TR 95/D24 - Income tax: international transfer pricing - penalty tax guidelines

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This document has been finalised by TR 98/16.

Generated on: 29 November 2026, 02:38:52 AM

Draft Taxation Ruling
Income tax: international transfer pricing - penalty tax guidelines

other Rulings on this topic

IT 2311; IT 2517; TR 92/10; TR 92/11; TR 94/3; TR 94/4; TR 94/5; TR 94/6; TR 94/7; TR 94/14; TR 95/23

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What this Ruling is about

Class of person/arrangement

1. This Ruling is intended for taxpayers who are involved in international cross-border dealings where those dealings are not conducted (or have not been adjusted for taxation purposes) in accordance with the arm's length principle.

Issues discussed in this Ruling

2. This Ruling provides guidelines on the imposition and remission of penalty tax under Part VII of the *Income Tax Assessment Act 1936* ('ITAA') in circumstances where the transfer pricing provisions of Division 13 of Part III of the ITAA ('Division 13') or a relevant provision of a double taxation agreement ('DTA'), contained in a schedule to the *International Tax Agreements Act 1953*, ('the Agreements Act'), have been applied in a taxpayer's assessment.

3. The Ruling outlines the application of section 225 and other relevant provisions of Part VII of the ITAA on the basis of the penalty tax provisions introduced in the *Taxation Laws Amendment (Self Assessment) Act 1992* ('the Self Assessment Act'), in cases where transfer pricing adjustments have been made by the ATO in an assessment for the 1992-93 and subsequent years of income.

4. The Ruling also provides guidelines on the special circumstances where the ATO will exercise a remission under subsection 227(3) of the ITAA to reduce Part VII penalty tax in respect of a transfer pricing adjustment made in an assessment of a taxpayer for the 1992-93 and subsequent years of income.

5. The Ruling explains how the ATO will exercise the general authority for remission, under subsection 227(3) of the ITAA, to apply the post Self Assessment Act penalty tax guidelines to transfer pricing adjustments made in relation to the 1991-92 year of income.

6. The Ruling explains how the guidelines provided in Taxation Ruling IT 2311, dealing with the remission of penalties imposed under section 225 of the ITAA - prior to amendment by the Self Assessment Act - have been revised in relation to income tax assessments in respect of years prior to the 1991-92 year of income.

7. The Ruling also provides practical guidance to taxpayers on possible steps that could be adopted to minimise the risk of incurring heavier penalties under Part VII of the ITAA.

Terms used in this Ruling

8. References to 'transfer pricing' and 'profit shifting' in this Ruling relate to the allocation of income and/or expenses, between tax jurisdictions, which may not be in accordance with the 'arm's length principle'. They are not intended to imply any purpose or intention of a taxpayer. For further discussion on the arm's length principle see Taxation Ruling TR 94/14 and the OECD publication *'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'*, OECD, Paris 1995 ('the 1995 OECD guidelines').

9. References to a 'scheme section' in this Ruling adopt the term used in the legislation (see paragraph 47 below). They are not intended to imply that a scheme actually exists or was the intention of the taxpayer. Where a scheme is entered into with an intention to avoid tax, the legislation specifically provides for higher penalties, in appropriate circumstances, as explained in this Ruling.

10. References to a 'relevant provision of a DTA' in this Ruling refer to the transfer pricing provisions of the Associated Enterprises Article or the Business Profits Article of the relevant DTA.

11. To avoid any possible confusion between interest under section 170AA of the ITAA and penalties under Part VII of the ITAA, all references to 'penalties' in this Ruling refer to the latter and any reference to a 'per annum' penalty is not a reference to interest.

Special rules for taxpayers with certain substituted accounting periods

12. The penalty amendments introduced by the Self Assessment Act do not apply to substituted accounting periods that commenced before 1 July 1992 that are in lieu of the 1992-93 year of income (see

paragraph 52 below). For taxpayers with such accounting periods, the amendments became effective for their 1993-94 year of income. Therefore, for taxpayers with such substituted accounting periods, all references in this Ruling to the '1992-93 year of income' should be read as a reference to the 1993-94 year of income. This Ruling also outlines special ATO penalty remission policy for one year of income prior to the commencement of the Self Assessment Act provisions. For the purposes of applying that policy to taxpayers with such substituted accounting periods, all references in this Ruling to:

(a) 'the 1991-92 year of income' should be read as a reference to 'the 1992-93 year of income'; and

(b) 'the 1990-91 year of income', should be read as a reference to 'the 1991-92 year of income'.

Ruling

Penalty remission policy prior to the 1992-93 year of income

13. The provision for remission of any additional tax will not generally be exercised to reduce the 10% per annum penalties imposed under former subsections 226(2B)-(2F) in respect of transfer pricing transactions entered into prior to 14 December 1984 **(paragraphs 71 to 73)**.

14. The ATO remission policy outlined in IT 2311 continues to apply to adjustments to assessments in respect of transfer pricing transactions entered into on or after 14 December 1984 and up to and including the 1991-92 year of income **(paragraphs 74 to 99)**.

15. The remission policy in IT 2311 is modified to adopt the principles set out in IT 2517 in all transfer pricing adjustments made to assessments for the 1985-86 to 1991-92 years of income, where such principles give a result that is more advantageous to the taxpayer than is provided under IT 2311 **(paragraphs 79 to 99)**.

16. Where a voluntary disclosure is made in respect of a year prior to the 1992-93 year of income, any reduction in section 225 penalties will be effected through a remission under subsection 227(3) in accordance with the remission guidelines detailed in IT 2517. If the disclosure accords with paragraph 24 of that Ruling, a culpability component will not be imposed under section 225 and the taxpayer will only be subjected to a 10% 'per annum' component - limited to a maximum of 50% of the tax avoided in any year **(paragraphs 84 to 89)**.

17. The remission policy in IT 2311 is further modified in respect of amendments to 1991-92 assessments made after 1 July 1992, so that

any penalty imposed under section 225 will be remitted to a level where the resultant penalty is no higher than the penalty that would be imposed under the Self Assessment Act principles **(paragraphs 91 to 98)**.

18. For the purposes of applying IT 2311, a 'per annum' component of section 225 penalties will generally be imposed in all transfer pricing cases regardless of the level of any 'culpability' component imposed **(paragraph 99)**.

19. The per annum component of any Part VII additional tax imposed, in an assessment prior to the 1992-93 year of income, is not interest and is not deductible for income tax purposes **(paragraph 99)**.

Penalty guidelines for 1992-93 and subsequent years of income

20. Penalties under both section 225 and the shortfall sections of the ITAA will be imposed in accordance with the particular behaviour or breach of penalty standard introduced under the Self Assessment Act **(paragraphs 45 to 70 and 100 to 104)**.

21. Penalties may be imposed on taxpayers who do not take reasonable care in the preparation of their return and throughout the year in respect of record keeping matters that have a bearing on the accuracy of their return and the tax payable **(paragraphs 105 to 115)**.

22. For business taxpayers, reasonable care requires putting into place an appropriate record keeping system and other procedures to ensure that the income and expenditure of the business is properly recorded and classified for tax purposes **(paragraphs 105 to 108)**.

23. A multinational company would not have exercised reasonable care in adopting the transfer prices of property (including services) transferred to or from a related company, if the company could reasonably be expected to have known or suspected that the transfer prices may not accord with the arm's length principle, or that such prices have not been adjusted for taxation purposes to accord with that principle **(paragraphs 105 to 113)**.

24. Where there is a clearly contentious area of the law, a position taken by a taxpayer will be reasonably arguable if, on an objective analysis of the law and the application of the law to the relevant facts, it would be concluded that the taxpayer's position was about as likely as not correct **(paragraphs 116 to 120)**.

25. A taxpayer may have a reasonably arguable position ('RAP') for the tax treatment of an item, despite the absence of authorities other than the law itself, provided the taxpayer has a well-reasoned construction of the applicable statutory provision which it could be

concluded was about as likely as not the correct interpretation **(paragraphs 116 to 124)**.

26. The RAP test looks at whether it is about as likely as not the relevant provisions do not apply **(paragraphs 116 to 130)**.

27. For a taxpayer to have a RAP where Division 13 or a relevant provision of a DTA applies, the taxpayer would need to demonstrate that the price they had used was about as likely as not the 'arm's length price' **(paragraphs 116 to 132)**.

28. A taxpayer would be best placed to show that its dealings were 'arm's length' if it maintained documents that were brought into existence as part of the process of determining the prices, the conduct of the relevant parties was consistent with the documentation and the documents accurately recorded the relevant facts and deliberations **(paragraphs 116 to 132)**.

29. Where a taxpayer is liable for Part VII penalties under both a shortfall section and a scheme section, the ATO will exercise the remission of one of those penalties, under subsection 227(3), to result in the most appropriate penalty rate that reflects the taxpayer's behaviour in the particular case - having regard to the legislative intent **(paragraphs 165 to 178)**.

30. A remission under subsection 227(3) will be made in the 1992-93 and subsequent years of income in genuine good faith, no-fault, cases where the only penalty liable to be imposed is under section 225 and where the taxpayer satisfies the conditions for remission detailed in paragraph 179 of this Ruling **(paragraphs 170 to 179).**

31. The ATO would not consider the remission under subsection 227(3) proposed in paragraph 30 above, where information that is reasonably available to a multinational company group would assist an Australian taxpayer member of the group to ascertain the best approximation of the arm's length outcome, but that information is not made reasonably available to the Australian taxpayer **(paragraphs 179 to 181)**.

32. Where a taxpayer voluntarily discloses to the ATO a matter which would result in the application of a transfer pricing provision of the ITAA, the penalty otherwise attracted under section 225 will be reduced in accordance with the relevant statutory reductions where:

- the disclosure is in writing and brings all the relevant facts and other information to the attention of the ATO that will allow the ATO to readily identify the transfer pricing matter, including the amount and nature of the relevant adjustment; and

- the disclosure is such that it could reasonably be estimated to have saved the ATO a significant amount of staff time or resources in looking into the matter disclosed

(paragraphs 182 to 195).

33. Where a taxpayer reviews their past transfer pricing practices and requests an amended assessment under subsection 170(1), on the basis that the past practice does not accord with the arm's length principle, any amendment made under subsection 170(1) would not activate the statutory penalties under section 225. If a complete voluntary disclosure is made in respect of the 1992-93 or subsequent year of income, and the taxpayer can demonstrate they had taken reasonable care in the preparation of their tax return and had a RAP, any Part VII penalty would be remitted in full under subsection 227(3). In other cases, the level of reduced penalty will depend on the relevant shortfall provision **(paragraphs 196 to 199)**.

34. The ATO will make an amendment under subsection 170(9B) where an amendment under subsection 170(1) arising from a complete voluntary disclosure is not possible due to statutory time constraints. In such cases, where the taxpayer fully co-operates with the ATO in finalising the amendment, the taxpayer will be afforded the benefit of any lower penalties for voluntary disclosures - by remission under subsection 227(3) - in a similar fashion to amendments made under subsection 170(1) **(paragraphs 196 to 200)**.

35. Where a taxpayer requires a formal determination to be made, in response to a voluntary disclosure, the amendment/s under Division 13 and/or the relevant DTA would be made pursuant to subsection 170(9B) and must attract the statutory penalties under section 225, with the relevant reduction in accordance with the statute. In these cases, the ATO may also require that a full audit or review be carried out on all related transfer pricing issues and the basis for imposition and remission of section 225 penalties would depend on the facts and circumstances of the particular case, including whether the taxpayer had a RAP and whether:

- the penalty is to be imposed under paragraphs 225(1)(d) or (e), or under subsection 225(2);
- the disclosure covers all subsequent adjustments made by the ATO and warrants a total (or only partial) reduction under the provisions of sections 226D or 226E, whichever is appropriate; or
- there are any circumstances which may warrant an increased or higher penalty rate (e.g., deliberate intent, recklessness, disregard of a private ruling, hindrance or prior application of section 225)

(paragraphs 196 to 202).

