TR 93/D20 - Income tax: tax shortfall penalties: reasonable care, recklessness and intentional disregard

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This document has been finalised by TR 94/4.

Australian Taxation Office

Draft Taxation Ruling
Income tax: tax shortfall penalties: reasonable care, recklessness and intentional disregard

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What this Ruling is about

1. This Ruling provides guidelines for officers involved in the imposition of additional tax under sections 226G, 226H and 226J (relating to penalties in respect of tax shortfalls) and sections 160ARZA, 160ARZB and 160ARZC (relating to penalties in respect of franking tax shortfalls) of the *Income Tax Assessment Act 1936* (ITAA). It discusses the concepts of reasonable care, recklessness and intentional disregard and provides examples where taxpayers may be liable for penalty for having breached those standards.

2. The Ruling is expressed in terms of tax shortfall penalties. However, as the provisions relating to franking tax shortfall penalties are substantially the same as those relating to tax shortfall penalties, the guidelines provided by this Ruling apply, subject to the necessary changes, to cases where the franking tax shortfall penalties are in question. The relevant franking tax shortfall penalty provisions are noted in brackets where appropriate.

3. Taxation Ruling TR 92/10 should be read in conjunction with this Ruling for the purpose of determining the nature of the modifications to be made to Taxation Ruling IT 2517 in respect of the remission of subsection 223(1) additional tax for the 1991-92 year of income. However, this Ruling does not fetter authorised officers when exercising the discretion to remit subsection 223(1) additional tax. Each case should be considered on the basis of its own facts and circumstances.

Legislative framework

4. A taxpayer who has a tax shortfall for a year of income may be liable to pay a penalty. Penalties are attracted at the following rates:

(a) 25% of the tax shortfall or part of the tax shortfall that was caused by the failure of the taxpayer or of a registered tax agent to take reasonable care to comply with the ITAA or the regulations - section 226G (and 160ARZA for franking tax shortfalls);

(b) 50% of the tax shortfall or part of the tax shortfall that was caused by recklessness of the taxpayer or of a registered tax agent with regard to the correct operation of the ITAA or the regulations - section 226H (and 160ARZB);

(c) 75% of the tax shortfall or part of the tax shortfall that was caused by the intentional disregard by the taxpayer or of a registered tax agent of the ITAA or the regulations - section 226J (and 160ARZC).

5. A tax shortfall is defined in section 222A (and a franking tax shortfall in 160ARXA), and broadly means, in relation to a taxpayer and a year of income, the difference between the tax properly payable by the taxpayer and the tax that would have been payable by the taxpayer if it were assessed on the basis of the taxpayer's return for the year of income.

Ruling

6. The reasonable care test requires a taxpayer to take the care that a reasonable, ordinary person would take in all the circumstances of the taxpayer to fulfil the taxpayer's tax obligations. Provided that a taxpayer may be judged to have tried his or her best to lodge a correct return, having regard to the taxpayer's experience, education, skill and other relevant circumstances, the taxpayer will not be liable to pay penalty.

7. Recklessness is gross carelessness. A taxpayer will have behaved recklessly if the taxpayer's conduct clearly shows disregard of, or indifference to, consequences that are foreseeable by a reasonable person as being a likely result of the taxpayer's actions. It is not necessary for a finding of recklessness that the taxpayer should have been acting dishonestly, nor that the taxpayer intended to bring about the consequences that his or her actions caused.

8. To find that a taxpayer has intentionally disregarded the ITAA or the regulations requires a finding that the taxpayer consciously decided

to disregard clear obligations imposed on the taxpayer by the ITAA or the regulations. Such a finding may be based on direct evidence of the taxpayer's intention (such as an admission) or may be inferred from all the facts and circumstances surrounding the taxpayer's behaviour.

9. Each case has to be considered on the basis of all the relevant facts. Rarely will the presence of one particular factor be determinative of the penalty that applies. While this Ruling provides a number of examples they do not replace the need for tax officers to make a decision based on the facts of the case before them.

Date of effect

10. This Ruling (that is, the final Taxation Ruling based on this Draft Taxation Ruling), to the extent it deals with the interpretation of sections 226G, 226H, 226J, 160ARZA, 160ARZB and 160ARZC, sets out the current practice of the Australian Taxation Office and is not concerned with a change in interpretation. Consequently, it applies from the date on which those sections commenced to operate.

11. To the extent that Taxation Ruling TR 92/10 should be read in conjunction with this Ruling, it applies where the Commissioner's discretion to remit subsection 223(1) additional tax is exercised after the date on which this Ruling is issued.

Explanations

Reasonable care

12. The reasonable care standard is central to the new penalties. As a minimum, all taxpayers are required to exercise reasonable care in the conduct of their tax affairs. The reasonable care test requires a taxpayer to exercise the care that a reasonable, ordinary person would exercise in the circumstances of the taxpayer to fulfil the taxpayer's tax obligations.

