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How to handle IRD investigations and enquiries for lawyers

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Introduction

Lawyers are in the protection-of-rights-business. If they are not then they should be.

An investigation by the Inland Revenue Department (**Revenue**) of a person's business and/or private affairs will often test a person's rights at the most fundamental level and in ways that a person will never experience at any other time in their life (e.g. "reviewing the children's bedrooms at the Webb house" and a photograph being taken "of an open clothes/underwear drawer", *Tauber & Ors v Commissioner of Inland Revenue*, CIV-2011-404-002036, 12 August 2011, Venning J at [62]).

Properly protecting a person's rights both during and following a tax investigation requires real care and attention. Mistakes made at any point can prove to be very costly for a person both in financial and reputational terms. Lawyers have a critical role to play in safeguarding their client's rights and obtaining the best taxation outcomes for any taxation adjustments that flow out of the investigation process.

This is an area of regulatory enquiry and intervention that will only increase in the future. The New Zealand Government is desperate for increased tax revenues to fund the rebuild of Christchurch, to provide normal Government services, and to repay the country's indebtedness .

As a recent *Sunday Star Times* article noted: "the IRD has become increasingly aggressive as its auditing funding has been boosted. The money has come with heightened expectations of success ..." (*Sunday Star Times*, February 26, 2012, D3).

The statutory and regulatory scheme

The statutory rules that regulate Revenue investigations (in particular, ss 16, 16B, 16C, 17, 17A, 17(1B) and 17(1C) of the Tax Administration Act 1994 (**TA Act**)) confer on the Revenue **some of the most extensive regulatory powers** that exist under New Zealand laws: see *C of IR v New Zealand Stock Exchange* (1990) 12 NZTC 7,259 7260 (CA).

The courts have consistently interpreted these powers in a manner that facilitates the Revenue to undertake its investigative functions, and have given the most liberal interpretation to the key phrase in ss 16 and 17 of the TA Act *for a purpose which the Comissioner considers is necessary or relevant*: see *Avowal Administrative Attorneys Ltd v DC* (2010)24 NZTC 24,252 (CA).

As the Court of Appeal recently observed in *Avowal Administrative Attorneys* [22]:

> "The circumstances in which tax investigations occur differ from criminal investigations and the Commissioner's powers under s 16 are necessarily broad given the complexity that is often inherent in tax investigations. We see no need to read down the plain words of s 16."

In addition, the Revenue and its staff carry out their investigative functions in a highly professional manner. They generally do their tax-collection job very well and a lot better than many taxpayers and their advisers do their "taxpaying" job. Any mistakes made by the Revenue in the procedures adopted in investigations in the past have now largely been addressed. Numerous Revenue "protocols" have been developed for addressing matters like legal professional privilege claims, access to private residences, uplifting documents and computer-based material, obtaining access with search warrants, letters requesting information from taxpayers, to mention just some things.

While all regulators make mistakes from time to time it will be unlikely that in the vast majority of investigations there will be clear evidence of "bad" Revenue conduct that will demand the intervention and criticism of a court. In saying this, individual regulators (like individual taxpayers) can always change the dimension of particular investigation scenarios. Like some taxpayers, the Revenue will at times "game" the system if it can get away with it, although in many tax investigations the pre-investigation evidence that the Revenue will have of taxpayer wrongdoing will provide a clear *prima facie* case for regulatory enquiry of a taxpayer.

In light of these judicial and regulatory realities:

- A taxpayer resisting the fact of its involvement in an investigation is generally a waste of time: the taxpayer needs to harden up and get on with it;

- Complaining that the Revenue's conduct and demands are unfair and Revenue officers are acting inappropriately is also (generally) a waste of time;

- Rushing off to court on a whole range of interlocutory matters to try and prevent the inevitable investigation is also (generally) a waste of time and money.

Taxpayers need to focus on complying meticulously with their legal obligations in this context so as to avoid any possible criticism that the Revenue could levy against them with a judge, which it will given the chance and if the course of the investigation starts going badly for it. Revenue "overreach" can also occur from time to time, but the impugned conduct needs usually to be very bad before it will be subject to judicial condemnation and action.

