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Our ref 160405KPMGsubIR10

5 April 2016

Dear Sir or Madam

KPMG submission - ED0184: Filing an IR 10 and section 108 of the TAA 1994

KPMG is pleased to make a submission on the draft Operational Statement on how the time bar provisions, in section 108 of the Tax Administration Act ("TAA"), should apply when a taxpayer files an IR 10 disclosure.

General comments

We agree with the thrust of the draft Operational Statement. In particular, we agree that the application of section 108(2)(b), for omitted income, requires careful consideration and application.

The decision should take into account the care and management factors of sections 6 and 6A of the TAA.

We further welcome the suggestion that the Commissioner is not required to reopen the return. The ability to use section 108(2) is a discretionary power (we refer to paragraph 14). It would be useful for the Commissioner to explicitly state in what circumstances, having regard to sections 6 and 6A of the TAA, the discretion may not be exercised.

You will note from our response that the draft Operational Statement necessarily raises the question of when financial statements are effective for section 108 purposes. Inland Revenue proposes to test the IR 10 for consistency with the financial statements and also whether the financial statements disclose an item of income. The Operational Statement needs to acknowledge this and consider further appropriate disclosures.

The issues we have considered are addressed below.

Policy implications

While the release of the draft Operational Statement is welcome, we consider that the need to issue the draft is indicative of problems with the time bar rules. We understand that the time bar

was noted as an issue under the Business Transformation tax administration framework consultation. The application of the time bar will be critical to the operation of the tax system in a post Business Transformation world. It is important that it be given appropriate focus so that a clear set of rules, which address the questions raised in the draft Operational Statement and in this response, can be implemented.

Commissioner's approach to the time bar

The draft Operational Statement proposes a three tiered approach, which we have attempted to summarise below (note, the underlined wording represents our assumptions):

- If a taxpayer files an IR 10, the time bar protection will apply if it discloses the unreturned income, gain or receipt (regardless of whether financial statements are also filed/not filed and/or disclose/do not disclose the income, gain or receipt).
- If a taxpayer files an IR 10 and this is consistent with the (filed or unfiled) financial statements, the time bar protection will apply if the financial statements disclose the unreturned income, gain or receipt (but the IR 10 does not because of limitations in the form).
- If a taxpayer files an IR 10 and this is consistent with the (filed or unfiled) financial statements, the availability of the time bar protection will be subject to review by Service Delivery management, if neither the IR 10 nor the financial statements disclose the unreturned income, gain or receipt.

Our concerns are in relation to the following issues:

Consistency of application of the time bar when IR 10 is not filed, but financial statements are (and vice versa)

The draft Operational Statement's starting position appears to be that an IR 10 will be filed in all circumstances (with or without a set of financial statements). This will not always be the case.

Most of KPMG's clients prefer to file their financial statements, rather than the IR 10, with their returns. (We note this requirement has now been made explicit for larger taxpayers under the Basic Compliance Package initiative). As the IR 10 effectively mirrors the information contained in the financial statements, this is an additional (and avoidable) compliance cost.

To date, we understand the Commissioner's practice has been to not require taxpayers to file both an IR 10 and their financial statements. The Commissioner should confirm, in her finalised Operational Statement, that her approach to the time bar also applies if only the financial statements are filed (instead of the IR 10), and the appropriate disclosures are made in those accounts. It should also be made clear that if an IR 10 is not filed (e.g. electronically with the return), the financial statements must be filed instead.

There is also a need for operational consistency. We have experience of Inland Revenue taking strange positions in relation to the non-filing of IR 10s. In one case, a client was told that they were selected for audit on account of an IR 10 not being filed (even though their financial

statements were provided instead). We have also heard anecdotally that Inland Revenue has argued that the time bar was not applicable due to the non-filing of an IR 10 (again, even though financial statements were provided).

Our submission will result in consistency. The diagram under paragraph 24 needs to be updated accordingly. We have attached an updated diagram, as an appendix, which we believe better reflects the process for determining whether the time bar applies.

A missing question

The proposed process involves the Commissioner considering the consistency of the IR 10 with financial statements and also whether the financial statements omit income.

The draft Operational Statement does not propose asking or answering the question of why there is inconsistency or omission.

For example, the Commissioner's earlier Statements referred to the incorrect completion of an IR 10. When we discuss financial statements disclosure below, we raise the question of aggregation for financial statement purposes.

