

MT 2008/2 - Shortfall penalties: administrative penalty for taking a position that is not reasonably arguable

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! There is a Compendium for this document: **MT 2008/2EC** .

! This document has changed over time. This is a consolidated version of the ruling which was published on 1 April 2015

16. The administrative penalty provisions consolidate and standardise the different penalty regimes that previously existed. In addition, the provisions apply in respect of various taxes and collection systems including income tax, FBT, goods and services tax, PRRT and pay as you go withholding and instalments.

17. Division 284 imposes penalties where an entity:

- makes a statement that is false or misleading in a material particular to:
 - the Commissioner or to an entity that is exercising powers or performing functions under a taxation law – subsection 284-75(1); or
 - to an entity other than the Commissioner and an entity that is exercising powers or performing functions under a taxation law and the statement is one required or permitted to be made by a taxation law – subsection 284-75(4).
- takes a position under a relevant tax law that is not reasonably arguable – subsection 284-75(2);
- fails to provide a return, notice or other document to the Commissioner that is necessary to determine a tax-related liability accurately, and the Commissioner determines the liability without the assistance of the document – subsection 284-75(3);
- disregards a private ruling;² or
- enters into a scheme to get a scheme benefit or a transfer pricing benefit – section 284-145.

18. This Ruling focuses on the penalty imposed under subsection 284-75(2) where an entity takes a position that is not reasonably arguable.

19. Subsection 284-75(2) and subsection 284-90(1) impose a penalty where:

- a statement is made by an entity or its agent, which treats a relevant tax law as applying to a matter in a particular way that is not reasonably arguable; and
- a shortfall amount resulting from the statement exceeds the reasonably arguable threshold set out in subsection 284-90(3) in relation to item 4, 5 or 6 of the table in subsection 284-90(1).

20. An entity’s agent, in this context, means someone who is authorised to represent the entity in making a statement to the Commissioner.

² This penalty does not apply in relation to income tax matters for the 2004-05 and later income years, FBT matters for the year beginning on 1 April 2004 and later years, and matters relating to other taxes for the year beginning 1 July 2004 and later years.

28. The reasonable care test requires entities to take the same care in fulfilling their tax obligations that could be expected of a reasonable person in the position of the entity. This means that even though the standard of care is measured objectively, it takes into account factors such as the entity's knowledge, education, experience and skill.⁶

29. In contrast there is no personal aspect to the reasonably arguable position test as it applies an objective standard involving an analysis of the law and application of the law to the relevant facts. It is not a question of whether an entity *thinks* or *believes* that its position is reasonably arguable, but simply whether it *is* reasonably arguable. Having a reasonably arguable position is a further requirement that must be satisfied where the shortfall amount is above a specified amount for the tax year. This approach is taken because the reasonable care standard on its own is seen as inadequate in large adjustment cases because of the personal considerations relevant to that test.⁷

30. In this sense, a higher standard is imposed than that required to demonstrate reasonable care. Because of these differences, an entity may not have a reasonably arguable position despite having satisfied the reasonable care test.

31. Although demonstrating a reasonably arguable position involves the application of a purely objective test, an entity will usually reach their position (at the time of making the statement) as a result of researching and considering the relevant authorities. In these circumstances, the efforts made by the entity to arrive at the correct taxation treatment will also demonstrate that reasonable care has been shown.

Ruling

Administrative penalty under subsection 284-75(2)

32. An entity will be subject to an administrative penalty under subsection 284-75(2) where the entity or their agent makes a statement to the Commissioner which treats a relevant tax law as applying to a matter (or identical matters) in a particular way that, when having regard to the relevant authorities, is not reasonably arguable and there is a shortfall amount that exceeds the reasonably arguable threshold in subsection 284-90(3)..

33. An amount is above the reasonably arguable threshold:

- where the shortfall amount exceeds the greater of \$10,000 or 1% of the tax payable for the tax year on the basis of the entity's tax return (in relation to item 4 in the table in subsection 284-90(1)); or

information paper) at paragraph 2.7 which were given effect to by the *Taxation Laws Amendment (Self Assessment) Act 1992*.

⁶ See the proposals made in the information paper at paragraphs 2.7 to 2.12.

⁷ See the proposals made in the information paper at paragraph 2.19.

taxpayer's argument should be cogent, well-grounded and considerable in its persuasiveness.

