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**The Compliance and Penalty Regime: Its role as a compliance  
instrument in combating the Criminalisation of Tax Fraud in  
New Zealand**

A thesis presented in partial fulfilment of the requirements  
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## **Abstract**

The Compliance and Penalty Regime which came into effect on the 1<sup>st</sup> April 1997 required taxpayers to take their tax obligations seriously and honestly. The adoption of the Compliance Triangle in the 2001/2002 fiscal year subsequently enabled the Inland Revenue if taxpayers deliberately confronted the tax authorities, by way of criminal tax fraud, to apply the “full force of the law”. This responsive approach in respect of criminal tax fraud was a deliberate attempt to decrease the level of criminal tax fraud and send a signal to the community that such behaviour was not to be tolerated.

The centre piece of the application of the “full force of the law” was Sections 141E, 143A and 143B of the Part IX of the Tax Administration Act 1994 which imposed upon those taxpayers who breached their tax obligations the possibility of stringent monetary and or custodial sentences. Since the sections were introduced fourteen years ago this thesis evaluates the effectiveness of the regime in combating criminal tax fraud in New Zealand.

An examination of archival data that relates to Inland Revenue compliance strategies revealed that criminal tax fraud has increased since the introduction of this regime. However, the extent of criminal tax fraud confronting the New Zealand society and tax discrepancies was difficult to tell. First, it was not easy to decipher from the Inland Revenue’s Annual Reports and media releases the full extent of tax fraud which taxpayers were indicted for. Second, the inconsistencies in reporting the tax shortfall discrepancies in its Annual Reports and its reports to Parliament clouds the true extent of criminal tax fraud discrepancies.

To achieve a reduction in criminal tax fraud, despite Inland Revenue continual focus on areas involving high tax risk, need to reinforce as a behavioural trait societies responsibility to pay tax by improving the flow and quality of information about the extent of criminal tax fraud in New Zealand. Only then will New Zealanders become aware of the burden that criminal tax fraud is. Inland Revenue also need to address the inherently conflicting principles of the Compliance and Penalty Regime, the

Compliance Triangle and the Purchase Agreement and seek to improve voluntary compliance by focusing its resources not on taxpayers who reside at lower strata but by concentrating on those taxpayers who intentionally non-comply.

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The opinions expressed in this thesis are mine and they do not represent the views of the Inland Revenue.

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# **Chapter 1**

## **Introduction**

### **1.1 Taxpayer compliance/non-compliance**

Tax non-compliance is an area of key concern for governments throughout the world for a number of reasons. First, all governments require tax to fund essential public goods and services of our society which the private sector under the free enterprise model is unable to finance. Second, tax is a method of redistributing the wealth of society and it needs to be fair or at least seen to be fair. If taxpayers find others evading tax and failing to pay their fair share, they may question the tax system operating in their society. A perception may exist that the tax authorities are failing to stem the tide of non-compliance. An adverse consequence of such a perception is that taxpayers may view non-compliance as a social norm. Finally, but not least, there is huge administration costs involved with investigating, prosecuting and recovering unpaid tax from non-compliant taxpayers. In many cases, the Revenue Authorities would have to write off unpaid tax debts, as unrecoverable, given the inability to recover from the taxpayer.<sup>1</sup> These write offs may send a further signal to taxpayers that non-compliance is a socially acceptable norm. Tax compliance is indeed an on-going issue that all tax authorities worldwide are grappling with.

Roth, Scholz and Witte defined tax compliance as:<sup>2</sup>

*“Compliance with reporting requirements means that the taxpayer file all required tax returns at the proper time and that the returns accurately report tax liability in accordance with the Internal Revenue Code, regulation, and court decisions applicable at the time the return is filed.”*

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<sup>1</sup> Inland Revenue Department Annual Reports from 30 June 1994 -2010 detail that \$1,380.60 million in debt was written off whilst insolvency debt during the same period amounted to \$2,184.00 million.

<sup>2</sup> *Taxpayer Compliance, Vol 1: An Agenda for Research*, University of Pennsylvania Press, Philadelphia (1989) 21. See also SB Long and JA Swingen, *Taxpayer Compliance: Setting New Agendas for Research* (1991) Vol 25 *Law and Society Review*, p 637 for a discussion of this concept.

Tax non-compliance according to the above definition therefore includes the failure to file a tax return or file a return late, failure to declare assessable income, claiming of non-deductible private expenditure, or failure to keep the necessary records as required by the taxing statutes.

In a practical sense, non-compliance can be intentional or non-intentional.<sup>3</sup> Intentional non-compliance exists when individual taxpayers are fully aware of their tax obligations under the existing tax statutes and intentionally choose not to comply. Tax evasion is an example of intentional non-compliance.<sup>4</sup> It refers to conscious acts of intentional non-compliance with tax laws or the illegal reduction of tax i.e. taxpayers knowingly report a tax liability that is less than the amount payable under the law with an attempt to deceive the tax authorities. In addition, intentional non-compliance includes taxpayers who operate within the hidden economy i.e. legal or illegal activities carried out but for which no tax is paid.<sup>5</sup>

An alternative definition of tax compliance was set out by James and Alley as:<sup>6</sup>

*“The willingness of individuals and other taxable entities to act in accordance within the spirit as well as the letter of tax law and administration, without the application of enforcement activity.”*

Their definition extends Roth et al.’s definition as it encompasses compliance with both the letter and spirit of the law. Tax avoidance, unlike tax evasion, refers to taxpayers’ attempts to legally reduce, defer, or eliminate their tax liability.<sup>7</sup> If taxpayers adopt an aggressive stance, but is unsupported by the policy intention of the tax law, then it is also non-compliance, according to James and Alley.

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<sup>3</sup> M McKerchar, 'Complexity, compliance and fairness: A study of personal income taxpayers in Australia', Taxpayers Australia National Council, (Perth 5-6 December, 2002).

<sup>4</sup> *Taylor v Attorney-General* [1963] NZLR 61.

<sup>5</sup> G Kirchgässner, Tax Morale, Tax Evasion, and the Shadow Economy (May 2010 Discussion Paper no. 2010-17) Department of Economics University of St. Gallen available at [ideas.repec.org/p/usq/dp2010/2010/.html](http://ideas.repec.org/p/usq/dp2010/2010/.html) (as at 14 November 2010).

<sup>6</sup> S James and C Alley, Tax Compliance, Self-Assessment and Tax Administration in New Zealand – Is the Carrot or the Stick More Appropriate to Encourage Compliance (1999) Vol 5:1 *New Zealand Journal of Taxation Law and Policy* 3, p 10.

<sup>7</sup> Serving Two Masters: The Role for Tax Practitioners S M Paquette PHD Thesis available at [accounting.uwaterloo.ca/phd/abstracts/paquette.hmt](http://accounting.uwaterloo.ca/phd/abstracts/paquette.hmt) (as at 13 October 2010).

An interesting question to ask at this stage is why do people not comply? The literature suggests several motives of non-compliance and they include taxpayers' perceptions of:<sup>8</sup>

- Deterrence, e.g. audits, perceived risk of detection and severity of sanctions;
- Norms, both personal and social norms;<sup>9</sup>
- Opportunities for evasion;
- Fairness, related to outcomes and procedures, and trust, both in the government and tax authority; and
- Economic factors, including general economic factors, factors related to the business or industry and amount of tax due.

A primary reason for intentional non-compliance is that taxpayers have direct financial benefits as can be seen in the many tax avoidance cases including the recent case of *Penny and Hooper v CIR*.<sup>10</sup> For instance, an intentional non-complier may weigh the consequences of cheating on his/her taxes by considering the risk and reward in cheating. The reward is the savings from a lower tax burden and the risk is being audited and the penalty imposed by the tax authority.

Fairness and trust are also important drivers of tax compliance,<sup>11</sup> particularly if taxpayers receive fair treatment by the tax authorities.<sup>12</sup> For voluntary compliance to take place the sanctions and penalties must also be seen to be fair and appropriate and the Inland Revenue should endeavour to maintain professional standards.

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<sup>8</sup> Organisation of Economic and Cultural Development Forum on Tax Administration: Small/Medium Enterprise (SME) Compliance subgroup Information Note Understanding and Influencing Taxpayers' Compliance Behaviour November 2010 available at [www.oecd.org/dataoecd/58/38/4627493.pdf](http://www.oecd.org/dataoecd/58/38/4627493.pdf) (as at 21 May 2010).

<sup>9</sup> Personal norms are defined as taxpayers' convictions about what one ought or ought not to do). M Fishbein and I Ajzen, *Belief, Attitude, Intention and Behaviour: An Introduction to Theory and Research*. (1975) Reading, MA: Addison-Wesley, whilst in the tax context, personal norms can be defined as the belief that there is a moral imperative that one should comply. M Wenzel, Motivation or Rationalisation? Causal relations between ethics, norms and tax compliance (2005) Vol 26:4 *Journal of Economic Psychology* 91.

<sup>10</sup> *Penny & Hooper v CIR* (2010) 24 NZTC 24,287.

<sup>11</sup> V Braithwaite, Tax Evasion, in M. Tonry (Ed.). *Handbook on Crime and Public Policy*, Oxford: Oxford University Press (2008) 381.

<sup>12</sup> E Kirchler and E Hoelzl, Modelling Taxpayers Behaviour as a Function of Interaction between Tax Authorities and Taxpayers. (2006) In H. Elffers, P. Verboon and W. Huisman (Ed). *Managing and maintaining compliance*. Boom Legal Publishers, The Hague.

Opportunity is another important factor in non-compliance. Prior studies have substantiated that compliance is highest when the opportunity for non-compliance is low, third party information exists which creates an audit trail, or a withholding tax regime is in place.<sup>13</sup>

Taxpayers can also be completely individualistic, amoral and display a willingness to underreport income or they can be influenced by social norms or by any form of social interactions.<sup>14</sup> For instance, fully compliant taxpayers may comply in one period, but when they come to know and realize others' non-compliant behaviour, they may choose in the subsequent period not to comply. This change can be attributed to the taxpayers' personal norms been influenced by society norms.<sup>15</sup>

Unintentional non-compliance, on the other hand, is non-deliberate and arises due to the complexity of the tax system. When taxpayers do not understand what the law requires, have difficult in keeping up to date with numerous tax changes or rely upon the advice of others the amount of tax they declared may not be correct. Unlike intentional non-compliance which is primary driven by monetary gain, unintentional non-compliance is usually not.

Intentional non-compliance which sadly exists in most societies is a challenge for tax authorities throughout the world to consider various ways to deter them.<sup>16</sup> If not, it may reach a point where society tolerance may weaken to the extent that tax evasion becomes acceptable. Over time as Slemrod cautioned "*the ranks of the dutiful will shrink, as they see*

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<sup>13</sup> G Antonides and H Robben, True Positives and False Alarms in the Detection of Tax Evasion", (1995) Vol 16:4 *Journal of Economic Psychology* 617.

<sup>14</sup> B Fortin, G Lacroix and Marie-Claire Villeval, Tax evasion and social interactions (2007) Vol 91 *Journal of Public Economics* 2089.

<sup>15</sup> M Wenzel, An Analysis of Norms Processes in Tax Compliance (2004) Vol 25 *Journal of Economic Psychology*, 213, and R Cialdini, Social Motivations to Comply: Norms, Values and Principles, in J.A. Roth, J.T. Scholz and A.D. Witte (Eds.), *Taxpayer Compliance Volume 1: An agenda for research*. Philadelphia: University of Pennsylvania Press, Philadelphia (1989) 200.

<sup>16</sup> F Schneider. The Value Added of Underground Activities: Size and Measurement of the Shadow Economies of 100 countries all over the World, A paper presented at the Australian National Tax Centre ANU, Canberra, Australia, (July 17, 2002).

*how they are being taken advantage of by the others.”*<sup>17</sup> Therefore, tax authorities as the arm of the state, play a critical role in the collection of revenue. The next section discussed the role of the Inland Revenue in New Zealand.

## 1.2. The Role of the Inland Revenue

The primary objective of the Inland Revenue is “to administer the Inland Revenue Acts”.<sup>18</sup> In the 1983/84 fiscal year, the Inland Revenue first produced a corporate plan which set out the purpose of the Department and an underlying philosophy emphasizing voluntary compliance<sup>19</sup> so that taxpayers pay “no more, no less of the correct amount of tax.”<sup>20</sup>

To achieve this objective the Inland Revenue sets out three intermediate broad aims: (i) to make as easy as possible for people to comply with the tax laws by letting them know their rights and obligations; (ii) to administer the law in a consistent, courteous and prompt manner, so that all people know they are treated fairly; and (iii) to detect those people who do not comply and, where appropriate, take action against them.

It was this third aim, which the Inland Revenue as with other Revenue Authorities applied the age old deterrence of criminal sanctions and the imposition of monetary penalties to compel taxpayers to voluntarily comply.<sup>21</sup> With this concept of “stick mentality”<sup>22</sup> of deterrence, Inland Revenue seeks to both penalised bad behaviour and send a strong signal to the complying taxpayers that the Revenue is determined to ensure that all taxpayers in a civilized society bear the burden of tax in an equitable manner.<sup>23</sup>

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<sup>17</sup> J Slemrod, Cheating Ourselves: The Economics of Tax Evasion. (2007) Vol 21, Number 1 *Journal of Economic Perspectives* 25.

<sup>18</sup> Inland Revenue Public Information Bulletin January 1984 Number 123, p 1.

<sup>19</sup> Inland Revenue Department Annual Report 1986, p 20.

<sup>20</sup> Inland Revenue Department Annual Report 1987, p 4.

<sup>21</sup> DG Duff, Rethinking Tax Enforcement and Compliance: Faculty of Law British Columbia available at [www.law.utoronto.ca/documents/conference](http://www.law.utoronto.ca/documents/conference), (as at 16 August 2010).

<sup>22</sup> See n 6.

<sup>23</sup> Justice Holmes famous quotation in *Compania General De Tabacos De Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100, dissenting; opinion (21 November 1927).

The Inland Revenue in 1984 was an aging relic of the past and with the election of the Fourth Labour Government under the leadership of (the late) David Lange, New Zealand began the economic experiment known as Rogernomics.<sup>24</sup> The Inland Revenue during this period began the process of a metamorphic conversion towards a modern focus revenue authority. From once using out-dated technology to assess manual returns and lacking computer technology to examine financial records of taxpayers, it changed to one of self-assessment; electronic filing and computer based auditing software. These changes enabled the Inland Revenue to switch its limited financial resources to focus on the policy of voluntary compliance. Electronic computer software was used to target those taxpayers who choose to avoid their legal tax obligations and a more aggressive approach was taken against those taxpayers who intentionally contravene the tax law.

Since the development of its corporate plan in 1983/84, Inland Revenue underwent significant structural changes, and in respect of voluntary compliance, Part IX of the Tax Administration Act 1994 came into law on the 1<sup>st</sup> of April 1997 which fundamentally reflects the most significant shift in Compliance Policy.<sup>25</sup> The new rules are now commonly termed as the “Compliance and Penalty Regime.”

Given that there are taxpayers who do not voluntarily or correctly self-assess the tax they have to pay, the dilemma for Inland Revenue and the Government is whether to reform the tax system to further tighten any loopholes or to impose harsher penalties for non-compliance.

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<sup>24</sup> Rogernomics is a term used to describe the economic policies followed by Roger Douglas after his appointment in 1984 as Minister of Finance in the Fourth Labour Government. Rogernomics was characterised by market-led restructuring and deregulation and the control of inflation through tight monetary policy, accompanied by a floating exchange rate and reductions in the fiscal deficit.

<sup>25</sup> Russell McVeagh McKenzie Bartleet & Co Submission to the Finance and Expenditure Select Committee dated 16 November 1995, Para 2.1.

To “enforce” citizens to pay taxes with a comprehensive deterrence policy involves high costs and cannot be achieved unless there is a tax administrator under every “bed”.<sup>26</sup> Slemrod for example states that:<sup>27</sup>

*“From the tax collection standpoint, it is extraordinarily expensive to arrange an enforcement regime so that, from a strict cost-benefit calculus, noncompliance does not appear attractive to many citizens.”*

It follows that, methods that reinforce and encourage taxpayers’ devotion to their responsibilities as citizens play a far more important role in the tax collection process, than simply the stick concept. Furthermore, several previous studies have shown the limitations of enforcement strategies.<sup>28</sup>

Inland Revenue compliance policy has matured since its initial pronouncements such that to the general public, paying tax was an obligation made of their own accord and increasingly regarded as contributing to society.<sup>29</sup> Prior to 2002, Inland Revenue had no underlying philosophy captured in a theoretical model in respect of this Compliance and Penalty Regime. In 2002, Inland Revenue adopted the Compliance Model which centred on the Compliance Triangle<sup>30</sup> and supplemented by the concepts of BISEP [Business, Industry, Sociological, Economic and Psychological] which is a responsive philosophy that suggests different strategies based on the attitudes and compliance stances taken by the taxpayer. This responsive philosophy is also reflected in the Customer Charter which involves 8 fundamental obligations and rights at its core.<sup>31</sup>

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<sup>26</sup> B Torgler and C Schaltegger Tax Morale and Fiscal Policy: Centre for Research in Economic, Management and the Arts Working Paper 2005 – 30, p 2 available at ideas.repec.org/f/psc347.html (as at 31 January 2011).

<sup>27</sup> J Slemrod (ed.) *Why People Pay Taxes. Tax Compliance and Enforcement.* University of Michigan Press. Michigan (1992).

<sup>28</sup> M Graetz. and L Wilde, The Economics of Tax Compliance: Facts and Fantasy (1985) Vol 38, *National Tax Journal* 345, J Alm, G McClelland and W Schulze, Why Do People Pay Taxes? (1992) Vol 48 *Journal of Public Economic* 21, B Frey and L Feld, Deterrence and Morale in Taxation: An Empirical Analysis, CESifo Working Paper No. 760, (August 2002).

<sup>29</sup> Inland Revenue: The New Zealand Business Plan. The Way Forward Onwards 2001, p 7.

<sup>30</sup> Compliance Triangle was developed in conjunction with the Australian Tax Office as a consequence of the cash economy project. This model is explained in Chapter 3 Part 3.5.

<sup>31</sup> Refer Chapter 2 part 2.7.6 which sets out the Inland Revenue Customer Charter. This charter set out Inland Revenue’s public promises to all New Zealanders on the standard of service that Inland Revenue aimed for as well as the obligations of its customers.

However, although this philosophy works well at the lower strata of the Compliance Triangle (e.g. helping to comply), it does not appear to have a yardstick to measure its success in combating non-compliance in the upper strata (e.g. full force of the law). Inland Revenue is now attempting to measure these upper stratum levels of taxpayers which require an estimation of the levels of uncollected tax, which by its very nature is generally not detected by the revenue authority.<sup>32</sup> It is this lack of measurement and yardsticks which will always constrain any Compliance Regime where incentives exist for a hidden economy, where the flight of capital to low tax regimes occurs, and where the government has difficulty in using withholding tax regimes to collect tax on certain types of transactions.

To further complicate the matter, benchmarks are indicative only and the bases of those indicative benchmarks are not disclosed.<sup>33</sup> Until an independent review is undertaken to establish such validity, it is questionable at best to contend whether the Revenue is winning the battle at the upper end of the Compliance Triangle.

Ironically, it was the less severe penalties for tax non-compliance<sup>34</sup> that became the subject of an extensive review by the Finance and Expenditure Committee of the House of Representatives in April 1999.<sup>35</sup> The consequences were an acceptance of the need for remedial legislation which increased the monetary thresholds of deficient tax liability before the imposition of monetary penalties. With this change, the Inland Revenue was required to undertake a fundamental shift in its philosophy towards those taxpayers at the bottom of the Compliance Triangle.

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<sup>32</sup> Inland Revenue Annual Report 2010, p 21.

<sup>33</sup> See n 32.

<sup>34</sup> Sections 141A to 141D of the Tax Administration Act 1994 which deal with Lack of Reasonable Care, Unacceptable Tax Interpretation, Abusive Tax Position and Gross Carelessness deal with taxpayers who reside at the lower strata of the Compliance Triangle. Refer to Appendix 1 that sets out these sections.

<sup>35</sup> Inland Revenue: Inquiry into the Powers and Operations of the Inland Revenue Department. Report of the Finance and Expenditure Committee (1999).

Since the enactment of the Compliance and Penalty Regime in July 1996 questions can be raised as to what extent the Inland Revenue is successful in deterring criminal tax fraud.<sup>36</sup> Criminal tax fraud is defined as any offence committed under section 141E, 143A and or 143B of the Tax Administration Act 1994.<sup>37</sup> There are several reasons why one should focus on whether the Inland Revenue has been successful in combating criminal tax fraud is that by reducing the incidence of such offending. Firstly, criminal tax fraud is a serious threat to the tax base. Secondly, if fewer taxpayers defraud the Inland Revenue this would lessen the tax burden on honest complying taxpayers. Thirdly, the Inland Revenue will incur lower costs in pursuing less of those types of taxpayers. Finally, society will begin to see that tax compliance is a social norm and tax fraud is a serious crime.

### **1.3 Aim and Objectives**

The Inland Revenue's primary aim may have broadened from a simplistic idea of collecting tax revenue, to one of being an integral part of economic and social policy of the Government.<sup>38</sup> As a result its Compliance Strategy has significantly changed. Once grounded on a "command and control" mentality which enabled avoidance and evasion to flourish,<sup>39</sup> and a seeming lack of understanding of what motivated taxpayers to intentionally not comply, the Inland Revenue is now modern, savvy, focus driven and prepared to listen and change to ensure voluntary compliance is society's accepted norm.<sup>40</sup>

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<sup>36</sup> Criminal tax fraud is defined as an offence within the provisions of sections 141E, 143A and 143B of the Tax Administration Act 1994.

<sup>37</sup> Refer to Appendix 1 which sets out these sections in full detail. In essence, however, s141E of the Tax Administration Act imposes a 150% penalty on the deficient tax for the taxpayer whom evades the payment of tax. Section 143A and 143B of the same Act, impose upon the offending taxpayer the possibility of both a custodial sentence of up to 5 years and or the imposition of a penalty under section 141E of a 150% penalty on the deficient tax.

<sup>38</sup> Inland Revenue Department Annual Report 2009, page 6 states that Inland Revenue's primary outcome was now about improving the economic and social wellbeing of New Zealanders. This is achieved by collecting revenue and distributing social policy payments to customers.

<sup>39</sup> Report of the Audit Office Inland Revenue Department: Income Tax Compliance Control 13 November 1987, p 33.

<sup>40</sup> Inland Revenue Department Annual Report 2010, p 25 that by working co-operatively with our customers to help them get it right compliance is improved.

In the ensuing years since Rogernomics,<sup>41</sup> tax fraud and tax evasion has become a powerful symbol of non-compliance which in turn requires Inland Revenue to use the full force of the law.<sup>42</sup> As an example, in December 2004, the Inland Revenue started to release, via its Corporate Communication Unit, selected extracts of prosecutions of taxpayers. Since then, the media releases set out the relevant information of 96 taxpayers prosecuted by the Inland Revenue between December 2004 and October 2010. Its rationale for the selection of selected releases included the following:

- The impact that high profile prosecutions involving large dollars might have on the general public and that the Inland Revenue was successful in pursuing non-complying taxpayers;
- If a prosecution was already subject to publication in a local newspaper, there was no reason for further additional publication; and
- High profile prosecutions relating to Industry Partnership Programme, particularly in the Horticultural Industry was the way Inland Revenue communicated to that Industry, and by analogy, compliant taxpayers would know of the success of its Industry partnership programme.

Further, the Inland Revenue has published in each of its Annual reports (1998 – 2006), the number of each prosecution and or offences committed under either the Inland Revenue Acts or Crimes Act 1961, together with details of shortfall penalties imposed under sections 141A to 141E of the Tax Administration Act 1994.

The aim of this thesis is to ascertain the effectiveness of the Compliance and Penalty Regime to deter criminal tax fraud. The objectives are to analyse:

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<sup>41</sup> See n 24.

<sup>42</sup> Inland Revenue Prosecution Framework. Our prosecution framework where the Inland Revenue states: “ our prosecution framework contributes to Inland Revenue’s strategic outcomes by ensuring prosecution activity is the appropriate action to be taken for the type and level of non-compliance identified., positively influences future compliance behaviour, affirms compliant behaviour, is publicised where appropriate, is an integral component of a balanced compliance programme”, available at [www.ird.govt.nz/technical-tax/prosecution-framework](http://www.ird.govt.nz/technical-tax/prosecution-framework) (as at 28 March 2010).

- The statistical data released by the Inland Revenue from its Corporate Communications in respect of prosecutions;
- Inland Revenue's Annual Reports since 1975;
- The Reports of the Office of Auditors Generals into the Operations of Taxpayer Audit in 1987, 2003 and 2006;
- The prosecution of criminal tax fraud and imposition of civil penalties in respect tax evasion, as a consequence of breaches of sections 141E, 143A and 143B of the Tax Administration 1994.

Insights gained from these analyses will help to draw conclusions as to the extent of effectiveness of the Compliance and Penalty Regime in combating criminal tax fraud.

## **1.4 Research Method and Scope**

This research uses an archival method of collecting data from various sources as set out below to investigate whether the Compliance and Penalty Regime had been effective in combating criminal tax fraud since its enactment on the 26<sup>th</sup> July 1996.<sup>43</sup>

The research involved:

- Reviewing all Inland Revenue Departments Annual Reports from 1975-2010 in respect of statistical information of tax revenues, tax returns, tax discrepancies, types of audits and investigations and what shortfall penalties were imposed;
- Reviewing all the commentary by the incumbent Commissioners on the modernisation of the Inland Revenue since 14 July 1984 as set out in the Annual Reports from March 1984 to June 1996;
- Reviewing Inland Revenue publications including the Way Forward, Compliance Strategy and Statements of Intent issued since 2000;

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<sup>43</sup> The Research was undertaken between the 1<sup>st</sup> of March 2010 and the 31 January 2011. Media releases in respect of prosecutions from the Inland Revenue Department website was only analysed from December 2004 to October 2010.

- Reviewing the Inland Revenue website to obtain information in respect of publications of its prosecutions, the prosecution framework and Standard Practice Statements in respect of tax evasion and tax fraud;
- Reviewing the Office of Auditor General Reports into the operations of Inland Revenue's Audit published in November 1987, July 2003 and October 2006;
- Reviewing the Office of Auditors General review of the effectiveness of Industry Partnership published April 2009;
- Reviewing all Discussion publication issued by Inland Revenue in respect of the Compliance and Penalty Regime and Modernisation of the Inland Revenue since April 1994;
- Obtaining under the Official Information Act 1982 details of shortfalls imposed by the Commissioner as reported to Parliament under section 141L of the Tax Administration Act 1994 and comparing these statistical information to that of its Annual reports;
- Obtaining access to the submissions made to the Finance and Expenditure Select Committee into the Compliance and Penalty Regime;
- Reviewing journal articles into the Compliance and Penalty Regime;
- Searching the New Zealand Gazette for publications of Tax evaders issued in terms of section 146 of the Tax Administration Act 1994;
- Reviewing journal articles into the Compliance Triangle; and
- Searching web sites for articles dealing with tax evasion and criminal tax fraud.

In addition, an interview with a Senior Official member of the Inland Revenue was requested to discuss the Inland Revenue's approach to the Compliance and Penalty Regime. At that meeting the questions that were to be raised involved how the Inland Revenue saw the Compliance and Penalty Regime as an instrument to reduce criminal tax fraud and whether that Compliance Regime was premised on the model of Deterrence or Behavioural school of Tax Compliance. Further, at that meeting it was hoped to raise the issue of what percentage of the tax population reside within each level of the Compliance Triangle. However the interviewed was declined. The Senior Official advised that the areas of question would only be available internally and would be 'tax secret' in terms of section 81

of the Tax Administration Act 1994. Under that section, disclosing of such information is broadly only permitted for the purposes of carrying into effect the requirements of the Revenue Acts. Much of what was requested in respect of what was requested does not appear to exist in terms of readily available Departmental information.

## **1.5 Summary**

The issue of criminal tax fraud and whether the Inland Revenue's Compliance and Penalty Regime has been successful in combating its growth is of fundamental importance to Inland Revenue and New Zealand society. Inland Revenue Compliance Strategy since July 1984 has evolved to target those taxpayers who resided at all levels of the Compliance Triangle, but with an emphasis on those at the upper levels. Inland Revenue has become more transparent in respect of its communications to taxpayers of the areas it will target, the criteria upon which it will prosecute cemented by the Compliance Triangle, with its prosecution framework clearly communicated.<sup>44</sup> This approach would show that the Inland Revenue has the apparatus to deter and reduce criminal tax fraud in the future and has been successful in the past in ensuring the prosecution of taxpayers who breach their tax obligations.

This thesis is set out to provide evidence of the effectiveness of the Inland Revenue strategies in combating criminal tax fraud.

The thesis is organized in the following manner. It comprised seven chapters. In chapter 2, a review of the structural changes that Inland Revenue underwent following the economic reforms of Roger Douglas since July 1984 is undertaken. The underlying limitations existing within Inland Revenue tax Compliance Strategy prior to the introduction of the

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<sup>44</sup> See n 42.

Compliance and Penalty Regime is also examined. Chapter 3 provides the background to the Compliance and Penalty Regime and the rationale for its introduction.

In Chapter 4, a review of the limited literature which examines the Compliance and Penalty Regime is presented. Whether the Compliance and Penalty Regime is grounded in either the theory of deterrence theory or behaviourist academic theories is also discussed. Chapters 5 and 6 are set out to evaluate whether the Compliance and Penalty Regime has been successful in combating criminal tax fraud. Chapter 5 begins with an examination as to whether the Compliance Triangle has a limitation in its design in respect of combating criminal tax fraud. In addition, the issue of data integrity as released by the Inland Revenue in respect of its prosecution and shortfall penalties is discussed as is the issue of what drives the Compliance Strategy of the Inland Revenue. In Chapter 6, an evaluation of the media releases in respect of tax prosecution is undertaken to determine how relevant and informative these media releases were. A brief review of Industry Partnership and its success in combating criminal tax fraud is also examined. The issue of research conducted by Inland Revenue into the Compliance and Penalty Regime is also briefly examined. Finally, Chapter 7 provides the conclusion, limitations and the areas of future research.

## Chapter 2

### New Zealand's Tax Administration: At the cross roads

#### **2.1 Introduction – the Economic Landscape**

The tax system of the 1970's and early 1980's in New Zealand was neither efficient nor equitable,<sup>45</sup> as it was used primarily as a tool to direct economic development and stimulate economic activity. Under the National Government which had dominated the political landscape of the time (1960-1972 and 1975–1984), various tax policies were used as an economic tool to meet New Zealand's difficulties on an ad hoc basis. Prices and income policies had been used to try to contain inflation. On the one hand attempts had been made to offset an over-valued currency by import restrictions and to limit New Zealand's exposure to a fluctuating exchange rate by exchange controls. In addition, various subsidies and tax reliefs were given to producers and potential exporters.

However, what distinguished New Zealand tax system at that time from other country's tax systems was its high percentage of tax revenue derived from a progressive income tax system. As set out in Figure 2.1,<sup>46</sup> New Zealand, unlike almost all other OECD<sup>47</sup> countries, raised no revenue from social security taxes, and comparatively little from indirect taxes. Thus, in the early 1980s, revenue from income tax in New Zealand amounted to over 20 per cent of the GDP<sup>48</sup> and around 83 per cent of the New Zealand's revenue came from income tax source deductions. In terms of the proportion of total tax revenue taken in income tax, New Zealand was in a league of its own.

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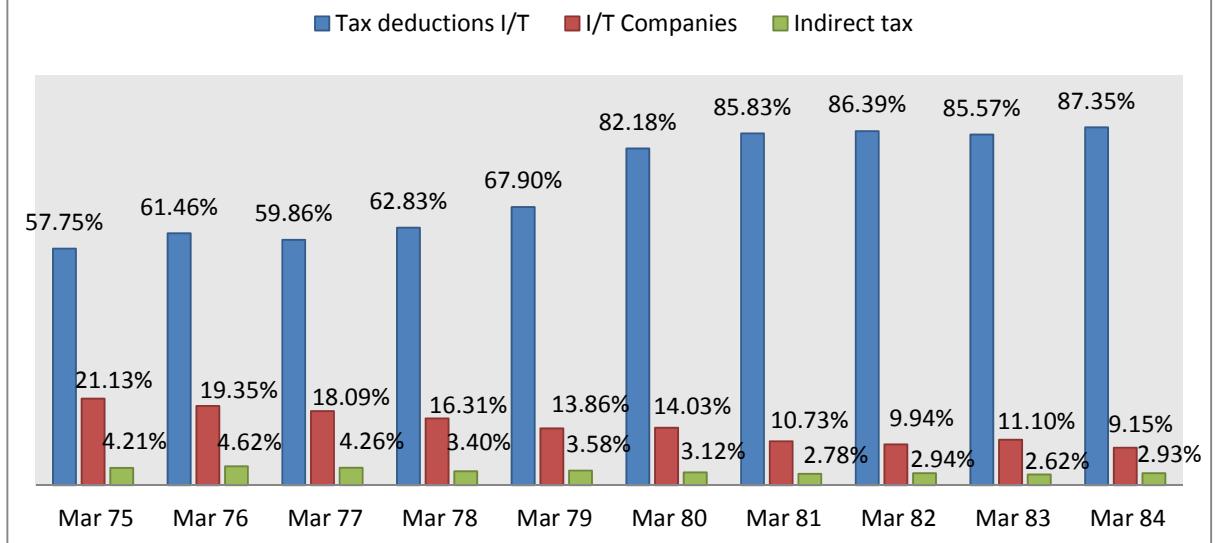
<sup>45</sup> As an example, Section 156A Income Tax Act 1976 provided taxpayers who derived export earnings a tax credit. Although this encourages export earnings, it did not encourage production based on real earnings. Rather, it became a method for avoiding tax by other taxpayers as opposed to legitimate exporters.

<sup>46</sup> Inland Revenue Department Annual Reports 1975 – 1984.

<sup>47</sup> OECD stands for the Organisation of Economic and Cultural Development.

<sup>48</sup> GDP is the term used for the gross domestic product of a country.

Figure 2.1 Tax Revenue % 1975 -1984.



Previous reports by the Ross and McCaw Committees stressed the need to reduce income tax and compensate the fall in revenue with a sales tax.<sup>49</sup> The McCaw Committee for instance saw a raft of tax issues which required the Government's immediate attention. The issues included tax avoidance by professional and semi-professional taxpayers, the growth of fringe benefits for employees to circumvent high marginal tax rates, the inequity of double taxation of company dividends, the need to improve family support measures in the face of any increase in indirect taxation and to rigorously scrutinize business tax incentives. Most importantly, the McCaw Committee stressed the need to move from a narrow based tax system dependent upon PAYE and income tax which was evident as shown in Table 2.1<sup>50</sup> to a more broad base system involving taxation on consumer spending.

<sup>49</sup> Taxation in New Zealand Review Committee (The Ross Report 1967) and Report of the Task Force on Tax Reform (The McCaw Report 1982). These Committees were set up to review and make recommendations concerning the New Zealand tax system.

<sup>50</sup> Public Information Bulletin Number 123 January 1984. Note other taxes included cheque duty, film hire duty, stamp duty, sales tax and highway tax Table 2.1 arose from a question raised by Mr Rodgers member of parliament for Dunedin North.

**Table 2.1 Tax percentage breakdown of receipts for personal income tax, company income tax and miscellaneous income taxes for the years 1960 – 1983.**

Year	Personal Income tax%	Company Tax %	Other %
1960	70.32	28.33	1.35
1961	70.59	28.18	1.23
1962	69.19	30.68	.13
1963	69.29	30.52	.19
1964	67.40	32.48	.12
1965	66.02	33.56	.42
1966	66.85	32.32	.83
1967	67.04	31.91	1.05
1968	67.04	32.07	.89
1969	69.72	29.29	.99
1970	70.13	29.02	.85
1971	70.78	28.31	.91
1972	74.82	24.30	.88
1973	77.40	21.90	.70
1974	77.27	22.08	.65
1975	78.64	20.74	.62
1976	81.01	18.28	.71
1977	81.66	17.70	.64
1978	83.52	15.83	.65
1979	86.16	13.05	.79
1980	84.16	15.20	.64
1981	87.07	12.32	.61
1982	87.28	12.03	.68
1983	86.09	13.24	.67

The failings of this tax system became evident in the inflationary conditions which prevailed towards the end of the 1970's. An increasing demand for revenue was prompted

by rising government expenditure and stagnating economic activity. Industrial subsidies, unfunded age entitlements and unemployment compensation, and a growing base-load of debt service and general inefficiency in departmental expenditure were other sources of extra revenue demands.

The narrow base of the tax system in New Zealand, and apolitical unwillingness to reverse the erosion of the tax base except in minor extension of the indirect taxes, led to a rapid escalation of average income tax rates over the later part of the 1970's and early 1980's. Much of the increasing tax revenue was achieved by the failure to fully or fairly index the progressive marginal tax rates. The result was that as taxpayers' middle and upper incomes increased, they encountered higher marginal tax rates, which encouraged them to utilize tax structures to minimise their overall exposure to tax.

The McCaw Committee further drew attention to the deficiencies in the New Zealand tax system and its growing unpopularity, taxpayers' dissatisfaction with tax rates and increasing resistance to higher taxes.<sup>51</sup> The resistance manifested itself in a proliferation of fringe benefits for high marginal rate individuals and tax based investment schemes. The McCaw Committee's solution was to shift more of the tax burdens to consumption expenditure, adopt a generally less progressive scale of marginal tax rates and carry out overdue repairs and maintenance on business tax provisions. Unfortunately, the recommendations of both the McCaw and Ross Committees never saw the light of day.

Under the then National Government, New Zealand was sliding to an abyss.<sup>52</sup> Tax legislation became increasingly structured to plug the growing loopholes in the ever widening tax avoidance industry that spanned from Kiwifruit to export incentives. Protective tariffs, including price and wage controls, import controls and foreign exchange regulations were used to foster and develop the domestic market.

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<sup>51</sup> See n 49.

<sup>52</sup> T Hazledine, *Taking New Zealand Seriously: The Economics of Decency* (HarperCollins Publishers 1998).

The New Zealand economic base involved strong state intervention, either as:<sup>53</sup>

*“a significant supplier or regulator in virtually every sector of the economy. This approach reached a peak during ‘the Muldoon years’ (1975-1984) when new government policies included a large expansion of the country’s tax-funded superannuation scheme, price subsidies for agriculture, extended tax concessions for manufactured exports, several ‘Think Big’ construction projects in the energy sector, and a general freeze on all incomes and prices in June 1982 that lasted nearly two years.”*

## 2.2 The July 1984 Snap Election – Rogernomics

Prior to the July 1984 snap election, the National party under the leadership of Sir Robert Muldoon held a 2 seat majority. Dissent within the National Party inspired by dissenting MPs Marilyn Waring and Mike Minogue saw Sir Robert Muldoon called a snap election to reinforce both his leadership and remove these dissenters.

However, growing dissatisfaction with the Muldoon government economic policies, which were rigid, inflexible, and increasingly unpopular, saw the Labour Party under the inspirational leadership of David Lange,<sup>54</sup> take the Treasury Benches. The Labour Government which came to power on the 14<sup>th</sup> of July 1984 inherited an overly-protected and highly regulated economy. Roger Douglas,<sup>55</sup> the Minister of Finance began to focus on reform on a de-regulated model developed by Treasury officials. Rogernomics<sup>56</sup> named after him were economic policies that involved the use of competition as a tool of policy,

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<sup>53</sup> P Conway, The New Zealand Experiment 1984-1999. Presentation to the GPN Asia/Pacific Regional Meeting 2-4 September 2002 available at [www.gpn.org](http://www.gpn.org) (as at 15 June 2010).

<sup>54</sup> David Lange was the leader of the Labour Party (1983 – 1989) and Prime Minister of New Zealand (1984 - 1989).

<sup>55</sup> Roger Douglas was the Minister of Finance in the Fourth Labour Government of 1984-1990. He resigned in January 1988 following internal disagreements with David Lange, the Prime Minister on economic policy.

<sup>56</sup> See n 24.

and market-led restructuring of the economy. It was influenced by the monetarist policies of Milton Friedman and the Chicago School.

To Roger Douglas, economic policies should be based on equity and efficiency as opposed to subsidising sectors within the economy. The economic landscape in New Zealand changed continuously Inland Revenue was both an envoy and casualty in this process of transformation. To comprehend this change one needs to discover the extent of these reforms. Roger Douglas used a 'big bang' approach<sup>57</sup> to reform as according to him,<sup>58</sup> "acceptance of these economic policies develops progressively after the decisions are implemented, as long as they deliver satisfactory outcomes to the public."

The economic reforms involved several areas and are discussed in the following sections.

### **2.3 Market Liberalization**

In the financial sector, controls that once existed in respect of prices, wages, credit, dividends, foreign exchange and out-bound overseas investment were lifted during 1984, and as a consequence of the foreign exchange crisis following the snap election in July 1984, the New Zealand dollar was floated early in 1985.

The banking sector was freed from many of the quantitative limits on their lending growth. As an example, the previous requirement for New Zealand banks to hold deposits with the Reserve Bank, or to retain specified investments in government securities, was abolished.

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<sup>57</sup> R Douglas, *Unfinished Business* (Random House Auckland 1993), p 257.

<sup>58</sup> Speech by Roger Douglas given on 28 November 1989 at the Mont Pelèrin Society Christchurch available at [www.rpgerdouglas.org.nz/images/peler1.pdf](http://www.rpgerdouglas.org.nz/images/peler1.pdf) (as at 15 January 2011).

The banking sector, once the preserve of four banks was opened up to full competition.<sup>59</sup> During this time previously state owned banks such as the Rural Bank, Development Finance Corporation, and the growth of merchant banking saw increased competition in all areas of finance.

In respect of import licensing, this was completely phased out by the early nineties. Import tariffs were progressively reduced from 1984.

In agriculture, previous subsidies were abolished at an early stage, while monopolies from domestic air services, long-distance road transport, quantitative licensing of the taxi industry, domestic shipping of the coastal trade, the prohibition on private sector electricity generation, the restriction on courier services (designed to protect the Post Office) and the tight constraint on telecommunications were also abolished.

The labour markets were spared economic reforms under Roger Douglas due to the alliance between the Labour Party and Unions. However, the enactment of the Employment Contracts Act 1991 saw compulsory unionism and the road to deregulation in the labour market begin.

## 2.4 Government Departments

The non-trading elements of New Zealand's public sector were reformed principally by the Public Finance Act 1989. This Act saw the responsibility for the financial operations move from Treasury to Departmental Chief Executives. The change to accrual accounting

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<sup>59</sup> BNZ, Bank of New South Wales, National Bank and the Australian New Zealand Bank.

facilitated a more comprehensive assessment as opposed to cash accounting, of the state sector's true financial position.

## **2.5 Corporatisation and Privatisation**

Prior to Rogernomics,<sup>60</sup> a wide large range of goods and services were provided by state owned organisations. They included the Development Finance Corporation, Rural Bank, Post Office Savings Bank, Shipping Corporation, Post and Telegraph, Air New Zealand, which in many other predominantly market economies are usually provided by the private sector.

Each of the state owned enterprises were extremely inefficient by international standards, and provided poor levels of service. These monopoly positions were also a substantial drain on the public purse. The state coal operations, for example, had, by 1986, made a loss in all of its previous 20 years of operations.

Under the reign of Roger Douglas, these operations were to undergo sweeping changes. Under the State-Owned Enterprises Act 1986, these commercial entities were recreated into State-Owned Enterprises (SOEs) which were required to operate under the same conditions as private sector enterprises, including the need to raise capital on the open market without government guarantee.

Further, New Zealand's ports were also 'corporatised', by the Government from the passing the Port Companies Act 1988. This legislation had the effect of creating corporate entities to operate the ports.

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<sup>60</sup> See n 24.

The Fourth Labour Government also enacted the Reserve Bank of New Zealand Act 1989 which set out the following key principles:

- Monetary policy was not to be used to engineer a sustainably faster rate of economic growth or a sustainably higher level of employment;
- It was for the elected government, not bureaucrats, to define 'stability in the general level of prices', and indeed to override that objective if it so chooses;
- Operating independently, accountability, in the form of a statutory obligation to report to Parliament at least six-monthly, and an ability for the Governor to be dismissed for 'inadequate performance' under the Policy Targets Agreement;
- The key to the Reserve Bank Act was transparency - indeed, chronologically it was the transparency in the Reserve Bank Act which inspired the idea of attempting something similar for fiscal policy.

In Appendix 2,<sup>61</sup> the economic and fiscal reforms are summarised, and it shows the extent of these reforms.

## 2.6 Tax System Reform

The tax system that the Lange Government inherited in 1984 was in a shambolic state of affairs. The Commissioner of Inland Revenue in the Inland Revenue's Annual Report for 1984 stated:<sup>62</sup>

*"the trend in legislation over a long period of years has been towards increased complexity rather than simplification....and the significant real growth in workloads also bears on the ability of the department to administer the tax system in a manner that is seen as fair, effective, and efficient."*

To Roger Douglas, as the Minister of Finance, fundamentally tax was grounded on efficiency or tax neutrality, horizontal equity and certainty and simplification.

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<sup>61</sup> L Evans, A Grimes and B Wilkinson, Economic Reforms in New Zealand 1984-95: The Pursuit of Efficiency: (December 1996), Vol. 34 Issue 4, *Journal of Economic Literature*, 1856, p 1859.

