# *TR 94/3 - Income tax: tax shortfall penalties: calculation of a tax shortfall and allocation of additional tax*

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Australian Taxation Office

# Taxation Ruling
Income tax: tax shortfall penalties: calculation of a tax shortfall and allocation of additional tax

*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the* ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

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## What this Ruling is about

1. This Ruling outlines the general basis on which additional tax should be calculated under sections 226G, 226H, 226J, 226K, 226L and 226M (the shortfall sections) of the *Income Tax Assessment Act 1936* (ITAA).

## Ruling

2. Additional tax under the shortfall sections is calculated in respect of a tax shortfall or part of a tax shortfall. While a tax shortfall is broadly the difference between the tax properly payable by a taxpayer and the lowest amount of tax that would have been payable by the taxpayer if it were assessed on the basis of the taxpayer's return, a tax shortfall will frequently need to be split into its component parts to determine the correct application of the shortfall sections.

3. The examples below illustrate the calculations to be followed in applying shortfall sections. The examples recognise that in the course of an audit a tax officer may detect a number of items that require adjustment, some of which may warrant penalty at different rates, some of which may not. In addition, there may be adjustments made in a taxpayer's favour which may or may not relate to the debit adjustments made. Further, the adjustments may be to income, deductions, rebates, foreign tax credits or offsets of franking deficit tax.

4. The basic rule is that if there is no tax shortfall for a year then additional tax cannot be imposed. For example, if a taxpayer has

omitted an amount of income, but the tax related to that matter is more than offset by an adjustment in the taxpayer's favour (whether or not related to the omitted income), no additional tax would be payable. Accordingly, the examples below only cover situations where, after the various adjustments to the taxpayer's assessment, there is a tax shortfall. Although all of the examples assume that the taxpayer was taxable to start with, the same principles for calculating penalty would apply where a taxpayer had originally returned a loss, provided there was in fact a tax shortfall after all adjustments had been made.

5. Where a taxpayer is in a loss situation and the audit adjustments made cause the taxpayer to become taxable, the process for calculating penalties on a tax shortfall is identical to that where the taxpayer was in a taxable situation before adjustments are made. That is, each matter that results in a tax shortfall is examined separately to determine which prescribed rate should be applied to that matter in view of the taxpayer's demonstrated behaviour. Once the appropriate prescribed rates are determined they are applied to the tax shortfall or part thereof in the same ratio as each individual shortfall is to the total tax shortfall. In other words, the prescribed rates are applied to the tax shortfall or part thereof on a pro-rata basis.

6. The pro rata basis of apportioning a tax shortfall where there are multiple debit adjustments to tax payable is considered to be the most practical methods for apportioning a tax shortfall given the number of permutations that can arise. For example, some adjustments may attract penalty, while others may not. Adjustments could attract penalties at different rates. Some adjustments may be subject to further penalty tax under section 226X, while others could attract reduced penalty tax under sections 226Z and 226ZA. While other methods for apportioning a tax shortfall may be possible, they were considered to need more complex calculations where some of the permutations mentioned are present. For this reason, the pro rata method of apportionment was preferred.

7. The examples below are assumed to be in respect of assessments for the 1992-93 year of income for a resident individual taxpayer. The principles illustrated apply equally to the calculation of penalty under the shortfall sections for other categories of taxpayers.

8. Other rulings dealing with the imposition of additional tax are:

- TR 94/2 Transitional arrangements for 1992-93 substituted accounting periods;
- TR 94/4 Reasonable care, recklessness and intentional disregard;
- TR 94/5 Reasonably arguable;
- TR 94/6 Voluntary disclosures; and

- TR 94/7 Exercise of the Commissioner's discretion to remit penalty.

## Date of effect

9. This Ruling sets out the current practice of the Australian Taxation Office and is not concerned with a change in interpretation. Consequently, it applies from the date on which the shortfall sections commenced to operate.