A taxpayer (and its lawyer) needs to be the "good guy" in this regulatory war, not an obstructive, uncooperative, whining and potentially non-paying-tax-guy, as they will be

characterised to be by the Revenue at any step in the investigative process if **the Revenue's demands are not complied with in full as required by law**.

Taxpayer obligations

In a tax investigation a lawyer needs to be aware that a taxpayer's obligations are to:

- Provide the Commissioner with access to all lands, buildings and places and to all books and documents (whether in the custody or under the control of the taxpayer) for the purpose of inspecting those books, documents, property or other matters: s 16(1) TA Act ;
- Provide reasonable facilities and assistance to the Commissioner to enable the effective exercise of the Commissioner's powers under s 16(1), s 16(2);
- Answer all proper questions relating to the exercise of the Commissioner's powers under s 16(1) (orally, in writing or by statutory declaration): s 16(2);
- With the consent of the occupier or in terms of a proper access warrant, provide access to a "private dwelling" (which definition includes things like a garage or shed at the dwelling and business premises within the dwelling: ss 16(3) - 16(8));
- Allow the Commissioner to remove books and documents for copying purposes: s 16B;
- Allow the Commissioner to remove and retain books and documents for a fuller inspection if the taxpayer has given their consent or an appropriate warrant is held by the Commissioner;
- To furnish in writing any information and produce for inspection any books and documents which the Commissioner considers necessary or relevant for any purpose relating to the administration or enforcement of any of the Inland Revenue Acts (which includes information or a book or document about a non-resident which the taxpayer controls): s 17;
- To furnish information in writing or the production of particular books and documents to a particular office of the Revenue: s 17(1)(D);
- To provide financial information about companies: s 17(2);
- To attend an enquiry before a District Court judge and before the Commissioner (including also producing information at those venues) to answer questions on oath or in writing.

Taxpayers who breach these obligations may face *inter alia*:

- Orders from the District Court requiring information under s 17 and tax returns to be provided to the Commissioner: s 17A;

- Prosecution for a criminal offence for failing to comply with a s 17A order;
- Prosecution for a criminal offence for "obstructing" the Commissioner in the discharge of his statutory functions: s 143H;
- Prosecution for failing to give evidence at a s 18 or s 19 enquiry;
- Prosecution for failing to provide information to the Commissioner when required to under a tax law: s 143B;
- Judicial criticism;
- Regulatory actions by the Commissioner to enforce the taxpayer's disclosure and assistance obligations;
- The truncation or alteration by the Commissioner of the normal disputes procedures: s 89N;
- Default assessments: s 106.

Taxpayer rights

During a tax investigation a taxpayer has the right to expect and require the Revenue (see e.g. s 6(2) TA Act and *Inland Revenue Charter*) *inter alia*:

- To comply with the law in terms of the use of its investigative and access powers;
- To determine their tax liability fairly, impartially and according to law;
- To keep their tax affairs confidential;
- To treat them like all other taxpayers;
- To exercise its investigative powers in a manner that complies with the reasonableness requirements of s 21 of the New Zealand Bill of Rights Act 1990;
- To treat them courteously and professionally at all times;
- To be responsive to a taxpayer's individual, cultural and special needs;
- To provide the name of the person the taxpayer is dealing with;
- To respond promptly to questions that the taxpayer or their adviser might raise;
- To advise a taxpayer about their entitlements and obligations;
- To provide them with reliable and correct advice about their taxation affairs;
- To address any complaints that the taxpayer may raise about the Revenue's conduct in a prompt, fair and full way;

- To not request access to the taxpayer's private dwelling without the taxpayer providing consent or the Commissioner having an appropriate access warrant: s 16(3);

- To allow it to inspect or obtain a copy of any book or document being removed by the Commissioner for copying: s 16B(4);

- To prevent the Commissioner from taking books and documents for a full and complete inspection without the taxpayer giving consent or an appropriate warrant being obtained: s 16C;

- To obtain a copy of any book or document retained by the Commissioner for inspection: s 16C(5)

As can be seen from the above list none of these "rights" would normally provide a material basis for challenging the fact of a Revenue investigation where the Revenue and its staff are acting in a professional and reasonable manner.

