TR 94/4 - Income tax: tax shortfall penalties: reasonable care, recklessness and intentional disregard

This cover sheet is provided for information only. It does not form part of *TR 94/4 - Income tax: tax shortfall penalties: reasonable care, recklessness and intentional disregard*

This document has changed over time. This is a consolidated version of the ruling which was published on *6 January 1994*

Generated on: 20 November 2026, 03:48:19 AM

Australian Taxation Office

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

other Rulings on this topic

IT 2517; IT 2565; TR 92/10

contents	para
What this Ruling is about	**1**
Legislative framework	**4**
Ruling	**6**
Date of effect	**11**
Explanations	**13**
Reasonable care	13
Recklessness	15
Intentional disregard	20
Review rights	25
Examples	**28**

*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.*

What this Ruling is about

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

2. The Ruling is expressed in terms of tax shortfall penalties. However, as the provisions relating to franking tax shortfall penalties are substantially the same as those relating to tax shortfall penalties, the guidelines provided by this Ruling apply, subject to the necessary changes, to cases where the franking tax shortfall penalties are in question. The relevant franking tax shortfall penalty provisions are noted in brackets where appropriate. This Ruling does not attempt to deal with cases of tax avoidance and profit shifting, which will be dealt with in subsequent rulings.

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

Legislative framework

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

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

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

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

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

Ruling

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

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

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

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

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

10. Other Rulings dealing with the imposition of additional tax are -

- TR 94/2 Transitional arrangements for 1992-93 substituted accounting periods;
- TR 94/3 Calculation of the tax and allocation of additional tax;
- 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

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

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

Explanations

Reasonable care

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

exercise in the circumstances of the taxpayer to fulfil the taxpayer's tax obligations.

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

(a) while the size of a tax shortfall is determined on the basis of statements made by a taxpayer, penalty is attracted for a lack of reasonable care on the part of the taxpayer or a registered tax agent. While a lack of reasonable care may result in making (or failing to make) a statement, it may equally result in an act or omission which lies behind the making of a statement (e.g. a failure to keep adequate records);

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

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

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

(e) a failure to maintain adequate records of income and expenditure will be a major reason for finding that a taxpayer has failed to take reasonable care. But this does not mean that a penalty is attracted every time an error is made in the taxpayer's books that leads to a tax shortfall, provided the taxpayer can show that its procedures are reasonably designed to prevent such errors from occurring. What is reasonable will depend, among other things, on the nature and size of the business, but could include, for example, frequency of internal audits, sample checks of claims made, adequate training of accounting staff and instruction manuals for staff;

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

(g) Where a taxpayer is uncertain about the correct tax treatment of an item, the taxpayer may apply for a Private Ruling. A taxpayer who applies for and receives a Private Ruling on an arrangement is required to follow the ruling when determining taxable income for assessment purposes. If the taxpayer does not follow the ruling and as a result there is a tax shortfall, the taxpayer will be liable to pay a penalty of 25% of the shortfall (see section 226M).

This penalty does not apply if there has been a decision of the AAT or of a court that applies to the Private Ruling. In such a case the taxpayer would be expected to follow the decision of the AAT or court when determining taxable income of the return to be lodged, even if the taxpayer has appealed against the decision. Failure to self assess in accordance with the decision of the AAT or court at the time of lodgement of a tax return would ordinarily amount to a failure to take reasonable care.

Where a taxpayer seeks a Private Ruling after lodging the relevant tax return, this penalty does not apply. If the Commissioner rules against the taxpayer, the Commissioner will amend the taxpayer's assessment to give effect to the ruling. An 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 the shortfall.

(h) Where a Public Ruling is available on a particular matter, a taxpayer would generally be expected to follow it. However, taking a contrary position to a Public Ruling does not necessarily mean that the taxpayer would fail the reasonable care test for that reason alone. Where a taxpayer has taken a position contrary to a Public Ruling, it would be necessary for the taxpayer to consider the arguments raised in the Public Ruling and be able to demonstrate that the Public Ruling does not apply to his/her particular circumstances in order to satisfy the reasonable care test. In addition, the reasonable care test will be taken to have been satisfied where a taxpayer did not know and could not reasonably be expected to have known that the Public Ruling existed, for example, where a taxpayer lodged a tax return at about the same time a Public Ruling issued that modified Tax Pack and materially affected the taxpayer's return.