## Examples

10. The examples below are based on combinations of the following income/rebate/credit adjustments, except for Example F which deals with a taxpayer in a loss situation. The abbreviations listed below are also used in the following examples:

| | | |
|---|---|---|
| TAXABLE INCOME AS RETURNED / ASSESSED (i.e. the Statement Tax) | (TIAR/A) | 35,000 |
| INCOME UNDERSTATED No. 1 (caused by recklessness - penalty 50%) | (IU No.1) | 1,000 |
| INCOME UNDERSTATED No. 2 (caused by lack of reasonable care - penalty 25%) | (IU No.2) | 2,000 |
| INCOME UNDERSTATED No. 3 (not culpable - no penalty) | (IU No.3) | 500 |
| INCOME OVERSTATED (OVERSTATEMENT OF INCOME UNRELATED TO THE UNDERSTATEMENTS) | (IO) | (300) |
| REBATE/CREDIT OVERSTATED No. 1 (caused by recklessness - penalty 50%) | (R/CO No.1) | 500 |
| REBATE/CREDIT OVERSTATED No. 2 (caused by lack of reasonable care - penalty 25%) | (R/CO No.2) | 1,000 |
| REBATE/CREDIT UNDERSTATED (UNDERSTATED REBATE/CREDIT UNRELATED TO OTHER REBATE/CREDIT MISSTATEMENTS) | (R/CU) | (400) |

**NOTES:**

- for the purpose of calculating tax shortfalls in the following examples, the medicare levy is calculated at 1.25%, not 1.4% which applies from 1 July 1993;
- "credits" for penalty purposes are foreign tax credits under Divisions 18, 18A and 18B of Part III of the ITAA, and offsets of franking deficit tax;
- for the purpose of calculating tax shortfalls in the following examples, 1992-93 resident individual rates of tax have been used;
- for the purpose of calculating interest in the following examples, the tax is assumed to have been avoided for a period of one year, and the rate of interest for the purpose of section 170AA of the ITAA is assumed to be 9.6% for that whole year.

**EXAMPLE A:**

**INCOME INCREASE**

| | | |
|---|---|---|
| TAXABLE INCOME AS RETURNED / ASSESSED | (TIAR/A) | 35,000 |
| INCOME UNDERSTATEMENT No. 1 (penalty 50%) | (IU No.1) | 1,000 |
| INCOME UNDERSTATEMENT No. 2 (penalty 25%) | (IU No.2) | 2,000 |
| INCOME UNDERSTATEMENT No. 3 (no penalty 0%) | (IU No.3) | 500 |
| INCOME OVERSTATED (UNRELATED OVERSTATEMENTS) | (IO) | (300) |

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| | | | |
|---|---|---|---|
| TIAR/A | | | 35,000 |
| Less IO | | | 300 |
| | | | 34,700 |
| Plus Net Debit Adjustment | | | |
| IU No.1 | 1,000 | | |
| IU No.2 | 2,000 | | |
| IU No.3 | 500 | | |
| | 3,500 | | 3,500 |
| Amended Taxable Income (ATI) | | | 38,200 |

**Tax Shortfall**

| | | |
|---|---|---|
| Tax on ATI of $38,200 | 9,886 | (i.e. Proper Tax) |
| Less | | |
| Tax on TIAR/A of $35,000 | 8,494 | (i.e. Statement Tax) |
| Plus | | |
| Medicare Levy Adjustment | 40 | ( [38,200 - 35,000] x 1.25% ) |
| Tax Shortfall | 1,432 | |

**Allocation of Tax Shortfall to Income Misstatements**

| IU No.1 | IU No.2 | IU No.3 |
|---|---|---|
| 1,000 x 1,432 | 2,000 x 1,432 | 500 x 1,432 |
| 3,500 | 3,500 | 3,500 |
| = 409.14 | = 818.28 | =204.57 |

