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Public Consultation
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ED0186: Payment of shortfall penalty using losses

Introduction

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on *Standard Practice Statement ED0186 – Payment of Shortfall Penalty Using Losses (SPS)*.
2. The Law Society's submission addresses the view expressed by the Commissioner of Inland Revenue (Commissioner) in the SPS as to the application of section IW 1(4) of the Income Tax Act 2007 (Act). Specifically, the submission addresses the interpretation advanced in the SPS that section IW 1(4) restricts the losses available to satisfy a shortfall penalty to those losses that are available at the time that notification is provided to the Commissioner.
3. The Law Society disagrees with this interpretation.

Comments

4. The provisions of the Act that are relevant to this submission are set out below:

IW 1 Shortfall penalties

When this section applies

- (1) This section applies in a tax year when a person has a shortfall penalty for an income tax liability.

Persons choosing to use tax losses

- (2) If the person has a tax loss for the tax year, they may use the amount of the tax loss to pay the penalty, notifying the Commissioner by the due date for payment of the penalty.

[...]

Time of use

- (4) The tax loss is used at the time of notification.

Lowest marginal tax rate and availability

- (5) Each dollar of an amount of tax loss that is used under this section—
- (a) is equal to 1 dollar multiplied by the rate of tax or lowest marginal rate of tax that would apply to the person in the return period to which the tax shortfall relates if the person had tax to pay;
 - (b) cannot, from the date the tax loss is used, be used or made available for use, or be carried forward to a later tax year.

Tax years and part-years

- (6) In this section, a tax year includes a part of a tax year that may be taken into account under this Part for continuity or grouping purposes.

Section IW 1(1)

5. The Commissioner's proposed interpretation of section IW 1 appears to focus on a taxpayer's loss balance at the time of notification. Specifically, at [13] the SPS states that "section IW 1 allows the utilisation of losses that have been assessed and are still available at the time the person notifies the Commissioner".
6. In the Law Society's submission, this interpretation does not accord with the language of subsection (1) which specifically states that the section "applies in a tax year when a person has a shortfall penalty", and subsection (2) which refers to tax losses that a taxpayer has "for the tax year".
7. It is the Law Society's view that:
 - the reference in subsection (1) to "the tax year in which a person has a shortfall penalty" is properly understood as referring to the tax year in which a shortfall penalty assessment is made; and

- the tax year referred to in subsection (2) is the same tax year referred to in subsection (1).
8. Together these two statements suggest that it is the taxpayer's loss balance for the tax year in which the shortfall penalty assessment is made that may be applied to satisfy that shortfall penalty liability (such loss balance being composed of carry forward losses and any current year losses, to the extent that current year losses have been assessed).
 9. This position is consistent with the view previously expressed by the Commissioner in respect of section IG 10 of the Income Tax Act 1994 (as precursor to section IW 1). Specifically, in *INV-245: Payment of shortfall penalty using losses (TIB Vol. 10 No. 3, March 1998)*, the Commissioner stated:

Loss must be available in year penalty imposed

It should be noted that losses must be available in the year in which the shortfall penalty is imposed. For example, if adjustments are made to the 1998 return and penalties imposed in 2000, losses must be available in 2000.

10. In this respect the SPS appears to be a departure from the Commissioner's earlier (correct) position.
11. We also note that application of section IW 1 in the manner described above would be consistent with the operation of the legislation relating to the loss grouping rules. Under subpart IC of the Act, the losses that may be grouped between two companies are determined by reference to the period for which the companies satisfy minimum common ownership requirements. The losses that may be grouped are not determined by reference to the loss balance available at the time notification is given (or subvention payment is made, as applicable).
12. The Law Society is not aware of any compelling policy rationale that would necessitate such different treatment of elections to use losses to pay shortfall penalties and elections to use losses.

Section IW 1(4)

13. On the above analysis, subsection (4) does not operate to determine the point of time at which losses must be available. Rather it merely operates to confirm that losses applied in

satisfaction of shortfall penalties are, from the time of an election, unavailable for other uses. In this sense it operates in conjunction with subsection (5)(b).