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

However, as a matter of practice, this would be a highly unusual case and it would be even more unusual that this would be the only factor influencing any decision about the imposition of penalty. If the correctness of a taxpayer's treatment of a matter is reasonably arguable, it may be

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

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

(k) a taxpayer does not satisfy his or her obligation to take reasonable care simply by using the services of a tax agent or other tax adviser. It would remain the taxpayer's responsibility, for example, to properly record matters relating to his or her tax affairs during the year, and to draw all the relevant facts to the attention of the agent or adviser, in order to satisfy the reasonable care test. In addition, a taxpayer would be expected to honestly answer any questions asked by the agent in respect of the preparation of the tax return;

(l) arithmetic errors may indicate a failure to exercise reasonable care, but each case will turn on the

circumstances, including the size, nature and frequency of the error. As a general proposition, most taxpayers could be reasonably expected to be able to accurately add up a column of figures. Where a taxpayer relies upon figures in a tax return that are provided by staff in another locality, whether the taxpayer has exercised reasonable care is dependent upon the adequacy of systems, controls, training, etc that are in place to ensure that the figures provided by the other party can be relied on. For example, where a company has its headquarters in a city CBD and operating facilities located in various other areas, a miscalculation by one of the operating facilities which caused an error in the tax return of the headquarters could be a failure to exercise reasonable care on the part of the headquarters;

(m) substantiation cases should be treated on the same footing as other cases where there is a tax shortfall. Accordingly, a taxpayer who has a tax shortfall and who acted carelessly in not meeting the substantiation requirements (that is, the taxpayer could be reasonably expected to have known of the substantiation requirements yet carelessly failed to meet them) would attract a 25% penalty. It may be noted that if, on the facts of the case, relief from the application of the substantiation provisions would not be provided to the taxpayer under section 82KZAA, the taxpayer would also generally be found to have not taken reasonable care to comply with those provisions. Accordingly, Ruling IT 2565 is withdrawn and the above principles should also be applied in exercising the discretion to remit additional tax imposed under section 223A in respect of income tax returns for 1992-93 and subsequent years.

(n) Where a taxpayer accepts the interpretation of the law as it applies to the particular circumstances of the taxpayer as a result of the settlement of an audit and the taxpayer fails, without good reason, to reflect this position in the tax return(s) following the settlement, the taxpayer would be considered not to have exercised reasonable care. This would be the case where, as part of the settlement agreement, it is accepted that the law will apply to future transactions of a similar nature but would not apply in the case of a general or 'in globo' settlement where a future basis of assessment is not agreed upon.

Recklessness

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

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

17. A person would be acting recklessly if:

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

(b) a reasonable person who, having regard to the particular circumstances of the person, knew or ought to have known the facts and circumstances surrounding the act would have or ought to have been able to foresee the probable consequences of the act;

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

(d) when the person did the act, he or she either was indifferent to the possibility of there being any such risk, or recognised that there was such risk involved and had, nonetheless, gone on to do it. That is, the person's conduct clearly shows disregard of, or indifference to, consequences foreseeable by a reasonable person.

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

19. Examples of how the term recklessness may apply in a tax context are given below (see Examples 4(b), 6(b) and 9).

Intentional disregard

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

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

22. In a tax context, penalty is attracted if a taxpayer intentionally disregards the ITAA or the regulations. Whether a taxpayer's disregard of the ITAA or regulations is intentional may be determined on the basis of direct evidence of the taxpayer's intention, but will more likely need to be inferred from the surrounding circumstances and conduct of the taxpayer. A taxpayer who does not include in his or her assessable income an amount of interest income may be suspected of having done so intentionally, but in the absence of an admission from the taxpayer that the omission was deliberate or conduct which might imply deliberate evasion, it would be difficult to judge that the taxpayer had intentionally excluded the amount from assessable income resulting in a 75% penalty being payable. On the other hand, if the interest omitted was from a bank account which the taxpayer had opened in a false name, this would be a circumstance which would infer that the taxpayer had acted intentionally.

23. It may be noted that for a taxpayer to intentionally disregard the ITAA or the regulations requires the taxpayer to know what the obligations under the ITAA or regulations are, and to choose to disregard them. Where, for example, the assessability of a particular amount is unclear, and a taxpayer chooses not to return the amount, the taxpayer would not have "disregarded" the ITAA, but would have taken a view of its effect which differs from the Commissioner's view. Provided that view was honestly held, and was not frivolous or unfounded, penalty for intentional disregard would not apply**.** The taxpayer may, of course, still be liable for penalty for lack of reasonable care or recklessness.

24. A taxpayer who requests a Private Ruling about how the tax laws apply to his/her own particular affairs and receives an

unfavourable ruling would not normally be liable to penalty for intentional disregard if the taxpayer fails to assess on the basis of the Private Ruling. Section 226J refers to intentional disregard of the ITAA or the regulations. Nothing in the ITAA or the regulations makes a Private Ruling the law. A Private Ruling is the Commissioner's interpretation of the law. It follows that a failure to assess on the basis of a Private Ruling would not, of itself, bring section 226J into operation where the taxpayer honestly holds an alternative view. Indeed, a Private Ruling would normally be sought because of the uncertainty in the way the law may operate in respect of the taxpayer's circumstances. A penalty under section 226M for recklessness may still apply. However, where a taxpayer requests a Private Ruling on a matter where the law is clearly established, for example, the non-allowance of child minding expenses in a case without special circumstances, and receives an unfavourable ruling, failure to assess on the basis of the Private Ruling may constitute intentional disregard of the ITAA. This is because the law which formed the basis of the Ruling is clear. Failure to assess in accordance with well established principles of tax law could constitute intentional disregard of the ITAA and the regulations. In any event, where a taxpayer does not accept the Commissioner's interpretation of the legislation, the taxpayer is able to object against the Private Ruling. For further examples of when the intentional disregard penalty may apply see examples 6(c), 10, 12 and 13 below.