<sup>62</sup> Inland Revenue Department Annual Report 1984, p 3.

Thus the tax reforms initiated by the Government from 1984 were to eliminate tax loopholes and tax concessions, while expanding the tax base. In other words, tax was to be a “true” tax on income and not a signal for taxpayers to use to them to avoid their legal liability to society via unproductive tax driven schemes.

The key to these reforms included:

- Reduction of the top individual marginal rate from 66% (tax year 1984) to 40.50% (tax year 1989);
- Reduction of the tax rate from 48% (tax year 1985) to 28% (tax year 1989) for resident companies;
- Substitution of a single-rated and broadly based value added tax, the Goods and Services Tax (GST), for diverse Wholesale Sales Taxes (the initial GST rate of 10% was increased to 12.5% in 1989);
- Removal of a wide range of business investment incentives, including export incentives and investment allowances and loss limitation rules;
- Introduction of a comprehensive fringe benefit tax payable by employers for in-kind compensation provided to employees;
- Introduction of an imputation scheme for corporate dividends to eliminate the inequitable effect of the double taxation of company income distributed to shareholders;
- Introduction of the accrual regime;
- Removal of tax preferences for income earned and distributed from pension schemes, placing such saving on an equal footing with other forms of saving;
- Introduction of withholding taxes on interest and dividends; and
- Introduction of rules aimed at taxing the foreign-source income of New Zealand residents.

These measures were aimed to secure both horizontal equity and tax neutrality to ensure that investments and the economic direction of the country were not merely tax driven. Efficiency could also be improved by implementing a broad-based, low-rate system and

removing tax preferences. The objectives of the reforms of the tax system were also to spread the responsibilities equitably across the economy in a bid to achieve what the government called a “level playing field.”

Against this backdrop, Inland Revenue confronted three critical issues. It had to first modernise its structure, as its aging computer systems was required to be replaced to successfully operate in a new and challenging environment. Second, Inland Revenue Audit functions and original strategy of command and control had to adapt to understand that the key element to compliance was the term “voluntary”, supplemented by a regime to encourage taxpayers to comply. Taxpayer Audit had to restructure to face a more customer focused environment. Finally, it had to maintain the existing tax system whilst these economic and social changes were taking place.

## **2.7 Inland Revenue Administration.**

### **2.7.1 Background**

Prior to these reforms, the Inland Revenue Department was an artefact of the past. It was only in 1983, that they developed as a consequence of a review by the State Services a corporate plan.<sup>63</sup> Its broad aims were to achieve effective and efficient use of Inland Revenue resources whilst providing a challenging and satisfying work environment.

National Objectives, being specific targets and derived from its corporate plan were set out. As an example, job descriptions for each employee, from the Commissioner to the receptionist at every public counter were developed.<sup>64</sup> As for technology, IR3 taxpayers tax records were transferred to a computer based ledger.<sup>65</sup>

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<sup>63</sup> Inland Revenue Department Annual Report 1983, p 3.

<sup>64</sup> Prior to the corporate plan, job descriptions at the Inland Revenue Department for every employee were not formally set out.

<sup>65</sup> An IR3 taxpayer are those taxpayers who derive self-employed income, interest and dividends and other non PAYE tax income and are required to file a return of income for each tax year.

The Inland Revenue during Rogernomics had the herculean task of drafting, consulting, enacting and enforcing these reforms, whilst at the same time maintaining the integrity of an ever rapidly changing tax environment.

The Commissioner stated:<sup>66</sup>

*“the department did its best to live up to its principles. During the second half of the year major new tax policies were announced by Government, including Fringe Benefit Tax (which came into effect on 1 April 1985) and a Goods and Services Tax (scheduled to start 1 April 1986). High level of staff resources were immediately allocated to working on the new tax policies with, inevitably, increased strain being experienced in the administration the current taxation system.”*

## **2.7.2 Corporate Plan - path to modernisation**

The Inland Revenue corporate plan became a founding document to provide a framework for the total operation of the department by:

- Providing a statement of principles setting out the purpose of the department and its underlying philosophy;
- Identifying strategic goals, being broad areas in which impact is to be made over a period of 3-5 years; and
- Choosing national objectives, being specific targets for achievement derived from the strategic goals and suitable for integrating into annual work plans.

Structurally like Roger Hall’s Glide Time which was the basis for the Television series “Gliding On”<sup>67</sup> and subsequently “Market Forces” the Inland Revenue began a metamorphosis from an ageing bureaucracy to a modern policy driven and focused arm of the state as:

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<sup>66</sup> Inland Revenue Department Annual Report 1985, p 4.

<sup>67</sup> Roger Hall’s publication Glide Time was a satirical view of the New Zealand public service.

- The Inland Revenue's information systems previously out-dated, inflexible, and close to collapse, was primed for modernisation;<sup>68</sup>
- The legislative framework for tax administration based on the thinking and methods used in the 1920s, saw a change as in the shift to self-assessment and the increasing use of technology;
- The structure had to be flexible enough to respond to government tax and social policy changes (for example the addition of Child Support to Inland Revenue's responsibilities);
- The Inland Revenue had to finance technology reforms from increased efficiencies;
- The fiscal risk had to be managed to maintain the flow of revenue to the Government; and
- The need for a focus on customer service was recognised as one key aspect of the 1988-1989 restructuring.

An example of the archaic methods employed by Inland Revenue was the assessment process. Traditionally, an assessment is a conclusion reached after an Inland Revenue officer had checked a taxpayer's liability for a tax period. This was a manual function and particularly labour intensive. In reality there were too many tax returns for manual processing in every case, and it was impractical given the large volume of information an officer would need to check to verify the income details returned by a taxpayer against other information held by Inland Revenue.

The fundamental reason for change was that the tax system prior to the snap election had been eroded of its effectiveness. The reforms from a tax policy prospective made equity decisions a far more decisive rationale while accentuating the consequences of an absence of a sound tax base.

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<sup>68</sup> Inland Revenue Department Annual Report 1988, p 13.

The reforms since 1984 had greatly increased the processing load carried by the Inland Revenue Department, which under the existing computer systems have limited functionality and data capacity. An out-dated and ageing computer system which required expensive maintenance together with a lack of integration between the various revenues of GST, PAYE, and Income Tax saw the system literally, on its last legs.

The environment in which Inland Revenue operated was not only affected by the tax reforms but also by the fundamental Public Sector Reforms in progress.<sup>69</sup> Consequently, the original corporate plan was subject to review, so as to link it more closely to the Government's budgetary process and the reporting requirements of Parliament. Furthermore, a technology plan was developed to assist the department in its electronic data processing functions, and there was a need to improved case selection for investigations.

The reason that the Inland Revenue was in 1984 a relic was that originally tax legislation was focused solely on the collection of revenue. To support this revenue collection the compliance arm, inspectors and auditors' goal were primarily based on the deterrence model.

The Inland Revenue cycle was originally grounded "on a finite 12 month cycle" in a 12 month mentality.<sup>70</sup> It was modernisation that forced Inland Revenue to plan forward as evidenced in its drive to develop modern processing centres, use of computer technology and modern corporate structure.

The economic reforms of Roger Douglas saw the Inland Revenue realize that its goals were not merely as a collector of taxes but also a key agent in the Government's social policy objectives. So the nature of tax administration had to change.

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<sup>69</sup> Inland Revenue Department Annual Report 1988, p 6.

<sup>70</sup> Inland Revenue Department Annual Report 1984, p 3.

David Henry upon his appointment as Commissioner set himself the following key tasks:<sup>71</sup>

- Ensure that the Government's tax reforms are properly implemented;
- Restructure Inland Revenue, to make it more responsive to the needs of taxpayers; to introduce the most modern technology into all aspects of the Department's work; and to improve Inland Revenue's ability to combat non-compliance with the tax laws;
- Keeps the present system going through this period of major change so that the Inland Revenue continues to fund the work of the Government by collecting the revenue; and
- Ensure that the Inland Revenue remains a good employer.

These key tasks were designed to ensure that the management and the administration of the tax system itself complemented the major changes which the government had made in the design of the tax system.

The Commissioner was aware that the management of the tax system was even more resting upon voluntary compliance by taxpayers. It also critical that assistance from and the goodwill of tax practitioners and support from the Government and Parliament in the allocation of resources to the Inland Revenue was maintained.

The Commissioner also realised that the continuation of the Government's taxation policy reform would result in the introduction of a number of major policy initiatives into legislation including major changes to provisional tax, company/shareholder taxation and international tax. The development and implementation of these new policies would have a major impact on their resources across a wide range of Inland Revenue department's activities.

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<sup>71</sup> Inland Revenue Department Annual Report 1989, p 7.

The volume and magnitude of the changes affected the environment in which the Inland Revenue operated particularly in terms of the need to assist taxpayers to voluntarily comply with the laws by making them aware of their obligations.<sup>72</sup>

### **2.7.3 Technology**

In respect of technology, major initiatives were undertaken during this period including:

- The increase in the reliability and processing speed of the current system. Faults in the computer system saw the processing of returns facing major difficulties.
- The development of new computer systems. The Inland Revenue systems were comparatively old and lack flexibility. To meet the needs for the future, the Department began the process of developing a new information system plan.

This plan comprised individual software and hardware projects ranging from the processing of tax returns and payments and the development of 2 to 3 processing centres. Further, these new computer systems would involve a computerised debt collection system and computerised payment processing system.

New technology would see the modernisation of the mechanisation of tax assessments – once done manually by IRD staff to one of the introduction of self-assessment. The modernisation of the Inland Revenue was large and complex, as it had to deal with IRD specific problems. It had to accommodate not just the integration of different taxes and divisions within each segment of Inland Revenue, but also the specific requirements of public sector reforms. It had to be flexible enough to respond to Government tax and social policy changes (for example the addition of Child Support to Inland Revenue's responsibilities) whilst managing to maintain the flow of revenue to the Government.

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<sup>72</sup> Inland Revenue Department Annual Report 1988, p 2.

With the demise of the Fourth Labour Government and the implementation of the “mother of all budgets”<sup>73</sup> under the National Government, the Inland Revenue had to undergo further restructuring.<sup>74</sup> The implementation of FIRST (Future Inland Revenue Systems and Technology) computer system saw some 53 projects involving the integration into a one-fit all computer system for Inland Revenue. For example, there was a need to integrate the computer system operating the GST revenue into the income tax system. Historical notes of taxpayer records, audits and reassessments which were completed separately for GST system originally based on a paper based record system also had to be phased in. In respect of income tax, reassessments were previously completed not by the investigators, but by Taxpayer Services. Now, investigators completed that process. The guiding purpose of the creation of FIRST was to ensure that all revenues systems including audit records, tax payments and assessments, file notes, customer details and correspondence were on one computer software program so that Inland Revenue staff could access data nationwide. The successful implementation of FIRST was fundamental to the continued growth and success of the New Zealand tax system.

In respect of tax policy, the extent of the task faced during this period by the Inland Revenue is well illustrated in the number of Acts drafted, reports prepared and legislative pages drafted as set out in Figures 2.2, 2.3 and 2.4.<sup>75</sup>

As a result, the on-going reforms increased the complexity in the tax system. That is, it increased the burden of cost, in terms of time, money and anxiety, imposed on taxpayers in complying with the new rules.

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<sup>73</sup> “The Mother of all budgets” is the term used to describe Ruth Richardson’s, the Finance Minister in the National Government of 1990-2000 first Budget. She jokingly dubbed her first budget “the mother of all budgets” – which significantly cut state spending in many areas as an attempt to bring the fiscal deficit under control.

<sup>74</sup> Inland Revenue Department Annual Report 1990, p 7.

<sup>75</sup> Inland Revenue Department Annual Report 1993, p 14 and Inland Revenue Department Annual Report 1996, p 16. Although the Inland Revenue Annual Reports from 1987 were based on a July to June fiscal year, Tables 2.2 and 2.3 which were extracted from Inland Revenue reports still detailed a March period. Further, the periods did not align either, hence the non-alignment of periods.

Figure 2.2 Number of Acts drafted from March 1983 - June 1995.

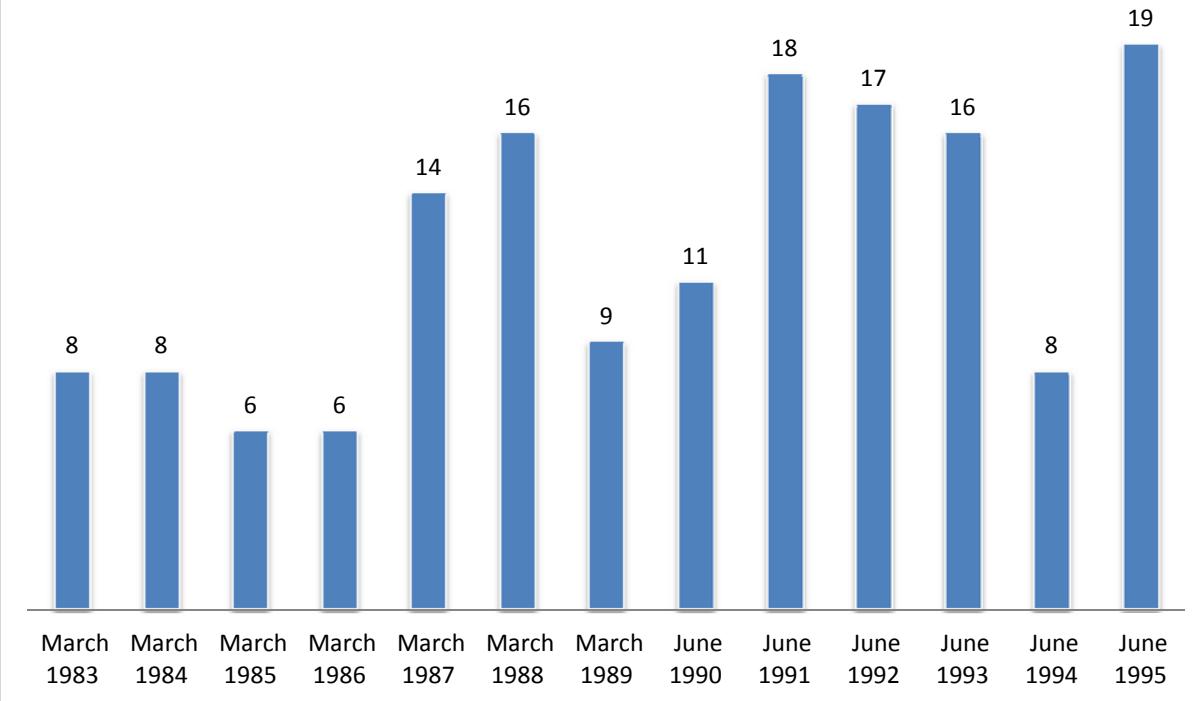


Figure 2.3 Pages of legislation drafted 1986 -1996.

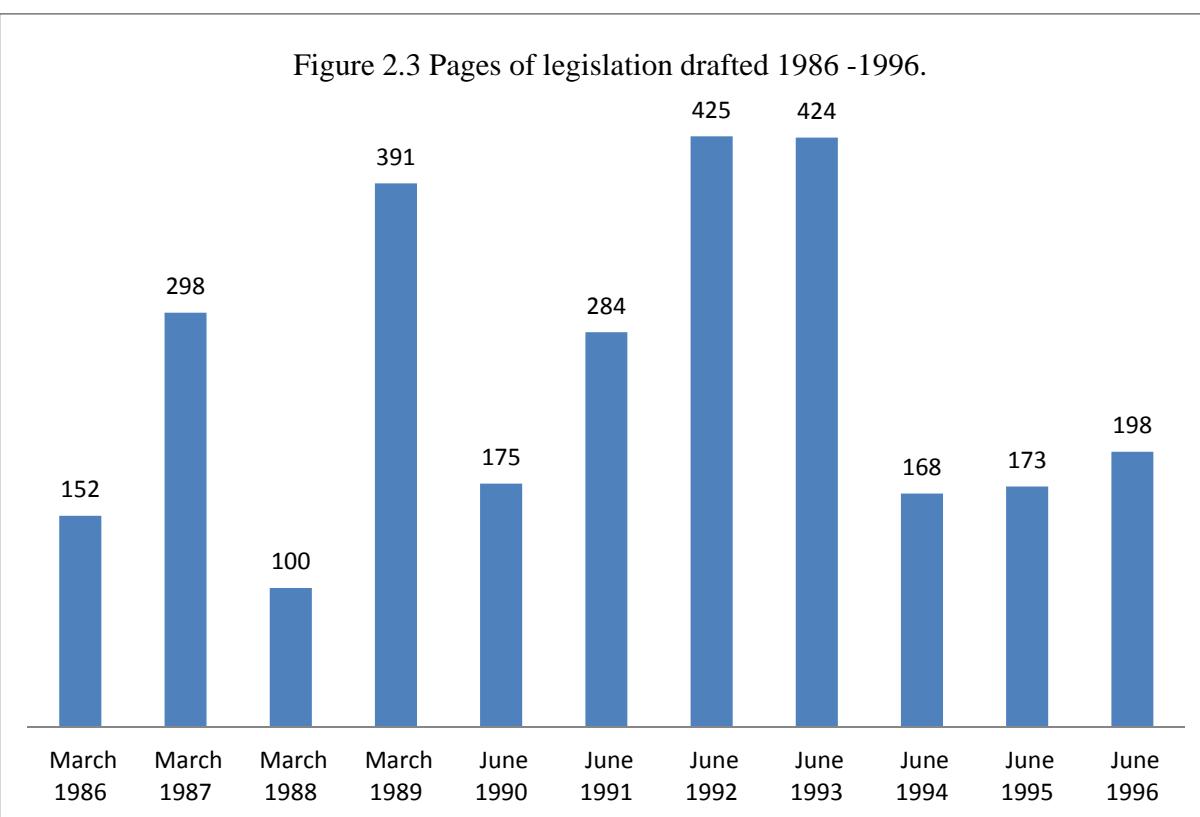
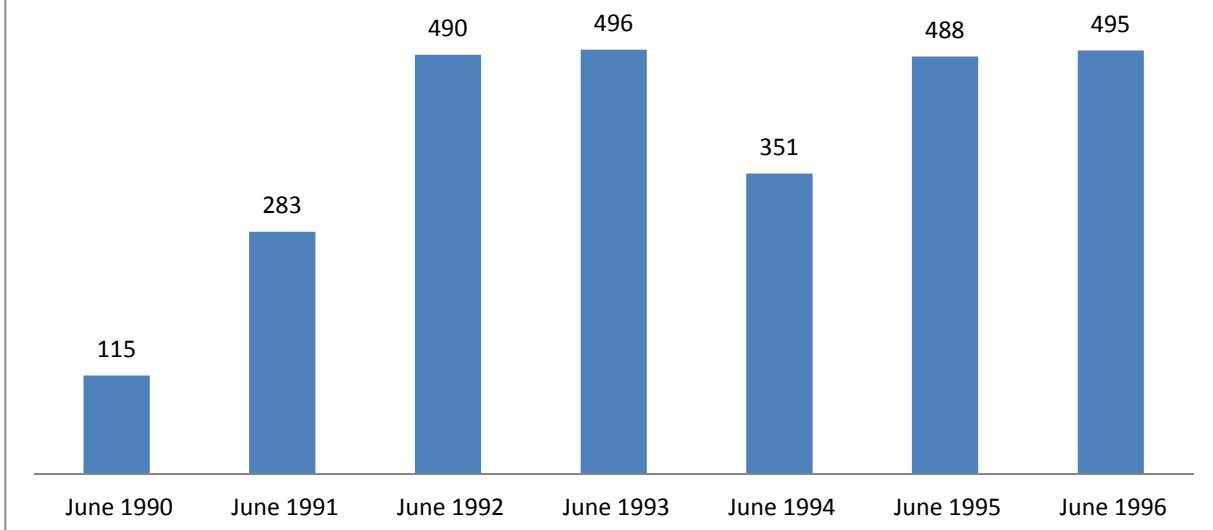


Figure 2.4 Number of reports prepared by Inland Revenue from June 1990 - June 1996.



The Richardson Report<sup>76</sup> and the new Commissioner<sup>77</sup> suggested that the Inland Revenue should be more oriented towards the customer.<sup>78</sup> The stance taken was to:

- Be less bureaucratic, less prescriptive and less hierarchical management style to encourage and reward innovation and initiative;
- Focus more on customer total needs; and
- Simplify the tax systems in order to maximise voluntary compliance and minimise compliance costs to customers.

The next section reviews the changes made to the Inland Revenue operational structure.

<sup>76</sup> Richardson Report refers to the Commission headed by Sir Ivor Richardson [Retired Court of Appeal Judge] into the reorganisation of the Inland Revenue dated April 1994.

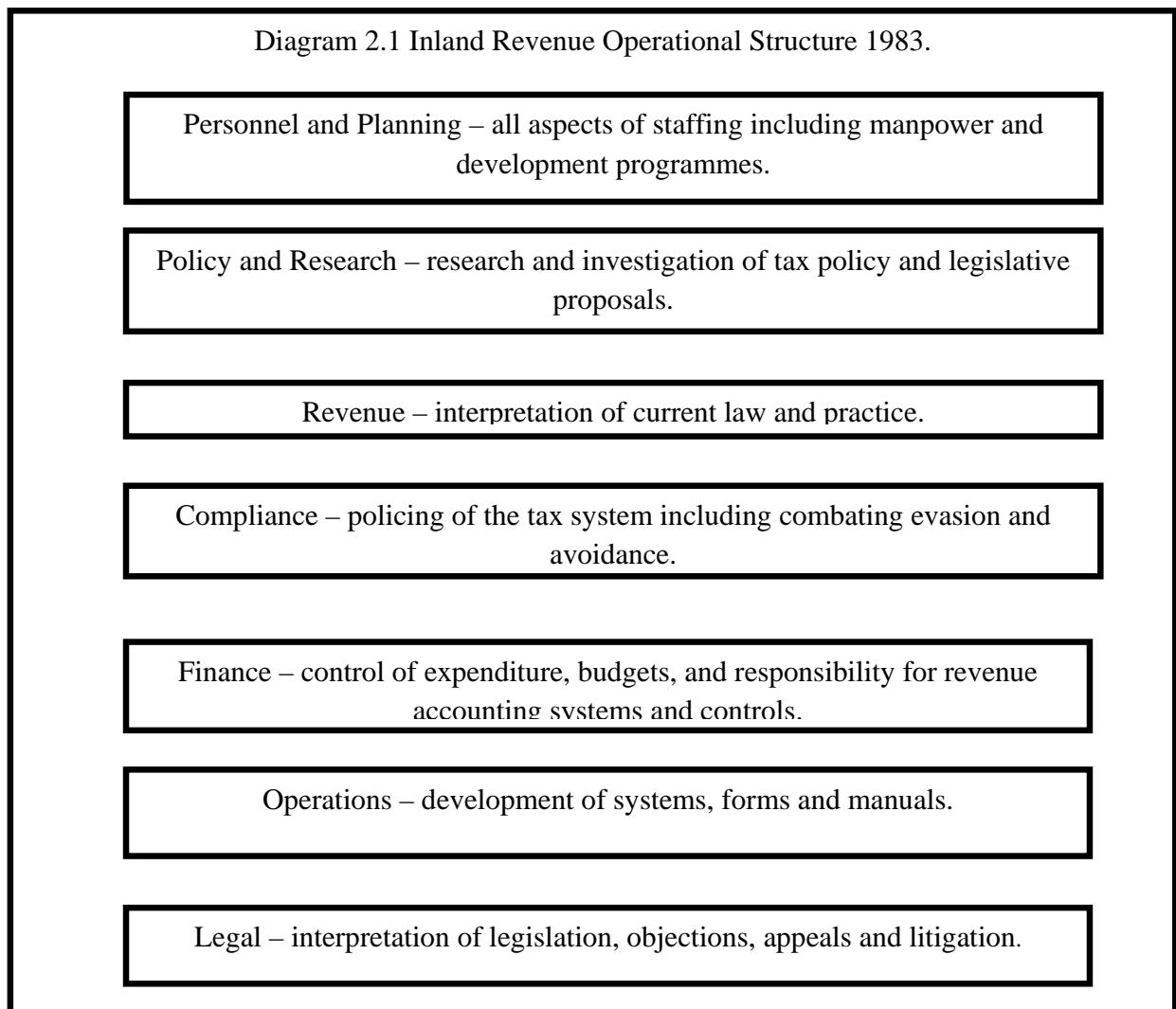
<sup>77</sup> Graham Holland was appointed Commissioner of Inland Revenue in February 1995, following the retirement of David Henry.

<sup>78</sup> Inland Revenue Department Annual Report 1995, p 10.

## 2.7.4 Inland Revenue Structure

To comprehend the changes to Inland Revenue, one must first grasp the structural changes that took place within Inland Revenue. Apart from the tax reforms under the Fourth Labour Government, the Inland Revenue underwent during the period March 1983 to June 1989 two internal structural changes.

Originally, as shown in Diagram 2.1 in March 1983 the Department operated under a 7 programme structure.<sup>79</sup>



<sup>79</sup> Inland Revenue Department Annual Report 1983, p 3.

In 1989 as a consequence of extensive internal and external reviews, the Inland Revenue was restructured into 5 programmes.<sup>80</sup> (See Diagram 2.2).

Diagram 2.2 Inland Revenue Operational Structure 1988.

Legislation – advice on tax laws design and drafting of legislation.

Taxpayer Services – advise to taxpayers on new and existing tax laws and dealing with queries on the tax system.

Revenue Assessment and Collection – the assessment and collection of tax.

Income Maintenance – administration of family support.

Taxpayer Audit – the audit of taxpayers with emphasis on high risk non-compliers.

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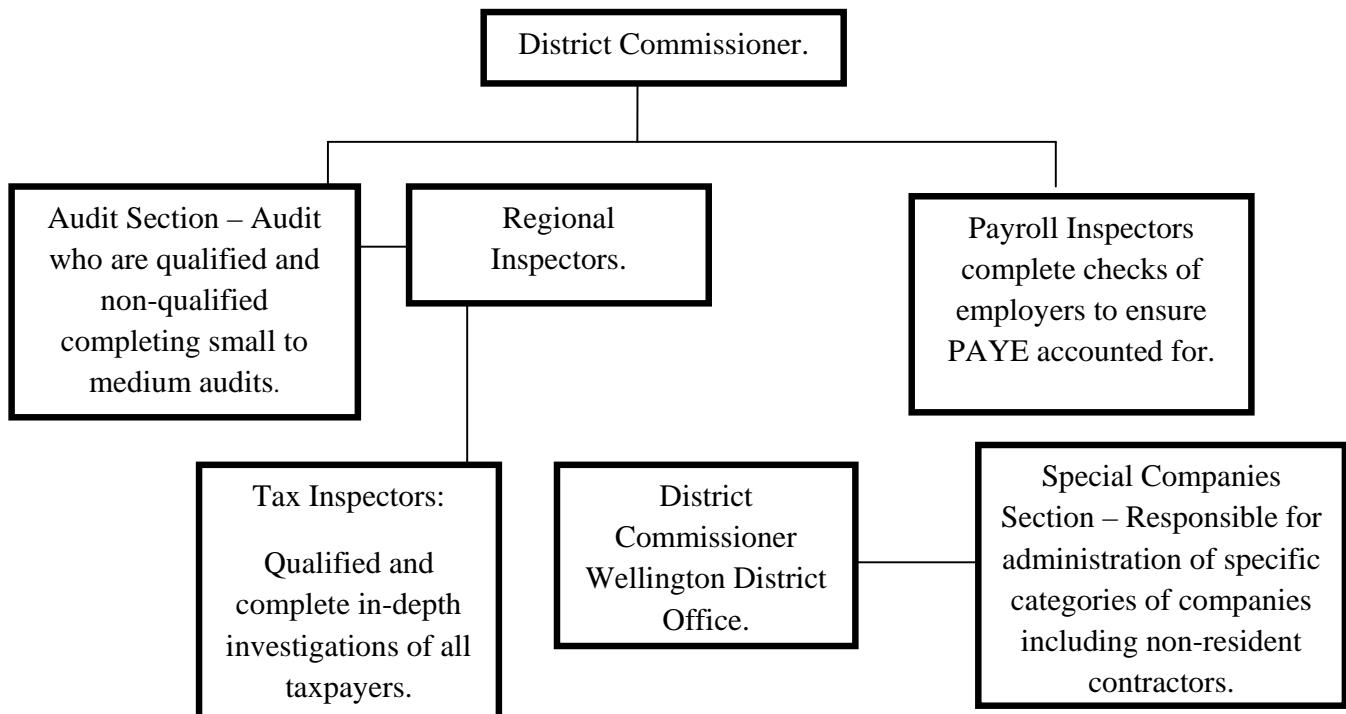
<sup>80</sup> Inland Revenue Department Annual Report 1989, p 11.

Each of these structural changes required amongst other matters, the resizing of staff in each programme, creation of new lines of authority and/or delegations, the redesign and/or development of new Departmental manuals, the advertising and appointment of staff, all of which required staff time and commitment whilst Inland Revenue still maintained the current tax system. In addition to structurally changing the Inland Revenue, Inland Revenue's audit function also underwent structural changes.

## 2.7.5 Compliance Structure

The restructuring of the Inland Revenue was not limited to its corporate structure; its compliance arm was also restructured during this period. Originally, the structure of compliance and its audit staff pre-1984 economic reforms was as per Diagram 2.3:<sup>81</sup>

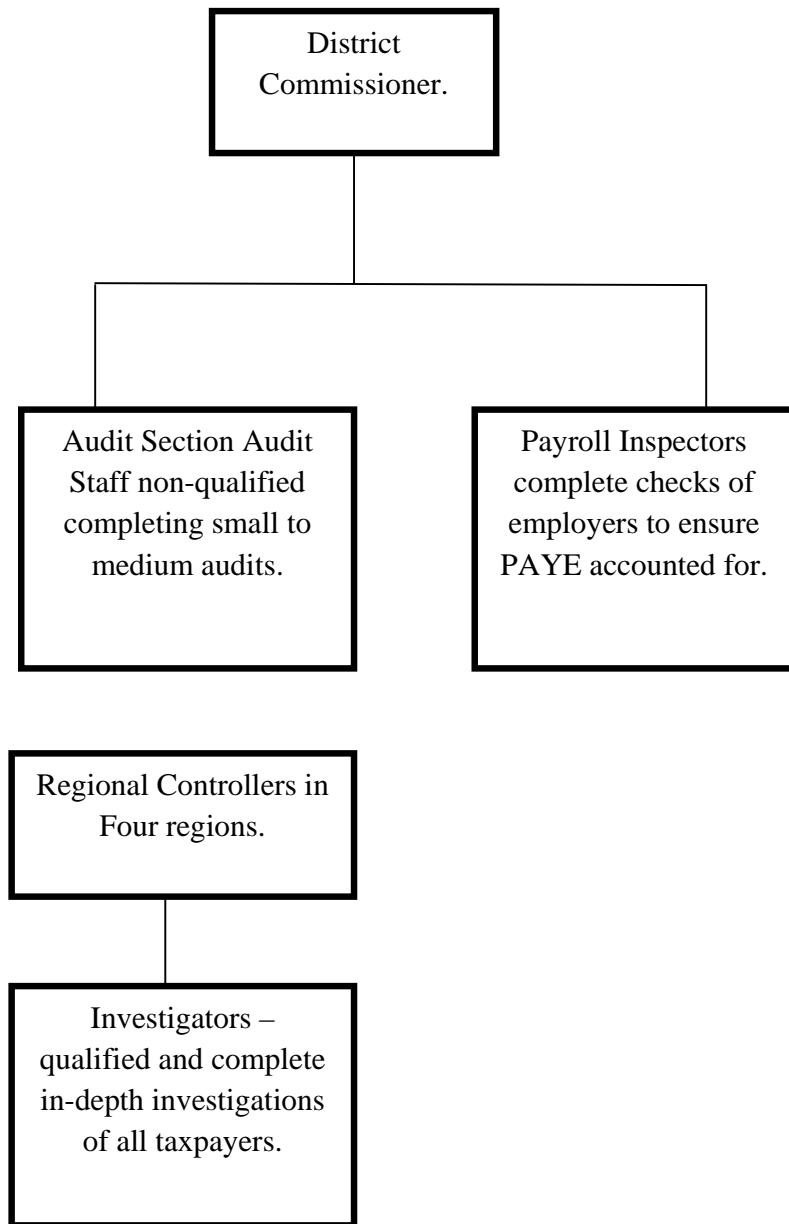
Diagram 2.3 – Structure and lines of Reporting Auditors and Inspectors: Inland Revenue Pre-1984.



<sup>81</sup> Inland Revenue Department Annual Report 1987, pp 17-20. Note, that the Regional Inspector line of reporting was direct to Inland Revenue Head Office and to a Deputy Commissioner (Revenue).

The above Compliance arm of the Inland Revenue was restructured again in October 1987, as shown in Diagram 2.4:<sup>82</sup>

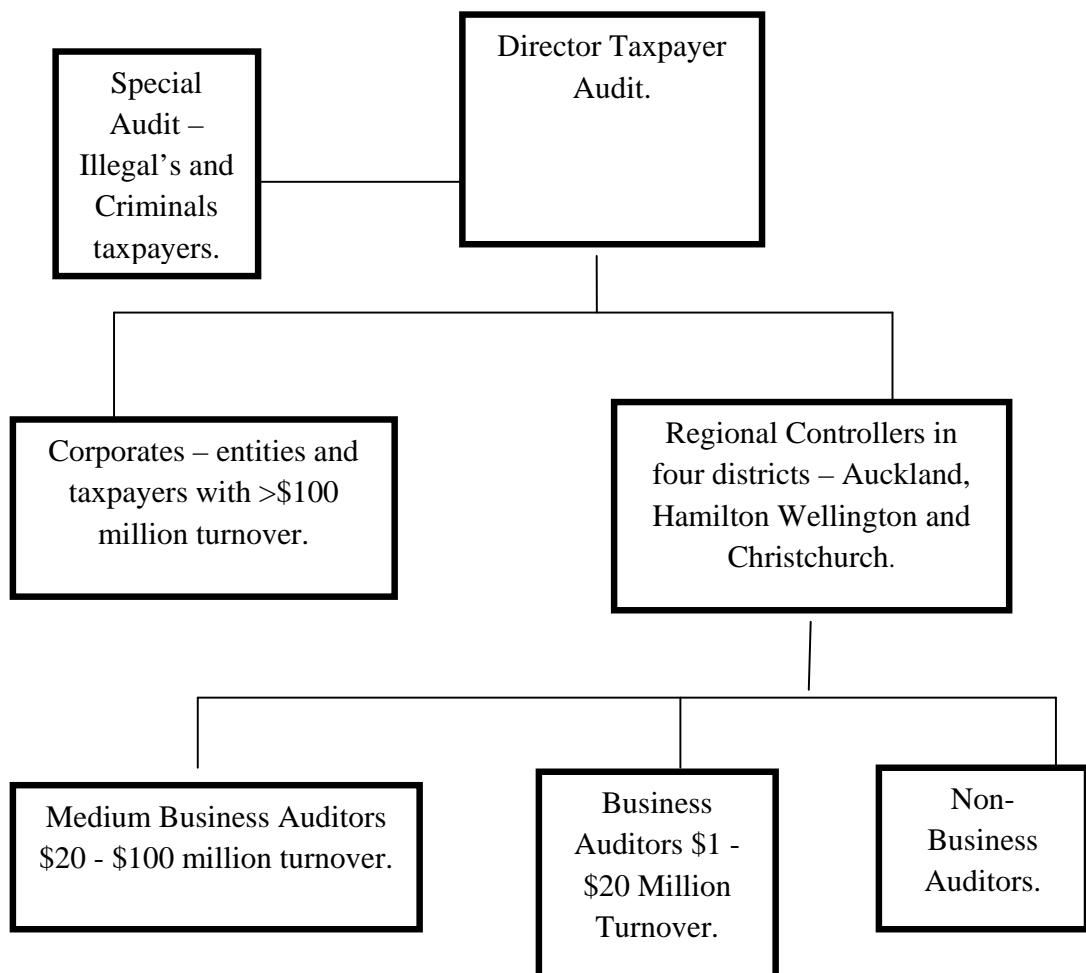
Diagram 2.4 Structure and lines of Reporting Auditors and Inspectors: Inland Revenue October 1987.



<sup>82</sup>Inland Revenue Department Annual Report 1989, pp 40 – 50. Note, Regional Controllers reported direct to Inland Revenue Head Office, Deputy Commissioner (Revenue). See Inland Revenue Department Report 1989, p 18.

Commencing in 1992, a lengthy and thorough evaluation of Taxpayer Audit programme was carried out which significantly changed the shape of the compliance arm of the Inland Revenue. The new structure created audit segments based on business size and the creation of Special Audit directly responsible to the Director, Taxpayer Audit (see Diagram 2.5<sup>83</sup>).

Diagram 2.5 Structure and lines of Reporting Auditors and Inspectors: Inland Revenue October 1992.



<sup>83</sup> Inland Revenue Department Annual Report 1995, pp 49- 52.

During this period, the growth in computer technology and software development was applied to the compliance arm of the Inland Revenue. Original investigation and inspector's manuals containing job descriptions, industry descriptions and risks, case law and the methodology of an investigation had to be updated to be relevant to a modern tax authority. Computer software was created to mine Inland Revenue's database to target taxpayers based on risk assessment.

The change in focus recognises that to actively encourage compliance with the tax laws a wider range of audit methods and tools were required. Providing post-audit education, industry seminar, case selection and research into taxpayer behaviour were examples of these new tools.<sup>84</sup>

Special Audit was set up to specialise in the investigation into the taxation affairs of taxpayers involved in the illegal sector. In addition, a National Research Unit was established in January 1994.<sup>85</sup> This Unit was to be responsible for empirical research in respect of taxpayer compliance where its findings could be used in developing the Inland Revenue's annual enforcement strategy and audit plan.

Inland Revenue outwardly had structurally undergone fundamental changes in this period, and had also to administer an ever changing tax environment. Against this background was the realisation that Inland Revenue was entering a critical stage in its compliance history. The incumbent Commissioner and his predecessor realised that the deterrent effect of the current compliance enforcement was weak.<sup>86</sup> Further, the concept of self-assessment flowing from the modernisation of the tax system and the new focus on voluntary compliance would require precise laws enacting a penalty regime that was simple, efficient and easy to administer.

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<sup>84</sup> Inland Revenue Department Annual Report 1994, p 40.

<sup>85</sup> See n 84.

<sup>86</sup> See n 77.

It was against these structural changes and the launch of the Inland Revenue Customer Charter which indicated the beginning of its customer focus approach to tax compliance. However, underneath these structural changes and the Customer Charter were also signals that limitations existed within Taxpayer Audit.

### **2.7.6 Inland Revenue Customer Charter**

Aligning the future of taxpayer voluntary compliance was the Customer Charter which had its origin in November 1992.<sup>87</sup> This charter sets out taxpayer's fundamental rights and it remains today a high profile philosophy within Inland Revenue. Its eight fundamental rights and obligations as shown in Diagram 2.6 is an important backdrop to Inland Revenue Compliance strategy. A taxpayer has certain right and obligations, which although not a statutory enactment as such, it sets out the ideology behind the compliance and penalty regime.

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<sup>87</sup> Inland Revenue Department Annual Report 1993, p 7. The Customer charter was subsequently revised in 2001 to become simply the Charter. In July 2008, the charter was again revised to become known as "Taxpayer Charter".

## Diagram 2.6 Inland Revenue Customer Charter

### Your Rights and Obligations.

#### **1 Your Right to Good Service**

You are entitled to prompt, courteous and efficient service from Inland Revenue.

#### **2 Your Right to Help**

We will give you the information you need to understand your rights, and to meet your obligations.

#### **3 Your Right to Confidentiality.**

We will respect the information you give us, and use it for lawful purposes only.

#### **4 Your Right to Question our Decisions.**

If you ask, we will explain how to object to any assessment or decision we make.

#### **5 Your Right to be Believed**

We will assume that you are honest in your dealing with us unless we have good reason to believe otherwise. However, sometimes we are required to check information you give us.

#### **6 Your Rights if you are Audited**

If you are selected for a tax audit, then we explain your rights and obligations to you.

#### **7 Your Right to Individual Attention.**

You are entitled to know the name of the staff member you are dealing with.

#### **8 Your Obligation to Act Honestly.**

You are obliged to act honestly in dealing with Inland Revenue for example, by disclosing all your income in your tax return.

## **2.8 Tax Non-Compliance – Pre Compliance and Penalty Regime**

### **2.8.1 Background**

It was against these dynamic structural changes to the Inland Revenue, within Taxpayer Audit and the introduction of a Customer Charter that limitations existing within Taxpayer Audit contributed to the introduction of the Compliance and Penalty Regime. A review by the International Monetary Fund of the Inland Revenue concluded, “that taxpayers lacked incentives to comply with the Revenue Acts.”<sup>88</sup> Modern tax compliance dwells upon two principles, firstly voluntary compliance and secondly, a sound tax enforcement strategy supported by a qualified and diligent audit section.

The New Zealand Inland Revenue had as its founding principles to “*administer the Inland Revenue Act.*”<sup>89</sup>

Its mission in applying those laws was to ensure that each taxpayer pays their correct amount of tax – no more and no less.<sup>90</sup> This underlying philosophy of modern voluntary compliance appears to be in tandem with this mission and Customer Charter.

### **2.8.2 Combating non-compliance**

The most effective way of enhancing voluntary compliance by Inland Revenue was expressed by way of tax audits. The functions of the Inland Revenue audits were to ensure that taxpayers pay their correct tax liability.<sup>91</sup> The Department’s original deterrent method was by:

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<sup>88</sup> See n 35 and also Inland Revenue Department Briefing Paper 2 Terms of Reference Inland Revenue Overview April 26 1999, Para 145.

<sup>89</sup> Inland Revenue Department Annual Report 30 June 1987, p 4.

<sup>90</sup> See n 66.

<sup>91</sup> Inland Revenue Department Annual 31 March 1985, p 15.

1. Checking returns to ensure that the income and deductions had been correctly reported prior to assessment; and
2. Conducting audits and investigations of both taxpayers' and employers' records to establish their correct tax liability.

In respect of tax compliance, for the first time the word voluntary compliance appeared to dominate its tax policy. However, the Commissioners began to realize that to achieve voluntary compliance by taxpayers, tax audits was not the most effective way of ensuring compliance.<sup>92</sup> To encourage voluntary compliance, the Inland Revenue began to comprehend that taxpayers had to know both their rights and their obligations. This obligation and knowledge is linked to the Customer Charter obligations number 8, i.e. to "act honestly in dealing with the Inland Revenue."

Voluntary compliance meant that taxpayers meet all their taxation obligations of their own volition. However Inland Revenue also had:

- To make as easy as possible for taxpayers to comply with the tax laws, by letting them know their rights and obligations;
- To administer the law in a consistent, courteous and prompt manner, so that all people know they are treated fairly; and
- To detect those people who do not comply and, where appropriate, take action against them.

The administration of the tax system was a massive and challenging task to the Inland Revenue.<sup>93</sup> The trend in tax reform legislation which closed loopholes and the broadened tax base increased the complexity of the tax system. This trend was a reflection of the increased commercial sophistication in financial matters, together with the long-established use of the tax system for economic and social purposes.

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<sup>92</sup> Inland Revenue Department Annual Report 1987, p 4 and Inland Revenue Department Annual Report June 1994, p 40.

<sup>93</sup> Inland Revenue Department Annual Report 1984, p 3.

It was against this backdrop that the growth in non-compliance continued to rise.<sup>94</sup> Firstly, unlike the modernisation process, the penalties that a taxpayer faced when they failed in their tax obligations lagged behind. In 1988 the Commissioner recognised that in any compliance system based on voluntary compliance, there must exist incentives and/or deterrents for the system to work effectively.<sup>95</sup> Failure on the part of taxpayers to make adequate disclosure of material information left the Department at a substantial disadvantage, while quite modest levels of penalties are inadequate as a deterrent to serious mischief. The inadequacies of the existing penalties were the seeds to the modern compliance regime which was enacted on the 1<sup>st</sup> of April 1997.

Secondly, one of the more vexing problems for policy makers within the Inland Revenue was in developing and executing tax laws to enhance tax compliance. Designing effective policies for reducing tax avoidance and tax evasion was in theory simply enough, but the difficulty lies in understanding the behavioural aspects of taxpayers who intentionally do not comply. The Inland Revenue realised that individual attitudes toward compliance were to be part of its focus to change the social and cultural norms which would complement its usual enforcement options.<sup>96</sup> In changing these norms, Inland Revenue had to identify and close loopholes which offered opportunities for tax avoidance and tax evasion and to maintain vigorous enforcement.

As the Australian Task Force of the Cash Economy put it more succinctly:<sup>97</sup>

*“none of these factors stand alone as the sole reason for a taxpayer’s behaviour, and equally, it is not possible to identify which factors in combination may influence the behaviour of any one particular person. However, it is possible to identify a combination of factors that is more likely to influence behaviour for certain categories of taxpayers.”*

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<sup>94</sup> Special partnerships, non-recourse loans, income splitting and use of tax shelters were forms of tax avoidance highlighted by report of the Audit Office into the Inland Revenue Income Tax Compliance dated 13 November 1987, pp 10-12.

<sup>95</sup> Inland Revenue Department Annual Report 1988, p 14.

<sup>96</sup> See n 84.

