SPEAKMAN LAW

Minimising Tax Penalties (Voluntary Disclosure)...

Taking an incorrect tax position carries the risk of penalty by what are referred to as shortfall penalties. These are assessed at a percentage of the shortfall in tax paid that has arisen as a result of the incorrect tax position. Broadly, where culpability involved is low, so is the penalty. The penalty is 20% of the tax shortfall for low culpable matters. Conversely, where culpability is high, so is the penalty. At its worst, for evasion, the penalty is 150% of the shortfall penalty.

The quantum of penalty can be greatly reduced by way of voluntary disclosure. Where the disclosure is early, a 100% reduction in the penalty is given for most types of shortfall penalties; a 75% reduction is given where the penalty is for evasion, gross carelessness or taking an abusive tax position. Where voluntary disclosure is given later (but before IRD action), there is a 40% reduction in the penalty.

Voluntary disclosures were most topical following the Penny & Hooper case. You may recall this case for its finding that tax avoidance existed in the case of individuals carrying on a business (in their case orthopaedic surgery) through a company. The tax avoidance aspect was pronouncedly low salaries in proportion to the business income. The Inland Revenue's focus on these structures received high publicity and prompted large numbers of taxpayers to put up their arms and take advantage of penalty relief by way of voluntary disclosure.

So what is involved in claiming relief here? All very straight forward. Disclosure can be made either in writing to the Department or by phone. Less common, but also possible, is disclosure by visiting an IRD office. The IRD does have a prescribed form (IR281) that they use for voluntary disclosures, but in fact, disclosure does not have to be made by using that form. Disclosure when made, needs to be sufficiently complete and to contain all details needed for Inland Revenue to determine the correct tax position.

In order to qualify for 100% penalty relief (or 75% relief, for the 3 higher end types of penalties) disclosure must be made prior to Inland Revenue notifying you that it proposes to commence an audit or investigation. Disclosure made subsequently will qualify for 40% relief. That will be the case provided disclosure is made before the IRD in fact commence the audit or investigation. In practice this is treated as conclusion of the first interview the IRD have with you. Hence it is possible to obtain 40% penalty relief by making a disclosure at the commencement of that interview.

Disclosure very often has potential to implicate another taxpayer. For example, in a business sale and purchase agreement it is common for the parties to provide for each other to adopt consistent tax treatment on a particular matter. This agreement might be to treat a transferred asset on capital account or an expense item as deductible in a current income year. If a party, perhaps on receiving later tax advice, subsequently forms the view that the earlier tax position taken (and agreed with the other party to the agreement) is incorrect, disclosure of that position becomes complicated. It would first be advisable to notify and consult with that other party to enable it to manage its own tax position.