CHAPTER 4: PENALTIES

This Chapter explains the penalties that can apply if a taxpayer understates their tax liability. The Chapter considers whether the standard of care required of taxpayers is sufficiently clear and whether there should be a penalty for failing to follow a Tax Office private ruling. It outlines a 'safe harbour' for taxpayers using agents and examines the Tax Office's power to remit penalties.

4.1 Penalties and self assessment

Penalties exist as incentives for taxpayers to comply with their various tax obligations. The penalties relevant to this Review are those that apply where, in self assessing, a taxpayer understates their liability and therefore pays less tax than they ought to. These are known as tax shortfall penalties.

Tax shortfall penalties may apply, depending on the degree of blameworthiness on the taxpayer's part, if a taxpayer has a tax shortfall resulting from any of the following:

- making a false or misleading statement. Omitting income, over-claiming deductions or claiming deductions that are not allowable will generally fall into this category
- failing to provide a document that the Tax Office needs to work out liability
- applying an income tax law in a way that is not reasonably arguable (but only if the tax shortfall amount exceeds the greater of $10,000 or 1% of the income tax payable by the taxpayer)
- disregarding a private ruling
- entering into a tax avoidance scheme or having a transfer pricing adjustment.

These culpability penalties are distinct from the General Interest Charge (see Chapter 5).

4.1.1 Scale of penalties

The amount of shortfall penalty for which a taxpayer may be liable depends on the reason for the shortfall, as set out in the following scale.

Table 4.1: Scale of shortfall penalties

Cause of shortfall	Base penalty amount (%)
Intentional disregard of a taxation law	75
Failure to provide a document necessary for the Commissioner to work out the liability	75
Recklessness	50
Lack of reasonable care	25
A position that is not reasonably arguable is taken on a large item	25
Disregard of a private ruling	25

The starting point for determining the penalty amount is a percentage of the shortfall. This can be varied up or down according to whether the taxpayer has hindered the Tax Office in investigating the shortfall, has previously had a shortfall amount with a similar cause, or has made a voluntary disclosure of the shortfall.

The scale works so that a taxpayer is not penalised if they have taken reasonable care (except in a few special cases dealt with later).

A taxpayer cannot be penalised for a shortfall caused by relying on Tax Office advice, publications, or general administrative practice.[1]

4.1.2 Remission of penalties

The Tax Office can reduce penalties partially or in full. This is known formally as the power of remission. The taxpayer can apply for remission of the penalty, or the Tax Office can remit the penalty on its own initiative. The Tax Office must advise the taxpayer in writing if it decides not to remit the penalty, or decides to remit only part of the penalty. The normal objection and review procedures apply to the remission decision if the amount of the penalty not remitted exceeds two penalty units (currently $220).

1. Subsection 284-215(1) of Schedule 1 to the *Taxation Administration Act 1953*.

4.1.3 Criminal offences

The law contains a range of criminal offences that can apply where taxpayers fail to meet their tax obligations. Some of the main offences relate to failing to comply with requirements under a tax law (for example, failing to lodge a tax return), making false or misleading statements and failing to keep adequate records. If a taxpayer is found guilty of an offence, a court can impose a fine or, in very limited circumstances, a prison sentence.

4.2 Issues for the Review

As explained in Chapter 1, penalties are a potential consequence of uncertainty for taxpayers. Practitioners and industry groups in particular have argued that:

- The meaning of key concepts such as 'reasonable care' and 'reasonably arguable position' are not clear.
- The penalty for failure to follow a private ruling should not apply if the taxpayer has taken reasonable care and, for a large item, has a reasonably arguable position.
- When a tax agent makes a mistake, penalties should not apply to a taxpayer who has taken reasonable care to provide the correct information to the agent.
- The Tax Office ought to be more flexible in remitting penalties.

These issues are considered in more detail below.

4.2.1 Meaning of reasonable care and reasonably arguable position

'Reasonable care' is not defined in the tax law and 'reasonably arguable' is only defined in general terms. The Explanatory Memorandum to the *A New Tax System (Tax Administration) Act (No. 2) 2000* (the EM) provides some explanation of these concepts and the Tax Office has issued Taxation Rulings[2] to explain their meaning. The courts have

2. Australian Taxation Office, *Taxation Rulings TR 94/4 and TR 94/5,* Australian Taxation Office, Canberra.

also provided guidance, for example about the meaning of reasonably arguable in the recent *Walstern* case.[3] Nevertheless, there may be some scope to clarify the terms.