Review rights

25. Whether a taxpayer has failed to exercise reasonable care or has acted recklessly or with intentional disregard are questions of law. Taxpayers have the right to object against a decision of the Commissioner that these penalty standards have been breached and to have the Commissioner's decision on the objection reviewed by the AAT or the Federal Court.

26. In making a determination as to whether a taxpayer has acted with reasonable care or has acted recklessly or with intentional disregard, the Commissioner will not be exercising a discretion. This is a significant change from the former penalty system. Under the former penalty system no review was available by the AAT if, in broad terms, penalty was imposed at a rate of 20% per annum or less. This restriction does not apply in respect of the new penalties. Also, while the AAT was able to step into the shoes of the Commissioner and examine the merits of the Commissioner's decision to remit the statutory 200% penalty, a court was restricted to reviewing whether the Commissioner had exercised the discretion to remit according to law. The circumstances in which the Commissioner will exercise the

power to remit penalties must be exceptional and are dealt with in Ruling TR 94/7.

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

Examples

28. The following examples are intended to provide an indication of how the reasonable care, recklessness and intentional disregard standards are seen as operating in practice. They are examples only and the conclusions are based on the information contained in each example. Notwithstanding that officers may be faced with cases that exhibit similar features, each case should be dealt with on an individual basis having regard to the particular circumstances. Where possible, officers should give taxpayers the opportunity to bring to attention any facts that may be relevant to the assessment of penalty.

Omission of Interest Income

Example 1(a)

Facts

29. The taxpayer, an aged pensioner without any commercial training or experience, invested monies in savings accounts and term deposits with a number of banks, a finance company and four different building societies. All the interest derived from these institutions was returned, with the exception of a single amount of interest derived from a building society. The amount of interest in question and the date on which it had been paid had been correctly recorded in the taxpayer's passbook but the transaction code used to record the payment of interest inaccurately described the payment. All other payments of interest made by the building society in the current and previous years had been identified with codes which more accurately described the nature of the payment, and had been correctly returned by the taxpayer. The taxpayer had carefully gone through bank statements and passbooks and extracted those amounts marked as interest. The amount omitted was not significant compared with the total amount of interest returned.

Penalty

30. The taxpayer had exercised reasonable care in gathering together the relevant records and information, examining those records and completing the return form. A reasonable person in the taxpayer's circumstances would not have foreseen that reliance upon the coded passbook would have resulted in a tax shortfall. In addition, the taxpayer's advanced age, lack of experience in financial matters, previous record of compliance and the small amount involved are all factors that need to be considered. While no single factor is conclusive, given all the circumstances the taxpayer's failure to return the interest was not unreasonable. Penalty is not attracted.

Example 1(b)

Facts

31. The taxpayer, an aged pensioner without any commercial training or experience, inherited monies in savings accounts, investment accounts and term deposits with a number of banks, finance companies and building societies. The monies were inherited from a relative experienced in financial matters and who had spread investments across a wide range of financial institutions. The taxpayer had not lodged a tax return for several years as his/her only income was from the aged pension. When preparing the first tax return since having received the inheritance, the taxpayer overlooked an amount of interest. The interest related to an account that had been closed during the income year and to which a small amount of interest had been credited when the account was closed. The taxpayer had otherwise carefully returned all other amounts of interest received, and had no previous record of tax shortfalls, that is, an honest mistake had been made.

Penalty

32. The taxpayer had exercised reasonable care. The minor nature of the oversight does not detract from the generally careful approach adopted by the taxpayer. In addition, the investments inherited from the relative were complex and diverse; a situation that the taxpayer had little experience with in the past. Penalty is not attracted.

Example 1(c)

Facts

33. The taxpayer, a computer specialist in a large company, had interest bearing accounts with several different financial institutions which were used for various purposes. The taxpayer had held these accounts for several years and interest was credited regularly either

two or four times a year, depending on the account. In preparing the tax return, the taxpayer overlooked a quarterly amount of interest earned in one of the accounts as it had not been clearly recorded in the relevant passbook (which was manually operated). The taxpayer had otherwise carefully returned all other amounts of interest received and had no previous record of tax shortfalls. In addition, at the time the tax return had been prepared, the taxpayer was heavily involved in installing a new computer system and had not been able to give as much attention to the preparation of the return as was usually the case. The taxpayer was able to support this claim with evidence provided by his/her employer.