Privilege and tax advice documents

The Commissioner's powers in ss 16 to 19 of the TA Act respect of access to places and to taxpayer information (and certain of the offence provisions that might apply in this context) are subject to the relevant information or book or document not being a **legally privileged communication**: s 20 TA Act. Discovery may not also be sought by the Commissioner in respect of any **tax advice document**: s 20B TA Act.

A taxpayer should be able to receive tax advice from a lawyer or accountant in the confidence that the content of their communications about taxation and other things is not available as a matter of course in a Revenue investigation.

Communications and advice with tax professionals will often identify taxation issues and problems which a taxpayer may or may not have acted on in transactions and actions having tax outcomes. As a consequence, a lawyer should always remember when giving any advice that the advice might be read subsequently by the Revenue or a Judge.

Given the express statutory protections that are afforded to legally privileged communications and tax advice documents in ss 20 and 20B, it is important that those protections are properly preserved by a lawyer in any information or document that is legally subject to protection. In practice this will require:

- At an **early state in the investigation** identifying what material (if any) may be eligible for non-disclosure on the grounds that it is privileged or a tax advice document;

- Putting that "privileged" material to one side in a manner that identifies it is "privileged";

- Explaining to the Revenue that certain items of requested information are **not going to be disclosed** as a consequence of the protections in s 20 and s 20B, and identifying (if requested to) what that non-disclosed information is;

- Working out how the protections are to be preserved if the Revenue contests non-disclosure (which may require having the claim to "privilege" assessed by a District Court Judge (see s 20(5) and s 20G));

- **Not waiving** (expressly or impliedly) the protection by handing the relevant material to the Revenue or not asserting a claim to protection as required by law. **A lawyer should never hand over any client file to the Revenue without the client's consent and before assessing whether any material on the file is eligible for protection**;

- Assessing how privilege in information held on computer hard drives and in similar locations is to be best protected and to be safeguarded where hard drives are to be inspected by the Revenue and possibly removed from the premises;

- Assessing how information held "offshore" is to be provided, if requested.

Lawyers need to also be aware that while statutory protection exists in this context the protections are subject to a good number of exceptions including *inter alia*:

- Legal privilege only attaches to "confidential communications". Lots of communications and dealings between a client and a lawyer (or adviser) do not have this quality: transactional documents etc are not usually privileged: see e.g. *C of IR v Feng* [2007] DCR 929;

- Trust/investment account information is not privileged: ss 20(2) and 20(3) TA Act;

- Communications that disclose illegal purposes (e.g. fraud) are not privileged;

- Privilege in a communication may already have been waived by the client or some third party;

- The Revenue may already have a copy of the communication;

- To be privileged the communication must have been sought for the purpose of obtaining legal advice and assistance (mixed purpose situations problematical);

- Does the relevant communication being sought involve a lawyer acting in the right capacity (in-house, fully qualified, etc);

- A general claim to privilege in respect of information held on computer hard drives may not prevent the Revenue from copying information on those hard drives without first conducting a keyword search: *Avowal Administrative Attorneys Ltd v DC* (2009) 24 NZTC 23,252.

- While non-disclosure can be sought for a "tax advice document" the scope of this protection is much more confined than that for legal professional privilege: see *Blakely v C of IR* (2008) 23 NZTC 21,865;

- The tax advice document must be one that is confidential and created for the purpose of tax advice or recording analysis about taxation laws and not created for an illegal purpose (e.g. fraud);

- A claim must be made that a relevant book or document is a tax advice document and by a person who is approved by the Commissioner as in the business of giving tax advice: ss 20B(3) and 20D. A brief description of the document being claimed must be provided;

- A claim by an authorised person that a book or document is a tax advice document must be made within certain time-frames - on the day on which disclosure of the book or document is requested by the Commissioner under ss 16 or 17 of the TA Act or at a later date by agreement (there are other time-frames also applicable where the information is sought under ss 17A, 18 or 19 of the TA Act);

- A tax advice document does not include "tax contextual information" which must be disclosed in a statutory declaration. This includes various facts and assumptions disclosed in the tax advice document and other matters contained in the document that do not relate to tax laws: ss 20E and 20F.