Lack of reasonable care

The EM makes the following points about the reasonable care test:

- The test requires a taxpayer to exercise the care that a reasonable person would be likely to have exercised in the circumstances of the taxpayer (including their knowledge, education, experience and skill).

- Taxpayers must take reasonable care not only in the preparation of their tax returns, but throughout the year on matters that may impact on their tax obligations, for example, record keeping.

- The reasonable care test is not intended to be overly onerous for taxpayers completing their own returns. For most taxpayers, an earnest effort to follow *TaxPack* instructions would usually be sufficient to pass the test.

- On questions of interpretation, if the taxpayer is uncertain about the correct treatment of a tax-related matter, reasonable care requires that they make reasonable enquiries to resolve the issue. Reasonable enquiry would include consulting someone or reference to a Tax Office publication to satisfy themselves about the proper tax treatment of the matter.

- Where a tax agent completes a return, the standard of care expected of the agent is much higher than the standard expected of the client.[4]

Reasonably arguable position

For large items,[5] taxpayers must not only take reasonable care, but must also adopt a reasonably arguable position. A position is reasonably arguable if it would be concluded in the circumstances, having regard to relevant authorities, that it is at least as likely to be correct as incorrect.[6]

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3. *Walstern Pty. Ltd. v Commissioner of Taxation* [2003] FCA 1428 which considered section 226K of the *Income Tax Assessment Act 1936*, the precursor of the current penalty for not having a reasonably arguable position.
4. The project on the regulation of the tax profession is considering the issue of the appropriate standard of care for taxpayers and tax agents (see below at 4.2.3).
5. Large items are tax shortfalls exceeding the greater of $10,000 or 1% of the income tax payable by the taxpayer.
6. Section 284-15 of Schedule 1 to the *Taxation Administration Act 1953*.

The EM explains this concept further as follows:

> '...the position must be a contentious area of the law, where the relevant law is unsettled or where, although the principles of the law are settled, there is a serious question about the application of those principles to the circumstances of the particular case.
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> The test does not require the taxpayer's position to be the 'better view'; the standard is 'as likely correct as incorrect', and not 'more likely to be than not'. However, the reasonably arguable position standard would not be satisfied if a taxpayer takes a position which is not defensible, or that is fairly unlikely to prevail in court. On the contrary, the strength of the taxpayer's argument should be sufficient to support a reasonable expectation that the taxpayer could win in court. The taxpayer's argument should be cogent, well-grounded and considerable in its persuasiveness.'

In the *Walstern* case, Justice Hill said (at paragraph 108 of his judgment) that:

> 'The case must be one where reasonable minds could differ as to which view, that of the taxpayer or that ultimately adopted by the Commissioner was correct. There must, in other words, be room for a real and rational difference of opinion between the two views such that while the taxpayer's view is ultimately seen to be wrong it is nevertheless "about" as likely to be correct as the correct view.'

4.2.2 Penalty for failure to follow a private ruling

Where a person has asked the Tax Office for a private ruling and failed to follow it, resulting in a tax shortfall, a penalty applies. This approach is not followed in Canada, New Zealand, the US or the UK. The rationale for applying this penalty is that, where the Tax Office has issued a private ruling, the taxpayer has sufficient guidance as to the law and, if they disregard it, they can no longer have a reasonably arguable position (or have taken reasonable care). Rather than simply ignoring a private ruling, a taxpayer can challenge it if they disagree — either through the objection and appeal processes or by assessing in accordance with the ruling and then objecting to the assessment.

The Review of Business Taxation (commonly called the Ralph review) recommended abolishing this penalty.[7] The Ralph review considered that 'the criteria for invoking the penalty should be concerned solely with considerations of whether the taxpayer has taken reasonable care and whether a reasonably arguable position has been adopted.

7. Commonwealth of Australia 1999, *Review of Business Taxation: A tax system redesigned*, July 1999, Commonwealth of Australia, Canberra, Recommendation 3.4.

Where this has been adopted, no penalties should apply — though interest should continue to be payable on any tax shortfall.'

The Ralph review reflects a different perspective from that in earlier papers[8] as to why taxpayers seek private rulings. The earlier papers took the approach that, in requesting a ruling, a taxpayer is seeking clarification of how the law works. In contrast, the Ralph review took the view that the taxpayer probably has a good idea of how the law works (from the taxpayer's own advisers), but wants to know the Tax Office view.

