Legislating for self-assessment of tax liability

A Government discussion document

Rt Hon Bill Birch
Treasurer and Minister of Finance
Minister of Revenue

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PREFACE

This discussion document on legislating for self-assessment is part of the Government's continued commitment to the reform of tax administration and reduced compliance costs.

For some years now, taxpayers have calculated their own tax liabilities, and their returns were then automatically processed by Inland Revenue. The practice of self-assessment is a modern and efficient basis for tax collection. It is not, however, reflected in the legislation. The Government is concerned that this gap causes inefficiencies.

The proposals outlined in this discussion document aim to address that gap. While the proposals are primarily intended to legislate for current practice, they also aim to ensure that codified self-assessment is consistent with other recent tax administration reforms, particularly the new disputes resolution procedures. This has involved reviewing some of the time limitations for actions such as amendment by the taxpayer.

The release of this discussion document for consultation is part of the generic tax policy process, to which the Government is committed. The Government welcomes the views of interested parties, taxpayers and their advisors on any aspect of the document.

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CHAPTER ONE

INTRODUCTION

1.1 Tax administration and compliance costs add to the total costs imposed on our economy by the tax system. Administrative efficiency in tax collection is, therefore, of critical importance to the Government.

1.2 In recent years the Government has undertaken a programme of important reforms in tax administration through the introduction of a system of binding rulings, a new disputes resolution process, new penalties aiming to clarify taxpayers' responsibilities and a progressive rewriting of the Income Tax Act 1994 (ITA). These reforms are cumulatively aimed at achieving a modern tax administration in which the revenue needed to fund the activities of the Government is raised fairly, efficiently and in a way that minimises the overall cost to the economy.

1.3 This discussion document presents for public consideration a series of proposals to implement one of the last stages of this reform process – the codification in legislation of the practice of self-assessment.

1.4 In practice, taxpayers often assess their own tax liabilities because their returns are automatically processed by Inland Revenue. However, as long as the legislation continues to place the responsibility on the Commissioner for making an assessment, that responsibility is duplicated. The proposals in this discussion document are a response to the concern that such duplication is economically inefficient. They also recognise that taxpayers, because of the information they possess, are best placed to assess their tax liabilities.

1.5 The central purpose of the proposals is to ensure that the legislation reflects the current practice of self-assessment. They also clarify ambiguities and address deficiencies in current practice. They do not aim to make significant structural changes to the system of tax administration or underlying tax policy.

The benefits of legislating for self assessment

1.6 Legislating for self-assessment will:

- bring the Tax Administration Act 1994 (TAA) into line with modern administrative practice;
- make the law on assessment consistent with other recent administrative reforms including the new penalties provisions, disputes resolution procedures and binding rulings legislation;

- clarify income tax law - particularly in the area of discretions; and
- lay a foundation for future phases of the project to rewrite the tax legislation.

Overview

1.7 This discussion document has been divided into five chapters. Chapter two explains the background to self-assessment and its place within the context of recent reforms in tax administration. Chapter three sets out the key proposals for amending the legislation, including new obligations placed on taxpayers and other changes to tax administration. Chapter four outlines the Government's policy approach to various types of discretions and explains proposals dealing with specific discretions. Legislating for self-assessment raises a number of other tax administration issues. These are discussed in chapter five.

SUMMARY OF MAIN PROPOSALS

The main proposals in this discussion document are:

- The general provision in the TAA requiring the Commissioner to make assessments will be replaced with a provision requiring taxpayers to assess their own income tax liability.
- Taxpayers' returns will be their self-assessments.
- The Commissioner's power of amendment in section 113 of the TAA will be more clearly linked to the disputes resolution process.
- The period in which the Commissioner must make a refund of excess tax will be reduced from eight years to four years.
- Taxpayers will continue to have a two-month period in which to adjust their assessments. The two-month period will run from the time the return is furnished rather than from the date of assessment by the Commissioner.
- Adjustments for goods and services tax input tax credits will be required to be made in a return period within six months immediately following the return period to which the input credit is attributable.
- The Commissioner and taxpayers will continue to be able to agree adjustments for both income tax and GST purposes.

- Provisions purporting to give, but which do not in fact give, the Commissioner a discretion or which are unnecessary in a self-assessment environment, will be repealed.
- Other discretions, including those relating to valuation, apportionment, and the availability of certain deductions, will be replaced with objective tests.
- Discretions to recharacterise avoidance arrangements will be retained.

Submissions

1.8 The Government invites submissions on the proposals in this discussion document. Submissions should be made by 2 October 1998 and addressed to:

Self-assessment Project
C/- The General Manager
Policy Advice Division
Inland Revenue Department
P O Box 2198
WELLINGTON

1.9 The Government's aim is that the proposed changes will apply from the income year beginning 1 April 1999.

CHAPTER TWO

THE CASE FOR SELF-ASSESSMENT

BACKGROUND

2.1 Tax administration has undergone enormous change in the last decade. Computerisation of administration, automation of return processing, the introduction of E-filing, and the greater use of withholding payments, all underpin the move towards the efficient collection of taxes. These changes reflect worldwide trends in tax administration.

2.2 The move towards a comprehensive system of self-assessment was foreshadowed in the Government discussion documents, *Compliance Standards and Penalties 2* and *Tax Simplification Issues*. As stated in those discussion documents, much can be done to align our tax legislation with the practice of self-assessment through the process of rewriting the ITA. This process, however, is not designed to resolve substantial policy issues which must be looked at separately.

The organisational review of the Inland Revenue Department

2.3 In 1993 the Government appointed a Review Committee, chaired by Sir Ivor Richardson, to carry out a "fundamental, strategic review of the Inland Revenue Department and its activities".[1] The Review Committee was to "investigate and recommend the optimal arrangements for the tax assessment and collection system". The Review Committee concluded that the department had made significant improvements to tax administration in recent years, but some important issues needed attention.

2.4 The three major changes that had affected tax administration were the expansion to a broad tax base, the introduction of advanced technology to perform operations that were once done manually, and the limited introduction of self-assessment by taxpayers. The move towards self-assessment was seen as a fundamental change in tax administration necessary to deal efficiently with the increasing number of returns being received by the department.

