duties. In particular, saying that tax is imposed by the Act often means little more than that, without the Act, there would be no tax. If you are concerned, for example, with tax accounting for a long term contract, although there will be a concern for tax principles they will not derive directly from the Act. The Act itself may adopt, or may by silence require, reference to accounting practice and conventions. In the case of depreciation a deduction is given by the Act which is unclear as to the basis of the deduction (whether it should relate to the actual loss in value of an asset) and silent as to the rates of depreciation.

I hope in this paper to examine the elements outside the Act which are significant in practice in the tax system and the forces which determine in many instances tax liability and the practical outcome of tax disputes. In Part Two my colleague Richard Green will examine in greater detail aspects of tax practice, some of which are only touched upon in this paper.

To set the scene consider the following situation: you are a shareholder in a small private company that makes whatgits for export. The export incentive allowances are vital for the present survival of the enterprise although you confidently anticipate that by the time they are phased out it will be profitable without them. The problem is that the deductions are available to the company but not to the four individual employee shareholders who operate it. This builds up a large profit and loss account with potential tax consequences for the shareholders. You are advised to form an export partnership which will be an export mechant buying the goods off the company, the partnership obtaining export incentives which will then be available for offset against partnership income and wages or salaries paid to you

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1 *Reckitt and Colman* v. *T.B.R.* [1966] N.Z.L.R. 1032, 1045 per McCarthy J.

and deducted against the profits left in the company. This you do. Everyone is happy, except the Commissioner, who invokes section 99 of the Income Tax Act 1976. In the result, he says that you are left with the wages and salaries that you earned from the company; that the partnership income is attributed to the company; and that no one gets the export incentive as the export partnership is void and the company is not the exporter of the goods.

Your lawyer is ecstatic about finally getting a case in the area and is so enthusiastic and certain that the Commissioner is wrong that he gives you no advice about further submissions to the department nor about accommodating the Commissioner's views in the meantime. You object but since you are in a net loss situation, or close to it, the question of payment of tax does not arise. A difference of opinion arises between the Crown Law Office and the Inland Revenue Department about the case with the result that the disallowance of the objection and the preparation of the case stated takes two years. It takes a further year to get before the High Court where judgment is given against you. This was anticipated by your lawyer who has the appeal papers prepared and, indeed, he is proved to be correct a further year later in the Court of Appeal. The Court of Appeal's decision is given on the third anniversary of the winding up of your company. Like all good examples this one is exaggerated and I have tried to make it as unfair to tax advisers as to the Commissioner. However, it is not too far removed from reality and does, I hope, illustrate that while tax may be imposed by the Act, other forces may in practice have even more impact on commercial consequences.

The point of the story and the theme of this paper is that for the practitioner the administration of the tax system is just as important as the charge to tax in the Act. He wants fairness, speed and consistency in the way the Act is applied. Above all he wants certainty as to past, and as far as is possible, future tax liabilities. All these come as much from the way the Act is administered as from the legislation.

It is unfortunate that little or no emphasis has been given in New Zealand to administration in the context of tax reform. Arguably, it was within the Task Force on Tax Reform's terms of reference, which required it to undertake a thorough and systematic review of all aspects of central government taxation. By contrast, the Carter Commission[2] in Canada devoted one volume of its six volume report to general tax administration. One conclusion and recommendation of the Carter Commission is, I feel, of particular interest in New Zealand at the present time; that is the recommendation that to deal with disputed income tax assessments a decentralised system of administrative hearings should be established, including a pre-assessment conference, a district conference and a regional conference and that a taxpayer should have a right to each of these conferences before taking his case to the courts.[3]

2 *Report of the Royal Commission on Taxation* (Queen's Printer, Ottawa, 1966).

3 Ibid. Vol. 5, 167-168.

Most of the other findings of the Commission on administrative matters seem just as relevant in New Zealand in 1982 as they were in Canada in 1966. For example, the Carter Commission in questioning standards of efficiency said:[4]

> [W]e would say that insufficient attention has been paid to the development of a guiding philosophy of tax administration at the federal level. The approach appears to have been dictated largely by a short-sighted attempt to achieve the maximum amount of revenue for a given amount of expenditure.