36. A taxpayer who has entered into an advance pricing arrangement ('APA') may be subjected to a transfer pricing adjustment, and the relevant penalties under Part VII, in relation to:

(a) non-arm's length dealings which are not specifically covered within the APA; or
(b) non-compliance with the terms of the APA, unless the taxpayer has made the necessary compensating adjustments - pursuant to the APA - in the relevant tax return

(paragraphs 203 to 205).

Date of effect

37. The penalty tax provisions of the Self Assessment Act as detailed in this Ruling apply only to the imposition of section 225 penalties in relation to assessments in respect of the 1992-93 year of income and all subsequent years.

38. Taxation Ruling IT 2311 continues to apply to the remission of penalties in respect of transfer pricing adjustments, where the relevant transactions were entered into on or after 14 December 1984, for all years up to and including the 1991-92 year of income. IT 2311 will not apply to the 1992-93 year of income or to any subsequent year of income.

39. IT 2311 has been modified, in relation to any amendment to an assessment for the 1985-86 to the 1991-92 years of income, to apply the principles of Taxation Ruling IT 2517 in cases where the principles in IT 2517 result in a greater remission of section 225 additional tax than would have been remitted under IT 2311.

40. For the 1991-92 year of income, IT 2311 is further modified, in relation to the rate of the culpability and per annum additional tax components applied under the principles in IT 2517, so that the section 225 additional tax after remission is no greater than the penalty tax which would be imposed under the Self Assessment Act provisions.

41. This Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of this Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Legislative framework

Legislation prior to the 1992-93 year of income

42. The present Part VII was inserted in the ITAA by the *Taxation Laws Amendment Act 1984* ('the 1984 Act') and applies from 14 December 1984. Section 225 of Part VII applies where the provisions of Division 13 or a relevant provision of a DTA is applied.

43. Section 225 replaced former subsections 226(2B)-(2F) which imposed additional tax at the rate of 10% per annum in cases where the provisions of Division 13 or a relevant provision of a DTA had been applied.

44. The rate of penalty applicable under section 225, prior to the amendments in the Self Assessment Act, was 200% where a provision of Division 13 or a relevant provision of a DTA was applied in relation to a scheme entered into for the sole or dominant purpose of enabling a person to pay no tax or less tax. In all other cases (e.g., where there is no tax avoidance purpose), the penalty rate was 25% per annum. Subsection 227(3) provided authority for the remission of all, or part, of any penalty imposed.

Legislation for the 1992-93 and subsequent years of income

45. As part of the 1992 improvements to the self assessment arrangements, the Self Assessment Act introduced a new system of penalties, under Part VII, for understatements of income tax. The new system has a basic requirement that taxpayers exercise reasonable care in carrying out their tax obligations and, in certain circumstances, includes a reasonably arguable position (RAP) test.

46. The changes to the penalty provisions were considered necessary as the previous penalty standard no longer reflected what is required of taxpayers under a self assessment system. Instead of requiring a taxpayer to make a full and true disclosure of all material facts, to enable the ATO to assess a taxpayer's liability, the self assessment system requires taxpayers to determine their own taxable income. Companies are also required to calculate the tax payable.

47. The new system of penalties in Part VII provides for penalties to be payable whenever a 'scheme section' or a 'shortfall section' is applied in the assessment of a taxpayer. Subsection 222A(1) of the ITAA defines 'scheme section' to mean sections 224, 225 or 226 and 'shortfall section' to mean sections 226G, 26H, 226J, 226L or 226M. The scheme sections were amended by the Self Assessment Act to reflect the new rates of penalty and to provide for variations in those

rates in certain circumstances. Penalty tax is attracted under the new shortfall sections at specific rates, for various breaches of the new penalty standards, with other provisions to vary those rates in certain circumstances.

48. The new penalty system sets out the standards that taxpayers should meet in fulfilling their tax obligations in a self assessment environment. The legislation sets out the circumstances where taxpayers will be subject to penalties, the rates of penalty and the circumstances in which the rates may vary (e.g., aggravating factors and voluntary disclosures).

49. The broad structure of the revised Part VII of the ITAA, and a summary of the applicable statutory rates of penalty, is reflected in the following table:

Culpable behaviour	**Primary penalty**	**Primary penalty increased for hinderance**	**primary penalty decreased for voluntary disclosures**	
			during audit	**before audit**
	%	**%**	**%**	**%**
Deliberate evasion	75	90	60	15
Recklessness	50	60	40	10
Tax avoidance (including profit shifting) ###	50(25)*	60(30)*	40(20)*	10(5)*
Profit shifting - with no tax avoidance purpose ##	25(10)*	30(12)*	20(8)*	5(2)*
No reasonable care	25	30	20	5
No reasonable arguable case	25	30	20	5
Private Ruling disregarded	25	30	20	5

* Bracket rates of penalty apply if the position adopted by the taxpayer is reasonably arguable

The penalties described above are expressed as a flat percentage (as distinct from a per annum basis) of the tax shortfall caused by the culpable behaviour, or of the tax sought to be avoided through participation in a tax avoidance scheme or profit shifting arrangement. Interest payable under section 170AA of the ITAA applies whether or not the penalty provisions apply.

50. The column headed 'primary penalty' in the table reflects the penalties that are imposed under specific sections of Part VII. Other provisions of Part VII, discussed below, have the statutory effect of increasing or decreasing the primary rate to the levels of rates reflected in the table - based on the specific circumstances of the taxpayer's case.

Section 225 penalties

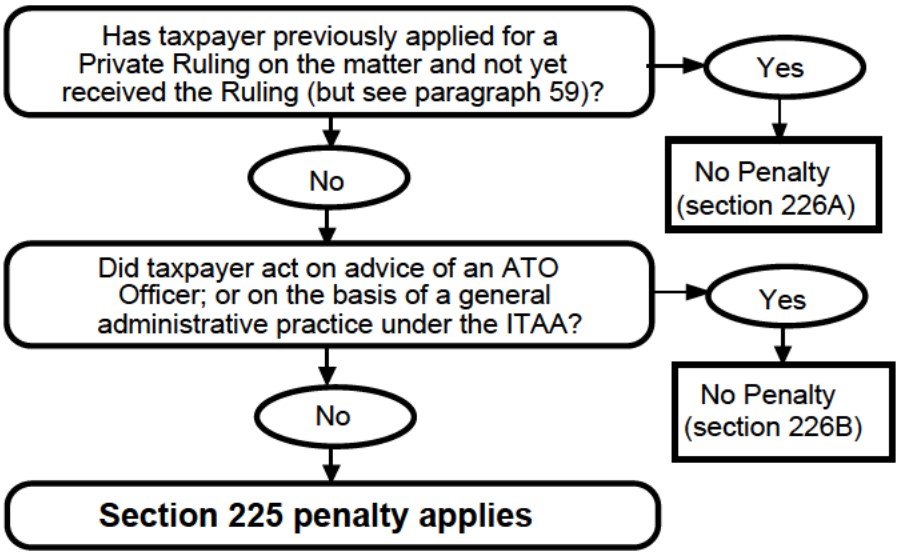
51. In the table at paragraph 49 above, the statutory penalties imposed under section 225 fall into the category of 'tax avoidance' (marked #### in the table) where Division 13 or a relevant provision of a DTA is applied in relation to a scheme entered into for the sole or dominant purpose of enabling a person to pay no or less tax. In other cases where Division 13 or a relevant provision of a DTA is applied (e.g., where there is no tax avoidance purpose), the statutory penalties under section 225 fall within the 'profit shifting' category marked ## in the table.

52. Section 225 was amended in 1992 as part of the overall Self Assessment Act package. These amendments apply to the 1992-93 year of income and all subsequent years, but do not apply to substituted accounting periods that commenced before 1 July 1992 which are in lieu of the 1992-93 year of income.

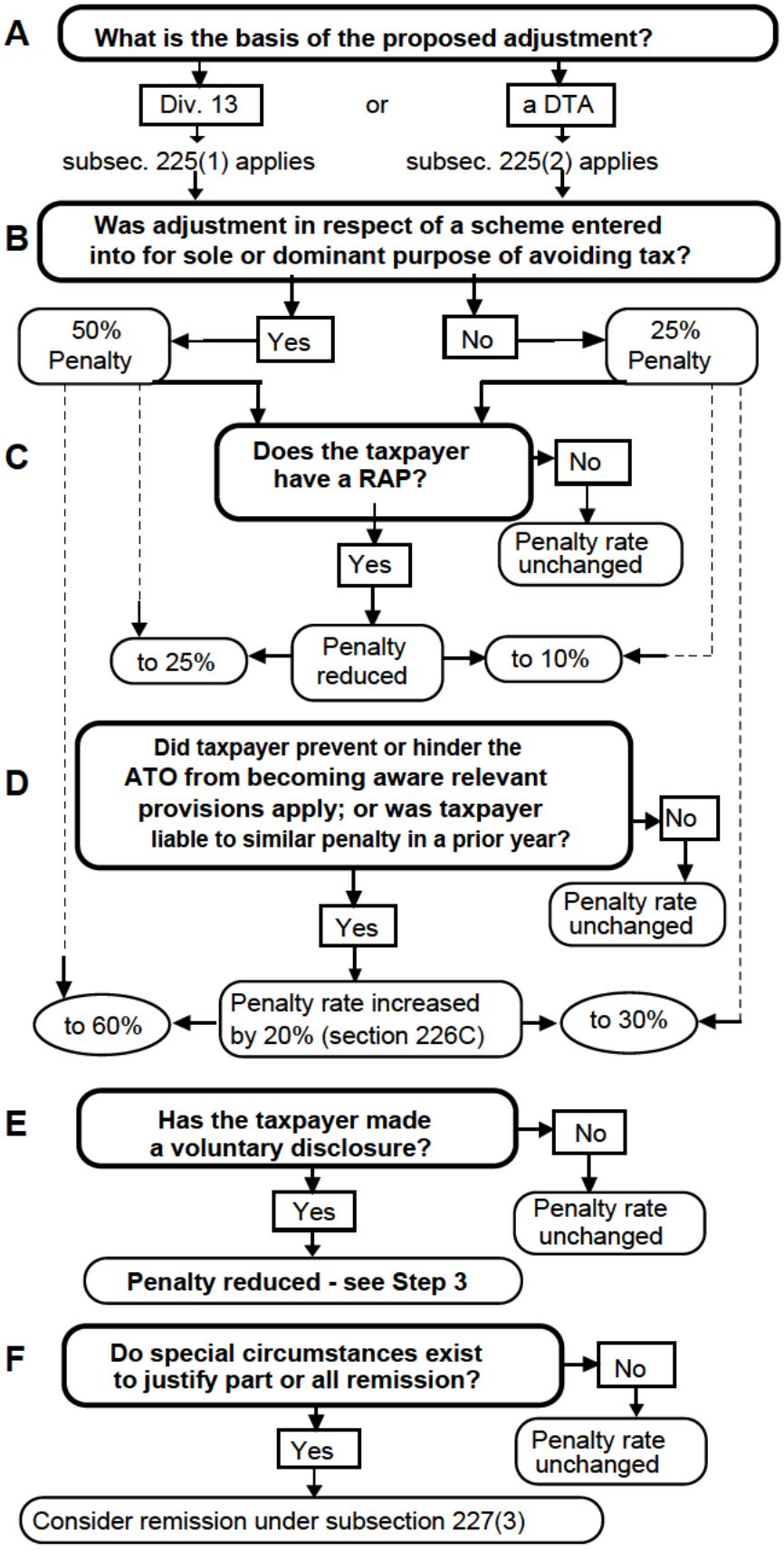
53. Section 225 of the ITAA applies where sections 136AD or 136AE of the ITAA or a relevant provision of a DTA is applied in the calculation of tax assessable to a taxpayer and the resultant amount of tax is greater than the amount of tax that would have been assessed had the relevant provisions not been applied. The actual rates of penalty and guidelines for any remission are discussed in detail later in this Ruling.