Voluntary disclosures

The voluntary disclosure rules in the TA Act provide a taxpayer with an opportunity to "fess up" to tax errors. Rectifying mistakes that are made in tax positions that are filed in a tax return is difficult to do subsequent to the return being filed. The voluntary disclosure rules in the TA Act provide a statutory mechanism that allows a taxpayer to notify the Revenue of the existence of a past taxation default(s).

The main advantages of a taxpayer making a voluntary disclosure of a tax default that a lawyer needs to be aware of are that:

- It allows a taxpayer to "come clean" about the default which often is a very significant relief for a taxpayer, particularly if the taxpayer has been aware for some time that there may be a problem with a filed tax position (e.g. overseas income not returned like it should have been). While there will be tax costs involved in disclosing the tax error (including usually use-of-money-interest), once the error is put to the Revenue it allows the taxpayer to go forward in the future with a clear conscience;

- It can assist with a reduction in shortfall penalties for any tax shortfall;

- It can avoid more serious prosecution action being taken in connection with the default.

However, like so much else in taxation law "timing" is everything if a person wants to maximise the benefits of a voluntary disclosure. For example, if a taxpayer only makes the voluntary disclosure after a pending tax investigation is first notified then the Revenue may still consider bringing an action for tax evasion and other similar criminal tax wrongdoing.

Similarly, potential shortfall penalties can be reduced significantly (an up to100% reduction where the shortfall penalty is for not taking reasonable care or taking an unacceptable tax interpretation position and up to 75% in all other cases). Even where the voluntary disclosure has been made after the investigation has commenced, shortfall penalties can be reduced by up to 40%.

In practice what these potential tax concessions mean is that voluntary disclosure is an option that a lawyer must discuss with a client **at the very first opportunity** and, in order to consider meaningfully whether a disclosure should be made, a lawyer will need to get a good feel for what potential tax defaults (and exposures) there might be in a taxpayer's past tax positions.

Any disclosure that is made must be a full and complete one if it is going to have the protective effect being sought. Again, this will require a lawyer to understand clearly what tax sensitivities there are in the client's past tax affairs and be able to logically explain the basis and reason for these in any voluntary disclosure document.

A voluntary disclosure can be made by notifying the Revenue in the usual ways (e.g. in writing, by telephone and during an interview). There is a Revenue form (*IR281*) which covers pre-notification and post-notification disclosures and requires certain minimum details to be provided - like the taxpayer's name and IRD number, contact details, the nature of the tax errors or omissions, an explanation as to how those errors or omissions arose, and generally enough information to enable the Revenue to assess the nature of the specific error.

The Revenue invariably takes a sensible approach to dealing with voluntary disclosures and the fact of a taxpayer making one at an early stage of a Revenue enquiry (or before) often sets the tone for the rest of the tax audit. It is a practice that lawyers should encourage clients to adopt if they are aware of historical tax errors and shortfalls, preferably before an audit has been signalled but even then only after a full evaluation of the potential tax risks for the taxpayer (which risks might include criminal prosecutions for very serious tax defaults).

Revenue interviews and communications

Tax investigations are information-gathering exercises with one purpose: to assist the Revenue collect more evidence and taxation.

Written communications to Revenue information-requests and other queries obviously "speak for themselves". Accordingly, they need to be accurate, truthful and respond completely to the point raised by the Revenue (but not necessarily beyond that).

Any oral communication with the Revenue (by telephone or at a meeting) about a taxpayer's affairs will usually be recorded **and if it is of assistance with the Revenue's theory regarding a technical tax position or otherwise will be used by the Revenue in any subsequent tax dispute or prosecution to advance its theory** (unless its admissibility is excluded, see e.g. s 19(4) TA Act).