14. Reference to the legislative history of subsection (4) supports this interpretation. Specifically, the legislative history suggests that the subsection is a vestige of the regime that existed prior to the introduction of the self-assessment regime in 2001. For instance, section IG 10(2) of the Income Tax Act 1994 stated:

(2) If a taxpayer makes an election under subsection (1) in relation to current year losses and the Commissioner subsequently issues a determination of net loss confirming that the net losses are available to be offset in the current income year, the time that the net losses are offset will be the time of the election.

15. Prior to the introduction of the self-assessment regime a taxpayer could make a return showing a tax loss which the Commissioner would subsequently confirm (or not) by making a determination of net loss pursuant to the then section 92 of the Tax Administration Act 1994. In this context section IG 10(2) can be seen as confirming the efficacy of an election to use them to pay a shortfall penalty at the time the election is made, notwithstanding the fact that those losses are yet to be finally determined by the Commissioner.

16. The words “the Commissioner subsequently issues a determination of net loss confirming that” were removed from the provision with the introduction of the self-assessment regime. The resulting section IG 10(2) stated:

(2) If a taxpayer makes an election under subsection (1) in relation to current year losses and the net losses are available to be offset in the current income year, the time that the net losses are offset will be the time of the election.

17. Section IG 10(2) of the Income Tax Act 1994 was carried over into section IG 10(2) of the Income Tax Act 2004. This provision stated:

(2) If a taxpayer makes an election under subsection (1) in relation to current tax year losses and the net losses are available to be offset in the current tax year, the time that the net losses are offset is the time of the election.

18. The references in this provision to current year losses were removed as a result of the 2007 re-write of the Income Tax Act when it appears section IG 10(2) was redrafted and incorporated into the Income Tax Act 2007 as section IW 1(4).

19. Given the historical function of the equivalents to section IW 1(4) in confirming the point in time at which an election to use losses is effective, it is the Law Society’s view that section IW

1(4) is not intended to have the effect of requiring losses to be available at the time of an election in order to satisfy the relevant shortfall penalty.

Practical effect – continuity breach

20. The practical significance of the Law Society's submission can be demonstrated by reference to a hypothetical situation wherein the following sequence of events occurs in a tax year in relation to a taxpayer which is in a loss position:
 - The taxpayer receives a shortfall penalty assessment;
 - The taxpayer suffers a breach of the continuity requirements in section IA 5; and
 - The taxpayer gives notice to the Commissioner under section IW 1(2).
21. In these circumstances, on the Commissioner's view, losses incurred prior to the continuity breach would not be available to satisfy the shortfall penalty assessment because notice is given under section IW 1(2) after the continuity breach.
22. However, on the Law Society's view, the continuity breach would not preclude the taxpayer's loss balance for the period prior to the breach being applied to satisfy the shortfall penalty liability. Specifically, and in light of the reference in section IW 1(6) to part-year loss calculations, the losses available to the taxpayer to satisfy the shortfall penalty liability would be prior year losses carried forward and any current losses for the part-year prior to breach (to the extent that such losses had been assessed at the time notification was given).

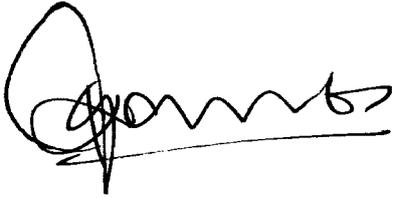
Other useful points for clarification

23. Where a taxpayer is assessed a shortfall penalty, it will generally receive a new due date for paying both the penalty and the tax shortfall to which the penalty relates (section 142F TAA).
24. In some practitioners' experience, there is some confusion within the IRD as to when the notice should be given where the taxpayer challenges that assessment under Part 8A of the TAA.
25. The draft SPS could usefully clarify that where a taxpayer challenges a shortfall penalty assessment under Part 8A, notice is only required to be given before the due date for the payment of the deferrable tax (i.e., by the 30th day after the last day of the relevant period of deferral).

Conclusion

26. This submission was prepared by the Law Society's Tax Law Committee. If you wish to discuss this further, please do not hesitate to contact the Tax Law Committee convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Tim Jones', with a horizontal line underneath.

Tim Jones
Vice-President