**Penalties**

| IU No.1 | IU No.2 | IU No.3 |
|---|---|---|
| 50% flat | 25% flat | no penalty |
| 409.14 x 50% | 818.28 x 25% | |
| = 204.57 | = 204.57 | |

Total Penalties = 204.57 + 204.57 = $409.14

**Interest**

1432 x 9.6% = $137.47 (deductible)

**EXAMPLE B:**

**REBATE/CREDIT REDUCTION**

| | | |
|---|---|---|
| TAXABLE INCOME AS RETURNED / ASSESSED | (TIAR/A) | 35,000 |
| REBATE/CREDIT OVERSTATED No. 1 (penalty 50%) | (R/CO No.1) | 500 |
| REBATE/CREDIT OVERSTATED No. 2 (penalty 25%) | (R/CO No.2) | 1,000 |
| REBATE/CREDIT UNDERSTATED (UNRELATED UNDERSTATED REBATE) | (R/CU) | (400) |

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| | |
|---|---|
| TIAR/A | 35,000 |
| Amended Taxable Income (ATI) | 35,000 |

**Tax Shortfall**

| | | |
|---|---|---|
| Tax on ATI of $35,000 | | 8,494 |
| Less | Tax on TIAR/A of $35,000 | 8,494 |
| | | 0 |
| Plus | R/CO No.1 | 500 |
| | R/CO No.2 | 1,000 |
| | | 1,500 |
| Less | R/CU | 400 |
| Tax Shortfall | | 1,100 |

**Allocation of Tax Shortfall to Rebate/Credit Misstatements**

| R/CO No.1 | R/CO No.2 |
|---|---|
| 500 x 1,100 | 1,000 x 1,100 |
| 1,500 | 1,500 |
| = 366.66 | = 733.33 |

**Penalties**

| R/CO No.1 | R/CO No.2 |
|---|---|
| 50% flat | 25% flat |
| 366.66 x 50% | 733.33 x 25% |
| = 183.33 | = 183.33 |

Total Penalties = 183.33 + 183.33 = $366.66

**Interest**

1,100 x 9.6% = $105.60 (deductible)

**EXAMPLE C**

**INCOME INCREASE, REBATE/CREDIT INCREASE**

| | | |
|---|---|---|
| TAXABLE INCOME AS RETURNED / ASSESSED | (TIAR/A) | 35,000 |
| INCOME UNDERSTATED No. 1 (penalty 50%) | (IU No.1) | 1,000 |
| INCOME UNDERSTATED No. 2 (penalty 25%) | (IU No.2) | 2,000 |
| INCOME UNDERSTATED No. 3 (no penalty) | (IU No.3) | 500 |
| INCOME OVERSTATED No. 4 (UNRELATED OVERSTATEMENT) | (IO) | (300) |
| REBATE/CREDIT UNDERSTATED (UNRELATED UNDERSTATED REBATE) | (R/CU) | (400) |

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| | | | |
|---|---|---|---|
| TIAR/A | | | 35,000 |
| Less IO | | | 300 |
| | | | 34,700 |
| Plus Net debit adjustment | | | |
| | IU No.1 | 1,000 | |
| | IU No.2 | 2,000 | |
| | IU No.3 | 500 | |
| | | 3,500 | 3,500 |
| Amended Taxable Income (ATI) | | | 38,200 |

**Tax Shortfall**

| | | |
|---|---|---|
| Tax on ATI of $38,200 | | 9,886 |
| Less | Tax on TIAR/A of $35,000 | 8,494 |
| | | 1,392 |
| Plus | Medicare Levy Adjustment | 40 |
| Less | Unrelated Rebate (R/CU) | (400) |
| Tax Shortfall | | 1,032 |

**Allocation of Tax Shortfall to Income Misstatements**

| IU No.1 | IU No.2 | IU No.3 |
|---|---|---|
| 1,000 x 1,032 | 2,000 x 1,032 | 500 x 1,032 |
| 3,500 | 3,500 | 3,500 |
| = 294.85 | = 589.71 | = 147.42 |

