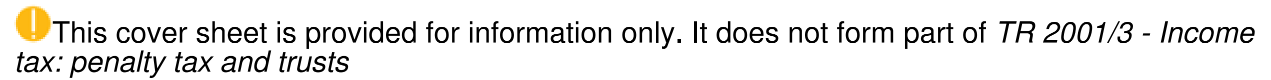
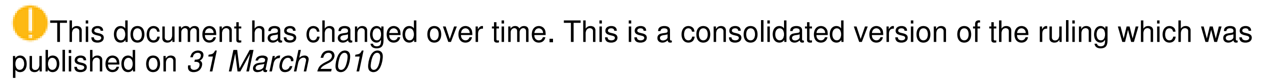
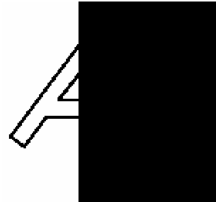
TR 2001/3 - Income tax: penalty tax and trusts


This cover sheet is provided for information only. It does not form part of *TR 2001/3 - Income tax: penalty tax and trusts*


This document has changed over time. This is a consolidated version of the ruling which was published on *31 March 2010*

Generated on: 8 March 2021, 06:32:11 PM



Australian
Taxation
Office

Taxation Ruling
Income tax: penalty tax and trusts

Contents Para

What this Ruling is about **1**
Ruling **3**
Date of effect **15**
Definitions **16**
Explanations **17**
Examples **64**
Detailed contents list **76**

Preamble

The number, subject heading, ***Class of person/arrangement, Date of effect*** *and* ***Ruling*** *parts of this document are a 'public ruling' for the purposes of Part IVAAA of the* ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

*[**Note:** This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]*

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to beneficiaries and trustees whose actions come within Part VII (‘the Penalty Tax provisions’) of the *Income Tax Assessment Act 1936* (‘the Act’).

2. The Ruling:

(a) discusses who may be liable to penalty tax under Part VII when there is an incorrect statement about the net income of a trust estate; and

(b) provides guidelines on how the Commissioner’s discretion to remit additional (penalty) tax under subsection 227(3) of Part VII may be exercised where both the trustee and a beneficiary of the same trust estate may be liable in respect of the same matter.

Note: These guidelines do not fetter authorised officers when exercising the discretion to remit. Each case should be decided on the basis of its own facts.

Ruling

Who can be liable

3. In the usual case, where a trustee has misstated the net income of a trust, resulting in a beneficiary of the trust having a tax shortfall, and this has been caused by culpable behaviour on the part of the trustee, penalty tax may be imposed upon the trustee.

4. However, the trustee penalty tax provisions in Part VII (sections 226R, 226S and 226T) are not an exclusive code for imposing penalty tax in respect of trust estates and the derivation of income by beneficiaries of those estates. The trustee or a beneficiary, or both, may be liable for penalty tax, depending on the circumstances. In the first instance, liability for penalty tax only arises if the trustee is deemed under sections 226R, 226S or 226T to have a 'tax shortfall', as defined in subsection 222A(1), or the beneficiary has an actual 'tax shortfall' under the 'shortfall sections' (sections 226G, 226H, 226J, 226K, 226L or 226M), or both occur.

5. Sections 226R, 226S, and 226T do not operate alone. Section 226R **Shortfall because of statement by trustee**, operates in conjunction with either of sections 226G, 226H or 226J. Section 226S **Shortfall because of unarguable position of trustee**, operates in conjunction with section 226K. Section 226T **Penalty tax because of unarguable position of trustee about scheme**, operates in conjunction with section 226L.

6. Sections 226G, 226H, or 226J are triggered when a tax shortfall is caused by certain culpable behaviour, namely, failure to take reasonable care, recklessness, or intentional disregard of the law, respectively. For section 226R to apply, a trustee must have behaved in one of these ways.

7. A trustee broadly is deemed to have a tax shortfall only if they have made an incorrect statement concerning the net income of the trust estate, which leads to a beneficiary of the estate having an 'estate shortfall excess' (see the definitions of 'estate taxation statement' and 'estate shortfall excess' in subsection 222A(1), reproduced in simple, guide form in paragraph 16 below).

8. Where the trustee of a trust estate has not made any incorrect statement about the net income of the estate, they cannot be deemed to have a tax shortfall, and thus they have no liability for penalty tax. However, this does not mean a beneficiary cannot have made an incorrect statement about their deriving income from the estate. If they have, and consequently have a tax shortfall in their own right, certain of the penalty tax provisions may apply to them, i.e., one of the shortfall sections, depending on their behaviour.