It is also possible that an amount may be disclosed in earlier or later financial statements or have a nil value at that point for financial accounting purposes.

We consider that these questions are material to the decision to re-assess a return. They should be asked by Inland Revenue.

Non-application of the time bar where Commissioner asserts tax avoidance

Paragraph 18 of the Operational Statement states that:

> *"It also follows the Commissioner will not want to fetter her discretion to reopen (or not reopen) an assessment that is time barred, in cases where the Commissioner is of the view that the taxpayer is involved in an aggressive tax scheme or tax avoidance".*

Firstly, this statement does not follow from any of the preceding paragraphs. Something more is required to justify the opening words.

We can see why the Commissioner would not wish to fetter her discretion if she considers that section BG 1 of the Income Tax Act is applicable. The Commissioner's Officers tend to consider section BG 1 as special and indicative of particular mischief. However, the Commissioner's discretion in section 108 makes no reference to section BG 1.

The Commissioner's power to re-open a tax return outside of the time bar is limited to the two factors listed under section 108(2).

It is possible that a return which the Commissioner is challenging under section BG 1 will be wilfully misleading or fraudulent. In that case, section 108(2)(a) will be a relevant factor. In other cases, where the taxpayer has disclosed to the Commissioner an arrangement, it is unlikely that section 108(2)(a) would apply.

For section 108(2)(b), the test is simply whether there is an omission of income. Generally, where the general anti-avoidance rule is applied, there will be technical legal compliance.

If the result is that a disclosed amount of the taxpayer is treated as not taxable, the same principles should apply as to any other omission.

This does not fetter the Commissioner from seeking to assess, as she has done, other taxpayers who may not have disclosed an amount if they are a party to the arrangement.

Our concern is that this statement by the Commissioner may be too readily used by Inland Revenue Officers to assert the time bar does not apply. The Commissioner should confirm that section BG 1 has no special status for the application of the time bar and the same principles should apply.

Evidencing the filing of financial statements

Another area of frustration for taxpayers, and their agents, is disputes over whether financial statements have been filed, at the time of return filing (or at all). The draft Operational Statement is silent on this important practical matter.

As there is no option to electronically file financial statements (similar to the tax return and IR 10), this can create problems evidencing that the financial statements were lodged at the same time as the tax return. Sending hard copy financial statements requires faith that the documents will be logged in Inland Revenue's system. Our experience is that this is not always the case, particularly if there is no accompanying hard copy return (as the return likely will have been electronically filed).

Further, it appears that Inland Revenue does not access such filed copies. A Basic Compliance Package request will invariably include a request for financial statements even where these have already been filed at the time of the return.

To ensure the application of the time bar, some taxpayers have taken extreme positions, such as hand delivering the financial statements to Inland Revenue. While sending the financial statements via email is another option, this will generally depend on whether a particular taxpayer has been allocated a specific Inland Revenue Officer as an account manager (if so they are likely to be a Basic Compliance Package taxpayer).

It should not be difficult to resolve this issue (e.g. a central IRD email address to which financial statements can be sent, such that this filing can be "date and time stamped" is one option). We expect that Business Transformation may provide longer term solutions to these information issues. However, there needs to be some action in the meantime.

Status of the tax reconciliation under the time bar

It is unclear what status a tax reconciliation has, for time bar purposes. This is relevant as, under the Basic Compliance Package, a taxpayer is now required to provide their tax reconciliation, along with their completed tax returns and financial statements.

The tax reconciliation provides greater information than the standard income tax return and, in many cases, the usual supporting source documents (i.e. the IR 10 or financial statements).

A tax reconciliation will disclose gains/(losses) and items of financial statement income or deductions that have been backed-out or added-back, for tax purposes. It should therefore have the same status as the IR 10 or financial statements for the operation of the time bar. This should be explicitly addressed in the finalised Operational Statement.

What disclosure of "income, gains or receipts" means in practice

The draft Operational Statement is unclear as to what constitutes appropriate disclosure of income, gains, or receipts in the IR 10, financial statements or other disclosures.

In the case of audited financial statements at least, there is limited scope to disguise income. In fact, accounting generally provides the contrary incentive, to recognise amounts as income where possible, rather than as a balance sheet item. The question is whether a financial statements disclosure will ever be sufficiently detailed enough to meet Inland Revenue's disclosure threshold for application of the time bar in practice.