Similarly, the conclusions of the Carter Commission on advance rulings, the drafting of tax legislation, the system of public examination of proposed tax legislation and the limitation of ministerial and administrative discretions would find a responsive note in New Zealand.

Quite apart from the Commissioner's discretionary powers in quantifying tax liability, the exercise of his administrative powers has a significant effect on taxpayers. The acceptance of a late objection, granting a change of balance date, withdrawal of special rate certificates for Pay As You Earn deductions and even the speed with which objections are dealt with may all be vital to the taxpayer. This aspect of the Commissioner's functions is dramatically illustrated by changes in relation to the payment of tax in dispute. Until recently the Commissioner's invariable practice was to defer the claim for tax in dispute until the outcome of any case stated procedure. The only exception to this was frivolous or vexatious cases. In any serious objection the Commissioner also agreed to remit any penalty in excess of $3\frac{1}{2}\%$ calculated on an annual basis. This approach, although favourable to taxpayers, was in the face of the clear scheme of the Act which is to make tax payable on assessment notwithstanding any objection. The Commissioner's practice apparently recognised the fact that no penalty or interest is payable by the Commissioner if the taxpayer is proved to be correct and avoided the inequities that would have occurred through loss of use of tax paid and the effects of inflation.

This practice was changed with effect from the first of February, 1981. The department now approves deferments of tax twelve months after the original last day for payment, when payment of one half of the tax in dispute is to be made; the balance of tax is deferred until the objection has been decided. If the department's assessment is upheld any penalty will be reduced to 5% per annum on an annual basis. The stated reason for this change was that in a number of cases objections had been taken to the case stated stage to enable the taxpayer to delay payment of outstanding tax and for additional tax for late payment to be reduced.

Although it is difficult to see how the taxpayer can cause delays when he is required to adhere to strict time limits, the change in practice may well be justified. It certainly brings the practice closer to what the Act itself requires. The point I wish to make is that quite outside the Act (possibly even in the face of the Act) this change has altered the practical balance between taxpayer and tax gatherer when assessments are in dispute. It means that where the Commissioner does make an incorrect assessment the cost to the taxpayer is even greater and

4 Ibid. 141.

it means that the speedy determination of disputes, a matter largely outside the taxpayer's control, is of even more concern to him than ever.

Unfortunately, in my view, there is an increasing tendency for the legislature to entrust various matters, in the first instance, to the determination or the discretion of the Commissioner. The provision in question may give guidelines, although this is not always the case. Almost invariably the issue can be the subject of an objection leading to a decision by the court being substituted for that of the Commissioner. There are of course important exceptions where no objection is allowed. The approval of superannuation schemes is one, as are many matters relating to time limits. But even accepting these limitations, this lazy approach to legislation should be avoided if possible. It gives the Commissioner an active role in the determination of tax liability beyond that traditionally ascribed to him.

In a recent thesis on judicial control of the Commissioner's discretions[5] it was suggested that the conferral of discretionary powers upon the Commissioner is justifiable and acceptable provided there also exist sufficient means of supervision and control over their exercise. It was further submitted that the best means of ensuring that these discretions are properly exercised is supervision by the courts. On an overall view, and provided enough cases are brought before the courts to establish a pattern, this may well be the case. On an individual or case by case basis, however, the possibility of some form of judicial review is frequently little or no comfort. The cost, delay, uncertainty and even publicity attaching to an objection may mean that an assessment must be borne without objection.

It is in the nature of things that more difficulties will occur when the determination of a matter is left in the first instance to the Commissioner. It is also inevitable that, having formed a view, without statutory criteria, the Commissioner is unlikely to be persuaded to change his mind in the absence of judicial review. All this leads to the situation in which the Commissioner may form a view and issue an assessment on which tax, or some of it, will be payable in circumstances in which there is a substantial dispute which has at no point been referred to any other body for consideration nor has been the subject of objective criteria.

I do not think it is appreciated how often the Commissioner's opinion or discretion is a triggering factor in tax liability. Nor is his role confined to comparatively minor matters capable of easy determination. It frequently involves complex and sophisticated matters of substance on which a variety of approaches might be taken and with significant tax results.