9. In some situations, both the trustee and the beneficiary(s) may have behaved in a way that results in them both being liable for penalty tax in respect of the same misstatement about the net income of the trust estate. Most commonly this is where the beneficiary(s) have knowledge of the trustee's behaviour (where, for example, they are in a position to control the trustee), and the behaviour of the trustee should also be imputed to the beneficiary(s). In such cases, our ultimate aim is to exercise the discretion under subsection 227(3) to remit the penalty tax amount that would otherwise be 'double tax' in

respect of the same matter. We attempt to determine the correct level of remission of penalty tax as between a trustee and any beneficiaries before raising any penalty tax. Where this is not possible or practical, it may be appropriate, initially, to raise penalty tax to both the trustee and the beneficiary(s) in respect of the same understatement of income. This does not preclude the gathering of further information in order to determine what the ultimate remission action should be.

10. In other words, we seek ultimately to impose, for the one misstatement of net income of the trust and the one tax shortfall of a beneficiary, only the one sum of penalty tax, as determined from a single application of the rate set down in the relevant shortfall provision to the tax shortfall of the beneficiary. This amount of penalty tax may be assessed to the trustee, or to the beneficiary(s), depending on who is primarily responsible for causing the tax shortfall, as explained further in this Ruling (see paragraph 48 and **Example 5**).

Exercise of the Commissioner's discretion

11. Where both the trustee and the beneficiary(s) are liable under the legislation the decision as to whether penalty tax will be fully assessed to the trustee only, or the beneficiary(s) only, or both parties, depends upon the facts and circumstances of each particular case. In determining by how much the penalty tax should then be remitted under subsection 227(3), regard is had to the following:

(a) the extent to which the respective behaviours of both have caused the misstatement of net income;

(b) the extent to which penalising the trustee may penalise 'innocent' beneficiaries (where to discharge the penalty tax liability the trustee can validly draw on assets of the trust estate);

(c) the capacity of the parties to pay the penalty tax amount; and

(d) there should be no 'double penalty tax' ultimately imposed.

12. The reference to 'innocent' beneficiaries in the paragraph above is not meant to imply a trustee can escape liability to penalty tax altogether where no beneficiaries have been culpable. Under Part VII, if a culpable trustee has caused an 'estate shortfall excess' of a beneficiary by misstating the trust net income, the trustee is liable to penalty tax, even though the beneficiary may not have exhibited any culpable behaviour.

13. However, there are circumstances where the trustee and at least one beneficiary have behaved culpably, so that both are

potentially liable for penalty tax, but there is also at least one 'innocent' beneficiary. In these cases, we think most often it is appropriate to assess the culpable beneficiary for penalty tax and remit the whole of the penalty tax otherwise payable by the trustee in respect of the tax shortfall of that beneficiary, in order not to further penalise the 'innocent' beneficiaries. Penalty assessments would still be raised however, upon the trustee in respect of the tax shortfalls of these 'innocent' beneficiaries (see **Example 5**).

14. Where penalty tax is initially raised to the fullest extent permitted under the Act to both the trustee and beneficiary(s), in terms of paragraph 9 above, the parties would be requested to make further submissions on what remission action should occur under subsection 227(3). Once it has been determined which party is ultimately to bear the penalty tax, the Commissioner's discretion in subsection 227(3) is to be used to achieve the appropriate outcome (see **Example 4**).

Date of effect

15. This Ruling applies to years commencing on or after 1 July 1992 and ending on or before 30 June 2000, where the provisions of Part VII apply. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). The Ruling does not apply to years commencing on or after 1 July 2000, to which Part 4-25 of Schedule 1 of the *Taxation Administration Act 1953* applies.

Definitions

16. The following terms are more fully defined in subsection 222A(1). Set out below are simplified versions, as a guide to assist in the reading of this Ruling:

'**estate taxation statement**' is a taxation statement relating to the net income of the trust estate. This includes oral and written statements (may be in the tax return or some other document) made in respect of the Act or regulations;

'**estate shortfall excess**' is, broadly, the tax shortfall of the beneficiary as caused by the estate taxation statement of the trustee;

'**tax shortfall**' is, in relation to a taxpayer and a year of income, the difference between the tax properly payable by a taxpayer and the tax that would have been payable if it were assessed on the basis of the taxpayer's return;

‘**taxation statement**’ is widely defined to include such things as statements made in tax returns, applications, objections, written or oral answers to questions asked under the Act or regulations, and other information given under the Act to a tax officer or other person. See also the definitions of ‘**taxation officer statement**’ and ‘**taxation purpose statement**’ in subsection 222A(1);

(Note that ‘this Act’ (for example, as referred to in the definition of ‘taxation officer statement’ of subsection 222A(1) of the Act) is defined in subsection 6(1) of the Act to include the *Income Tax Assessment Act 1997*);

‘**shortfall sections**’ are sections 226G, 226H, 226J, 226K, 226L, and 226M of the Act

‘**scheme sections**’ are sections 224, 225, 226, or 226AA[1] of the Act.