13. The explanatory memorandum to the *Taxation Laws Amendment (Self Assessment) Act 1992* (SAA), at pages 80 to 83, contains an explanation of the reasonable care standard. That explanation should be used by officers as a general guide for administering sections 226G and 160ARZA. There are, however, several key points to note:

(a) while the size of a tax shortfall is determined on the basis of statements made by a taxpayer, penalty is attracted in respect of a careless act or failure to act on the part of the taxpayer or a registered tax agent. While the act of

carelessness may be in making (or failing to make) a statement, it may equally be an act or omission which lies behind the making of a statement e.g. a failure to keep adequate records;

(b) the explanatory memorandum to the SAA, at p.80, states that "the reasonable care test is not intended to be overly onerous for ordinary taxpayers". This is a critical point. The changes to the penalty system represent a balancing act between the need for returns to be correct and the difficulties that taxpayers face in ensuring they are correct. Officers involved in the imposition of penalties under the new system should bear in mind that under self assessment taxpayers are required to resolve issues that may sometimes be quite complex. Provided that a taxpayer may be judged to have tried his or her best to lodge a correct return, having regard to the taxpayer's experience, education, skill and other circumstances, the taxpayer should not be subject to a culpability penalty;

(c) it will not always be the case that an officer will have in his or her possession all of the relevant information that may bear on the question of penalties. Nor will it always be possible or practical for the officer to obtain the relevant information. In such cases the officer must make a judgment on the available facts. For example, it would be open for an auditor to conclude that a taxpayer does not have the necessary substantiation documents to support a claim if the taxpayer fails to respond to a subsection 82KZA(2) notice (after having been given an adequate opportunity to do so). From that conclusion, and taking into account whatever else may be known about the circumstances of the taxpayer, the auditor could make a decision about whether the taxpayer has exercised reasonable care;

(d) a taxpayer whose only explanation for omitting an amount of assessable income (for example, interest) is that he or she "forgot", should not, in the absence of other relevant factors, ordinarily be accepted as having taken reasonable care;

(e) a failure to maintain adequate records of income and expenditure will be a major reason for finding that a taxpayer has failed to take reasonable care. But this does not mean that a penalty is attracted every time an error is made in the taxpayer's books that leads to a tax shortfall, provided the taxpayer can show that its procedures are reasonably designed to prevent such errors from occurring.

What is reasonable will depend, among other things, on the nature and size of the business, but could include, for example, internal audits, sample checks of claims made, adequate training of accounting staff and instruction manuals for staff;

(f) on questions of interpretation, reasonable care requires a taxpayer to come to conclusions that would be reasonable for an ordinary person to come to in the circumstances of the taxpayer. If the taxpayer is uncertain about the correct tax treatment of an item, reasonable care requires the taxpayer to make reasonable enquiries to resolve the issue. This contrasts with the reasonably arguable position standard, which does not look at the taxpayer's efforts in resolving the issue, nor the circumstances of the taxpayer, but solely at the merits of the arguments in support of a position;

(g) a taxpayer who takes a position on a matter of interpretation contrary to that outlined in a Public Ruling will not have failed to take reasonable care by virtue of that reason alone. If the taxpayer can demonstrate, for example, that he or she did not know and could not reasonably be expected to have known that the Ruling existed, or that his or her situation differed materially from that covered by the Ruling and there was a reasonable basis for an alternative treatment, then the taxpayer may be treated as having taken reasonable care;

(h) in large adjustment cases, where the matter turns on a question of interpretation, the reasonably arguable test is an additional standard to be satisfied over and above the reasonable care standard. That is, a taxpayer who can demonstrate that the treatment of a matter is reasonably arguably correct may still be subject to penalty if the taxpayer did not take reasonable care in identifying and resolving the issue when preparing his or her return. For example, if a taxpayer claimed a deduction for an item of expenditure without knowing or caring whether it was deductible (and perhaps suspecting that it was not), but later discovers there is in fact a strong argument supporting its deductibility, then the taxpayer would not have taken reasonable care even though the deductibility of the expense may be reasonably arguable.

However, as a matter of practice, this would be an unusual case. If the correctness of a taxpayer's treatment of a matter is reasonably arguable, it may be difficult to show that the

taxpayer had not considered whether there was some reasonable basis for the treatment of the relevant matter at the time the taxpayer prepared his or her return. For example, a taxpayer should not be penalised for not having taken reasonable care just because the taxpayer had not prepared a detailed analysis of the authorities affecting the relevant issue at the time of preparing the return - the reasonably arguable test does not necessarily require such an analysis to be done at that time. But there should nevertheless be some evidence of the taxpayer having made a considered judgment on the issue when preparing the return. The message of the new penalties is clear - taxpayers should take reasonable care in identifying and addressing all issues when preparing their returns;

(i) a taxpayer who seeks advice from a qualified accountant or lawyer or similar kind of advisor, and follows the advice provided, would ordinarily be accepted as having exercised reasonable care in respect of the matter on which the advice was sought. However, if the advisor is a tax agent, whether or not the advisor is also a qualified accountant or lawyer etc, the new penalties apply on the basis that the taxpayer is vicariously liable for the tax agent's careless errors. The taxpayer's remedy against his or her tax agent is under section 251M of the ITAA, which provides that a taxpayer may recover from a registered tax agent any additional tax or interest which the taxpayer has become liable to pay through the negligence of the tax agent;