One of the more extreme examples of the Commissioner's role is depreciation, which is dealt with in the Act as an afterthought in one of the provisos in section 108. *C.I.R.* v. *Banks*[6] went some way to dispelling the conceptual difficulties with the basis of depreciation but did not resolve the question whether depreciation is necessarily tied to an actual or factual loss in value. The conditions precedent to

5 P. L. Reddy *Judicial Control of the Commissioner's Income Tax Discretions* Unpublished LL.M Thesis, V.U.W., 1979.
6 (1978) 2 T.R.N.Z. 323.

the allowing of depreciation under the Act are that there has in fact been depreciation suffered by fair wear and tear, but the Act arguably leaves open the question as to what actually constitutes "depreciation".

As a matter of administrative convenience, the Commissioner publishes tables showing the depreciation allowable in respect of various classes of asset. There is no statutory justification for such a list of standard depreciation rates. It is obviously of great practical assistance and is accepted in practice as discharging the Commissioner's duty under section 108 to fix a "just" rate of depreciation. In any case where the taxpayer can show an actual rate of depreciation greater than the standard rate the Commissioner considers depreciation based on that higher rate but again in practice the Commissioner does not enquire into the question of whether a particular asset is actually subject to the rate of depreciation fixed by the standard schedule for that class of assets.

Although in practice the Commissioner is unlikely to depart from the rate of depreciation in the tables he could, theoretically, deny a deduction for depreciation on the grounds that a particular asset is not depreciating or because the deduction is in any event discretionary. In a less extreme context the Commissioner has wide powers with major consequences in determining the depreciation rate appropriate to new types of assets, such as those used in new technologies, and assets not easily categorised, such as a structure which is part plant and part building.

Another area of practical difficulty occurs where the Act and the cases do not cope easily with developing structures, relationships and techniques. It may be a conceit of the current generation to think that modern commercial techniques (and I do not mean tax avoidance techniques) raise unique problems in the application of the Act. Possibly every generation goes through the same process providing, in turn, answers for the next. However, this part of this generation feels that modern funding and structural techniques do raise questions that are not easily answered by an Act conceived in a different age and refined in interpretation in a different commercial context. A good example is provided by the current dispute over the taxation of film projects. The department has taken the view that costs can be written off over a two year period commencing at the time when the film is first ready for exhibition or at some stage just prior to that. This appears to be a form of depreciation of an asset based on a 50% rate. On the other hand, there is the view that expenses should be deducted when incurred as in any business enterprise. Without assessing the merits of either argument, it does appear that the Act is not working well when there can be such a fundamental dispute as to the taxation of an industry involving many millions of dollars a year. I think the Act is clear — if there is a difficulty it is because the rules were not devised with industries as complex as and with the characteristics of the film industry in mind.

Another example is provided by the current form of financing known as gearing or leverage, found not only in the film industry but in so-called leverage leases. Essentially, this is the deduction of moneys borrowed by the taxpayer and in respect of which there is not an absolute obligation to repay. The obligation may, for example, be limited to profits derived from the enterprise. Some of the tax consequences of this form of funding are apparently not acceptable. As much as anything, this results from the fact that while the Act remains the same or changes slowly, commercial realities change quickly. The result is that the old rules, applied in new situations, produce a different result which may or may not be acceptable to the taxpayer and the tax collector. The Task Force on Tax Reform identified an important area in the impact of inflation and the effects on interest rates where interest is deductible and capital gains are not taxable. The Task Force suggested that interest is in part a repayment of capital on an inflation adjusted basis and suggested that if capital gains were not taxed that part of the interest representing repayment of capital should not be deductible.[7] This idea has been picked up in the 1982 Budget as the basis for the recapture of interest on development expenditure on the sale of property within ten years. However, even before the Budget announcement, there were suggestions from the Department that where interest on money borrowed to acquire land is payable, part of the interest is incurred to create a capital gain and is therefore not deductible under existing legislation. I must add that the conceptual basis for this and other proposed changes is difficult to understand. They are in that sense unprincipled. They appear to be reactions to purely fiscal needs achieved in the crudest fashion and deriving their only support from the fact that they are alleged to be anti-tax avoidance measures.