37. The Full Federal Court in *Pridecraft Pty Ltd v. Federal Commissioner of Taxation* [2004] FCAFC 339; 2005 ATC 4001; (2004) 58 ATR 210 at paragraph 108 agreed that Hill J in *Walstern's* case had outlined the correct approach to the imposition of additional tax by way of penalty under the former subsection 226C(1) of the ITAA 1936:

1. The test to be applied is objective, not subjective. This is clear from the use of the words 'it would be concluded' in paragraph (1)(b) of the section.⁹
2. The decision maker considering the penalty must first determine what the argument is which supports the taxpayer's claim.
3. That person will already have formed the view that the claim is wrong, otherwise the issue of penalty could not have arisen. Hence the decision maker at this point will need to compare the taxpayer's argument.
4. The decision maker must then determine whether the taxpayer's argument, although considered wrong, **is about as likely as not correct, when regard is had to 'the authorities'**.
5. It is not necessary that the decision maker form the view that the taxpayer's argument in an objective sense is more likely to be right than wrong. That this is so follows from the fact that tax has already been short paid, that is to say the premise against which the question is raised for decision is that the taxpayer's argument has already been found to be wrong. Nor can it be necessary that the decision maker form the view that it is just as likely that the taxpayer's argument is correct as the argument which the decision maker considers to be the correct argument for the decision maker has already formed the view that the taxpayer's argument is wrong. The standard is not as high as that. **The word 'about' indicated the need for balancing the two arguments, with the consequence that there must be room for it to be argued which of the two positions is correct so that on balance the taxpayer's argument can objectively be said to be one that while wrong could be argued on rational grounds to be right.**
6. An argument could not be as likely as not correct if there is a failure on the part of the taxpayer to take reasonable care. Hence the argument must clearly be one where, in making it, the taxpayer has exercised reasonable care. However, mere reasonable [care] will not be enough for the argument of the taxpayer must be such as, objectively, to be 'about as likely as not correct' when regard is to be had to the material constituting 'the authorities'.

⁹ See subsection 284-15(1) of Schedule 1 to the *Taxation Administration Act 1953* which uses the same words.

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Transfer Pricing Scheme Penalties: Documenting a transfer pricing treatment for eligibility to take a reasonably arguable position

51B. Section 284-250 states that if, an entity does not have records explaining the particular way in which the transfer pricing rules apply (or do not apply) to a matter (or identical matters) (referred to as 'transfer pricing treatment'), then that treatment will not be a reasonably arguable position for administrative penalty purposes. The specific requirements for documenting a transfer pricing treatment in a way so that the treatment is eligible to be taken as reasonably arguable are set out in section 284-255 ('documentation requirements').

51C. If an entity has not met the requirements for documenting a transfer pricing treatment (referred to as an 'undocumented transfer pricing treatment'), the entity cannot take a reasonably arguable position concerning that undocumented treatment. If an entity has met the requirements for having a 'documented transfer pricing treatment', that entity is eligible to take a reasonably arguable position, for the purposes of Division 284, for that treatment.

51D. Guidance on the documentation requirements can be found in paragraphs 72 to 79 of Law Administration Practice Statement Law Administration PS LA 2014/2 *Administration of transfer pricing penalties for income years starting on or after 29 June 2013*. PS LA 2014/2 sets out the process for determining whether an entity will have a documented or undocumented transfer pricing treatment when assessing transfer pricing scheme penalties.

51E. Further guidance on the documentation requirements is contained in Taxation Ruling TR 2014/8 *Income tax: transfer pricing documentation and Subdivision 284-E*. This ruling sets out the ATO's view on documenting a transfer pricing treatment contemporaneously.

Documenting a reasonably arguable position in all other cases

52. The general administrative penalty provisions do not require an entity to document their reasonably arguable position at the time that the statement is made. The Commissioner considers that, whilst the reasonably arguable position is determined at the time the statement is made, an entity has the opportunity to demonstrate their position when a shortfall amount in terms of subsection 284-80(1) is identified, which may be a number of years later.

53. When an entity provides their cogent reasons for taking a particular position, this will assist the Tax Office to objectively and expeditiously determine whether a reasonably arguable position was taken at the time the statement was made. When providing these reasons, a discussion as to why the alternative arguments do not apply would be useful.

54. Although it is common practice for an entity to provide supporting reasons for the position they have taken, the failure to do so does not by itself mean that the entity does not have a reasonably

arguable position. This is because the test is objective. Accordingly, in determining whether an entity has a reasonably arguable position, the Tax Office will consider all authorities relevant to the tax treatment of an item, including contrary authorities.

Is the shortfall amount above the requisite threshold?

55. An entity is only required to have a reasonably arguable position for the purposes of the administrative penalty provisions where their statement results in a shortfall amount which exceeds the relevant threshold outlined in paragraph 33 of this Ruling.