<sup>97</sup> Cash Economy Task Force, *Improving Tax Compliance in the Cash Economy* (1998), p 20. Australian Taxation Office, Canberra.

Hence, a new role for Taxpayer Audits was to influence groups of taxpayers with similar non-compliant behaviour patterns to comply with the requirements of the Inland Revenue Acts through a combination of audit activities, education and opportunities to correct their taxation affairs voluntarily.<sup>98</sup>

The underlying reason for this change in focus was that the tax system was becoming increasingly difficult to maintain and the Inland Revenue set out the following tasks:

- Make it (Inland Revenue) more responsive to the needs of taxpayers, Government and Parliament;
- Introduce the most modern technology into all aspects of the Department's work; and
- Improve Inland Revenue's ability to combat non-compliance with the tax laws.

The first significant review of the Inland Revenue's Compliance Strategy was published in the Audit Office report of November 1987.<sup>99</sup> The review indicated that the decline in compliance was due to:

- Increased complexity of tax law administration;
- The Audit section which used to be staffed by experienced officers – was no longer the case;
- A conscious decision to lend staff to other sections [GST and FBT] had a cost in lost tax; and
- Many of these audit staff were subsequently permanently transferred to GST Section.

Further compounding the issue of voluntary compliance was that there was no comprehensive programme to identify taxpayers who were not recorded in the tax system.

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<sup>98</sup> See n 84.

<sup>99</sup> See n 39.

In other words, no comprehensive analysis of the extent of the underground economy in New Zealand was undertaken and the extent of the loss of tax revenue was unknown.<sup>100</sup>

Although tax evasion might have been higher if no reforms of the 1980's which broadened the tax base were made, it was acknowledged that Inland Revenue had:<sup>101</sup>

*"insufficient resources to tackle residual areas of tax evasion, particularly where the essential problem is non-declaration of income."*

In its report on the Inland Revenue's Tax Compliance Control the Audit Office also ascertained that a vital part of the Department's corporate plan was to prosecute those taxpayers who committed offences against the Revenue Acts.<sup>102</sup> The statistical data from Inland Revenue Annual Reports indicate that between 1983 – 1997, a total of 24,730 taxpayers were prosecuted for offences under these Acts.<sup>103</sup>

Out of this total, 22,395 or 91.35%, relate to the prosecution for failure to furnish either an income tax or GST return (this area is discussed further in later chapters). This meant that only a very small percentage of taxpayers were prosecuted for fraudulent tax offences.

To maintain the confidence in the law, abiding taxpayers need to know that those taxpayers who do not comply, particularly those who committed tax fraud are prosecuted. The Inland

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<sup>100</sup> See n 39, p 15.

<sup>101</sup> *Tax Compliance*, (Wellington, December 1998), Para 7.32.

<sup>102</sup> See n 39, p 31.

<sup>103</sup> The Inland Revenue Acts are set out in Schedule to the Tax Administration Act 1994 to include Estate and Gift Duty Act 1968, Estate and Gift Duties Act 1968. Stamp and Cheque Duties Act 1971. Gaming Duties Act 1971. Goods and Services Tax Act 1985. Land Tax Abolition Act 1990. Child Support Act 1991. Student Loan Scheme Act 1992, Estate Duty Abolition Act 1993. Income Tax Act 1994, Tax Administration Act 1994. Taxation Review Authorities Act 1994, [Stamp Duty Abolition Act 1999.] [Estate Duty Repeal Act 1999.], Income Tax Act 2004, Kiwisaver Act 2006 and Income Tax Act 2007.

Revenue was also not imposing penal tax<sup>104</sup> due to staff limitations, and or cost considerations.<sup>105</sup>

These signals of lower prosecutions and an increasing percentage of audit discrepancies as a percentage of tax revenue suggests that Inland Revenue was neither vigilant in reducing the level of tax evasion and or tax avoidance during this period.<sup>106</sup> In fact, the Audit Office Report of November 1987 concluded that the “low prosecution levels and imposition of penal tax on relatively few taxpayers have eroded the deterrent effect of these measures”.<sup>107</sup>

The decline in the audit rate, prosecution and increase in revenue discrepancies as a percentage of tax revenue could be associated with the gradual increase in the size of the New Zealand hidden economy as estimated in proportion to GDP over the period 1969 to 1993 (see Figure 2.5<sup>108</sup>).

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<sup>104</sup> Penal tax is when the Inland Revenue imposes up to 300% of the deficient tax on taxpayers who have either been prosecuted for tax evasion or have committed an offence under the Revenue Acts, which warrants the imposition of such a penalty.

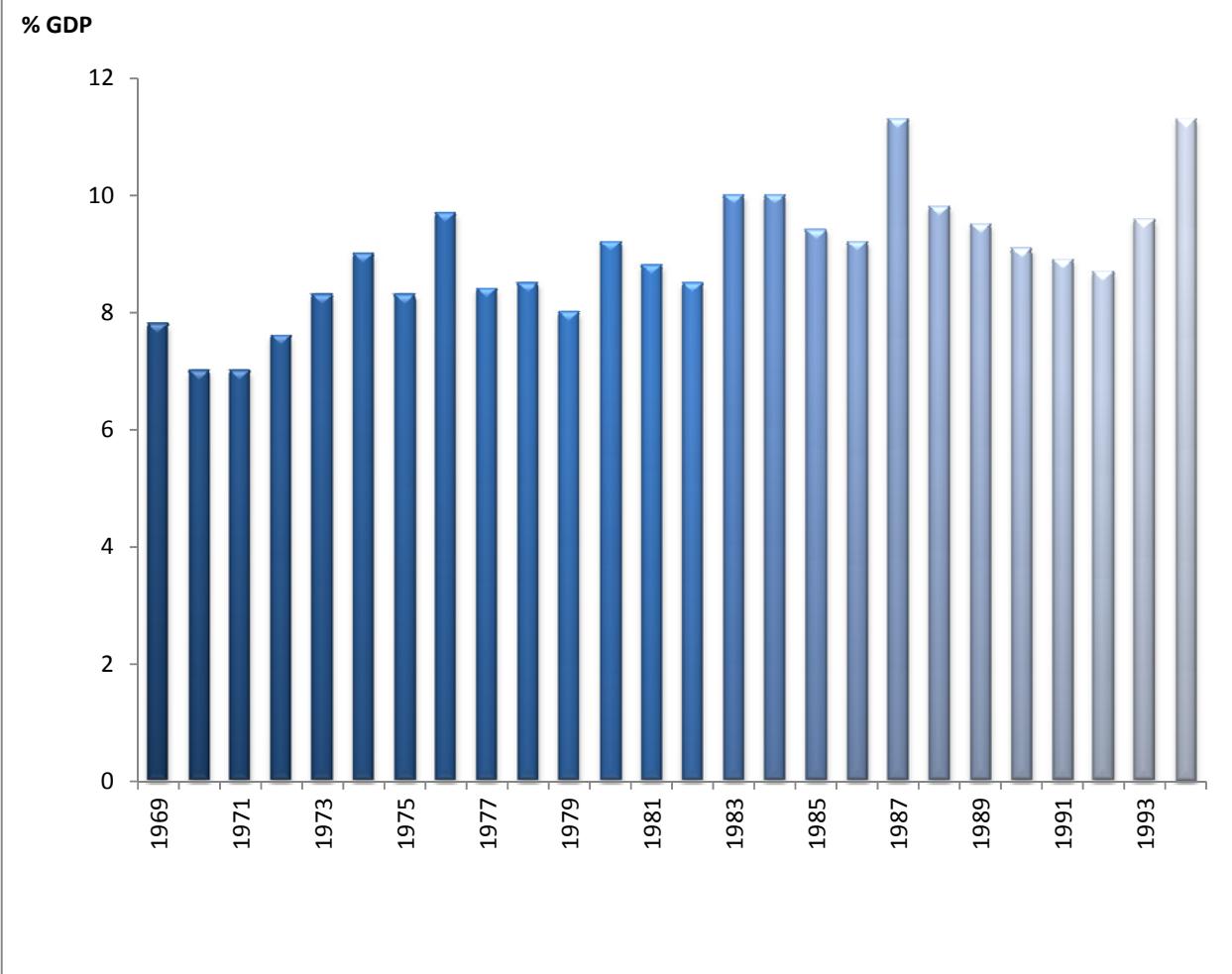
<sup>105</sup> See n 39, p 32. The Audit Office report did not define the term cost consideration. However on page 32 of their report they indicated that cost equated to the time and effort required to establish the standard of proof necessary make it un worthwhile to pursue many individual cases.

<sup>106</sup> This matter is further discussed in later chapters.

<sup>107</sup> See n 39, p 33.

<sup>108</sup> Supplementary Briefing Volume 2 Report on Research Commissioned by Inland Revenue November 1999 page 38. Note this Figure was extracted from this report and the graph was unable to be altered by way of inserting axis definitions.

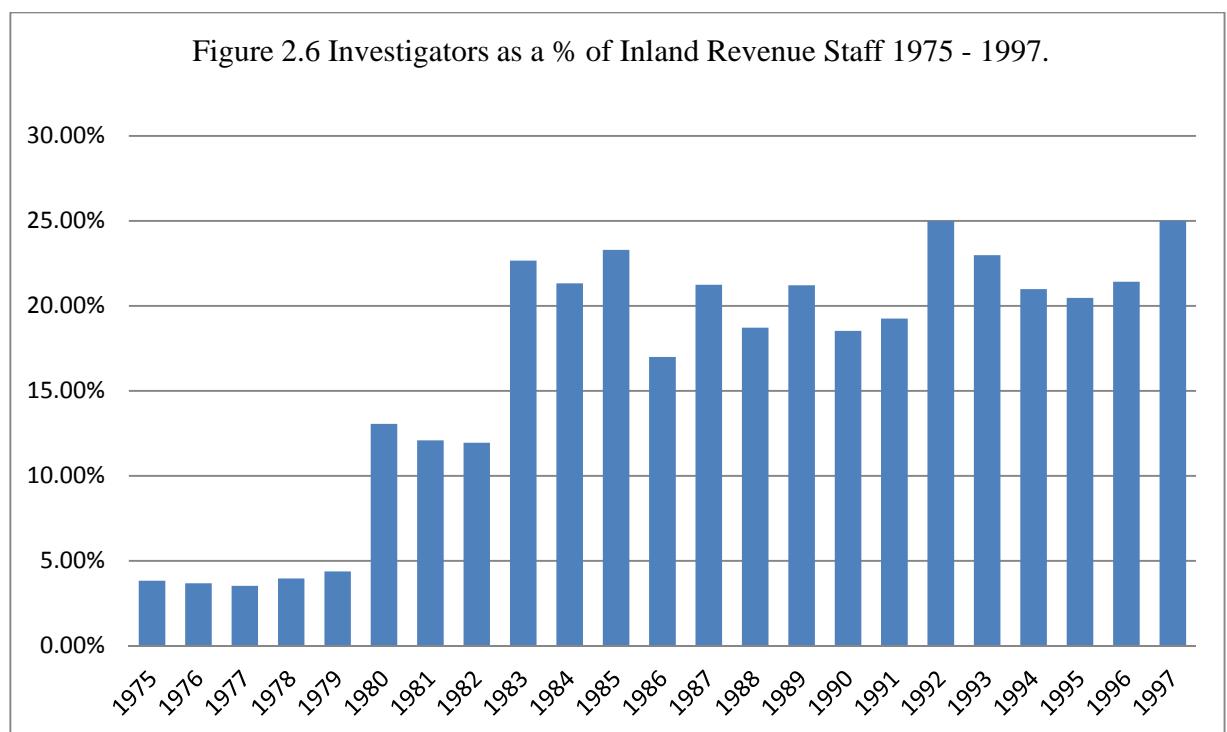
Figure 2.5 Hidden Economy as % GDP 1969-1993



Would the decline in number of prosecutions indicate to society that the tax authorities were not serious in their attempt to prohibit tax evasion and or tax fraud? Were unpunished tax evaders not considered a direct threat to the Inland Revenue and the law?

A more alarming problem within this period, for Inland Revenue was one of staff retention primarily in the area of compliance. The Audit Office Report set out that in the 1984 financial year, 26 inspectors with a total of 251 years of tax experience resigned. In the

previous fiscal year, 20 had resigned.<sup>109</sup> Consequently, the training of new inspectors would require experienced inspectors to become mentors. But this would reduce the hours those experienced inspectors had available to complete their own investigations. As a result, it was anticipated that the effectiveness of the compliance arm of the Department would be compromised. Figure 2.6 shows the number of investigators as a percentage of total Inland Revenue Staff.<sup>110</sup>



The two Commissioners during the period July 1984 - 1993 found to their dismay that despite increasing the level of staff in audit, the loss during this same period of experienced staff was a problem for an organisation funded by the public purse as compared to the private sector flush with funds.<sup>111</sup>

<sup>109</sup> See n 39, p 25.

<sup>110</sup> Inland Revenue Department Annual Reports 1975 – 1997.

<sup>111</sup> John Simcock 1982 -1988 and David Henry 1988 – 1995.

The Audit Office commented that:<sup>112</sup>

*“the gap between public and private sector pay has widened to such an extent that the loyalty and commitment of inspectorate staff to remain with the Department can no longer be reasonably be counted on”.*

Was this a clear and sterner message to the Commissioner and Government that unless this staffing issue was addressed, auditing as a compliance method of deterrence was facing a critical stage?

To remedy the decline in audit staff numbers, the restructuring of the Inland Revenue saw the creation of a centralized Taxpayer Audit Program which brought the different strands of Investigations, Business Audit, and Specialist Investigations. Its purpose was to:<sup>113</sup>

*“detect non-compliance and deter future non-compliance thus contributing to the correct assessment and collection of tax.”*

In addition, a comprehensive review of remuneration and subsequent lifting of salaries for the investigation staff saw a growth in and retention of experienced staff.

However, the area of investigation by the Inland Revenue of criminal activities was sadly lacking during then 1980's and early 1990's. It was only in 1992 that the Revenue set up an investigation unit which focused on this area. However, apart from the results published in the 1998 Compliance report,<sup>114</sup> no further details have been published of the audit discrepancies ascertained by special audit. One must therefore question how successful this audit area has been given the lack of statistical data of its results?

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<sup>112</sup> See n 39, p 26.

<sup>113</sup> Inland Revenue Department Annual Report 1993, p 40.

<sup>114</sup> See n 101.

## 2.9 Summary

Inland Revenue was an aging and bureaucratic Department of Government prior to the snap election of 14 July 1984. The election of the Fourth Labour Government with Roger Douglas at the helm of economic and tax reform saw the beginnings of the birth of a modern tax administration. However, it faced teething problems in terms of how to continue to manage the existing tax structures, whilst bedding down new tax laws and policies. The Inland Revenue's compliance policy initially lacked any coherent methodology and or real vision of how to ensure voluntary compliance. The research findings concerning deterrence and behaviourists approaches to compliance were also not originally on the Inland Revenue's radar. The Inland Revenue Tax Audit and Compliance Strategies had limitations and faced resourcing issues, both in staffing numbers to combat the rise in tax evasion and tax avoidance schemes.

Unlike the modernisation process, tax penalties on the other hand lagged behind. One could suggest that Inland Revenue and its advisors either put this issue in the too hard basket given the speed and complexities that they faced during the 1980's reforms or were awaiting the legislation of self-assessment which required a comprehensive penalty regime.

Failure on the part of taxpayers to make adequate disclosure of material information left the Department at a substantial disadvantage, while quite modest levels of penalties were an inadequate deterrent to serious mischief. The adequacy of these penalties would require further consideration.<sup>115</sup>

Under the direction of the Commissioner of Inland Revenue, the Compliance Strategy was not only to target audit, but to also influence groups of taxpayers whose patterns of non-compliant behavioural may be mirrored by others.<sup>116</sup> If one could change those patterns of non-compliance to one of compliance through a combination of audit activities, education

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<sup>115</sup> Inland Revenue. Taxpayer Compliance, Standards and Penalties: A Discussion Document, (Wellington, August 1994).

<sup>116</sup> See n 84.

and opportunities to correct their taxation affairs voluntarily, the deterrent approach of auditing would no longer dominate the Compliance Strategy of the Inland Revenue.

The Inland Revenue had indeed undergone dramatic changes in its structure and key obligations to the Government since July 1984. What had not been the subject to major change was the law as regards the imposition of penalties for those taxpayers who choose deliberately to confront and intentionally disobey their legal tax obligations.

The Inland Revenue in conjunction with outside experts had in 1994 began the process of seeking submissions in respect of the penalty provisions of the Inland Revenue Acts.<sup>117</sup> This process had as its beginning, the growth in tax avoidance and tax evasion of the 1980's, the structural changes to Inland Revenue and the findings of Audit Report of November 1989 into the operations of Taxpayer Audit.

The modernization of the New Zealand tax system involved a jigsaw combination of various legislated and administration reforms as shown in the Diagram 2.7.

The sequence of these reforms as set out in Diagram 2.7 had to be enacted in a coordinated approach. As an example, if the concept and legislation of self-assessment was not coordinated into each of the component parts the following consequences may follow:<sup>118</sup>

- Government revenue would reduce, imposing an additional burden on compliant taxpayers;
- The equity objectives of the tax system would be jeopardized; and

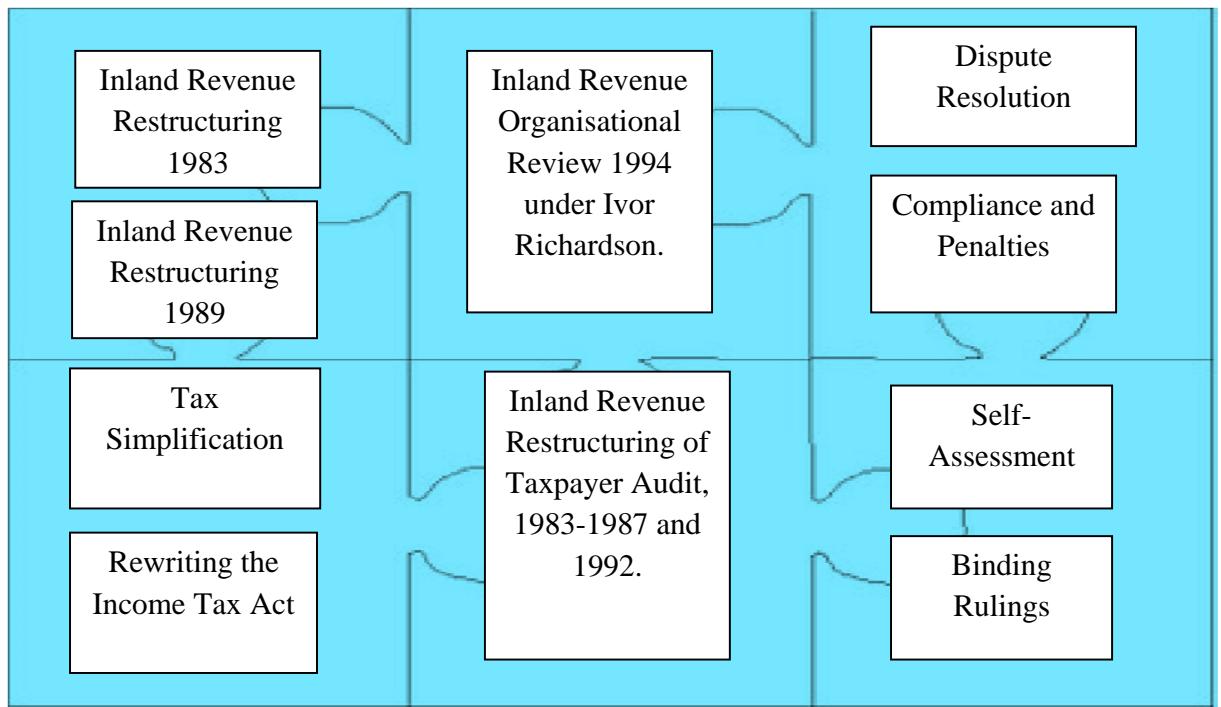
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<sup>117</sup> Inland Revenue, Organisational Review of the Inland Revenue Department (April 1994). Membership included Sir Ivor Richardson, David Edwards Deloitte Touche Australia, Dr Murray Horn Secretary for Treasury, David Henry CIR, Paul Carpinter Department of the Prime Minister and Cabinet, Chris Pinfield Treasury], Ross Tanner State Services Commission], Maria McKinley IRD, Graham Holland IRD, Rob McLeod New Zealand Society of Accountants, Geoff Harley New Zealand Law Society, and Mary Ann Macpherson IRD.

<sup>118</sup> Inland Revenue: Legislating for Self-Assessment of tax liability: A Government Discussion Document (Wellington, August 1998).

- Administrative and compliance costs would increase.

Diagram 2.7 Modernisation of the New Zealand Tax System.



A future New Zealand tax system based on self-assessment required a compliance regime that set a legal standard for taxpayers to take their obligations seriously. The objective of this regime was to be a cornerstone of an effective tax system.

In Chapter 3, the background to the rationale for such penalty provisions is discussed. The regime was part of a series of reforms linked into other tax reforms which set new standards for taxpayers to comply and formed part of a comprehensive change to the tax environment in which taxpayers existed.

# **Chapter 3**

## **The Genesis of the NZ Compliance and Penalty Regime**

### **3.1 Introduction**

The Inland Revenue programme of modernization which had commenced after the snap election of July 1984 was at its mid-point by April 1992. Designated processing centres for the automation of tax payments, maintenance of tax records, policing returns and income verification were operational by April 1992. This programme of re-development had radically changed not just the way the Inland Revenue collected taxes, but saw the transfer of significant monetary resources to enforcement and education.

The extent of the discussion proposals and legislative programme which Inland Revenue had dealt with was also significant.<sup>119</sup> Fringe Benefit Tax (FBT),<sup>120</sup> Goods and Services Tax (GST),<sup>121</sup> Accruals regime,<sup>122</sup> Provisional tax regime,<sup>123</sup> Superannuation and Life insurance changes,<sup>124</sup> Resident Withholding Tax on interest and dividends,<sup>125</sup> Dividend imputation,<sup>126</sup> Foreign Dividend Withholding Tax and an international tax regime covering

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<sup>119</sup> Inland Revenue: Tax Simplification: Final Report of the Consultative Committee (Wellington, September 1990).

<sup>120</sup> Income Tax Amendment Act (No 2) (1985) inserted part XB by No 59, s 34 the fringe benefit tax regime with application from 1<sup>st</sup> April 1985.

<sup>121</sup> Inland Revenue: Proposal for the Administration of the Goods and Services Tax: (March 1985). The introduction of the Goods and Services Tax Amendment Act 1986 was enacted on 8 August 1986.

<sup>122</sup> Inland Revenue: Consultative Document on Accrual Tax Treatment of Income and Expenditure (October 1986) saw the introduction of accrual regime as per Income Tax Amendment Act (No 5) 1988.

<sup>123</sup> Income Tax Amendment Act (No 4) 1988 saw the introduction of a comprehensive regime of provisional tax on income.

<sup>124</sup> Inland Revenue: Consultative Document on Superannuation and Life Insurance, Volume 1 and 2 (March 1988).

<sup>125</sup> Inland Revenue: Discussion Document on Domestic Interest and Withholding Tax (October 1988), and enacted under the Income Tax Amendment Act (No 2) 1989.

<sup>126</sup> Inland Revenue: Consultative Document on Full Imputation: (December 1987) and enacted under the Income Tax Amendment Act (No 5) 1988.

New Zealand controlled foreign companies and investments<sup>127</sup> inundated both the Inland Revenue and taxpayers alike.<sup>128</sup>

On the horizon was the restructuring of the Inland Revenue,<sup>129</sup> and its involvement with Tax Simplification<sup>130</sup>, Binding Rulings,<sup>131</sup> Rewrite of the Income Tax Act<sup>132</sup> and the concept of Self-assessment.<sup>133</sup> It appeared that the Inland Revenue began to reflect on whether its “current penalty regime”<sup>134</sup> was a relic of the past given the breadth and scope of these reforms.

## **3.2 Background to the Compliance and Penalty Regime.**

### **3.2.1 Criticism of the Old Regime**

In the 1992 budget, Ruth Richardson<sup>135</sup> commented that the current obligations and penalty provisions as contained in the Income Tax Act 1976 and Goods and Services Act 1985 were a maze of inconsistency and disincentives for deferral and avoidance were inadequate.<sup>136</sup> As pointed out by her:

*“The current regime of obligations and penalties is inconsistency between different Acts and does not establish adequate disincentives for deferral and avoidance... it does not achieve the goal of the regime of taxpayer obligations and penalties of the*

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<sup>127</sup> Inland Revenue: Consultative Document on International Tax Reform (December 1987) and enacted under Income Tax Amendment Act 255.

<sup>128</sup> Inland Revenue: Simplification Committee: Final Report of the Consultative Committee (Wellington, September 1990).

<sup>129</sup> See n 117.

<sup>130</sup> Inland Revenue : Tax simplification Consultative Document on Tax Simplification. (December 1989).

<sup>131</sup> Inland Revenue: Binding Rulings on Taxation: A Discussion Document on the Proposed Regime (June 1994).

<sup>132</sup> Inland Revenue: Rewriting the Income Tax Act: A Discussion Document (May 1995).

<sup>133</sup> See n 118.

<sup>134</sup> The term penalty regime refers to the mishmash of offences provisions contained within the Income Tax Act 1976, and Goods and Services Tax Act 1985.

<sup>135</sup> Ruth Richardson MP and Minister of Finance in the 1990-1993 National Government.

<sup>136</sup> See n 135.

*enforcement activities of Inland Revenue, to provide appropriate incentives for taxpayers to comply with the law....Underpinning a strong economy must be a fair regime of taxation promoting so far as possible voluntary compliance by taxpayers, with strong enforcement and heavy penalties for non-compliance. The way in which tax laws are implemented also requires attention.”*

The policy rational was that any new legislation had two strategies i.e. to reinforce the Commissioner’s role in the administration of the compliance strategy and more importantly to encourage greater voluntary compliance from taxpayers. The main deterrent contained in the Income Tax Act 1976 was:

- Additional tax was imposed when income tax assessed or GST was not paid by the due date. In respect of income tax, a 10% compounding penalty was imposed. In respect of GST it was 10% plus 2% per month thereafter.
- If the Commissioner reassess a taxpayer’s tax liability as a consequence of an investigation, additional tax was not applied unless the Commissioner could sustain the taxpayer was guilty of neglect or default. Otherwise a fresh due date was set under section 398 of the Income Tax Act 1976.
- The Commissioner has discretion to impose penal tax<sup>137</sup> where the taxpayer had attempted to evade payment of tax.
- If the taxpayer failed to deduct and account for PAYE or resident withholding tax, failed to furnish a return or provide information to the Commissioner when required, monetary penalties could be imposed.

If automatic penalties for non-compliance were applied in every case, this would inevitably lead to unfair outcomes, since the size of the penalty will not necessarily reflect the differing levels of culpability. These rules were seen as unfair to the majority of taxpayers.

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<sup>137</sup> Penal tax can impose on the additional tax payable up to 300 per cent at his discretion. As this penal tax is discretionary, it creates inconsistencies between different district offices and the interpretation by Inland Revenue Staff.

Any additional tax was a fixed percentage penalty for late payment but also purported to be a charge for use of money.<sup>138</sup>

An inadequacy in the old legislation was that the law was focused on taxpayers providing factual information. It did not painstakingly address those taxpayers who choose not to meet the legal obligations placed on them. This imposed unnecessary costs for taxpayers, their agents and the tax administration. The rules were becoming less effective in supporting taxpayer obligations in an environment where self-assessment was dawning.

The Income Tax Act 1976 also had no direct sanctions to address serious forms of carelessness, either deliberate or otherwise.<sup>139</sup> The growth of aggressive interpretations of tax law, or tax avoidance which creates tax leakage was not addressed in the previous Income Tax Act 1976.<sup>140</sup> With the lack of penalties for late payment,<sup>141</sup> incentives existed for taxpayers to tax arbitrage using the marginal tax rates.<sup>142</sup>

The issue for the Inland Revenue was that aggressive interpretations of tax law did not provide the necessary grounds for a prosecution. Those schemes and techniques which were detected revealed that it was more of a lack of neglect rather than intent to evade a test that the Commissioner was required to sustain for evasion.<sup>143</sup>

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<sup>138</sup> See n 115 and Inland Revenue Department Briefing Paper 2 Terms of Reference Inland Revenue Overview April 26 1999, Para 170.

<sup>139</sup> See n 115, Para 167.

<sup>140</sup> See n 115 and Inland Revenue Policy and Advice File number 96/52 as per submissions to the Finance and Expenditure Select Committee.

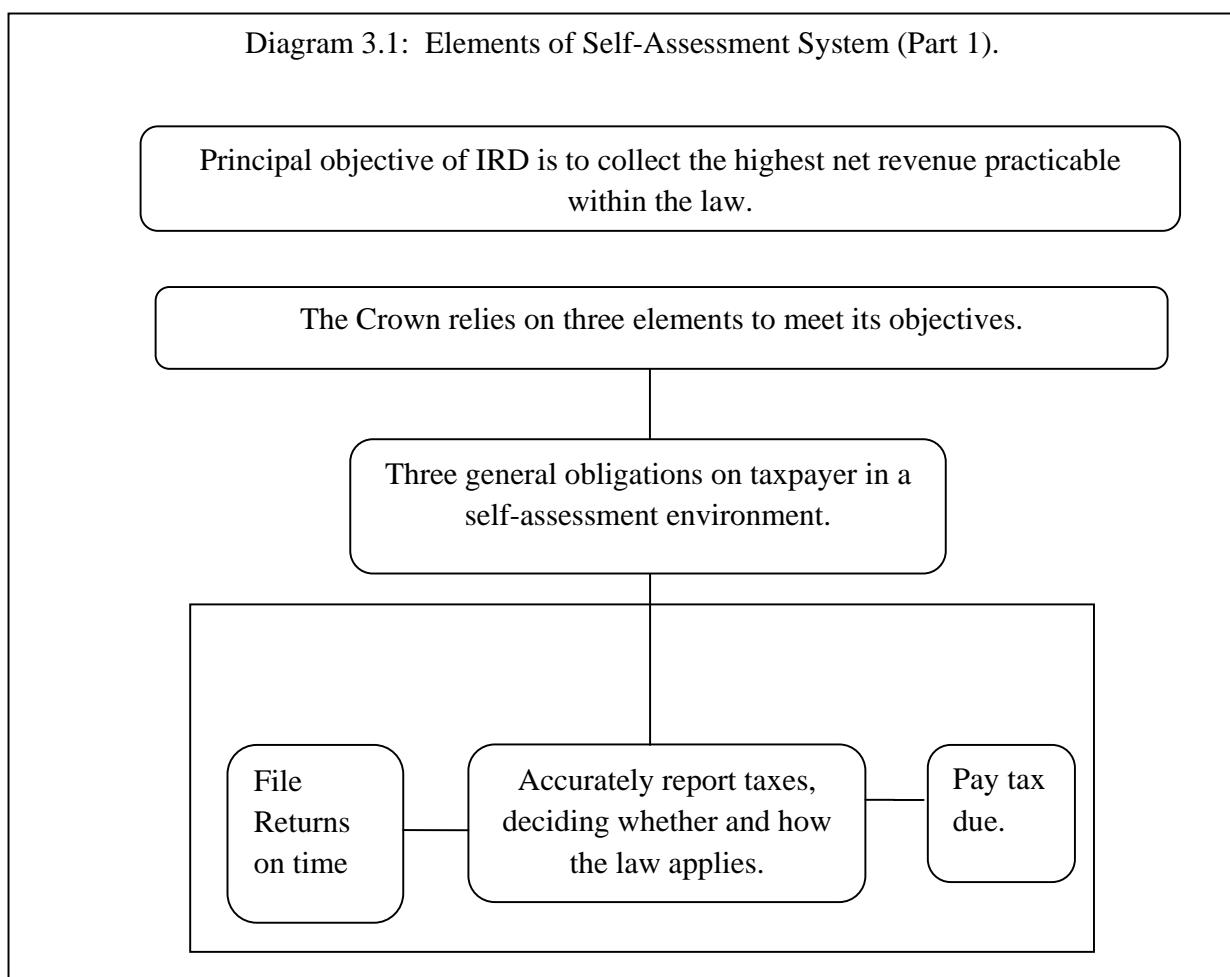
<sup>141</sup> Under section 398A of the Income Tax Act 1976, the Commissioner was obliged to set a fresh due date for the payment of outstanding tax unless the default was due to neglect. Given that tax avoidance did not involve neglect or default, it could be an issue in any settlements for tax avoidance schemes. Such arrangements created disparities in the treatment of different taxpayers, which strikes at the very heart of an equitable tax system.

<sup>142</sup> Tax arbitrage exists when a taxpayer spreads his/her income over various entities to take advantage of the existing marginal tax rates existing.

<sup>143</sup> *Greogoridis v CIR* [1985] 7 NZTC 5,150: [1985] 8 TRNZ 705.

### 3.2.2 New Regime

The background for the introduction of the Compliance and Penalty Regime can be traced back to the review of the Inland Revenue Department, chaired by Sir Ivor Richardson.<sup>144</sup> Richardson pointed out that New Zealand was moving towards a tax system of self-assessment, under which individuals and companies would assess their own tax liability and pay tax according to the requirements of the law.<sup>145</sup> As shown in Diagram 3.1<sup>146</sup> and 3.2<sup>147</sup>, the Compliance and Penalty Regime was an integral part of its objectives of collecting the highest net revenue over time under a self-assessment system.



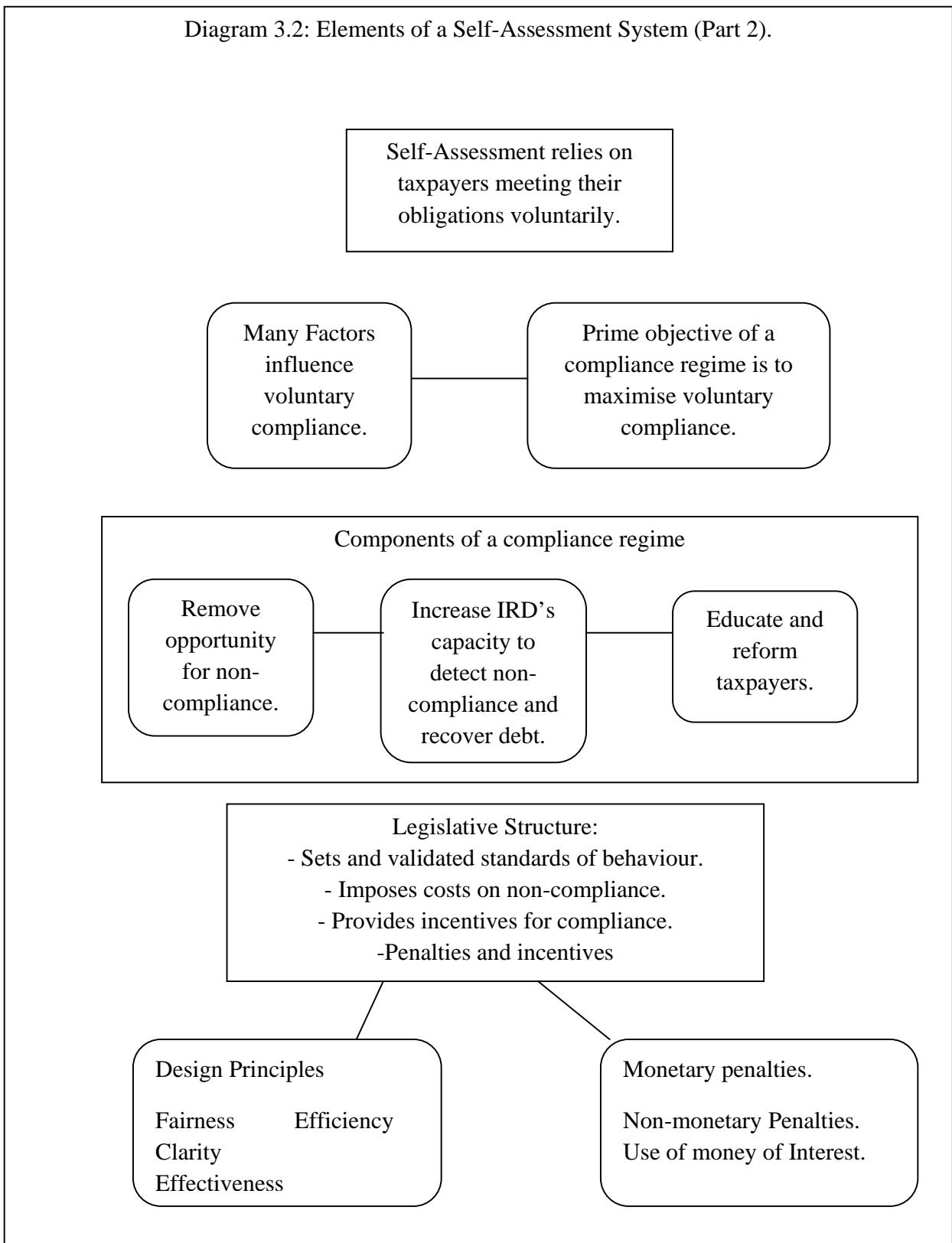
<sup>144</sup> See n 115.

<sup>145</sup> See n 115.

<sup>146</sup> See n 115 Para 2.6.

<sup>147</sup> See n 115.

Diagram 3.2: Elements of a Self-Assessment System (Part 2).



A number of issues needed to be considered in designing the penalty regime. In particular, if the new Compliance and Penalty Regime was not seen to be fair, it would undermine voluntary compliance by taxpayers. The new regime therefore required a trade-off between compliance and the administrative costs. The principles of reforms were initially outlined in a discussion document issued in August 1994.<sup>148</sup> In April 1995, the Government then issued a second document which contained detail proposals and draft legislation for further consultation.<sup>149</sup>

It was fundamental that under self-assessment, taxpayers must be aware of their primary tax obligations which required a corresponding obligation should they fail in their responsibility to determine the correct amount payable and paying it on time. To reinforce taxpayer self-assessment, and their tax liability, it was necessary to set a standard that taxpayers were legislatively obliged to meet. As a result, the founding principle for the new regime was “reasonable care”. This legal concept became the basic standard that all taxpayers must exercise in fulfilling any tax obligation, i.e. taxpayers must take the same level of care that a reasonable person would take in the same circumstances.

What is “reasonable” depends on the facts and circumstances of each situation, including the person’s experience, education and skills. It equates to the concept of negligence in the civil law of torts, for which the jurisprudence was well established. It recognized a balance between the need for returns to be correct and the recognition of the difficulties that taxpayers may face in ensuring that they are correct. The reasonable care standard was a fluid concept as it:<sup>150</sup>

*“recognises the distinct characteristics of individual taxpayers and the different burdens placed on them. Applying a standard of reasonable care does not require that a taxpayer actually foresaw that the breach or default would cause a shortfall; it simply requires that a reasonable person in those circumstances would have foreseen the shortfall as a reasonable probability.”*

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<sup>148</sup> See n 115.

<sup>149</sup> Inland Revenue Taxpayer Compliance, Standards and Penalties 2: Detailed proposals and Draft Legislation. A Government Discussion Document (April 1995).

<sup>150</sup> Inland Revenue. Taxpayer Compliance, Standard and Penalties: A Review (August 2001), Para 4.4.

This new regime was to apply to everyone and force taxpayers to think about those obligations honestly, repeatedly and regularly. The Compliance and Penalty Regime also required individual taxpayers to determine their tax liability involving the interpretation of tax laws and its application to the situation. The policy behind these standards was to ensure that not only taxpayer obligations would be met, but it would also increase the robustness of the tax base and the fairness of the tax system with the introduction of comprehensive penalties.

There is much wisdom in enacting this standard of primary obligations,<sup>151</sup> as the Revenue's goal was to establish a regime of legal principles so that taxpayers who breach those legal principles would be penalized.<sup>152</sup> These standards were to be achieved by:

- Signalling clearly what was expected of both taxpayers and their advisors;
- Increasing the effectiveness of incentives to comply with tax laws and imposing costs on those who do not comply; and
- Linking taxpayer obligations with sanctions for non-compliance to improve compliance with the tax laws.

This regime of standards and consequences created a philosophy behind the compliance strategy, which was sadly lacking in the past.<sup>153</sup> The enforcement activities of Inland Revenue, would apply to those taxpayers who failed to comply with the set legal standards.

In enacting this regime, Inland Revenue had to be able and willing to offer a sustainable and precise level of certainty in respect of its interpretation of the penalty provisions. The publication of the Standard Practice Statements in respect of Part IX of the Tax Administration Act 1994 provided taxpayers with Inland Revenue's interpretation of these

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<sup>151</sup> See n 25.

<sup>152</sup> Section 15A and 15B of the Tax Administration Act 1994 sets out those obligations.

<sup>153</sup> Previously, no Inland Revenue publication existed that sets out a connection between why tax penalties were imposed and a standard that the Inland Revenue expected of its taxpayers.

new penalty provisions.<sup>154</sup> Linked to these publications was an obligation by Inland Revenue to make it as simple as possible for the imposition and administration of any penalties.<sup>155</sup>

### **3.2.3. Penalties: A Comparison of the Old and the New**

To understand the background to the Compliance and Penalty Regime, one needs to compare the previous legislation dealing with offences to understand the logic of the legislation contained in the new sections 143 to 148 of Part IX of the Tax Administration Act 1994 as set out below in Table 3.1.<sup>156</sup>

**Table 3.1 Comparison of Old and New Penalties Regimes.**

Nature of Offence	ITA 1976/GST Tax Act 1985 (old)	Penalty Imposed	TAA 1994 (New)	Penalty Imposed
Failure to retain or provide records	s416 ITA 1976	Monetary Fine	s143	Monetary Fine
Knowledge offences	s416 ITA 1976	Monetary Fine	s143A or s143B	Monetary Fine or imprisonment.
Criminal Fraud	No section applicable		s143A or s143B	Monetary Fine or imprisonment
Obstruction	s416[1][c] s62[1][i] GST Act 1985	Monetary Fine	s143H	Monetary Fine
Aiding or abetting	s416[e] ITA 1976 s62[1][p], 62[5] GST Act 1985	Monetary Fine	s148	Monetary Fine or imprisonment.

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<sup>154</sup> A Standard Practice Statement describes how Inland Revenue will exercise a statutory discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts available at [www.ird.govt.nz/technical/tax/standards](http://www.ird.govt.nz/technical/tax/standards) (as at 30 August 2010).

<sup>155</sup> See n 115, Para 3.3 and Para 3.10.

<sup>156</sup> See n 115, Table 3.1 was adapted from Appendix 3 of the Discussion Document.

The original tax offences legislation was primarily contained in section 416 of the Income Tax Act 1976 and in respect of GST offences, in Section 62 of the GST Act. The Compliance and Penalty Regime logically consolidated these two diverse sections into one comprehensive part of the Tax Administration Act 1994.<sup>157</sup>

In respect of tax fraud, the original Acts were “silent” as regards any monetary fine or custodial sentence.<sup>158</sup> Rather, the Inland Revenue would refer the case for prosecution to the Police or Serious Fraud Office. Those two authorities would then lay charges primarily under section 229B of the Crimes Act 1961.<sup>159</sup> Under sections 143A or section 143B of the Tax Administration Act 1994, the Commissioner could now pursue criminal fraud and seek custodial sentences to be imposed by the Courts.

The primary motivation behind the new Compliance and Penalty Regime can be explained further in that the civil penalties did not exist to raise revenue.<sup>160</sup> Rather, the civil penalties were to enforce voluntary compliance. Civil penalties act as a signal to taxpayers that voluntary compliance is the norm and that non-compliance is unacceptable. This signal is particularly relevant in a self-assessment tax environment. Taxpayers and their advisors had to understand that these standards were required to be met and a penalty will occur if they fail to meet the required standard.<sup>161</sup>

However, it is important that the penalty provisions, its administrative practice, costs of administration and its practical application complement the efficient operation of the tax

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<sup>157</sup> Offences contained in sections 143C, 143D, 143E which deals with secrecy, s143F Inquiries, s143GO Court orders, s144 Stamp Duties, s145 offences for which no specific penalty imposed, s147 Employees and s147B directors and offices of foreign companies have not been included in the comparisons.

<sup>158</sup> The Income Tax Act 1976 contained three penal provisions that allowed for maximum sentences of up two years imprisonment. Firstly, for supplying false information with respect to interests in foreign controlled companies or trusts. Under section 416B(2A) and relating to resident withholding tax, non-resident withholding tax or source deduction payments under Section 416B(1). Finally under section 368 of the Income Tax act 1976 in relation to PAYE offences a term of 12 months imprisonment.

<sup>159</sup> See Appendix 3 section 229A Crimes Act 1961.

<sup>160</sup> Section 141A to 141E of Part IX Tax Administration Act 1994 dealt with monetary penalties for lack of reasonable care, unacceptable tax interpretation, gross carelessness and tax evasion.