(j) a taxpayer does not satisfy his or her obligation to take reasonable care simply by using the services of a tax agent or other tax advisor. It would remain the taxpayer's responsibility, for example, to properly record matters relating to his or her tax affairs during the year, and to draw all the relevant facts to the attention of the agent or advisor, in order to satisfy the reasonable care test;

(k) arithmetic errors may indicate a failure to exercise reasonable care, but each case will turn on the circumstances, including the size, nature and frequency of the error. As a general proposition, most taxpayers could be reasonably expected to be able to accurately add up a column of figures;

(l) substantiation cases should be treated on the same footing as other cases where there is a tax shortfall. Accordingly, a taxpayer who has a tax shortfall and who acted carelessly in not meeting the substantiation requirements (that is, the

taxpayer could be reasonably expected to have known of the substantiation requirements yet carelessly failed to meet them) would attract a 25% penalty. It may be noted that if, on the facts of the case, relief from the application of the substantiation provisions would not be provided to the taxpayer under section 82KZAA, the taxpayer would also generally be found to have not taken reasonable care to comply with those provisions.

Recklessness

14. The word "recklessness" is not a term of legal art that has a special meaning, but rather has a well established ordinary meaning which the courts have generally had no difficulty applying. Literally, the word "reckless" means "without reck", "reck" being an old English word meaning "heed", "concern" or "care" (*R v Bates* [1952] 2 All ER 842). The courts, however, have long recognised that the ordinary meaning of recklessness involves something more than mere inadvertence or carelessness (for example, see *Derry v Peek* (1889) 14 App. Cas. 337; 5 T.L.R. 625).

15. Briefly stated, recklessness is gross carelessness - the doing of something which in fact involves a risk, whether the doer realises it or not, and the risk being such having regard to all the circumstances, that the taking of that risk would be described as "reckless" (*Shawinigan Ltd v Vokins & Co Ltd* [1961] 3 All ER 396). In other words, recklessness involves the running of what a reasonable person would regard as an unjustifiable risk (*Reed (Albert E) & Co Ltd v London and Rochester Trading Co Ltd* [1954] 2 Lloyds Rep 463).

16. The test of recklessness is an objective one, along similar lines to that of the reasonable care test. A person would be acting recklessly if:

(a) the person did an act which in fact created a risk of a particular consequence occurring (e.g. a tax shortfall);

(b) a reasonable person who knew the facts and circumstances surrounding the doing of the act which the doer of the act knew or ought to have known would have foreseen the risk of the consequences;

(c) the risk would have been foreseen by a reasonable person as being great, having regard to the likelihood that the consequences would occur, and the likely extent of those consequences (e.g. the size of the tax shortfall); and

(d) when the person did the act, he or she either had not given any thought to the possibility of there being any such risk, or

recognised that there was such risk involved and had none the less gone on to do it. That is, the person's conduct clearly shows disregard of, or indifference to, consequences foreseeable by a reasonable person.

17. It should be noted that a finding of dishonesty is not necessary to a finding of recklessness (*R v Grunwald & Ors* (1963) 1 Q.B. 935; *R v Bates* (supra)). Rather, it is sufficient that the person's behaviour displayed a high degree of carelessness.

18. Examples of how the term recklessness may apply in a tax context are given below (see examples 4(b) and 8).

Intentional disregard

19. The ordinary meaning of the word "intends" is "to mean, to have in mind". Accordingly, what is involved in intentional behaviour is the directing of the mind, having a purpose or design (*R v Willmot* [1985] 2 Qd R 413). A person who acts intentionally *decides* to bring about a state of affairs which the person has a reasonable prospect of being able to bring about, by the person's own act of volition (*Cunliffe v Goodman* [1950] 2 KB 237).

20. A person's intention is a question of fact. It may be proved by direct evidence of a person's state of mind (e.g. an admission), but may also be inferred from the circumstances and conduct of the person. In this regard a person is normally presumed to intend the natural consequences of his or her own acts (*Lloyds Bank Ltd v. Marcan* [1973] 2 All ER 359), although such a presumption may be rebutted by other evidence.

21. In a tax context, penalty is attracted if a taxpayer intentionally disregards the ITAA or the regulations. Whether a taxpayer's disregard of the ITAA or regulations is intentional may be determined on the basis of direct evidence of the taxpayer's intention, but will more likely need to be inferred from the surrounding circumstances and conduct of the taxpayer. A taxpayer who excludes from his or her assessable income an amount of interest income may be suspected of having done so intentionally, but in the absence of an admission from the taxpayer that the omission was deliberate, and with nothing more, it would be difficult to sustain a 75% penalty. On the other hand, if the interest omitted was from a bank account which the taxpayer had opened in a false name, this would be a circumstance which would infer that the taxpayer had acted intentionally.

22. It may be noted that for a taxpayer to intentionally disregard the ITAA or the regulations requires the taxpayer to know what the obligations under the ITAA or regulations are, and to choose to

disregard them. Where, for example, the assessability of a particular amount is unclear, and a taxpayer chooses not to return the amount, the taxpayer would not have "disregarded" the ITAA, but would have taken a view of its effect which differs from the Commissioner's view. Provided that view was honestly held, and was not frivolous or unfounded, penalty for intentional disregard would not apply. The taxpayer may, of course, still be liable for penalty for carelessness or recklessness.