56. The method for working out whether an entity has a shortfall amount is provided for in the table in subsection 284-80(1).

57. Where a shortfall amount results from the entity treating the tax law as applying in a particular way that was not reasonably arguable, the base penalty amount under subsection 284-90(1) is 25% of the shortfall amount.

Example 1 – shortfall amount is less than the threshold

58. *AJ Pty Ltd is liable to pay \$50,000 based on its tax return in respect of a year of income and has claimed a deduction which is not properly allowable, leading to a shortfall amount of \$7,000. Before consideration can be given to imposing an administrative penalty under subsection 284-75(2) the shortfall amount must exceed the greater of \$10,000 or 1% of the income tax payable which is \$500.*

59. *In this case, AJ Pty Ltd has a shortfall amount of \$7,000 which is less than \$10,000 and so the requisite threshold has not been met.*

Example 2 – shortfall amount greater than the threshold

60. *Hill Pty Ltd is liable to pay \$20 million based on its tax return in respect of a year of income. The company has omitted income from the sale of a property resulting in a shortfall amount of \$500,000. Before consideration can be given to imposing an administrative penalty under subsection 284-75(2), the shortfall amount must exceed the greater of \$10,000 or 1% of the income tax payable. In these circumstances, 1% of the income tax payable by Hill Pty Ltd is \$200,000.*

61. *Hill Pty Ltd has a shortfall amount of \$500,000 which is greater than \$200,000 and so the requisite threshold has been met.*

Identical matters

62. The threshold is applied separately to each non-identical situation in which the entity did not take a reasonably arguable position. If however, the matters were identical then paragraph 284-75(2)(b) ensures that they are treated as a single

matter. This rule is designed to prevent single matters being split into smaller components to avoid the operation of the section. This provision should not be used to treat, as a single matter, numerous similar but distinct items of adjustment.

Example 3 – identical matters are treated as a single matter

63. *Trevor fails to include interest. If there are statements about two matters, each causing a shortfall amount of \$7,500, and those matters are identical, their values are combined, resulting in a total shortfall amount of \$15,000. This exceeds the \$10,000 threshold and if that is higher than the 1% alternative threshold, Trevor is potentially subject to the administrative penalty under subsection 284-75(2).*

Circumstances where the shortfall amount is reduced

64. Subsection 284-224(1) sets out a number of situations which reduce an entity's base penalty amount under section 284-90.^{18A} The base penalty amount is reduced to the extent that it was caused by the entity or its agent treating a taxation law as applying in a way that is consistent with any of the following:

- advice given to the entity or its agent by or on behalf of the Commissioner (paragraph 284-224(1)(a));¹⁹
- general administrative practice under that law (paragraph 284-224(1)(b))²⁰ or
- a statement in a publication approved in writing by the Commissioner paragraph 284-224(1)(c), for example, a statement made in *TaxPack*.

65. [Omitted].

Reasonable care exception does not apply

66. Under subsection 284-75(5) an entity is not liable to an administrative penalty as a result of a false or misleading statement if the entity or its agent took reasonable care in making the statement. In these circumstances, an administrative penalty will not arise under subsection 284-75(1) or (4).²¹

^{18A} For guidance on the periods before 4 June 2010, see Miscellaneous Tax Ruling MT 2008/1 issued 12 November 2008.

¹⁹ Generally, 'advice' would include correspondence from the Tax Office on a matter relating to a taxation law, a private ruling, a binding oral ruling and statements made in public rulings.

²⁰ A general administrative practice under a taxation law is a practice adopted by the Commissioner which applies to all entities, to a class of entities or to a specified group within a class.

²¹ For guidance on the periods before 4 June 2010, see Miscellaneous Tax Ruling MT 2008/1 issued 12 November 2008.

67. However, at paragraph 1.110 of the Revised Explanatory Memorandum to the A New Tax System (Tax Administration) Bill (No. 2) 2000 it is pointed out that taking reasonable care in making such a statement will not provide protection against the 'no reasonably arguable position' penalty under subsection 284-75(2). This is because the 'no reasonably arguable position' penalty operates as a stand alone provision.

Errors of fact

68. The reasonably arguable position test only applies to shortfall amounts caused by an entity treating a relevant tax law as applying in a particular way. This occurs where the entity concludes that, on the basis of the facts and the way the law applies to those facts, a particular consequence follows.

69. However, an entity's conclusions on a particular matter may have been based on incorrect primary facts which the entity did not know and could not reasonably be expected to have known were not the true facts. An example is where an entity relies on a bank to provide details of the amount of interest earned on a deposit. In other cases, the statements in an entity's return may not represent conclusions of the entity, but might reflect errors in calculation or transposition errors.