<sup>161</sup> See n 115, Para 3.1

system. This meant that the standards enacted by Inland Revenue had to be enforceable, capable of being imposed without undue costs on the tax administration and taxpayers.<sup>162</sup>

The standards which taxpayers are expected to meet in interpreting and applying the laws were introduced with effect from the 1997-1998 income years, and were contained in sections 141A through 141E of the Tax Administration Act 1994.<sup>163</sup>

The penalties imposed under the provisions of sections 141A through 141E of the Tax Administration Act 1994 fulfil a number of functions. They include a reminder of appropriate community standards in meeting one's taxation obligations, an incentive to complete tax obligations, punishment for non-compliance, a deterrent for future non-compliance; and a defining boundary line to support the overall integrity of the tax system.<sup>164</sup>

The other contentious issue was to the onus of proof. It must be borne in mind that the onus of proof<sup>165</sup> applies to establish the facts of the case, not the law as applied to the facts.<sup>166</sup> From a policy rationale, the Inland Revenue's justification for placing the onus of proof upon the taxpayer was that the tax positions taken by a taxpayer are first and foremost within the knowledge of the taxpayer. Proper record-keeping, full and honest disclosure and conformity with tax law were all matters within the taxpayer's control.

Retaining the onus of proof upon the taxpayers is also consistent with the rationale for self-assessment that is, taxpayers had more information about their tax liabilities and are, therefore, in a better position to assess their own tax liability than the Commissioner.

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<sup>162</sup> See n 115, Para 3.3

<sup>163</sup> The Tax Administration Act (No 2) 1996 (1996 No 56), enacted 26 July 1996 (with effect from the 1997-1998 income year).

<sup>164</sup> See n 115, Para 3.6.

<sup>165</sup> *Meulen's Hair Stylists v Commissioner of Inland Revenue* (1963) NZLR 797 (NZSC) and *McGregor J and Godfrey Allan Ltd v DCIR* (1980) 4 NZTC 61,548: (1980) 3 TRNZ 533.

<sup>166</sup> See n 150, Para 5.8.

As the Court of Appeal in *Buckley & Young v Commissioner of Inland Revenues* said:<sup>167</sup>

*“the Commissioner could not sensibly be expected to bear the onus of proof of matters which originate with the taxpayer and which usually are peculiarly within his knowledge and power. Thus there are sound if not compelling practical reasons why the legislation requires him to provide satisfactory evidence to support his calculation of his assessable income.”*

In cases involving evasion, hindrance and criminal prosecution, that onus would lie with the Commissioner.<sup>168</sup> The penalties legislated for in respect of evasion, hindrance and criminal prosecution were to be treated in the same way as criminal law. This was formulated as a trade-off between fairness and efficiency implicit in the law.

In discharging these tax obligations, it was not intended to be onerous. Rather, taxpayers were expected to take extra care in interpreting the legislation if there is a significant amount of tax at stake.<sup>169</sup>

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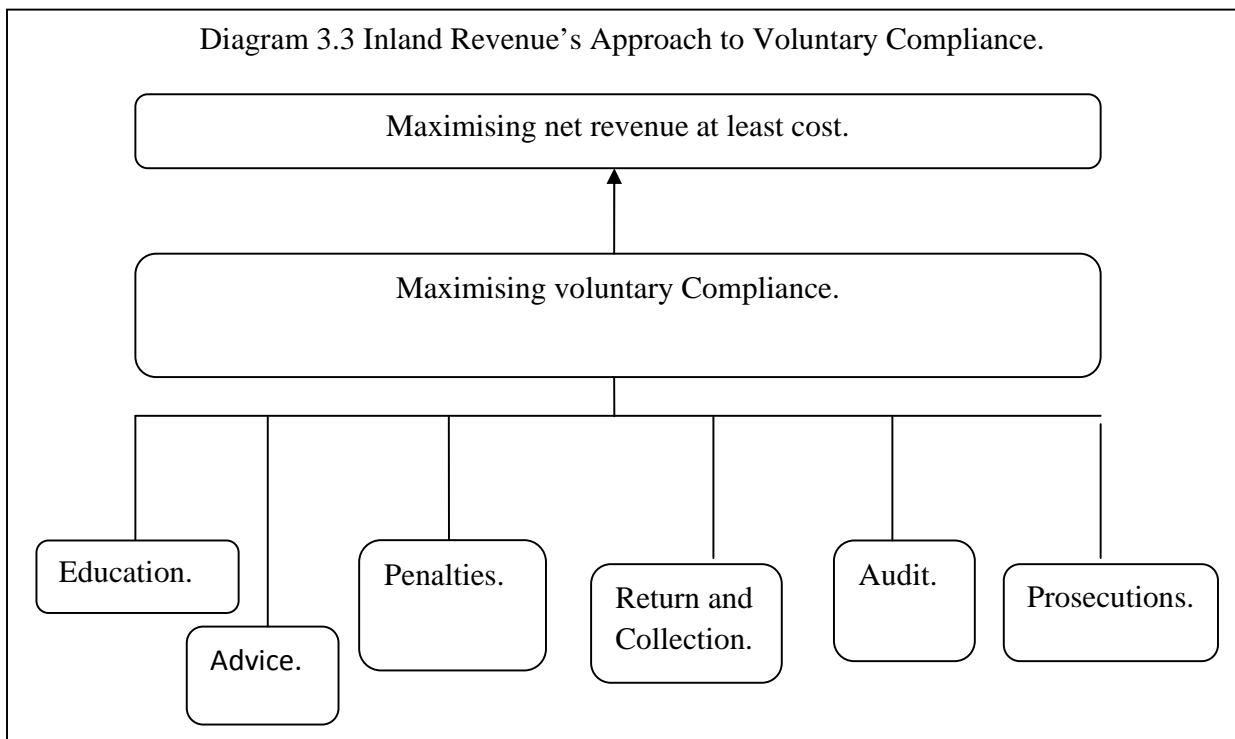
<sup>167</sup> (1978) 2 NZLR 485; 78 ATC 6019: 9 ATR 106 (CA).

<sup>168</sup> See n 115, Para 6.10 and 6.47.

<sup>169</sup> See n 115, Para 4.3.

### 3.3 Policy Structure of Inland Revenue

The Compliance and Penalty Regime was to be seen as one of the policy planks of the Inland Revenue to respond to varying levels of compliance in a variety of ways. Further, to minimize the opportunities for non-compliance, the Inland Revenue as shown in Diagram 3.3<sup>170</sup> had a variety of systems in place to ensure voluntary compliance:



The Compliance and Penalty Regime was a decisive step towards the modernisation of the New Zealand tax system. Civil tax penalties were designed to be fair, while the criminal penalty provisions were to deter bad conduct without punishing good conduct or punishing the innocent. The Regime was part of a range of tools used for the purpose of encouraging voluntary compliance with the tax laws. The aim of the civil and criminal penalties was not designed to simply to raise revenue. The standard of conduct required of taxpayers was readily known and is easy to understand.

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<sup>170</sup> Policy and Inland Revenue File number IRD/INQ/1 as per submissions to the Finance and Expenditure Select Inquiry into the powers and operations of the Inland Revenue Department April 19, 1999, p 6.

Taxpayers trying to do the right thing were not to be subject to onerous standards as opposed to intending to evade the law. The penalties were to be seen as encouraging and not discouraging taxpayers to take their responsibilities seriously.

Finally, the Inland Revenue began although somewhat slowly in designing administrative procedures for imposing penalties so that all taxpayers were treated in a fair and equitable manner as a consequence of the audits carried out by the Inland Revenue.

### 3.4 Criminal Sanctions

Every criminal system:

*“has deterrence as its primary and essential postulate. It figures most predominately throughout our punishing and sentencing decisions legislative, judicial and administrative.” When confronted with a criminal problem legislator’s often agree that the best hope of control lies in “getting tough” with criminals by increasing penalties.”<sup>171</sup>*

Providing for imprisonment for serious tax offences has two purposes. First, it signals that tax evasion has serious consequences. It is analogous to crimes addressed under Acts like the Crimes Act 1961, Companies Act 1993 and the Serious Fraud Act 1990.<sup>172</sup> Second, there have been occasions where the imposition of a monetary fine was not appropriate, and the courts in earlier cases have commented that, given the nature of the offence, a term of imprisonment (or periodic detention or community service) would have been imposed if this avenue were available.

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<sup>171</sup> Crime and Penalties in California, (1968), a publication of the California Assembly Office of Criminal Proceedings available at [www.sagepublications.com](http://www.sagepublications.com), (as at 13 July 2010).

<sup>172</sup> See Appendix 3 for a list of the relevant sections of these Acts.

Despite these legal and philosophical concepts previous research had established that there had been more emphasis for monetary penalties, as low number of custodial sentences was of concern, given the initial establishment of the range and breadth of custodial offences.<sup>173</sup>

Inland Revenue made it publically clear that:<sup>174</sup>

*“Tax evasion [was] a crime, with real victims and those that evade get caught and penalised. It is critical for voluntary compliance that New Zealanders all realise this.”*

The Government for the first time comprehensively introduced a regime which categorised various offences as criminal and by analogy the seriousness of such offending. What the Government was also signalling to the Courts was that tax fraud was a scar upon the community. It appears to be a reminder to the Courts that the deterrent policies of the Inland Revenue were not to fail.<sup>175</sup> The question for the Courts would be whether to follow their previous track record which was to impose monetary fine or discharged the taxpayer.<sup>176</sup>

The provisions of section 143A and 143B are the prime criminal sanctions contained in Part IX of the Tax Administration Act 1994 which the Inland Revenue can use to prosecute non-complying taxpayers. The logic behind the enactment of these two sections was that tax non-compliance as a criminal activity warranted the full response of the law. A strong message would have to be sent to the community that compliant behaviour was seen as a cost-effective way of improving taxpayer compliance.<sup>177</sup>

These new standards set a new environment for which taxpayers, advisors and the Inland Revenue had to confront. The criminal sanctions contained in the Compliance and Penalties

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<sup>173</sup> K Devos, Penalties and Sanctions for Taxation Offences in New Zealand: Implications for Taxpayer Compliance. (2004) Vol 10:3 *New Zealand Journal of Taxation and Policy* 212.

<sup>174</sup> Inland Revenue Strategic Business Plan 1998-2001, p 36.

<sup>175</sup> See n 6, p 14.

<sup>176</sup> See n 165.

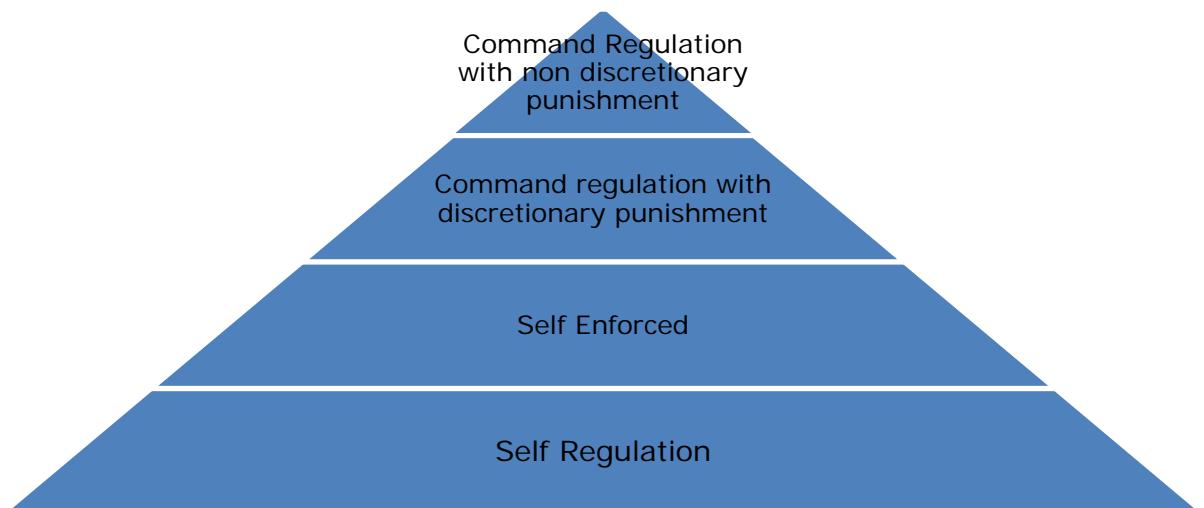
<sup>177</sup> V Braithwaite, Criminal Prosecution within responsive regulatory practice. American Society of Criminology (2010) Vol 9 Issue 3 *Criminology & Public Policy* 515.

Regime characterizes a historic effort to redesign the obligations of taxpayers, increase the severity of the consequences for failing to achieve and maintain basic legal obligations.

### 3.5 Compliance Model

As mentioned earlier, Inland Revenue's Compliance and Penalty Regime was focused on setting a legal standard for taxpayers to comply to. This regime became an integral part of its Compliance Strategy. However, what Inland Revenue lacked prior to the appointment of David Butler as Commissioner in February 2001,<sup>178</sup> was a philosophy behind how it would respond to each and every taxpayers compliance behaviour. Thus the Australian Tax Compliance Model which had originated from research by John Braithwaite and Ian Ayer's<sup>179</sup> became of interest to the Inland Revenue.

Figure 3.1 Pyramid of Regulatory Strategies.



In the context of regulatory strategies as shown in Figure 3.1<sup>180</sup> authorities' response is based on where taxpayers are located. If taxpayers were located at the base of the pyramid, they are fully compliant and imposed the least cost for the taxpayer in this case and the

<sup>178</sup> David Butler was appointed Commissioner of Inland Revenue in February 2001. He was previously the Deputy Commissioner, Small Business Income Australian Tax Office and a member of the Cash Economy Project which was the genesis of the ATO Compliance Triangle.

<sup>179</sup> I Ayres and J Braithwaite, *Responsive Regulation, Transcending the Deregulation Debate*, (Oxford University Press, New York (1992) 3.

<sup>180</sup> See n 97.

revenue authority. If taxpayers reside in the upper echelons of the pyramid, they are non-compliant. By using a responsive approach in the first instance of persuasion or failing that approach the full force of the law, the Revenue Authority attempts to move taxpayers towards the “base of the cooperative pyramid.”<sup>181</sup>

Building on the work of Dr Valerie Braithwaite<sup>182</sup> on motivational postures and trust norms, the final model developed by the Australian Tax Office (ATO) is set out in Figure 3.2<sup>183</sup>. Five motivational postures; BISEP that are considered to influence the behaviour of taxpayers are also relevant. These five motivational postures are shown below in Table 3.2.

Table 3.2 Motivational Postures.	
<b>Business Profile</b>	Structure – sole trader, partnership, company, trust, size and age of the business, type of activities carried out, focus – local versus international. Its financial data – capital investment, and its business intermediaries
<b>Industry factors</b>	The definition /size of the Industry, major participants in the industry, profit margins, cost structures, industry regulation, working patterns, industry issues such as levels of competition, seasonal factor and infrastructure issues.
<b>Sociological factors</b>	Cultural norms, ethnic background, attitude to Government, Age, Gender, Educational level
<b>Economic factors</b>	Investment, Demographic, Tax System, Government policies, International Influences, Inflation, Markets
<b>Psychological factors</b>	Greed, risk, fear, trust, values, fairness/equity, opportunity to evade

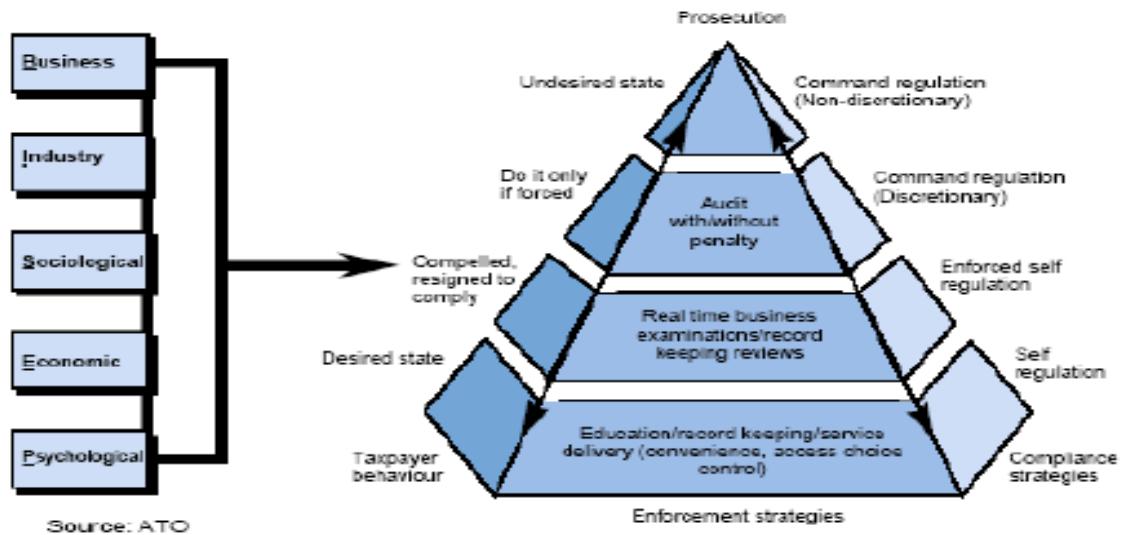
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<sup>181</sup> See n 97.

<sup>182</sup> See n 97.

<sup>183</sup> Australian Tax Office via Google images available at <http://google.com/images?hl=en&source=hp&biw=1180&bih=543&qato+co+model&btnG=search&images&gbv> (as at 22 July 2010).

Figure 3.2 Compliance Model.



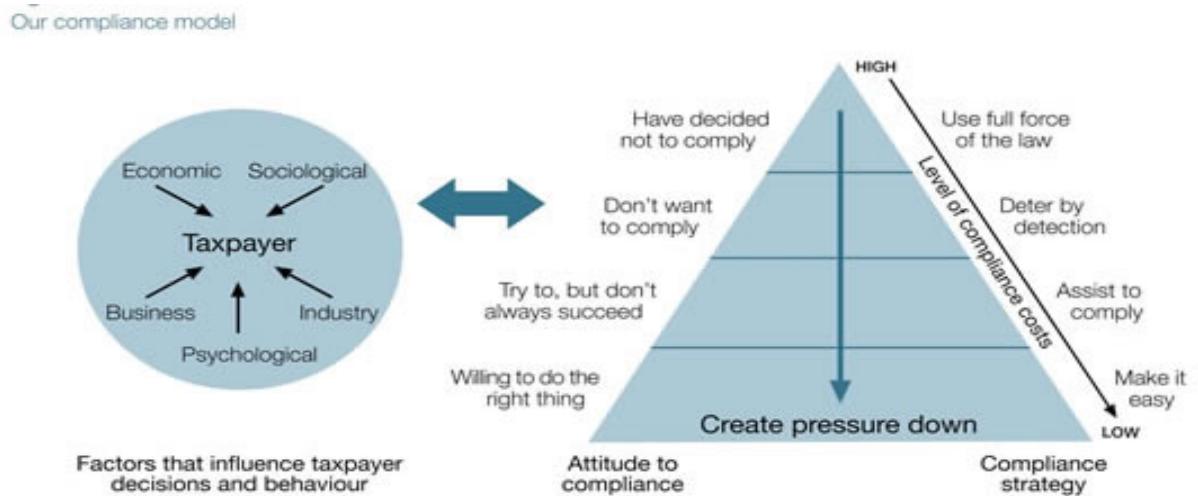
The Commissioner saw the ATO compliance model in Figure 3.2 as a way to promote a “more tailored, responsive approach to taxpayers which recognised external factors that influenced their compliance attitudes and behaviours.<sup>184</sup> The model was seen as vital to ensure that tax laws were applied in a consistent and fair manner. It also allowed the audit unit to adapt its interventions based on taxpayer’s circumstances. The full force of the law could be applied by imposing criminal or civil sanctions to those who had decided not to comply.

In its Annual Report for 2002, Inland Revenue explained this Compliance Model as shown in Figure 3.3 and it was this model that has set the agenda for the Inland Revenue’s future compliance strategy.<sup>185</sup>

<sup>184</sup> Inland Revenue Department Annual Report 2002, p 19.

<sup>185</sup> See n 174.

Figure 3.3 New Zealand Compliance Model.



### 3.6 Summary

The Compliance and Penalty Regime and the tax penalties set out in sections 141A to 141E and the relevant criminal sanctions as set out in sections 143A to 143B of the Tax Administration Act 1994 were severely warranted in an attempt to combat the growth of non-compliance.

According to Inland Revenue, for a voluntary compliance system to work:<sup>186</sup>

*"[the] tax system should be seen as fair and reasonable. If it is not people will stop voluntarily complying with their tax obligations."*

The tax environment which existed was long overdue for a comprehensive redesign. The scope of the redesign was unprecedented in New Zealand's tax history. The Compliance and Penalty Regime enabled the Inland Revenue to begin the process of identifying and

<sup>186</sup> See n 115 and Inland Revenue Final Submission to Finance and Expenditure Select Committee on the Public enquiry into IRD (Wellington, 1999), p 8.

designing a credible compliance strategy. The problem that confronted Inland Revenue as Slemrod and Bakeja so rightly encapsulated was, what public debate had existed about these tax reforms and whether they would work?<sup>187</sup>

The new Compliance and Penalty Regime was focused on setting an expectation of taxpayers' behaviour buttressed with sanctions for non-compliance. In respect of criminal tax fraud, prosecution under the Crimes Act 1961 was a further back up to sections 143A and 143B of the Tax Administration Act 1994.<sup>188</sup> Whether the charges should be under the Crimes Act 1961 or the relevant sections of the Tax Administration Act 1994, the Committee of Experts on Tax Compliance stated:<sup>189</sup>

*"The court has expressed its views strongly that tax fraud is very serious and is appropriate to be dealt with by the Crimes Act 1961... When fraudulent activity is detected, the department should ensure that its officers are aware that the Crimes Act 1961 is the appropriate vehicle for prosecution."*

The New Zealand tax system, where self-assessment was to be the expectation of all taxpayers would require honesty and diligence in meeting their tax obligations. To this effect, a comprehensive system of rules and penalties was set out in Part IX of the Tax Administration Act 1994 to enforce voluntary compliance.

It was these rules and penalties together with the Compliance Triangle that formed a comprehensive strategy towards achieving a tax system which is based largely on voluntary compliance. But is the Compliance and Penalty Regime working?

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<sup>187</sup> J Slemrod and J Bakeja, *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform*, (1996), Cambridge, Mass MIT Press 253.

<sup>188</sup> See n 101, Para 13.89.

<sup>189</sup> See n 101.

The next chapter provides an overview of the literature on the Deterrence Theory and Behaviourists Theories and their association with taxpayer's compliance behaviour. Studies carried out in New Zealand on the Compliance and Penalty Regime are also reviewed.

# **Chapter 4**

## **Review on Tax Compliance Studies**

### **4.1 Introduction.**

This chapter provides an overview of the literature on tax compliance and considers whether the Compliance and Penalty Regime was based either on the deterrence or behaviourist theories of tax compliance. It also reviews three studies on the Compliance and Penalty Regime carried out in New Zealand.

### **4.2 Compliance and Penalty Regime – Deterrence or Behaviourist?**

#### **4.2.1 Deterrence Theory**

One key issue is whether the Compliance and Penalty Regime is centred on the deterrence theory or behavioural theories.

The most popular and widely examined model for taxpayer behaviour is the traditional economic model, hereafter termed the “deterrence model”.<sup>190</sup> The deterrence model is a classical economic concept of tax evasion which assumes that taxpayers behave in an economic rational manner. Compliance and non-compliance is the result of a cost benefit calculation. The deterrence model expressed the view that a taxpayer’s behaviour can be explained in purely economic terms, i.e. namely; their decision to comply is a result of balancing the risk of detection and punishment with the economic benefit derived from evading tax.<sup>191</sup> This approach can be termed, “the tax evasion gamble”.<sup>192</sup>

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<sup>190</sup> M Allingham and A Sandmo, Income tax evasion: A Theoretical Analysis. (1972) 1 *Journal of Public Economics* 323.

<sup>191</sup> E Branham, Closing the Tax Gap: Encouraging Voluntary Compliance through Mass-Media Publication of High Profile Tax issues (June 2009) Vol 60 *Hastings Law Journal* 1507.

Allingham and Sandmo adapted the earlier model of Becker<sup>193</sup> by making the following assumptions about taxpayer's behaviour:

- Have knowledge of their actual income;
- Know the probability of audit;
- Know the rate of tax penalties;
- Tax rate is constant and known; and
- They are utility maximisers.

Allingham and Sandmo concluded that there were two unambiguous results from their studies. An increase in the penalty rate will always increase the fraction of income declared, and any increase in the probability of detection will always lead to a larger income being declared.<sup>194</sup> These results are consistent with other studies such as Witte and Woodbury<sup>195</sup> and Tittle<sup>196</sup> who ascertained that severe penalties would reduce tax non-compliance. Hasseldine et al.'s later study confirmed these original findings.<sup>197</sup> Braithwaite further argued that if a non-compliant taxpayer fears no punishment they will not just cheat but instead they will cheat again.<sup>198</sup> If however, they are punished, they will factor in the costs of cheating and will shy away from taking that risk and opt to be law-abiding.

The deterrence model was adopted by Revenue Authorities during the 1970's and 1980's to deter so called tax non-compliers.<sup>199</sup> It was also used as a justification for specific deterrents against those taxpayers found to be non-compliant and subsequently prosecuted.

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<sup>192</sup> M Bernasconi, Tax Evasion and orders of risk version. (1998) Vol 67:1 *Journal of Public Economics* 123.

<sup>193</sup> G S Becker, Crime and Punishment: An economic approach. (1968) Vol 76:2 *Journal of Political Economy* 169.

<sup>194</sup> M McKerchar: The Impact of Complexity upon Tax Compliance A Study of Australian Personal Taxpayers: Research Study (Australian Tax Research Foundation): No 39.

<sup>195</sup> A Witte and D Woodbury, 'The effect of tax laws and tax administration on tax compliance (1985) 38 ', *National Tax Journal* 1.

<sup>196</sup> C Tittle, *Sanctions and Social Deviance: The Question of Deterrence*, New York: Praeger (1980).

<sup>197</sup> J Hasseldine, P Hite, S James and M Tomui Persuasive communications: Tax Compliance Enforcement Strategies for Sole Proprietors (Spring 2007), Vol 24 Issue 1. *Contemporary Accounting Research* 171.

<sup>198</sup> V Braithwaite, Ten Things You Need To Know About Regulation But Never Wanted To Ask, *Occasional paper Number 10 December 2006* Regulatory Institutions Network Research School of Social Sciences Australian National University Canberra ACT 0200.

<sup>199</sup> K Murphy, Moving towards a more effective model of regulatory enforcement in the Australian Taxation Office (Working Paper No 45, Centre for Tax System Integrity, Research School of Social Science Australian National University November 2004).

The initial explanation offered by the deterrence model has been the subject of extensive research among other academic scholars who varied the underlying assumptions.<sup>200</sup> Milliron and Toy pointed out that extensions to this model have been achieved by “relaxing assumptions, focusing on specific issues, and utilising more sophisticated techniques.”<sup>201</sup>

For instance Falkinger examined the relationship between the taxpayer and government within a tax evasion setting.<sup>202</sup> By examining how a rational tax offender is affected by the benefits from public expenditures, he found that evasion decreases when a taxpayer is aware of the benefits received in return for tax payments. This relates to a fundamental principle of taxation – equity. As to whether inequity is a cause of tax evasion or a rationalisation of past behaviour, Falkinger maintains there is some theoretical support for the latter.

Some other researchers have extended early economic models to include the taxpayer’s incentive to purchase tax advisory services<sup>203</sup> and the effect of practitioners and tax administration on tax evasion.<sup>204</sup>

However, other researchers questioned the plausibility of this theory particularly Weigel et al. argued that the absence of motivational concepts suggests the inadequacy of the expected utility theory in this context, as economic deterrence models tend to assume motivation as given and behaviour as primarily responsive to consequent costs and benefits.<sup>205</sup> They pointed out that the plausibility of this assumption is questioned by the

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<sup>200</sup> J Andreoni, B. Erard, and J.S Feinstein J.S (1998) 36(2) Tax Compliance, *Journal of Economic Literature* 818, C Fischer, M Wartick, and M Mark, Detection probability and Taxpayer Compliance: A Review of the Literature, (1992) Vol 11, *Journal of Accounting Literature* 1, L Franzoni, Tax evasion and tax compliance, in B. Bouckaert and G. DeGeest (eds.) (2000) Vol IV, *Encyclopaedia of Law and Economics*, 51. Cheltenham: Edward Elgar. K. Murphy Enforcing Tax Compliance: To Punish or Persuade? (2008) Vol 38:1 *Economic Analysis & Policy* 113.

<sup>201</sup> V Milliron and D Toy, “Tax Compliance: An Investigation of Key Features,” (1998) Vol 10:1 *The Journal of the American Taxation Association* 84.

<sup>202</sup> J Falkinger, “Tax Evasion and Equity: A Theoretical Analysis,” (1988) Vol 43:3 *Public Finance* 388.

<sup>203</sup> P Beck, J Davis, and J Woon-Oh “Tax Advice and Reporting under Uncertainty: Theory and Experimental Evidence,” (1991) Spring 1996 Vol 13:1 *Contemporary Accounting Research* 49.

<sup>204</sup> S Klepper, M. Mazur, and D Nagin, “Expert Intermediaries and Legal Compliance: The Case of Tax Preparers,” (1991) Vol 34:1 *Journal of Law and Economics* 205.

<sup>205</sup> P Webley, H Robben, H Elffers and D Hessing *Tax Evasion: An Experimental Approach*, Cambridge University Press, Cambridge (1991).

lack of empirical support and the criticism it has provoked. In a related commentary, Alm concluded that compliance decisions depend on many factors, and although the deterrence theory may continue to have some success in explaining *changes* in reporting behaviour, it does not explain the *level* of tax reporting behaviour.<sup>206</sup>

The model's inherent assumption is further questioned that all taxpayers will respond in an identical and predictable manner when exposed to a change in any variable is further questioned.<sup>207</sup> Other assumptions made were that all taxpayers seek to maximise utility and that the sole purpose of a tax system is to collect revenue. The model has rarely been the subject of empirical testing other than at an aggregated and abstract level.

For example a taxpayer may still be compliant even if the risk of detection is low. The reason for this behaviour is that some taxpayers believed that tax evasion is immoral as they exist in societies with a strong sense of social cohesion.<sup>208</sup> Taylor found that the fear of guilt and risk of social stigmatisation i.e. personal and social norms had a considerable influence on the decision to pay tax other than pure self-economics.<sup>209</sup> A taxpayer having knowledge of a low risk of detection will still be compliant due to an appeal to conscience and feelings of shame and guilt.<sup>210</sup> Even subject to a low probability of detection, it is this uncertainty which imposes upon that taxpayer both fear and duty. If a taxpayer has no temptation to cheat, the risk of detection has no affect.<sup>211</sup>

In summary, as the deterrence model failed to explain the high level of voluntary compliance,<sup>212</sup> a shift beyond the classical expected utility theory into theories of behaviour

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<sup>206</sup> J Alm, "A Perspective on the Experimental Analysis of Taxpayer Reporting," (1991) Vol 66:3 *The Accounting Review* 577.

<sup>207</sup> See n 205, pp 38-39.

<sup>208</sup> J Vogel, J "Taxation and Public Opinion in Sweden: An Interpretation of Recent Survey Data" (1974) Vol 27 *National Tax Journal* 499.

<sup>209</sup> N Taylor, *Understanding Taxpayer Attitudes Through understanding Taxpayer Identities*. (Centre for Tax System Integrity, The Australian National University 2000 Working Paper No 14).

<sup>210</sup> B Erard, and J.Feinstein "The Role of Moral Sentiments and Audit Perceptions in Tax Compliance", (1994) Supplement *Public Finance* 70.

<sup>211</sup> T Scholz. and N Pinney Duty, Fear, and Tax Compliance: the heuristic basis of citizenship behaviour', (1995) Vol 39 *American Journal of Political Science* 490.

<sup>212</sup> See n 204.

is offered by psychologists, sociologists and anthropologists to explain the levels of reporting behaviour.

#### 4.2.2 Behaviourist Theory

Tax compliance is a complex phenomenon, and could be addressed from a variety of perspectives.<sup>213</sup> Tax compliance under the behaviourist approach is examined on the belief that social factors such as attitude, level of education and knowledge appear to influence behaviour.<sup>214</sup> Perception of social norms as mentioned earlier is another important factor. Social norm is defined as the rules and standards that are understood by members of a group, and that guide and/or constrain social behaviour without the force of law.<sup>215</sup>

Behaviourists base their philosophy on the principles that people are more likely to pay taxes if they believe that their friends and other citizens pay taxes<sup>216</sup> as social sanctions affect compliance rates.<sup>217</sup>

While behaviourist models focused on social norms other researchers focussed on moral influences such as “tax duty”. Scholz and Pinney examined this concept of “tax duty” and ascertained that although it had a positive effect on compliance, it also increases the taxpayer’s subjective probability of the likelihood of detection.<sup>218</sup>

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<sup>213</sup> L Franzoni, Tax Evasion and Tax Compliance University of Bologna, Italy available at enclo.findlaw.com web site. (as at 27 July 2010).

<sup>214</sup> C Coleman, ‘Changing Attitudes of Small Business Owners to the ATO in a Tax Reform Environment’ (Paper presented at Australian Tax Teachers’ Association Conference, Canberra, (6 February 1999).

<sup>215</sup> R Cialdini & M Trost, Social Influence: Social norms, conformity, and compliance. In D. Gilbert, S. Fiske and G. Lindzey (Eds.), *The Handbook of Social Psychology* 4th edition, (Oxford University Press, New York (1998).

<sup>216</sup> Yankelovich, Skelly, & White, Inc. Taxpayer Attitudes Study, final report Washington, DC: Internal Revenue Service (U.S Dept of the Treasury 1984).

<sup>217</sup> H Grasmick and W. Scott, ‘Tax evasion and mechanisms of social control: a comparison with grand and petty theft’. (1982) Vol 2 *Journal of Economic Psychology* 213.

<sup>218</sup> T Scholz and N Pinney Duty, Fear, and Tax Compliance: the heuristic basis of citizenship behaviour (1995) Vol 39(2) *American Journal of Political Science* 490.

People are also more likely to pay taxes if tax authorities are seen to be fair and have fair procedures.<sup>219</sup> However it appears that most people do not think of tax cheating as being as serious as embezzlement.<sup>220</sup> People also tend to be more willing to pay taxes after being reminded of their moral obligations as citizens.<sup>221</sup>

Contrary to the deterrence theory, behaviourist theories of tax compliance presuppose that it is moral and ethical concerns which are of primary importance to taxpayers that do not think that non-compliance is right. This theory suggests that changing individual attitudes towards tax system rather than focusing on audit risk and penalties, would bring about greater compliance.<sup>222</sup> However an issue with these models is that they usually only address part of the problem and therefore there is no prescribed “best practice.”

Based on Jackson and Milliron’s study,<sup>223</sup> Fischer et al summarised the factors of tax compliance discussed above and are shown in Figure 4.1.<sup>224</sup> This model incorporates factors considered to be important under both the deterrence and behavioural theory.

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<sup>219</sup> See n 27 and K Kinsey article Deterrence and Alienation Effects of IRS Enforcement: An Analysis of Survey Data, asserting that hearing about unfair treatment of taxpayers by the IRS increases future intentions of noncompliance available at [openlibrary.org/.../Deterrence\\_and\\_alienation\\_effects\\_of\\_IRS-enforcement](http://openlibrary.org/.../Deterrence_and_alienation_effects_of_IRS-enforcement) (as at 31 January 2011).

<sup>220</sup> L Ekstrand. (1980) “Factors Affecting Compliance: Focus Group and Survey Results, in S J Bowers (ed), Proceedings of the 73<sup>rd</sup> Annual Conference on Taxation, Columbus: National Tax Institute Association – Tax Institute of America.

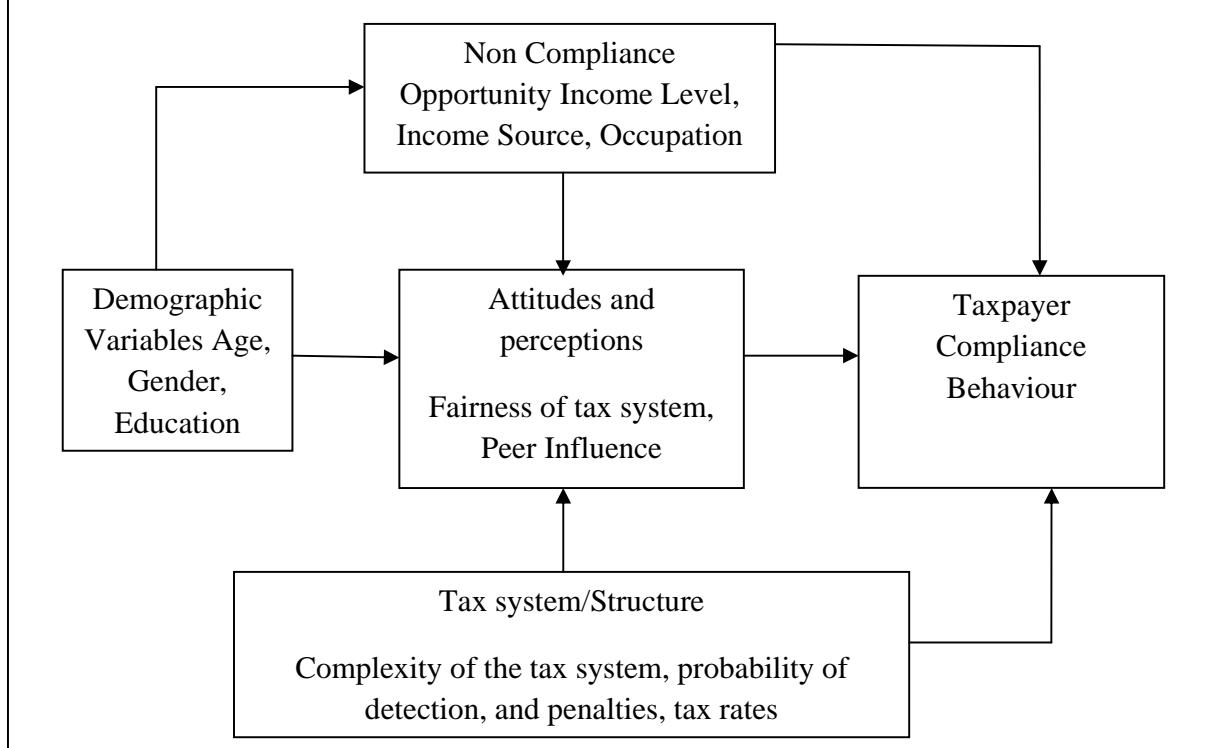
<sup>221</sup> R Schwartz and S Orleans, On Legal Sanctions (1967), Vol 34 No 2 *The University of Chicago Law Review* 274.

<sup>222</sup> O Marti, M. Wanjohi and O Magutu Taxpayers Attitudes and tax Compliance behaviour in Kenya. How Taxpayers’ Attitudes Influence Compliance Behavior among SMEs Business Income Earners in Kerugoya Town, Kirinyaga District (2010) Vol. 1 *African Journal of Business & Management (AJBUM)* 112.

<sup>223</sup> B Jackson and V Milliron, “Tax Compliance Research: Findings, Problems and Prospects (1986) Vol 5, *Journal of Accounting Literature* 125.

<sup>224</sup> G Chau and P Leung, A Critical Review of Fischer Tax Compliance Model, A Research synthesis (2009) Vol 1(2) *Journal of Accounting and Taxation* 34.

Figure 4.1 Fischer et al. (1992) Tax-Compliance Model.



#### 4.2.3 Compliance and Penalty Regime – Deterrence or Behaviourist

Given these two theories which attempt to explain both compliance and non-compliance, is the Compliance and Penalty Regime deterrence or behavioural based?

Although the deterrence model is in some ways a crude contest between punishment and persuasion, whilst the behaviourists look to non-economic persuasion, each theory is influential in the policy rationale of the Compliance and Penalty Regime.<sup>225</sup>

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<sup>225</sup> V Braithwaite and J Braithwaite. Managing Taxation Compliance: The evolution of the ATO Compliance Model A version of this paper appears in "Crimes of Privilege" edited by Neal Shover and John Paul Wright (Oxford: Oxford University Press, 2000).

The Compliance and Penalty Regime sets out an expectation that increased regulatory sanctions would increase taxpayer's perception of penalties for non-compliance. Through incentives and threats, and public statements of what the community considers proper and improper, the Compliance and Penalty Regime was to be used as an instrument of law to shape and maintain behaviour. As a policy instrument, it both provides an incentive for cooperation and a punishment to those who fail the legal standard set. This involves the implementation of a range of credible sanctions, and a clear signal of increasing penalties should compliance not prevail.

Social theories that understand compliance from the perspective of institutional legitimacy and procedural fairness are also given effect in the formulation of this compliance regime, as taxpayers will regard tough enforcement action as more procedurally fair when persuasion has been tried first. It would send a signal that tax non-compliance is a behavioural problem and the success of the tax system in enhancing tax compliance was dependent on the co-operation from taxpayers.<sup>226</sup>

The aim of the Compliance and Penalty Regime is to impose a standard expected of society and is centred on changing norms both personal and social. Norms are influenced by threats of punishment, which in turn affects the internal norms of taxpayers. This fear of guilt and risk of social stigmatisation has a powerful influence.

Inland Revenue understood that neither the deterrence or behaviourists theories were the sole reason for a taxpayer's behaviour as no one theory fully explains the behaviour of its taxpaying population. The Compliance and Penalty Regime is thus based on both the deterrence and behaviourists theories. Given the increase in tax evasion and tax avoidance, law enforcement by way of the deterrence model is necessary. The introduction of custodial sentences would influence taxpayers' perception of the probability of criminal prosecution for various types of offences. Alternatively, the desire to change taxpayers' behaviour based on the behaviourist theory is also evident in the application of the regime.

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<sup>226</sup> G Schmölders, (1970). Survey research in Public Finance: A Behavioural Approach to Fiscal Theory', (1970) Vol 25 *Public Finance* 300, p 302.

Studies on the Compliance and Penalty Regime carried out in New Zealand are scarce. Apart from Sawyer<sup>227</sup>, Devos's,<sup>228</sup> and Ascroft,<sup>229</sup> there was no other published work<sup>230</sup> that analyses using published data on tax compliance. Each of these researchers is discussed in the following sections.

## 4.3 New Zealand Studies

### 4.3.1. Sawyer's Work

Adrian Sawyer<sup>231</sup> viewed the penalty regime at the proposal stage as reflecting the consequences of the seriousness of the failure to comply with the previous Revenue Acts.<sup>232</sup> The regime is set out to increase both the clarity and fairness in the old tax system. His comment that voluntary compliance was regarded as the norm and non-compliance as socially unacceptable was presupposed in the first discussion document. He observed that for some taxpayers non-compliance was a way to redress the imbalance arising from their payment of tax and public goods and services received in return.<sup>233</sup>

The first discussion document on the penalty regime according to him placed an emphasis on incentives to comply with the law whilst imposing costs and sanctions for taxpayers

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<sup>227</sup> AJ Sawyer, "Raising the Threshold for Taxpayer Compliance: A New Era of Compliance Standards and Penalties", (1994) Vol 48 *Bulletin for International Fiscal Documentation* 655. AJ Sawyer, "Taxpayer Compliance Standards and Penalties: Version II Signifies Progress." (1995) Vol 49 *Bulletin for International Fiscal Documentation*, 510. AJ Sawyer, "Two Significant Legislative Developments: Taxpayer Compliance, Penalties and Dispute Resolution and Taxation Core Provisions Bills Become Law," (1996) Vol 50 *Bulletin for International Fiscal Documentation* 440.

<sup>228</sup> See n 73, K Devos's is attached to Monash University in Australia.

<sup>229</sup> P Ascroft, "The Criminal Aspects of Tax Evasion in New Zealand", (2010) Vol 16.1 *New Zealand Journal of Taxation Law and Policy* 21.

<sup>230</sup> The writer conducted various searches of databases on articles dealing with the Compliance and Penalty Regime. From these searches to my knowledge, the quoted articles are the only ones that deal with this regime.

<sup>231</sup> See n 227.

<sup>232</sup> See n 227 and AJ Sawyers submission on Taxpayer Compliance, Penalties, and Dispute Resolution Bill 9 November 1995. Note the writer was unable to obtain Sawyer's submissions to the Inland Revenue in October 1994 in respect of the earlier discussion documents.

<sup>233</sup> See n 227.

who do not comply.<sup>234</sup> These objectives involved the principles of fairness, efficiency, clarity and effectiveness. In respect of criminal penalties he viewed that: sanctions are to be consistent with the seriousness of the offence (fairness), standards must be enforceable and penalties imposed without undue costs (efficiency) sanctions are consistent across Inland Revenue Acts (clarity) penalties should deter future non-compliance and those compliance standards must be in line with community standards (effectiveness).<sup>235</sup>

As to the provisions for the publication of non-compliant taxpayers, Sawyer commented that “*the literature supports the publication of names of non-compliers as a mechanism with the potential to improve compliance, provided it is accompanied by formal sanctions*”.<sup>236</sup> These sanctions are effective for those taxpayers where professional integrity and reputation are vital to maintaining society’s expectation of their image.

One pessimistic comment in respect of the proposed regime was Sawyer’s concerns that taxpayers would incur the costs of recovering fines, penalties and/or additional tax due to the negligence of that adviser. Sawyer also noted as a consequence of submissions made to the Select Committee and despite efforts made to raise the standard expected of tax advisers, taxpayers are left to litigate against their advisers as a consequence of negligent advice. His original suggestion was that direct action against the advisers by Inland Revenue as opposed to taxpayers where it could “readily establish negligence” would be more cost effective method. With due respect Inland Revenue would then be required to undertake civil litigation under the guise of negligence, which requires the Revenue to prove that the adviser had a duty of care to the Inland Revenue. Civil litigation as is tax litigation is an expensive and time consuming matter and those costs would ultimately fall on the public purse.<sup>237</sup>

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<sup>234</sup> See n 227.