2.5 Following the review, the department was restructured with the intention of supporting an administration based on self-assessment. New Service Centres were structured around particular customer groups and audit and technical functions were reorganised.

2.6 Despite these changes and the other reforms that were undertaken, the legislative framework does not yet fully support self-assessment. The

[1] Statement by the Ministers of Finance and Revenue on 8 July 1993 announcing the *Organisational Review of the Inland Revenue Department*.

Government has recognised the gap between administrative practice and the law, and views the situation as undesirable.

SELF-ASSESSMENT IN THE CONTEXT OF OTHER REFORMS

2.7 The sequence in which the recent tax administration reforms have been introduced has allowed for the orderly and manageable implementation of an administrative framework to support the codification of self-assessment.

2.8 Legislating for self-assessment would not have been possible without the recent introduction of the disputes resolution process, the compliance and penalties legislation and the binding rulings system. The reforms could have been undertaken concurrently but because of the significant impact of the disputes resolution and compliance and penalties reforms on taxpayers, it was decided to deal with self-assessment separately. The relationship between the proposals to legislate for self-assessment and other recent tax administration initiatives is discussed in the following paragraphs.

Disputes resolution process

2.9 The Government recognises that taxpayers' compliance with their tax obligations is affected by their perceptions of fairness, and the speed with which disputes are resolved. An effective self-assessment system requires the early identification and prompt resolution of issues that may lead to disputes.

2.10 To address these issues, in 1996, Parliament enacted a new disputes resolution process which places increased emphasis on information disclosure and early discussion between the Commissioner and the taxpayer. The intention is to ensure that each party is fully informed of the facts, propositions of law and arguments on which their respective positions are based.

2.11 Legislating for self-assessment will place the disputes resolution process in its appropriate context. Some amendment to the disputes resolution legislation will be necessary. For example, section 113 of the TAA, which allows the Commissioner to make amended assessments, may need to be linked more clearly to the disputes resolution process to remove any doubt about whether it creates an alternative avenue for disputes resolution. Other minor changes will be necessary to reflect assessment by the taxpayer rather than the Commissioner.

Compliance and penalties

2.12 In 1996 the Government enacted new compliance and penalties legislation which recognised the department's increasing reliance on self-assessment to administer tax collection. The legislation encourages voluntary compliance by requiring taxpayers to take their obligations seriously and perform the various tasks required of them honestly and with reasonable care. A self-assessment system cannot function properly without such voluntary compliance. It has, however, been recognised that the policy underlying the penalties legislation is inconsistent with legislation based on assessment by the Commissioner.[2]

2.13 The compliance and penalties rules will not, in substance, be affected by the Government's move to an explicit self-assessment system. The criteria relating to shortfall penalties and penalties for not taking reasonable care, for an unacceptable interpretation of the law, for gross carelessness or for an abusive tax position, will remain the same.

2.14 Legislating for self-assessment will, however, require some minor changes to be made to the compliance and penalties legislation.

2.15 Although most discretionary powers affecting the quantification of liability are inconsistent with self-assessment and will therefore be removed, the Commissioner will continue to exercise various discretions after an assessment is made. This should not affect the application of the penalties legislation. (Discretions are discussed in detail in chapter four.)

Binding rulings

2.16 The complex nature of tax law inevitably results in uncertainty as to the tax implications of some transactions. The binding rulings legislation enacted in 1995 is an integral part of a tax administration based on self-assessment because it allows taxpayers to obtain certainty on the Commissioner's view of the tax treatment of their transactions.

2.17 Legislating for self-assessment will require minor changes to be made to the binding rulings legislation.

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[2] This contradiction was acknowledged by the Government in its discussion document *Taxpayer Compliance Standards and Penalties 2.*

Tax simplification

2.18 The Government has a continuing commitment to simplification of the tax system and reducing compliance costs for taxpayers. Initiatives were outlined in the discussion documents, *Tax Simplification Issues* (1996) and *Simplifying Taxpayer Requirements* (1997). The Government will ensure that the codification of self-assessment is consistent with further tax simplification initiatives.

Rewriting the Income Tax Act 1994

2.19 A key objective in rewriting the ITA is to ensure the legislation is applied in the way Parliament intended. Legislating for self-assessment will mean that the ITA can be drafted in the "language" of self-assessment. It will also set a framework within which the Commissioner's discretions can be reviewed, and will resolve a number of policy issues in advance of the process of rewriting the ITA. In addition, the proposals will lay the groundwork for the TAA to be rewritten in the future.

CHAPTER THREE

LEGISLATING FOR SELF-ASSESSMENT

Key proposals in this chapter:

- Taxpayers will be required to assess their own liability, and their returns will be their self-assessments.
- The Commissioner's power of amendment in section 113 of the TAA will be more clearly linked to the disputes resolution process.
- The period in which the Commissioner must issue a refund of excess tax will be reduced from eight years to four years.
- When an adjustment is not agreed with the Commissioner, taxpayers will have two months from the date their return is furnished to adjust their assessments.
- Adjustments for GST input tax credits will be required to be made in a return period within six months after the period in which the credit would otherwise arise.

THE COMMISSIONER'S CURRENT ROLE

3.1 The central proposal in this discussion document is to enact legislation requiring taxpayers to assess their own income tax liability in accordance with the core provisions in Part B of the ITA.

3.2 The legislation imposes an obligation on the Commissioner to assess income tax (section 92(1) of the TAA):

> "…the Commissioner shall in and for every year, and from time to time and at any subsequent time as may be necessary, assess the taxable income and income tax liability of the taxpayer and the tax payable by the taxpayer."

3.3 Although the Commissioner is required to assess the tax liability of a taxpayer, what constitutes an assessment is not specified. The law on this has been developed through the courts and has been continually refined.

3.4 In summary, an assessment by the Commissioner requires:

- a consideration of the facts relating to the taxpayer's financial affairs;[3]
- the interpretation and application of the law to those facts;[4]
- the determination of the amount of tax owing by the taxpayer;[5] and
- an intention that the determination of the amount owing is final.[6]

3.5 The consistent theme underpinning decisions by the courts in this area is that an assessment takes its character from the nature and quality of the decision made and not from matters of process or administration.