Penalty

34. While the ATO expects that taxpayers should give the preparation of tax returns their full attention and make every endeavour to prepare an accurate tax return, in this case the taxpayer's circumstances were unusual. In addition, the quantum was small in relation to the overall income from interest and the taxpayer had no previous record of tax shortfalls. Given all the circumstances, the taxpayer had exercised reasonable care. While the taxpayer was well acquainted with the operation of the accounts, the minor nature of the oversight does not detract from the generally careful approach adopted by the taxpayer. Penalty is not attracted. However, this is a borderline case. Each case needs to be considered on its merits as to whether it was reasonable for a taxpayer to rely on codings provided by a financial institution to record a credit for interest earned. Whether a taxpayer has or has not exercised reasonable care would depend on such factors as the amount of the interest omitted in relation to the total interest received, the regularity with which interest is credited throughout the year, the amount of time the taxpayer operated the account and the familiarity of the taxpayer with the type of account being operated.

Example 1(d)

Facts

35. Same as in 1(c) above except that the taxpayer sought the services of a tax agent to prepare the return. When preparing the return, the tax agent had relied entirely upon the codings for interest as recorded by the financial institutions when calculating the taxpayer's assessable income. No other checks or further consideration was given to the matter by the tax agent.

Penalty

36. The standard of care required by a tax agent is higher than that expected of an ordinary taxpayer due to the knowledge, education, skill and experience of the agent obtained from continual exposure to the operation of the financial system and similar transactions in numerous clients. When examining a taxpayer's affairs, a tax agent would be expected to apply this experience to the taxpayer's situation and to ask the questions necessary to correctly prepare the client's return. In this situation the tax agent should have been aware that the passbook should have contained four entries for interest during the financial year. In some cases, the amount of interest earned on the account may be excessively low in comparison to the average balance of funds held in the account. The agent's failure to further investigate the absence of an interest credit is considered a failure to exercise reasonable care. Penalty is attracted at the rate of 25%.

Example 1(e)

Facts

37. The taxpayer, a middle aged public servant, had only one interest bearing account to which interest was credited twice a year. The taxpayer had operated this account over a period of several years. The building society had incorrectly coded one of the interest credits and the amount represented about half of the taxpayer's total interest income for the year.

Penalty

38. The amount of interest omitted is significant when compared to the total amount of interest earned by the taxpayer for the year. Although the taxpayer had relied upon the codings provided by the building society, a reasonable person in this situation would have realised that there was only one amount of interest credited to the account for the year when the taxpayer was aware, from past experience, that interest was credited twice a year. In addition, the amount of interest credited to the account was low in relation to the average balance of funds held in the account. The taxpayer had not exercised reasonable care in preparing the tax return. Penalty tax of 25% is attracted.

Example 1(f)

Facts

39. The taxpayer had only two interest bearing accounts in which all entries of interest had been correctly coded. The taxpayer overlooked the interest earned on one of the accounts, which amounted to about half of the taxpayer's total interest income.

Penalty

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

Example 1(g)

Facts

41. The taxpayer emigrated to Australia just after the end of World War II. The taxpayer had attended school infrequently and never learned to speak English very well. The taxpayer had not married and preferred the company of other migrants whose situation was similar.

42. The taxpayer's uncle, who emigrated to America, died in May 1992 and left the taxpayer $150,000. In July 1992 the taxpayer put the money into a three year fixed term deposit as it earned higher interest. The bank clerk told the taxpayer that the money could not be touched until the end of the fixed term, in July 1995. The taxpayer did not return any interest for the financial year ended 30 June 1993 as no money had been received. While the bank credited an amount of $9,000 interest to the account for the financial year ended 30 June 1993 it did not send an advice to the taxpayer.

Penalty

43. Given the taxpayer's poor understanding of English and the absence of advice from the bank, the taxpayer could not reasonably be expected to have understood the taxation requirements surrounding the interest on the fixed deposit. In addition, the taxpayer's only previous source of income was from a pension and he/she had no experience with the investment of large sums of money. No penalty is attracted.

Example 1(h)

Facts

44. The taxpayer, an elderly pensioner, was forced to move into a nursing home due to ill health. The taxpayer's house was sold not long after moving into the nursing home and the proceeds from the sale were deposited into a bank account. As a result, the taxpayer earned $3,000 in interest income during the year. The taxpayer had not lodged tax returns for a number of years as the taxpayer's only other source of income during those years was the age pension. In any event, the taxpayer believed that the interest was not assessable because "the family home is exempt from tax".

Penalty

45. The taxpayer's age, health, residence in a nursing home, access to documentation, previous lodgement history and general knowledge of tax law should all be taken into consideration when making a decision on the imposition of any penalty. While no single factor is conclusive, given all the circumstances the taxpayer's failure to return the interest was not unreasonable. No penalty is attracted.