<sup>235</sup> See n 227.

<sup>236</sup> See n 227.

<sup>237</sup> The legal costs of the Penny & Hooper case involving tax avoidance are such that other professionals in that Industry are assisting the litigants in their legal costs available at [www.highbeam.com](http://www.highbeam.com) (as at July 20 2010).

Sawyer expected that Inland Revenue and the Government undertake educational programmes once the final version of the regime was completed. The rationale was that given the vast changes that the New Zealand tax regime had undergone, the New Zealand tax system was not well understood by either taxpayers and or their advisers. Given the subsequent findings of the Inquiry into the Inland Revenue<sup>238</sup> was Inland Revenue expecting too much of taxpayers and their advisers.

In both his published article and his submission to the select committee Sawyer noted the absence of a standard for the Commissioner.<sup>239</sup> The regime could therefore be seen as “a one way street approach.”<sup>240</sup> As such there was no appropriate balance of rights and obligations of the taxpayer as compared to the possible creation of statutory and judicially enforceable obligations as against the Commissioner.<sup>241</sup> This one way street remains a thorn of contentions given the ability of the Commissioner and his delegated officers to remain outside the scope of civil redress.<sup>242</sup> However, Inland Revenue investigators are often the only face of Inland Revenue at times, deal with complex legislation and often confront those taxpayers and particularly advisers who choose deliberately to abuse their obligation to pay tax.

Sawyer further viewed that it is imperative that taxpayers and advisers become intricately aware of the regime.<sup>243</sup> One reason was that the final draft legislation was pro-revenue, because it was the New Zealand Government that had initiated the changes.<sup>244</sup> Penalties when viewed as a group reflected a harsh regime which would require high standards of compliance initially from taxpayers and subsequently advisers, otherwise, costs in terms of a civil penalty and use of money interest would be substantial.

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<sup>238</sup> Inland Revenue. Inquiry into the Powers and Operations of the Department of Inland Revenue. Report of the Finance and Expenditure Committee (October 1999).

<sup>239</sup> See n 227.

<sup>240</sup> See n 227.

<sup>241</sup> See n 227.

<sup>242</sup> See n 227.

<sup>243</sup> See 227, p 521.

<sup>244</sup> See n 227.

Lastly, Sawyer realised that the penalty provisions of the Income Tax Act 1976 was long over-due for a comprehensive overhaul. The Compliance and Penalty Regime provided a positive approach to creating a benchmark standard of reasonable care and in reforming, correcting and strengthening taxpayers' obligations. To Sawyer those obligations were to be taken seriously and honestly.<sup>245</sup>

### **4.3.2 Devos's Work**

#### **4.3.2.1 Findings**

Devos's study was published in 2004 and he noted that as with most compliance regimes, a common feature was "the existence of a formal penalty regime for taxation offences".<sup>246</sup>

He defines taxpayer non-compliance as "general breaches of the Tax Administration Act 1994 as set out in the annual reports of the Inland Revenue". Using a series of Inland Revenue Audit results from 1985-1986 to 2000-2001 Devos compared the audits results – the actual investigations (excluding GST Audits) together with actual fines, average income and the prosecutions to determine whether the Compliance and Penalty Regime introduced in April 1997 had a deterrent effect on New Zealand taxpayers. His conclusions were that:

- Taxpayer non-compliance in NZ decreased marginally over the period examined (65% in 1985-86 to 53% in 2000-01 (See Table 4.1); for over half of the taxpayers audited, a material discrepancy was discovered.
- From a community perspective and government point of view, this rate of taxpayer non-compliance is arguably still unacceptable. Tax evasion is not a victimless crime and indeed, as evasion increases, honest taxpayers shoulder an increased burden that includes the taxes not paid by the evaders plus the resources consumed by Inland Revenue in its attempts to collect those taxes.
- The relatively high levels of non-compliance have remained notwithstanding the

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<sup>245</sup> See n 227, p 440.

<sup>246</sup> See n 173.

increase in the number of tax offences with statutory terms of imprisonment, doubling from 5 to 10 years during the period (see Table 4.4) and an increase in statutory fines post 1996-97, ranging from \$6,000 to \$50,000 (see Table 4.2). Table 4.3 (see below) also indicates that the majority of monetary penalties imposed for criminal taxation offences lacked the element of proportionality when compared to figures given for average weekly earnings.

- Results in Table 4.5 and Table 4.6 indicate that the deterrent effect of both custodial and non-custodial sanctions imposed by the Courts may have been found wanting. This is particularly so when one considers the view of the Court in *Maxwell v CIR*<sup>247</sup> that discusses imprisonment as the form of punishment that fits tax fraud, yet the statistics figures revealed that many offenders received only monetary fines or were discharged. Deterrence theory suggests that major violations of the tax laws ought to be punished with high penalties being imposed for tax fraud that ultimately shapes tax morals.<sup>248</sup> Unfortunately, the figures suggest that the Courts have not followed this approach.

Devos's acknowledged the limitations of his study given that the compliance figures were derived from the audited samples which are unlikely to be representative of the whole taxpayer population. Biases may also exist in the figures reported in Inland Revenue's Annual Reports. Despite these limitations, the results provide preliminary evidence of the possible effect of penalties upon maintaining and improving taxpayer compliance.

Devos's final conclusion was that from a tax policy viewpoint:

*“there must be a right balance between encouraging voluntary compliance and deterring wilful non-compliance. Therefore, the imposition and increase in penalties alone, perhaps, should rightfully be seen as only one part of an overall Compliance Strategy.”*

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<sup>247</sup> *Maxwell v CIR* (1959) 708 CA.

<sup>248</sup> L Feld and B Frey, “Deterrence and Morale in taxation Tax Morals: An Empirical Analysis. (Paper presented at the Centre for Tax System Integrity Third Annual Conference on ‘Response Regulation: International perspective on taxation’. Canberra, (24-25 July 2003).

Table 4.1 Level/Rate of Taxpayer Non-Compliance amongst those selected for Audit/Investigation in New Zealand.

<b>Year</b>	<b>Number of Taxpayer Investigations</b>	<b>Number of Non-Compliance<sup>249</sup></b>	<b>% of taxpayer Non-compliance</b>	<b>Annual % variation in taxpayer non-compliance</b>
1985-1986	23,440	15,236	65	
1986-1987	27,222	19,238	71	+6
1987-1988	35,940	24,439	68	-3
1988-1989	74,698	49,300	66	-2
1989-1990	131,734	97,483	74	+8
1990-1991	124,037	80,624	65	-9
1991-1992	71,488	50,042	70	+5
1992-1993	58,067	33,379	58	-12
1993-1994	36,608	23,063	63	+5
1994-1995	28,281	16,685	59	-4
1995-1996	77,099	46,259	60	+1
1996-1997	82,411	51,095	62	+2
1997-1998	92,540	44,419	48	-14
1998-1999	50,953	30,062	59	+11
1999-2000	43,479	21,740	50	-9
2000-2001	53,657	28,438	53	+3

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<sup>249</sup> Performance Delivery - effective case selection results in material discrepancy being identified in this number of cases. These taxpayers are selected because they are likely to be more at risk of being non-compliant.

Table 4.2: Maximum Statutory Fines and taxpayer Non-Compliance 1985 -2001.

<b>Year</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
1985-1986	65		21,012	15,000	15,000	6,000	25,000	6,000	25,000	50,000
1986-1987	71	+6	22,319	15,000	15,000	6,000	25,000	6,000	25,000	50,000
1987-1988	68	-3	23,178	15,000	15,000	6,000	25,000	6,000	25,000	50,000
1988-1989	66	-2	24,102	15,000	15,000	6,000	25,000	6,000	25,000	50,000
1989-1990	74	+8	25,196	15,000	15,000	6,000	25,000	6,000	25,000	50,000
1990-1991	65	-9	27,828	15,000	15,000	6,000	25,000	6,000	25,000	50,000
1991-1992	70	+5	28,659	15,000	15,000	6,000	25,000	6,000	25,000	50,000
1992-1993	58	-12	28,886	15,000	15,000	6,000	25,000	6,000	25,000	50,000
1993-1994	63	+5	29,544	15,000	15,000	6,000	25,000	6,000	25,000	50,000
1994-1995	59	-4	30,365	15,000	15,000	6,000	25,000	6,000	25,000	50,000
1995-1996	60	+1	31,412	15,000	15,000	6,000	25,000	6,000	25,000	50,000
1996-1997	62	+2	32,368	15,000	50,000	6,000	50,000	12,000	25,000	50,000
1997-1998	48	-14	33,800	15,000	50,000	6,000	50,000	12,000	25,000	50,000
1998-1999	59	+11	35,984	15,000	50,000	6,000	50,000	12,000	25,000	50,000
1999-2000	50	-9	36,816	15,000	50,000	6,000	50,000	12,000	25,000	50,000
2000-2001	53	+3	37,856	15,000	50,000	6,000	50,000	12,000	25,000	50,000

Key to Table 4.2.

1	Annual non-compliance rate
2	Annual variation in taxpayer non-compliance
3	Average annual income
4	Maximum Fine under 143C and 143D TAA 1994
5	Maximum Fine under 143H TAA 1994
6	Maximum Fine under 143F TAA 1994
7	Maximum Fine under 143A TAA 1994
8	Maximum Fine under 143[1] TAA 1994
9	Maximum Fine under 145 TAA 1994
10	Maximum Fine under 143B TAA 1994

Table 4.3: Average penalty imposed by the courts and taxpayer non-compliance 1985 -2001.

<b>Year</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
1985-1986	65		21,012	1,105	7.30	7.30	18.41	4.42	18.41	4.42
1986-1987	71	+6	22,319	1,165	7.76	7.76	19.42	4.66	19.42	4.66
1987-1988	68	-3	23,178	1,729	11.52	11.52	28.82	6.92	28.82	6.92
1988-1989	66	-2	24,102	1,770	11.80	11.80	29.50	7.08	29.5	7.08
1989-1990	74	+8	25,196	3,729	24.86	24.86	62.15	14.92	62.15	14.92
1990-1991	65	-9	27,828	3,274	21.83	21.83	54.57	13.10	54.57	13.10
1991-1992	70	+5	28,659	3,897	25.98	25.98	64.95	15.59	64.95	15.59
1992-1993	58	-12	28,886	4,446	29.64	29.64	74.10	17.78	74.10	17.78
1993-1994	63	+5	29,544	5,088	33.92	33.92	84.8	20.35	84.80	20.35
1994-1995	59	-4	30,365	9,833	65.55	65.55	100	39.33	100	39.33
1995-1996	60	+1	31,412	5,861	39.07	39.07	97.78	23.47	97.78	23.47
1996-1997	62	+2	32,368	5,201	34.67	10.40	86.68	10.40	86.68	20.80
1997-1998	48	-14	33,800	15,965	100	31.93	100	31.93	100	63.86
1998-1999	59	+11	35,984	31,464	100	62.93	100	62.93	100	100
1999-2000	50	-9	36,816	12,370	82.46	24.74	100	24.74	100	49.48
2000-2001	53	+3	37,856	33,075	100	66.15	100	66.15	100	100

Key to Table 4.3.

1	Annual non-compliance rate
2	Annual variation in taxpayer non-compliance
3	Average annual income
4	Average fine imposed under s 143 to 145 TAA 1994
5	Average fine expressed as a % of the maximum fine [\$15,000.00] set by legislature under s 143 and 143D TAA 1994
6	Average fine expressed as a % of the maximum fine [\$15,000.00] set by legislature under s 143H TAA 1994 [\$50,000.00 post 1995 -1996]
7	Average fine expressed as a % of the maximum fine [\$6,000.00] set by legislature under s 143F TAA 1994
8	Average fine expressed as a % of the maximum fine [\$25,000.00] set by legislature under s 143A[8] TAA 1994 [\$50,000 post 1995 -1996]
9	Average fine expressed as a % of the maximum fine [\$6,000.00] set by legislature under s 143[1] TAA 1994 [\$12,000 post 1995 -1996]
10	Average fine expressed as a % of the maximum fine [\$25,000.00] set by legislature under s 145 TAA 1994

Table 4.4 Maximum Statutory Term of Imprisonment and taxpayer non-compliance 1985 -2001.

	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>
Year									
1985-1986	65		N/A	1	1	N/A	3	N/A	5
1986-1987	71	+6	N/A	1	1	N/A	3	N/A	5
1987-1988	68	-3	N/A	1	1	N/A	3	N/A	5
1988-1989	66	-2	N/A	1	1	N/A	3	N/A	5
1989-1990	74	+8	N/A	1	1	N/A	3	N/A	5
1990-1991	65	-9	N/A	2	2	N/A	3	N/A	7
1991-1992	70	+5	N/A	2	2	N/A	3	N/A	7
1992-1993	58	-12	N/A	2	2	N/A	3	N/A	7
1993-1994	63	+5	N/A	2	2	N/A	3	N/A	7
1994-1995	59	-4	N/A	2	2	N/A	3	N/A	7
1995-1996	60	+1	N/A	2	2	N/A	3	N/A	7
1996-1997	62	+2	3	1	1	2	3	N/A	10
1997-1998	48	-14	3	1	1	2	3	N/A	10
1998-1999	59	+11	3	1	1	2	3	N/A	10
1999-2000	50	-9	3	1	1	2	3	N/A	10
2000-2001	53	+3	3	1	1	2	3	N/A	10

Key to Table 4.4.

1	Annual non-compliance rate
2	Annual variation in taxpayer non-compliance
3	Number of tax criminal offences with 6 months maximum imprisonment term
4	Number of tax criminal offences with 1 year maximum imprisonment term
5	Number of tax criminal offences with 2 year maximum imprisonment term
6	Number of tax criminal offences with 5 year maximum imprisonment term
7	Number of tax criminal offences with 10 year maximum imprisonment term
8	Number of tax criminal offences with 20 year maximum imprisonment term
9	Number of tax criminal offences with 5 year maximum imprisonment term [columns 4 to 9]

Table 4.5: Convictions and Sentencing for tax Offences and taxpayer Non-Compliance 1985 - 2001.

<b>Year</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
1985-1986	65		3,133	50	279	21	56	796	13	1215
1986-1987	71	+6	2,230	45	273	18	55	637	21	1049
1987-1988	68	-3	1,927	49	254	38	50	590	24	1002
1988-1989	66	-2	2,487	39	331	57	65	606	58	1156
1989-1990	74	+8	1,419	58	459	90	70	642	65	1384
1990-1991	65	-9	1,344	32	11	4	5	260	4	316
1991-1992	70	+5	2,850	64	22	8	5	467	7	573
1992-1993	58	-12	6,814	104	35	12	12	930	12	1105
1993-1994	63	+5	5,096	130	34	14	9	1308	12	1507
1994-1995	59	-4	4,389	122	34	15	10	1224	12	1417
1995-1996	60	+1	3,710	74	20	10	8	870	8	990
1996-1997	62	+2	2,471	53	28	14	14	480	8	597
1997-1998	48	-14	2,464	62	39	14	8	418	10	551
1998-1999	59	+11	2,105	40	24	13	9	336	10	432
1999-2000	50	-9	2,282	39	43	14	12	386	11	505
2000-2001	53	+3	3,823	29	41	12	14	389	12	497

Key to Table 4.5

1	Annual non-compliance rate
2	Annual variation in taxpayer non-compliance
3	Number of persons receiving convictions
4	Convictions and discharge
5	Custodial and periodic Detention
6	Community service programs
7	Supervision
8	Monetary
9	Deferment
10	Number of cases where penal tax imposed

Table 4.6 Type and number of offences against the Inland Revenue Acts and taxpayer non-compliance 1985 -2001.

<b>Year</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
1985-1986	65		82	2812	4	32	182	0	1	20
1986-1987	71	+6	47	2259	4	1	99	4	1	15
1987-1988	68	-3	66	1525	5	3	112	2	0	9
1988-1989	66	-2	81	1238	7	5	103	1	0	3
1989-1990	74	+8	62	691	7	0	123	0	1	2
1990-1991	65	-9	34	278	1	0	50	0	0	3
1991-1992	70	+5	14	436	0	0	40	1	0	7
1992-1993	58	-12	22	522	12	N/A	50	2	2	4
1993-1994	63	+5	37	894	4	N/A	134	0	2	10
1994-1995	59	-4	27	1166	1	N/A	36	0	0	1
1995-1996	60	+1	7	904	4	N/A	18	0	0	2
1996-1997	62	+2	19	361	1	N/A	22	0	0	3
1997-1998	48	-14	12	399	2	N/A	0	0	0	0
1998-1999	59	+11	5	349	0	N/A	4	0	0	0
1999-2000	50	-9	7	260	2	N/A	7	0	0	0
2000-2001	53	+3	7	553	1	N/A	20	0	0	4

Key to Table 4.6.

1	Annual non-compliance rate
2	Annual variation in taxpayer non-compliance
3	Wilfully or negligently furnishing false returns [ s 143A TAA 1994]
4	Failure to furnish income tax returns [s 143[1] TAA 1994]
5	Aiding, abetting, or inciting the making of false returns [s 148[1] TAA 1994]
6	Failure to produce records when required [s 143[1] TAA 1994]
7	Failure to deduct or account for PAYE deductions [s 143A TAA 1994]
8	Furnishing false tax code declarations [s 143B TAA 1994]
9	Wilfully misleading the Commissioner [s 143B TAA 1994]
10	Aiding or abetting or failure to account for PAYE deductions [s 148[1] TAA 1994]

#### **4.3.2.2. Its Limitations**

Although his results are insightful, there appears to be a number of limitations in his study. Devos's study used investigations and material discrepancies from such investigations as the initial foundations of his findings. Firstly, Inland Revenue during those periods used an Output Model (see Appendix 4, which will be discussed in greater detail in Chapter 5) for the funding of Taxpayer Audit.<sup>250</sup> Secondly, it is essential to understand how Inland Revenue actually selects investigations. Investigations can result from computer based software programs using a score or rating determined by the risk associated with each industry and comparisons of the financial accounts ratios.<sup>251</sup> As an example, if the Industry is cash based, the level of the Industries Gross Percentage is one indicator used to determine whether an investigation is to commence.<sup>252</sup> In respect of GST refunds, they are screened by an investigator to detect potential fraud.<sup>253</sup> Inland Revenue also receives anonymous information about taxpayers who attempts to cheat the Revenue by not paying the correct amount of tax. Again, an experienced investigator will then review the anonymous information about a taxpayer and will select only those cases with a high risk of discrepancies.<sup>254</sup> Investigations also arose from knowledge of an industry and/or experienced gained from years as an investigator.

In summary, given the requirements of the Output Agreement and the method of selection of investigations, it is rational to expect that material discrepancies will arise each year. Given these conclusions it was to be expected that Devos would conclude that the rate of taxpayer non-compliance each year would be unacceptable.

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<sup>250</sup> The Output Model is an agreement reached between the Minister of Revenue and the Commissioner of Inland Revenue for funding of their operations. Refer to Appendix 4.

<sup>251</sup> M Nel, "An Analysis of the Compliance Approach used by Revenue Authorities with Specific Reference to Case Selection and Risk Profiling". (A Thesis submitted in fulfilment of the requirements for the degree of Masters in Commerce Taxation 2004 Rhodes University South Africa) p 35-36 available at [eprints.ru.ac.za/964](http://eprints.ru.ac.za/964) (as at 30 June 2010).

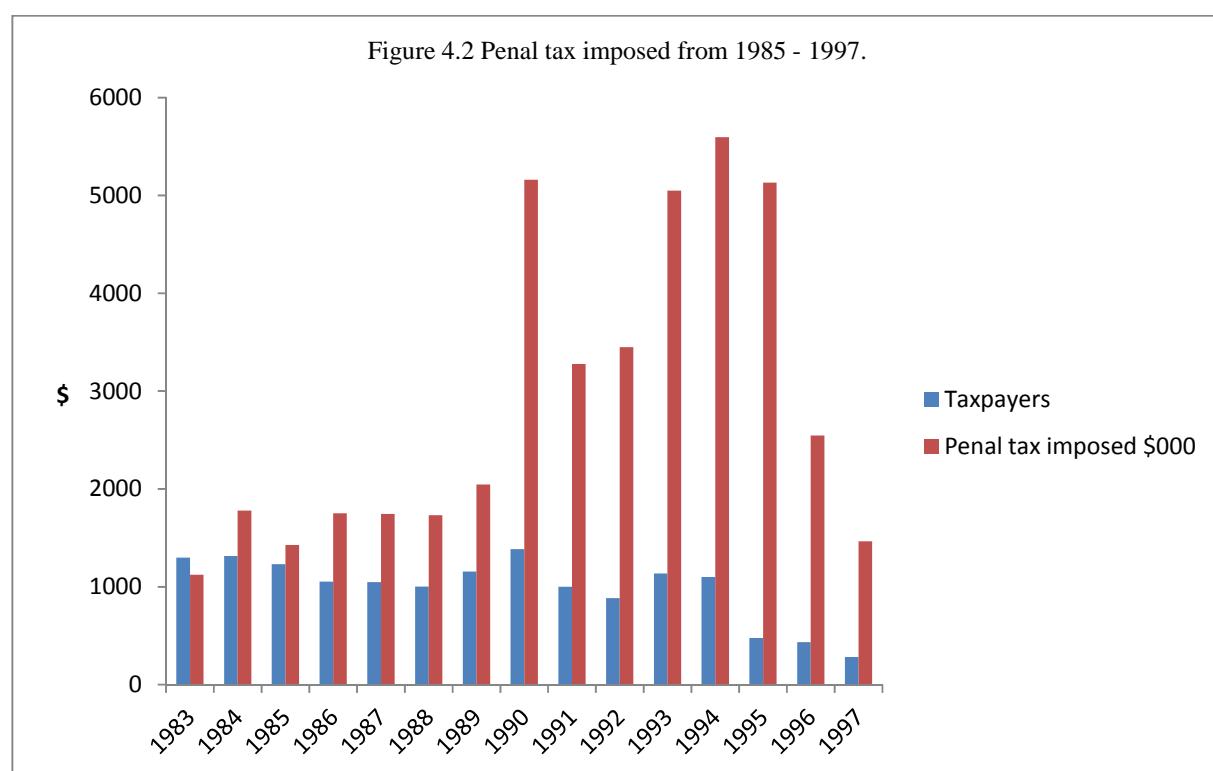
<sup>252</sup> Gross percentage is accounting formulae of Gross Sales Less Cost of Goods sold.

<sup>253</sup> See n 251, pp 29-30.

<sup>254</sup> Controller and Auditor-General Inland Revenue Department: Performance of Taxpayer Audit (July 2003), p 47.

Devos made the point that even with the introduction of the penalty regime the level of non-compliance is still high. However, he failed to consider the implications in the change in Taxpayer Audit which occurred in this period and the findings of the Audit Office review of Inland Revenue Audit.<sup>255</sup> Penal tax is imposed under the provisions of section 420 of the Income Tax Act 1976 when the Commissioner has discretion to impose (subject to a case stated appeal to the Taxation Review Authority) a penalty of up to 300% of the deficient tax.

Figure 4.2<sup>256</sup> sets out the penal tax imposed from 1983 – 1997.



The Audit Office Report of November 1987 found significant shortcomings in the application of penal tax.<sup>257</sup> As shown in Figure 4.2 Inland Revenue imposition of penal tax began to climb significantly after that Audit Office Report in 1990 and then from 1991 to 1994. Interesting questions could be raised at this stage. Was the subsequent increase in the imposition of penal tax a consequent of the report? Was the change in Taxpayer Audit

<sup>255</sup> See n 39, p 32.

<sup>256</sup> Inland Revenue Department Annual Reports 1983 – 1997.

<sup>257</sup> See n 39, p 32.

structure an influence on the increase in penal tax imposed? As a consequent, had Inland Revenue increased its focus on tax evasion, and adopted a more aggressive approach in respect of material discrepancies due to this report?

Although one can agree with the concept that monetary penalties alone will not diminish non-compliance, what Devos's failed to question and explain is what is a material discrepancy? In fact, Inland Revenue has not in any of its Annual Reports during Devos's study defined this term. As shown in the Inland Revenue Statistics (see Chapter 5 Figure 5.1) tax discrepancies each year continue to grow. Was this continual growth due to the requirement to obtain budgetary and material discrepancy often in excess of 45% of major investigation cases?<sup>258</sup>

Devos's study dealt exclusively with the prosecution of taxpayers for breaches of the Inland Revenue Acts and those cases that the Department considered that an offence under the Crimes Act 1961 had been committed. One has to remember that the decision to prosecute is discretionary which brings with it the elements of evidential issues.<sup>259</sup> Also, the decision to prosecute may be different for each Regional Office. As an example, the Regional Office dealing with the Horticultural Industry would have a higher rate of prosecutions given the location of the Kiwifruit Industry. Various offences such as failure to furnish returns are subject only to the legal standard of strict liability and it is the discretion of the Courts to impose a custodial sentence.<sup>260</sup>

In addition, Devos's study did not show which areas a material discrepancy were ascertained. This distinction is important as since 1996, Inland Revenue (see Appendix 5) has set out in its Annual reports and various other publications the areas of audit focus.<sup>261</sup> If the material discrepancies are primarily centred on the same areas such as the cash

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<sup>258</sup> Inland Revenue Department Annual Report 2002, p 95.

<sup>259</sup> Evidential Issues include the quality of evidence, the quality of investigation work papers, and the ability of the officer's to create a case for a successful prosecution.

<sup>260</sup> Strict liability is a legal concept that does not require mens rea – simply failing to furnish a tax return is an offence. Section 143 of the Tax Administration Act 1994 refers.

<sup>261</sup> Inland Revenue: The Way Forward 2010-2013.

economy that the Inland Revenue was targeting, then the increase may indicate a more successful Inland Revenue Compliance Strategy.

Finally, Devos also reflected on the Court's approach to custodial as opposed to monetary penalties. The number of convictions does not necessarily indicate whether sanctions had an impact upon taxpayer compliance, as it is possible that the impression of the Courts' preference is for monetary penalties.<sup>262</sup>

#### **4.3.3 Ascroft's Study**

A more recent study by Philip Ascroft was published in March 2010.<sup>263</sup> Ascroft viewed that, the penalties regime in the Tax Administration Act 1994 Act introduced a much more systematic approach to penalties. Significant frauds and or evasive schemes were to be prosecuted, as the Inland Revenue had to use the Crimes Act 1961 to prosecute taxpayers involved in filing fraudulent GST returns. The Tax Acts had no corresponding provision. His commentary pointed out that case law and by analogy the seriousness of the crime was a starting point for sentencing.<sup>264</sup>

Irrespective of which Act was cited in the charges, few cases exists where the maximum penalty was imposed. Discounts were allowed for showing remorse, lack of prior convictions, guilty pleas, assisting in the investigation; difficult personal circumstances, and a wide variety of other factors.

Further, Ashcroft pointed out:<sup>264</sup>

*"It takes time for a pattern of prosecution and appropriate procedures to develop. If Inland Revenue consistently used s 143B Tax Administration Act 1994 to prosecute*

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<sup>262</sup> See n 229.

<sup>263</sup> *Clemm v CIR* (2005) 22 NZTC 19,495 (HC) *R v Hunter* (2002) 20 NZTC 17,784 (CA), *R v Rose* (1990) 2 NZLR 552 (CA) and *Cole v Police* (2001) 2 NZLR 139 (HC).

<sup>264</sup> See n 229.

*serious tax offenders, then the section would gain prominence as the primary section for dealing with tax evaders.”*

In his article he sets out that the imposition of criminal penalties reflects:

*“elements of a moral justification and an unfair competitive advantage suggests that a criminal offence may be appropriate to reflect society’s disgust and outrage at those who deliberately evade paying their taxes.”*

However, given the ability of the Inland Revenue to lay charges under either Act, it is this discretion or lack of precise data which as Ascroft pointed out creates further ambiguity. As an example, Inland Revenue use of prosecution for GST fraud was due historically to the fact that in the original legislation for GST there existed no term of imprisonment for an offence of filing a false GST return. Instead Inland Revenue laid charges under the Crimes Act 1961 in the context of GST returns.

Ascroft further noted that the Tables produced in the Annual Reports were open to interpretation as to which Act the Inland Revenue used in its prosecution and media releases were written in a non-technical manner without reference to the relevant statutes.<sup>265</sup> Given studies that indicated tax evasion was perceived as less serious than other comparable crimes,<sup>266</sup> Ascroft questioned either; the Inland Revenue use whenever possible the tax statutes in its prosecutions which would clearly identify what the offender had done or increased the maximum penalties under the Statute.<sup>267</sup>

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<sup>265</sup> See n 229, p 43.

<sup>266</sup> R Gupta, “How Perceptions of Tax Evasion as a Crime and other Offences Mirror the Penalties”, (2007) Vol 13:4 *New Zealand Journal of Taxation Law and Policy* 607.

<sup>267</sup> See n 229, p 45.

## **4.4 SUMMARY**

The Compliance and Penalty Regime is neither based solely on the deterrence and/or behaviourists theories. Rather, it is a mixture of both. As a deterrent, the Regime was necessary to combat tax evasion and tax avoidance by increasing the level of penalties imposed. It was also behavioural, in the desire to influence taxpayer behaviour.

Sawyer saw the Compliance and Penalty Regime as a far reaching and significant “effort of revamping the obligations of taxpayers, and increasing the severity of the consequences for failing to achieve and maintain those obligations”.<sup>268</sup> Although the regime did not address the issue of negligence by taxpayer agents, it was skewed in favour of the revenue. The need for sound preparation by agents and taxpayers in considering their tax obligations is fundamental to compliance with the regime. There existed a critical need to educate those taxpayers and tax agents given the monetary penalties involved should the taxpayer fail to comply with the legal standards within the regime.

Although limitations exist in Devos’s findings, it is the quality of data that the tax authorities retain in respect of those cases that hinder further in-depth analysis. He acknowledges other limitations of his study as the audited samples are unlikely to be representative of the whole taxpayer population and biases may even exist in the figures reported in Inland Revenue’s Annual Reports. However, Devos’s final conclusion that the imposition and increase in penalties alone should rightfully be seen as only one part of an overall Compliance Strategy is correct.

Ashcroft article sets out that additional data is required to really sustain any conclusion as to whether the criminal sanctions require modification.<sup>269</sup> Inland Revenue holds significant data concerning both the taxpayer profiles and the section used in the prosecution of taxpayers who have breached their obligations under sections 143A and 143B of the Tax Administration Act 1994.

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<sup>268</sup> See n 227.

<sup>269</sup> See n 229.

Since the introduction of the Compliance and Penalty Regime, the Inland Revenue has begun to publish not just within its Annual Reports, but a series of other publications,<sup>270</sup> which set out its success, aims and obligations to achieving voluntary compliance as an accepted expectation of society. As an example, commencing in December 2004, the Inland Revenue Communications Unit began publishing extracts of successful prosecutions of taxpayers for tax offences committed.

Given the increase in publication by Inland Revenue of its Compliance Strategy and results, an analysis of the published data is used to ascertain the effectiveness of the Compliance and Penalty Regime to deter criminal tax fraud. The findings are reported in the next two chapters. The review spans the period since the introduction in April 1997 until the year ending 30 June 2010.

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<sup>270</sup> Inland Revenue: The Way Forward is an Inland Revenues pronouncement of its goals towards achieving its obligations to Government. It was first published in July 2001.

## **Chapter 5**

### **Inland Revenue Compliance and Penalty Strategy to Criminal Tax Fraud - An Evaluation (Part 1)**

#### **5.1 Introduction**

The number of issues can be raised regarding the Inland Revenue's published data and the adoption of the Compliance Triangle. An overview of these issues is discussed in this section followed by more detail discussions in other chapters.

#### **5.2 Overview of Inland Revenue Published Data**

A number of issues can be raised regarding the Inland Revenue's published information and the Compliance Triangle. An overview of these issues is discussed in this section.

Since the introduction of the Compliance and Penalty Regime and the adoption of the Compliance Triangle, there is insufficient research (except for those mentioned in Chapter 4) or quantitative data provided by Inland Revenue that shows whether the regime has been effective in reducing non-compliance. Was this due to a lack of available data or that Inland Revenue's Compliance Strategy has a limitation in its application.

Inland Revenue's strategy in respect of criminal tax fraud appeared to lack a statistical precision. First, access to the data is restricted in terms of the provisions of section 81 of the Tax Administration Act 1994.<sup>271</sup> Even when the data is published in the Inland Revenue Annual Reports of offences committed, details as to which Acts or within each of

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<sup>271</sup> Section 81 of the Tax Administration Act 1994 requires the Inland Revenue to restrict the tax details of taxpayers to, taxpayers, their agents or those duly authorized to receive it.

these Acts the relevant sections of these offences were committed were not disclosed.<sup>272</sup> Second, within the published data on audits, there is an inconsistency as over time the Inland Revenue changed its measurement basis from number of audits to complete to one of budget hours.<sup>273</sup> Thus change which took place following the 2000/2001 financial year makes comparison of audits from 2002 onwards difficult. This issue of data integrity will be further addressed in later sections of this chapter.

An analysis of tax evasion imposed under section 141E of the Tax Administration Act 1994 since the 1<sup>st</sup> of April 1997 revealed that since the introduction of the Compliance and Penalty Regime tax evasion as a percentage of total shortfall penalties had remained constant from 14.36% to 14.96%.<sup>274</sup> However the \$ dollar amount of tax evasion per taxpayer rose from \$2,365.57 to \$10,210.47.<sup>275</sup> One may question whether this statistic indicates fraud is on the increase per taxpayer. Or whether it is due to the audits cover more periods per taxpayer? These questions in relation to statistical information raises an uneasiness about Inland Revenue's reporting methods.

A final question that could be raised is - what is really driving the Inland Revenue's Compliance and Penalty Strategy? Is it the desire to combat criminal fraud, or is it the Output Agreements<sup>276</sup> that Inland Revenue enters into each year to delivery an ever increasing tax discrepancy to Government?<sup>277</sup>

### **5.3 Inland Revenue Strategy based on the Compliance Triangle**

As mentioned in Chapter 3, the Compliance Model which is made up of the pyramid (or triangle), and BISEP, is central to the Tax Compliance Strategies in Australia, New Zealand

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<sup>272</sup> See n 228, p 43.

<sup>273</sup> Inland Revenue Department Annual 2002, pp 93 -95.

<sup>274</sup> Inland Revenue Annual Reports 1998 - 2009.

<sup>275</sup> Inland Revenue Annual Reports 1998 - 2009.

<sup>276</sup> See Appendix 4 Purchase Agreement between Minister of Revenue and Commissioner.

<sup>277</sup> See Appendix 5 Material Discrepancies.

and Great Britain.<sup>278</sup> This concept segments taxpayers into different groups according to their willingness and capacity to voluntarily comply with the law. The tax authorities then choose different measures for different groups.

The model asserted that the taxpayers take various tax positions, either fully compliant (located at the base of the triangle), to one of fully non-compliant (located at the top of the triangle). The Revenue's primary aim is to use the appropriate response for each tax position taken by the taxpayer, either by means of education and assistance for those at the bottom, or to use the full force of the law for those at the top of the pyramid.

The primary and central purpose of the Revenue is to move non-compliant taxpayers' to the bottom of the pyramid. This model and its theoretical foundations were adopted by the Australian Tax Office in 1998 and subsequently by New Zealand's Inland Revenue in 2002.<sup>279</sup>

This theoretical framework was termed as<sup>280</sup> “*responsive regulation*”, and the Revenue was to strike a balance between the deterrence and accommodative models of regulation.<sup>281</sup> The Inland Revenue began to evaluate the range of opportunities that taxpayers had for non-compliance with the tax system, and to focus their resources on tax evasion and tax fraud.<sup>282</sup> But is this strategy effective. An actual case scenario is that of Andrew John Caddy.<sup>283</sup> This taxpayer was previously investigated by the Inland Revenue Department, but changed

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<sup>278</sup> I Ayres and J Braithwaite, 1992 *Responsive Regulation, Transcending the Deregulation Debate*, pp3-53 Oxford University Press, New York and Improving Tax Compliance in the Cash Economy Australian Tax 1998, p 52 and K Murphy Moving Towards a more effective Model of Regulatory Enforcement in the Australian Taxation Office. (Centre for Tax System Integrity Research School of Social science Australian National University Working paper 45 November 2004).

<sup>279</sup> Inland Revenue Department Annual Report 2002, p 19.

<sup>280</sup> See n 185.

<sup>281</sup> An accommodative model is another term for a responsive model. If a Tax Authorities attempts to persuade taxpayers to comply as opposed to assuming they are motivated by self-interest and impose punitive penalties, resistance will follow. By using an accommodative approach it is less costly, and will elicit a more cooperative approach.

<sup>282</sup> Although leverage finance involved tax avoidance, it meant that the previous image of Inland Revenue not chasing large corporate was seen to be a philosophy of the past.

<sup>283</sup> Tax Offender used new identity to obtain GST refunds, *Media Release* (24 November 2010), available at <http://ird.govt.nz/aboutir/media-centre/media-releases/2010/media-release-2010-11-24.html> (as at 24 December 2010)

his name by deed poll to Andrew Skipper Kendell. Prior to changing his name, Andrew John Caddy had twice been bankrupted. Under his new identity, Andrew Skipper Kendell incorporated three companies, SKP Construction, Tuatara Farms and OMS Performance for the sole purpose of claiming GST refunds. He registered for GST in December 2004, and obtained \$153,000.00 in GST refunds. Upon Investigation by the Inland Revenue, charges were laid for GST tax fraud, and in November 2010, he was sentenced to 34 months in jail. Inland Revenue's commentary in respect of this prosecution was that, what made this offence worse was that it was the second time he had attempted to cheat on tax. It appears that Inland Revenue's previous response to Caddy's tax position did not change his future behaviour.

Although this is only one case, two questions arise: On a larger scale what investigations did Inland Revenue completed since the introduction of the Compliance and Penalty Regime and the adoption of the Compliance Triangle which either resulted in a prosecution or the imposition of a tax evasion shortfall penalty? In answer to the first question, Inland Revenue prosecutions were 6,264 while 9,104 evasion shortfall penalties were imposed.<sup>284</sup> This raises the second question, what research has been undertaken by Inland Revenue or other researchers that the initial contact and use of a persuasive response saw a movement by those taxpayers towards the bottom of the Compliance Triangle?<sup>285</sup>

The case of Penny and Hooper is a classic example of the Compliance Triangle and the responsive approach in action.<sup>286</sup> Ignoring the specific details of the case, the tax years in question were between 2000 and 2004. The case which is now at an appeal stage in the Supreme Court. The question raised is simply, if the appeal fails and Inland Revenue position that the arrangement is one of tax avoidance, will those taxpayers alter their tax position in future years and move down the Compliance Triangle. In fact, will all taxpayers

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<sup>284</sup> Inland Revenue Annual Reports 1988-2009 and Official Information Requests, Appendix 11.

<sup>285</sup> The writer has reviewed to the best of his ability all Discussion documents issued by the Inland Revenue located at Brookers web site, the Centre for Tax Integrity web site, Google Web sites and Massey's Google scholar as at 28 February 2011.

<sup>286</sup> See n 10.

involved in similar positions do likewise? This is the weakness in adopting the Compliance Triangle. A review of the tax returns could perhaps be undertaken to ascertain whether the previous arrangements ascertained by an investigation has continued. This will give an indication of the Inland Revenue's success in moving taxpayers like Penny and Hooper and Andrew Skipper Kendell towards the bottom of the Compliance Triangle. This matter will be further discussed in chapter 6.

## **5.4 Data Integrity**

### **5.4.1 Annual Reports**

The financial details that Inland Revenue publishes in its Annual Reports are required under the provisions of section 15 of the Tax Administration Act 1994 and section 39 of the Public Finance Act 1989. These Annual Reports are the first step in analysing whether Inland Revenue has been successful in combating criminal tax fraud. Therefore, it is critical that this information is precise, informative, and conveys that message that the stewardship that the Government has placed upon the Inland Revenue has been successfully carried out.

An examination of the Annual Reports setting out the prosecution of criminal tax fraud showed that it lacked precise information. In particular, it was not clear:

- Which sections of the Inland Revenue Acts or Crimes Act 1961 taxpayers were prosecuted under;<sup>287</sup>
- What was the true occupation of taxpayers that were prosecuted – for example the term company director adds little to the exact nature of the business that the “director” was involved in;
- What was the business category or industry in which those offences were committed;

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<sup>287</sup> See n 229, p 44.

- What amounts of funds were defrauded by those taxpayers, gross discrepancy and/or tax amount?
- Over what period of time the offences were committed. One year, two years?
- What amount of tax revenue was recovered, if any;
- In which Court were the offences trialled; and
- What the comments of the presiding judge were (in a District Court for example).

There are significant limitations on what inferences can be drawn from the information contained in these Annual Reports. Information which may help gauge the extent of non-compliance, ascertain the industries in which non-compliance exists, and the seriousness of the offences as viewed by the judiciary were missing.

In the Inland Revenue's Annual Reports tax offences are listed in terms of a written description of the offence. However, exact sections of the Acts those taxpayers were prosecuted is absent. As an example, Table 5.1 was sourced from Inland Revenue Annual Reports since 1983 and each report failed to set out the relevant statutory sections of the Income Tax Act 1976, Tax Administration Act 1994 and/or Crimes Act 1961 the relevant offence was prosecuted under.<sup>288</sup>

Table 5.1 Prosecution Under the Revenue Acts and the Crimes Act 1961 1983-2009.		
Type of offence	Pre Compliance and Penalty Regime	Post Compliance and Penalty Regime
Wilfully Furnishing False Returns	639	62
Aiding and Abetting PAYE	1362	216
Failure to Furnish returns of Income	16835	5816
Furnishing False GST returns	35	80
GST Fraud	36	41
Crimes Act	0	29

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<sup>288</sup> Inland Revenue Department Annual Reports 1983 – 2009.

Although the judgments at District Court trials are primarily verbal, Inland Revenue has extensive information as contained in its summary of facts, which provide precise and critical information as to the nature, extent and seriousness of the offending. Inland Revenue within its database for each case filed has information on the relevant tax periods involved, business activity that the taxpayer was conducting, gross income or taxable supplies omitted, core tax liability and shortfall penalties imposed. This information subject to the requirements of section 81 of the Tax Administration Act 1994 would provide a database for more in-depth evaluation of their strategy.

With the introduction of FIRST,<sup>289</sup> use of modern computer technology and with the data warehouse selections<sup>290</sup> this information can be easily extracted. The information would give an indication of the extent of non-compliance which can be based on the better Australian and New Zealand Standard Industry Classification codes (ANZSIC).<sup>291</sup>

As set out in Figure 5.1 the information from the Inland Revenue Annual Reports concerning tax discrepancies does not break down the discrepancies by revenue type – GST,

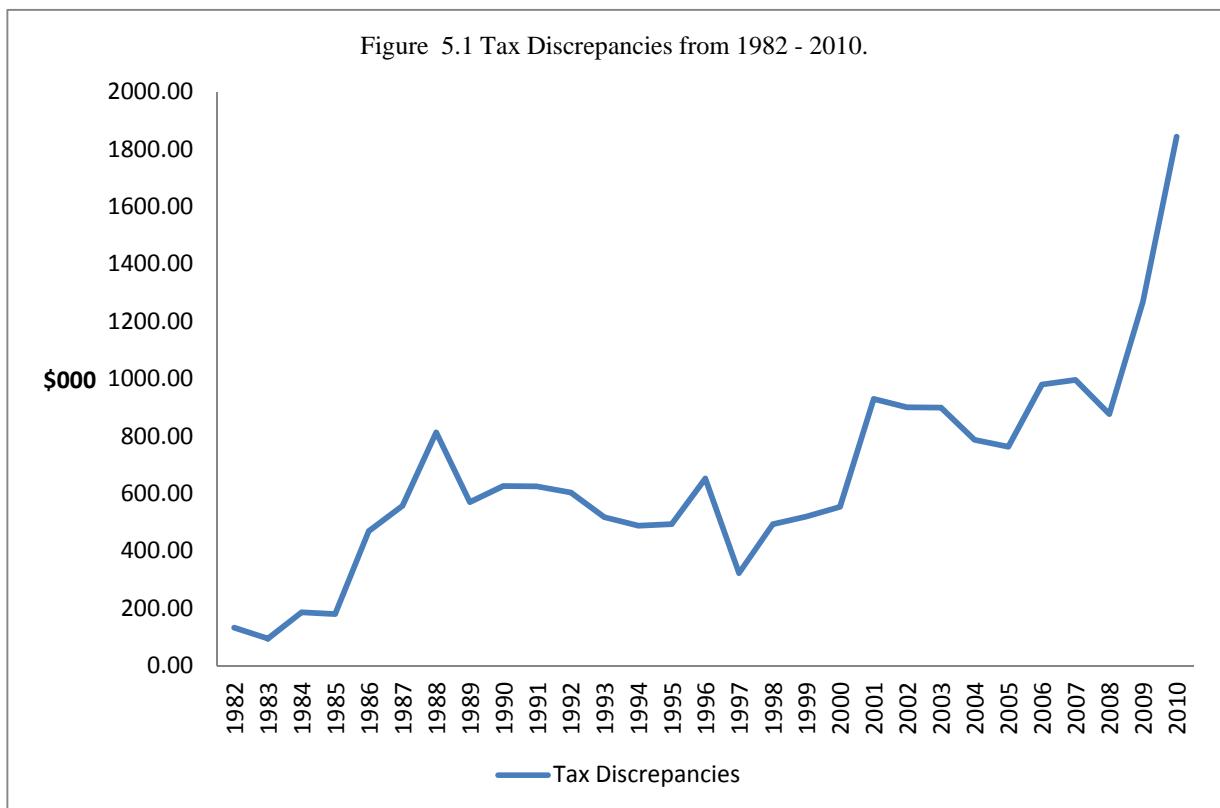
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<sup>289</sup> See p 31 which defines FIRST as Future Inland Revenue System Technology, which was the computer system introduced by Inland Revenue during the modernisation of Inland Revenue in the late 1980's and early 1990s.