70. As a broad rule, where a shortfall amount was caused by an error of fact or calculation, the 'no reasonably arguable position' penalty will not apply since the entity has not treated a relevant tax law as applying to a matter in a particular way.

71. In this context, errors of fact are errors of primary fact and not wrong conclusions of fact which an entity may make which bear on the correct application of a tax law, such as whether the entity is carrying on a business. Whether the statements in an entity's return represent conclusions of the entity or were caused by errors of fact or calculation should be determined on the basis of all the available evidence. Note that where there is an error of fact it may be necessary to consider whether the entity has taken reasonable care.

Example 4 – error of fact – income tax matter

72. *Bill when looking up the effective life of a particular asset mistakenly selects the wrong effective life. Bill knows the relevant asset category but accidentally selects the effective life for the asset category listed next to the correct one. Although Bill has claimed a deduction for decline in value using the incorrect effective life as a result of this error, it does not involve treating an income tax law as applying in a particular way.*

73. *In these circumstances, the 'no reasonably arguable position' penalty will not apply because Bill has not treated an income tax law as applying to a matter in a particular way.*

Definitions

Base penalty amount

74. In the context of Division 284, subsection 995-1(1) of the *Income Tax Assessment Act 1997* (ITAA 1997) states that the base penalty amount for calculating the amount of an administrative penalty is worked out under:

- section 284-90, where the penalty is for a false or misleading statement, or a position that is not reasonably arguable; and
- section 284-160, where the penalty relates to a scheme.

75. The base penalty amount is the starting point for the calculation of an administrative penalty.

Income tax law

76. Income tax law under subsection 995-1(1) of the ITAA 1997 means a provision of an Act or regulations under which is worked out the extent of liability for:

- (a) tax; or
- (b) Medicare levy; or
- (c) franking tax; or
- (d) withholding tax; or
- (e) mining withholding tax.

MRRT law

76A. [Omitted.]

PRRT law

76B. PRRT law under section 995-1 of the ITAA 1997 means:

- (a) the *Petroleum Resource Rent Tax Assessment Act 1987*;
- (b) any Act that imposes PRRT; and
- (c) the TAA, so far as it relates to any Act covered by paragraphs (a) and (b);
- (d) any other Act, so far as it relates to any Act covered by paragraphs (a) to (c) (or to so much of that Act as is covered); and

- (e) regulations under an Act, so far as they relate to any Act covered by paragraphs (a) to (d) (or to so much of that Act as is covered).

Scheme

77. 'Scheme' is very widely defined in subsection 995-1(1) of the ITAA 1997. It means any arrangement, scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise.

78. An arrangement is further defined in subsection 995-1(1) of the ITAA 1997 as any arrangement, agreement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings.

Shortfall amount

79. 'Shortfall amount' is defined in subsection 995-1(1) of the ITAA 1997 as having the meaning given by section 284-80.

80. Item 3 and 4 of the table in subsection 284-80(1) provide that a shortfall amount is the amount by which the relevant tax-related liability, or the payment or credit, is less than or more than it would otherwise have been if the statement did not treat a relevant tax law as applying in a way that was not reasonably arguable.

Taxation law

81. 'Taxation law' is defined in subsection 2(1) of the TAA as having the meaning given by the ITAA 1997. Subsection 995-1(1) of the ITAA 1997 defines 'taxation law' as an Act of which the Commissioner has the general administration and any regulations under such an Act. It also includes part of an Act (and associated regulations) to the extent that the Commissioner has the general administration of the Act.

82. However subsection 2(2) of the TAA provides that an Excise Act (as defined in subsection 4(1) of the *Excise Act 1901*) is not a taxation law for the purposes of Subdivision 284-B (administrative penalties relating to statements).

Tax-related liability

83. 'Tax-related liability' is defined in subsection 995-1(1) of the ITAA 1997 as having the meaning given by section 255-1.

84. Section 255-1 provides that a tax-related liability is a pecuniary liability to the Commonwealth arising directly under a taxation law (including a liability the amount of which is not yet due and payable).

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Page status: **legally binding**

Commissioner of Taxation

12 November 2008

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Other references:

- Improvements to self assessment – Priority Tasks, An Information Paper August 1991 circulated by the Honourable John Kerin, MP, Treasurer
 - Law Administration Practice Statement PS LA 2012/4
 - Law Administration Practice Statement PS LA 2012/5
 - Revised Explanatory Memorandum to the A New Tax System (Tax Administration) Bill (No. 2) 2000
 - TaxPack (NAT 2541)
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ATO references

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