54. The following charts reflect the overall application of section 225 penalties under the self assessment system where a transfer pricing adjustment is made by the ATO under Division 13 (sections 136AD or 136AE) or under a relevant provision of a DTA:

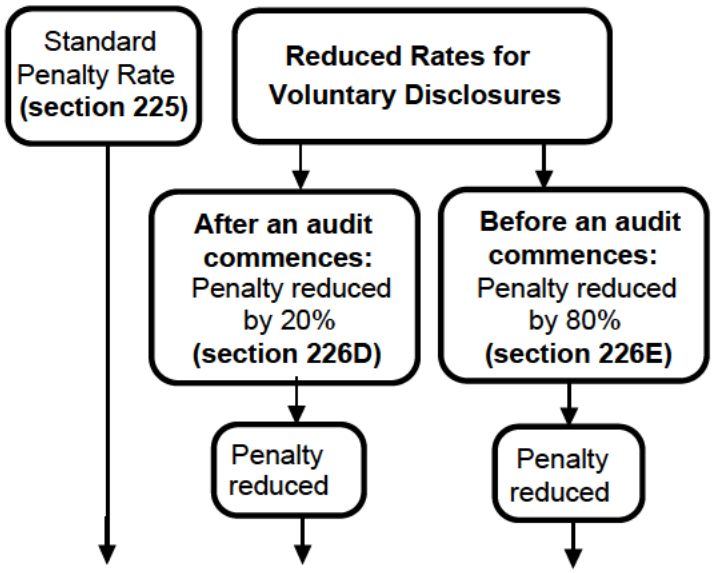
Step 1: Determine if a section 225 penalty should be imposed



Step 2: Determine the rate of section 225 penalty


A
What is the basis of the proposed adjustment?
Div. 13
or
a DTA
subsec. 225(1) applies
subsec. 225(2) applies
B
Was adjustment in respect of a scheme entered into for sole or dominant purpose of avoiding tax?
50% Penalty
Yes
No
25% Penalty
C
Does the taxpayer have a RAP?
No
Penalty rate unchanged
Yes
to 25%
Penalty reduced
to 10%
D
Did taxpayer prevent or hinder the ATO from becoming aware relevant provisions apply; or was taxpayer liable to similar penalty in a prior year?
No
Penalty rate unchanged
Yes
to 60%
Penalty rate increased by 20% (section 226C)
to 30%
E
Has the taxpayer made a voluntary disclosure?
No
Penalty rate unchanged
Yes
Penalty reduced - see Step 3
F
Do special circumstances exist to justify part or all remission?
No
Penalty rate unchanged
Yes
Consider remission under subsection 227(3)

Step 3: Reduced section 225 penalty rates for voluntary disclosures



Sole or dominant tax avoidance purpose cases

Where taxpayer does not have a RAP	50%	to 40%	to 10%
Where the taxpayer has a RAP	25%	to 20%	to 5%

All other cases

Where taxpayer does not have a RAP	25%	to 20%	to 5%
Where the taxpayer has a RAP	10%	to 8%	to 2%

55. As indicated in the above charts, penalties under section 225 may not be imposed if a taxpayer has made an application for a Private Ruling which the Commissioner is required to comply with and is awaiting the Private Ruling (section 226A) or the taxpayer follows ATO advice or a general administrative practice (section 226B). Section 225 penalties may be increased if there is hindrance by a taxpayer (section 226C), or they may be reduced in cases of voluntary disclosures (sections 226D or 226E). Subsection 227(3) gives an authority for remission of all, or part of such penalties in exceptional cases to prevent unintended or unjust results. The relevant sections are discussed below.

56. Subsection 225(1) applies where 'prescribed provisions' have been applied and these are defined in subsection 225(4) to mean sections 136AD or 136AE of Division 13. The rates of penalty applied by subsection 225(1) are determined by references to a 'first penalty percentage' and a 'second penalty percentage' which are defined in subsection 225(1A).

57. Where sections 136AD or 136AE have been applied in relation to a scheme entered into for the sole or dominant purpose of enabling a person to pay no or less tax, penalty at the 'first penalty percentage' is applied. This rate is 50%, or 25% if it is reasonably arguable that the provisions of Division 13 do not apply. In other cases where sections 136AD or 136AE have been applied, e.g., where there is no tax avoidance purpose, the 'second penalty percentage' applies. This rate is 25%, or 10% if it is reasonably arguable that the provisions of Division 13 do not apply. For further discussion on what constitutes a RAP see paragraphs 116 to 132 below.

58. Subsection 225(2) applies where the provisions of 136AD or 136AE were not applied by reason of the Agreements Act (which includes a DTA - being a schedule to that Act). Subsection 4(2) of the Agreements Act provides that provisions of that Act shall have precedence over the ITAA where there is an inconsistency. This means that where a transfer pricing adjustment is made under a provision of a DTA (e.g., Article 7 or Article 9 of the Australia-Vietnamese DTA) the penalty is applied under subsection 225(2). The penalty to be applied under subsection 225(2) is that which would have been applied under subsection 225(1) if the relevant provisions of the DTA were a 'prescribed provision'. In this manner, the rates of penalty set under subsection 225(1A) are applied in DTA cases, i.e., the same rates that apply as a result of the application of sections 136AD or 136AE, as set out in paragraph 57 above.

No section 225 penalties in certain circumstances

59. Section 226A ensures that taxpayers will not be subject to penalties under scheme sections where they had previously made an application for a Private Ruling from the ATO, which the Commissioner was required to comply with, but had not received that ruling at the time the taxpayer's wrongful treatment of the law happened. If the Private Ruling, when made, is unfavourable to the taxpayer the ATO will amend the taxpayer's assessment and charge interest, as necessary. The limitation under section 226A is only available if the arrangement set out in the Ruling application is not materially different from the actual arrangement that was dealt with in the taxpayer's return. As a general rule, Private Rulings will not be given in relation to transfer pricing issues (see paragraphs 154 and 155 below). Accordingly, such Private Ruling applications will not normally qualify as applications that the Commissioner is required to comply with - so that section 226A will not normally be relevant in transfer pricing cases.

60. Section 226B ensures a taxpayer will not incur a penalty under section 225 where they applied the law in a way which agreed with advice provided by a taxation officer on the particular transfer pricing matter or in accordance with a general administrative practice under the ITAA.

Circumstances where section 225 penalties may be increased

61. Section 226C provides for an increase in the penalty applied under section 225 where there are aggravating factors such as where:

- a taxpayer has taken steps to prevent or hinder the ATO from becoming aware that the provisions of Division 13 and/or the relevant DTA apply; or
- the taxpayer was liable to pay additional tax under any of the scheme sections in respect of an earlier year of income.

In such cases, the primary penalty is increased by 20% so that a total penalty of 60% (i.e., 50% + [20% of 50% = 10%] = 60%) is payable by the taxpayer in tax avoidance cases and increased to 30% (i.e., 25% + [20% of 25% = 5%] = 30%) in cases where there is no tax avoidance. For further discussion on hindrance see paragraphs 135 to 139 below.

Circumstances where section 225 penalties may be reduced

62. Sections 226D, 226E and 226F provide for a reduction in the penalty applied under section 225 where certain voluntary disclosures are made by the taxpayer.

63. Section 226D applies where, **after** the ATO has informed a taxpayer that a tax audit is to be carried out for the year in which the penalty is applied, a taxpayer voluntarily advises the ATO in writing about the matter which led to the application of Division 13 or a relevant DTA. In these cases, section 226D applies to reduce the section 225 penalty by 20%, e.g., a 25% penalty under section 225 would be reduced to 20% (i.e., 25% - [20% of 25% = 5%] = 20%).

64. Section 226E will reduce any section 225 penalty by 80% where a taxpayer similarly informs the ATO **prior to** being advised that a tax audit is to be carried out for the year in which the penalty is applied. In these cases the reduction is 80 of the section 225 penalty, e.g., a 25% penalty under section 225 would be reduced to 5% (i.e., 25% - [80% of 25% = 20%] = 5%).

65. Under section 226F the Commissioner has a discretion to determine, for the purposes of sections 226D and 226E, that the taxpayer informed the ATO prior to the ATO advising the taxpayer that the audit was to be carried out. This discretion may be exercised where it is considered appropriate in all of the circumstances. The effect of the exercise of the discretion is that a taxpayer would obtain an 80% reduction in the penalty otherwise attracted in respect of the disclosure - rather than a 20% reduction.

66. The discretionary authority contained in subsection 227(3) of the ITAA for the Commissioner to remit penalties was retained under the Self Assessment Act provisions in recognition of the fact that there may be exceptional cases where the penalty standards prescribed in the law, if applied rigidly, might produce unintended or unjust results. As a general rule, the new legislative system is designed to impose specific penalty tax rates for certain breaches of standards (or specific kinds of behaviour) and does not contemplate a further reduction from the rates set by legislation. This is consistent with the legislative intention of increasing consistency in relation to the imposition of penalties and the level of penalties.

67. Special circumstances where the remission provisions under subsection 227(3) would be exercised, in relation to transfer pricing adjustments, are detailed in paragraphs 170 to 181 below. For further comments on the ATO general policy for the application of subsection 227(3) see Taxation Ruling TR 94/7.

Shortfall section penalties

68. Penalties, other than those imposed under the scheme sections, are specifically imposed in relation to a tax shortfall. The sections under which they are imposed are referred to as shortfall sections (see paragraph 47 above). Tax shortfall is defined in subsection 222A(1) 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.

69. Where a transfer pricing adjustment is made, shortfall section penalties must also be considered and applied, when appropriate, in addition to the application of section 225 penalties. The relevance of each shortfall section, in relation to transfer pricing adjustments, is explained in paragraphs 105 to 156 below. The imposition of two of more penalties in respect of the same adjustment is discussed in paragraphs 165 to 169 below. The ATO guidelines for remission of penalties under subsection 227(3), in cases where section 225 and shortfall section penalties both apply, are given in paragraphs 170 to 178 below.

70. Penalties under the shortfall sections operate in a similar manner to section 225 penalties discussed in paragraph 55 above. They may not be imposed if a taxpayer has made an application for a Private Ruling which the Commissioner is required to comply with and is awaiting the Private Ruling (section 226U) or the taxpayer follows ATO advice or a general administrative practice (section 226V). Such penalties may be increased if there is hindrance by a taxpayer (section 226X), they may be reduced in cases of voluntary disclosures (sections 226Y or 226Z) and they may be remitted (in full or in part) under subsection 227(3). Taxation Rulings TR 94/3 to TR 94/7 inclusive provide detailed explanations of the general operation of the various shortfall sections.

Penalty remission policy up to the 1991-92 year of income

Imposition of penalties prior to 14 December 1984

71. As explained in paragraph 42 above, the present section 225 of the ITAA was introduced into the legislation by the 1984 Act and applies from 14 December 1984. The last detailed guidelines, specifically dealing with the imposition and remission of transfer pricing penalties under section 225, were issued by the ATO on 18 June 1986 in Taxation Ruling IT 2311.