Explanations

The scheme of Part VII

17. Part VII contains the main penalty tax provisions of the Act, which apply to all taxpayers for financial years commencing on or after 1 July 1992 (but not for an accounting period adopted in lieu of the 1992/93 year of income that commenced before 1 July 1992).

18. Sections 226G, 226H, 226J, 226K, 226L and 226M (the shortfall sections) specify certain rates of penalty tax applicable to specific behaviours of taxpayers who have a ‘tax shortfall’ in respect of a ‘taxation statement’.

19. Specific provisions (sections 226R, 226S and 226T – the trustee penalty tax provisions) deal with the application of the shortfall sections to trustees. The effect of section 226R is to make a trustee liable to penalty tax on an ‘estate shortfall excess’ of the beneficiary(s) that resulted from an understatement of trust income caused by an offending ‘estate taxation statement’ of the trustee. The ‘estate shortfall excess’ is deemed to be a tax shortfall of the trustee and the rate of penalty tax specified in sections 226G, 226H, or 226J is then applied to the trustee, depending upon the behaviour of the trustee that caused the deemed tax shortfall. Sections 226S and 226T apply similarly to a trustee in the circumstances specified in sections 226K and 226L respectively.

---

[1] Section 226AA is applicable in relation to schemes that were entered into after 4.00p m., by legal time in the Australian Capital Territory, on 13 August 1998.

20. Sections 224, 225 226 and 226AA (the scheme sections) specify certain rates of penalty tax that are applicable to taxpayers where the Commissioner assesses tax in relation to the taxpayer's involvement (which can include a trustee's involvement), in a 'tax avoidance scheme' (as defined in subsection 224(2)), or in relation to the Commissioner having made a determination under Division 13 of Part III, or under subsection 177F(1) of Part IVA, respectively.

Tax shortfall and culpable behaviour

21. Liability to penalty tax under Part VII is dependent upon the existence of two key concepts: 'tax shortfall' and culpable behaviour.

22. 'Tax shortfall' is defined in subsection 222A(1) as, broadly, the amount by which the taxpayer's 'statement tax' is less than the taxpayer's 'proper tax' for the year. These two terms are in turn defined in subsection 222A(1). 'Statement tax' is, broadly, the tax payable by the taxpayer in respect of a year of income 'if it were assessed on the basis of [taxation] statements made by the taxpayer'. 'Proper tax' is, broadly, the tax payable in respect of a year of income 'in accordance with the law'.

23. The shortfall sections specify certain rates of penalty tax for different types of culpable behaviour, which are then applied to the amount of the particular tax shortfall. For instance, section 226G sets a rate of 25% penalty tax for the lowest level of culpable behaviour, being lack of reasonable care.

24. Culpable behaviour of a kind referred to in the shortfall sections must be evident in the taxation statements of the taxpayer, in order to trigger a penalty tax liability. 'Taxation statement' is defined in subsection 222A(1) (refer '**Definitions**' in paragraph 16 above). An omission of income is specifically deemed to be a statement that the income was not derived during the period, as per section 222F.

25. Guidelines on the concepts of reasonable care, recklessness and intentional disregard of the law, as used in sections 226G, 226H, and 226J, can be found in Taxation Ruling TR 94/4. Guidelines on reasonably arguable position and voluntary disclosures, for the purpose of Part VII, can be found in Taxation Rulings TR 94/5 and TR 94/6 respectively.

Operation of the trust penalty tax provisions

26. The trustee penalty tax provisions (sections 226R, 226S, 226T) apply where a beneficiary has an 'estate shortfall excess' and in relation to the excess the trustee has made an 'estate taxation statement'. Refer to paragraph 16 above for simplified definitions of these terms. Once these conditions have been satisfied, section 226R,

for example, deems the tax shortfall of the beneficiary to be that of the trustee. Where the trustee has exhibited the prerequisite behaviour required under one of the shortfall sections, liability to penalty tax upon the trustee has been triggered. For instance, if the estate taxation statement of the trustee was caused by a lack of reasonable care, section 226G would impose 25% penalty tax on the trustee based on the amount of the beneficiary's tax shortfall.

27. 'Estate taxation statement' is defined in subsection 222A(1) as 'in relation to a trust estate, means a taxation statement relating to the net income of the estate'.

28. 'Estate shortfall excess' is also defined in subsection 222A(1), and is, broadly, the difference between the beneficiary's tax shortfall as calculated using the share of trust income based on the trustee's estate taxation statement, and the beneficiary's tax shortfall using the share of correct trust net income.

Trustee and/or beneficiary liability

29. Where there is an estate taxation statement causing an estate shortfall excess, and there has been culpable behaviour by the trustee, penalty tax is payable by the trustee. On the other hand, where the trustee has not exhibited any of the types of culpable behaviour mentioned in the shortfall sections, the trustee cannot be liable.