**Penalties**

| U No.1 | IU No.2 | IU No.3 |
|---|---|---|
| 50% flat | 25% flat | no penalty |
| 294.85 x 50% | 589.71 x 25% | |
| = 147.42 | = 147.42 | |

Total Penalties = 147.42 + 147.42 = $294.84

**Interest**
1,032 x 9.6% = $99.07 (deductible)

**EXAMPLE D**

**INCOME INCREASE, REBATE/CREDIT REDUCTION**

| | | |
|---|---|---|
| TAXABLE INCOME AS RETURNED / ASSESSED | (TIAR/A) | 35,000 |
| INCOME UNDERSTATED No. 1 (penalty 50%) | (IU NO.1) | 1,000 |
| INCOME UNDERSTATED No. 2 (penalty 25%) | (IU No.2) | 2,000 |
| INCOME UNDERSTATED No. 3 ( no penalty) | (IU No.3) | 500 |
| INCOME OVERSTATED (UNRELATED OVERSTATEMENT) | (IO) | (300) |
| REBATE/CREDIT OVERSTATED No. 1 (penalty 50%) | (R/CO No.1) | 500 |
| REBATE/CREDIT OVERSTATED No. 2 (penalty 25%) | (R/CO No.2) | 1,000 |
| REBATE/CREDIT UNDERSTATED (UNRELATED UNDERSTATED REBATE) | (R/CU) | (400) |

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| | | |
|---|---|---|
| TIAR/A | | 35,000 |
| Less OI | | 300 |
| | | 34,700 |
| Plus Net debit adjustment | | |
| IU No.1 | 1,000 | |
| IU No.2 | 2,000 | |
| IU No.3 | 500 | |
| | 3,500 | 3,500 |
| Amended Taxable Income (ATI) | | 38,200 |

**Tax Shortfall**

| | |
|---|---|
| Tax on ATI of $38,200 | 9,886 |
| Less | |
| Tax on TIAR/A of $35,000 | 8,494 |
| | 1,392 |
| Plus | |
| Medicare Levy Adjustment | 40 |
| | 1,432 |
| Plus | |
| R/CO No.1 | 500 |
| R/CO No. 2 | 1,000 |
| R/CU | (400) |
| | 1,100 |
| Tax Shortfall | 2,532 |

**Allocation of Tax Shortfall to Income and Rebate/Credit Misstatements**

| IU No.1 | IU No.2 | IU No.3 |
|---|---|---|
| 1,000 x 1,432 | 2,000 x 1,432 | 500 x 1,432 |
| 3,500 | 3,500 | 3,500 |
| = 409.14 | = 818.28 | = 204.57 |

| R/CO No.1 | R/CO No.2 |
|---|---|
| 500 x 1,100 | 1,000 x 1,100 |
| 1,500 | 1,500 |
| = 366.66 | = 733.33 |

**Penalties**

| IU No.1 | IU No.2 | IU No.3 |
|---|---|---|
| 50% flat | 25% flat | no penalty |
| 409.14 x 50% | 818.28 x 25% | |
| = 204.57 | = 204.57 | |

| R/CO No.1 | R/CO No.2 |
|---|---|
| 50% flat | 25% flat |
| 366.66 x 50% | 733.33 x 25% |
| = 183.33 | = 183.33 |

Total Penalties = 204.57 + 204.57 + 183.33 + 183.33 = $775.80

**Interest**

2532 x 9.6% = $243.07 (deductible)