<sup>290</sup> Report of the Controller General and Auditor-General Inland Revenue Department: Performance of Taxpayer Audit. (July 2003), Para 4.12.

<sup>291</sup> Australian and New Zealand Standard Industrial Classification code was developed by the Australian Bureau of Statistics and Statistics New Zealand in order to make it easier to compare Industry statistics.

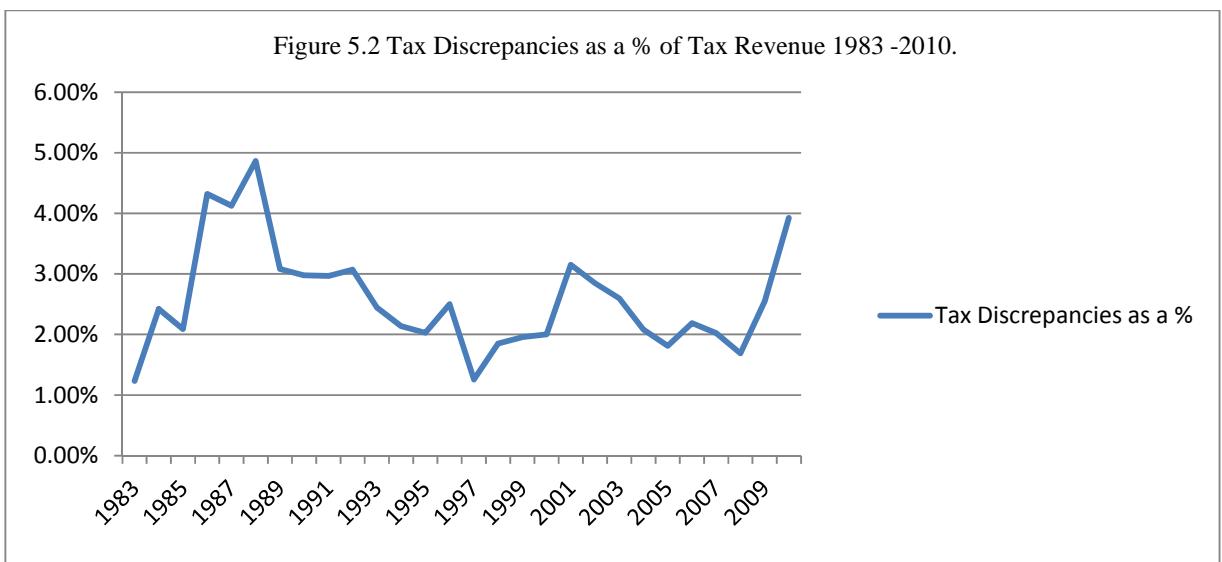
PAYE and Income tax or by Industry.<sup>292</sup>



A second issue is the percentage of tax discrepancies as compared to tax revenue which is set out in Figure 5.2.<sup>293</sup> The trend is that after the introduction of the Compliance and Penalty Regime as well as the adoption of the Compliance Triangle, tax discrepancies have also climbed as a percentage of tax revenue.

<sup>292</sup> Inland Revenue Department Annual Reports 1982 – 2010.

<sup>293</sup> Inland Revenue Department Annual Reports 1982 – 2010.



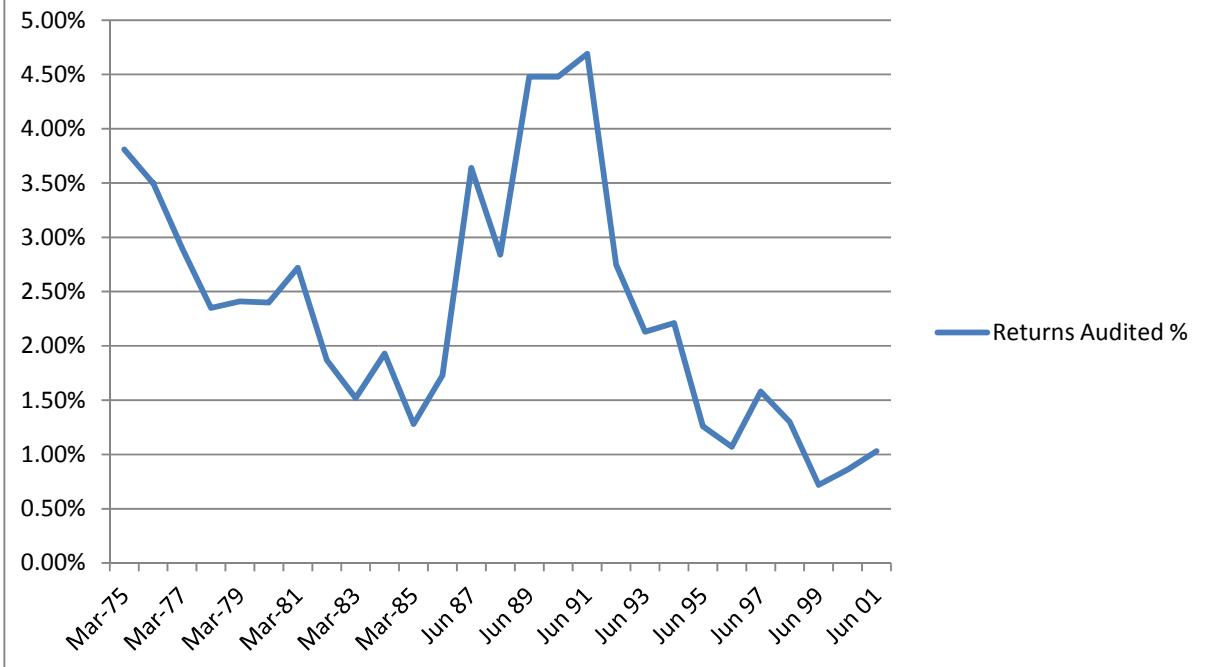
The second issue (which Devos<sup>294</sup> also confronted see Figure 5.3), was that after 2001, it was not possible to ascertain the percentage of returns audited as audit results were published in terms of budget hours to actual hours.<sup>295</sup> Given Devos's conclusion that the rate of material discrepancies was still not acceptable, it was not possible to trace for years after 2001 as hourly basis of audits as opposed to number of audits and the term material discrepancy was absent. What further complicates this issue (as shown in Table 5.10) is that Inland Revenue completes a variety of audits each year. Each audit has a set budget of hours for it to be completed in. Further, depending on the each sector, Non Business, Business Audit, Medium Business and Corporates complete similar types of audits.<sup>296</sup> Over time each of these audit units changed to become incorporated into one final Taxpayer Unit and it would be statistically incorrect to compare 1996 audit results with audit results for 2006.

<sup>294</sup> See n 228.

<sup>295</sup> Inland Revenue Department Annual Reports 1975-2001.

<sup>296</sup> Non Business Audit would for example have no hours allocated for an audit involving transfer pricing, whereas Corporates would.

Figure 5.3 Returns Audited as a % of returns filed from 1975 - 2001.



A third issue is that given the nature of our tax system under self-assessment, audits are backward focused. As an example, in the Taxation Review Case W33 Inland Revenue auditors commenced an investigation into the taxation affairs of a dentist in relation to the 1996 and 1997 years<sup>297</sup>. The case was finally heard in July 2003. Hence, it is unknown as to which period the tax discrepancies would be allocated. Was it in 1996, 1997 or 2003? What trend would exist in respect of those tax discrepancies if they were reported in the 1996 and 1997 period as opposed to 2003 year? In fact, how does Inland Revenue report its tax discrepancies and prosecutions each year and how would that reporting affect any trend in tax non-compliance is not known. This matter is discussed further in Section 5.4.3.

<sup>297</sup> W33 (2004) 21 NZTC 11,321.

## **5.4.2 Shortfall Penalties, Annual Reports and Official Information Requests 2006 -2009.**

The purpose of shortfall penalties was to set a standard that would require all taxpayers to act reasonably in the conduct of their tax affairs. That standard was the test of reasonable care, i.e. whether a taxpayer of ordinary skill and prudence would have foreseen as a reasonable probability or likelihood the prospect that an act (or failure to act) would cause a tax shortfall, having regard to all the circumstances.

The Committee of Experts agreed that a tax system, based on self-assessment, requires an effective statutory penalties regime to provide taxpayers with appropriate incentives to comply.<sup>298</sup> During the intervening period, as per Table 5.2 tax evasion and to a lesser extent gross carelessness dominated this period.<sup>299</sup>

Table 5.2 Shortfall Penalties Imposed 1998 – 2009.

Lack of Reasonable Care	\$37,001,584.00
Unacceptable Tax Interpretation/Position	\$30,911,022.00
Gross Carelessness	\$47,228,864.00
Abusive Tax Position	\$88,986,424.00
Tax Evasion	\$263,974,391.00
Total	\$468,102,285.00

As a consequence, as set out in Figure 5.4 tax evasion shortfalls as a percentage of those tax discrepancies continue to climb and was a significant percentage of the total tax shortfalls imposed during this period.<sup>300</sup> In 2006, Tax Evasion shortfalls amounted to \$143M out of total shortfalls of \$154M.

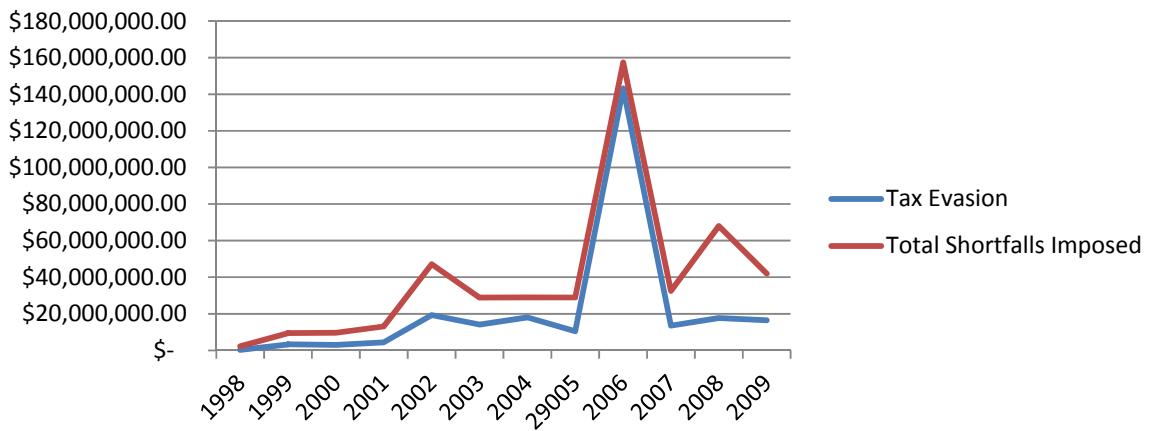
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<sup>298</sup> See n 101.

<sup>299</sup> Inland Revenue Department Annual Reports 1998 – 2006 and Official Information Requests 2007-2009.

<sup>300</sup> Inland Revenue Department Annual Reports 1998 – 2006.

Figure 5.4 Tax Evasion Shortfalls as compared to total Shortfalls Imposed as per Annual Reports 1998-2006 and Official Information Requests 2006-2009.



#### 5.4.3 Shortfall Penalties and Official Information Requests 1998 -2009

Under section 141L of the Tax Administration Act 1994 the Commissioner is required to reports to the Minister of Revenue of tax shortfalls imposed each year. This information unlike the Annual Reports is assessable only by a request under the Official Information Act 1982. As shown in Table 5.3 those reports reveal in terms of shortfalls imposed is a totally different picture to that issued in the Annual Reports.<sup>301</sup>

Table 5.3 Shortfall Penalties Imposed 1998 – 2009.

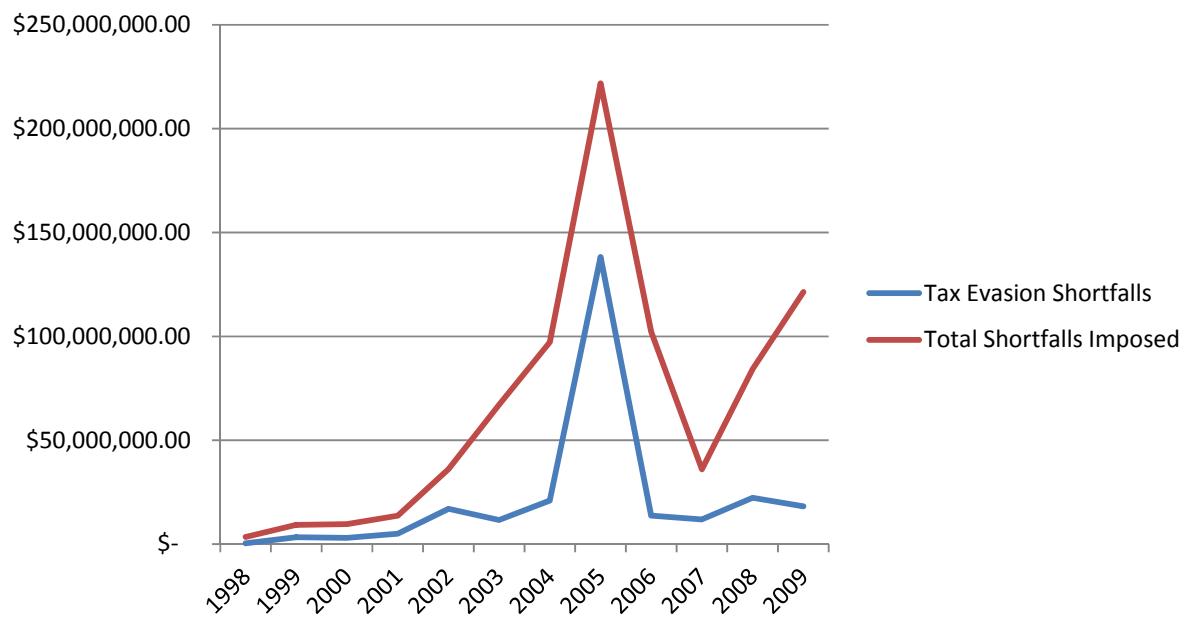
Lack of Reasonable Care	\$33,052,525.00
Unacceptable Tax Interpretation/Position	\$40,126,804.00
Gross Carelessness	\$47,446,981.00
Abusive Tax Position	\$416,395,584.00
Tax Evasion	\$265,178,197.00
<b>Total</b>	<b>\$802,200,091.00</b>

In terms of the trend for tax evasion shortfalls Figure 5.5 revealed a disparity. These differences raise further questions about the integrity of the published data.<sup>302</sup>

<sup>301</sup> See Appendix 11.

<sup>302</sup> See Appendix 11.

Figure 5.5 Tax Evasion Shortfalls as compared to total Shortfalls Imposed as per Official Information Requests 1998 -2009.



The question which was raised previously was how does Inland Revenue record its discrepancies. Was it by the year investigated or simply the year the case was closed? The answer is conflicting and depends on whether it is a tax discrepancy or a tax shortfall penalty. Inland Revenue does not count a tax discrepancy until the case is closed.

As an example, in the 2010 Annual Report (page 35), the structured finance cases involving the major trading banks of tax discrepancies of \$1,790 million was recorded as a tax discrepancy. These cases and the possible discrepancies of \$1,790 million were not counted as a tax discrepancy, until the case was closed. However, these cases involved tax discrepancies which spread over the 1996-2005 tax years. If one was to be precise, one would spread the discrepancy back over the relevant tax years to obtain a true record of the trends in tax discrepancies.

A comparison of these two sources of information is shown in Table 5.4.

Table 5.4 Comparison of Tax Shortfalls 1998 – 2009 from Inland Revenue Annual Reports and Official Information Requests.

	Column 1	Column 2	Column 3
Year	Annual Reports	Official Information Requests	Disparity
30 June 1998	\$2,276,237.00	<b>\$3,432,924.00</b>	(\$1,156,687.00)
30 June 1999	\$9,439,928.00	<b>\$9,262,624.00</b>	\$177,304.00
30 June 2000	\$9,614,082.00	<b>\$9,614,082.00</b>	\$0.00
30 June 2001	\$13,157,515.00	<b>\$13,663,362.00</b>	\$505,847.00
30 June 2002	\$47,138,000.00	<b>\$36,083,573.00</b>	\$11,054,427.00
30 June 2003	\$28,846,000.00	<b>\$67,087,365.00</b>	(\$38,241,364.00)
30 June 2004	\$28,993,000.00	<b>\$97,263,217.00</b>	(\$68,270,217.00)
30 June 2005	\$28,879,000.00	<b>\$221,887,742.00</b>	(\$193,008,742.00)
30 June 2006	\$157,325,000.00	<b><u>\$102,232,323.00</u></b>	\$55,092,677.00
30 June 2007	<b>\$32,490,090.00</b>	<b><u>\$35,994,420.00</u></b>	(\$3,504,330.00)
30 June 2008	<b>\$67,994,604.00</b>	<b><u>\$84,296,495.00</u></b>	(\$16,301,891.00)
30 June 2009	<b>\$41,948,829.00</b>	<b><u>\$121,381,964.00</u></b>	(\$79,433,135.00)
Total	\$468,102,285.00	\$802,200,091.00	(\$334,097,806.00)

Key: Items in bold were obtained by Official Information Requests. Items in italics were obtained from Inland Revenue Annual Reports. Data in bold and underlined was obtained from an article presented at the New Zealand Law Society's Tax Conference September 2010, refer Appendix 7. The disparities are simply the difference between the Column 1 less column 2.

However, other disparities remain puzzling to say the least. As per the 2006 Inland Revenue Department Report Tax Evasion shortfall penalties amounted to \$143,144,000.00.<sup>303</sup> Subsequent Official Information Requests showed that the discrepancy for that period revealed tax evasion of \$13,683,960.00. In the 2005 year, tax evasion

<sup>303</sup> See Appendices 11 and 12.

shortfalls as per the Annual Report were \$10,480,000.00. However, the Official Information request advised that Tax Evasion shortfalls in 2005 were \$138,216,684.00.<sup>304</sup> It appears that these two records indicate the shortfall for tax evasion has moved from a future year to a prior year. One can therefore question the reliability of the published data.

Further as seen in Table 5.5, the number of cases cited in 2006 was 2,516 resulting in tax shortfalls of \$157,325,000.00. In subsequent Official Information Requests the number of cases changed to 3,033 resulting in shortfall penalties of \$102,232,323.00.

The reason for such an approach is that in regards to the tax shortfall penalties, as cases are closed, the shortfall is allocated across the years involved. Hence, disparities will result between published data as per the Annual Reports and subsequent Official Information requests,<sup>305</sup> which are in direct conflict with the recording of tax discrepancies as per the Annual Reports.

Hence, numbers increased, but the tax shortfalls decreased by \$55,092,677.00.

Table 5.5 Comparison of Shortfall Cases as per Inland Revenue Annual Reports and Official Information Requests.		
Tax Shortfall Penalties Imposed	Cases as per Inland Revenue's Annual Reports	Cases as per Official Information Requests.
Year ending 30 June 2006	2,516	3,033
Year ending 30 June 2007	2,416	2,632
Year ending 30 June 2008	1,478	1,998
Year ending 30 June 2009	1,295	1,441
Total	7,705	9,104

It is such ambiguities and the overall disparity of \$334,097,806.00 between its Annual Reports and information released under the Official Information Act 1982 which amounts

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<sup>304</sup> See Appendices 11 and 12.

<sup>305</sup> See Appendices 11 and 12.

to an increase of 71.37% that casts serious doubts on the data that Inland Revenue produces. It is critical in tax research to have the right information and from the right source. If the published data that Inland Revenue produces differs to this extent it is pertinent to update them in subsequent Annual Reports so that the true extent of shortfalls imposed is made known.

#### **5.4.4 Breakdown of Shortfall Penalties**

Another issue is the breakdown of tax shortfalls by tax type, value and number of shortfall penalties imposed.<sup>306</sup> This is only accessible by a request under the Official Information Act 1982. To complicate further the research into this area, in the years prior to 1 July 2000, shortfall penalties by revenue type was not recorded by the Inland Revenue and was unable to be provided. In addition, from 1 July 2001 the shortfalls imposed by Business Units were not provided, rather the shortfall information was based on revenue type.

As shown in Table 5.6<sup>307</sup> (refer to Appendices 7 and 11) the majority of tax shortfalls imposed related to income tax only.

Table 5.6 Tax Shortfalls Imposed by Revenue Type 2001 – 2009.

Tax Type	2001 \$m	2002 \$m	2003 \$m	2004 \$m	2005 \$m	2006 \$m	2007 \$m	2008 \$m	2009 \$m
GST	\$8.60	\$15.87	\$8.60	\$24.65	\$7.59	\$14.01	\$10.17	\$14.32	\$12.32
PAYE	\$2.28	\$13.71	\$3.47	\$2.48	\$17.97	\$2.56	\$2.67	\$1.95	\$1.18
Income tax	\$2.36	\$4.33	\$54.78	\$69.86	\$211.97	\$85.13	\$22.60	\$67.65	\$107.7
Other	\$0.00	\$2.16	\$.24	\$.26	\$.52	\$.52	\$.54	\$.36	\$.16

By combining Table 5.6 results with those of Table 5.7<sup>308</sup> one can draw the conclusion that in the area of tax avoidance which primarily involves income tax, the Inland Revenue

<sup>306</sup> See Appendix 11.

<sup>307</sup> Appendices 7 and 11. Note, only from periods after 2001, did Inland Revenue identify the revenue types that shortfalls were imposed on.

obtains the greatest discrepancies, from Abusive Tax Position (blatant tax avoidance taken by taxpayers) which has a long gestation period starting from its initial identification, investigation, and possible dispute resolution process, subsequent trial in either the Courts or final assessment. Hence, there will be large disparities in discrepancies each year which relate solely to income. Of note is that Abusive Tax Position is on an upward trend.

In comparison, Tax Evasion which involved all revenue types, income, GST and PAYE, and the trends each year has remained consistent.

Table 5.7 Tax Shortfalls Imposed by Penalty Criteria 2001 – 2009.

Year	2001 \$m	2002 \$m	2003 \$m	2004 \$m	2005 \$m	2006 \$m	2007 \$m	2008 \$m	2009 \$m
LRC	\$3.681	\$3.439	\$4.121	\$3.585	\$3.520	\$2.372	\$2.052	\$1.728	\$1.644
UTP	\$.699	\$.760	\$6.321	\$2.089	\$9.611	\$4.589	\$4.833	\$6.847	\$3.400
GC	\$3.145	\$5.684	\$3.719	\$3.334	\$3.633	\$4.431	\$4.439	\$5.312	\$8.058
ATP	\$1.157	\$8.576	\$41.883	\$67.421	\$67.965	\$77.155	\$12.797	\$48.154	\$90.124
TE	\$4.955	\$16.939	\$11.578	\$20.897	\$138.216	\$13.683	\$11.870	\$22.252	\$18.154
Key									
Notation	Description								
LRC	Lack of Reasonable Care Section 141TAA1994.								
UTP	Unacceptable Tax Position Section 141B TAA 1994.								
GC	Gross carelessness section 141C TAA 1994.								
ATP	Abusive Tax Position								
TE	Tax Evasion								

Another interesting area to look at is the number of taxpayers involved in each shortfall imposition. This is shown in Table 5.8<sup>309</sup> below. These statistics suggests that the lesser penalties of Lack of Reasonable Care and Unacceptable Tax Position were on a declining trend, whereas Gross Carelessness which is the lesser evil of tax evasion was still

<sup>308</sup> See Appendix 11.

<sup>309</sup> See Appendix 11.

substantial. On the other hand the trend for Tax Evasion and Unacceptable Tax Interpretation fluctuated up and down.

Table 5.8 Tax Shortfalls by Taxpayer Numbers 2001 – 2009.									
Year	2001	2002	2003	2004	2005	2006	2007	2008	2009
LRC	4576	5612	4997	5550	4253	4306	4249	2482	2054
UTP	113	2847	2828	3271	2896	1075	1038	717	417
GC	2188	171	366	506	1097	3065	3218	2209	2609
ATP	23	187	111	464	446	554	246	364	191
TE	881	1603	1750	2418	2317	2768	2120	2865	1778

A further comparison of Tax Evasion and Abusive Tax Position in terms of the actual imposition of shortfall cases and dollars per tax imposition showed a significant disparity. (see Table 5.9.<sup>310</sup>)

Table 5.9 Comparison of Tax Evasion/Abusive Tax Position % of cases 2001 – 2009.									
Year	2001	2002	2003	2004	2005	2006	2007	2008	2009
ATP	11%	15%	17%	20%	21%	24%	20%	33%	25%
TE	.002%	.017%	.011%	0.038%	0.004%	0.047%	0.022%	0.42%	0.027%

These tables showed that although significant amounts of tax shortfalls (and by analogy tax discrepancies) were obtained in tax avoidance cases, tax evasion still remained significant as a percentage which averaged around 20%. In total, tax evasion shortfalls accounted for \$265,178,197.00 of the \$802,200,091.00 or 33.06% of the total shortfalls imposed by the Inland Revenue for the period 1<sup>st</sup> of April 1997 to 30 June 2009.

These statistical results confirmed that a growing prevalence of Tax Evasion still exists within the tax community and the level of tax evasion could have a significant impact on our society. A number of questions in relation to the Inland Revenue Compliance Strategy

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<sup>310</sup> See Appendix 11.

and the Compliance and Penalty Regime that can be raised here

- Was the way Inland Revenue targeted Tax Evasion by using sophisticated software such as audit templates,<sup>311</sup> use of third party data and risk analysis on target specific industries (using leverage tools) not sufficient?<sup>312</sup>
- Was the investment in its knowledge base, by the creation of industry profiles,<sup>313</sup> identification of best practice in audit case management, use of compliance risk analysts,<sup>314</sup> use of educational ASPIRE<sup>315</sup> programmes for audit staff, tax evasion training for investigation staff, and the improvement in remuneration for Audit Staff not sufficient?
- Was it because Inland Revenue was focusing on in-depth investigations undertaken with the deterrent effect of audit activities being achieved through prosecutions and the application of a range of interventions to maintain visibility throughout the whole community?
- Was it due to the introduction of a case management reporting system that created a more effective Taxpayer Audit?<sup>316</sup>
- Was it due to changing demographics of New Zealand tax population including changes in cultural profiles, age structure and geographic distribution of the population that makes deterrent difficult?
- Was the growth of tax avoidance schemes<sup>317</sup> possibly caused by the increase in the marginal tax rates,<sup>318</sup> and the publication in the media<sup>319</sup> and\or Discussion documents by Inland Revenue<sup>320</sup> that taxpayers in cash businesses are evading tax by omitting income?

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<sup>311</sup> See n 290.

<sup>312</sup> Inland Revenue Department Annual Report 2003, p 30.

<sup>313</sup> Inland Revenue Department Annual Report 2003, p 29.

<sup>314</sup> Statement of Intent 2003/2004, p 29.

<sup>315</sup> ASPIRE stands for Acquisition of Skills Programme for Inland Revenue Employees and was introduced to increase the level of knowledge and skills for each Inland Revenue employee.

<sup>316</sup> See n 290.

<sup>317</sup> See n 297.

<sup>318</sup> Section HH3A of the Income tax Act 2004 deemed income derived by a minor beneficiary to be tax at the trustees' marginal tax rate of 33%.

<sup>319</sup> Avoidance (Surgeons, Salaries and Structures) available at

<http://www.taxcounsel.co.nz/Resources/NZ+Tax+Case+Notes> (as at 22 November 2010)

<sup>320</sup> Inland Revenue Mass-marketed tax schemes: An Officials' Issues Paper on Suggested Legislative Amendments (January 2002).

- Was it due to a softer approach to tax shortfalls for lack of reasonable care and or unacceptable tax position following the review into Tax Compliance and Penalty Regime?<sup>321</sup>

Irrespective of any possible explanations, one underlying thread remains i.e. despite 14 years since the Compliance and Penalty Regime was introduced, even with education, Industry partnerships and improved technology larger amounts of tax are evaded each year.

Inland Revenue although acknowledging its success in each of its Annual Reports, has failed to highlight the continual trend in criminal tax fraud, which still exists irrespective of its auditing techniques, increase use of technology and investment in its audit staff. Or is such a trend partly attributed to what drives its Compliance Strategy? The next section considers this possibility.

## **5.5 Audit Methodology**

### **5.5.1 Drivers of Compliance Strategy**

Given the continual growth in tax evasion and nature of prosecution cases, a more intriguing question raised is what really drives the Inland Revenue's Compliance Strategy. Is it to achieve a reduction in non-compliance, dollar discrepancies or a balanced coverage of all taxpayers?

Inland Revenue Taxpayer Audit undertakes each year a balanced programme of activities which involves a series of investigations.<sup>322</sup> This is based on Inland Revenue Purchase Agreement with the Minister of Revenue where an agreement is reached as to a number of audit hours and dollar return per hour.<sup>323</sup> Those hours are allocated across a series of audits which are then allocated to each service centres.<sup>324</sup> Within each Service Centre were

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<sup>321</sup> Inland Revenue Taxpayer Compliance, Standards and Penalties: A Review: A Government Discussion Document: (August 2001).

<sup>322</sup> See n 254, p 77.

<sup>323</sup> See Appendices 4 and 5.

<sup>324</sup> An Inland Revenue service center carries out all the functions of the Inland Revenue and is located in major cities and provincial towns.

several Audit Teams, managed by an Audit Area Manager.<sup>325</sup> Each auditor depending on their skill and experience is set a target for the number and type of audits to be undertaken. Their focus is then on completing these audits given the hours each task is allocated.

As an example, these audits are set out below in Table 5.10.<sup>326</sup>

Table 5.10<sup>327</sup> Type of Audit Tasks Undertaken by Inland Revenue.

Type of Audit	Tasks Undertaken by Inland Revenue
Short term Audits – generally deal with one type of return period and one tax type. They are of short duration, taking less than 20 hours.	Registration Checks. Non-filer Checks Goods and Services tax [GST] refund checks Income tax audits GST Audits Payroll Audits Voluntary Disclosure Checks
Medium-Term [Extended] Checks – generally deal with more than one return period for more or more tax types. They are medium duration taking 20-50 hours	Extended Income tax audits Extended GST audits Multi-Revenue Audits Extended dual revenue audits
Long-term Audits [Investigations] generally deal with more than one return period and all tax types. They are relatively long duration and ordinarily take 50-500 hours. In the Corporate division these audits can take well over 1000 hours	GST investigations Full Investigations Aggressive tax issues [tax avoidance] investigations Evasion investigations Criminal Fraud Investigations

Linked to these audits is the requirement to achieve a standard return per dollar spent. Examples extracted from the Inland Revenue Report for the year ending 30 June 1993 are shown below:

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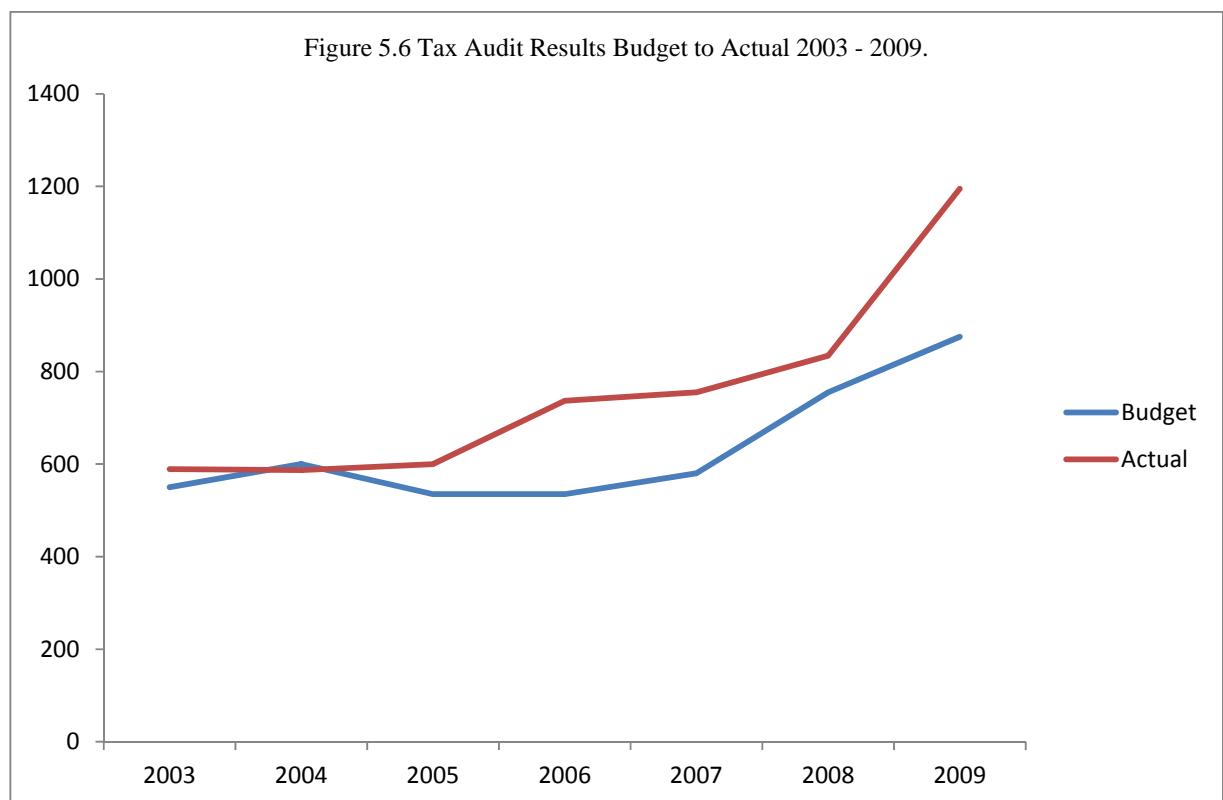
<sup>325</sup> See n 254, Para 2.19.

<sup>326</sup> See n 254, Para 2.19.

<sup>327</sup> See n 254, Para 2.19.

- Complete 68,000 GST Audits and checks with emphasis on high risk non-compliers and assess \$9.00 of tax for each programme dollar spent on GST Audits and checks.<sup>328</sup>
- Complete 6,900 Investigations, International audits and checks with emphasis on high risk non-compliers assess \$13.00 of tax for each programme dollar spent.<sup>329</sup>

Subject to the restructuring of Inland Revenue Audit (as explained in Chapter 2) an examination of Annual Reports showed a continual trend that Taxpayer Audit was to achieve a greater dollar discrepancy per year. This trend is shown in Figure 5.6.<sup>330</sup>



With the emphasis on a dollar return, it is not surprising to find that Inland Revenue is focused more on achieving dollars per investigation than reducing the levels of non-

<sup>328</sup> Inland Revenue Department Annual Report 1993, p 35.

<sup>329</sup> See n 328, p 36.

<sup>330</sup> Inland Revenue Department Annual Report 2003 – 2009.

compliance. If Inland Revenue was set out to reduce the levels of non-compliance within an industry, then the dollar discrepancy would decrease if levels of non-compliance decreased. Given the continual increase in budgetary amounts as per its Purchase agreement with the Government, the question is whether the Audit Strategy of Inland Revenue is really focused on influencing a change from a non-compliant behaviour to one of compliance in the future.

The other issue centres on the funding of investigation and its coverage. Depending on the level of experience, an auditor selects their own audits, or they are allocated by the Team Leaders.<sup>331</sup> More experienced auditors such as Level 3 Investigators<sup>332</sup> work on complex evasion, fraud or tax arrangements which have a higher dollar budget to achieve,<sup>333</sup> whereas Level 1 auditors work on less complicated cases with a lower dollar budget.

Given the varying experience of Inland Revenue audit staff and the differing budgetary dollars allocated to each type of audit, it is highly conceivable that Inland Revenue has to balance its funding across all revenues, types of taxpayers and types of audits. This approach and the discrepancies ascertained are reflected in the Table 5.11 below.<sup>334</sup>

Table 5.11 Tax Discrepancies 2003 – 2009 by Tax Type and Tax Units \$M.

Type of Tax/Unit	2003	2004	2005	2006	2007	2008	2009	Total
Aggressive tax issues	\$146.10	\$181.00	\$165.00	\$254.00	\$247.00	\$313.00	\$123.00	\$1,429.10
Tax Evasion Fraud	\$54.50	\$49.00	\$76.00	\$72.00	\$128.00	\$75.00	\$127.00	\$581.00
Corporates	\$383.04	\$297.00	\$268.00	\$357.00	\$359.00	\$723.00	\$583.00	\$2,970.04
Business/Non Business	\$315.40	\$260.00	\$254.00	\$297.00	\$262.00	\$338.00	\$436.00	\$2,162.40

<sup>331</sup> See n 254, p 47.

<sup>332</sup> Level 3 Investigators are required to hold a relevant business qualification equivalent to NZQA level 7 being a bachelor's degree in accounting or law available at [www.ird.govt.nz](http://www.ird.govt.nz) careers and the job description for an Investigator based at Christchurch dated 17 February 2011.

<sup>333</sup> Inland Revenue Department Annual Reports 1996 – 2000.

<sup>334</sup> Inland Revenue Department Annual Reports 2003 – 2009.

Inland Revenue's strategy clearly focused on all taxpayers at the upper, middle and bottom layers of the Compliance Triangle and obtained significant discrepancies and funding for its programme. Business and Non Business derived 30.27% of the total tax discrepancies during this period. These taxpayers whose shortfall penalties for Lack of Reasonable Care and Unacceptable Tax Interpretation/Position amounted to \$55,058,477.00 or 7.5% of the total shortfalls imposed of \$730,143,526.00.

The question to be raised is that by focusing their funding at taxpayers located at lower layers of the Compliance Triangle and obtaining "easy discrepancies", which was 8.14% of total tax discrepancies did they accept a trade off in regards a certain amount of criminal tax fraud? Or was it, that Inland Revenue Compliance Strategy is driven by the Compliance and Penalty Regime, aims of the Compliance Triangle and the objectives of the Purchase Agreement objectives? If so, do those objectives conflict to restrict the possibility of a reduction in criminal tax fraud?

The other intriguing unanswered question is during this period what percentage of tax discrepancies were recovered from compliant taxpayers<sup>335</sup> as opposed to non-compliant and does that have a bearing on audit coverage?<sup>336</sup> As an example, what amount of tax defrauded was recovered from the investigations into the Horticultural Industry, as compared to those taxpayers who had shortfall penalties for Lack of Reasonable Care and Unacceptable Tax Interpretation/Position imposed?

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<sup>335</sup> Compliant Taxpayers are defined as those located at the bottom of the Compliance Triangle and whose tax affairs and investigated and either a shortfall penalty for Lack of Reasonable Care or Unacceptable tax Interpretation was imposed. Non-Compliant Taxpayers are those at the top of the Compliance Triangle who like David Rowan who failed to furnish tax returns for 9 years and evaded tax of \$59,074.25. He was sentenced to 18 months jail available at <http://ird.govt.nz/aboutird/media-centre/media-release/2005-04-06> (as at 15 December 2010).

<sup>336</sup> Thanh Van Tran omitted income of at least \$343,000 in his GST returns, and \$324,000 in his income tax returns. No reparation was sought, because Tran does not have the funds to pay it. Bank records indicate he was regular customer at casinos. No reparation was sought as Thanh van Tran had no funds available at <http://ird.govt.nz/aboutird/media-centre/media-release/2009-09-25> (as at 25 November 2010).

## **5.6 Summary**

The Inland Revenue application of the Compliance and Penalty Regime and its adoption of the Compliance Triangle appear to be a simple and easy decision. Inland Revenue believed that voluntary compliance would be enhanced by exercising a systematic approach to managing tax compliance, identifying risks to the revenue,<sup>337</sup> assessing, prioritising and then treating those risks.

However, the Compliance Triangle so central to the Inland Revenue's Compliance Strategy as a responsive model only addressed the first step towards voluntary compliance. It is the next step that was missing in Inland Revenue's application of the Compliance Triangle i.e. how did Inland Revenue attempt to "measure" the original levels of compliance and non-compliance prior to an investigation and how did those percentage levels changed post investigation.

The Inland Revenue's Annual Reports revealed that as a percentage of tax revenue, tax discrepancies continued to climb each year. Further examination of data shows that criminal tax fraud (in the form of tax evasion) has retained a significant portion each year of the discrepancy ascertained and shortfalls imposed. Inland Revenue in adopting the Compliance Triangle and the application of the Compliance and Penalty Regime irrespective of its approach to combat criminal tax fraud has seen a continual growth in tax evasion each year.

In addition, data integrity is critical for any evaluation and consistency in the manner the data is released is crucial. The lack of precise sections of the Inland Revenue Acts and/or the Crimes Act 1961 which taxpayers were prosecuted under requires further clarification.

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<sup>337</sup> As an example, a risk to the Revenue is when people are selling their own home to a Loss Attributing Qualifying Companies, then renting back the property to themselves and claiming a tax deduction for the property that would otherwise be considered a private expense available at <http://www.ird.govt.nz/technical-tax/revenue-alerts/revenue-alert-ra/0701.html> (as at 25 October 2010).

As the public normally access Inland Revenue data by way of its Annual Reports sourced from its website, it is incumbent upon Inland Revenue to update correct and detail information so as to reveal the true extent of each type of tax shortfalls imposed and the full extent of criminal prosecutions. It is only by such revelations that the extent of the problem of criminal tax fraud can be deduced.

A more elusive question is what really drives the Compliance Strategy of Inland Revenue in its attempts to combat criminal tax fraud. Is there an inherent conflict between the need for a balanced coverage of all taxpayers, with resourcing spread over the number of hours per audit and forsaking leakage, or to target those taxpayers who deliberately contest the right of Inland Revenue to collect tax? In other words, does this inherent conflict force Inland Revenue to “accept a level of criminal tax fraud” in society? If so, this question and future response go to the very heart of the Compliance and Penalty Regime.

The next chapter further evaluates the effectiveness of the Compliance and Penalty Regime based on the media releases, Industry Partnership formed by the Inland Revenue with various Industries and other areas of research into tax compliance.

## **Chapter 6**

### **Inland Revenue Compliance and Penalty Strategy to Criminal Tax Fraud - an evaluation (Part 2)**

#### **6.1 Introduction**

Inland Revenue's began to develop new strategies to the problem of criminal tax fraud that was prevalent in New Zealand society. Using its Corporate Communication Unit as a media outlet it publicised the results of criminal prosecutions to send a "strong message to people in the community that fraudsters will be caught and the Courts will deal severely with them".<sup>338</sup> The decision to publicise such prosecutions was part of Inland Revenue's strategy to deter future non-compliance, encourage and reinforce compliance whilst maintaining the community's perception of the integrity of the tax system that Inland Revenue administered.

Inland Revenue prosecution strategy was an integral component of a balanced compliance programme. To be effective and appropriate, it had to respond to those taxpayers who deliberately confronted the right of the Inland Revenue to administer sections 6 and 6A of the Tax Administration Act 1994.<sup>339</sup> The prosecution framework was designed to ensure that those taxpayers who posed the greatest risk to the integrity of the tax and social policy systems administered by the Inland Revenue were subject to the full force of the law.

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<sup>338</sup> Inland Revenue media commentary on the sentencing of Gavin Richard Harris to 2 years 6 months jail who had filed fictitious GST returns involving the defrauding of GST \$455,310.79 available at <http://www.ird.govt.nz/aboutird/media-centre-media-release2005-12-03> (as at 15 July 2010).

<sup>339</sup> In summary, Section 6 of the Tax Administration Act 1994 requires the Commissioner to protect the integrity of the tax system, and section 6A subject to the resources available to the Commissioner to collect the highest revenue over time whilst promoting the importance of compliance, especially voluntary compliance, by all taxpayers with the Inland Revenue Acts.

A more interesting and difficult question involves research skirting around the specific areas of tax non-compliance in New Zealand. These studies by way of the “hidden economy”, Inland Revenue National Research Unit, or the Review into Compliance in 2001 although promising, all failed and publicise the issue of non-compliance.

## **6.2 Media Releases**

### **6.2.1 Publication of Names**

In December 2004, Inland Revenue commenced publicising through its website under the icon media, details of prosecutions of taxpayers who had committed offences under the Inland Revenue Acts and/or Crimes Act 1961. Prior to its repeal in June 2005, Section 146[1][a] or [b] of the Tax Administration Act 1994 was the relevant section that the Commissioner published the details of taxpayers who had tax shortfall penalties imposed for either taking an abusive tax position, committed tax evasion, or had been convicted of a criminal offence.<sup>340</sup> This requirement was not on an annual basis.<sup>341</sup>

Under this section, the Commissioner was required to release various details. They included the address, occupation, description of taxable activity of the business, years/tax periods involved, in which the offence/s were committed, the amount of tax evaded and the penal tax imposed. Included in such publication was also the section of the Act that the offence was committed under. A copy of the New Zealand Gazette notice dated 25 January 2001 setting those details for the year ended 30 June 1999 is attached in Appendix 13. Given that the requirement to issue such a notice ceased in June 2005, the dilemma for

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<sup>340</sup> Section 141D of the Tax Administration Act 1994 imposes a 100% penalty on a taxpayer who has taken what is termed an abusive tax position. A civil penalty for tax evasion results when a taxpayer evades their tax obligations under Section 141E of the Tax Administration Act 1994. Abusive Tax Position involves the interpretation of a tax law with the dominant position of avoiding tax. The relevant Sections of the Tax Administration Act 1994 here are Sections 143B or section 148 which relates to knowledge offences and the aiding and abetting of an offence.