72. IT 2311 also explained that former subsections 226(2B)-(2F) imposed additional tax at the rate of 10% per annum where the provisions of Division 13 or a relevant provision of a DTA had been

applied in respect of transactions entered into prior to 14 December 1984. The Ruling indicated that the law was seen as expressing general legislative intent that the taxpayer should be left to bear the full statutory penalty and that the power to remit any additional tax would not generally be exercised in respect of transactions entered into prior to 14 December 1984.

73. This means that in respect of transactions entered into prior to 14 December 1984, the ATO will not generally remit any of the 10% additional tax imposed under former subsections 226(2B)-(2F).

Remission policy from 14 December 1984 up to and including the 1991-92 year of income

74. In the commentary on section 225, IT 2311 expressed the ATO view of the general legislative intention that, from a revenue point of view, the legislature clearly regarded profit-shifting arrangements as unacceptable and that the new transfer pricing penalty provisions represent a signal that firms ought to be steering clear of profit shifting practices or, at least, from reliance on them in the presentation of their annual tax returns.

75. IT 2311 recognised of course that there could be transfer pricing cases where the price setting practices are based on individual judgment and that many cases would probably not involve deliberate tax avoidance. The Ruling explained that this was reflected in the legislation because it specifically contained a two tier structure - to impose the heaviest penalties (200%) for those cases involving schemes designed to avoid tax, with lower penalties (25% per annum) in other cases where avoidance was not a key purpose.

76. The Ruling also stated that, in addition to discouraging the use of transfer pricing practices, the rate of penalties was a clear indication to firms engaging in such practices that they will not be allowed to benefit financially from avoiding their proper liabilities to Australian tax.

77. The Explanatory Memorandum ('EM') to the 1984 Act indicated that a general power of remission of all penalties would continue - under subsection 227(3). Taxation Ruling IT 2311 indicated that the question of remission had to considered against the general legislative intention in introducing the statutory penalty provisions. The Ruling explained that it was clear the legislature did not intend the power of remission to be generally exercised to reduce the statutory rates of penalties imposed under section 225.

78. IT 2311 provided guidelines for the remission of section 225 penalties in specific circumstances, viz:

- to ensure the 200% rate upper limit was not exceeded in non-scheme cases where the 25% per annum rate could exceed the 200% rate;
- in non-scheme cases where a prepayment of tax, in relation to a Division 13 or treaty adjustment, was made prior to the relevant assessment or amendment - to reduce the period (up to the date of prepayment) for imposition of the 25% per annum penalty;
- for scheme cases, remissions could be considered on the basis of retaining a minimum flat 40% culpability component plus a 20% per annum component in cases where there is reasonable co-operation with the ATO inquiries, and the culpability component should be increased a further 10%-50% (subject to the overall maximum of 200%) for various circumstances; and
- to ensure that any remission granted in scheme cases would not bring the penalty below the level of the 25% per annum rate imposed for non-scheme cases;

and advised that other cases of remissions were expected to occur in very limited and exceptional cases. The facts and recommendations in these cases were to be referred to ATO Head Office for consideration.

79. The ATO section 225 penalty remission policy has been revised in respect of all years of income subsequent to the introduction of section 170AA of the ITAA. The revision of such policy was reflected in Taxation Ruling TR 92/11, as discussed below.

80. Section 170AA was inserted into the ITAA by the *Taxation Laws Amendment Act 1986* and provides for the payment of interest where an amendment to an assessment (or an amendment of a determination reducing a credit) is made and results in an increase in the taxpayer's tax liability. Section 170AA applies to assessments made from 1 July 1986, but only in respect of the 1985-86 and later years of income and to a later amendment of such assessments.

81. Subsection 170AA(1AA) provides for the imposition of interest where additional tax is payable but applies only in relation to amendments of assessments in respect of the 1992-93 and subsequent years of income. Section 170AA interest was not imposed in relation to amended assessments, up to the 1991-92 year of income, on any tax or additional tax payable under Part VII (including a section 225 penalty arising from a transfer pricing adjustment) pursuant to former subsection 170AA(2).

82. In February 1989, Taxation Ruling IT 2517 provided new guidelines on the exercise of the discretion to remit penalties imposed under the general provisions of section 223 and the former subsection

226(2). That Ruling revised the previous general penalty remission guidelines in the light of the interest imposed under the new section 170AA. It continued the concept of two components (viz, 'per annum' and 'culpability') within the penalty remission policy, maintaining the 'per annum' additional tax component to protect the revenue in the absence of interest under section 170AA. The Ruling stated that it did not deal with penalties imposed under section 225.

83. The penalty remission policy stated in Taxation Ruling IT 2311 was not specifically revised subsequent to the introduction of section 170AA although the concepts introduced in IT 2517 have been considered and applied, where appropriate, in past section 225 penalty cases as a matter of general policy. This approach was recognised in Taxation Ruling TR 92/11 for Division 13 cases where the policy in IT 2517 is more favourable to the taxpayer.

84. In paragraph 30 of TR 92/11, which dealt with a specific transfer pricing issue (the provision of loan arrangements and credit balances), the ATO advised that the principles set out in IT 2517 may be adopted to adjustments made under Division 13 to assessments for the 1990-91 and earlier years of income, where such principles give a result that is more advantageous to the taxpayer.

85. The following table, extracted from paragraph 41 of IT 2517, provides a broad summary of penalties remaining after the remission policy outlined in that Ruling. For the ATO views on the various terms used in the table, the basis for adopting such rates, and the circumstances which warrant an increase or decrease in the resultant penalty rates suggested in this table, see IT 2517:

REASON FOR THE FALSE OR MISLEADING STATEMENT	**ADDITIONAL TAX**	
	'PER ANNUM' COMPONENT	**'CULPABILITY' COMPONANT**
Deliberate evasion (without aggravating factors)	YES	45
Recklessness (short of deliberate evasion	YES	30-40
Carelessness	YES	15-30
Minor case of carelessness	YES	5-15
Inadvertent error, honest mistake, (dependent on the degree of care)	YES	0-5
Contentious item	YES	0-5

Genuine misunderstanding of the requirements of the legislation	YES	NIL
Did not know and could not be expected to know	NO	NIL

86. The per annum component referred to in IT 2517 was designed to substitute for the interest not able to be imposed under section 170AA because of the former subsection 170AA(2).

87. IT 2517 explained that the 'rate of the per annum' penalty component would be equivalent to the interest rate prevailing under section 170AA. Until 30 June 1992, that rate was set at 14.026% per annum under former subsection 170AA(7). It should be noted that the per annum component of any Part VII additional tax is not interest and is not deductible for income tax purposes.

88. Paragraphs 21-30 of IT 2517 also address the issue of voluntary disclosures. Where the disclosure accords with paragraph 24 of that Ruling, a culpability component is not imposed and the taxpayer is only subjected to a 'per annum' component. IT 2517 advised that all penalties except a 10% 'per annum' component (and limited to a maximum of 50% of the tax avoided in any year) would be remitted for voluntary disclosures. This represents a significant reduction in the total penalties to be imposed, compared to the 14.026% per annum component otherwise payable plus any culpability component.

89. The advice given in paragraph 30 of TR 92/11 means that the penalty remission guidelines provided in IT 2311 were revised to ensure that, where Division 13 cases fall within the principles set out in IT 2517, remission of section 225 penalties for adjustments to assessments for the 1985-86 to 1990-91 years of income will be afforded any benefit from the principles set out in IT 2517. The ATO accepts that this policy should be extended to include transfer pricing cases where the section 225 penalties relate to adjustments made under a DTA. Taxation Ruling IT 2311 is modified accordingly.

90. In cases that fall outside the IT 2517 principles, including adjustments to assessments for the 1984-85 year of income (in respect of transactions entered into on or after 14 December 1984) or where the guidelines in IT 2311 result in lower penalties than set out in IT 2517, the guidelines in IT 2311 continue to apply.

Further penalty remission policy for the 1991-92 year of income

91. The penalty remission policy outlined in Taxation Ruling TR 92/10 is also relevant in respect to transfer pricing cases with regard to amendments to 1991-92 assessments made after 1 July 1992.

92. TR 92/10 specifically dealt with the remission of penalties imposed under section 223. Paragraph 16 of the Ruling specifically stated that it did not deal with how the penalty provisions apply where false or misleading statements are made in cases of tax avoidance and profit shifting, which were to be dealt with in another Ruling.

93. In TR 92/10, the ATO agreed to retrospectively apply the penalty principles of the Self Assessment Act to the 1991-92 year of income for cases where penalties were imposed under subsection 223(1). This was achieved by exercising the remission provisions under subsection 227(3) in a manner that would provide the same result, for false or misleading statements made in relation to income tax returns in the 1991-92 year, as the penalty provisions of the Self Assessment Act.

94. TR 92/10 advised that the principles of the self assessment penalty legislation are to apply to income tax returns for the 1991-92 year of income where an amendment is made after 30 June 1992. It also explained that, for reasons of equity, consistency and ease of administration, the penalty principles of the Self Assessment Act will not apply to income tax returns for years of income prior to 1991-92.

95. TR 92/10 also advised how the two main components of penalties under IT 2517 (viz, 'culpability' and 'per annum') were revised for the purposes of providing the benefit of the same lower penalties for 1991-92 as would be imposed under the Self Assessment Act provisions.

96. TR 92/10 explained that the powers of remission will continue to be used to apply a 'per annum' component to additional tax imposed under section 223 in respect of income tax returns for the 1990-91 and prior years of income for amounts underpaid from 1 July 1992. For the purposes of applying IT 2517, TR 92/10 reduced the 'per annum' component to 10% pa. from 1 July 1992, in line with the reduction in the rate prescribed under paragraph 170AA(4)(b).

97. The principles outlined in TR 92/10 in relation to the general provision for remission under subsection 227(3) will also be applied so as to provide the benefit of the same lower penalties under section 225, as would be imposed under the Self Assessment Act principles, in respect of amendments to 1991-92 assessments made after 1 July 1992. Taxation Ruling IT 2311 is further modified accordingly.

98. The modification of IT 2311, as detailed in paragraph 89 above, also applies to the 1991-92 year of income as well as the modification outlined in paragraph 97 above. The ATO penalty remission policy under subsection 227(3), for the 1991-92 year of income - for amendments made after 1 July 1992 - therefore reflects the lowest

level of penalty which would be imposed on the basis of the following remission guidelines:

(a) Taxation Ruling IT 2311; or

(b) IT 2311, as revised to take into account any benefit to the taxpayer of the principles of Taxation Ruling IT 2517; or

(c) IT 2311, as revised to take into account any benefit to the taxpayer of lower penalties that would be imposed under the Self Assessment Act principles.

99. For the purposes of applying IT 2311 and any modification thereof, the 'per annum' component of section 225 additional tax is generally imposed in all transfer pricing cases regardless of the level of any 'culpability' component imposed. The exception would be for those cases where IT 2517 specifically provides that no per annum component should be imposed. It should be noted that the 'per annum' component of additional tax imposed under section 225 is not interest and is not an allowable deduction for income tax purposes.

Penalty guidelines for 1992-93 and subsequent years of income

100. The overall changes to Part VII of the ITAA arising from the amendments introduced by the Self Assessment Act, including the amendments to section 225, apply to the 1992-93 year of income and all subsequent years. This means that the guidelines in IT 2311 cease to apply in respect of years of income to which the Self Assessment Act provisions apply.

101. The penalty provisions under the Self Assessment Act were designed to provide, amongst other things, more certainty and greater consistency in relation to the administration of penalties. It also limited the need for value judgments to be made by the ATO, by providing a statutory scale for the assessment of penalties according in effect to the taxpayer's degree of 'culpability' based on the new standards.