23. An example of a matter that would be frivolous or unfounded for the purposes of the previous paragraph would be where a taxpayer claimed that his or her salary income was not assessable because of the taxpayer's particular beliefs. For further examples of when the intentional disregard penalty may apply see examples 9, 11 and 12 below.

Review rights

24. Each of the penalty standards of reasonable care, recklessness and intentional disregard are ultimately objective tests. Taxpayers have full rights to seek review by the AAT and the courts on the merits of whether the penalty standards have been breached in the circumstances of their case.

25. This is a significant change from the former penalty system. First, under the former penalty system no review was available by the AAT if, in broad terms, penalty was imposed at a rate of 20% per annum or less. This restriction does not apply in respect of the new penalties. Secondly, while the AAT was able to step into the shoes of the Commissioner and examine the merits of the Commissioner's decision to remit the statutory 200% penalty, a court was restricted to reviewing whether the Commissioner had exercised his discretion to remit according to law. Under the new penalties this restriction also will not usually apply, since the Commissioner will generally not be exercising a discretion.

26. As with the former penalty system officers will need to record the reasons why it was concluded that a particular penalty standard has been breached. This would include, for example, details of the circumstances surrounding the taxpayer's behaviour which led to the particular conclusion.

Examples

27. The following examples are intended to provide an indication of how the reasonable care, recklessness and intentional disregard

standards are seen as operating in practice. They are examples only and the conclusions are based on the information contained in each example. Notwithstanding that officers may be faced with cases that exhibit similar features, each case should be dealt with on an individual basis having regard to the particular circumstances. To the extent possible, officers should give the taxpayer the opportunity to bring to attention any facts that may be relevant to the assessment of penalty.

Example 1: Omission of interest income

Facts

28. The taxpayer, an aged pensioner without any commercial training or experience, invested monies in savings accounts and term deposits with a number of banks, a finance company and four different building societies. She returned all interest derived from these institutions, with the exception of a single amount of interest derived from a building society. The amount of interest in question and the date on which it had been paid had been correctly recorded in the taxpayer's passbook but the transaction code used to record the payment of interest inaccurately described the payment. Other payments of interest made by the building society in the current and previous years had been identified with codes which more accurately described the nature of the payment, and had been correctly returned by the taxpayer.

29. The taxpayer had carefully gone through her bank statements and passbooks and extracted those amounts marked as interest. The amount omitted was not significant compared with the total amount of interest returned.

Penalty

30. The taxpayer had exercised reasonable care in gathering together the relevant records and information, examining those records and completing her return form. A reasonable person in the taxpayer's circumstances would not have foreseen that reliance upon the coded passbook would have resulted in a tax shortfall. Penalty is not attracted.

Facts

31. The same as example 1 para.28, except that instead of the interest amount having been miscoded by the building society, the taxpayer simply overlooked the interest received on that particular account, that is, the taxpayer made an honest oversight. (For example, the account may have been closed during the year, or the interest

received close to the end of the year and the taxpayer thought it was assessable in the subsequent year). The taxpayer had otherwise carefully returned all other amounts of interest received, and had no previous record of tax shortfalls.

Penalty

32. The taxpayer had exercised reasonable care. The minor nature of the oversight does not detract from the generally careful approach adopted by the taxpayer. Penalty is not attracted.

Facts

33. The same as example 1 para.28, except that the taxpayer had only two interest bearing accounts, and the amount miscoded by the building society represented about half of the taxpayer's total interest income.

Penalty

34. While the amount of interest omitted is relatively more significant, the age and experience of the taxpayer and her honest reliance upon the codings provided by the building society would mean that the taxpayer had exercised reasonable care. Penalty is not attracted. (Note that this is a borderline case. Each case would need to be considered on its merits as to whether it was reasonable for the taxpayer to have relied on the building society codings).

Facts

35. The same as example 1 para.28, except that the taxpayer had only two interest bearing accounts, the building society had correctly coded all entries of interest, but the taxpayer overlooked the interest earned on one of the accounts which amounted to about half of the taxpayer's total interest income.

Penalty

36. Whether the taxpayer had exercised reasonable care would depend on all the circumstances of the case. In the absence of extenuating circumstances, the omission of the relatively significant amount of interest income would indicate that the taxpayer had been careless in gathering together and examining the information relevant to determining her interest income for the year. Penalty of 25% is attracted.

Facts

37. The taxpayer emigrated with her son and daughter-in-law and their family to Australia 20 years ago. Her husband had died prior to her emigrating. She had attended school infrequently due to World War II and had married at a young age. She had never learned to speak English very well and preferred the company of women whose situation was similar to hers.

38. The taxpayer's uncle, who emigrated to America, died in May 1990 and left her $120,000. In July 1990 the taxpayer put the money into a two year fixed term deposit as it earned higher interest. The bank clerk told the taxpayer that she could not touch the money until the end of the fixed term, in July 1992. The taxpayer did not return any interest for 1991 as she had not received any money. While the bank recorded an amount of $16,000 interest for the financial year ended 30 June 1991 it did not send an advice to the taxpayer.