THE PROPOSAL THAT TAXPAYERS ASSESS THEIR OWN TAX LIABILITY

3.6 The legislation requires taxpayers to calculate their tax liabilities. Section 15B of the TAA imposes various obligations on taxpayers, including the obligation to:

> (a) Correctly determine the amount of tax payable by the taxpayer under the tax laws.

3.7 Section 15B was inserted as part of the compliance and penalties reforms to identify obligations that have interest or penalty consequences if they are breached.

3.8 The obligation to determine the correct amount of tax payable, while reflecting the practice of self-assessment, is not, strictly speaking, the same thing as requiring taxpayers to assess their own liability. An assessment is the process for establishing the debt owed by the taxpayer to the Crown.

Proposed obligations

3.9 When self-assessment is enacted, taxpayers will be required to carry out the assessment function previously carried out by the Commissioner. In other words, taxpayers will be responsible for:

- considering the facts relating to their own financial affairs;
- interpreting and applying the law to those facts;
- determining the amount of tax owing; and
- making that determination with an appropriate degree of finality.

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[3] *R v DFC of T ex parte Hooper* (1926) 37 CLR 368.
[4] *Batagol v FCT* (1963) 109 CLR 243.
[5] *CIR v Canterbury Frozen Meats Co Ltd* (1994) 16 NZTC 11,150.
[6] *FC of T v S Hoffnung & Co Ltd* (1928) 42 CLR 39.

3.10 These obligations will not be explicitly stated in the legislation. They are inherent in taxpayers' current obligations to determine their tax liability and will continue to apply. For example, when a return is furnished, it will be assumed that the taxpayer intended that the amount determined as owing is final. As is the current position, failing to comply with these obligations will breach the standard of care required to avoid penalties.

3.11 One difference between assessment by the Commissioner and assessment by the taxpayer is that the Commissioner must comply with the administrative law principles of natural justice and fairness. Those principles aim to ensure consistency of treatment between taxpayers. The penalties legislation, the disputes resolution process and the binding rulings system are all intended to ensure that these outcomes are achieved when taxpayers assess their own liability.

3.12 The Government proposes to repeal the obligation imposed on the Commissioner to assess taxpayers under section 92 of the TAA. It will be replaced with a new provision requiring taxpayers to assess their own tax liability.

3.13 The Commissioner's powers to make corrective or default assessments are not inconsistent with self-assessment and are clearly a necessary part of the effective tax administration. Those powers will be retained.

Method of self-assessment

3.14 Taxpayers who must file a return will continue to be required to do so under an explicit self-assessment system. The date on which the return is furnished will be treated as the date that the self-assessment is made. The Commissioner will not issue a notice of assessment in response to the taxpayer's self-assessment, but will continue to issue statements to confirm the amount of tax owing.

3.15 At present, taxpayers can calculate their tax liability themselves or elect to have Inland Revenue calculate their liability on their behalf. This will continue. Calculation by Inland Revenue could appear to be inconsistent with self-assessment, however, it is more correct to say that the Commissioner is undertaking the calculation on the taxpayer's behalf, rather like a service, and that this does not, therefore, detract from the nature of the return as a self-assessment.

3.16 The Government does not propose as part of legislating for self-assessment to align the dates for filing income tax returns with the date for payment of tax, as is the case with GST, nor to introduce any further record keeping requirements.

3.17 The liability for tax will exist whether or not taxpayers assess their own liability. The late filing penalty will, therefore, continue to apply.

Validity of assessments

3.18 Sections 109 and 114 of the TAA provide in effect that an assessment made by the Commissioner may not be disputed except through the objection or challenge procedures specified in the TAA and the assessment is deemed to be correct until successfully challenged.

3.19 The presumption of validity of an assessment by the Commissioner underpins, inter alia, the ability to collect the non-deferrable portion of the tax once the assessment is made and this presumption will, therefore, be retained. However, to support the assumption that a self-assessment is the taxpayer's final determination of liability, the Government proposes to extend the presumption of validity to assessments by taxpayers.

AMENDMENTS BY THE COMMISSIONER

3.20 The Commissioner's function of administering the tax laws will not change substantially under codified self-assessment. As part of this function is to ensure that taxpayers comply with their tax obligations, the Commissioner must be able to correct assessments and to make default assessments. This section of the chapter discusses how this function can be better aligned with the objectives of the disputes resolution process by:

- creating consistency between section 113 of the TAA (the Commissioner's general power of amendment) and the disputes resolution process;
- removing redundant provisions in section 89C of the TAA which permit the Commissioner to make adjustments without issuing a notice of proposed adjustment (NOPA);
- changing the period within which the Commissioner must issue a refund from eight years to four years.

Commissioner's power to amend assessments

3.21 The Government does not propose to alter significantly the circumstances in which an assessment can be amended by the Commissioner. Accordingly, the Commissioner will be able to amend assessments by taxpayers:

- after a NOPA has been issued by the Commissioner;

- in most of the circumstances in which the Commissioner is now able to issue an assessment without a NOPA, such as to correct a simple or obvious mistake or when an amendment is otherwise agreed between the taxpayer and the Commissioner (section 89C of the TAA).

3.22 Section 113 of the TAA allows the Commissioner to amend an assessment in order to ensure its correctness. Its scope is very wide. Although the intention of the disputes resolution reforms was that amendments must be preceded by a NOPA or fall within section 89C of the TAA, there is a possible argument that section 113 allows taxpayers and Inland Revenue to use the provision as an alternative to the disputes resolution process.

3.23 In addition, the intention of the new disputes resolution process, that parties are fully informed of the facts and of the propositions of law and interpretations upon which their respective positions are based, is not reflected in the language of section 113. The retention of this wide power of amendment is therefore inconsistent with having an effective method of disputes resolution to support self-assessment.

3.24 Nevertheless section 113 is a key provision that enables the Commissioner to issue an assessment:

- to make amendments following an investigation;
- to reflect the resolution of a dispute; and
- for any of the circumstances prescribed in section 89C of the TAA.

3.25 The Government proposes that section 113 be retained but that it should be redrafted to specify the assessments that the Commissioner may make and to reflect self-assessment.