102. Section 225 does not require the ATO to establish the taxpayer's purpose or intention in transfer pricing cases, unless the ATO is seeking to apply the higher penalty rates. For higher penalty rates to be applied, the ATO must be satisfied on reasonable grounds that the transfer pricing adjustments relate to a scheme within the meaning of Part IVA of the ITAA and that the scheme was entered into for the sole or dominant purpose of avoiding tax.

103. A major aspect of the revision of Part VII under the Self Assessment Act was the introduction of new standards, such as 'reasonable care' and 'RAP'. In addition to specific scheme section penalties, specific statutory penalties are also imposed under Part VII

for a failure to satisfy these standards and for acts of recklessness, intentional disregard, other cases of tax avoidance and disregard of a Private Ruling. There are also specific provisions to address circumstances where the acts, or failure to satisfy the standards, are attributable to a partner or a trustee.

104. The new standards, together with all other statutory penalties imposed under the revised Part VII, are also relevant in transfer pricing cases. They must also be considered and penalties applied, where appropriate, in addition to the application of section 225 penalties. They must therefore be considered in relation to the overall ATO policy for remission, under subsection 227(3), of all or part of some penalties - including section 225 penalties. Paragraphs 51 to 67 above provide a detailed explanation of the operation of section 225 and the relevant scheme section provisions that apply in transfer pricing cases. Paragraphs 68 to 70 above provide a brief explanation of the operation of the shortfall sections in such cases. Each relevant shortfall provision is discussed below. The effect of the imposition of two or more penalties is discussed in more detail in paragraphs 165 to 169 below.

Reasonable care

105. Under section 226G a taxpayer will be liable to pay a penalty of 25% of a tax shortfall caused by a failure by the taxpayer to take reasonable care to comply with the ITAA or the regulations.

106. Although section 225 does not expressly mention the reasonable care standard, it is a matter that is relevant in the overall application of Part VII (see paragraphs 103 and 104 above) and to the exercise of the remission power in subsection 227(3). Having regard to the clear legislative intent in relation to cases where taxpayers do not exercise reasonable care, it would be inappropriate to remit section 225 penalties, under subsection 227(3) (see paragraphs 178, 179 and 198 below), in cases where the taxpayer had not exercised reasonable care. In these cases, it would also be inappropriate to remit any overall penalties below the rate imposed under section 226G for a lack of reasonable care.

107. As explained in the EM to the Self Assessment Act, the reasonable care test requires a taxpayer to exercise the care that a reasonable ordinary person would be likely to have exercised in the circumstances of the taxpayer to fulfil the taxpayer's obligations under the ITAA and the regulations. Taxpayers must take reasonable care not only in the preparation of their return, but throughout the year in respect of matters that have a bearing on the accuracy of their return and the tax payable, for example, record keeping. A tax shortfall may

be caused not only by the taxpayer being careless in making (or not making) taxation statements, but also by the careless acts or omissions of the taxpayer that lie behind the statements that are (or are not) made. Whether a taxpayer has behaved reasonably will depend on all the facts of each case.

108. The EM explained that, for business taxpayers, reasonable care would require the putting into place of an appropriate record keeping system and other procedures to ensure that the income and expenditure of the business is properly recorded and classified for tax purposes. The taxpayer should be able to show that its procedures are reasonably designed to prevent errors from occurring. What is reasonable care will depend, among other things, on the nature and size of the business, the implementation of good processes and procedures, the documentation of events that will have a material bearing on the taxpayer's tax obligations and the complexity and importance of the particular issue. It could include, for example, the taxpayer providing for internal audits, sample checks of claims made, adequate training and guidelines for accounting and tax return preparation staff, and relevant instruction manuals for staff.

109. On questions of interpretation, the EM explained that 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. Of course, in the case of a business person, the comparison should be with a 'reasonable business person'. If a taxpayer is uncertain about the correct tax treatment of an item, which could have a material effect on the amount of tax payable, reasonable care requires the taxpayer to make reasonable enquiries to resolve the issue. Reasonable enquiry would include the taxpayer ascertaining the ATO position and obtaining competent advice about the proper tax treatment of the item. The taxpayer would need to have reasonable grounds for believing the source consulted was objective and that the advice reflected the correct tax position in respect of the item.

110. The EM also indicated that a mere reading of a provision of the ITAA that the taxpayer believed to be the relevant one might not constitute a reasonable enquiry unless the taxpayer had reasonable grounds for believing that they had understood the requirements of the law. An incorrect application of a statutory provision that is clear and unambiguous would tend to suggest that the taxpayer did not exercise reasonable care. The ultimate consideration would be the honest efforts of the taxpayer to ascertain the proper tax position.

111. The taking of a position with respect to an item that is frivolous, or which lacks a reasonable basis, would be a strong indication of a lack of reasonable care.

112. A taxpayer who relies upon advice from an independent unrelated third party of a fact that is material to the preparation of the taxpayer's return (e.g., a bank providing advice on interest rates) will not usually be considered to breach the reasonable care test if the advice is wrong - taxpayers are ordinarily entitled to rely on such advice. However, if the taxpayer knew, or could reasonably be expected to have known or suspected that the advice was wrong, the taxpayer would risk penalty.

113. A multinational company would not have exercised reasonable care in adopting the transfer prices of property (including services) transferred to or from a related company, if the company could reasonably be expected to have known or suspected (e.g., because of the relationship between the transferor and transferee companies) that the transfer prices may not accord with the arm's length principle (or that such prices have not been adjusted for taxation purposes to accord with that principle).

114. Arithmetical errors may also indicate a failure to take reasonable care. For business taxpayers, as indicated above, it would depend on the procedures the taxpayer has in place to detect such errors and it may depend on the size, nature or frequency of the errors.

115. For a further explanation of 'reasonable care', in the context of section 226G, see paragraphs 13 and 14 of Taxation Ruling TR 94/4.

Reasonably arguable position (RAP)

116. Under section 226K a taxpayer may be liable to pay a penalty of 25% of a tax shortfall that is caused by the taxpayer taking a position on a question of interpretation (including a conclusion of fact) that is not reasonably arguable at the time the position is taken, i.e., where the taxpayer does not have a RAP.

117. Penalties under section 225, the other scheme sections and section 226L, are primarily set at a statutory rate of 50%. Such penalties are reduced to 25% where the taxpayer has a RAP. The RAP provisions are therefore relevant for the purpose of setting the level of section 225 penalties.

118. Section 222C provides that the correctness of the treatment of the application of a law or another matter is reasonably arguable if, having regard to the relevant authorities and the facts on the matter in relation to which the law is applied, it would be concluded that what is argued for is about as likely as not correct. The section provides a non-exhaustive list of the authorities that may be taken into account for this purpose.

119. Section 222C provides guidance as to the operation of the RAP test in cases where the way in which an income tax law operates is dependent on the ATO exercising a discretion.

120. As explained in the EM to the Self Assessment Act, under section 222C a position taken by a taxpayer will be reasonably arguable if, on an objective analysis of the law and the application of the law to the relevant facts, it would be concluded that the taxpayer's position was about as likely as not correct. The position must involve a clearly contentious area of the law, that is, one where the relevant law is unsettled or where, although the principles of law are settled, there is a serious question about the application of those principles to the circumstances of the particular case.

121. The test does not require the taxpayer's position to be the 'better view', rather the standard is 'about as likely as not' and not 'more likely than not'. However, the RAP standard would not be satisfied if a taxpayer takes a position which is not defensible, or that is fairly unlikely to prevail in court. 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.

122. For the purposes of determining whether a taxpayer has a RAP for the tax treatment of an item, subsection 222C(4) includes the following relevant authorities:

- an income tax law, for example a provision of the ITAA or of a DTA;
- material for the purposes of subsection 15AB(1) of the *Acts Interpretation Act 1901*, such as explanatory memoranda and second reading speeches;
- a decision of a court, the AAT or a Board of Review;
- a Public Ruling issued by the ATO under the binding ruling system also introduced in the Self Assessment Act.

123. The list is not intended to be exhaustive, and a wider range of authorities may be taken into account in weighing up the merits of the competing arguments. For example, authorities relating to other areas of the law may provide support for a particular treatment of an item. Taxation Rulings issued by the ATO prior to the new arrangements may also be considered.

124. A taxpayer may have a RAP for the tax treatment of an item despite the absence of authorities other than the law itself. What is required in such cases is that the taxpayer has a well-reasoned construction of the applicable statutory provision which it could be concluded was about as likely as not the correct interpretation.

125. An opinion expressed by an accountant, lawyer or other advisor is not an authority. However, the authorities used to support or reach the view expressed by the particular advisor, including a well-reasoned construction of the relevant statutory provisions, may support the position taken by a taxpayer.

126. The relevance of any authority is a matter to be weighed against other authorities, including the applicable statutory provisions, and the facts of the case. An authority that has some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue.

127. An authority that merely states a conclusion is ordinarily less persuasive than one that reaches its conclusion by cogently relating the applicable law to the pertinent facts. It will be relevant, however, to consider the source of an authority. For example, a High Court decision on all fours with the tax treatment in question will be accorded more weight than a Federal Court decision, which in turn would be accorded more weight than a decision of the AAT.

128. There will be cases where a taxpayer, in applying the tax law to the facts, will need to form a view as to how the ATO would interpret the relevant provision. In these cases, a taxpayer will have a RAP to the extent that the assumption is in the range of positions which, if decided by the ATO in the circumstances of the case, a court would be about as likely as not to conclude was decided according to law.

129. This approach, in accordance with subsection 222C(2), effectively puts the taxpayer in the shoes of the Commissioner, and looks to whether the taxpayer, in making the assumption, has taken into account all relevant considerations, and not taken into account any irrelevant considerations, that bear materially on the decision reached.

130. Because section 225 contemplates action by the ATO in exercising a discretion to apply a provision against a taxpayer's tax liability, the 'reasonably arguable' test looks at whether it is about as likely as not the relevant provisions do not apply.

131. In a case to which Division 13 or the relevant provision of a DTA applies, a taxpayer would need to demonstrate that, for example, the price the taxpayer had used was about as likely as not the 'arm's length price', or that an arm's length party would enter into the relevant dealing under such terms. A taxpayer would be best placed to show that its dealings were 'arm's length' if it maintained documents that were brought into existence as part of the process of determining the dealings, the conduct of the relevant parties was consistent with the documentation and the documents accurately recorded the relevant facts and deliberations.

132. The fact that the ATO may not have released final Rulings on all aspects of the operation of Division 13 or the relevant provisions of a DTA does not in itself provide a basis for a taxpayer to satisfy the RAP test since the taxpayer has to show that the position taken on the tax issue is reasonably arguable. For a further detailed explanation of RAP, in the context of section 226K, see Taxation Ruling TR 94/5.

Treating the law as not applying is an application of the relevant provision

133. The expression 'treating an income tax law as applying in relation to a matter in a particular way' is used in some provisions to focus on a tax shortfall brought about by a taxpayer taking a particular position on a question of interpretation. Variations of this expression are used in some sections relevant to section 225, e.g., sections 226A and 226B (see paragraphs 59 and 60 above).

134. Under section 222D a taxpayer will be taken to have treated an income tax law as applying in a particular way even where the taxpayer treats a provision as not applying to a matter, for example, where the taxpayer treats a provision as not applying to include an amount in assessable income, or as not applying to disallow a deduction.