Penalty

39. Given the taxpayer's poor understanding of English and the absence of advice from the bank, the taxpayer could not reasonably be expected to have understood the taxation requirements surrounding the interest on the fixed deposit. No penalty is attracted.

Facts

40. The taxpayer, an elderly pensioner, was forced to sell her home due to ill health, prior to moving into a nursing home. The proceeds from the sale were deposited in a bank account and, as a result, the taxpayer earned $3,000 in interest income during the year. The taxpayer did not return the income. She had not lodged returns for a number of years because her income was below the threshold. In any event she believed that the interest was not assessable because "the family home is exempt from tax".

Penalty

41. In all the circumstances the taxpayer's failure to return the interest was not unreasonable. No penalty is attracted.

Facts

42. The taxpayers, a husband and wife, worked as a mechanic and clerk in the Public Service respectively. In December 1994 they closed their joint savings account with one of the major banks and transferred it to a building society. The amount transferred represented the taxpayers' total savings. The cheque they received from the bank included $2,000 of interest earned from 1 July 1994 until the account was closed, although this was not immediately

apparent from the letter the taxpayers received from the bank, which the taxpayers had filed away without giving much thought.

43. In July 1995 the taxpayers had to rush their daughter to hospital for an appendectomy, which went smoothly. Shortly afterwards, the taxpayers completed their returns for the 1995 year, but omitted to include $1,000 each of the interest earned from the bank. They did return interest earned on their savings since it had been held at the building society.

Penalty

44. The taxpayers acted carelessly in failing to check the correspondence from the bank, or to check with the bank directly, as to what amount of interest they had earned prior to transferring their savings to the building society. While the poor standard of the letter from the bank and the distraction of their daughter's operation are matters to be considered, they do not detract in this case from the carelessness of the taxpayers in dealing with interest earned on their savings. Penalty of 25% is attracted.

Example 2: Incorrect spouse rebate claims

Facts

45. The taxpayer claimed a spouse rebate for his wife for the 1992 income year. His wife had commenced work in April 1992 and had received her group certificate and lodged her return early in July 1992. The return disclosed income of $4000, but she did not keep a copy of it, nor of the group certificate. The taxpayer lodged his return in October 1992. He asked his wife how much she had earned, and she guessed $1500. The taxpayer thought it was more, and estimated it to be $2000 and claimed a reduced spouse rebate accordingly.

Penalty

46. The taxpayer had been careless in estimating his wife's separate net income. A reasonable person in the taxpayer's circumstances would have asked his wife to check with her employer or with the Tax Office about the level of her income. Penalty of 25% of the shortfall caused by the overclaimed rebate would apply.

Facts

47. The taxpayer claimed a spouse rebate for his wife, unaware that she had commenced part time work during the day. His wife had deliberately chosen not to tell him of her employment for personal reasons. In preparing his return the taxpayer includes only a share of

joint interest income as his wife's separate net income, having no reason to suspect that she has earned income from other sources.

Penalty

48. Under the circumstances, a reasonable person in the shoes of the taxpayer could not be expected to know of his wife's additional income. The taxpayer has taken reasonable care in preparing his return, and no penalty is attracted.

Example 3: Substantiation

Facts

49. The taxpayer claimed motor vehicle expenses for the 1993-94 and 1994-95 years of income using the log book method. During the 1993-94 financial year the taxpayer was employed as a floor tile salesman and kept a log book for the required 12 week period. The taxpayer also had all the relevant receipts for the motor vehicle expenses incurred during the two years in question. However, in July 1994 the taxpayer changed jobs to become a used car salesman, and as a result the business usage of the taxpayer's vehicle was much reduced (changing by more than 10%). A new log book was not kept for the 1994-95 year.

Penalty

50. Penalty of 25% is attracted because the taxpayer had been careless in claiming motor vehicle expenses in the 1994-95 year without having maintained a new log book. Tax Pack is clear about the need for a new log book in these circumstances, and the change of jobs by the taxpayer should have alerted him to the likelihood of a changed business usage of the vehicle. (Note that because the taxpayer has maintained all relevant receipts there may be a case for allowing the taxpayer a deduction for a portion of total motor vehicle expenses in the 1994-95 year if a reasonable estimate of business kilometres travelled could be made).

Example 4: Rental properties

Facts

51. The taxpayer inherited two rental properties from her father upon his death in 1993. The properties were rented out before her father's death and were managed by separate real estate firms.

52. In her return for the 1995 year of income the taxpayer understated her gross income from rents by $600 (she returned

$8,000). She explained that this must have been caused by her making an arithmetic error in adding up the monthly rental statements provided by the real estate agents, notwithstanding that she had checked the total several times.

53. In addition, she had claimed in full the cost of installing a new solar hot water system ($2,000) at one of the properties, and she had also claimed the stamp duties ($2,000) on transfer of the land from her father's nominee company to her. The taxpayer had prepared her return herself and had not realised that the hot water system should be depreciated and that the stamp duty was a capital expense.