Amended assessments if a NOPA is not required

3.26 Some of the circumstances in which the Commissioner may issue an assessment without preceding it with a NOPA (section 89C of the TAA) require review in the context of the proposal to legislate for self-assessment. The main change proposed is to remove the Commissioner's power to issue an assessment merely confirming the taxpayer's return (section 89C(a)). This will be superfluous, because the taxpayer's return will be the assessment.

3.27 The power to issue an assessment that has been agreed by the Commissioner and the taxpayer to correct a tax position previously taken by the taxpayer (section 89C(c)) is also unnecessary. That power exists in the provisions allowing the Commissioner to issue an assessment that reflects an agreement reached between the Commissioner and the taxpayer (section 89C(d)).

3.28 Section 89C will otherwise be retained, including the power to issue an assessment that corrects a simple or obvious mistake or oversight in a taxpayer's return (section 89C(b)). That power will be clarified to allow the Commissioner to correct an obvious mistake or oversight made by either the taxpayer or the Commissioner.

Agreed adjustments

3.29 It is common practice for Inland Revenue and taxpayers to agree to adjustments, and for the Commissioner to issue assessments reflecting those agreements, particularly when the issue is one of fact rather than law.

3.30 This practice has several advantages for taxpayers:

- They can initiate adjustments outside the time limits prescribed by the NOPA process.
- This method is easier to instigate than the NOPA process and may involve lower compliance costs.

3.31 The corresponding advantages for Inland Revenue are the ease with which an adjustment can be made and the resultant administrative cost savings.

3.32 However, under this process, if the Commissioner does not agree to an adjustment, the taxpayer has no right of appeal. Because taxpayers have a limited period in which to make non-agreed adjustments to their assessments, taxpayers may find it necessary to prepare a NOPA to protect their position, while waiting for the Commissioner's agreement. The compliance costs savings in having an agreed adjustment process, as an alternative to the NOPA process, are diminished when taxpayers invoke both processes.

3.33 The Government considers that this disadvantage is outweighed by the reduced compliance and administrative costs of the agreed adjustment process. Therefore, the Government proposes that the practice of agreed adjustments should continue. This may require a review of the existing processes in order to formalise in legislation a coherent process with uniform application.

The four-year statute bar

3.34 The four-year period within which the Commissioner can issue amended assessments (section 108 of the TAA) now applies from the end of the income year in which the return was provided. Previously the statute bar applied from the end of the income year of original assessment. This change was made as part of the disputes resolution reforms and reflects the shift to self-assessment. No further reduction in the overall time within which an investigation by the Commissioner must be completed is therefore proposed.

The eight-year period for refunds

3.35 At present, the Commissioner, if satisfied that tax has been paid in excess of the amount properly payable, must refund that excess (section MD 1 of the ITA). Refunds are generally not available after eight years from the end of the year of assessment.

3.36 The Government considers that eight years is too long for final determination of a tax liability. It proposes that the eight-year period be replaced with a four-year period for income tax and GST.

3.37 Four years is more consistent with the disputes resolution process which aims to resolve disputes speedily and finalise the tax liability within four years of an assessment being made. The period will run from the date the return is furnished, although it may need to be extended in some instances where there are exceptions to the four-year statute bar on amendments by the Commissioner (for example, in retrospective spreading provisions, as discussed in chapter five). Submissions are invited on any difficulties that this might pose for taxpayers.

AMENDMENTS BY TAXPAYERS

3.38 The most significant issue to be addressed in legislating for self-assessment is the extent to which taxpayers should be entitled to amend their own assessments. Under the disputes resolution process, a taxpayer may dispute an assessment made by the Commissioner. Legislating for self-assessment will mean that the Commissioner no longer makes the assessment. Therefore taxpayers disputing an assessment will, in effect, be "disputing" their own assessment.

3.39 This section discusses:

- whether amendment by taxpayers of a self-assessment is appropriate;
- the effect of the proposals on the time period for NOPAs issued by the taxpayer;
- the apparent asymmetry between the timeframes for amendments by the Commissioner and the taxpayer;
- a proposal for introducing a timeframe within which GST input credits must be claimed.

Current process for amendments by taxpayers

3.40 If taxpayers disagree with an assessment made by the Commissioner without the issue of a NOPA, they must themselves issue a NOPA within two months from the date of the assessment. Failure to issue the notice means that the taxpayer has no power to amend the assessment, unless exceptional circumstances exist. A taxpayer's NOPA is followed by the Commissioner's notice of response (NOR), again within the two-month time limit. Unless the taxpayer rejects the NOR within that time, the NOR is deemed to have been accepted by the taxpayer and the Commissioner's assessment stands.

3.41 If agreement cannot be reached, a conference may take place in an effort to resolve the dispute. If this fails, the Commissioner issues a disclosure notice and the taxpayer may issue a statement of position in response. The Commissioner has a right of reply within two months of the issue of the statement of position. Failure to resolve the dispute at that stage results in referral to Adjudication for determination.

Should taxpayers be able to "dispute" their self-assessment?

3.42 A self-assessment will not in the first instance include adjustments by the Commissioner. Arguably, therefore, there is little rationale for taxpayers to be able to amend an assessment. Taxpayers' ability to amend their own assessments might be seen as inconsistent with the necessary element of finality that characterises an assessment.

3.43 However, an advantage for taxpayers in being able to dispute an assessment is to eliminate their exposure to shortfall penalties. At present, a taxpayer can make a return on a conservative basis and then file a NOPA on a less conservative basis. As penalties are calculated by reference to the tax position taken in a return, rather than in a NOPA, this approach avoids the application of penalties. Allowing taxpayers to amend an assessment also provides an opportunity to address an issue before investigation. This may allow early resolution of the issue.

3.44 The Government, therefore, considers that taxpayers' right to amend their own assessment should be retained. It proposes that the amendments continue to be initiated by a NOPA and that the two-month period in which adjustments must be made continue to apply from the date of assessment.

3.45 The circumstances in which taxpayers may issue NOPAs will not change. However, because the date of assessment will be the date the return is furnished, and not the date of assessment by the Commissioner, the period for amendment will begin earlier. The Government is interested in receiving submissions on any practical difficulties that this might cause.