**EXAMPLE E**

**INCOME REDUCTION, REBATE/CREDIT REDUCTION**

| | | |
|---|---|---|
| TAXABLE INCOME AS RETURNED / ASSESSED | (TIAR/A) | 35,000 |
| INCOME OVERSTATED | (IO) | (300) |
| REBATE/CREDIT OVERSTATED No. 1 (penalty 50%) | (R/CO No.1) | 500 |
| REBATE/CREDIT OVERSTATED No. 2 (penalty 25%) | (R/CO No.2) | 1,000 |
| REBATE/CREDIT UNDERSTATEMENT (UNRELATED UNDERSTATED REBATE) | (R/CU) | (400) |

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| | |
|---|---|
| TIAR/A | 35,000 |
| Less IO | 300 |
| Amended Taxable Income (ATI) | 34,700 |

**Tax Shortfall**

| | | |
|---|---|---|
| Tax on ATI of $34,700 | | 8,380 |
| Less Tax on TIAR/A of $35,000 | | 8,494 |
| | | (114) |
| Less Medicare Levy Adjustment | | (3.75) |
| | | (117.75) |
| Plus R/CO No.1 | 500 | |
| R/CO No.2 | 1,000 | |
| | 1,500 | 1,500.00 |
| | | 1,382.25 |
| Less R/C U | | 400.00 |
| Tax Shortfall | | 982.25 |

**Allocation of Tax Shortfall to Rebate/Credit Misstatements**

| R/CO No.1 | R/CO No.2 |
|---|---|
| 500 x 982.25 | 1,000 x 982.25 |
| 1,500 | 1,500 |
| = 327.41 | = 654.83 |

**Penalties**

| R/CO No.1 | R/CO No.2 |
|---|---|
| 50% flat | 25% flat |
| 327.41 x 50% | 654.83 x 25% |
| = 163.70 | = 163.70 |

Total Penalties = 163.70 + 163.70 = $327.40

**Interest**

982.25 x 9.6% = $94.29 (deductible)

**EXAMPLE F**

**INCOME INCREASE (IN A LOSS SITUATION)**

| | | |
|---|---|---|
| TAXABLE INCOME AS RETURNED / ASSESSED | (TIAR/A) | (15,000) |
| INCOME UNDERSTATEMENT No. 1 (penalty 50%) | (IU No.1) | 10,000 |
| INCOME UNDERSTATEMENT No. 2 (penalty 25%) | (IU No.2) | 18,000 |
| INCOME UNDERSTATEMENT No. 3 (no penalty) | (IU No.3) | 1,500 |
| INCOME OVERSTATED (UNRELATED OVERSTATEMENTS) | (IO) | (300) |

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| | | |
|---|---|---|
| TIAR/A | | (15,000) |
| Add IO | | ( 300) |
| | | (15,300) |
| Plus Net Debit Adjustment | | |
| IU No.1 | 10,000 | |
| IU No.2 | 18,000 | |
| IU No.3 | 1,500 | |
| | | 29,500 |
| Amended Taxable Income (ATI) | | 14,200 |

**Tax Shortfall**

| | | |
|---|---|---|
| Tax on ATI of $14,200 | 1,760 | |
| Less | | |
| Tax on TIAR/A of $(15,000) | NIL | |
| Plus | | |
| Medicare Levy Adjustment | 177.50 | ( 14,200 x 1.25% ) |
| Tax Shortfall | 1,937.50 | |

**Allocation of Tax Shortfall to Income Misstatements**

| IU No.1 | IU No.2 | IU No.3 |
|---|---|---|
| 10,000 x 1,937.50 | 18,000 x 1,937.50 | 1,500 x1 ,937.50 |
| 29,500 | 29,500 | 29,500 |
| = 656.78 | = 1,182.20 | = 98.52 |

**Penalties**

| IU No.1 | IU No.2 | IU No.3 |
|---|---|---|
| 50% flat | 25% flat | no penalty |
| 656.78 x 50% | 1,182.20 x 25% | |
| = 328.39 | = 295.55 | |

Total Penalties = 328.39 + 295.55 = $623.94

**Interest**

1,937.50 x 9.6% = $186.00 (deductible)

**Commissioner of Taxation**

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