Example 1(i)

Facts

46. The taxpayers, a husband and wife, worked as a mechanic and clerk in the Public Service. In November 1994 they closed their joint savings account with a bank and transferred it to a building society. The amount transferred represented the taxpayers' total savings. The cheque they received from the bank included $2,000 of interest earned from 1 July 1994 until the account was closed. The taxpayers received a letter from the bank confirming the closure of the account and the amount of interest credited on closing the account. The taxpayers had filed away this letter without giving it much further thought.

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

Penalty

48. The taxpayers acted carelessly in failing to review the correspondence from the bank or to check with the bank directly as to what amount of interest they had earned prior to transferring their savings to the building society. Also, this single account represented

their total savings and would have been difficult to overlook. While the distraction of their daughter's operation is a factor to be considered, it does not detract in this case from the carelessness of the taxpayers in dealing with interest earned on their savings. Penalty of 25% is attracted.

Incorrect Spouse Rebate Claims

Example 2(a)

Facts

49. The taxpayer claimed a spouse rebate for the 1992 income year. The taxpayer's spouse had commenced work in April 1992 and had received a group certificate and lodged a tax return early in July 1992. The return disclosed income of $4000, but the taxpayer's spouse did not keep a copy of it, nor of the group certificate. The taxpayer lodged a return in October 1992. Prior to lodging the tax return, the taxpayer asked the spouse how much separate income had been earned. The taxpayer's spouse guessed an amount of $1500 but indicated that this may not be the exact figure. The taxpayer thought it was more, and estimated it to be $2000 and claimed a reduced spouse rebate accordingly.

Penalty

50. The taxpayer had been reckless in estimating the spouse's separate net income without making further enquiries. A reasonable person in the taxpayer's circumstances would have asked the spouse to check the relevant records or with the Tax Office about the correct amount of income. Furthermore, the taxpayer's behaviour demonstrates an indifference to the probable consequences of incorrectly claiming a spouse rebate. Penalty of 50% of the shortfall caused by the overclaimed rebate would apply.

Example 2(a)

Facts

51. The taxpayer claimed a full spouse rebate, unaware that the spouse had commenced part time work during the day. Even though the taxpayer asked the spouse if separate net income had been earned as this was required for taxation purposes, the spouse had deliberately chosen not to tell of the employment for personal reasons.
In preparing the tax return, the taxpayer included only a share of joint interest income as the spouse's separate net income, having no reason to suspect that income had been earned from other sources.

Penalty

52. Under the circumstances, a reasonable person in the shoes of the taxpayer could not be expected to know of the spouse's additional income. The taxpayer has taken reasonable care in preparing the tax return, and no penalty is attracted. However, the spouse could be prosecuted under subsection 8J(9) of the Taxation Administration Act (1953) for having made a false or misleading statement which caused the taxpayer to make an incorrect return.

Substantiation

Example 3 (a)

Facts

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

Penalty

54. Penalty of 25% is attracted because the taxpayer had been careless in claiming motor vehicle expenses in the 1994-95 year without having maintained a new log book. Tax Pack is clear about the need for a new log book in these circumstances, and the change of jobs by the taxpayer should have alerted to the likelihood of a changed business usage of the vehicle. Because the taxpayer maintained all relevant receipts, there may be a case for allowing the taxpayer a deduction for a portion of total motor vehicle expenses in the 1994-95. In such a case, there would be no tax shortfall for that part of the original claim for motor vehicle expenses that may be an allowable deduction and, consequently, no penalty could be imposed on that portion of the original claim. However, penalty would still be imposed on that portion of the claim in excess of that ultimately allowed.

Example 3(b)

Facts

55. The ATO conducted a review of work-related expense claims for a taxpayer, a mechanic, for the 1993 income year as a result of information held in respect of work-related expenses for the previous income year. The taxpayer was advised, prior to having prepared and lodged an income tax return for the 1993 year, that work-related expense claims would be subject to review and to ensure that they were able to properly substantiate any claims for work-related expenses made in the return. The taxpayer was also requested to forward, along with the income tax return, documentation to support all claims for work-related expenses in the tax return.

56. After the 1993 tax return was lodged, the claims for work-related expenses were reviewed as part of the assessment process.

Penalty

Issue (a)

57. The taxpayer was unable to properly substantiate a claim for a work related expense with the actual source document. However, the taxpayer had included in the return an explanation to support the claim. The explanation provided with the income tax return was insufficient for the purposes of exercising the discretion under section 82KZAA.

58. The explanation provided for the absence of proper documentary evidence and the taxpayer's honest belief that this was acceptable for substantiation purposes are relevant factors to be considered when making a decision in respect of the imposition of penalties. However, given that the taxpayer had been advised prior to lodging the return that a review of work-related expenses would be made and that these claims should be properly substantiated, it is considered that the taxpayer had failed to exercise reasonable care in making the claim. Penalty is attracted at the rate of 25%.