30. Any beneficiary whose own culpable behaviour has caused the shortfall may still be liable in their own right.

31. There is no express or implied declaration in Part VII to the effect that, where a trustee is subject to penalty tax under the trustee penalty tax provisions, the shortfall sections cease to have effect with respect to the beneficiary (i.e., the trustee penalty tax provisions are not an exclusive code for imposing penalty tax on trustees and beneficiaries).

32. This non-exclusive code interpretation also means both the trustee and the beneficiary can be liable in relation to the same tax shortfall of a beneficiary, where both parties have behaved in a relevant culpable manner causing the shortfall.

33. Take an example where an estate taxation statement by a trustee has led to an understatement of trust income and, therefore, a tax shortfall for the beneficiary. If we assume it was caused by a lack of reasonable care on the part of the trustee, the trustee is liable to penalty tax under section 226G, by virtue of section 226R. The potential for the beneficiary also to be liable to penalty tax in relation to the same tax shortfall arises when the knowledge of the trustee can be imputed to the beneficiary. In this regard, the explanatory memorandum relating to the *Taxation Laws Amendment (Self*

Assessment) Act 1992 makes the following statement in its discussion of 'reasonable care':

> 'A taxpayer who relies upon advice from a third party of a fact that is material to the preparation of the taxpayer's return (e.g., a bank providing a statement of the amount of interest earned by the taxpayer) will not usually be liable for penalty 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.' (page 82)

34. Although this statement was made in the context of advice from a third party, similar reasoning applies to a beneficiary relying on advice of a trustee concerning the net income of the trust.

35. Having regard to the above comments, the potential for both the trustee and beneficiary to be liable may occur in the following types of situations:

- (a) the trustee is controlled by the beneficiary (for example, the beneficiary may be a shareholder and/or director of the trustee company);
- (b) the trustee and the beneficiary are the same person/entity;
- (c) the trustee and the beneficiary acted in collusion in respect of the matter resulting in the tax shortfall;
- (d) the beneficiary directed how the tax returns should be prepared, and the trustee had full knowledge of the items leading to the shortfall; or
- (e) there were reasonable grounds for the beneficiary to have doubts as to the accuracy of the trustee prepared tax return, but the beneficiary's tax return does not indicate those doubts.

Non-exclusive code

36. The non-exclusive code approach to the trustee penalty tax provisions is supported by the recent decision of Sundberg J in *Zeta Force Pty Ltd v. FC of T* 98 ATC 4681; (1998) 39 ATR 277. Sundberg J's judgment is significant for its consideration of the 'proportional' and 'quantum' approaches to the determination of a beneficiary's assessable income for the purposes of subsection 97(1). However, Sundberg J also considered the construction and application of the former section 223 penalty provisions to trusts.

37. The former section 223 provisions operated in a similar manner to the current Part VII provisions with respect to trusts.

Subsection 223(1) was the general provision creating a penalty tax liability for a taxpayer who made a statement leading to an underpayment of 'tax properly payable'. This subsection has effectively been replaced by the shortfall sections in Part VII. Subsection 223(4) provided a trustee may be liable to penalty tax, in a manner similar to the operation of the trustee penalty tax provisions in the current Part VII.

38. The *Zeta Force* case concerned an amended assessment issued by the Commissioner to increase a beneficiary's assessable income, as a result of using the 'proportional' method, and included penalty tax imposed under subsection 223(1). It was argued by the taxpayer that (using the words of Sundberg J) 'a beneficiary is not liable to additional tax under s223 where the trustee omits to return income of the trust estate', and that, 'additional tax is to be imposed on the trustee under s223(4) and not on the beneficiary under sub-s(1)'. It was further argued 'if this were not so, additional tax would be imposed more than once by reason of what was in substance the same omission'[2] (ATC 4694; ATR 291).

39. Sundberg J provides the following reasoning for rejecting the above argument, at ATC 4695; ATR 292:

> 'Section 223 adverts to trust estates and beneficiaries of trust estates: sub-ss (4) and (7). The reference to a beneficiary in sub-s (4)(b) is to a beneficiary who by reason of the trustee's false statement has paid a smaller amount of tax than would have been payable but for the falsity. Sub-section (3) deals with the case of a potential double penalty being imposed on a person arising out of the one matter. In those circumstances it is inappropriate to read into the Act another qualification upon sub-s (1) so as to protect a beneficiary who makes a false return from a penalty under sub-s (1) on the ground that the trustee may be liable to a penalty under sub-s (4). Parliament has dealt with the case where the one person might be liable to penalties under different sub-sections arising out of the one matter. It would, in my view, be a legislative exercise for me to imply an analogous protection for one person (a beneficiary) against liability under one sub-section on the ground that another person (the trustee) might be liable to a penalty in respect of the same matter under another sub-section.'