Balancing taxpayers' and the Commissioner's powers of amendment

3.46 Taxpayers have no general power to amend assessments of their tax liabilities. However, they can use the agreed adjustment process and issue NOPAs in certain circumstances, as discussed.

3.47 By contrast, the Commissioner has four years from the end of the year in which a return is filed to amend a taxpayer's assessment. It is well established in case law that the Commissioner is required to assess a taxpayer in accordance with the Commissioner's interpretation of the law as at the time of assessment.[7] The only exception to this rule is when the Commissioner is bound to apply an interpretation following a binding ruling.

3.48 One reason for the apparent asymmetry between these positions is that the Commissioner must administer the tax laws for all taxpayers, whereas taxpayers' responsibilities are limited to their own tax affairs. Another reason is that if taxpayers had the freedom to reconsider their own assessments at any time within that four-year period, the "real" date for self-assessment would be the end of that four-year period. This would make the administration of the tax system, including the application of penalties and the administration of payments and refunds problematic and expensive.

3.49 It might also be argued that taxpayers should be able to re-open assessments in light of subsequent case law which could be interpreted as reducing their liability. Any right to adjust assessments in light of favourable case law would need to be accompanied by an obligation to reassess income tax obligations in light of subsequent unfavourable case law. Following this argument the Commissioner would then have to take into account the impact of post-assessment case law in applying any penalties or use of money interest. Accordingly taxpayers' compliance costs and the Government's administration costs could increase significantly.

3.50 Increasing the time in which taxpayers are able to amend their assessments would also have an impact on the time available to the Commissioner to review that amendment. The Commissioner's duty to ensure that taxpayers comply with their obligations would be undermined if the Commissioner were not allowed further time to review taxpayers' final assessments and make amendments to them.[8]

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[7] *CIR v Lemmington Holdings* (1982) 5 NZTC 61,268.

[8] In Australia, a further period for review is allowed under section 170(1A) of the Income Tax Assessment Act (Cth) 1936. A taxpayer has four years to make a statement amending their assessment. If a taxpayer makes an amendment to their assessment that results in a reduction of their liability, the Federal Commissioner of Taxation may, within four years of the date of the amended assessment, further amend the taxpayer's assessment to increase their liability.

3.51 In summary, giving taxpayers wider powers to amend their own assessments would be inconsistent with the Government's objectives of obtaining finality in the assessment process and of the speedy resolution of disputes.

GST and amendment of assessments

3.52 Taxpayers assess their own GST liability and pay GST at the time a return is made. The Commissioner makes an assessment only if taxpayers have failed to file a return, or if the Commissioner is dissatisfied with a taxpayer's return, or if asked to do so by a taxpayer. Taxpayers may initiate amendments to the Commissioner's assessment through the disputes resolution process.

3.53 The Commissioner cannot issue an assessment or amend an assessment to increase the GST liability four years after the return is provided or the original assessment by the Commissioner is made (section 108A of the TAA). On the other hand, under section 20(3) of the GST Act 1985, taxpayers have an unlimited time in which to adjust for unclaimed input tax credits. Adjustments may be made in current period returns.

3.54 The unlimited time for making claims causes uncertainty in the level of tax collected. The provision also enables unlimited retrospective adjustment by taxpayers following favourable new case law. The Commissioner has no corresponding power to make adjustments increasing taxpayers' liability.

3.55 The Government does, however, recognise the value in allowing taxpayers to make adjustments in current periods for transactions in a prior return period, rather than strictly adhering to the general time of supply rules.

3.56 Accordingly, the Government proposes to continue to allow returns to be adjusted for input tax attributable to an earlier period. However, in the absence of exceptional circumstances (similar to those described in section 89 K(3)), it is proposed that adjustments for input tax must be made in a return within six months immediately following the return period to which the input tax is attributable.

3.57 The adjustment period of six months is longer than the two-month period for taxpayers to make income tax adjustments. The Government recognises that claiming GST input tax credits may depend on the ability to obtain a tax invoice. More than two months is, therefore, considered necessary (despite section 24 of the GST Act 1985, which requires suppliers to provide tax invoices within 28 days of being asked to do so).

3.58 As with income tax, adjustments agreed between the Commissioner and the taxpayer, including those for simple or obvious mistakes and oversights will be able to be made within four years of the return being furnished.

SELF-ASSESSMENT AND TAX SIMPLIFICATION

3.59 The simplification proposals in the Government's discussion documents *Tax Simplification Issues* and *Simplifying Taxpayer Requirements* relieve a significant number of current IR5 taxpayers from making a return. No assessment will be required because these taxpayers will effectively have determined that their tax obligations are satisfied through the deduction of PAYE and RWT from their income.

3.60 Income statements issued by the Commissioner will replace income tax returns for taxpayers affected by social policy measures implemented through the tax system and for taxpayers whose PAYE or RWT has been under- deducted. Taxpayers whose assessments are not in line with their income statement will be required to amend and return the statement. Taxpayers who are not required to file a return, or whose income statement requires no amendment, will be deemed to have assessed their liability at the terminal tax date for the relevant income year on the basis that their tax liability has been met by withholding tax payments.

3.61 A taxpayer who is required to amend an income statement but fails to do so, will be deemed to have assessed his or her own liability on the basis of the latest income statement. The self-assessment will be deemed to have occurred at the terminal tax date for the relevant income year. Penalties may apply if, in a subsequent audit, the income statement is found to be deficient.

CONSEQUENTIAL CHANGES

3.62 Legislating for self-assessment will require numerous minor amendments to both the ITA and the TAA to ensure that both Acts are consistent with the proposals in this discussion document. One of the main tasks will be to identify terminology premised on assessment by the Commissioner and amend it to reflect self-assessment.

3.63 Most of the consequential amendments will be made when the proposals are enacted. However, some of the more mechanical changes, particularly to the ITA, will be made through the process of rewriting the ITA. There will be opportunity to make submissions on the changes when draft legislation is referred to Parliament's Finance and Expenditure Committee.