Issue (b)

59. The taxpayer also made a claim for a work-related expense which was not supported by any documentation. In addition, the taxpayer had not provided an explanation or other reason for failing to have the necessary supporting documentation. It is considered that the taxpayer's behaviour showed indifference to or disregard of the specific advice provided by the ATO on what was required to prepare an accurate tax return in respect of this matter. Consequently, the taxpayer is considered to have acted recklessly in making a claim

without having, or without providing a reason for not having, supporting documentation. Penalty of 50% is attracted.

Issue (c)

60. The taxpayer also made a claim for a work-related expense which, even though the expense could be substantiated, was not an allowable deduction. In making the claim the taxpayer had failed to properly read the relevant section of the Tax Pack. Given the circumstances, it is considered that the taxpayer had failed to exercise reasonable care in making the claim. Penalty is attracted at the rate of 25%.

61. Note that even though the above adjustments were made as part of the assessment process, penalty was imposed on each issue because the tax shortfalls arose as a result of the taxpayer having a statement tax, at the time that the return was lodged, which was less than the taxpayer's proper tax for that year. The taxpayer would not be entitled to a reduction in the prescribed rate of penalty of 80% for voluntary disclosure prior to audit as the taxpayer had been given notification of intent to audit for that year prior to the lodgement of the tax return. As the provision of the documents was in response to normal audit enquiries, the Commissioner would not use his discretion under section 226ZA of the ITAA to treat the disclosure as having been made prior to an audit and, for similar reasons, the taxpayer would not be entitled to a reduction in the prescribed rate of penalty of 20% for disclosure during the audit.

Rental Properties

Example 4(a)

Facts

62. The taxpayer inherited two rental properties in 1993. The properties were rented out prior to being inherited by the taxpayer and were managed by separate real estate firms.

63. In the tax return for the 1995 year of income the taxpayer understated the gross income from rents by $650 ($7,300 was returned). The taxpayer had not included one of the monthly rental statements provided by the real estate agents.

64. In addition, the taxpayer had claimed in full the cost of installing a new solar hot water system ($2,000) at one of the properties, and she had also claimed the stamp duties ($2,000) on transfer of the properties from a nominee company. The taxpayer had prepared the tax return without professional help and had not realised that the hot

water system should be depreciated and that the stamp duty was a capital expense, despite it being specifically mentioned in Tax Pack.

Penalty

65. The taxpayer had been careless in not bringing together in the tax return all the receipts for the full year when preparing the tax return. The taxpayer had also been careless in claiming the hot water system and stamp duty expenses without checking whether they were in fact deductible. A reading of the relevant part of Tax Pack would have alerted a reasonable person that there was some doubt that the expenses were deductible and that further enquiries should be made. Penalty of 25% is attracted.

Example 4(b)

Facts

66. The taxpayer claimed the entire loss relating to a rental property for the 1994 to 1996 income years. Upon audit by the ATO it was discovered that the property was owned jointly by the taxpayer with his wife. When challenged on this, the taxpayer claimed there must have been a mistake since it was always his intention that the property should be held solely in his name so that he alone could claim the advantages of negative gearing. Although this was found to be the plan with which he started negotiations, the taxpayer had later agreed to joint ownership and shared commitments with his wife.

67. The mortgage over the property was in joint names but the taxpayer claimed that he could not recall signing the transfer of title, which clearly showed that the property was held in joint names. The mortgage interest was debited to a joint account into which the salaries of both taxpayers were deposited.

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

Penalty

69. It is reasonable to conclude that the taxpayer ought to have known that the property was held in joint names due to the documentation available when the tax return was prepared. The mortgage statement would have made it clear that the payments of interest were jointly shared with his wife and his failure to read this

document carefully demonstrates an indifference to the consequences. A reasonable person in possession of that knowledge would have realised that there was a significant risk that the taxpayer was not entitled to claim the whole of the rental loss. The taxpayer had accordingly behaved recklessly, and penalty of 50% is attracted.

Small Business - omitted income

Example 5(a)

Facts

70. The tax return of a small, newly established business experiencing rapid growth was prepared from an inadequate and poorly supervised accounting system which had not kept pace with the firm's very fast expansion. An audit was conducted by the ATO and several omissions of income (being in respect of accounts for services rendered by the firm) were detected together with overstated claims for deductions. The tax shortfalls could have been avoided if proper records had been maintained.

Penalty

71. The taxpayer had been careless in maintaining an inadequate accounting system which had resulted in the tax shortfall. For business taxpayers, reasonable care would require the putting into place of an appropriate record keeping system to ensure that the income and expenditure of the business is properly recorded and classified for tax purposes. A reasonable person conducting the business of the taxpayer would have foreseen that the poor accounting system would have resulted in an understatement. Penalty of 25% is attracted.

Example 5(b)

Facts

72. The same as in example 5(a) above except that the amounts involved were small in relation to total income for the year. The errors had occurred early during the period of rapid expansion and the taxpayer had since remedied the problem with the accounting system. No errors were detected in the latter part of the year.