<sup>341</sup> Hansard – Question and Answer 26 August 2004 Question 11660 from P Wong National to M Cullen Minister of Finance. The Minister also stated that the Inland Revenue had submitted a report to him considering that the section be repealed available at [http://www.knowledge-asket.co.nz/search/doc\\_view.php?d2=wq/text/2004/08/06\\_087.html](http://www.knowledge-asket.co.nz/search/doc_view.php?d2=wq/text/2004/08/06_087.html) (as at 30 January 2011).

research on tax evaders is one of collating the information into a comprehensive database given the provisions of section 81 of the Tax Administration Act 1994 which prevents the release of many previously known details.

The rationale for the publication of these taxpayers it is suggested is both the public stigma attached to such publication as noted by Justice Moore in *Case H45*<sup>342</sup>, and or the consequences for such media exposure on one's future business activities.<sup>343</sup> Such exposure sends a clear message to the public of the extent of this non-compliance, but also that failure to pay one's taxes is not socially acceptable. If publication is a method of improving compliance and the reduction in criminal tax fraud and given the use of modern technology, what was the rationale for the repeal of this section? It is interesting to note that in respect of the repeal of section 146 of the Tax Administration Act 1994 the Inland Revenue provided the Minister with a report dealing with its repeal. The Inland Revenue argued that the empirical evidence was inconclusive about the effectiveness of publication; it was inappropriate and harsh in many cases; and as there was only a single level of publication available, it was unable to take account of differing levels of culpability.<sup>344</sup>

## 6.2.2 Offence category

A media release should convey relevant, precise and educational information that will inform and educate the reader. In respect of the media releases involving the prosecution of taxpayers issued by the Inland Revenue since December 2004, which totalled 96 they were neither informative nor conveyed relevant and precise information.<sup>345</sup>

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<sup>342</sup> (1986) 8 NZTC 367.

<sup>343</sup> For example, Terry Serepisos, a Wellington Property developer and owner of the Wellington Phoenix, a soccer team playing in the Australian Football league has various companies in debt to the Inland Revenue for some \$3.5 million dollars which includes PAYE available at [www.nzherald.co.nz/buisness /news/article.cfm](http://www.nzherald.co.nz/buisness /news/article.cfm) (as at 10 March 2011). Given that failure to account for PAYE, it is conceivable that Mr Serepisos and his companies would have faced either a civil penalty under section 141E of the Tax Administration Act 1994, or a criminal prosecution for failure to account under section 143B(1)(D) of the Tax Administration Act 1994.

<sup>344</sup> See n 221 p 42.

<sup>345</sup> Inland Revenue media releases are available at <http://ird.govt.nz/aboutir/media-centre/media-releese> via the Inland Revenue web site at [www.ird.govt.nz](http://www.ird.govt.nz) at the icon media. This icon enables the reader to view any

The media releases mirrored the deficiencies which were identified in relation to data integrity (see chapter 5 Para 5.4) in respect of relevant statutory references,<sup>346</sup> occupation of the taxpayer,<sup>347</sup> amount of funds defrauded by the taxpayer, whether the funds were subsequently recovered by the Inland Revenue,<sup>348</sup> and the period the offences were committed all of which were not provided.<sup>349</sup> Unlike the listing of prosecutions, when a monetary amount was quoted, often one was unable to decipher whether the amounts involved was a gross amount or actual tax.<sup>350</sup> Finally and in line with the commentary by M Cullen,<sup>351</sup> the decision to publish the details of a prosecution is discretionary, or whether those details were already published in a local or national newspaper.<sup>352</sup>

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media statements released by the Inland Revenue from December 2004 to October 2010 which was the date this thesis used as cut-off.

<sup>346</sup> A review of the 96 publications of taxpayers between December 2004 and October 2010 convicted for offences either under the Crimes Act 1961 or the Tax Administration Act 1994, not one cited the section of those Acts that the taxpayer was convicted under.

<sup>347</sup> David John Lindup, the sole shareholder and director of a Lindup Holdings Ltd was sentenced to four years imprisonment after defrauding the Inland Revenue of up to \$866,773.82 in GST, none of which was recovered by the Inland Revenue available at <http://ird.govt.nz/anoutir/media-centre/media-release2009-06-06> (as at 3 December 2010). Alison Margaret Douglas, a manager of Surf Life Saving Taranaki, was jailed for 3 years 6 months involving 23 charges for failing to make PAYE deductions to the Inland Revenue. The unpaid PAYE amounting to \$61,518.61 was not recovered available at <http://ird.govt.nz/anoutir/media-centre/media-release2009-05-29> (as at 3 December 2010).

<sup>348</sup> Barry and Heather Reid were convicted on the 25 April 2005 for knowingly withholding information from the Inland Revenue concerning their vacuum cleaning business and the income, PAYE and GST omitted from 2000 to late 2003. No amount was cited as to the extent of income, PAYE, or GST omitted. They received 9 and 6 months imprisonment with the ability to apply for home detention available at <http://ird.govt.nz/anoutir/media-centre/media-release2005-04-25> (as at 3 December 2010). Ahmad Bakhtiar who it was estimated had defrauded the \$5,185,441.00 in GST, PAYE and income tax was sentenced to 2 years 10 months jail in respect of admitting 64 counts of tax evasion and 22 counts of using a document. No details were provided in the media release whether any funds were recovered available at <http://ird.govt.nz/anoutir/media-centre/media-release2009-11-11> (as at 3 December 2010).

<sup>349</sup> Sandeep Sood was convicted in June 2006 for evading tax of more than \$1.5 million dollars involving the issuing of false invoices to kiwifruit contractors. Although he operated in the Tauranga and Hawkes Bay regions between November 2003 and December 2005, no time period was cited as to when those tax offenses were committed available at <http://ird.govt.nz/anoutir/media-centre/media-release2007-06-01> (as at 3 December 2010).

<sup>350</sup> Robin Claude Smith was sentenced to 10 months jail and 250 hours of community work for tax of almost \$250,000.00 he used two separate books of account in his spray painting business available at <http://ird.govt.nz/anoutir/media-centre/media-release2007-01-25> (as at 3 December 2010).

<sup>351</sup> See n 221.

<sup>352</sup> Inland Revenue prosecution Framework – states” We will publicise the outcomes of prosecution cases where we consider it appropriate. When deciding to publicise a prosecution, we will consider the public interest, including deterring future non-compliance, encouraging and reinforcing compliant behaviours and maintaining the community's perception of the integrity of the tax and social policy systems we administer. Brett Knock, an Auckland Accountant was jailed for six years after admitting 14 representative fraud and forgery charges. Knock clients still owe nearly \$1 million tax to the Inland Revenue when he defrauded his clients out of tax refunds or filed false tax returns for his clients available at [www.sharechat.co.nz](http://www.sharechat.co.nz) dated 16 July 2004 (as at 14 December 2010).

Another possible source of prosecution details are the Inland Revenue Department Annual Reports. In the period of July 2004 to June 2009 the number of offences cited was 851. These are set out in Table 6.1.<sup>353</sup>

It is obvious that out of a possible 851 prosecutions as reported in the Annual Reports Inland Revenue choose to include only 96 in its media releases. What also makes comparison is that Inland Revenue Annual Reports run from a July to June calendar year, whereas the media run from December 2004 to October 2010. Further compounding the issue of comparability is the year the Inland Revenue reports an offence, the period of the offence, or the date of the Court judgment. Subject to these limitations, Inland Revenue failed to disclose some 755 offences during this period.

A further issue relates to the amount of funds defrauded. The media releases of the 96 taxpayers the total amount defrauded equates to \$59,416,801.91. The question that one would like to pose is of the other 755 offences listed, what amount of funds were defrauded? Without access to this information, one is unable to determine the full extent of frauds committed by taxpayers who reside at the upper strata of the Compliance Triangle. A more interesting question in respect of those 755 taxpayers is what funds were recovered if any from the frauds that they committed?

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<sup>353</sup> Inland Revenue Department Annual Reports 2005 -2009. The offence of failing to furnish a tax return has been excluded from this calculation. In the period the number of taxpayers prosecuted for this offence amounted to 2,656.

Table 6.1 Prosecution 2005 – 2009 as per Inland Revenue Department Annual Reports and Official Information Requests.

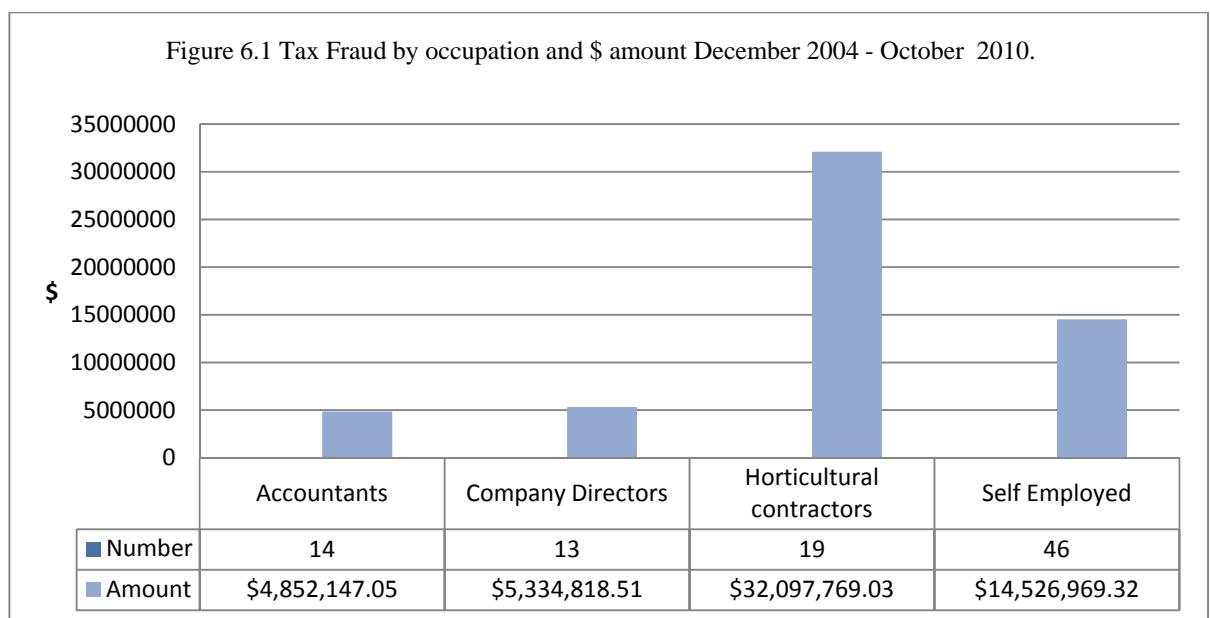
Year	A	B	C	D	E	F	G	H	I	Total
2005	3	0	2	316	7	2	5	0	0	335
2006	8	4	7	331	11	1	7	0	0	369
2007	3	8	6	0	2	0	9	0	0	28
2008	0	6	25	0	9	2	0	9	1	52
2009	0	6	18	10	11	1	0	20	1	67
Total	14	24	58	657	40	6	21	29	2	851
Key										
A	False returns or Wilfully furnishing false returns									
B	Aiding, abetting or inciting to make a false Income tax return.									
C	Aiding, Abetting or inciting to make a false return.									
D	Failure to Furnish GST Returns									
E	False GST Returns									
F	Knowingly not proving Information									
G	Fraud GST									
H	Crimes Act									
I	Section 17 and Section 17A									

If Inland Revenue was truly diligent in its desire to curb criminal tax fraud, it should perhaps release the full extent of its prosecutions each year, convey the appropriate and relevant information as to the level this offending which the notices under section 146 of the Tax Administration Act 1994 originally provided. This request for such publication has been raised previously i.e. as a means “to underscore the seriousness of the offence...and help indicate that these offences carried a higher level of stigma than less serious offending”.<sup>354</sup> The lack of publication possibly as a consequence of the application of section 81 of the Tax Administration Act 1994 in respect of its media releases provides an appropriate shield to our society of the full extent of criminal tax fraud in New Zealand.

<sup>354</sup> See n 229, p 43.

### 6.2.3 Occupation category

Irrespective of the shortcomings in these media releases, using that data and allowing for the appropriate reclassification of occupation, businesses and pruning (Refer to Appendix 6) one can recreate various analyses of such data.<sup>355</sup> Figure 6.1 shows the occupation categories and amount of funds defrauded.<sup>356</sup>



In respect of Accountants, their extensive understanding of the tax system enabled them to use this tax system to create a second layer of fraud. For example, an Auckland tax agent banked nearly \$750,000 in cheques made out to the Inland Revenue<sup>357</sup> and some \$90,000 of tax refunds, in individuals' names, also ended up in another agent's bank account.<sup>358</sup> Another tax agent fraud involved not just the alteration of clients GST and Income tax returns, but also the ability to use tax refunds for the payment of private expenses.<sup>359</sup>

<sup>355</sup> If the taxpayer is cited as a Plaster/Tiler, he is termed self-employed. If he is involved in the preparation of tax returns, he is cited as an Accountant. Where no occupation is given, that taxpayer is removed from the survey. As per Figure 6.1, the total selection amounted to 92. The total dollars one ascertained from the media releases was \$59,416.801.00. Figure 6.1 dollar amount equates to \$56,811,703.00.

<sup>356</sup> Inland Revenue Media Releases December 2004 – October 2010 available at <http://ird.govt.nz/aboutird/media-centre/media-release> (as at 3 December 2010).

<sup>357</sup> See [www.sharechat.co.nz](http://www.sharechat.co.nz) 16 July 2004 (as at 14 May 2010).

<sup>358</sup> See n 357.

<sup>359</sup> Inland Revenue Media Release 27 February 2009. Graham McCready was sentenced to 6 months home detention in February 2009 for defrauding the Inland Revenue of \$92,320.00 in Income tax and \$90,835.00 in GST available at <http://www.ird.govt.nz/aboutir/media-centre/media-release/2007/media-release-2007-02-27> as at 3 December 2010.

The term company directors in this period were used whenever the occupation of the taxpayer was cited or the taxpayer was a director of a company charged with an offence. The ability of a taxpayer to use the company structure to defraud the Inland Revenue is often simplistic and often hypnotic. One taxpayer for example had incorporated 11 companies, using the identities of other taxpayers, as a director or shareholder without their knowledge of consent.<sup>360</sup> He defrauded the Inland Revenue of some \$243,026.00 in Goods and Services tax refunds, fled to Australia and was subsequently extradited.

In respect of self-employed taxpayers, this involved a range of taxpayers, from tilers, plasterers, farmers, owners of cash businesses such as dairies and takeaways, property developers and a variety of taxpayer occupations. From a review of the media releases the offences committed by these taxpayers were the failure to account for PAYE, GST and or Income tax from businesses within the tax system.

The Horticultural Industry is interesting by itself and will be discussed later in this chapter under 6.4.2.

#### **6.2.4 Revenue type**

An alternative approach in respect of the media releases is an analysis by revenue type as set out Figure 6.2.<sup>361</sup>

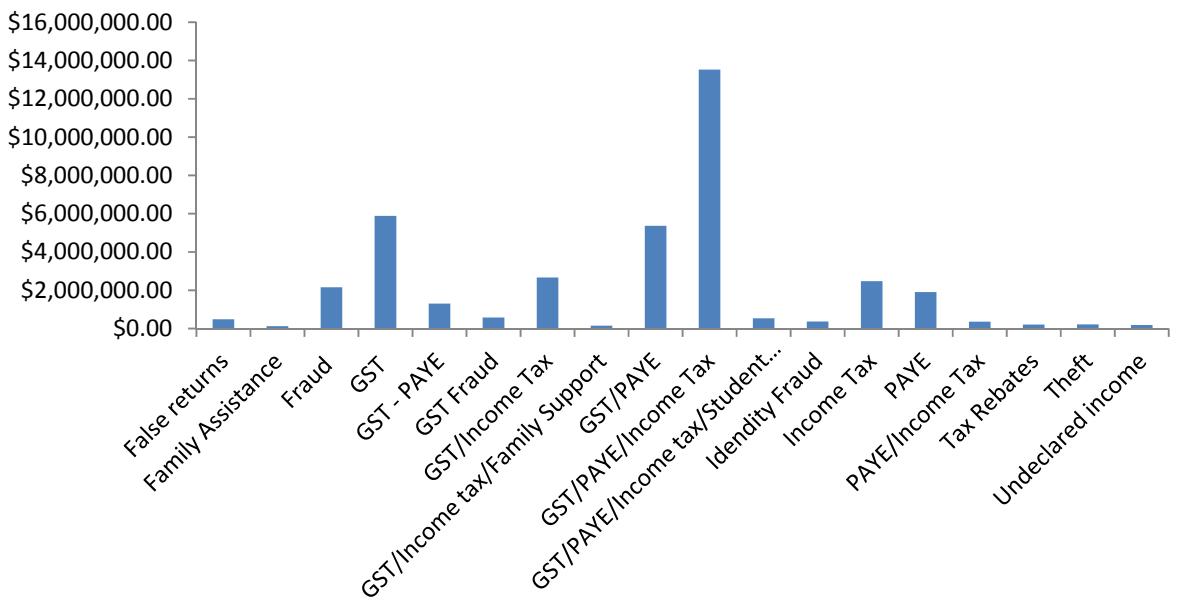
The categorisation of tax types indicates that it is in the area of GST and PAYE that the major offending took place. The reason for the dominance of GST and PAYE was that criminal tax fraud particularly in the Horticultural Industry simply involved the non-payment of PAYE that the contractor failed to pass on to the Inland Revenue and the failure to account for GST on invoices issued to growers for actual work done.

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<sup>360</sup> Christopher Goldsmith was sentenced to 28 months jail in December 2007 available at <http://www.ird.govt.nz/aboutir/media-centre/media-release/2007/media-release-2007-12-19> (as at 3 December 2010).

<sup>361</sup> Inland Revenue Media Releases December 2004 – October 2010 available at <http://www.ird.govt.nz/aboutir/media-centre/media-release/>. (as at 24 November 2010).

Figure 6.2 Media Releases by tax type from December 2004 - October 2010.

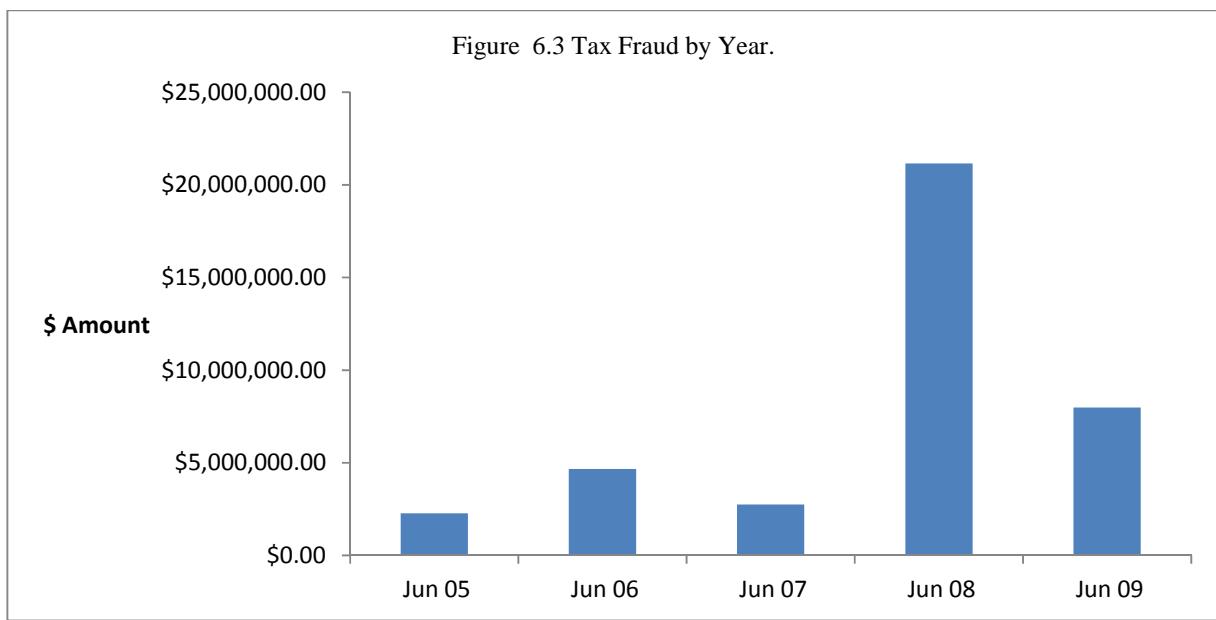


At a more simplistic example, a company director failed to account for PAYE from May 2001 to May 2003 amounting to \$1,267,008.00.<sup>362</sup> Although this information is informative, to ascertain the true trend in offending, (as discussed previously in Chapter 5 Para 5.4.1), it is the tax periods in which the offence was committed that is critical. If one knew the periods involved one could graph more precisely the trends of such offending.<sup>363</sup> Using simply “estimates”, Figure 6.3 provides a rough indication of the level of tax involved as per the Inland Revenue media releases.<sup>364</sup>

<sup>362</sup> K Unka a company director was sentenced to 21 months jail for failing to account for \$1,278,008.00 in PAYE from the operation of 10 rest homes. \$913,000.00 remained unaccounted for and all 8 companies have been liquidated available at <http://www.ird.govt.nz/aboutir/media-centre/media-release/2006/media-release2006-05-21.html> (as at 3 December 2010).

<sup>363</sup> This concept was referred to in Chapter 5, 5.4.1 in respect of the information contained in the summary of facts presented to a District Court Judge.

<sup>364</sup> The estimate involves taking the tax figure as quoted in the media release, and judging whether the sum involved was a gross figure for income or GST omitted or whether it was a net tax amount.



### **6.2.5 Prosecution - Decision to prosecute**

When an examination is completed of the media releases in terms of prosecutions by revenue type, the majority are again in the areas of GST and PAYE fraud as per Figure 6.2.<sup>365</sup> When one examines the information contained in the media publications, sophistication is lacking in respect of the frauds committed. It may appear that these taxpayers have the belief that if one is registered for GST and PAYE, and ignore the obligation to file and pay their due liability, Inland Revenue will not pursue the outstanding tax returns and arrears.

A more relevant issue for the Inland Revenue should be at ascertaining what type of taxpayers are involved in the cash economy<sup>366</sup> and hidden economy.<sup>367</sup> It is within this area, that a lack of an audit trail exists, and the greatest gap in revenue exists as set out in Figure

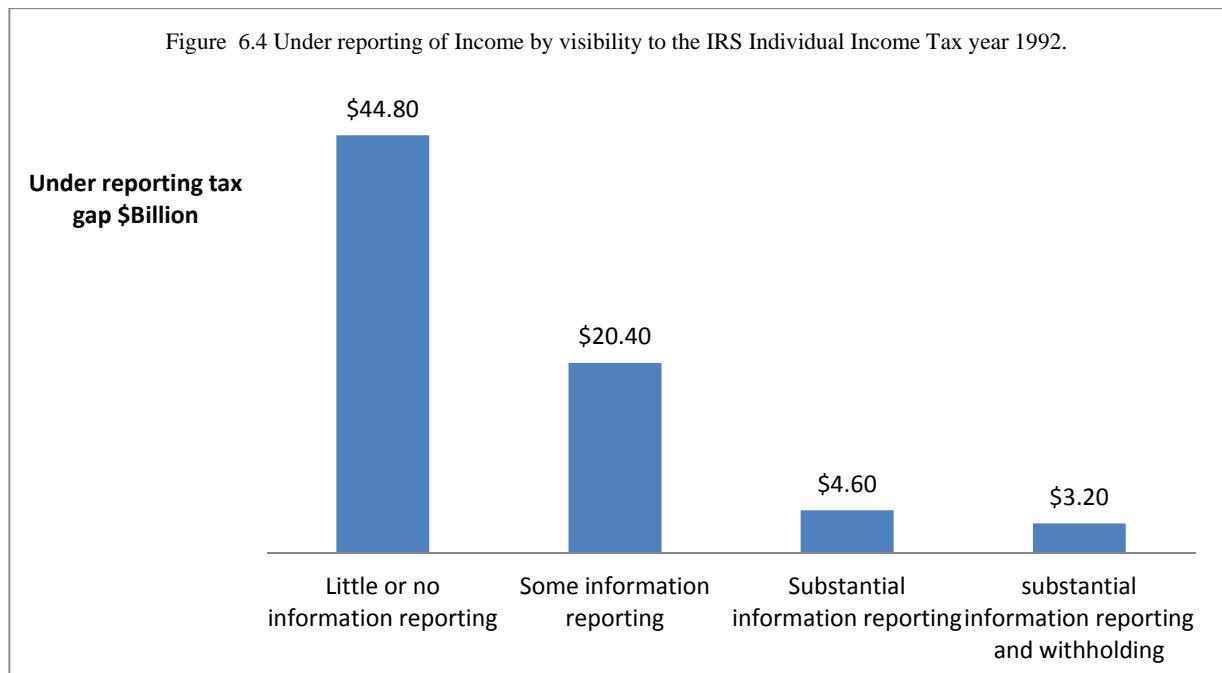
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<sup>365</sup> See n 356.

<sup>366</sup> The cash economy is a term used to describe transactions that are in cash. Office of Auditors General Report: Inland Revenue Department: Effectiveness of the Industry Partnership Programme April 2008. Part 1 Introduction p 9.

<sup>367</sup> The Hidden economy is a term used to describe, “businesses and individuals who deal mainly in cash, so they can have a greater opportunity to underestimate their income, overstate their expenses or operate entirely outside the tax system”. Inland Revenue Compliance Focus 2010-2011 available at <http://www.ird.govt.nz/axagents/compliance/focus/hiddeden-economy> (as at 3 December 2010).

6.4.<sup>368</sup> The Inland Revenue prosecutions since December 2004 provided little or no real indication of those taxpayers residing in these categories. Does that infer that Inland Revenue has been ineffective in policing this area?



A further concern is the failure of Inland Revenue to prosecute those taxpayers for failure to retain sufficient records as required by section 22 of the Tax Administration Act 1994. A search of tax cases and the relevant statutes ascertained not a single tax prosecution for failure to retain records under this section of the Act.<sup>369</sup> What signal would taxpayers receive either directly or indirectly that the Inland Revenue accepts this lack of an effective audit trail?

The information released by the Inland Revenue via its media releases dealing with its prosecutions is a source of information for research into criminal tax fraud. Unfortunately, when one begins to unravel the details that are released in respect of criminal tax fraud,

<sup>368</sup> Compliance Risk Management: Managing and Improving Tax Compliance Organisation of Economic and Cultural Development. March 2004, p 54 available at [www.oecd.org/dataoecd/21/55/37212610.pdf](http://www.oecd.org/dataoecd/21/55/37212610.pdf) (as at 21 August 2010).

<sup>369</sup> Using the term “failure to retain records” on Massey University library website and searching the Brookers Online database at [www.massey.ac.nz](http://www.massey.ac.nz), no legal cases were cited. (as at 23 May 2010).

limitations exist for future research. Further, given the differences in the prosecution numbers between Inland Annual Reports and their media releases one must question the nature and extent of those remaining prosecutions. Does this lack of exposure give assurance that Inland Revenue has been effective in combating criminal tax fraud? It is incumbent upon the Inland Revenue given the ease in which information can be conveyed that it must address these matters in future media releases.

A further issue is what determines the decision to prosecute. Devos<sup>370</sup> pointed out that Inland Revenue “*appears to lack any formal prosecution policy*” as it was not made known.<sup>371</sup> It was only recently that Inland Revenue published its prosecution framework.<sup>372</sup> The framework sets very clearly that the decision to prosecute is discretionary.<sup>373</sup> Inland Revenue listed 13 key factors and non-compliance that will be taken into account in the decision to prosecute.

An examination of the Inland Revenue’s media releases since December 2004 indicates these 13 key factors are obviously present. However, Inland Revenue tends only to publish “the high profile cases” particularly the horticultural cases and those that involved significant sums of monies.<sup>374</sup> This philosophy is also prevalent in its Annual Reports.<sup>375</sup>

Does that indicate that Inland Revenue is prioritising its resources – to obtain the maximum publicity and dollars in areas of risk,<sup>376</sup> or that “*it (Inland Revenue) has become shrewd and*

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<sup>370</sup> See n 229.

<sup>371</sup> Prior to the release in February 2010 of its prosecution framework, Inland Revenue decision to prosecute was based on a penal manual. That manual set out the factors that the Inland Revenue considered relevant in the decision to prosecute.

<sup>372</sup> See n 42.

<sup>373</sup> See n 42.

<sup>374</sup> See n 357.

<sup>375</sup> Inland Revenue Department Annual Report 2004 page 56, Inland Revenue Department Annual Report 2005 page 42; Inland Revenue Department Annual Report 2006 page 35; Inland Revenue Department Annual Report 2007, page 38; Inland Revenue Department Annual Report 2008, page 36; Inland Revenue Department Annual Report 2009; page 34.

<sup>376</sup> [www.victoria.ac.nz](http://www.victoria.ac.nz) which included a response from Inland Revenue in respect of additional funding to pursue tax avoidance and tax evasion.

*experienced at making arguments and picking low hanging fruit.”*<sup>377</sup> Or is the decision to prosecute a balanced between prosecution and maintaining society’s perception of the integrity of the tax system, or the delivery of dollars.<sup>378</sup> If it is dollars that sway the decision, although non-compliance was identified, does it positively influence the future compliance of society, when anonymity for such criminal tax fraud becomes cloaked in a shroud?<sup>379</sup> It is when such decisions of dollars and the ability to recover such outstanding tax dominates the decision, society tends to become immune to the existing the criminal tax fraud.

## **6.3 Industry Partnership**

### **6.3.1 Background**

Industry Partnership was an approach by Inland Revenue to build relationships with selected industries by dialogue, communication and to build a knowledge base within Inland Revenue of each these industries. In this way, Inland Revenue sought to improve the levels of compliance of those industries.<sup>380</sup> The Industries which were selected was based on various criteria including average tax returns outstanding, average tax debt outstanding and likelihood of a taxpayer having tax discrepancies. Table 6.2 shows the various Industries which Inland Revenue had formed partnerships with.<sup>381</sup>

The focus was on tax risks associated with in an industry where a cash economy perceived to exist. Its purpose was using: “*the compliance model develop, test and implement a*

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<sup>377</sup> Sunday Star Times 13 June 2010 at [www.stuff.co.nz/business/30806619/taxman-on-the-hunt](http://www.stuff.co.nz/business/30806619/taxman-on-the-hunt) (as at 31 August 2010).

<sup>378</sup> Robin Oliver Deputy Commissioner; Sunday Star Times 13 June 2010 available at [www.stuff.co.nz/business/30806619/taxman-on-the-hunt](http://www.stuff.co.nz/business/30806619/taxman-on-the-hunt) (as at 31 August 2010).

<sup>379</sup> Unlike section 146 of the Tax Administration Act 1994 which required publication of the relevant details of a prosecution, unless Inland Revenue releases the details, no public details exist of a prosecution. The case of Brett Knock was not released to the media by the Inland Revenue, yet it involved \$1 million is tax owing to the Inland Revenue from clients he defrauded. See also n 357 for details of further information concerning B Knott’s offending.

<sup>380</sup> Report of the Controller General and Auditor-General Inland Revenue Department: Performance of the Effectiveness of the Industry Partnership programme (9 April 2009).

<sup>381</sup> See n 380, Para 1.14.

*relationship-based approach to working with small and medium enterprises within selected cash economy industries to encourage and enable voluntary compliance.”<sup>382</sup>*

In forming these Industry partnerships, Inland Revenue was attempting to translate the theory of the Compliance Triangle into practical reality.<sup>383</sup> In tandem with the Compliance Triangle, Inland Revenue Compliance Strategy was to apply the full force of the law where it was determined that taxpayers had decided not to comply by way of prosecution, bankruptcy, liquidation and the application of shortfall penalties together with maximum publicity.<sup>384</sup>

Table 6.2 Industry Partnership.

Industry	Date when added to programme	Type of relationship
Electrical Services	May 2002	Industry strategic partnership
Electrical services	May 2002	Industry alliance
Painting and decorating Services	May 2002	Industry partnership
Painting and decorating Services	May 2002	Industry alliance
Services to agriculture	March 2003	Industry partnership
Services to agriculture	March 2003	Industry alliance
Entrepreneurial services	March 2003	Industry alliance
Hairdressing and beauty salons	April 2003	Industry partnership
Smash repairing	May 2003	Industry partnership
Automotive repair and services	July 2003	Industry partnership
Long Distance bus transport	July 2003	Industry partnership
Long distance bus transport	July 2003	Industry alliance
Plumbing services	July 2003	Industry partnership
Taxi and other road transport	November 2003	Industry partnership
Plastering and ceiling services	March 2004	Industry partnership
Carpentry services	April 2004	Industry partnership
Gardening services	June 2004	Industry partnership
Landscaping services	August 2004	Industry partnership
Bricklaying services	September 2004	Industry partnership
Gardening and Landscaping services	December 2004	Industry alliance

<sup>382</sup> T Morris and M Longsdale, Translating the Compliance Model into Practical Reality New Zealand Inland Revenue available at [www.irs.gov/pub/irs-soi/04moori.pdf](http://www.irs.gov/pub/irs-soi/04moori.pdf) (as at 15 July 2010).

<sup>383</sup> Inland Revenue: New Zealand Business Plan. The Way Forward 2001 Onwards Strategic initiative 6.9 Enhance Audit Activities, p 51

<sup>384</sup> See n 380.

### **6.3.2 Application**

The most publicised of the Industry partnership was that involving the Horticultural Industry.<sup>385</sup> Inland Revenue found that traditional investigation techniques into the horticultural industry were inappropriate. As an example, the use of transient workers either legal or illegal [and were ghost employees<sup>386</sup>] would leave the country before an investigation commenced meant that PAYE was unaccounted.

Inland Revenue applying the Compliance Triangle and BISEP approach formed key relationships within the Industry to develop industry profiles, educate taxpayers within the Industry and identifying non-compliance by using new investigative techniques.<sup>387</sup>

In using BISEP, Inland Revenue obtained an understanding of the specific features of this industry. Using this industry profile, Inland Revenue understood the key factors dominant within this industry which enabled it to develop strategies to manage non-compliance and to combat criminal tax fraud which was seriously present within the horticultural Industry. Inland Revenue Compliance Strategy included, spot checks at orchards where contractors were working and subsequent data matching of those details. In identifying those contractors who had outstanding tax obligations, Inland Revenue obtained third party details of assets including bank account details and liaison with other Government Departments to develop a specific database of those taxpayers subject to the use of the full force of the law.

The high rate of prosecutions published was due to the blatant non-compliance by an ethnic group whose tax practices are atypical of classic criminal fraud.<sup>388</sup> Falsified documents

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<sup>385</sup> Inland Revenue estimate that some \$31 million was involved in these tax frauds involving bogus companies, fictitious invoicing and the use of immigrants to form companies as conduits for the laundering of monies available at [www.bayofplentytimes.co.nz](http://www.bayofplentytimes.co.nz) (as at 23 August 2009).

<sup>386</sup> A ghost employee is a person, who is on your payroll, receiving wages, but no PAYE tax is deducted or paid or the tax authority.

<sup>387</sup> See n 382, p 74. One technique involved developing relationships with local banks who would contact Inland Revenue when contractors would request the payment of large cheques in cash. Inland Revenue could then search their database to ascertain of that taxpayer had outstanding tax owing. If that was the case, Inland Revenue would intercept the payment of the cash cheque and retain the funds.

created paper trails of work supposedly completed by subcontractors for work often never done. The employment of invoice writers, often recent immigrants to New Zealand to incorporate further sub-contracting companies to act as conduits further aided the laundering of income.<sup>389</sup> The cheques paid by growers to the horticultural contractors involved in these criminal tax fraud schemes were cashed and the proceeds quickly laundered.

The prosecution details as set out in Figure 6.1, depicts the seriousness of criminal fraud that existed within the Horticultural Industry. It was estimated that some 33 people were involved over a five year period, in which some \$31 million dollars in tax was defrauded. In several cases, the people involved had left New Zealand before Inland Revenue could complete its tax audit.<sup>390</sup>

The extent of this criminal tax fraud saw legislation enacted whereby a withholding tax was required to be deducted at the source when paid to contractors, unless that contractor held a valid exemption certificates. This exemption certificate would only be issued where the contractor had a “good” tax history.<sup>391</sup>

However, despite the success of this relationship, various questions have to be asked in respect of Industry partnership and the horticultural sector. Inland Revenue was aware even several years before the horticultural project was commenced that normal investigative techniques were not effective in combating evasion and fraud.<sup>392</sup> Given that substantial prosecutions that primarily relate to GST and PAYE, Inland Revenue does not appear to have taken preventative measures. Further, the ethnic background of those taxpayers who

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<sup>388</sup> The taxpayers involved were from Pakistan, India or Bangladesh: Source Forbidden Fruit: The \$31 Million Kiwifruit Fraud. Source: Bay of Plenty Times 29 August 2009 available at [www.bayofplentytimes.co.nz/local/...kiwifruit-tax-fraud/39031771/](http://www.bayofplentytimes.co.nz/local/...kiwifruit-tax-fraud/39031771/). (as at 4 November 2010).

<sup>389</sup> Horticultural student Gurpreet Singh who was on a temporary immigration visa and permitted to study as a horticultural student by using a company structure issued some \$3,426,335.00 invoices for work actually done. His company received a fee for the false invoices and tax of some \$683,604.00 was evaded available at <http://www.ird.govt.nz/aboutir/media-centre/media-release/2008/media-release-2008-07-02.html> (as at 2 July 2010).

<sup>390</sup> See n 382.

<sup>391</sup> See n 382.

<sup>392</sup> See n 382.

participated in these frauds<sup>393</sup> was well known. In registering as a taxpayer in this Industry, perhaps the Inland Revenue records should flag immediately that taxpayer is a high risk to the Revenue.

### 6.3.3 Industry partnership – other issues

Aside from the Horticultural Industry partnership, Inland Revenue has attributed various reductions in debt and outstanding returns to Industry partnership. As an example is shown in Table 6.3.<sup>394</sup>

What the Office of Auditor General ascertained was that:

*“Early in the programme, IRD carried out a lot of data cleansing. It included removing inaccurate records of taxpayers. Doing so changed the size of the population of a given Industry Partnership industry within IRD’s information system. For example, during 2002/03 IRD removed 2032 records (about 10%) from the population of electricians, painters, and decorators. These 2032 records were then counted as part of the reduction in the number of electricians, painters, and decorators owing tax debt. There were similar issues with the reported results of the programme in terms of taxpayers with outstanding tax returns.”<sup>395</sup>*

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<sup>393</sup> See n 382. Note, the taxpayers who participated in the committing these frauds were of Pakistanis, Indian or Bangladesh origin. Source: Review of Inland Revenue media releases from December 2004 – October 2010.

<sup>394</sup> Inland Revenue Department Annual Report 2003, p 25.

<sup>395</sup> See n 380, Para 4.43–4.47.

Table 6.3 Success of Industry Partnership.	Industry Type	Debt profile
Tax Type	Electricians, painters, and decorators	Overall Debt profile
Debt cases	19.4% decrease	5% decrease
Average age of debt	8.3% decrease	4.4% decrease
Debt under arrangement	195% increase	26% increase
Outstanding returns	7.7% decrease	1.3% decrease
Average age of outstanding returns	10% decrease	2.55 decrease

The Auditor General further commented when he further stated:

*“We were unable to replicate IRD’s historical information because the IRD’s information system is live. This means records are added or removed from it over time. We cannot assess whether the records removed by IRD as part of its data cleansing had the same or similar characteristics to those of the remaining records for taxpayers in Industry Partnership industries. If the removed records had the same distributions of tax debt or outstanding tax returns, then the information made publicly available by IRD about these attributes of the programme **overstates** the results of the programme.”<sup>396</sup>*

The Inland Revenue was given a stern warning about the accuracy of its publicly available results, and the need to bring within the tax system those taxpayers outside the system and for which criminal penalties should have been applicable.<sup>397</sup> It is interesting to note that apart from the 2003, 2004 and 2005 Annual reports, Statements of Intent and the various papers published within Inland Revenue no further mention was made of Industry

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<sup>396</sup> See n 380, Para 4.5.

<sup>397</sup> See n 380, Para 5.2

partnership and its successes in reducing the level of non-compliance in “cash Industries”.<sup>398</sup>

But some questions remain unaddressed:

- What BISEP<sup>399</sup> were identified within each of these Industries?
- Were those BISEP common across all Industries?
- Did those BISEP include a lack of audit trails as identified in Figure 6.4, page 129?
- Did those BISEP ultimately assist Inland Revenue in developing their Compliance strategy for its investigation into those Industries?
- What was the number of Investigations carried out into each of the industry partnerships?
- Given the comments of the Auditors General as to the accuracy of the results of Industry Partnership,<sup>400</sup> what other statistical information as to the success of Industry Partnership are “suspect”?
- Are prosecutions one-sided? About 50% of prosecutions so far were from the Horticultural Industry.<sup>401</sup>

A more relevant question is whether the level of non-compliance decreased for each Industry thereby decreased in tax discrepancies? If not, is it that Inland Revenue is unable in reality to influence or change the behaviour of those taxpayers at the top stratum of the Compliance Triangle and accept a certain level of “leakage”? Industry Partnership may have created a wealth of information for Inland Revenue and a large volume of reports<sup>402</sup> but no evidence exists that these “partnership” has decreased criminal tax fraud in these industries.

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<sup>398</sup> See n 380, and the Office of Auditor General report set out that during 2004 to 2005 Inland Revenue wrote seven papers that evaluated aspects of the programme and specific initiatives with it including, field team activity, external relationships, service delivery initiates, research and issues gathering, communications, data integrity, and field delivery.

<sup>399</sup> See n 97.

<sup>400</sup> See n 380.

<sup>401</sup> See n 380, Para 4.32.

<sup>402</sup> Inland Revenue wrote 7 papers that evaluated aspects of the programme including • field team activity;• external relationship management;• 10 service delivery initiatives;• research and issues gathering;• communications;• data integrity; and• field delivery.

## **6.4 Other Issues**

### **6.4.1 Hidden Economy**

A fundamental issue for Inland Revenue is the size of the tax base, the level of unreported income and the on-going maintenance of the tax base.<sup>403</sup> The Inland Revenue defined the hidden economy as economic activity that is not captured by the Official Gross Domestic Product [GDP] statistics such as small cash jobs to the large scale trade in illegal goods.<sup>404</sup>

An Inland Revenue research examined the relationship between the level and mix of taxation (direct and indirect taxation) and the hidden economy.<sup>405</sup> That publication ascertained that between 1969 and 1994 the range of the hidden economy was 8.8% to 11.3% of Gross Domestic Product and a positive correlation existed between the business cycle and the size of that hidden economy. Although the research confirmed that a decrease in the Tax/GDP would reduce the hidden economy, a substantial reduction in tax revenue [\$1billion] had to be sacrificed for only marginal gains in reducing the level of the hidden economy [\$200 million].

Given the level of tax to GDP and the mix of direct and indirect tax, a significant reduction in tax evasion would only be achieved by large modifications to the tax system. Further, if the Tax/GDP ratio fell below 21%, the decrease in the hidden economy falls at a slower rate. The report also concluded that most of the tax evasion over and above criminal activity was due to individuals, small businesses and the self-employed. Evidence from audits also suggested that this relationship was true.

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<sup>403</sup> Size of the Hidden Economy Chapter 3 Official Briefing papers to the Minister of Revenue November 1999.