Even if one accepts that tax is imposed by the Act, a new element has been introduced in recent years: which Act? We have recently experienced various forms of retrospective tax legislation, usually after budget announcements, operative in the tax year beginning on the first of April in that same year. This is clearly retrospective legislation affecting things done in the interim and there is no justification for it. Current budget proposals in this category are the taxation of profits on intra-group transactions and the abolition of bonus issue tax but with the taxation at full rates of distributions of capitalised income within ten years of capitalisation.

Sometimes these changes are foreshadowed by general ministerial statements and are backdated to the timing of such statements, as was the case with changes in 1980 to the carrying forward and offsetting of tax losses by companies; sometimes there are general but vague statements such as those by the Prime Minister in early 1982 on corporate taxation; and sometimes there is no warning at all. This latter situation occurred in 1980 when the definition of royalties was changed in August with effect from the preceding April.

Quite apart from the issues of principle that this type of legislation raises, it will, if it gets to be more common, create a feeling of unease for the period from the first of April to Budget night as to what, if any, changes might be made retrospectively. There will be a silly season when commercial activity will not proceed normally.

Less obvious, but equally as significant in practice, are changes effective from their enactment or even subsequently but which affect the tax consequences of earlier Acts. In this category is the taxation of profit of sales after a certain date,

7 *Report of the Task Force on Tax Reform* (Government Printer, Wellington, 1982) 82-83.

as occurred in 1974, and not just the increment accruing after that date. Similarly, in the 1982 Budget the proposal to tax interest and development expenditure recouped on sale, although it applies only to sales after Budget night, effectively alters the tax liability for those years in which those deductions were properly claimed.

Finally, there are changes which affect established relationships and the tax status of established entities without ameliorating or transitional provisions. When the syndicate provisions were introduced into the Act in 1971 they effectively did not apply to syndicates formed before that date. In a similar vein, when section 99, then section 108, was amended in 1974 there were transitional provisions relating to schemes or arrangements entered into before the announcement of the amendments. In the 1982 budget there are to be transitional provisions in some areas, notably the proposed changes to superannuation provisions, but it appears at present as though in other cases, notably the taxation of partnerships of more than six, there will be retrospective application and no transitional provisions. The commercial community deserves better than this. Nothing in the area that is now so loosely being characterised as "tax avoidance" requires this sort of legislation.

The final element in the tax system is the courts. On one level judgments of the courts are a decision on the facts of a particular case and interpret the legislation and apply it to those facts, but even where interpretation is the principal factor, decisions reflect unique aspects of a case not only in the facts but in matters such as the arguments of counsel, decisions as to the presentation of the case, tactics that may have been adopted and concessions that may have been made. Every judgment has a historical quality relevant to its time and is related to current attitudes, practices, writing and knowledge. An example of this is the recent decision of the Court of Appeal in *Smout*[8] in which the Court of Appeal interpreted the section of the Act relating to capital dividends in the context of the scheme of the Act as a whole, commercial practice, the practice of the Commissioner and the legislative and practical history of the section and its predecessors.

At a different level, tax decisions raise questions other than interpretation such as the decision whether transactions should be analysed according to their form or substance. The courts may even go beyond the Act in developing or creating principles that have tax consequences. In the recent case of *W. T. Ramsey Ltd.* v. *I.R.C.*[9] the House of Lords analysed a number of comparatively complicated transactions entered into for the purpose of avoiding capital gains tax. The exact circumstances and techniques used in these cases are of no direct relevance in New Zealand. They were graphically summarised by Lord Wilberforce as follows:[10]

> In each case two assets appear, like particles in a gas chamber with opposite charges, one of which is used to create the loss, the other of which gives rise to an equivalent gain which prevents the taxpayer from supporting any real loss, and which gain is intended not to be taxable. Like the particles, these assets have a very short life.

8 *C.I.R.* v. *Smout* (1982) 13 A.T.R. 147.
9 [1981] 1 All E.R. 865.
10 Ibid. 870.

> Having served their purpose they cancel each other out and disappear. At the end of the series of operations the taxpayer's financial position is precisely as it was in the beginning, except that he has paid a fee, and certain expenses, to the promotor of the scheme.