Penalty

73. The taxpayer had realised that the accounting system had proven inadequate for the expanding needs of the growing business and had

taken positive steps to resolve the problem as soon as it became obvious. A reasonable person, when establishing the business of the taxpayer, may not have foreseen that the poor accounting system would be inadequate for a larger business. No penalty tax is attracted.

Small Business - record keeping audit

Example 6(a)

Facts

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

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

Penalty

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

Example 6(b)

Facts

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

Penalty

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

Example 6(c)

Facts

79. The same as example 6(a), but the taxpayer completely ignored the advice of the record keeping auditor and made no attempt to improve the adequacy of records kept.

Penalty

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

Contentious Item - new law

Example 7(a)

Facts

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

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

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

Penalty

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

Example 7(b)

Facts

85. The same as example 7(a), except that a Taxation Ruling had issued on the new scheme which made clear the changed approach to overheads under the new scheme. The explanatory memorandum also referred to the change.

Penalty

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

Deferred Interest Security - advice from institution

Example 8

Facts

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

88. The finance company indicated in its prospectus that under the ITAA, income accruing to investors from discounted and other

deferred interest securities is taxed each year. At the end of the year it also informed investors of the amount to be included as assessable income for Division 16E purposes. The taxpayer had not realised that income accruing on deferred interest securities was assessable as it accrues, notwithstanding the advice received from the company. The taxpayer believed that interest was assessable only when it was received. The taxpayer was not commercially literate.

Penalty

89. While some confusion may have genuinely arisen in the taxpayer's mind as to the assessability of the amounts in question, the taxpayer had been careless in ignoring the information provided by the finance company and in failing to at least make further enquiries. Penalty is attracted at 25%. [Note: in some cases involving a deferral of tax where the taxpayer has been careless it may be appropriate to partially remit the penalty otherwise attracted - see Ruling TR 94/7.]

Repairs

Example 9

Facts

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

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

92. The $250,000 was claimed as an allowable deduction by the company. The director of the company who was responsible for the preparation of the company's tax return was familiar with the extent of the work carried out in respect of the damaged floor. The director had a broad knowledge of tax law and was aware that some business expenses could be treated differently for tax purposes than for accounting purposes. Nonetheless, the director made no attempt to ascertain the correct tax treatment of the expense and showed an

indifference to the consequences of failing to do so. Rather, the director had relied upon the description on the invoice, notwithstanding that the claim was relatively large in the context of the company's tax return (assessable income totalled $5m).

93. On audit by the ATO it was concluded that the replacement of the floor was in the nature of an alteration and improvement, and the expenditure was of a capital nature. In making this decision, the ATO auditor referred to decided cases in which the circumstances were similar.

Penalty

94. While the auditor decided that there was insufficient evidence of intentional disregard of the provisions of section 53 of the ITAA it was concluded that the claim had been made recklessly in that the taxpayer's conduct (through the director responsible for the preparation of the return) displayed an indifference to the considerable risk that the claim would result in a tax shortfall without some attention being given to the correct treatment of the expense - a risk which would have been foreseen by an ordinary person with the commercial experience of the director. Penalty of 50% of the tax shortfall caused by the repair claim was therefore attracted.

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

Trading Stock - understatement of value at year end

Example 10

Facts

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

97. The taxpayer had debited its purchases account for the cost of the consignment stock and the various suppliers were treated as creditors. The director responsible for the preparation of the return indicated to the ATO officer auditing the taxpayer's affairs that once consignment stock is accepted, the items are included in the stock sheets.

98. Examination of the stock sheets indicated this was not the case and, in fact, substantial amounts of stock purchased in the normal course of business had also been omitted from the stock sheets. Some consignment forms were retained by the director and the details were not entered on stock sheets. Questioning of an employee indicated that this was a common practice but contrary to the company's properly established procedures.

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

Penalty

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

101. Because the shortfall in this case was caused by an error in respect of trading stock, it may be that there was only a deferral of tax. Whether a remission under subsection 227(3) of the 75% penalty attracted is warranted would depend on all the relevant circumstances and is dealt with in Ruling TR 94/7. However, he taxpayer's intentional behaviour in this case would militate against any remission.

Lease Premiums - capital gain - error by tax agent

Example 11

Facts

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

reaching the conclusion that the premium was not assessable the tax agent had failed to check the capital gains tax provisions or any other text or source on capital gains. The agent had only limited experience with capital gains issues.

Penalty

103. The taxpayer's tax agent had not taken reasonable care in dealing with the lease premium in the taxpayer's return. Even a cursory examination of a basic income tax text would have alerted the tax agent to the possible tax implications of the lease premium. As a result, the taxpayer would be subject to a 25% penalty but could consider recovering the penalty from the tax agent under section 251M. The tax agent is not considered to have behaved recklessly. While a reasonable person would have foreseen the risk of a tax shortfall, the risk, in all the circumstances of this case, is not considered to have been foreseeable by a reasonable person as being of such a magnitude as to justify a finding of recklessness. The amount involved and the experience of the tax agent are particularly relevant to this conclusion.