CHAPTER FOUR

THE COMMISSIONER'S DISCRETIONS

Key proposals in this chapter:

- Those Commissioner's discretions that are not exercised in practice, or that can be removed leaving in place an objective test without changing the effect of the law, will be removed.
- Discretions which allow the Commissioner to value specific assets will be replaced with a general requirement to use market value.
- Discretions which require the apportionment of consideration between revenue and non-revenue assets will be replaced with a general requirement to value the assets at market value and pro-rate the consideration accordingly.
- Specific application to write off assets not disposed of but no longer used will not be required for assets under $2,000 provided the criteria in section EG 12 are met.
- The circumstances in which the Commissioner will accept the stated value of an asset on transfer between associated persons will be set out in the legislation (section EG 17).
- The Commissioner's discretions in anti-avoidance provisions to recharacterise avoidance arrangements will be retained.

THE PROPOSED APPROACH TO DISCRETIONS

4.1 Many provisions in the legislation reserve powers to the Commissioner. These powers are generally in the form of discretions allowing the Commissioner to carry out administrative duties, and make decisions regarding the affairs of individual taxpayers. Discretions permit a level of flexibility to address unforeseen situations. They are also used when it is undesirable to legislate for matters of detail or for multiple permutations.

4.2 Since their existence often assumes an active role for the Commissioner in the calculation of taxpayers' liabilities, discretions can be incompatible with self-assessment. There may also be some uncertainty as to whether taxpayers must specifically apply for a particular discretion to be exercised.

Types of discretions

4.3 Discretions can be classed as follows:

- Administrative discretions, allowing the Commissioner to carry out the duties of revenue collection. These do not generally have an impact on the ability of taxpayers to assess their own liability.

- Discretions exercised on the application of the taxpayer under a defined process, including depreciation determinations and determinations made under the accrual rules. These similarly do not require any change under the proposals for self-assessment.

- Discretions affecting the determination of tax liabilities, which give (or purport to give) the Commissioner powers that need to be exercised in order for taxpayers' income tax liabilities to be determined. These include anti-avoidance discretions, which give powers to the Commissioner to ensure that the revenue base is protected.

The focus of this chapter is on the last class.

4.4 In considering how to deal with the last class of discretions under a self-assessment system, three categories emerge:

- discretions that do not confer any true discretionary power and can be removed because they are not in practice exercised or exercisable;
- discretions in provisions that can become objective by removing the discretion;
- discretions that can be replaced by specific objective rules.

4.5 Discretions in the first category are already embodied in the Commissioner's general administrative and collection powers. An example is section DJ 1(a)(iii) of the ITA, under which the Commissioner must be satisfied that a bad debt has actually been written off. Such discretions are superfluous. The Government's view is that discretions of this type can be removed without changing the effect of the law.

4.6 Discretions in the second category are not dissimilar to those in the first category, the distinguishing feature being that they may give rise to an issue of interpretation. An example of this type of discretion is the proviso to section CN 2(1), by which the Commissioner can exempt a non-resident film maker from the application of the section, if the income from renting films in New Zealand is "minor and insignificant". Such discretions can be removed leaving in place an objective test.

4.7 These two types of discretions will be removed during the rewriting of the ITA.

4.8 Discretions in the third category will be replaced by objective rules that are consistent with the underlying policy of the provision. If the Commissioner's practice in exercising the discretion is generally accepted, that practice could provide the basis for the rule. An example is section EG 17(2) under which the Commissioner may determine the level of depreciation deduction in respect of property acquired from an associate. (The proposed approach is discussed in a later section.)

PARTICULAR DISCRETIONS AFFECTING THE DETERMINATION OF TAX LIABILITY

4.9 This section discusses particular discretions in the third category including discretions to value specified items, to apportion income between revenue account and other assets, and to restrict the amount of a deduction available to taxpayers. It also discusses anti-avoidance discretions.

Discretions as to valuation

4.10 These discretions allow the Commissioner to determine what value will be attributed to an item for tax purposes and are generally intended to be used if an item has no readily ascertainable value. This situation may arise if the item is valued or grouped with other items, if an in-kind payment is made or when the item in question is intangible. Examples are:

- Section GD 1: trading stock sold without consideration in money is deemed to be sold at market price. When there is no market price, the Commissioner has the discretion to determine the price.

- Section CF 2(5): the meaning of market price of property is set out for the purposes of the dividend rules and, if an actual market value is not available, the Commissioner is able to set a price that may be expected to be realised on an arm's length sale of the property.

- Section CH 2(3): the Commissioner is able to value benefits to an employee under a share purchase scheme.

- Section EN 2(4): the Commissioner, in case of dispute, has the discretion to value non-cash consideration received in payment for patent rights.

4.11 In each case, the Commissioner is required to make an objective determination of value. In practice the valuation is more often carried out by the taxpayer. The Commissioner becomes involved only at the audit stage if a question arises on whether the taxpayer's valuation reflects the true market value of the asset.

Proposed treatment

4.12 Even when market value is not specifically provided, case law suggests that it should be adopted.

4.13 The Government, therefore, proposes to replace discretions of the type discussed above with a general requirement to adopt market valuation. To cover situations where there is no ready market, market value would be broadly defined to include willing parties acting at arm's length.

Discretions as to apportionment

4.14 If revenue account assets are acquired or disposed of with other assets, the expenditure incurred or income derived must be apportioned between the assets. Sections FB 4(1) (sale of trading stock), FB 6 (acquisition of a film with other property) and FC 5(3) (property subject to specified leases) provide that the Commissioner may determine the proportion of the combined consideration to be attributed to the revenue account property. The sections, however, give no guidance as to how that should be done.

Proposed treatment

4.15 The application of section FB 4(1) was discussed in *CIR v Edge*[9] and *Hansen & Others v CIR.*[10] It was decided that once the combined value of the assets is ascertained, any consideration should be apportioned between them at the same ratio, with proportional reductions if the consideration is less than the combined actual value. The rule is effective if the values of all of the assets are known, or are able to be determined. Adoption of market value or an equivalent hypothetical valuation method would remove the need for the Commissioner to be involved in the apportionment.

4.16 It is proposed that discretions to apportion income from the disposition of revenue account assets with other assets be replaced by specific rules requiring proportional apportionment in relation to total assets. The provisions affected would be limited to those where there are no alternative rules.

[9] [1958] NZLR 42.
[10] [1972] NZLR 193.