Penalty

54. The taxpayer had been careless in adding up her rental income, and in claiming the hot water system and stamp duty expenses without checking whether they were in fact deductible. A reading of the relevant part of Tax Pack would have alerted a reasonable person that there was some doubt that the expenses were deductible. Penalty of 25% is attracted.

Facts

55. The taxpayer claimed the entire loss relating to a rental property for the 1994 to 1996 income years. Upon audit by the ATO it was discovered that the property was owned jointly by the taxpayer with his wife. When challenged on this the taxpayer claimed there must have been a mistake since it was always his intention that the property should be held solely in his name so that he alone could claim the advantages of negative gearing.

56. The mortgage over the property was in joint names, which the taxpayer was aware of, but claimed that he could not recall signing the transfer of title, which clearly showed that the property was held in joint names.

57. The taxpayer held a degree in computing science, and displayed a sound general understanding of the tax system and of the implications of negative gearing in particular. The taxpayer's records were meticulously kept, but did not mention the title of the rental property.

Penalty

58. The taxpayer ought to have known that the property was held in joint names, and a reasonable person in possession of that knowledge and otherwise in the circumstances of the taxpayer would have realised that there was a significant risk that the taxpayer was not entitled to claim the whole of the rental loss. The taxpayer had accordingly behaved recklessly, and penalty of 50% is attracted.

There is insufficient evidence on the facts of this case to suggest that the taxpayer both knew that the property was held in joint names and that this meant that the loss from the property should be split with his wife. A finding of intentional disregard was therefore not warranted

Example 5: Small business - omitted income

Facts

59. The tax return of a small, newly established business experiencing rapid growth was prepared from an inadequate and poorly supervised accounting system which had not kept pace with the firm's very fast expansion. An audit was conducted by the ATO and several omissions of income (being in respect of accounts for services rendered by the firm) were detected together with overstated claims for deductions. The amounts involved were small in relation to total income for the year. The services provided in these particular cases were unusual in nature when compared with the mainstream operations of the firm.

Penalty

60. The taxpayer had been careless in maintaining an inadequate accounting system which had resulted in the tax shortfall. A reasonable person conducting the business of the taxpayer would have foreseen that the poor accounting system would have resulted in an understatement. Penalty of 25% is attracted.

Example 6: Small business - record keeping audit

Facts

61. A taxpayer who carries on a small business was subject to a record keeping audit by the ATO. As a result of the audit the taxpayer was given specific, written advice by the auditor of areas where the records were inadequate and what was required to remedy the situation. The taxpayer was advised that there was a real risk that he would not return the correct amount of taxable income if his record keeping practices were not improved. The taxpayer accepted the comments of the record keeping auditor and sought to follow the advice provided.

62. The following year the same taxpayer was subject to an income tax audit and a tax shortfall was detected. The shortfall was caused by the taxpayer having misunderstood and incorrectly implemented a small part of the advice provided by the record keeping auditor - in all other respects the taxpayer had satisfactorily implemented the advice provided.

Penalty

63. The taxpayer had made a reasonable attempt to keep adequate records following the record keeping audit and the error was an isolated incident. No penalty is attracted.

Facts

64. The same as example 6 para.61, but the taxpayer, rather than implementing the ATO suggestions, took some other measures which did not materially improve the adequacy of the taxpayer's records. In designing those measures the taxpayer did not seek advice from anyone with accounting or tax qualifications, nor did the taxpayer have any reasonable grounds to believe that the measures taken improved his records. Records were still not regularly updated and the information was recorded in general terms only (e.g. various items were all lumped together under one general heading, such as expenses).

Penalty

65. The taxpayer was reckless in not properly altering his record keeping practices in the face of advice that failure to do so would most likely result in the taxpayer having a tax shortfall. Penalty of 50% is attracted.

Facts

66. The same as example 6 para.61, but the taxpayer completely ignored the advice of the record keeping auditor and made no attempt to improve the adequacy of records kept.

Penalty

67. The taxpayer intentionally disregarded the need to keep adequate records (section 262A) after having been specifically advised of the requirement to do so. Penalty of 75% is attracted.

Example 7: Contentious item - new law

Facts

68. The taxpayer claimed a deduction of $500,000 as expenditure on eligible research and development activities under a newly introduced research and development incentive provision of the ITAA. It was subsequently ascertained by the ATO auditor that included in this amount was an allocation of overheads totalling $10,000. These overheads included canteen facilities and banking charges. The method adopted by the company for allocating the expenditure was accepted as being reasonable. The company believed that the

expenditure came within the statutory requirement that it be "incurred directly in respect of research and development activities".

69. Relatively little guidance had been provided on interpretation of the legislation or of the type of expenses that came within the legislation - no Taxation Ruling had been issued, and the explanatory memorandum was silent on the question of overheads and did not provide examples. The taxpayer had sought out available material on the new scheme, but in the end only had the words of the statute to guide him. In addition, expenses on canteen facilities and bank charges had been allowable under the previous research and development incentive scheme.