This issue is intimately linked to the design of the private ruling system. Abolishing the penalty for failing to follow a ruling, without other changes, could bias the system by providing strong incentives to seek private rulings (that is, free private advice potentially conferring a commercial benefit), with little or no cost or disadvantage. This could result in a significant increase in private ruling applications and therefore either increase the Tax Office's administration costs, to be borne by all taxpayers, or draw resources from other aspects of revenue collection. To overcome those difficulties, the Ralph review also recommended that the Tax Office charge for selected private rulings — making the recipient bear at least some of the costs.

It should be noted that, even if the penalty were abolished, a taxpayer not following a private ruling could still be liable for a penalty for failing to take reasonable care or, for a large item, not having a reasonably arguable position. Further, the Tax Office might need to improve procedures to check whether a taxpayer has followed a ruling, perhaps by requiring a declaration in their tax return.

4.2.3 A 'safe harbour' for taxpayers using tax agents

Under the existing law, as before self assessment, taxpayers are responsible for errors in returns made by their tax agents. There are no penalties directly for agents, although the criminal offence provisions can apply to them.

Over ten years ago, the Self Assessment Priority Tasks project flagged a possible 'safe harbour' for taxpayers when the agent makes an error, if they have provided their agent with all the details necessary to complete their return. The previous Government decided to consider the issue further as part of a broader review of the role of tax agents.

On 6 April 1998, the then Assistant Treasurer, Senator the Hon Rod Kemp, announced that the Government had approved a new legislative framework for tax agent services. He said that:

8. See footnote 4 of Chapter 1.

> 'The proposals will give taxpayers who engage a tax agent a 'safe harbour' from penalties, providing they exercise reasonable care in furnishing all the relevant taxation information to their tax agent. Taxpayers will no longer be vicariously liable for penalties imposed under the current law as a result of the actions of their tax agent.
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> Similarly, there will be no sanctions against tax agents who meet a defined standard of reasonable care in the preparation of tax returns...
>
> Where a taxpayer satisfies these obligations [to take reasonable care], and there is a tax shortfall caused by the tax agent failing to exercise reasonable care, the taxpayer will have a 'safe harbour' and not be penalised. Instead the tax agent may be subject to a disciplinary measure.'

At the request of industry representatives, the Government deferred the implementation of that announcement until after tax reform was bedded down. Since then there have been further consultations between government officials and industry representatives about the announced framework.

The Government intends that the safe harbour issue will be finalised as part of the project on the regulation of the tax profession that is being undertaken concurrently with this Review. The proposed new framework will include a regulatory body for the profession (the National Tax Agents' Board) and effective sanctions for poor performance by agents (for example, repeated failure to take reasonable care).

4.2.4 Administration of the remission power

The Tax Office's power to remit shortfall penalties is theoretically unrestricted. While the law does not set out any conditions or grounds for remission, the Tax Office has published guidelines for its staff.[9]

The current system of imposition matches the penalty to the seriousness of the wrongdoing and fine-tunes that amount for aggravating or mitigating factors. Consequently, remission of penalties should not be the norm, as it was before self assessment, when there was a statutory 200% penalty for false or misleading statements.

9. Australian Taxation Office 2002, *Practice Statement PS LA 2002/8*, Australian Taxation Office, Canberra. The Tax Office is currently reviewing this Practice Statement and expects to release revised guidelines shortly.

Practitioners and industry representatives have asserted that the Tax Office automatically applies penalties in a 'speeding infringement' fashion, even where it may have contributed to the taxpayer failing to meet their obligations.[10]

The raw quantitative evidence does not show that the Tax Office applies penalties (or fails to remit them) indiscriminately. In the 2002-03 year, for example, the Tax Office initiated debit amendments for individuals not in business (excluding tax avoidance cases) that raised total primary tax of around $160 million. Although 90% of these amendments were for omitted income, the total penalty imposed was under $9 million.

10. See Inspector-General of Taxation 2003, *Issues Paper Number 4: ATO law enforcement and governance*: <http://www.igt.gov.au/content/submissions.asp?NavID=7>.

4.3 Questions for consultation

4.A **What (if any) clarification of the terms 'reasonable care' and 'reasonably arguable position' is needed?**

4.B **What is the effect of the penalty for failing to follow a Tax Office private ruling? Do taxpayers only request PBRs when they are confident of a favourable ruling?**

4.C **If the penalty for failing to follow a Tax Office private ruling were to be removed, what other changes would be appropriate?**

4.D **What further guidance on grounds for remission of penalties is required?**