Increased penalties where there is hindrance by a taxpayer

135. There are some situations where a taxpayer liable to pay a section 225 penalty may be liable to pay a further penalty of 20% of that penalty under section 226C, i.e., a penalty of 50% may be increased to 60%, or a penalty of 25% may be increased to 30%. Where a shortfall section is applied, section 226X similarly increases such penalties by 20%.

136. Subparagraphs 226C(b)(i) and 226X(b)(i) apply to increase the penalty where a taxpayer takes steps to prevent or hinder the ATO from discovering that a transfer pricing provision should be applied or from discovering the tax shortfall. This would include unreasonable delay by the taxpayer in responding to enquiries by taxation officers, or the taxpayer failing to attend a scheduled interview at a time previously agreed without reasonable cause. It would also include instances where the taxpayer destroyed or falsified relevant records, unreasonably failed to produce them, or colluded with other persons (after the relevant dealing had been made) to conceal or distort the matter.

137. Where a taxpayer becomes aware of an error in calculation or fact that has caused a tax shortfall, then fails within a reasonable time

to notify the ATO of the error, subparagraph 226X(b)(ii) may apply to increase the penalty where the particular issue falls within the scope of both the scheme and shortfall sections. This covers situations such as where a taxpayer relies upon factual information from a third party in preparing the taxpayer's return, and subsequently finds that the information supplied was inaccurate (e.g., the basis upon which the transfer price was set). This provision does not require a taxpayer to monitor developments in the law, but rather looks solely at errors of a factual nature.

138. Where the taxpayer has been penalised under a scheme section in a prior year of income, subparagraph 226C(b)(ii) makes the taxpayer liable to the increased penalty when a scheme section is applied to the taxpayer in a subsequent year of income. If a taxpayer is liable to penalty for carelessness, recklessness or deliberate intention, and has been penalised in a prior year for one of those reasons, the further penalty is attracted under subparagraph 226X(b)(iii).

139. The ATO would be reluctant to consider a remission under subsection 227(3) (see paragraphs 178 and 179 below), where the taxpayer had hindered the transfer pricing review and where the result of any remission would be to impose lower overall Part VII penalties than the legislation provides should be imposed for the relevant act of hindrance.

Penalty for reckless behaviour

140. Under section 226H a taxpayer will be liable to pay a penalty of 50% of a tax shortfall caused by the taxpayer behaving recklessly with regard to the operation of the tax law.

141. A taxpayer would be behaving recklessly if the taxpayer's conduct shows disregard of, or indifference to, consequences foreseeable by a reasonable person. A finding of dishonesty is not necessary for a taxpayer to be subject to this penalty.

142. The concept of recklessness for the purposes of this penalty covers behaviour which could be described as gross negligence. It would also be considered reckless of a taxpayer, who had engaged in cross-border dealings with associates, not to consider whether the dealings complied with the arm's length principle for tax purposes. For a detailed explanation of the ATO view of the meaning of 'recklessness' see paragraphs 15 to 19 of Taxation Ruling TR 94/4.

143. Having regard to the legislative intent to impose high penalties in cases where a taxpayer acts in a reckless manner, it would be inappropriate to remit any overall Part VII penalties below the rate imposed under section 226H for recklessness. The ATO would not

consider a remission under subsection 227(3), such as proposed in paragraphs 178 and 179 below, where the taxpayer had also committed an act of recklessness in relation to the transfer pricing matter and where the result would be to impose a lower overall penalty under Part VII than the legislation intended to be imposed for reckless behaviour.

Penalty for intentional disregard

144. Where a tax shortfall was caused by the intentional disregard of the ITAA or the regulations, by the taxpayer or by a registered tax agent, section 226J sets the highest rate of penalty tax at 75% of the tax shortfall. Thus, where a taxpayer intentionally excludes from its assessable income an amount knowing it to be assessable, or claims a deduction, rebate, credit or offset knowing that it is not allowable under the law, the taxpayer will be liable to a penalty of 75% of a tax shortfall so caused. For a detailed explanation of the ATO view of the meaning of 'intentional disregard' see paragraphs 20 to 24 of Taxation Ruling TR 94/4.

145. Section 226J penalties operate independently of section 225, and it is therefore possible that a taxpayer could be liable to a Part VII penalty under both sections in a particular case (see paragraphs 165 to 169 below). In blatant transfer pricing tax avoidance cases, which also clearly fall within the provisions of section 226J, the ATO would consider whether the facts and circumstances of the particular case warrant the imposition of the highest possible penalties, or the extent to which such total penalties should be remitted under subsection 227(3), having regard to the legislative intent in relation to cases where taxpayers intentionally disregard the ITAA.

146. Under no circumstances would the ATO consider an overall remission under subsection 227(3) of Part VII penalties (see paragraphs 178 and 179 below) where an underpayment of tax has occurred because the taxpayer intentionally disregarded the provisions of the ITAA and where the effect of the remission would be to reduce the penalty below the level intended by Parliament for such behaviour.

Penalties in tax avoidance cases

147. Where a taxpayer enters into any tax scheme with the sole or dominant purpose of avoiding tax, the taxpayer will be liable under each of the scheme sections to pay a penalty equal to 50% of the tax sought to be avoided. The penalty will be reduced to 25% if the position adopted by the taxpayer in relation to the correctness of the scheme for tax purposes was based on a RAP.

148. Tax adjustments made by the ATO in respect of transfer pricing matters under Division 13 and a relevant provision in a DTA (e.g., through the use of 'non arm's length' prices in international dealings), where the case does not involve a scheme entered into for the sole or dominant purpose of avoiding tax, attract a penalty of 25% under subsections 225(1) and 225(1A), or subsection 225(2) in the case of a DTA. The rate is reduced to 10% where the taxpayer has a RAP.

149. Section 226L penalises at the same rates of penalty as the scheme sections, schemes within the meaning of subsection 224(1), that are entered into for the sole or dominant purpose of avoiding tax, in cases where the ATO has not applied any of the scheme sections. This section recognises that many schemes are found to be ineffective under the ordinary provisions of the ITAA (e.g., sections 25 and 51) without need for recourse to specific anti-avoidance or transfer pricing provisions. Schemes falling into this category, that are defeated under the ordinary provisions, face the same penalties under section 226L as if an anti-avoidance provision had been applied (see paragraph 147 above), if it can be concluded that the scheme was entered into for the sole or dominant purpose of avoiding tax.

Penalty for disregarding a Private Ruling

150. A taxpayer who applies for and receives a Private Ruling on an arrangement is required to follow the ruling when determining their taxable income for self assessment purposes. If the taxpayer does not follow the Ruling and this results in a tax shortfall the taxpayer will be liable under section 226M to pay a penalty of 25% of the shortfall.

151. Of course, a taxpayer who is dissatisfied with a Private Ruling can have the Ruling reconsidered by the AAT or a court once normal objection procedures are finalised. However, a taxpayer who has forgone or exhausted those rights of objection and appeal is bound to follow the Private Ruling.

152. The EM to the Self Assessment Act states that:

> 'Under subsection 226M(2) this penalty does not apply if there has been a decision of the AAT or of a court that applies to the Ruling. In such a case the taxpayer would be expected to follow the AAT or court decision when determining the taxable income, even if the taxpayer has appealed against the decision. Failure to self assess [*within a reasonable time*] in accordance with the decision of the AAT or court would ordinarily amount to a failure to take reasonable care under section 226G' (*parenthesis added*).

153. Where a taxpayer seeks a Private Ruling after lodging the relevant return of income, section 226M does not apply. If the ATO

rules against the taxpayer, the ATO will amend the taxpayer's assessment to give effect to the Ruling. The application for a Ruling after the return has been lodged may, however, qualify as a voluntary disclosure, and so affect the rate of penalty that may be applicable to any tax shortfall. For a more detailed explanation of the Private Rulings legislation, see Taxation Ruling TR 93/1.

154. There are limits as to the matters for which a Private Ruling can be given. As a general rule Private Rulings will not be given on transfer pricing issues. Paragraph 10 of Taxation Ruling TR 93/1, which deals with Private Rulings, states that:

> 'Private Rulings cannot be given if they would require the Commissioner to forecast a value, whether market value, fair and reasonable value or some other value.'

155. An example given in the EM to the Self Assessment Act, in regard to subparagraph 14ZAN(j)(1) of the *Taxation Administration Act 1953*, supports this view. The subparagraph provides that the Commissioner is not required to deal with a private ruling request if, in the Commissioner's opinion, it would be unreasonable to comply having regard to the extent of the Commissioner's resources that would be required to comply. The example given in the EM is:

> *'where the Commissioner is asked to give an opinion as to an 'arm's length price' under Division 13 ... that would involve a study of the particular industry over a considerable period of time.'*

156. Should a taxpayer receive a Private Ruling in respect of a transfer pricing issue and not follow that Ruling, the provisions of sections 225 and 226M may both apply. In such cases, the ATO would consider the extent to which such total penalties should be remitted under subsection 227(3), having regard to the legislative intent in relation to cases where taxpayers fail to follow a Private Ruling. It would be inappropriate to consider an overall remission under subsection 227(3) of Part VII penalties (see paragraphs 178 and 179 below) where an underpayment of tax has occurred because the taxpayer failed to follow a Private Ruling in relation to a transfer pricing matter and where the effect of the remission would be to reduce the penalty below the minimum level intended by Parliament for such behaviour.

Liability and review

157. Under section 227, penalties under Part VII will be assessed by the ATO and the taxpayer notified accordingly. Penalties imposed under Part VII are subject to review rights - including those rights

provided under section 14ZS of the *Taxation Administration Act 1953*, to a review by the AAT under Part IVC of that Act.

Taxpayers who use tax agents

158. Where a taxpayer uses a tax agent the taxpayer is vicariously liable for any penalty arising from culpable errors, including negligence, of the tax agent. The legislation specifically provides that the taxpayer is liable to penalties under certain provisions of Part VII even if they may have been caused by the culpable conduct of a tax agent in dealing with the taxpayer's affairs.

159. Where a taxpayer has a penalty imposed that is caused by a registered tax agent either failing to take reasonable care (section 226G), behaving recklessly (section 226H) or intentionally disregarding the provisions of the ITAA (section 226J), the taxpayer will still be liable to pay penalty at the relevant prescribed rate.

160. Penalties attracted under the other sections of Part VII, including the scheme sections, fall on the taxpayer irrespective of whether the taxpayer uses a tax agent, since those penalties do not depend on a taxpayer's behaviour for their application.

161. The use by a taxpayer of a tax agent is not conclusive as to whether the taxpayer has, for example, exercised reasonable care in carrying out their tax obligations. If the taxpayer does not provide a full and true disclosure of all the relevant facts to the tax agent, and that gives rise to a tax shortfall, the taxpayer would not have exercised reasonable care. Similarly, there may not have been reasonable care on the part of the taxpayer if the taxpayer could reasonably have been expected to pick up errors of fact or law when signing the return.

162. There may, however, be cases where penalty is attracted solely because of culpable behaviour on the part of the tax agent. Where a taxpayer is liable to a penalty because of the negligence of the tax agent, section 251M provides a remedy for taxpayers to sue the agent and recover such penalties in a court of competent jurisdiction.

No penalty in good faith cases

163. In August 1991 an information paper entitled '*Improvements to Self Assessment - Priority Tasks*' outlined how certain 'good faith' considerations would be taken into account for the purposes of the new penalties under the proposed self assessment system. In this regard sections 226B and 226V provide that a taxpayer who has been misguided by advice from the ATO, or by an ATO administrative practice, will not be subject to penalty in relation to an adjustment that was caused by relying on the advice or practice.

164. The EM to the Self Assessment Act also indicated that the retention of the discretion to remit the penalties otherwise attracted would also cover any 'good faith' considerations not specifically addressed in the legislation. Consistent with this statement, together with other comments in the EM, the ATO will adopt this approach in certain section 225 penalty cases as indicated in the paragraphs below.