Restrictions on deductions

4.17 In some provisions, a particular deduction may be allowed at the discretion of the Commissioner. For most of these, criteria exist either in the legislation or in policy statements issued by the Commissioner. If there are no criteria in the legislation, but the criteria in policy statements are sufficiently objective to be applied effectively by taxpayers, these could form part of the legislation. Discussion of two discretions that may be used by the Commissioner to restrict deductions follows.

4.18 Under section EG 12, the Commissioner may agree to write off a depreciable asset if it is established that it is no longer used in the production of gross income. Taxpayers must specifically apply for the deduction. The discretion can be exercised only when the cost of disposing of an asset that is no longer used, exceeds any consideration that would be received on its disposition.

4.19 Section EG 17(2) allows the Commissioner to waive the rule that deems depreciable assets transferred between associated persons to have been transferred at the lower of market value of the asset when it became depreciable to the seller, or at the buyer's cost price. The rule is intended to prevent assets being written up to market value on a transfer between associates in order to gain a tax advantage. The exception to the rule ensures that legitimate arm's length purchases of second hand assets are not disadvantaged.

4.20 The Commissioner's current policy[11] is to apply the discretion when:

- there is a bona fide sale of an asset;
- the purchase price is the fair market value of the asset;
- the purchaser buys the asset for income producing purposes; and
- the vendor no longer uses it.

Proposed treatment

4.21 The discretion in section EG 12 must be exercised for all depreciable assets. As such, it is probably broader than is desirable and could be limited to writing off assets with an adjusted tax value over a certain threshold. The Government proposes a threshold value of $2,000 per asset, below which taxpayers may write off assets that are no longer used, without having first to apply to the Commissioner for exercise of the discretion. The requirement that disposal costs exceed estimated consideration on sale will continue to apply. (The $2,000 threshold level takes account of the costs involved in applying to the Commissioner.) Specific application to write off depreciable assets over $2,000 in value will still be required.

[11] *Tax Information Bulletin* vol 4, no 5 (December 1992).

4.22 The criteria to be exercised for the discretion in section EG 17 could be enacted as objective rules. Although the characteristics of a "bona fide" sale are difficult to define, the other criteria provide more objective guidance in determining whether a transfer between associates is being made to obtain a more favourable depreciation rate. A relevant factor in the case leading to the enactment of section EG 17(2)[12] was that the vendor had not retained any beneficial interest in the assets or any virtual ownership of them.

4.23 The Government proposes that objective criteria be enacted setting out the circumstances in which section EG 17 will not apply. These criteria will focus on the objective tests (fair market value, the purchaser's purpose and use by the vendor) rather than whether or not there has been a bona fide sale.

Avoidance

4.24 The general anti-avoidance rule in sections BG 1 and GB 1 of the ITA has two key elements – the determination of whether an arrangement constitutes tax avoidance and the ability of the Commissioner to counteract the arrangement through reconstruction of the parties' tax affairs.

4.25 The first element is an objective test. The second element involves the Commissioner's discretion. This format has been adopted in other avoidance provisions, such as section GC 22, relating to tax avoidance under the imputation rules.

4.26 The objective nature of the first element is consistent with self-assessment. In general, the interpretation of the anti-avoidance provisions by the Commissioner or by taxpayers will be either accepted by both parties or litigated in the courts to ascertain the boundaries of the rules. In practice, and at least in part to mitigate the effect penalties might have, taxpayers will assess whether an arrangement they have entered into is likely to be held to be an avoidance arrangement.

4.27 The Government's view is that it is necessary to retain the discretion to reconstruct transactions.[13] Avoidance arrangements often involve multiple transactions between a number of taxpayers. Individual taxpayers who do not know the full extent of the arrangement cannot be expected to calculate the extent of the tax advantage achieved through the arrangement. It is therefore appropriate to retain the Commissioner's discretion to recharacterise an avoidance arrangement as a post-assessment function.

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[12] *CIR v Lys & Others* (1988) 10 NZTC 5,107.
[13] The Valabh Committee supported this approach in its discussion paper *Key Reforms to the Scheme of the Tax Legislation,* published in October 1991.

4.28 Some avoidance provisions clearly specify the transaction to which they apply and the consequent tax treatment. Most of these provisions do not rely on the Commissioner exercising a discretion to reconstruct the transaction. An example is section GC 15(1), relating to fringe benefits provided by employers or associates of employers to associates of employees. Under the section the employee is deemed to receive a benefit. However, when the avoidance provision does not apply to a specific type of transaction, discretions to reconstruct are likely to be necessary.

4.29 The fact that the Commissioner has this post-assessment role in reconstructing taxpayers' affairs should not alter the application of penalties to the calculation by taxpayers of their income tax liabilities.

CHAPTER FIVE

OTHER ISSUES

Key proposals in this chapter:

- Provisions that allow retrospective spreading or retrospective adjustments will be amended to ensure that taxpayers are not restricted by the two-month time period for amendments to assessments.
- The discretion in section DH 3 which allows the Commissioner to request additional records to those specified in relation to motor vehicle usage will be removed.
- The need to retain section EC 1 relating to changes in accounting practice will be reviewed following submissions.
- Section HG 8(l) will be amended to allow the Commissioner to recover an appropriate portion of tax from an electing shareholder in a qualifying company, rather than requiring the Commissioner to issue an assessment.
- The requirement for a special tax code (sections NC 13 and 14) when an employee wishes to increase the rate of deduction from their income will be removed.

5.1 This chapter discusses changes that will be required to other provisions of the ITA in legislating for self-assessment. The provisions discussed generally contain discretionary powers. However, the need for the changes results not so much from the discretion itself, but from other administrative requirements in the section.

5.2 These provisions include:

- retrospective spreading provisions, such as section EN 3, relating to assignments of copyright;
- other retrospective adjustment provisions, such as section LC 4(1), which applies when an amount of a foreign tax credit cannot be determined at the time the return is required to be filed;
- provisions containing record keeping requirements, such as section DH 3, relating to the use of logbooks for motor vehicles;
- section EC 1, which allows adjustments for adopting an incorrect accounting practice;

- section HG 8(1), which allows the Commissioner to assess a person for the income tax liability of a qualifying company when that person has elected to be liable for the tax; and

- sections NC 13 and 14, relating to special tax codes.