70. That part of the research and development deductions relating to the canteen facilities and bank charges was disallowed as not being incurred directly in respect of research and development activities.

Penalty

71. The taxpayer had exercised reasonable care in seeking out information on the new incentive scheme. The taxpayer's reliance on the words of the new provision and the fact that there was no indication that the treatment of overheads had been changed from the previous incentive scheme made the taxpayer's treatment of the overheads reasonable under the circumstances. No penalty is attracted.

Facts

72. The same as example 6 para.61, except that a Taxation Ruling had issued on the new scheme which made clear the changed approach to overheads under the new scheme. The explanatory memorandum also referred to the change.

Penalty

73. Given the size of the total research and development claim, and the fact that it was the first year of a new scheme, a reasonable person would have sought out official explanations of the new scheme when calculating his or her claim. A tax shortfall that was caused by a failure to make such enquiries would, in these circumstances, attract penalty at 25%.

Example 8: Deferred interest security - advice from institution - carelessness

Facts

74. The taxpayer invested $10,000 on fixed deposit for 3 years with a finance company on 1 August 1993. The terms of the investment were that interest was payable on maturity of the investment but would accrue at a nominal interest rate of 13% per annum with 6 monthly rests. The taxpayer did not disclose in her 1994 return the amount of interest that had accrued for the period from 1 August 1993 to the end of the year of income.

75. The finance company indicated in its prospectus that under the ITAA, income accruing to investors from discounted and other deferred interest securities is taxed each year. At the end of the year it also informed investors of the amount to be included as assessable income for Division 16E purposes. The taxpayer stated she had not realised that income accruing on deferred interest securities was assessable as it accrues, notwithstanding the advice received from the company. She believed interest was assessable only when it was received. The taxpayer was not commercially literate.

Penalty

76. While some confusion may have genuinely arisen in the taxpayer's mind as to the assessability of the amounts in question, the taxpayer had been careless in ignoring the information provided by the finance company and in failing to at least make further enquiries. Penalty is attracted at 25%. [Note: in some cases involving a deferral of tax where the taxpayer has been careless it may be appropriate to partially remit the penalty otherwise attracted - see Draft Ruling TR 93/D23].

Example 9: Repairs - recklessness

Facts

77. Export Pty Ltd carried on a significant exporting business and owned a warehouse in which it stored its stock. To comply with health and safety standards it was ordered by a maritime building authority to replace the existing floor. The rotting wooden floor was replaced with a steel and concrete floor which had distinct advantages over the old wooden floor. The invoice for the work totalled $250,000 and stated in part "parts and labour involved in repairing floor."

78. The employee of the taxpayer responsible for preparing cash books recorded the expense as a repair. The employee had received no training on how to distinguish between allowable repairs and capital expenses for tax purposes, and there was no manual available to the employee that provided any guidance.

79. The $250,000 was claimed as a deduction by the company. The director of the company who was responsible for the preparation of the

company's tax return was familiar with the work carried out in respect of the damaged floor but had not bothered to enquire into the correct tax treatment of the claim. Rather, the director had relied upon the description on the invoice, notwithstanding that the claim was relatively large in the context of the company's tax return (assessable income totalled $5m). The director had no formal training in accounting or commercial law but possessed extensive commercial experience.

80. On audit by the ATO it was concluded that the replacement of the floor was in the nature of an alteration and improvement, and the expenditure was of a capital nature.

Penalty

81. While the auditor decided that there was insufficient evidence of intentional disregard of the provisions of section 53 of the ITAA it was concluded that the claim had been made recklessly in that the taxpayers conduct (through the director responsible for the preparation of the return) displayed an indifference to the considerable risk that the claim would result in a tax shortfall, which risk would have been foreseen by an ordinary person with the commercial experience of the director. Penalty of 50% of the tax shortfall caused by the repair claim was therefore attracted.

82. [Note that because of the size of the claim, the reasonably arguable test would also need to be met. On the facts, the claim is not reasonably arguable, which means that penalty of 25% would be attracted under that heading. Because the 50% penalty for recklessness is greater, that penalty is the one that applies - section 226W].

Example 10: Trading stock - understatement of value at year end - intentional disregard

Facts

83. Import Ltd held consignment stock on display on its premises together with stock purchased on normal terms. The consignment goods were delivered "on approval" or "on sale or return" so that a sale to the taxpayer was contemplated at the time of delivery.

84. The taxpayer had debited its purchases account for the cost of the consignment stock and the various suppliers were treated as creditors. The director responsible for the preparation of the return assured the taxation officer auditing the taxpayer's affairs that, having taken up the consignment stock as a purchase, the items would be included in the year end stock sheets.

85. Examination of the stock sheets indicated this was not the case and, in fact, substantial amounts of stock purchased in the normal course of business had also been omitted from the stock sheets. Questioning of an employee indicated that the director was aware the items were omitted from the stock sheets and that the value of closing stock was understated.

86. The relevant director claimed he had minimal knowledge of the tax law and accounting practices and that the understatement of income arose out of his ignorance. However, this was at odds with earlier conversations with the director, with the intricate record keeping system the taxpayer had in place and with the evidence of the employee.