For example, in the case of gains on investments, financial statements will generally not disaggregate the gain/(loss) based on individual transactions. Instead, the total realised and unrealised gain/(loss) amount will generally be disclosed.

In this situation, it is not clear from the draft Operational Statement whether the disclosure threshold will be met. Similarly, even tax reconciliations may not disclose disaggregated gains/(losses), although it may separate out other income/(deductions) that are deducted/(added).

Where the financial statements (or tax reconciliations) disclose aggregate investment gains/(losses), and/or other amounts deducted or added-back, this should meet the relevant disclosure threshold. That is, the Commissioner should not be allowed to ignore the time bar on the basis of section 108(2)(b) if income from a particular transaction has been included in the aggregate figure disclosed. The onus should be on Inland Revenue to review the financial statements, IR 10 or tax reconciliation (as relevant) and query the aggregate amount, if necessary, within the time bar period.

We understand that this is the current Operational position. This should be made explicit.

The alternative would mean every single transaction (that has a tax effect) needs to be separately disclosed in the financial statements, the IR 10, or the tax reconciliation. This would effectively make the time bar redundant, particularly for a complex taxpayer, as it would be impossible for every single transaction to be fully disclosed in the supporting documents.

When an IR 10 is not required

While paragraph 22 of the draft Operational Statement alludes to income not being disclosed *"due to limitations in the IR 10 form"* (see our comments above), it is silent on whether/how the Commissioner's proposed approach to the time bar will apply in cases where a taxpayer is not required to provide either an IR 10 or their financial statements.

The specific situation we have in mind is that of multi-rate PIEs that file tax returns under either the exit calculation or quarterly options in subpart HM of the ITA. (We note that Listed PIEs

and multi-rate PIEs filing under the provisional tax payment option are still required to file an IR 4 or IR 44 income tax return with the same disclosures as other "in business" taxpayers.)

These multi-rate PIEs are required to file periodic IR 852 income tax returns depending on the filing frequency elected (i.e. annually and monthly for investor exits, or quarterly). They are also required to provide a year-end reconciliation of the monthly/quarterly returns filed (called the IR853) as well as certificates containing the income and tax deducted for each investor at their nominated tax rate (called the IR854).

The IR 852 (and IR 853 and IR 854) do not contain details of the nature and source of taxable income/(loss) for a multi-rate PIE. These entities are only required to disclose, in their IR 852 return, gross income, deductions, any pre-PIE losses (or losses carried forward, in certain circumstances), the total tax paid/(rebated), and tax credits utilised. Neither the IR 853 nor IR 854 expand on the taxable income calculation. There is no other information required to be provided in respect of a multi-rate PIE's tax calculations that we are aware of. (Further, even financial statement information provided by provisional tax paying multi-rate PIEs may have no direct relationship to their actual PIE tax income or tax calculations, as the PIE regime is a special set of tax rules.)

Our concern is how section 108 will be applied by the Commissioner in the case of multi-rate PIEs and others not required to file IR 10s. Prima facie, it appears that the time bar will not be applicable as there is no scope for full disclosure (or for that matter any disclosure) of income of a particular nature or from a particular source.

The time bar should apply to prevent Inland Revenue re-opening an IR 852 return after 4 years of filing. The lack of an IR 10, financial statements or any other income disclosure equivalent for a multi-rate PIE was a deliberate design choice at the time of introduction of the PIE rules (i.e. to support electronic filing of the IR 852, IR 853 and IR 854 returns). Therefore, the onus should be on the Commissioner to undertake any compliance action within the 4 year time bar period.

The time bar position for taxpayers not required to file an IR 10 (or financial statements), such as multi-rate PIEs, therefore needs to be confirmed in the finalised Operational Statement.

Non-application of the time bar

NRWT

At present, section 108(1) requires a taxpayer to furnish an income tax return and for an assessment to have been made in order for the time bar to apply. This has consequences in the NRWT context, where a payer has taken a position, at the time, that no withholding tax was payable and, as a result, no NRWT return was filed. This is likely to be the case where AIL was paid instead. However, if it subsequently arises that NRWT should have been payable instead of AIL, Inland Revenue has argued that there is no time bar protection for taxpayers as a NRWT return has not been filed and no NRWT assessment has been made.

This is inequitable where a genuine tax position has been taken (e.g. where AIL was paid). This can and should be contrasted with deliberate non-compliance with the NRWT rules.