Retrospective spreading provisions

5.3 Rules allowing allocation of income or expenditure from one income year to other income years are used widely in the ITA. These often apply to particular industries or activities, and allow taxpayers to spread income or expenditure received or paid in a lump sum over a more extended period.

5.4 Examples of these provisions are section EJ 1 (income from the sale of timber), section EN 3 (income from royalties and the granting of rights in a copyright), and section EN 4 (compensation received on acquisition of land by the Crown).

Proposed treatment

5.5 The allocation of income or expenditure to preceding income years has implications for self-assessment. Once income or expenditure has been allocated to a previous income year, assessments must be adjusted retrospectively. There is some conflict between these provisions and the proposed amendment rules. It will be necessary to allow specifically for amendment by taxpayers of their assessment beyond the proposed period for amendments.

5.6 Generally speaking, allocation provisions were introduced when tax rates were more graduated than they are now. With the advent of relatively flat tax rates, allocation provisions are less likely to be used. Some allocation provisions will be reviewed in a discussion document on timing issues planned for release later this year.

Other retrospective adjustments

5.7 Some provisions allow for the re-opening of an assessment if an amount subject to tax does not become known until after assessment. An example is in the second proviso to section LC 4(1), which allows retrospective amendment of a taxpayer’s assessment when the amount of a foreign tax credit for attributed foreign income could not be determined before the taxpayer’s return was required to be filed. Similarly, section CH 2(4) allows the Commissioner to alter an assessment if the value of a benefit under an employee share purchase agreement is removed or reduced in one of the prescribed circumstances. Retrospective adjustments are also required when income or expenditure is recharacterised following the application of an anti-avoidance provision.

5.8 Some of these adjustments are subject to the Commissioner's four-year statute bar, others are not.

Proposed treatment

5.9 As most adjustments will need to be made after the two-month timeframe for amendment of the assessment by the taxpayer, specific extensions to this period will need to be enacted.

5.10 The alternative to retrospective amendment is to allow current year adjustments for past year over-calculations or under-calculations of income and deductions. This would be simpler than allowing reassessments, but does not allow the matching of expenditure and income and is, therefore, not favoured.

Record keeping requirements

5.11 In addition to the record keeping requirements in the TAA, the Commissioner has a discretion to require taxpayers to keep and produce further accounts or records in some specific instances. Section DH 3 sets out the requirements for motor vehicle logbooks. Section DH 3(2)(b) gives the Commissioner a discretion to require further records to be kept. Extra records required to be retained may include the name of the client visited, the specific purpose of the trip and the reason the travel was necessary.

5.12 Under section DJ 9, which makes specific provision for deductions for expenditure on scientific research, the Commissioner may refuse a deduction when insufficient records of expenditure have been retained.

Proposed treatment

5.13 Other jurisdictions that have moved to self-assessment have extended their record keeping requirements as part of that move. However, Part III of the TAA already contains comprehensive record keeping requirements and it is not proposed to extend these further as part of codifying self-assessment. The burden of proof on taxpayers when an assessment is disputed should in itself provide the incentive to retain sufficient records of business transactions.

5.14 Section DH 3 clearly sets out the motor vehicle use records that should be retained, and it is proposed to retain these. The Government does propose, however, to remove the discretion to require taxpayers to retain extra details, as the section is already sufficiently prescriptive.

5.15 As section DJ 9 applies only to a limited type of activity, a definition of what constitutes sufficient records could be enacted. But, as section DJ 9 is the subject of a wider review of research and development expenditure, proposals for its amendment are not considered here.

Change in accounting practice – section EC 1

5.16 Section EC 1 allows a current year adjustment of a taxpayer's income tax liability when an incorrect accounting practice has been adopted in a previous year. It was intended that the section apply only when an assessment could not be made within the statutory timeframe for ordinary reassessments. However, the Court of Appeal held in *Hutchinson Bros Ltd* v *CIR*[14] that the section is subject to the four-year statutory time bar. The section, therefore, appears primarily to apply in situations already covered by the Commissioner's general power to reassess.

5.17 Given the limitation placed on it by *Hutchinson Bros*, the scope of section EC 1 is unclear and it is appropriate to consider whether it should be retained. Submissions are therefore invited on the situations (not covered by the Commissioner's general power to reassess) to which the section should apply.

Qualifying companies – section HG 8(1)

5.18 A person may elect to be liable for the tax of a qualifying company (section HG 8(1)). The section provides that although the company is assessed for the tax in the first instance, the Commissioner may also assess that person and they will be liable as agent of the company. The discretion is designed for a tax system based on assessment by the Commissioner.

Proposed treatment

5.19 The practical effect of the section could be achieved in a manner more consistent with self-assessment if it simply enabled the Commissioner to recover the company tax liability from the electing person. An example of a similar provision is section HK 11, which makes company directors and shareholders liable for the company's income tax when an arrangement has the effect that the company is unable to satisfy its own tax liability. It is therefore proposed to replace section HG 8 with a provision that makes an electing person liable for the appropriate portion of a qualifying company's tax liability if the qualifying company fails to pay the tax.

[14] (1997) 18 NZTC 13,374.

Special tax codes – sections NC 13 and 14

5.20 Section NC 13 gives the Commissioner a discretion to reduce the amount of any PAYE deductions. The discretion can be exercised if the income from a particular period is not a true reflection of the annual income of an employee, resulting in an over-deduction or under-deduction.

5.21 In order to apply the discretion in section NC 13, the Commissioner has a further discretion in section NC 14 to issue a special tax code certificate to an employer who then makes the increased or decreased deductions.

Proposed treatment

5.22 The discretion to issue special tax code certificates is inconsistent with self-assessment. The Commissioner issues certificates based on the information provided by the taxpayer. Instead of applying for a certificate, employees could simply notify their employers of the tax code, and, therefore, the level of PAYE deductions to be applied.

5.23 This could, however, create scope for employees deliberately to seek under-deductions of PAYE. To prevent this, the Commissioner's discretion to issue tax code certificates for deductions at a lower rate needs to be retained. The Government proposes, however, to remove the requirement for special tax codes when employees wish to increase the rate of deduction from their income.