40. We believe a court would adopt a similar approach to the interpretation of the new provisions (such as sections 226G and 226R)

---

[2] This argument was based on a similar submission put forward on behalf of the taxpayer in *Grollo Nominees Pty Ltd v. FC of T* 97 ATC 4585; (1997) 36 ATR 424 (at ATC 4642-4; ATR 440-2). The court described the submission as 'attractive', but did not decide the issue.

that replaced subsections 223(1) and (4), as they operate in a substantially similar manner in all respects relevant to this argument.

41. It should be pointed out, however, that a material change to the operation of Part VII, compared to that which Sundberg J was considering, is that the new shortfall sections recognise specific levels of culpable behaviour to which specific rates of penalty tax apply. This means beneficiaries that have understated income from a trust, due to the culpable misstatement of income by a trustee, can themselves also be liable to penalty tax under Part VII only if their behaviour has also been culpable. This differs from the former provisions where the beneficiary could be liable to penalty tax by virtue of making a 'false or misleading' statement, even though the statement may have relied purely on advice from the trustee.

Subsection 227(3) – Commissioner's discretion

42. Subsection 227(3) gives the Commissioner the power to remit the whole or any part of the additional tax imposed under Part VII.

43. Guidelines for the exercise of this discretion can be found in Taxation Ruling TR 94/7. This Ruling refers to the explanatory memorandum relating to the *Taxation Laws Amendment (Self Assessment) Act 1992*, which includes the following example of when it may be appropriate for the Commissioner to exercise the discretion:

> '… where the application of the special rules in respect of partners and trustees imposes an overly burdensome penalty on the defaulting partner or trustee.' (page 99)

44. The aim of the Part VII penalty tax provisions is to provide certainty by prescribing specific rates for certain types of behaviour. The explanatory memorandum makes it clear the discretion is meant to be used only in exceptional circumstances, to avoid disrupting this certainty. However, it is also clear the trustee penalty tax provisions are one area where it is appropriate to use the discretion.

45. In *Zeta Force* Sundberg J said at ATC 4695; ATR 292:

> 'Rather than imply that a beneficiary who makes a false return cannot be liable to a penalty because the trustee may be liable, it is appropriate to recognise that where a beneficiary's false return is wholly consequential on the falsity of the trustee's return, that will be reflected in the penalty imposed. See the power to remit penalty in s227(3).'

46. Sundberg J thereby acknowledges the potential for 'double penalty' in relation to the same matter, and points to the Commissioner's discretion as an appropriate means to overcome this situation. However, as pointed out in paragraph 41, the beneficiary

and trustee must have both exhibited culpable behaviour for both to be potentially liable under the current Part VII provisions.

Exercise of the Commissioner's discretion

47. In situations where both the trustee and the beneficiary are potentially liable to penalty tax, the particular circumstances of each case must be taken into account in determining whether the trustee, the beneficiary, or both, should be properly assessed to penalty tax. The Commissioner uses the discretion in subsection 227(3) to achieve the appropriate result. Rights of objection against penalty assessments exist in the *Taxation Administration Act 1953*.

48. In cases where there is potential liability on both the trustee and the beneficiary(s), the circumstances are examined to determine the extent of fault in the behaviour of each of the parties that has led to the tax shortfall, in terms of the criteria in paragraph 11. Where it is determined that either the trustee or the beneficiary(s) are primarily responsible for the shortfall, penalty tax should *prima facie* be imposed on that party only.

49. In cases where difficulties in ascertainment of the facts make it hard to determine which party is more responsible, penalty tax may initially be imposed on both parties to the fullest extent permitted under the Act, as explained in paragraph 9 above. The parties would then be requested to make further submissions on what remission should occur under subsection 227(3) (see **Example 4**).

50. It is noted in *Zeta Force* Sundberg J suggests, at ATC 4695; ATR 292, that 'were the Commissioner to impose a substantial penalty on both beneficiary and trustee when the error of the beneficiary is consequent on the error of the trustee, review on the merits, or perhaps on unreasonableness grounds, may be available'.

51. We consider, in making this statement, Sundberg J had in mind the imposition of penalty tax on both the trustee and beneficiary with a view to collecting the penalty tax from both. Raising dual assessments to facilitate the penalty process in circumstances where both the trustee and a beneficiary are liable and it is unclear who is the 'correct' party upon whom penalty tax should be raised, is, we think, entirely reasonable and appropriate. There is no suggestion double penalty tax will actually be collected. Ultimately, the Commissioner's discretion under subsection 227(3) will be used to remit the excess penalty tax raised to either the trustee or the beneficiary, once the appropriate party to bear the penalty tax has been determined.

Dual assessments to both trustee and beneficiary

52. The validity of the Commissioner issuing dual assessments in relation to the same matter has been considered in the Courts, though in respect of normal tax assessments, rather than penalty tax.