What a taxpayer says directly about things having a taxation implication is often the best evidence about the purpose and reason for those things and once a communication is made (written or otherwise), it usually cannot be withdrawn or altered.

Tax laws are technically complicated and most taxpayers do not understand them. They rely on professional advisers to assist them get their tax positions "right". Unfortunately, some tax professionals do not understand some of the important complexities and nuances in tax laws (and their consequences). Because of this a taxpayer should as a general rule never provide detailed explanations and information to the Revenue about "tax" things without first consulting an adviser and clarifying what it is that the Revenue is likely to be concerned about and what all this means for the taxpayer. Given that the Revenue sets deadlines for most of their information-requisitions and other enquiries, getting in touch with an adviser early in the audit process is something a taxpayer should be encouraged to do.

Obviously, if the taxpayer has nothing in a tax sense to be concerned about the position may be different. However, often a taxpayer will assume (understandably) that because they have relied in the past on a professional to file their tax returns and take their tax positions that will provide a sufficient basis in law to avoid any unexpected taxation costs. Sometimes this assumption may prove to be correct if the adviser has been a good one. Often this will not be the case and the taxpayer may in fact be punished more harshly in a tax sense because of the nature of the professional advice received and relied on. Blaming professional advisers for tax mistakes may assist a taxpayer to give vent to their feelings, but it usually provides little assistance with avoiding or paying unaccounted for taxation.

Interviews with Revenue officers are part and parcel of the investigation process, at least if the perceived taxation defaults are material ones. Interviews conducted by the Revenue can be done on a voluntary basis (where the taxpayer can leave at any time and not answer questions) and on a more compulsory basis (where the taxpayer is effectively obliged to answer questions, see ss 18 and 19 of the TA Act).

Whichever interview format is adopted the questions and answers will usually be recorded and often available to be used as evidence by the Revenue in the future. Recordings are often played in full and listened to by a Judge in criminal proceedings and this fact alone means that both a taxpayer and their lawyer should consider carefully the nature of their responses and demeanour and role in any interview which they attend.

While the interview process can be a cooperative and helpful mechanism for allaying Revenue concerns about certain things, one problem with the process sometimes is that the Revenue may already have (it invariably does) a well-developed theory of a particular technical position or case in advance of the interview. As such, a series of questions to a taxpayer about the meaning of documents and the like will often be designed to confirm the Revenue's theory, with the taxpayer having little knowledge of (or having long forgotten) the basis and reason for the factual and tax things being discussed.

In this type of setting where a taxpayer may not fully understand the significance of the questions that are being raised it is easy for them to say "loose" things about say their "purpose" or "knowledge" of transactions and events. Obviously, for this reason getting an idea of the likely line of questioning (and information) in advance of any interview (if possible) is very helpful so that there are not too many "surprises" on the day.

Risks for lawyers

In the context of a tax investigation (and its aftermath) the risks for lawyers include *inter alia:*

- Ensuring that at all times one's advice and conduct comply with the law and the lawyer's fundamental obligations under s 4 of the Lawyers and Conveyancers Act 2006 and under professional or ethical rules to which the lawyer may be subject. Fulfilling this standard will require a lawyer to have a sound working knowledge of a client's legal and tax obligations under New Zealand taxation laws, the TA Act and more generally. For example, there is a 90-day response requirement under s 21 of the TA Act in connection with a Commissioner's information-requisition in respect of a claimed tax deduction for an offshore payment. Failure to comply with the 90-day response period can lead to a denial of the deduction by the Revenue which subsequently may not be able to be challenged. It could also lead to other taxation consequences for the client. A lawyer unaware of this response obligation might allow a client to unknowingly breach it with adverse consequences;

- Not advising a client of the potential tax and other risks for them (and possibly their family and other third parties) associated with an investigation. This will require the lawyer at a very early stage of an audit to identify what those potential risks are. This in turn will require an early evaluation of the taxation issues and liabilities that the investigation could uncover which the Revenue's initial enquiries will often identify or which a client (or their accounting adviser) may be aware of. Put differently, the initial tax "due diligence" is likely to determine the way in which the client and their advisers (including the lawyer) deal with the Revenue and the client's obligations going forward;

