# *TR 93/D21 - Income tax: tax shortfall penalties: reasonably argued*

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This document has been finalised by TR 94/5.

# Draft Taxation Ruling
Income tax: tax shortfall penalties: reasonably arguable

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## What this Ruling is about

1. This Ruling provides guidelines for officers involved in the imposition of additional tax under section 226K (relating to tax shortfalls) and section 160ARZD (relating to franking tax shortfalls) of the *Income Tax Assessment Act 1936* (ITAA). While the Ruling is expressed in terms of tax shortfalls, similar considerations would apply where penalty was attracted under section 160ARZD in respect of a franking tax shortfall.

## Legislative framework

2. Where a taxpayer has a tax shortfall for a year of income the taxpayer will be liable to pay additional tax if:

- the shortfall or a part of it was caused by the taxpayer, in a taxation statement, treating an income tax law as applying in relation to a matter or identical matters in a particular way;
- the shortfall or part so caused exceeded the greater of $10,000 or 1% of the taxpayer's return tax for the year; and
- when the statement was made, it was not reasonably arguable that the way in which the application of the law was treated was correct.

The penalty payable is 25% of the tax shortfall or part caused by the treatment (section 226K).

3. A tax shortfall is defined in section 222A to mean, in broad terms, 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. (A franking tax shortfall is defined in section 160ARXA).

4. A taxation statement is also defined in section 222A (160ARXA), and for most practical purposes means the statements made by a taxpayer in his or her return. Return tax is the tax that would be payable on the basis of the taxpayer's return for the year (section 222A and subsection 160ARZD(5)).

5. Section 222C provides that the correctness of the treatment of the application of a law is reasonably arguable if, having regard to the relevant authorities and 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. Section 222C also provides a non-exhaustive list of the authorities that may be taken into account in determining whether the treatment of a matter is reasonably arguably correct.

## Ruling

6. The explanatory memorandum to the *Taxation Laws Amendment (Self Assessment) Act 1992*, at pages 83 to 87, should be used as a general guide for administering sections 226K and 160ARZD. The following points expand on the matters covered by the explanatory memorandum:

(a) the reasonably arguable test does not require that the treatment given a particular matter by a taxpayer must be the better view, or be more likely than not the correct treatment. The test is "about as likely as not". This requires that the prospects that the taxpayer's treatment will be upheld by a court as being the correct treatment must be substantial, whether or not those prospects are less than or greater than 50 per cent;

(b) the list of authorities in subsection 222C(4) is not exhaustive. In broad terms, the authorities that may be taken into account for the purpose of determining whether the treatment of a matter is reasonably arguable are those that would be accepted by a court as bearing upon the correct treatment of a matter. Authorities could include, for example, authoritative statements in reputable texts about how the law operates, particularly in cases where there are few authorities on the correct treatment of a matter apart from the law itself. The relative weight to be given to each authority would depend on the circumstances;

(c) while a Public Ruling issued by the Commissioner under Part IVAAA of the Taxation Administration Act is an authority (subsection 222C(4)), the mere fact that a Public Ruling has issued does not mean that alternative treatments to that suggested by the Public Ruling cannot be reasonably arguable. For example, a taxpayer's treatment could be reasonably

arguable if there was a line of court decisions (which had not been overturned by any subsequent decisions) that supported the taxpayer's treatment as opposed to the treatment suggested by the Commissioner. Whether the taxpayer's treatment was reasonably arguable would depend on its relative strength when compared with the Commissioner's and other possible treatments. In other words, taxpayers should take particular note of the Commissioner's views on the correct operation of the law as expressed in a Public Ruling, but may adopt alternative treatments provided there are sound reasons for doing so;

(d) the reasonably arguable test only applies to tax shortfalls caused by a taxpayer treating an income tax law as applying in a particular way. A taxpayer treats an income tax law as applying in a particular way where the taxpayer concludes that, on the basis of the facts and the way the law applies to those facts, a particular consequence follows (for example, an amount of expenditure incurred is deductible). Subject to the other preconditions of section 226K, the reasonably arguable test is designed to encourage taxpayers to ensure that the conclusions they reach are sound ones.

However, in some cases, a taxpayer's conclusions on a particular matter may have been based on incorrect primary facts which the taxpayer did not know and could not reasonably be expected to have known were not the proper facts, such as where a taxpayer relies on a bank to provide details of the amount of interest earned on a deposit. In other cases, the statements in a taxpayer's return may not represent conclusions of the taxpayer, but might reflect errors in calculation or transposition errors. As a broad rule, where a tax shortfall was caused by an error of fact or calculation section 226K will not apply since the taxpayer will not have treated an income tax law as applying in relation to a matter in a particular way. In this context, errors of fact are errors of primary fact and not wrong conclusions of fact which a taxpayer may make which bear on the correct application of a tax law, such as whether the taxpayer is carrying on a business.

Whether the statements in a taxpayer's return represent conclusions of the taxpayer or were caused by errors of fact or calculation should be determined on the basis of all the available evidence;

(e) identical matters are treated as a single matter for the purposes of section 226K (paragraph 226K(b)). This rule is designed to prevent single matters being split into smaller components to avoid the operation of the section. It should not be used to treat as a single matter numerous similar but distinct items of

adjustment. For example, in the case of repairs to similar but distinct items of plant, the application of the law to each repair will turn on the particular facts, so that each repair would need to be considered separately to determine the correct tax payable. On the other hand, in the case of lease payments made in respect of a single item of plant, the same considerations would ordinarily be relevant to the treatment of each lease payment, so that the sum of the lease payments for the year would be treated as a single matter in relation to which the correct application of the law needed to be determined;

(f) the words "another matter" and "the other matter" used in subsection 222C(1) refer to the operation of the reasonably arguable test as it applies in sections 224, 225 and 226 and do not affect its operation in respect of section 226K;

(g) where the application of section 226K (and 160ARZD) results in an unduly harsh outcome in all the circumstances of the case then the penalty otherwise attracted may be remitted in whole or in part (see Draft Ruling TR 93/D23).

## Date of effect

7. This Ruling (that is, the final Taxation Ruling based on this Draft Taxation 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 sections 226K and 160ARZD commenced to operate.

**Commissioner of Taxation**

22 April 1993

ISSN 1039 - 0731

ATO references
NO 93/2071-7
BO

Not previously released to the public
in draft form

Price $0.40

FOI index detail
*reference number*

*subject references*
- additional tax
- reasonably arguable
- self assessment
- tax shortfall penalties

*legislative references*
- ITAA 222C; ITAA 226K;
  ITAA 227(3)