53. *Richardson v. FC of T* (1932) 2 ATD 19; (1932) 48 CLR 192 is a longstanding authority for the proposition the Commissioner can assess more than one person to income tax on the same income where insufficient information is available to determine which one is liable, providing it is not for the purpose of double recovery of the tax.

54. More recently, a similar finding was made in *DFC of T v. Richard Walter Pty Ltd* 95 ATC 4067; (1995) 29 ATR 644. In this case, it was concluded the Commissioner may issue alternative assessments to different taxpayers regarding the same income, providing the Commissioner has made a genuine attempt to exercise his power in a *bona fide* manner, and it was not exercised in bad faith or for improper purpose. As issuing assessments to both the trustee and the beneficiary would only occur in circumstances where the Act provides that each party is liable, due to their own actions triggering the penalty tax provisions, this is considered to be a *bona fide* use of power.

55. The assessments must also be definitive, and not issued on a tentative basis. The trustee and beneficiary assessments would specify a final tax liability to the taxpayer they are directed to, and, therefore, cannot be regarded as tentative. In dealing with further submissions on appropriate remission action, as discussed in paragraph 49, we advise it is our intention only to seek to recover the penalty tax from one of the parties, either the trustee or the beneficiary(s), in respect of each tax shortfall.

No penalty tax triggered

56. Where there is a tax shortfall but both parties have exercised reasonable care, the penalty tax provisions are not triggered by either the trustee or the beneficiary(s). In these circumstances, neither the trustee nor the beneficiary(s) would be liable to penalty tax. Example 6 in paragraphs 74 and 75 of this Ruling illustrates this possibility.

Form of notice of assessment of additional tax to the trustee, and disclosure of details of calculation to the trustee

57. Where penalty tax is to be imposed on a trustee, and the trustee has no primary tax liability, a ‘penalty only’ notice of assessment needs to be issued to the trustee.

58. Where a penalty tax liability arises in respect of more than one beneficiary of the same trust, a separate notice of assessment is required for each beneficiary. The notices may be presented together, and may be on the same document.

59. It is preferable that the notice of assessment provides sufficient information to enable the trustee to check the calculation of penalty tax, where possible. However, certain personal information relating to the beneficiaries of the trust must be known in order to check this calculation. Disclosure by the Commissioner of this personal information to the trustee may constitute a breach of the *Privacy Act 1988*. For this reason the Commissioner must seek the consent of each beneficiary whose details are required in order to check the calculation, before making any such disclosure of personal information to the trustee in the notice of assessment.

60. If consent is not provided by a particular beneficiary, the only information specific to that beneficiary that can be disclosed in the notice of assessment is the beneficiary's name, the revised amount of trust net income to which the beneficiary is presently entitled, and the amount of penalty tax referrable to that beneficiary. The trustee should approach the beneficiary directly for any additional personal information. In respect of beneficiaries that do give their consent, the Commissioner should include with the notice of assessment sufficient information to identify which beneficiaries are being referred to, a summary of the penalty calculation, the amount of the pre-adjustment taxable income of each affected beneficiary, the adjustment for each affected beneficiary, and any other factors critical to the calculation of the tax shortfall. The beneficiary details advised on the distribution statement of the trust tax return would normally be sufficient to identify the relevant beneficiary. The tax file numbers of beneficiaries are not to be disclosed.

Widely held trusts

61. It is acknowledged that some flexibility may be required in the administration of the Part VII penalty tax provisions with respect to widely held trusts. Such trusts may have hundreds or thousands of beneficiaries affected by a misstatement of net income in the trust return, which makes the calculation of any penalty tax applicable to the trustee very onerous. Such situations are considered on an individual basis, and may require consultation between the trustee and the Australian Taxation Office to establish a workable solution acceptable to both parties, with respect to the calculation of the penalty tax due by the trustee. Such cases are not expected usually to involve any beneficiary also behaving in a culpable manner, so that it is most often only the trustee who might have any liability for penalty tax.

The scheme sections

62. Penalty tax under Part VII is imposed in a different fashion where the Commissioner calculates a taxpayer's liability to income tax in relation to:

(a) their having participated in a 'tax avoidance scheme', as defined in subsection 224(2) (refer section 224);

(b) the Commissioner having made a determination under either section 136AD or 136AE of Division 13 of Part III (refer section 225); or

(c) the Commissioner having made a determination under subsection 177F(1) of Part IVA (refer sections 226 and 226AA).

63. The scheme sections (sections 224, 225, 226 and 226AA) apply only where the Commissioner determines a taxpayer's liability to income tax pursuant to the provisions mentioned in paragraph 62 above. Accordingly, they apply only to a trustee where the Commissioner raises an assessment directly against that trustee, such as under sections 98, 99, 99A or 102. As the broad structure of these assessment provisions in Division 6 of Part III is not to tax both the trustee and the beneficiary in respect of the same income, issues of double penalty tax do not arise.