Penalty

87. The auditor concluded on the basis of all the circumstances that the taxpayer had intentionally disregarded the requirements of section 28 of the ITAA to take into account the value of all trading stock at the end of the year in ascertaining taxable income. Penalty of 75% of the tax shortfall caused by the trading stock error was therefore attracted.

88. [Note that because the shortfall in this case was caused by an error in respect of trading stock, it may be that there was only a deferral of tax. Whether a remission under subsection 227(3) of the 75% penalty attracted is warranted would depend on all the relevant circumstances. The taxpayer's intentional behaviour in this case would mitigate against any remission].

Example11: Lease premiums - assessable capital gain - error by tax agent - carelessness

Facts

89. The taxpayer company owned properties which it leased to third parties. During the 1993 income year the taxpayer received a lump sum receipt as a premium for the grant of a lease over a hotel. The premium was a relatively small amount. The taxpayer did not include the lump sum in its assessable income. On audit by the ATO the taxpayer was found, on advice from its tax agent, to have treated the amount as a capital profit in its financial statements that was not subject to tax. The taxpayer had provided its agent with all of the relevant information surrounding the granting of the lease. Neither the taxpayer nor its agent had sought a ruling on the matter. In reaching the conclusion that the premium was not assessable the tax agent had failed to check the capital gains tax provisions or any other text or source on capital gains. The agent had only limited experience with capital gains issues.

Penalty

90. The taxpayer's tax agent had not taken reasonable care in dealing with the lease premium in the taxpayer's return. Even a cursory examination of a basic income tax text would have alerted the tax agent to the possible tax implications of the lease premium. As a result the taxpayer would be subject to a 25% penalty. The tax agent is not considered to have behaved recklessly. While a reasonable person would have foreseen the risk of a tax shortfall, the risk, in all the circumstances of this case, is not considered to have been foreseeable by a reasonable person as being of such a magnitude as to justify a finding of recklessness. The amount involved and the experience of the tax agent are particularly relevant to this conclusion.

Example12: Capital gains tax - intentional disregard - hindrance

Facts

91. In 1984 the taxpayer purchased land and a building from which he carried on a retailing business. In February 1989 he added an additional storey to the building. This improvement cost $80,000. The taxpayer paid $60,000 of this account from his business cheque account and $20,000 from his personal bank account. On 1 August 1992 the taxpayer sold the land and building for $500,000. In his tax return for the year ended 1993 the taxpayer did not return any assessable income from the sale.

92. On audit by the ATO the taxpayer explained that he had enquired about the capital gains tax implications of the improvements to the building. He was informed the improvement would not be caught by the capital gains provisions providing it did not cost more than $63, 450 (the indexed value under s.160ZJ). He stated that since the improvement only cost $60,000, no amount was assessable as a result of the sale.

93. The taxpayer produced an invoice for $60,000 that he said was for the cost of the improvements. The taxpayer failed to produce the personal bank account when requested to do so by the auditor. When confronted with the $20,000 payment from his personal bank account and with a copy of a second invoice from the builder which showed the extra $20,000 cost the taxpayer admitted that he had deliberately structured the payment for the improvement so as to avoid tax. After allocating the sale proceeds of $500,000 between the original land and buildings and the improvement, the real gain on disposal of the improvement was included in the taxpayer's assessable income.

Penalty

94. The auditor concluded that the taxpayer had intentionally disregarded the capital gains provisions of the ITAA so that a 75% penalty was attracted under section 226J. In addition, the taxpayer had taken steps to prevent or hinder the Commissioner from becoming aware of the shortfall by presenting only one of the two invoices, refusing to produce the personal bank account, and making false statements about the cost of the improvements. As a result, section 226X applied to increase the penalty otherwise attracted by 20%, so that a total penalty of 90% was payable by the taxpayer.

Example 13: Skimming of cash receipts - intentional disregard - hindrance

Facts

95. The taxpayer leased several shops in which managers were appointed. The ATO was informed that in two of those shops the cash registers were closed off each day at a certain time and monies representing the proceeds of sales were set aside and collected by the taxpayer. These monies were not recorded in the taxpayer's accounts or returned as assessable income. This practice continued over a number of years.

96. The taxpayer was interviewed and initially denied the practice existed. However, when confronted with a copy of a book showing these amounts, the taxpayer admitted that the omission of income in the manner alleged was correct. He insisted, however, the monies were used for cash purchases for the shops and were not claimed as deductions. This was subsequently found not to be true as the cash purchases had already been claimed as deductions.

Penalty

97. The facts disclose a deliberate intention to evade tax. As such, penalty of 75% of the tax shortfall is attracted. In addition, the failure to honestly answer questions during the course of the audit amount to steps taken by the taxpayer to prevent or hinder the Commissioner from becoming aware of the shortfall, so that the penalty otherwise attracted is increased by 20%, to 90%.

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- ITAA 82KZAA; ITAA 170AA; ITAA 224; ITAA 225; ITAA 226; ITAA 226G; ITAA 226H; ITAA 226J; ITAA 226K
- ITAA 226L; ITAA 226M; ITAA 226X; ITAA 226Y; ITAA 226Z

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