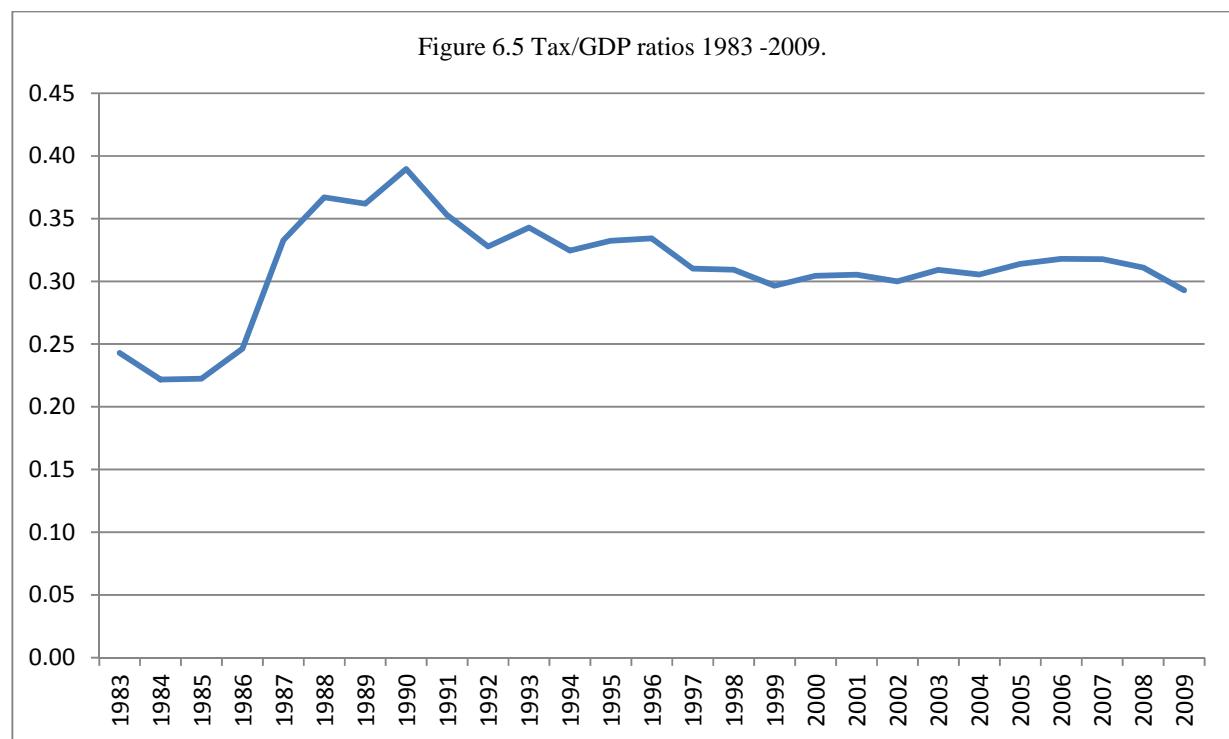
<sup>404</sup> See n 403.

<sup>405</sup> D Giles (1996) *The Learning path of the Hidden Economy” Tax and Growth Effects in New Zealand*, Working paper No 21, Inland Revenue, December 1996 and D Giles, (1996) *Simulating the Relationship Between the Hidden economy and the Tax Mix in New Zealand*, Working paper No 22, Inland Revenue, December 1996.

That research further concluded was that other factors, including economic growth, government regulation, unemployment and inflation were found to be significant contributors to the size of the hidden economy.

The problem that this working paper raised was that this was the first and sadly last time that any research was commissioned by Inland Revenue into the hidden economy. The question of whether the hidden economy has been reduced and by assumption of the success of the Compliance and Penalty Regime can only be evaluated by further research. If factors which are outside of Inland Revenue's sphere influences tax evasion, surely this is a matter that Inland Revenue must address with the Government.

The briefing paper indicated that to achieve a reduction in tax evasion the tax/GDP ratio had to drop towards 21%. From 1997/1998 to 2009, this ratio has in fact remained constant at around 30% (see Figure 6.5). Hence Inland Revenue would face a continuing obstacle towards compliance as there were no reduction in the Tax/GDP ratio.<sup>406</sup>



<sup>406</sup> New Zealand's Official Year Books 1983 – 2009.

The dilemma articulated by Inland Revenue is that only by a major shift in tax policy in respect of the direct and indirect tax mix will the hidden economy be reduced. An example of this change was once exhibited in the 1980's under Rogernomics with the introduction of Goods and Services Tax (GST) and the change in the marginal tax rates. Unfortunately, the Compliance and Penalty Regime as a tax policy is not focused on changing the mix of direct and indirect tax.

#### **6.4.2 National Research Unit**

In the Inland Revenue's 1996/97 Annual Report, the Commissioner stated that evaluating change was important. For example, once implemented, "the new compliance and penalty regime and new dispute resolution process will need to be tested to determine the effectiveness of their impacts on the tax system and tax administration".<sup>407</sup>

In the 1997/1998 year, Inland Revenue indicated, "work was to be implemented on developing a measurement system to monitor changes in compliance behaviour. Measurement of these changes will be important for evaluating the effectiveness of this regime."<sup>408</sup> In its 2001 forecast, the Commissioner commented on the upcoming review into the Compliance and Penalties legislation stating "*the review is concentrating on how well the objectives of the relatively new legislation are being met, including whether it has resulted in changes in taxpayer behaviour.*"<sup>409</sup>

Appendix 1 of the Compliance Review stated that it would consider the following issue:

*"Whether there has been any change in compliance behaviour caused by the new legislation."*<sup>410</sup>

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<sup>407</sup> Inland Revenue Department Forecasts 1996/1997, p 14.

<sup>408</sup> Inland Revenue Department Forecasts 1997/1998, p 14.

<sup>409</sup> Inland Revenue Department Forecasts 2000/2001, p 15.

<sup>410</sup> See n 150.

Given that in 1994 to assist the focus on future compliance, Inland Revenue had established a National Research Unit in 1994 to carry out research on taxpayer compliance. However to date no published work has been issued by this Unit into the effectiveness of this regime and tax compliance. This is despite the fact that one of the stated objectives of the Compliance Review in 2001 was to determine whether there had been in change in compliance behaviour. It is this lack of publications and discussion that one begins to question Inland Revenue knowledge base and whether tucked away in its archives is information available to assess the effectiveness of the Compliance and Penalty Regime and or taxpayer compliance?

A further example of the research issues was detailed in the review by the Controller of Auditor General in 2003.<sup>411</sup> He stated:

*“an ideal outcome is that every taxpayer pays the correct amount of tax that is due. However, complete compliance is unlikely to be achieved. Nor would it be possible to demonstrate that complete compliance had been achieved because there is no internationally agreed methodology for measuring the size of the country’s cash economy (sometimes called as the black economy).”*

The Inland Revenue he noted was investigating the possibility of creating an econometric model to estimate improved compliance attributable to Industry Partnerships. Whether the model would be successful was subject to sufficient and reliable data. Since April 2003, no further publication or commentary has arisen in respect of this research. The question that it raises is what were the results of that model?

As an example of the extent to which research can extract information by Inland Revenue and specifically it's National Research Unit was in March 2010 when it published a paper showing the characteristics of number of active enterprises (see Table 6.4<sup>412</sup>).

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<sup>411</sup> See n 380 Para 6.14- 6.16.

<sup>412</sup> Inland Revenue Department Profiling of Small and Medium Enterprises in New Zealand: March 2010 available at [www.capabilitynz.org/content/downloads/pdfs/ird\\_sme\\_nz\\_2009.doc](http://www.capabilitynz.org/content/downloads/pdfs/ird_sme_nz_2009.doc) (as at 15 November 2010).

The Research Unit was able to extract from within those number of enterprises, details of turnover and other demographics. If this Unit can extract such details, why has it not published and disseminate information particularly in respect of non-compliance?

#### **6.4.3 Use of Possible Additional Funding from Government**

In September 2009, Inland Revenue was asked by the Tax Working Group if they received additional funding what would it invest in (excluding policy changes) to increase revenue.<sup>413</sup> Inland Revenue responded that in respect of any additional \$100 million they would gather an additional \$500 million in tax revenue.<sup>414</sup>

Table 6.4 Profile of Small and Medium Business Enterprises 2006 -2009 Active in Business.			
Tax Year	Total number of enterprises	Number of enterprises active in business	Proportion of active in business
2006	992,846	659,305	66%
2007	1,046,672	677,740	65%
2008	1,097,764	695,539	63%
2009	1,119,509	679,642 <sup>415</sup>	61%

Part of any such the funding would be used to create a dedicated team to focus on:

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<sup>413</sup> Tax Working Group was set up in May 2009 by the New Zealand Government by way of a partnership between Victoria University, Treasury, Inland Revenue, and the Centre for Accounting, Governance and Taxation Research to address medium term tax policy challenges facing New Zealand. Its final report was released in January 2010.

<sup>414</sup> See n 413, p 1.

<sup>415</sup> The number of active enterprises may be more than 679,642. The activeness is measured by filing or paying GST or PAYE, or paying income tax. At the time of data extraction, the filing and payment for income tax for 2009 were still not due.

- *Facilitating a cash economy workshop (or on-line forum) with key businesses and industry partners;*
- *Expanding industry partnership work and pilot benchmarking for industry. Benchmarking in New Zealand would take Inland Revenue between 2 and 3 years to implement;*
- *Leveraging educational material into schools and trade schools – this would be done through the existing curriculum set by the Ministry of Education; and*
- *Increasing presence – the emphasis in this area would be on social marketing campaigns.*

Inland Revenue further indicated that they would support the above investment by a greater emphasis on intelligence tools and processes in areas of automated data-matching campaign management and sophisticated business rules.<sup>416</sup> This investment would enable the Inland Revenue to capture information as to what drives compliant and non-compliant behaviour. Inland Revenue would then be able evaluate the effectiveness of responses to compliance and establish social norms and outliers dealing with tax non-compliance.

The relevance of these comments is that, it appears that only 14 years after the Compliance and Penalty Regime was introduced that Inland Revenue openly acknowledges that it wishes to examine what drives compliant and non-complaint behaviour and how effective is the compliance responses. This research would also establish social norms and identifying outliers.<sup>417</sup> The above plans will arise only if additional funding is provided. Given the current economic conditions, and decisions of the current Government to restrain its future expenditure, it is highly unlikely that Inland Revenue would receive the requested additional funding.

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<sup>416</sup> See n 413, p 7.

<sup>417</sup> An outlier in statistics is an observation that is numerically distant from the rest of the data: V Barnett and T Lewis, *Outliers in Statistical Data*. John Wiley & Sons. 3<sup>rd</sup> edition (1994).

## **6.5 Summary**

Inland Revenue's Annual reports revealed that as a percentage of tax revenue, tax discrepancies continued to climb each year and from a purely dollar calculation this Regime has failed to stem the tide of an increasing level of criminal tax fraud. Irrespective of the secrecy objectives of section 81 of the Tax Administration Act 1994, the Inland Revenue publications lacked precision as to the relevant tax discrepancies, tax recovered, industries involved, ethnical background and the statutes that the taxpayer was charged with breaching.

The Inland Revenue in communicating successful prosecutions although to be commended conveyed information that lacked essential qualities so necessary for current or future research into the trends of criminal tax fraud. That is, depth as to the tax periods, gross discrepancies and core tax liability, occupation of the taxpayer and whether the funds were recovered need to be further discussed.

The repealed section 146 of the Tax Administration Act 1994 in June 2005 saw the removal of a valuable although time consuming source of information as to the trends of tax evasion and prosecution of taxpayers. The replacement by way of media releases, and Annual Reports fails to mirror this alternative source of information.

Industry partnership as a strategy to create a BISEP base of information and a lasting relationship with Industries that the Inland Revenue considered as risks was successful in respect of the Horticultural Industry. Its success was based on applying the concepts and principles of the Compliance Triangle towards those taxpayers involved in the Horticultural Industry. Inland Revenue however has failed to publicise whether the other Industry partnership has also been successful so as to bring to heel those taxpayers outside the tax net.

Inland Revenue National Research Unit has access to a vast amount of data about taxpayers and their compliance behaviour. To date, it appears that little or no research has been

commissioned into this area. Unless it begins to use this information productively in its Compliance Strategy to target those who commit criminal tax fraud, the tax/GDP which is a key indicator of the hidden economy will remain exactly that, “hidden.”

Inland Revenue will not fully succeed in its application of the Compliance and Penalty Regime to combat criminal tax fraud until it begins a proactive approach encompassing research into the very taxpayers who commit criminal tax fraud. This research must produce quality data that when made public will accurately convey the extent of the problem of criminal tax fraud in New Zealand.

The predicament for Inland Revenue in publicising the full extent of criminal tax fraud in New Zealand may create a perception that tax evasion is a common occurrence and acceptable social norm.

## **Chapter 7**

### **Conclusion**

This study has examined whether the Compliance and Penalty Regime has been effective as an instrument in combating criminal tax fraud. This chapter is set out in three parts, with section 7.1 presenting a summary of the findings of this study. Section 7.2 sets out the limitations of this study. This chapter concludes with suggestions for future research.

The problem of criminal tax fraud has existed for as long as taxes were levied.<sup>418</sup> The question for the Inland Revenue as a tax administration with limited resources and limited opportunity for surveillance and audit activities is whether the Compliance and Penalty Regime achieved its objectives of enhancing voluntary compliance and reducing criminal tax fraud.<sup>419</sup> Given that taxes have existed in New Zealand since its colonisation, together with enforcement activities, it seems strange that today we continue to puzzle over the problem of taxpayers' tax fraud as though it was a completely new phenomenon.<sup>420</sup>

Inland Revenue modernised due to the reforms of Rogernomics to become a far more focused and determined Tax Authority, by identifying risks to the integrity of the tax system and prepared in time to use the full force of the law to bring to heel those taxpayers who contested their obligations to pay tax.

The research question raised in this thesis is whether the Compliance and Penalty Regime which required taxpayers to take their tax obligations seriously has been effective as an instrument in combating criminal tax fraud by deterring the taxpaying population from

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<sup>418</sup> G. David (ed.) *We Won't Pay: A Tax Resistance Reader* which dealt with the rendering of taxes to the Roman Authorities.

<sup>419</sup> One purpose of a tax penalty for tax fraud is to reduce the incidence of tax fraud and show to the complying taxpayers the success of such deterrents.

<sup>420</sup> In 1840, when British sovereignty was declared, taxes on imports such as alcohol and tobacco were imposed.

committing criminal tax fraud and to show society that the current tax enforcement regime actually worked as compared to the previous penalty regime. The findings drawn from the published data and media releases by Inland Revenue are summarised in the next section.

## **7.1 Summary of Findings and Implications**

To evaluate the regime's effectiveness requires access to relevant and precise statistical information which is comparable. Inland Revenue's Annual Reports are the most obvious and initial source of such information in respect of tax discrepancies. In the period 1998 – 2009, tax discrepancies as a percentage of tax revenue, continued to climb from 1.85% to 3.96%. Within these tax discrepancies were both tax evasion and fraud investigations. During this same period, tax evasion shortfall penalties rose from 14.35% to 39.27%. Information released under section 141L of the Tax Administration Act 1994 revealed that tax evasion shortfalls as a percentage increased from 9.52% to 14.96%. Irrespective of which source is used, tax evasion shortfalls, which is one part of the concept of criminal tax fraud, has increased since the introduction of the Compliance and Penalty Regime in July 1996.

In respect of taxpayers charged with criminal offences which are the other leg of the definition, no statistical information were released during this same comparable period. The only information that was released via Inland Revenue's website, detailed that during the period December 2004 to October 2010, \$56,914, 801.14 was defrauded and insufficient evidence exists as to the extent the taxes were recovered from those taxpayers.

Inland Revenue media website has released information in regards to its prosecutions since December 2004. Of the 96 cases cited, the clear patterns are of taxpayers who were registered and who ignored the most obvious requirement to account for tax. However the

Inland Revenue failed to disclose was the other 755 taxpayers were also prosecuted for which no statistical information were released. What is more disturbing is the lack of prosecution of those taxpayers who resided in the hidden economy, an area that was difficult to investigate and for which little return was obtained.<sup>421</sup>

Inland Revenue has an inherent conflict between obtaining tax discrepancies and decreasing the level of non-compliance. In its purchase agreement the Minister of Revenue, has agreed each year to obtain a greater return for every dollar it allocates to Taxpayer Audit. Each year it continues to meet this targeted discrepancy. It also has, since the adoption of the Compliance Triangle, the purpose of pursuing taxpayers to become more compliant which in time will render less tax discrepancies. Since 2001/2002 greater dollar discrepancies have been detected with criminal tax fraud a continual contributor. What also adds to the mixture is the Inland Revenue's Audit coverage of all taxpayers in the Compliance Triangle. Inland Revenue obtains significant tax discrepancies from those taxpayers who were compliant. It also appears that Inland Revenue was unable to focus solely on reducing non-compliance due to the monetary requirements to allocate its budget allocation across all taxpayers and types of Audits. As an example, in the 2002/2003 year: - only 11% of its targeted hours were devoted to aggressive tax issues and 10.5% to tax evasion.<sup>422</sup> This meant that 79.5% of the dollars were allocated to other investigations which were neither evasion nor aggressive tax issues. It is this hurdle - how to allocate dollars across various types of audits that Inland Revenue forsakes dollars and prosecutions for more technical audits.<sup>423</sup>

Industry partnerships were a valuable source of information and building a relationship with taxpayer groups. Inland Revenue, apart from disclosing their successful partnership in respect of the Horticultural Industry has not publicised how effective such relationships with other industries were in combating criminal tax fraud in those industries. What further

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<sup>421</sup> Report of the Finance and Expenditure Committee 2008/2009 review of the Inland Revenue 18 November and 16 December 2009 available at <http://www.parliament.nz/en-NZ/PB/SC/Reports/A/2/6/49> DBSCH-scr4955-1 2008-2009- financial-review-of-inland-revenue (as at 28 February 2010).

<sup>422</sup> See n 254, Para 5.62.

<sup>423</sup> See n 254, Para 6.7. By way of explanation, the Auditor General noted that discrepancies were counted when there was no likelihood of recovery. No dollar value was quoted.

clouds the issues, was the commentary by the Auditor General into Inland Revenue's manipulation of statistical information to convey its success, which raises a very reflective question-; what other information has Inland Revenue manipulated to portray success?

The Inland Revenue National Research Unit was created in 1994 to undertake empirical research in respect of taxpayer compliance to assist Inland Revenue's in the development of its Compliance Strategy. Given the vast amount of data that Inland Revenue's retains about taxpayers, its investigations and research into compliance behaviour by other tax authorities,<sup>424</sup> there has been little or no public dissemination of the Unit's research. This lack of public dissemination is disturbing as Inland Revenue as an arm of Government has a responsibility to inform society of its success, failures, and whether society has accepted voluntary compliance as a social norm. One can view that Inland Revenue's failure to make these findings public, or any findings as to whether this Regime has changed the compliance behaviour of taxpayers, is surely a breach of its moral duty to protect the revenue and society as a whole. The Commissioner did acknowledge that there is an underground economy or hidden economy in New Zealand but that Inland Revenue has not done any research into this area as it is hard to measure.<sup>425</sup>

Finally any evaluation, data integrity is critical. In other words, even if data is available, it needs to be reliable. This study found that there were disparities between the Annual Reports and Official Information requests in respect of Shortfalls Penalties imposed. Further, in respect of prior years, Inland Revenue was unable to differentiate the revenue that those shortfalls were imposed on. However, Inland Revenue failed to inform Society of these changes and the true extent of criminal tax fraud by way of tax evasion shortfalls. What further reinforces this data integrity let down is that numerous disparities exist within the information provided (which were discussed in Chapter 5). For instance, tax evasion as a percentage of total tax shortfalls calculated based on data provided in the annual reports

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<sup>424</sup> Right from the Start. Research and Strategies, Swedish Tax Authority available at [www.skatteverket.se/international/inenglish.4.3a542410ab40421c80006827.html](http://www.skatteverket.se/international/inenglish.4.3a542410ab40421c80006827.html) (as at 1 August 2005).

<sup>425</sup> Report of the Finance and Expenditure Committee 2008/2009 review of the Inland Revenue 18 November and 16 December 2009 available at <http://www.parliament.nz/en-NZ/PB/SC/Reports/A/2/6/49> DBSCH-scr4955-1 2008-2009- financial-review-of-inland-revenue (as at 28 February 2010).

(1998-2009) was 56.39% whereas from the Official Information Requests, it came to 33.05%. What is significant concerning the latter figure is that 1/3<sup>rd</sup> of all tax shortfalls arose from tax evasion and that was over a period of 12 years since the Regime came into force. It appears that despite the education such as espoused in the Inland Revenue's Statements of Intent, The Way Forward and its Compliance Strategy, tax evasion as a subset of criminal tax fraud is "alive and well." What is more alarming is that Inland Revenue within its publications continues to change the type of information that it releases. It is this lack of comparability that is a hurdle for research into the effectiveness of the Compliance and Penalty Regime. In respect of mapping the trends in tax evasion, one requires information that is precise and not subject to disparities within tax years.

## **7.2 Limitations of this study**

One of the limitations of this study is that the evaluation of the effectiveness of the regime was carried out by analysing the publications and media releases. Data which were not available or within the author's access obviously were not considered in the evaluation. These "missing data" however might provide further evidential support as to the effectiveness of the regime.

Insights gained from Inland Revenue personnel involved with criminal fraud might also further strengthen the research findings. However, even though attempt was made to interview the Inland Revenue staff, it was declined unfortunately.

Notwithstanding these limitations, this study has made a valuable contribution to the research into whether the Compliance and Penalty Regime has been effective in combating criminal tax fraud. The conclusions are important as they highlight the deficiencies in the Inland Revenue reporting mechanisms of its prosecutions and imposition of shortfall penalties. This study also highlighted the apparent conflict between the goals of the Compliance and Penalty Regime, the Compliance Triangle and the Purchase Agreement. Each of these concepts are principally in conflict. Inland Revenue need to address these

inherently conflicting principles and seek to improve voluntary compliance by focusing its resources not on taxpayers who reside at lower strata but by concentrating on those taxpayers who intentionally not comply.

### **7.3 Future Research**

Given the continual prevalence of criminal tax fraud in New Zealand and the dearth of research into the effectiveness of the Compliance and Penalty Regime, future studies into this area are required.

Building on Devos's initial study would assist in determining whether his tentative conclusions that the level of taxpayer non-compliance is still unacceptable and the increase and imposition of penalties alone should form part of an overall Compliance Strategy. Future research could seek information from Inland Revenue, such as the number of audits completed for the years ending 30 June 2002 to 30 June 2010, number of investigations that shortfall penalties that were imposed during this period and Inland Revenue's definition of material discrepancy for the years that Devos's studied. Such information would be valuable in determining the overall trend in respect of whether the Inland Revenue's Compliance and Penalty Regime has reduced the growth of criminal tax fraud further examined.

As one of the main purposes of the Compliance Review was to ascertain whether there has been any change in compliance behaviour after the implementation of the Compliance and Penalty Regime, access into the submissions to Inland Revenue and Inland Revenue's findings would help to provide further indication as to whether Inland Revenue's attempts to curb criminal tax fraud was successful.<sup>426</sup>

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<sup>426</sup> See n 150.

Criminal tax fraud is by its very nature a challenge to the fabric of society. Unless society and Inland Revenue confronted those who undertake to oppose the very right to tax, tax revenue so essential for the provision of public goods and services will decline. The ability of Government to then fund essential goods and services from an ever decreasing tax take will see the burden passed onto those ever declining honest taxpayers, which in turn will result in even fewer honest taxpayers. Given the continual level of criminal tax fraud in New Zealand since the Compliance and Penalty Regime was enacted in July 1996, it is time to reconsider the essential priorities that Inland Revenue must address in order to reduce the level of non-compliance. Otherwise New Zealand as a society will accept a certain level of criminal tax fraud.

## **Appendices.**

- Appendix 1      Section 141A, 143A and 143B Tax Administration Act 1994.
- Appendix 2      Economic and Fiscal Reforms.
- Appendix 3      Crimes Act 1961 Sections 66(1) and (2), 228 and 229A, Companies Act 1993 Section 373(3), Serious Fraud Act 1990 Sections 45, 46 and 47.
- Appendix 4      Output Agreement Minister of Revenue – Commissioner of Inland Revenue 2010-2011.
- Appendix 5      Material Discrepancies as per Annual Inland Revenue Reports.
- Appendix 6      Selection of names published from Inland Revenue Media Website involving tax prosecutions.
- Appendix 7      New Zealand Law Society Continuing Legal Education Tax Conference September 2010.
- Appendix 8      Inland Revenue Department Letter 9 July 2010 advising shortfall penalties imposed for 2008 and 2009 Tax Years.
- Appendix 9      Inland Revenue Department letter 17 August 2010 advising tax shortfalls imposed for the 2007.
- Appendix 10     Inland Revenue Department letter 22 October 2010 advising the tax discrepancies for the 2000, 2001 and 2002 years taxes.
- Appendix 11     Inland Revenue Department letter 11 February 2011 advising the tax shortfalls imposed for the years 1998, 1999, 2000, 2001, 2002, 2003, 2004 and 2005 and the various categories, i.e. Lack of Reasonable Care etc.
- Appendix 12     Inland Revenue Department Annual Report 2005, page 146 table 2 setting out the tax shortfalls imposed for the 2005 tax year and Inland Revenue Department Annual Report 2006 page 134, Table 2 setting out the tax shortfalls imposed for the 2006 tax year.
- Appendix 13     New Zealand Gazette Issue No 10 dated 25 January 2001 pages 197 -207.

## **Appendix 1 Tax Administration Act 1994.**

### **[141E Evasion or similar act**

- (1) A taxpayer is liable to pay a shortfall penalty if, in taking a tax position, the taxpayer—
- (a) Evades the assessment or payment of tax by the taxpayer or another person under a tax law; or
  - (b) Knowingly applies or permits the application of the amount of a deduction or withholding of tax made or deemed to be made under a tax law for any purpose other than in payment to the Commissioner; or
  - ~~[(c) knowingly does not make a deduction, withholding of tax, or transfer of payroll donation required to be made by a tax law; or]]~~
  - (d) Obtains a refund or payment of tax, knowing that the taxpayer is not lawfully entitled to the refund or payment under a tax law; or
  - ~~[(da) attempts to obtain a refund or payment of tax, knowing that the taxpayer is not lawfully entitled to the refund or payment under a tax law; or]]~~
  - (e) Enables another person to obtain a refund or payment of tax, knowing that the other person is not lawfully entitled to the refund or payment under a tax law; or
  - ~~[(f) attempts to enable another person to obtain a refund or payment of tax, knowing that the other person is not lawfully entitled to the refund or payment under a tax law—]]~~
- (referred to as **evasion or a similar act**).

### **[143A Knowledge offences]**

- (1) A person commits an offence against this Act if the person—
- (a) Knowingly does not keep the books and documents required to be kept by a tax law; or
  - (b) Knowingly does not provide information (including tax returns and tax forms) to the Commissioner or any other person when required to do so by a tax law; or
  - (c) Knowingly provides altered, false, incomplete, or misleading information (including tax returns and tax forms) to the Commissioner or any other person in respect of a tax law or a matter or thing relating to a tax law; or
  - (d) Knowingly applies or permits the application of the amount of a deduction or withholding of tax made or deemed made under a tax law for any purpose other than in payment to the Commissioner; or
  - (e) Knowingly does not make a deduction or withholding of tax required to be made by a tax law; or
  - (f) Knowingly issues 2 tax invoices (as defined in the [Goods and Services Tax Act 1985](#)) in respect of the same taxable supply.
- ~~[(2) No person may be convicted of an offence against subsection (1)(b) for knowingly not providing information (other than tax returns and tax forms) to the Commissioner if the person proves that, as and when the person was required by the Commissioner to provide the information—~~
- ~~(a) the person did not have the information in the person's knowledge, possession or control; and~~

(b) no non-resident, who under section [17\(1C\)](#) was controlled directly or indirectly by the person, had the information in the non-resident's knowledge, possession or control.]

#### **143B Evasion or similar offence**

- (1) A person commits an offence against this Act if the person—
- (a) Knowingly does not keep the books and documents required to be kept by a tax law; or
  - (b) Knowingly does not provide information (including tax returns and tax forms) to the Commissioner or any other person when required to do so by a tax law; or
  - (c) Knowingly provides altered, false, incomplete, or misleading information (including tax returns and tax forms) to the Commissioner or any other person in respect of a tax law or a matter or thing relating to a tax law; or
  - (d) Knowingly does not make a deduction or withholding of tax required to be made by a tax law; or
  - (e) Pretends to be another person for any purpose or reason relating to a tax law,— and does so—
  - (f) Intending to evade the assessment or payment of tax by the person or any other person under a tax law; or
  - (g) To obtain a refund or payment of tax in the knowledge that the person is not lawfully entitled to the refund or payment under a tax law; or
  - (h) To enable another person to obtain a refund or payment of tax in the knowledge that the other person is not lawfully entitled to the refund or payment under a tax law.
- (2) A person who evades or attempts to evade the assessment or payment of tax by the person or another person under a tax law commits an offence against this Act.
- (3) *Repealed.*

## **Appendix 2 Economic and Fiscal Reforms.**

Extract from L Evans, A Grimes and B Wilkinson, Economic Reforms in New Zealand 1984-95, The Pursuit of Efficiency: (December 1996), Vol. 34 Issue 4, *Journal of Economic Literature* 1856, page 1859 showing the extent of the economic and fiscal reforms during the 1984 – 1995 years.

## **Appendix 3.**

### **Crimes Act 1961**

#### **66 Parties to offences (1)**

Every one is a party to and guilty of an offence who—

- (a) Actually commits the offence; or
- (b) Does or omits an act for the purpose of aiding any person to commit the offence; or
- (c) Abets any person in the commission of the offence; or
- (d) Incites, counsels, or procures any person to commit the offence.

(2) Where 2 or more persons form a common intention to prosecute any unlawful purpose, and to assist each other therein, each of them is a party to every offence committed by any one of them in the prosecution of the common purpose if the commission of that offence was known to be a probable consequence of the prosecution of the common purpose.

#### **229A Taking or dealing with certain documents with intent to defraud**

Every one is liable to imprisonment for a term not exceeding 7 years who, with intent to defraud,—

- (a) Takes or obtains any document that is capable of being used to obtain any privilege, benefit, pecuniary advantage, or valuable consideration; or
- (b) Uses or attempts to use any such document for the purpose of obtaining, for himself or for any other person, any privilege, benefit, pecuniary advantage, or valuable consideration.]

#### **228 Dishonestly taking or using document**

Every one is liable to imprisonment for a term not exceeding 7 years who, with intent to obtain any property, service, pecuniary advantage, or valuable consideration,—

- (a) dishonestly and without claim of right, takes or obtains any document; or
- (b) dishonestly and without claim of right, uses or attempts to use any document.]

## **Companies Act 1993**

### **373 Penalty for failure to comply with Act**

Subsection (3) A person convicted of an offence against any of the following sections of this Act is liable to a fine not exceeding \$50,000 or to imprisonment for a term not exceeding 2 years:

[(a) section 261(6A) (which relates to the power of liquidators to obtain documents and information);]

[(b) section 273(2) (which relates to certain prohibited conduct);]

[(c) 274(2) section (which relates to the duty to identify and deliver property).]

(4)

A person convicted of an offence against any of the following sections of this Act is liable to imprisonment for a term not exceeding 5 years or to a fine not exceeding \$200,000:

Section 304(6) (which relates to false claims by unsecured creditors in liquidations):

(b) Section 305(11) (which relates to false claims by secured creditors in liquidations):

(c) Section 377 (which relates to false statements):

(d) Section 378 (which relates to the fraudulent use or destruction of property):

(e) Section 379 (which relates to falsifying records):

(f) Section 380 (which relates to carrying on business fraudulently):

(g) Section 382(4) (which relates to persons prohibited from managing companies):

(h) Section 383(5) (which relates to acting as a director of a company while prohibited by the Court):

(i) Section 385(9) (which relates to acting as a director of a company or taking part in the management of a company while prohibited by the Registrar).

[(j) section 386A(2) (which relates to acting as a director of a phoenix company).]

## **Serious Fraud Office Act 1990**

### **45 Offence to obstruct investigation, etc**

Every person commits an offence, and is liable on conviction on indictment,—

(a) In the case of an individual, to imprisonment for a term not exceeding 12 months or to a fine not exceeding \$15,000:

(b) In the case of a corporation, to a fine not exceeding \$40,000,— who,—

(c) Without lawful justification or excuse, resists, obstructs, or delays any member of the Serious Fraud Office in the exercise of any power conferred by section 9 of this Act; or

(d) Without lawful justification or excuse, refuses or fails to—

(i) Attend before the Director; or

(ii) Answer any question; or

(iii) Supply any information; or

(iv) Produce any document; or

- (v) Provide any explanation; or
- (vi) Comply with any other requirement,—  
as required pursuant to the exercise of any power conferred by section 9 of this Act; or
- (e) In the course of complying with any requirement imposed pursuant to section 5 or section 9 of this Act, gives an answer to any question, or supplies any information, or produces any document, or provides any explanation, knowing that it is false or misleading in a material particular or being reckless as to whether it is so false or misleading.

#### **46 Offence to destroy, alter, or conceal records, etc**

- (1) Every person commits an offence, and is liable on conviction on indictment to imprisonment for a term not exceeding 2 years or to a fine not exceeding \$50,000, who, with intent to defeat any investigation being carried out or likely to be carried out by the Serious Fraud Office, or with intent to prevent the Serious Fraud Office exercising any power under this Act,—
  - (a) Destroys, alters, or conceals any book, document, or record; or
  - (b) Sends any book, document, or record out of New Zealand.
- (2) If, in any prosecution for any such alleged offence, it is proved that the person charged with the offence has—
  - (a) Destroyed, altered, or concealed any book, document, or record; or
  - (b) Sent any book, document, or record out of New Zealand,—

the onus of proving that in so doing that person had not acted in contravention of this section shall lie on that person.

#### **47 Offence to resist search**

Every person commits an offence, and is liable on summary conviction to imprisonment for a term not exceeding 3 months or to a fine not exceeding \$5,000, who intentionally resists, obstructs, or delays any person executing, or assisting in the execution of, any warrant issued under this Act.

## **Appendix 4.**

### **Output Plan**

#### **Minister of Revenue – Commissioner of Inland Revenue**

Extracts from the 2010/2011 Output Plan for the Inland Revenue for Taxpayer Audit Output Delivery Targets and its performance Measures Para 5.1.0 to 5.1.6 attached. A full copy of the Output Plan is available at [www.ird.govt.nz/aboutir/reports/output-plan](http://www.ird.govt.nz/aboutir/reports/output-plan) citing the words output plan reports available for download (as at 31 January 2011).

## **Appendix 5 Material Discrepancies.**

Summary of Extracts Inland Revenue Department Annual Reports 1996 – 2002 setting out material discrepancies standards for Inland Revenue Taxpayer Audit

<b>Year</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>
Non Business Audit	50%	50%	50%	A
Material Discrepancy				
Business Audit	40%	40%	45%	A
Medium Business [B]	60%	60%		
Corporates	60%	A	A	A

### **Key**

- A No Standard was reported for a material discrepancy to be achieved by Corporates  
B In 1997/1998 Medium Business was incorporated into Business Audit

After 1999, Inland Revenue began to identify its audits by type, namely audits, extended Audits, Investigations.

**Appendix 5(1)** Extract from Taxpayer Audit Output Class 6 as per Inland Revenue's Forecast Financial Statement and performance objectives 1999/2000 year

### **Business Audit Description**

This output involves the detection of non-compliance and deterrence of future non-compliance among businesses with a turnover of up to \$100 million (excluding groups in the Corporate segment). It includes duties audits and non-resident audits.

### **Quality**

Effective case selection results in a material discrepancy being identified in:

- 45% of audits
- 55% of extended audits.
- 65% of investigations

**Appendix 5(2)** Extract from Taxpayer Audit Output Class 6 as per Inland Revenue's Forecast Financial Statement and performance objectives 2000/2001 year

### **Business Audit Description**

This output involves the detection of non-compliance and deterrence of future non-compliance among businesses with a turnover of up to \$100 million [excluding groups in the Corporate segment]. It includes duties audits and non-resident audits.

## **Quality**

Effective case selection results in a material discrepancy being identified in:

- 50% [45%] of audits
- 55% of extended audits.
- 70% [65%] of investigations

**Appendix 5(3)** Extract from Taxpayer Audit Output Class 6 as per Inland Revenue's Forecast Financial Statement and performance objectives 2001/2002 year

## **Business Audit Description**

This output involves the detection of non-compliance and deterrence of future non-compliance among businesses with a turnover of up to \$100 million [excluding groups in the Corporate segment. It includes duties audits and non-resident audits.

## **Quality**

Effective case selection results in a material discrepancy being identified in:

- 50% [45%] of audits
- 55% of extended audits.
- 70% [65%] of investigations

## **Appendix 5(4) Inland Revenue's Audit Compliance Focus 1996 - 2010**

Year ending 30 June 1996	Not listed.
Year ending 30 June 1997	Not listed
Year ending 30 June 1998	Not listed
Year ending 30 June 1999	Not listed
Year ending 30 June 2000	Not listed
Year ending 30 June 2001	Not listed
Year ending 30 June 2002	Not listed
Year ending 30 June 2003 <sup>427</sup>	Large Enterprises, Avoidance Schemes, Tax Evasion.
Year ending 30 June 2004 <sup>428</sup>	Large Enterprises, Aggressive Tax issues, Tax Evasion,
Year ending 30 June 2005 <sup>429</sup>	Industry partnership
Year ending 30 June 2006 <sup>430</sup>	Tax evasion, and tax avoidance, technical non-compliance, aggressive tax planning, related party financing, intangible property,
Year ending 30 June	Property, Evasion and Avoidance, tax non-technical compliance,

<sup>427</sup> Inland Revenue's Statement of Intent 2005 - 2008.

<sup>428</sup> Inland Revenue's Statement of Intent 2004 - 2005.

<sup>429</sup> Inland Revenue Department Annual Report 2005, p 31.

<sup>430</sup> Inland Revenue Department Annual Report 2006, p 33.

2007 <sup>431</sup>	Income suppression child support, Aggressive tax issues, high wealth individuals,
Year ending 30 June 2008 <sup>432</sup>	Evasion and Fraud, Property Transactions, Aggressive tax planning, large enterprise audits,
Year ending 30 June 2009 <sup>433</sup>	Evasion and Fraud, Property Transactions, Online Traders, Horticultural contracting, Structural Finance.
Year ending 30 June 2010 <sup>434</sup>	Property, Evasion and Fraud in the hidden economy, Aggressive Tax planning, High-Wealth Individuals, large Enterprises

Inland Revenue Audit Focus has remained somewhat shrouded until recently with the publication, Inland Revenue's Compliance Focus 2010-2011. This publication set out 10 key areas that the Revenue saw as its compliance focus. Previously, the Inland Revenue's compliance focus was gathered from its annual Reports, and various networks such arising from the Accountants conferences, Tax seminars, Industry newsletters, and other third party networks.

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<sup>431</sup> Inland Revenue Department Annual Report 2007, p 36.

<sup>432</sup> Inland Revenue Department Annual Report 2008, p 37.

<sup>433</sup> Inland Revenue Department Annual Report 2009, p 34.

<sup>434</sup> Inland Revenue Department Annual Report 2010, p 35.

## **Appendix 6.**

A selection of taxpayers prosecuted by Inland Revenue Department for offences committed under the Tax Administration Act 1994 and or Crimes Act 1961 and released from the Inland Revenue media website.

Date of Publication	7 December 2004
Name of Taxpayer	Davinder Sigh
Court in which charges were laid	Tauranga District Court
Tax Revenue	PAYE/GST
Tax Periods	Not published
Gross tax Discrepancy	\$437,351.43
Tax Liability	\$110, 937.10
Tax Recovered	Not published
Sentence	12 months imprisonment
Method of fraud	False Invoices
Industry	Horticulture
Occupation as per publication	Horticultural Contractor

Date of Publication	10 December 2004
Name of Taxpayer	Anna Zigova
Court in which charges were laid	Tauranga District Court
Tax Revenue	Not Published
Tax Periods	Not published
Gross tax Discrepancy	\$110,000.00
Tax Liability	\$33,150.00
Tax Recovered	Not published
Sentence	4 months imprisonment
Method of fraud	False Identities
Industry	Not published
Occupation as per publication	Horticultural Contractor

Date of Publication	12 January 2005
Name of Taxpayer	Wendy Robyn Harrison
Court in which charges were laid	Hastings District Court
Tax Revenue	PAYE
Tax Periods	Not published
Gross tax Discrepancy	\$40,000.00
Tax Liability	\$40,0000.00
Tax Recovered	Not published
Sentence	300 hours community Service
Method of fraud	Failing to account for PAYE

Industry	Horticulture
Occupation as per publication	Horticultural Contractor
Date of Publication	21 January 2005
Name of Taxpayer	Manjit Singh
Court in which charges were laid	Tauranga District Court
Tax Revenue	Not Published
Tax Periods	Not published
Gross tax Discrepancy	Not published in precise details
Tax Liability	Not published in precise details
Tax Recovered	Not published
Sentence	24 months imprisonment
Method of fraud	False Invoices
Industry	Horticulture
Occupation as per publication	Horticultural Contractor

Date of Publication	1 March 2005
Name of Taxpayer	Stephen Norton
Court in which charges were laid	Hamilton District Court
Tax Revenue	PAYE
Tax Periods	Not published
Gross tax Discrepancy	\$7,515.00
Tax Liability	\$7,515.00
Tax Recovered	Not published
Sentence	180 hours of community service
Method of fraud	Failing to account for PAYE.
Industry	Not published
Occupation as per publication	Self Employed

Date of Publication	6 April 2005
Name of Taxpayer	David Rowan
Court in which charges were laid	New Plymouth District Court
Tax Revenue	Income tax
Tax Periods	Not published
Gross tax Discrepancy	Not published in precise details
Tax Liability	Not published in precise details
Tax Recovered	Not published
Sentence	18 months imprisonment
Method of fraud	Failing to file any tax returns for 9 years
Industry	Bricklayer
Occupation as per publication	Self employed

Date of Publication	26 April 2005
Name of Taxpayer	Barry Reid
Court in which charges were laid	Palmerston North District Court
Tax Revenue	Income Tax, GST and PAYE
Tax Periods	Not in precise details
Gross tax Discrepancy	Not published.
Tax Liability	Not published.
Tax Recovered	Not published
Sentence	9 months imprisonment – possibility of home detention
Method of fraud	Not published in precise details
Industry	Distribution of Vacuum cleaners
Occupation as per publication	Self Employed
Date of Publication	26 April 2005
Name of Taxpayer	Heather Reid
Court in which charges were laid	Palmerston North District Court
Tax Revenue	Income Tax, GST and PAYE
Tax Periods	Not in precise details
Gross tax Discrepancy	Not published.
Tax Liability	Not published.
Tax Recovered	Not published
Sentence	6 months imprisonment – possibility of home detention
Method of fraud	Not published in precise details
Industry	Distribution of Vacuum cleaners
Occupation as per publication	Self Employed
Date of Publication	13 May 2005
Name of Taxpayer	David L Masters
Court in which charges were laid	Auckland High Court
Tax Revenue	Not published in sufficient detail
Tax Periods	Not published in sufficient detail
Gross tax Discrepancy	\$525,000.00
Tax Liability	Not published
Tax Recovered	Not published
Sentence	42 months imprisonment
Method of fraud	False GST input claims
Industry	Not published
Occupation as per publication	Not Published

Date of Publication	3 June 2005
Name of Taxpayer	Matthew Liang
Court in which charges were laid	Tauranga District Court
Tax Revenue	GST
Tax Periods	Not published
Gross tax Discrepancy	\$750,000.00
Tax Liability	\$83,333.00
Tax Recovered	Not published
Sentence	8 months imprisonment
Method of fraud	False GST Returns
Industry	Not published
Occupation as per publication	Self employed
Date of Publication	14 June 2005
Name of Taxpayer	Kathryn Louise Webber
Court in which charges were laid	North Shore District Court
Tax Revenue	GST and Income tax
Tax Periods	Not published
Gross tax Discrepancy	\$1.2 million
Tax Liability	Not published in sufficient detail.
Tax Recovered	Not published
Sentence	30 months imprisonment.
Method of fraud	Failing to account for income tax and GST
Industry	Legal profession.
Occupation as per publication	Solicitor
Date of Publication	8 July 2005
Name of Taxpayer	Mohammad Ataur Rahman
Court in which charges were laid	Tauranga District Court
Tax Revenue	GST and PAYE
Tax Periods	Not published
Gross tax Discrepancy	Not published in precise details
Tax Liability	Not published in precise details
Tax Recovered	Not published
Sentence	30 months imprisonment
Method of fraud	False Invoices
Industry	Horticulture
Occupation as per publication	Horticultural Contractor

## **Appendix 7.**

Extracts from Brown and McKay's paper Managing Tax Audits Investigations and Disputes presented at the New Zealand Law Society Continuing Legal Education Limited Law Conference September 2010 (pages 162-165) which sets out the tax shortfalls imposed for the 2006 -2009 tax years.

## **Appendix 8.**

Inland Revenue letter dated 9 July 2010 as a consequence of a request under the Official Information for prosecution and tax shortfall details for the 2008 and 2009 tax years.

## **Appendix 9.**

Inland Revenue letter dated 17 August 2010 as a consequence of a request under the Official Information for tax shortfall imposed for the 2007 tax year.

## **Appendix 10.**

Inland Revenue letter dated 22 October 2010 as a consequence of a request under the Official Information for tax discrepancies ascertained in the Inland Revenue investigations for the 2000, 2001 and 2002 tax years.

## **Appendix 11.**

Inland Revenue letter dated 11 February 2011 as a consequence of a request under the Official Information for tax shortfall imposed for the 1998- 2005 years in terms of section 141L of the Tax Administration Act 1994.

## **Appendix 12.**

Copy of Page 146 Inland Revenue Department Annual Report 30 June 2005 table 1 (Analysis of Overdue debt) and Table 2 Shortfall Penalties Imposed 2000-01 to 2004-05 and page 134 Inland Revenue Department Annual Report 30 June 2006 table 1 (Analysis of Overdue debt) and Table 2 Shortfall Penalties Imposed 2001-02 to 2005-06. Note Table 2 in each of the Reports set out the shortfall penalties imposed that are relevant extracts for this thesis.

## **Appendix 13.**

New Zealand Gazette of 25 January 2001 Issue Number 10 setting out the names of taxpayers evaders as required by section 146 Tax Administration Act 1994.