Examples

Example 1 – beneficiary culpable, trustee not

64. The tax return of a discretionary trust is prepared correctly and the trustee duly notifies the beneficiary of his distribution for the year. However, the beneficiary inadvertently overlooks the distribution when completing his tax return, and in doing so, fails to exercise reasonable care concerning the operation of the Act. The Australian Taxation Office discovers this error and adjusts the beneficiary's return to include the correct income.

65. In this situation, the trustee has not made an estate taxation statement that has caused any estate shortfall excess and there is in fact no error in the trust return, so there can be no liability to penalty tax of the trustee under the trustee penalty tax sections. The beneficiary taxpayer has made the offending taxation statement in his own tax return, by omitting the income (section 222F), and is liable to penalty tax under section 226G.

Example 2 – trustee culpable, beneficiary not

66. An elderly investor/beneficiary in a large public unit trust (not a public trading trust) lodges his tax return based solely on the income distribution statement from the trustee. It later comes to light the net income of the trust was determined incorrectly such that the beneficiary has a tax shortfall. In these circumstances, the beneficiary placed complete reliance on the trustee and had no reason to suspect anything to the contrary. Penalty tax is levied against the trustee pursuant to section 226R and, say, section 226G, where the trustee has shown a lack of reasonable care in making a statement relating to the net income of the trust. No penalty tax is levied upon the beneficiary, although an amended assessment may still issue to the beneficiary to include the omitted income from the trust.

Example 3 – beneficiary culpable, trustee not

67. A small delicatessen is operated by a discretionary trust, with the husband and wife beneficiaries both working in the shop. The trustee of the trust is an independent accountant, who also prepares the taxation returns. The beneficiaries regularly skim money from the business so the income of the trust is understated. Subsequently, an Australian Taxation Office audit results in adjustments to the tax return of the trust to include the amounts taken by the beneficiaries as income.

68. The trustee is completely unaware this is happening, and has no reason to suspect anything is wrong from the records of the business. The trustee, therefore, has acted completely honestly, not knowingly making any statement that has led to the tax shortfall. On the other hand, the beneficiaries have clearly knowingly caused the tax shortfall in the trust return, which is reflected in the business records provided to the trustee.

69. There is *prima facie* liability to penalty tax on both the trustee and the beneficiary. However, the trustee cannot be said to have behaved in a culpable manner, and, therefore, has no liability to penalty tax under any of the shortfall sections. It is clear the trustee had no direct involvement, and has largely been the innocent party. On the other hand, the beneficiaries have knowingly provided false business records to the trustee, resulting in the misstatement of the net income of the trust, and, thus, also in them both having an estate shortfall excess. Accordingly, they both are liable for penalty tax under the appropriate shortfall section.

Example 4 – both trustee and beneficiary culpable, assess both

70. Assume the same facts as outlined in the first paragraph of **Example 3**, except the trustee was aware of, or perhaps involved in, the beneficiaries' actions, and, thus, the income understatement. Therefore, both parties are potentially liable to penalty tax for the understatement. Further, the tax auditor has experienced great difficulty in obtaining enough information to determine the involvement of the parties, such that it is unclear who is most at fault in relation to the misstatement of net income, and, therefore, who should ultimately be made liable to the penalty tax. Given this uncertainty, the auditor decides it is appropriate to assess both parties to penalty tax to the fullest extent permitted under the Act, and then request the parties to make further submissions on what remission action should occur under subsection 227(3).

Example 5 - trustee culpable, two beneficiaries culpable, two beneficiaries innocent

71. Again, assume the same facts as outlined in the first paragraph of **Example 3**, with the addition that the trustee was aware of, or perhaps involved in, the beneficiaries' actions, and, thus, the income understatement. Furthermore, the brother of one of the first beneficiaries, and the brother's wife, are also beneficiaries of the discretionary trust. These further beneficiaries do not participate in the day to day operation of the delicatessen, and are completely unaware of the understatement of trust net income caused by the behaviour of the first two beneficiaries and the trustee.

72. Each of the four beneficiaries has an estate shortfall excess, but as the brother and his wife have not behaved in a culpable manner, they have no liability to penalty tax under the shortfall sections. The trustee is *prima facie* liable to penalty tax in respect of the estate shortfall excesses of all four beneficiaries, under section 226R and section 226J, assuming his behaviour amounts to intentional disregard of the law. As the first two beneficiaries have behaved in a culpable manner they are also *prima facie* liable to penalty tax on their own tax shortfalls, under section 226J.