Where more than one section of Part VII applies

165. Under Part VII, it is possible that more than one shortfall section may apply in respect of the same tax shortfall, while the same matter may also fall within the provisions of a scheme section.

166. Two shortfall sections could apply, for example, where a taxpayer may be liable for a penalty under section 226H for recklessness in the preparation of the tax return and also be liable for penalty under section 226K for not having a RAP in respect of the relevant issue. In such cases, where two shortfall sections apply, section 226W provides that the taxpayer is liable to pay only one penalty. Where one penalty is higher than the other (e.g., 50% under section 226H and 25% under section 226K), under section 226W the taxpayer is liable to pay the higher one.

167. If the same matter falls within a scheme section, the taxpayer could be liable under one or more shortfall sections and a scheme section. Again, section 226W would operate to limit any penalty for the tax shortfall to the highest one of the shortfall section penalties. However, the legislation does not limit any further imposition of a penalty under the relevant scheme section in such cases, although the statutory penalties under the scheme sections make specific provision for a reduction in the rate of penalty where the taxpayer has a RAP.

168. For example, where a section 225 penalty applies and the tax shortfall was clearly caused by the intentional disregard of the ITAA or the regulations, the penalty under section 226J (75%) exceeds the highest that could be imposed under section 225 (50%). Similarly, there could be cases where the taxpayer has clearly been reckless (which would attract a 50% penalty under section 226H) in relation to a transfer pricing matter and the section 225 penalty may be either 25% or 50%. In such cases, the ATO would be required by statute to apply both penalty provisions.

169. The ATO will reduce the effect of double penalties in such cases, by the exercise of a remission under subsection 227(3) of one of those penalties, to result in the most appropriate penalty rate that reflects the taxpayer's behaviour in the particular case - having regard to the legislative intent.

Remission under subsection 227(3)

170. The EM to the Self Assessment Act indicated there will be exceptional cases where the prescribed rates of penalty may be inappropriate and that, in such cases, there may be a remission of the whole or part of the prescribed penalty.

171. One purpose of the revised overall penalty provisions was to provide a set of standards for taxpayers in carrying out their self assessment taxation obligations. The legislation prescribes specific penalties for breaches of standards set by statute, which means that taxpayers clearly know what penalties will be attracted for delinquent behaviour. This replaced the general system whereby penalties were automatically attracted at a rate of 200%, which could then be all or partly remitted at the discretion of the ATO (subject to the normal objection and appeal procedures).

172. The legislation provides a set of rules and accompanying penalties which will cover all but exceptional cases. However, there may be cases that do not fit neatly into a category, or for which the prescribed rates of penalty are inappropriate. For this reason the discretion which the ATO has to remit penalty in whole or in part (section 227) was not removed, so that the ATO has the flexibility to deal with exceptional cases that may arise.

173. The AAT is able to exercise this power of remission, in appropriate cases, when reviewing decisions of the ATO and the courts are able to adjudicate on whether the discretion was exercised in accordance with the law. Of course the penalty is also dependent on the primary adjustment being sustained on such an appeal.

174. The clear legislative intention in the original section 225 penalty enactment was to signal that taxpayers ought to be steering clear of profit shifting practices and trying to get their dealings in line with the arm's length principle or, at least, not relying on non-arm's length positions and outcomes in the presentation of their annual tax returns.

175. The ATO policy on remissions was explained in Taxation Ruling TR 92/10 - which stated the intention was that remissions should be used infrequently and only in cases where the statutory penalty may not provide an intended or just result. It stated that any remission would depend upon the facts of the particular case. The ATO general policy was repeated in Taxation Ruling TR 94/7, which dealt with remission of penalties under the shortfall sections of Part VII.

176. The ATO has been asked to consider if section 225 penalties could be reduced to nil, for all years of income which fall within the Self Assessment Act amendments, for those transfer pricing cases where there has been no tax avoidance intention or purpose, the

taxpayer has made their best effort to comply with the arm's length principle on the basis of all the information available to it and has fully documented the process adopted. In view of the statutory nature of section 225 the only legislative basis to achieve no penalties, in cases where an adjustment has been made under Division 13 or a relevant provision in a DTA, would be to exercise a remission under subsection 227(3).

177. The design of the Self Assessment Act envisaged that 'scheme section' penalties would be higher than ordinary shortfall section penalties, other than the penalties for evasion (intentional disregard) and possibly in cases of recklessness, given that scheme section penalties are imposed even where the taxpayer has a RAP. It would be inappropriate to exercise the discretion under subsection 227(3) where the effect would be to reduce the penalty imposed under section 225 (a scheme section) to a rate lower than the statutory culpability penalty which would be imposed under a shortfall section for the same or a similar behaviour. In other words the treatment of a failure to exercise reasonable care, hindrance, recklessness, wilful intent, etc., under the shortfall provisions will be taken as an expression of general legislative intent and, in the absence of a contrary intention, will be used as a guide in the exercise of the remission power.

178. Where the statute imposes a penalty under both a scheme section and a shortfall section the ATO would, however, exercise a remission under subsection 227(3) of one of those penalties, as indicated in paragraph 169 above, to reduce the effect of double penalties. This will result in the most appropriate penalty rate that reflects the taxpayer's behaviour in the relevant circumstances - having regard to the legislative intent.

179. Given the need to encourage voluntary compliance and to apply Part VII penalties in a manner which will not impose an undue burden in genuine good faith, no-fault cases, a remission under subsection 227(3) will be made in relation to the 1992-93 and subsequent years of income in cases where a section 225 penalty is to be imposed and where the taxpayer:

(a) has genuinely made a reasonable good faith attempt to comply with the arm's length principle and has not engaged in tax avoidance or evasion;

(b) has fully documented the process of selecting and applying an arm's length method at the time the transaction was negotiated or, at the very latest, the time the relevant income tax return was prepared;

(c) has adopted, for taxation return purposes, what the taxpayer considered - on reasonable grounds - to be the

best approximation of the arm's length outcome, on the basis of the information in the taxpayer's possession and any other information that was reasonably available to the taxpayer at the time;

(d) can satisfy the ATO that there was no tax avoidance intention or purpose in making the decision to adopt, for income tax purposes, the position taken in subparagraph (c) above;

(e) has a RAP in relation to the matter (see paragraphs 116 to 134 above);

(f) has fully co-operated with the ATO in achieving an early conclusion of the audit and has not taken steps to prevent or hinder the ATO from becoming aware that an increase in tax is warranted under the relevant transfer pricing provisions, nor been liable to a penalty under any of the scheme sections in an earlier year of income (see paragraphs 135 to 139 above);

(g) is not also liable to a penalty under any shortfall section of Part VII, in respect of the particular adjustment, for which a remission is to be made in accordance with paragraph 178 above; and

(h) is not liable for the section 225 penalty because of the taxpayer's failure to make an adjustment in the tax return in accordance with the terms and conditions of any advance pricing arrangement (APA) the taxpayer has with the ATO (see paragraphs 203 to 206 below).

180. For the purposes of subparagraph 179(c) above, information that was held by the taxpayer and information that was reasonably available to the taxpayer includes relevant information held in Australia or offshore that was reasonably available to an associate of the taxpayer where that information would assist the taxpayer to ascertain the best approximation of the arm's length outcome.

181. The ATO would not consider a remission under subsection 227(3) where information that is reasonably available to a multinational company group would assist an Australian taxpayer member of the group to ascertain the best approximation of the arm's length outcome and that information is not made reasonably available to the taxpayer. Such information includes any reasonably available evidence the taxpayer would produce to support its case in the event of litigation.

Minimising the risk of incurring section 225 penalties

Voluntary disclosures

182. The ATO acknowledges that setting transfer prices, on the basis of the arm's length principle, may impose an additional burden on many taxpayers. It is also aware that many taxpayers have not established procedures in the past to set their transfer prices on the basis of the arm's length principle - or made appropriate adjustments in their taxation returns to reflect that principle. Since IT 2311 was released in 1986 the ATO has advised taxpayers to make appropriate adjustments in their tax returns or risk the heavy penalties under section 225 where the ATO makes such adjustments. This comment was restated in Taxation Ruling TR 94/14.

183. The ATO penalty remission policy prior to the Self Assessment Act amendments fully supports the concept of voluntary disclosures by a taxpayer and provides the incentive of minimum culpability penalties to those taxpayers who voluntarily choose to remedy their tax affairs. This policy was introduced into the statute, as part of the Self Assessment Act, by providing significant statutory reductions in penalties to taxpayers who do so.

184. Paragraphs 62 to 65 above outline the statutory provisions of sections 226D, 226E and 226F which provide relief from the primary penalty tax rates imposed under section 225, in respect of the 1992-93 and subsequent years of income, where a taxpayer makes a voluntary disclosure on a transfer pricing matter. The table of penalty tax in paragraph 49 above and Step 3 of the charts at paragraph 54 above reflect the statutory penalty reductions as a result of making such voluntary disclosures in those years.

185. As explained in the EM to the Self Assessment Act, to benefit from the penalty reductions, a voluntary disclosure must be in writing, bring all the relevant facts and information to the attention of the ATO - so as to allow the auditor to identify the amount and nature of the tax shortfall - and should be such that it could reasonably be estimated that the advice has saved the ATO a significant amount of time or significant resources in the audit. For further guidelines on the ATO policy for remission of penalties for voluntary disclosures, in relation to cases where the shortfall sections apply, see Taxation Ruling TR 94/6.

Voluntary disclosures during an audit

186. Where a taxpayer voluntarily discloses to the ATO a matter which would result in the application of a transfer pricing provision of the ITAA and an audit has commenced or advice of an impending

audit has been given, the penalty otherwise attracted under section 225 will be reduced by 20% under section 226D.

187. As indicated in the EM to the Self assessment Act, the taxpayer's disclosure must be in writing, and must bring all the relevant facts and other information to the attention of the auditor that will allow the auditor to readily identify the transfer pricing matter, including the amount and nature of the relevant adjustment. The disclosure should be such that it could reasonably be estimated to have saved the auditor a significant amount of time or resources in looking into the matter disclosed.

188. A taxpayer need not admit liability in respect of the matter disclosed. A taxpayer is eligible for the discounted penalty whether or not the taxpayer maintains an opinion contrary to that of the auditor, or disputes the adjustment the auditor makes to the taxpayer's assessment.

189. Where the failure to conduct dealings at arm's length or use arm's length prices was due to a scheme being entered into for the sole or dominant purpose of avoiding tax and the taxpayer brings the failure to the auditor's attention, the section 225 penalty will be discounted from 50% to 40% where the taxpayer did not have a RAP, or from 25% to 20% where the taxpayer did have a RAP. Where such a disclosure is made in cases where there is no tax avoidance purpose the penalty will be discounted from 25% to 20% where the taxpayer did not have a RAP, or from 10% to 8% where the taxpayer has a RAP.

Voluntary disclosures before an audit

190. Where a taxpayer voluntarily discloses to the ATO a matter which would result in the application of a transfer pricing provision of the ITAA before any audit action has commenced, the penalty otherwise attracted under section 225 will be reduced by 80% under section 226E.

191. As with disclosures during an audit, disclosures before an audit must be in writing. The disclosure must also contain all the relevant facts and other information, including the amount and nature of the transfer pricing adjustment, to enable the ATO to make an adjustment of the taxpayer's assessment.

192. Again, a taxpayer need not admit liability in respect of the matter disclosed to qualify for the discounted penalty, provided there is full disclosure of the relevant facts and the other conditions of the section are satisfied.