Capital Gains Tax - intentional disregard

Example 12

Facts

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

105. On audit by the ATO the taxpayer indicated that enquiries had been made with the ATO about the capital gains tax implications of the improvements to the building. The taxpayer was informed the improvement would not be caught by the capital gains provisions providing it did not cost more than $63,450 (the indexed cost base limit under s.160ZJ). The taxpayer stated that since the improvement only cost $60,000, no amount was assessable as a result of the sale.

106. The taxpayer produced an invoice for $60,000 and claimed that this was the total cost of the improvements. The taxpayer failed to produce the personal bank account when requested to do so by the auditor. When confronted with the $20,000 payment from the

personal bank account and with a copy of a second invoice from the builder which showed the extra $20,000 cost the taxpayer admitted that the payment for the improvement had deliberately structured so as to avoid tax. After allocating the sale proceeds of $500,000 between the original land and buildings and the improvement, the real gain on disposal of the improvement was included in the taxpayer's assessable income.

Penalty

107. The auditor concluded that the taxpayer had intentionally disregarded the capital gains provisions of the ITAA so that a 75% penalty was attracted under section 226J. In addition, the taxpayer had taken steps to prevent or hinder the Commissioner from becoming aware of the shortfall by presenting only one of the two invoices, refusing to produce the personal bank account, and making false statements about the cost of the improvements. As a result, section 226X applied to increase the penalty otherwise attracted by 20% (i.e. 20% of 75% = 15%), so that a total penalty of 90% (i.e. 75% + 15% = 90%) was payable by the taxpayer.

Skimming of Cash Income - intentional disregard - hindrance

Example 13

Facts

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

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

Penalty

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

Further Penalty Tax - additional tax in respect of an earlier year

Example 14

Facts

111. The taxpayer was notified of an audit of the 1993 income year as a result of an income matching project. During the audit a tax shortfall was found as a result of the omission of income from interest earned on a bank account. The taxpayer was unable to provide an acceptable reason for the omission and penalty of 25% of the tax shortfall was imposed for failure to exercise reasonable care. At the conclusion of the audit the taxpayer was advised in writing that any future earnings of income from interest would be assessable income and must be included in the relevant tax returns for those future years.

112. In the 1995 income year the taxpayer was again subjected to an audit and a tax shortfall was found as a result of the omission of income from interest earned on another bank account. During the audit the taxpayer advised that the only reason for the omission of the income from interest is that he/she "forgot" to include it

.

Penalty

113. If the taxpayer had properly turned his/her mind to the correct preparation of the 1995 tax return, the taxpayer would have been aware of what was required to prepare an accurate tax return and the probable consequences of failing to return all income from interest . The taxpayer's behaviour, in omitting income from interest after having been advised that future earnings of interest would be assessable income, shows a disregard of or indifference to the correct operation of the Act as previously advised by the ATO. Accordingly, a penalty of 50% is attracted for recklessness.

114. In addition, as the taxpayer had been liable to pay penalty under section 226G in respect of an earlier year of income, the taxpayer is liable, as a result of the operation of paragraph 226X(b)(iii), to further penalty equal to 20% of the penalty otherwise payable (i.e. 50% + 10% = 60%).

115. However, it should be noted that it is still necessary to look at all the circumstances of the taxpayer for each tax shortfall. It is possible that the reason for the tax shortfall in the 1995 year may not bear any relationship to that for the 1993, for example, the information may have been

incorrectly advised by the financial institution, and it may be that the taxpayer did exercise reasonable care in the 1995 year . Generally, however, a taxpayer would be expected to exercise a higher standard of care where specific advice had been previously provided by the ATO.

Commissioner of Taxation

6 January 1994

ISSN 1039 - 0731

ATO references
NO 93/2071-7
BO

Previously released in draft form
as TR 93/D20

Price $3.40

FOI index detail
reference number
I 1014125

subject references
- additional tax
- intentional disregard
- reasonable care
- recklessness
- self assessment
- substantiation

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

case references
- Cunliffe v. Goodman [1950] 2 KB 237
- Derry v Peek (1889) 14 App Cas 337; 5 TLR 625
- Lloyds Bank Ltd v. Marcan [1973] 2 All ER 359
- R v. Bates [1952] 2 All ER 842
- R v. Grunwald & Ors (1963) 1 QB 935
- R v. Willmot [1985] 2 Qd R 413
- Reed (Albert E) & Co Ltd v London and Rochester Trading Co Ltd [1954] 2 Lloyds Rep 463
- Shawinigan Ltd v Vokins & Co. Ltd [1961] 3 All ER 396