We would support an interpretation of section 108(1) which treats the non-filing of a NRWT return, where AIL has been paid, as effectively the equivalent of filing of a "nil" return, with an accompanying nil assessment of withholding tax.

This interpretation should be considered under the Commissioner's "Care and Management" responsibilities in sections 6 and 6A as it would allow for the effective operation of the time bar in these circumstances.

Expenditure

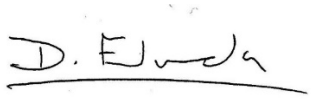
Matters of dispute between the Commissioner and taxpayers often involve deductibility of expenditure. Expenditure is not an item of income of a particular nature or from a particular source.

We assume that the Commissioner considers that she can only re-assess if she considers that the return is fraudulent or wilfully misleading. The finalised Operational Statement should confirm that position.

Further information

Please do not hesitate to contact us, John Cantin on 04 816 4518 or Darshana Elwela on 09 367 5940, if you require further information in relation to this submission.

Yours sincerely



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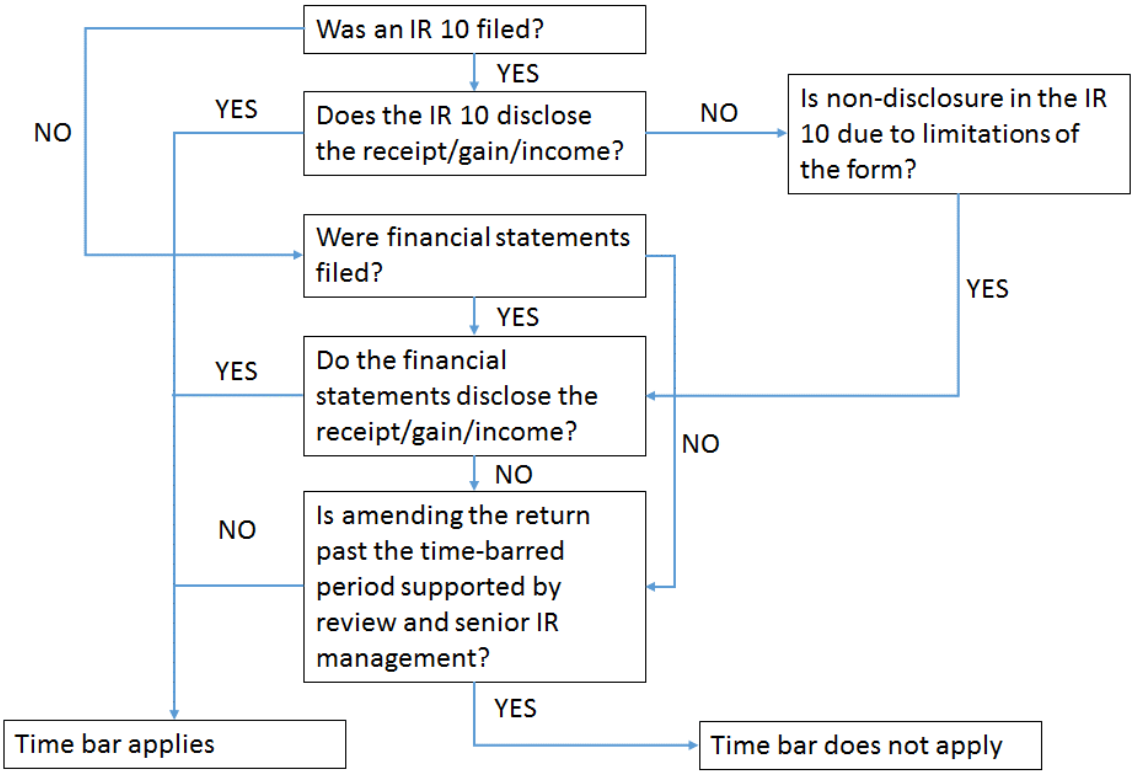
Appendix


Was an IR 10 filed?
YES
NO
Does the IR 10 disclose the receipt/gain/income?
YES
NO
Is non-disclosure in the IR 10 due to limitations of the form?
YES
Were financial statements filed?
YES
Do the financial statements disclose the receipt/gain/income?
YES
NO
NO
Is amending the return past the time-barred period supported by review and senior IR management?
NO
YES
Time bar applies
Time bar does not apply