- Not considering and requesting the opportunity to make a "voluntary disclosure" on behalf of the client with the Revenue and doing this at the earliest point (even pre-investigation);

- Not explaining to the client what the taxation implications are likely to be in tax and financial terms if material adjustments and tax shortfalls arise as a consequence of the investigation. Those implications are likely to include accruing use-of-money-interest and shortfall penalty costs;

- Not explaining to the client the potential risks of criminal prosecution for serious tax defaults identified during the investigation. In 2000 314 prosecutions were taken by the Revenue for "criminal" tax offence breaches of the TA Act. In 2008 that figure had reached 9,563 and in 2009 it was 8,316. An early voluntary disclosure may be essential to insure against this possibility as it may also for certain shortfall penalties;

- Not assessing with the client the potential for future liability actions against professional advisers and running the investigation process with the Revenue in a manner that does not compromise in any way those future actions;

- Not seeking specialist advice for a client at an early stage of an investigation (essentially at the point of the first "notification" of the investigation) to the extent

that the lawyer lacks the requisite skills to deal with the likely technical taxation and compliance questions arising from the investigation;

- Not protecting fully the client's rights to claim legal professional privilege in respect of particular "communications" and/or any non-disclosure rights in "tax advice documents";

- Not discussing the risks for the client in "obstructing" the Revenue or otherwise failing to meet timeframes on information requests and other filing obligations;

- Not protecting provisional positions on a "without prejudice" basis;

- Not discussing with the client the advantages of pre-paying the tax liability and working through the formal steps in the disputes procedures (and the likely costs) and considering whether things like outstanding returns may need to be filed to perfect statutory challenge and other rights;

- Not considering the operation of protections like the statutory time-bar and waivers of time-bar that may assist a resolution of the dispute;

- Not considering and discussing with the client the wider implications were its involvement in a tax investigation to become publically-known as is increasingly the case (those implications impacting on job security, the ability to raise finance and with business customers);

- Not discussing with a client the risks associated with attending voluntary and compulsory interviews with the Revenue and otherwise assessing all written and other responses to the Revenue;

- Not considering the possibility of an early "settlement" of the dispute in a manner that is favourable to the client or allowing the Revenue's position to become entrenched or stronger through client (or lawyer) inertia or uncooperativeness;

- Not considering the implications of tax and other liabilities in other tax jurisdictions (brought by foreign regulators) as a consequence of the investigation;

- Where the defaulting taxpayer in an investigation is an entity, not considering what, if any, personal liability a director, shareholder or officer may be subjected to in respect of the taxation defaults.

Conclusions

The Revenue has been equipped by Parliament with immense legal powers and resources to investigate taxpayer conduct, to recover outstanding tax, and to punish a taxpayer with additional taxes and in some situations criminal prosecutions that may lead to a custodial sentence.

None of this would matter if tax law and tax compliance was straightforward. Generally it is not, which is why thousands of professionals (accounting and otherwise) spend their lives assisting taxpayers to get their tax positions correct. As the recent litigation in *Penny & Hooper* and the *Banking* cases illustrates even with professional advice a taxpayer's tax position may still come up short in tax terms and substantially so.

Another dilemma for taxpayers is that in the tax investigation context there are few statutory or other rules that operate in their favour to protect their rights or tax positions. In addition, in the writer's view there is generally a high level of tolerance to Revenue investigative activities and behaviour amongst judges (it requiring specific evidence of really egregious conduct before any criticism will be made of Revenue activities).

In such an environment, and it is similar (and in fact worse) in other countries, it is essential that a taxpayer gets access to good legal advice about their taxation rights and obligations and has access to a lawyer who can from the outset of a tax investigation assist them with discharging all the things (e.g. information responses) that the Revenue will require of them, can advise them properly about their (few) rights, and can monitor Revenue behaviour to ensure that, whatever tax adjustment or shortfall (if any) arises as a consequence of the investigation, it is one determined correctly and fairly according to law.

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