73. It is assumed in this example that the trustee can validly draw on the assets of the trust estate to make payment of any penalty tax liability (although this is not always the case). In this situation, the Commissioner imposes penalty tax on the trustee in respect of the estate shortfall excess of the two innocent beneficiaries, but chooses to exercise his discretion to remit the trustee's liability in respect of the two culpable beneficiaries. Rather, penalty tax is imposed directly on the two culpable beneficiaries in respect of their own tax shortfalls. Penalty tax arising from the culpable beneficiaries' liability is not imposed on the trustee, as doing so would have the effect of further

penalising the innocent beneficiaries when the trustee draws on assets of the trust estate to make payment. Where the trustee does not have a right to draw on trust assets to pay the penalty tax, the Commissioner's discretion may be exercised differently, depending on the circumstances.

Example 6 – neither trustee nor beneficiary culpable

74. The trustee of a deceased estate has omitted interest income from the return of the deceased estate. While he was alive, the deceased taxpayer had invested money in an interest bearing deposit with a financial institution in a false name. Being very secretive with his financial affairs he had not told anyone of the deposit, such that the trustee was not aware of this investment.

75. The trustee has acted honestly as he could not reasonably have known about the further interest. In these circumstances, we consider the trustee cannot be liable to penalty tax under the shortfall sections, as the forms of behaviour required to trigger sections 226G, 226H, or 226J are not present. As the beneficiaries are also innocent of the income understatement, they, too, are not liable to penalty tax under the shortfall sections.

Detailed contents list

76. Below is a detailed contents list for this Ruling:

	Paragraph
What is this Ruling about	**1**
Class of person or arrangement	1
Ruling	**3**
Who can be liable	3
Exercise of the Commissioner's discretion	11
Date of effect	**15**
Definitions	**16**
Explanations	**17**
The scheme of Part VII	17
Tax shortfall and culpable behaviour	21
Operation of the trust penalty tax provisions	26
Trustee and/or beneficiary liability	29
Non-exclusive code	36

Subsection 227(3) - Commissioner's discretion 42
Exercise of the Commissioner's discretion 47
Dual assessments to both trustee and beneficiary 52
No penalty tax triggered 56
Form of notice of assessment of additional tax to the trustee, and disclosure of details of calculation to the trustee 57
Widely held trusts 61
The scheme sections 62
Examples **64**
Example 1 – beneficiary culpable, trustee not 64
Example 2 – trustee culpable, beneficiary not 66
Example 3 – beneficiary culpable, trustee not 67
Example 4 – both trustee and beneficiary culpable, assess both 70
Example 5 – trustee culpable, two beneficiaries culpable, two beneficiaries innocent 71
Example 6 – neither trustee nor beneficiary culpable 74
Detailed contents list **76**

Commissioner of Taxation
16 May 2001

Previous draft:
Previously issued as TR 1999/D2

Related Rulings/Determinations:
TR 94/2; TR 94/3; TR 94/4; TR 94/5; TR 94/6; TR 94/7; TR 92/20

Subject references:
- culpability
- income tax shortfall
- penalty
- reckless behaviour
- remission of penalties
- scheme section
- trusts

Legislative references:
- ITAA 1936 Div 6 Part III
- ITAA 1936 Part VII
- ITAA 1936 Div 13
- ITAA 1936 97
- ITAA 1936 97(1)
- ITAA 1936 98
- ITAA 1936 99
- ITAA 1936 99A
- ITAA 1936 102
- ITAA 1936 136AD
- ITAA 1936 136AE
- ITAA 1936 177F(1)
- ITAA 1936 222A
- ITAA 1936 222A(1)
- ITAA 1936 222F
- ITAA 1936 223
- ITAA 1936 223(1)
- ITAA 1936 223(3)
- ITAA 1936 223(4)
- ITAA 1936 223(4)(b)

- ITAA 1936 223(7)
- ITAA 1936 224
- ITAA 1936 224(2)
- ITAA 1936 225
- ITAA 1936 226
- ITAA 1936 226AA
- ITAA 1936 226G
- ITAA 1936 226H
- ITAA 1936 226J
- ITAA 1936 226K
- ITAA 1936 226L
- ITAA 1936 226M
- ITAA 1936 226R
- ITAA 1936 226S
- ITAA 1936 226T
- ITAA 1936 227(3)

Case References:

- DFC of T v. Richard Walter Pty Ltd 95 ATC 4067; (1995) 29 ATR 644
- Grollo Nominees Pty Ltd v. FC of T 97 ATC 4585; (1997) 36 ATR 424
- Richardson v. FC of T (1932) 2 ATD 19; (1932) 48 CLR 192
- Zeta Force Pty Ltd v. FC of T 98 ATC 4681; (1998) 39 ATR 277
- Case 14/93 93 ATC 192; AAT Case 8627 (1993) 25 ATR 1095
- Case V22 88 ATC 224; AAT Case 4078 (1988) 19 ATR 3173

ATO References:
NO 98/3305-6
BO
FOI Number: I 1025097
ISSN: 1039-0731