193. Where the failure to use arm's length prices was due to a scheme being entered into for the sole or dominant purpose of avoiding tax and the taxpayer brings the failure to the auditor's attention, the section 225 penalty will be discounted from 50% to 10% where the taxpayer did not have a RAP, or from 25% to 5% where the taxpayer has a RAP. Where such a disclosure is made in cases where there is no tax avoidance purpose, the penalty will be discounted from 25% to 5% where the taxpayer did not have a RAP, or from 10% to 2% where the taxpayer has a RAP.

Discretion regarding timing of a disclosure

194. In some instances, even where an audit has commenced or the commencement of an audit has been advised to a taxpayer, it may be appropriate to grant the taxpayer the higher penalty discount of 80% in respect of disclosures. Section 226F enables the ATO to grant this concession in the appropriate circumstances by deeming a disclosure to have been made prior to the taxpayer being informed of an audit.

195. This may be the case, for example, where an audit of a group of companies has commenced and a company which is a part of the group, but not the focus of the audit, discloses the relevant matter which was unlikely to have been detected by the audit.

Alternative to section 225 penalties for voluntary disclosures

196. Since IT 2311 issued in 1986 the ATO has advised taxpayers that, in the presentation of their annual tax returns, they should make adjustments for transfer pricing practices that do not comply with the arm's length principle. This statement was reconfirmed by the ATO in Taxation Ruling TR 94/14.

197. TR 94/14 advised taxpayers to review their past transfer pricing practices and stated that section 225 would not apply in cases of voluntary disclosures (see paragraph 109 of TR 94/14). The Ruling suggested that in such cases, the taxpayer should request an amended assessment under subsection 170(1) and stated that the normal procedures regarding voluntary disclosures would apply.

198. The resultant amendment under subsection 170(1) would not involve an application of Division 13, which is a prerequisite to activating the statutory penalties under section 225. Of course, where a voluntary disclosure is made in respect of the 1992-93 or subsequent year of income, if the taxpayer can demonstrate they had taken reasonable care in the preparation of their tax return and had a RAP, there would be no Part VII penalty under the Self Assessment Act

provisions. But it is extremely rare that such a case would give rise to the need for a voluntary disclosure.

199. There will be other cases where some lower level of penalty is applicable, and these are seen as the great majority of voluntary disclosure cases. The level of reduced penalty will depend on the relevant shortfall provision as shown in the table at paragraph 49 above.

200. Where such an amendment under subsection 170(1) is not possible due to statutory time constraints, the ATO will make the amendment under subsection 170(9B) - which enables an initial transfer pricing amendment to be made at any time. In such voluntary disclosure cases, the ATO will have to consider any possible future limitations imposed under subsection 170(9C). Subject to the comments in paragraphs 106 and 198 above, where the taxpayer fully cooperates with the ATO in finalising the amendment, the taxpayer will still be afforded the benefit of any lower penalties for voluntary disclosures - by remission under subsection 227(3) - in a similar fashion to amendments made under subsection 170(1).

201. However, where the taxpayer requires a formal determination to be made, the amendment/s under Division 13 and/or the relevant DTA would be made pursuant to subsection 170(9B) and must attract the statutory penalties under section 225, with the relevant reduction under either section 226D or 226E (see paragraphs 62 to 65 above). In these cases, the ATO may also require that a full audit or review be carried out on all related transfer pricing issues after giving consideration to the possible limitations imposed under subsection 170(9C).

202. The basis for imposition and reduction of section 225 penalties would depend on the facts and circumstances of the particular case, including whether the taxpayer had a RAP and whether:

- the penalty was being imposed under paragraphs 225(1)(d) or (e), or under subsection 225(2);
- the disclosure sufficed to cover all subsequent adjustments made and warranted a total (or only partial) reduction under the provisions of sections 226D or 226E, whichever appropriate; or
- there are any circumstances which may warrant an increased or higher penalty rate (e.g., deliberate intent, recklessness, disregard of a private ruling, hindrance or prior application of section 225).

Advance pricing arrangements (APAs)

203. An APA assists a taxpayer to resolve the uncertainties in the selection and application of the most appropriate transfer pricing methodology or methodologies suitable to the particular taxpayer's cross-border dealings. Where an APA covers all a taxpayer's cross-border dealings with associated companies, the risk of incurring a transfer pricing adjustment and the associated Part VII penalties is significantly reduced if all of the relevant dealings during the year conform within the critical assumptions and the terms and conditions of the APA.

204. The ATO endorses the use of APAs in appropriate cases and has issued a comprehensive set of procedures (Taxation Ruling TR 95/23) to assist taxpayers who may be considering this option to resolve any uncertainties they have in relation to the transfer pricing legislation and the APA process.

205. A taxpayer who has entered into an APA may nevertheless be subjected to a transfer pricing adjustment, and the relevant penalties under Part VII, in relation to:

(a) non-arm's length dealings which are not specifically covered within the APA; or

(b) non-compliance with the terms and conditions of the APA, unless the taxpayer has made the necessary compensating adjustments - pursuant to the APA - in the relevant tax return.

206. In relation to the situation referred to in paragraph 205(b) above, where a taxpayer has not made the necessary compensating adjustments in the relevant tax return and the ATO makes a subsequent adjustment under the provisions of Division 13 or the relevant DTA, it would be inappropriate to consider that the taxpayer has no-fault and has acted in good faith. The ATO would not consider the remission under subsection 227(3) of any section 225 penalty in these circumstances (see paragraph 179 above).

ATO risk assessment guidelines

207. The ATO has actively encouraged voluntary compliance by taxpayers in respect of their transfer pricing activities as part of the overall principle of self assessment. Taxation Ruling TR 94/14 advised taxpayers to review their transfer pricing practices and make appropriate adjustments to their income tax returns where the prices adopted in the accounts do not conform to the arm's length principle.

208. In Pre-Ruling Consultative Document No 6, the ATO provided a set of broad guidelines to assist taxpayers in making their own

assessment of the risks they face in having a transfer pricing audit carried out - with adjustments made when appropriate. The risk assessment guidelines have since been reviewed and are now reflected in Draft Taxation Ruling TR 95/D23. A further level of risk has been included in the revised guidelines, although the broad concepts remain unaltered.

209. An examination of the risk assessment guidelines reflects that there is a significant relationship between the levels of risk and the levels of penalty imposed under Part VII. The highest risk category is more likely to be the same situations where the highest penalties will be imposed wherever a transfer pricing adjustment is made by the ATO.

210. The chart below is indicative of how the penalty rates are likely to be reduced as the level of risk of an audit reduces:

AUDIT RISK LEVEL	CHARACTERISTIC	POSSIBLE PENALTY RATE/S	RELEVANT SECTION/S
HIGHEST RISK	DELIBERATE TAX AVOIDANCE	75% 50%	226J 225
HIGH RISK	**	50% 25%	225 & 226H 225, 226G & 226K
MEDIUM-HIGH RISK	**	50% 25% 25%	225 & 226H 225 with RAP 225, 226G & 226K
MEDIUM RISK	**	25% 25% 10%	225 with RAP 225, 226G & 226K 225 with RAP
LOW-MEDIUM RISK	**	25% 10% Nil	225, 226G & 226K 225 with RAP 227(3) remission
LOW RISK	**	10% Nil	225 with RAP 227(3) remission
LOWEST RISK	APA PROPERLY ADHERED TO	Nil	N/A

** For a more detailed explanation of the characteristics of each of these risk categories, see the ATO Booklet 'International Transfer Pricing - Minimising the

taxation risks in international associated party dealings'. It is also appropriate to refer to the commentaries for each category in the booklet and to the Note to the Chart on page 10 of the booklet which indicates there is no clearly defined border to each category.

211. The chart in paragraph 210 above does not include:

- increased rates for hindrance (sections 226C & 226X);
- reduced rates for voluntary disclosures (sections 226D, 226E, 226Y or 226Z); or
- cases where there has been disregard of a Private Ruling (section 226M),which are discussed in detail earlier in this Ruling.

OECD views on the imposition of penalties

212. In the 1995 OECD guidelines, the OECD acknowledges that penalty systems often impact on how tax administrations determine their administrative response to ensuring compliance with their own transfer pricing rules. The OECD Committee on Fiscal Affairs previously recognised that promoting compliance should be the primary objective of tax penalties (see: OECD publication *Taxpayers' Rights and Obligations*, 1990).

213. Tax penalties are a common means to promote compliance in OECD countries with the more significant penalties directed at the understatement of tax liability. In most OECD countries, the rate of the penalty increases as the conditions for imposing the penalty increase. The higher rate penalties often can only be imposed by showing a high degree of taxpayer culpability, such as a wilful intent to evade. No-fault penalties tend to be at lower rates than those arising from taxpayer culpability.

214. The OECD considers that improved compliance in the transfer pricing area is of some concern and that the appropriate use of penalties may play a role in addressing this concern. Given the nature of transfer pricing problems, the OECD recommends that care should be taken to ensure that the administration of a penalty system when applied in such cases is fair and not unduly onerous for taxpayers.

215. The OECD suggests that because cross-border transfer pricing issues implicate the tax base of two or more jurisdictions, an overly harsh penalty system in one jurisdiction may give taxpayers an incentive to overstate taxable income in that jurisdiction contrary to Article 9 of the Model Tax Convention on Income and on Capital.

216. It is generally regarded by OECD countries that the fairness of the penalty system should be considered by reference to whether the

penalties are proportionate to the offence. This would mean that the severity of a penalty would be balanced against the conditions under which it would be imposed, and that the harsher the penalty the more limited the conditions in which it would apply.

217. As penalties are only one of many administrative and procedural aspects of a tax system, the OECD could not conclude whether a particular transfer pricing penalty is fair or not without considering all other aspects of the tax system. OECD countries have agreed, however, that the following conclusions can be drawn - regardless of the other aspects of the tax system in place in a particular country:

(a) imposition of a sizeable 'no-fault' penalty based on the mere existence of an understatement of a certain amount would be unduly harsh when it is attributable to good faith error rather than negligence or an actual intent to avoid tax; and

(b) it would be unfair to impose sizeable penalties on taxpayers that made a reasonable effort in good faith to set the terms of their transactions with related parties in a manner consistent with the arm's length principle. In particular, it would be inappropriate to impose a transfer pricing penalty on a taxpayer for failing to consider data to which it did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer.

218. The graduated system adopted in Australia does not materially differ from the 1995 OECD guidelines. Part VII penalties are clearly based on the degree of culpability of the taxpayer, with:

(a) minimal or no sizeable penalties in cases where the taxpayer has done everything that could be reasonably expected of them;

(b) slightly higher penalties in cases of inadvertent error;

(c) penalty rates increasing in severity for cases of negligence or the failure to make reasonable attempts at compliance; and

(d) the highest penalties for cases of recklessness, tax avoidance schemes or wilful evasion.

219. The remission provided under subsection 227(3) in the circumstances detailed in paragraph 179 above indicates the ATO policy accords with the OECD recommendation for no sizeable penalties to be imposed in genuine no-fault cases.

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220. **Detailed contents list:**

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Your comments

221. If you wish to comment on this Draft Ruling, please send your comments, by Friday 1 December 1995, to:

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222. Wherever possible, comments should include a reference to the specific paragraph to which the comments relate. Comments intended to express an alternative view to that expressed in the Draft Ruling should also include the reasoning upon which such view was formed - to enable the matter to be considered in detail.

Commissioner of Taxation

29 September 1995

ISSN 1039 - 0731

Price $4.80

ATO references:
NO 95/4732-1
95/8031-0

FOI index detail
reference number

Not previously released to the public in draft form

subject references

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