It was hoped as far as the taxpayer was concerned that at the end of the scheme, although in a commercial sense the taxpayer would have made neither a loss nor a gain, for tax purposes he would have made a deductible loss and non-assessable gain. Thus the scheme was intended to leave the taxpayer with a deductible loss which could in due course be offset against any assessable gain which would otherwise be liable to tax. It was in these circumstances that the House of Lords was invited to take what appeared to be a new approach. They were asked by the Crown, in effect, to treat the various transactions as a fiscal nullity producing neither a gain nor a loss for tax purposes. On the facts the House of Lords concluded that it was consistent with the intentions of the parties and with the documents to find that apart from a comparatively small sum there was neither a gain nor a loss both in fact and for tax purposes. "The capital gains tax was created to operate in the real world, not that of make believe".[11] The real extends beyond tax avoidance schemes and one hopes that the same approach will be adopted in other contexts possibly to the advantage of the taxpayer. This will require more of the practitioner in anticipating the attitude of the courts far beyond mere matters of interpretation.

Nowhere are the tensions between the words of the Act and the other forces determining tax liability more apparent than in the context of tax avoidance and section 99. The history of section 99 in the courts has been the creation of a series of glosses and refinements clarifying and limiting the wide words of the section itself. No one reading the words of the section alone could begin to assess the application of the section in practice. Even in its terms section 99 gives wide powers to the Commissioner, particularly section 99(3) in relation to powers of reconstruction. Although these reconstruction powers are subject to objection, they give the Commissioner extremely wide power to create a notional income with a real tax liability, some or all of which may have to be met before the case is decided. Equally as important is the practice of the Commissioner in deciding whether to invoke the section and whether, having invoked it, to press with an assessment based on it.

The fact that the section in practice is much threatened but that little litigation has resulted may come either from the fact that taxpayers and their advisers, when faced with section 99, accept such assessments or from the fact that in many cases threatened assessments under section 99 are not proceeded with. In my experience the latter occurs more frequently than the former. Although there appears at first sight to have been a number of New Zealand cases on section 99, in fact they are quite restricted in the variety of fact situations they deal with, being broadly deduction cases and cases involving alienation of income and income splitting. There has been little comment in relation to commercial enterprises on a large scale and whole areas of commercial activity have simply not

11 Ibid. 873 per Lord Wilberforce.

been the subject of analysis in terms of section 99. In this situation pity the poor practitioner who is faced with words in an Act which cannot be taken literally, a range of cases which are often difficult to interpret, are not always consistent, and in any event cover a comparatively narrow range of fact situations, combined with the frequent invocation of section 99 by the Department in almost any situation in which it feels that tax has not been paid which should have been.

The limitations of the Act and its occasional inability to deal with situations, together with the increasingly active role of the Commissioner, have led and will continue to lead to the growth of forms of action outside the objection procedure. The objection procedure is the statutory, and until comparatively recently was regarded as the unique, form of proceedings through which to determine tax liability. Clearly, the scheme of the Act is to confine to the objection proceedings matters relating to an actual tax liability in a particular year. It is possibly unlikely that that range of actions will develop in this context. However, there are a range of other situations in which the objection proceedings are not adequate: declaratory judgment proceedings to determine issues of interpretation outside an actual assessment or to pre-determine a tax liability before events occur; review or other proceedings against the Commissioner in respect of his administrative functions not leading directly to an assessment; discovery against the Department in order to put taxpayer and tax collector on a more even footing before the courts; injunctions to prevent precipitating action and possibly even actions for negligence against officers of the Department where incorrect advice has been given.

The growth of the actions I have just referred to in a way sums up modern tax practice.

There was a time where legislation was introduced with effect from the beginning of the next fiscal year. There was a time when the Commissioner, although something of a policeman, rode a bicycle and was prepared to talk on the street corner. He now has squad cars (possibly even armed offender squads) and things you say might be taken down and used in evidence. Equally, I hasten to add, advisers and taxpayers are more conscious of their rights, more aggressive and sometimes even more devious.

If the tax system is to remain efficient and fair, all elements of it will have to achieve a degree of professionalism. Continued effort will have to go into seeing that the Act is administered fairly and efficiently and that changes occur when needed and are based on sound tax and commercial principles.