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Administrative penalties

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Introduction[1]

In 2005, Treasury released a report on aspects of tax self-assessment, better known as ROSA – the Review of Self Assessment. ROSA resulted from a brief given to treasury to examine all aspects of the self-assessment regime, and make recommendations to improve the system. As part of this review, administrative penalties were considered, and it was recommended that the Australian Taxation Office (ATO) should revise its rulings on "reasonable care" and "a reasonably arguable position". Draft Miscellaneous Tax Rulings *MT 2008/D1* and *MT 2008/D2* are those revised rulings (collectively, Rulings).

The Rulings further explain concepts used in the uniform administrative penalty regime. The uniform penalty provisions apply in respect of various taxes – including income tax, FBT, goods and services tax (GST) – and collection systems – including pay as you go withholding and instalments. The regime applies penalties over three broad areas: penalties for statements, unarguable positions and schemes (Division 284 of Schedule 1 to the *Taxation Administration Act 1953* (Cth)); penalties for failing to lodge documents on time (Division 286); and miscellaneous administrative penalties (Division 288). This paper focuses on penalties for false and misleading statements and unarguable positions, and analyses the impact of the Rulings and the issues they create.

All references in this paper to legislation are references to the *Taxation Administration Act 1953* (Cth) (TAA) unless otherwise specified.

Background

Administrative penalties have long been a feature of our tax system. The current uniform administrative penalty regime was introduced in 2000. The regime sets out a uniform approach to administrative penalties that apply to entities that fail to satisfy certain obligations under many different taxation laws. The administrative penalty provisions consolidate and standardise the different penalty regimes that previously existed.

Prior to the introduction of the uniform administrative penalty regime, specific administrative penalty provisions existed in various tax laws for the specific operation of those tax laws. These provisions evolved over time in an uneven and ad hoc manner. For example, the explanatory memorandum to the Act that introduced the current regime[2] (Explanatory Memorandum) contrasts the penalty that could have applied to a person who was late lodging a fringe benefits tax (FBT) return with that of an income tax return. The FBT return late lodgement penalty was potentially up to double the amount of tax payable for the year, while the income tax return late lodgement penalty, for exactly the same transgression, was $10 for each week late up to a maximum of $200. The disparate penalties applied for the same misconduct clearly demonstrated the need for a new, uniform regime, to provide punitive measures that were consistent across various taxes.

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1 Disclaimer: This paper is for general purposes only and is not intended, and must not be relied on, as advice in relation to any particular matter.

2 The *A New Tax System (Tax Administration) Act (No 2) 2000* (Cth).

Division 284 outlines the provisions for penalties for statements, unarguable positions and schemes. A penalty may be imposed where an entity:

1. makes a statement which is false or misleading in a material particular (s 284-75(1));
2. takes a position under an income tax law that is not reasonably arguable (s 284-75(2));
3. fails to provide a return, notice or other document to the Commissioner of Taxation (Commissioner) that is necessary to determine a tax-related liability accurately, and the Commissioner determines the liability without the assistance of the document (s 284-75(3));
4. disregards a private ruling (prior to the income year commencing 1 July 2004 for all matters except FBT and the FBT year commencing 1 April 2004) (former s 284-75(4)); or
5. enters into a scheme to get a scheme benefit (s 284-145).

It should be noted that the penalty for failure to provide a document under s 284-75(3) and the scheme provisions contained in s 284-145 are beyond the scope of this paper and the discussion contained within.

False and misleading statements and "reasonable care"

Broadly, subsection 284-75(1) imposes a penalty where:

1. an entity or its agent makes a statement to the Commissioner or to an entity that is exercising powers or functions under a taxation law;
2. the statement is false and misleading in a material particular whether because of things in it or omitted from it; and
3. there is a shortfall amount as a result of the statement.

However, there is an exception contained in subsection 284-215(2). It applies so that there is no shortfall amount, for the purpose of determining liability for an administrative penalty, as a result of a false or misleading statement to the extent that reasonable care was taken in making the statement. Where a shortfall amount results from a failure to take reasonable care, the base penalty imposed is 25 per cent of the shortfall amount. Where recklessness to the operation of the taxation law results in a shortfall amount, the base penalty is 50 per cent of the shortfall amount. And finally, where intentional disregard of a taxation law results in a shortfall amount, the base penalty is 75 per cent of the shortfall amount.

Reasonable care

Given that establishing reasonable care prevents the imposition of a penalty for false and misleading statements, the question still remains, what exactly amounts to reasonable care? *MT 2008/D1* explains that "reasonable care" is not a defined term in the tax legislation, and thus takes its ordinary meaning. The ruling then draws the conclusion that the reasonable care test requires an entity "to take the same care in fulfilling their tax obligations that could be expected of a reasonable ordinary person in their shoes". This essentially means that, although the standard of care applied is objective (that of a reasonable person), it takes into account subjective factors (being in the shoes of the taxpayer). The factors that the Commissioner has outlined he will use to determine the standard of care include:

- the personal circumstances of the taxpayer, including age, health and background;
- the level of knowledge, education, experience and skill of the taxpayer; and
- the taxpayer's understanding of the tax laws.

Reasonable care requires a taxpayer to make a reasonable attempt to comply with the provisions of the income tax laws and regulations, taking into account all the taxpayers circumstances, including knowledge, education, experience and skill.

Reasonable care also does not connote the highest level of care or perfection. As noted in *Maloney v Commissioner for Railways*, perfection or "the use of increased knowledge or experience embraced in hindsight" should form no part of the components of what is reasonable in the circumstances.[3] However, the test is also not intended to be reduced to the level of the lowest common denominator. As the Explanatory Memorandum notes, the reasonable care test "is not intended to be overly onerous for taxpayers". It concludes that, for an individual salary and wage earner, "an earnest effort to follow *TaxPack* instructions" would be sufficient to satisfy the test.

A lack of reasonable care must also be positively established by the Commissioner. There is no presumption that the existence of a shortfall amount created by a false and misleading statement is the result of a failure to take reasonable care.[4]

Example 1

Based on the first example provided in *MT 2008/D1*, a taxpayer (T) has been diagnosed with cancer and has been undergoing intensive treatment. In preparing their tax returns, T overlooked a relatively small amount of interest from one investment account, and also misplaced the statement stating the amount.

The Commissioner concludes that T's illness contributed to her failure to correctly record the interest income earned. A reasonable person in the same circumstances would possibly not be as thorough in keeping their records as someone who is able and healthy.

Example 2

The impact of a taxpayer's agent's individual skills, knowledge and experience is illustrated in *Arnett & Ors v FCT*[5]. In this case, a taxpayer had been made redundant and received a lump sum payment representing unused long-service leave and annual leave. The taxpayer's engaged a tax agent who assumed concessional treatment of the amount as a bone fide redundancy payment applied and lodged returns on that basis. The payment in fact was not a bone fide redundancy payment and no concessional treatment should have been afforded.

The AAT held that reasonable care had *not* been taken, despite the taxpayer's use of a tax agent. As outlined above, a taxpayer can be penalised where they or their agent does not take reasonable care. The AAT held that a tax professional should have been expected to know, or at least find out, about the possible tax treatment of the lump sum payment.

Example 3

Measures undertaken by a taxpayer to ensure compliance with the tax law will also help to establish reasonable care. Example 4 in *MT 2008/D1* helps illustrate this. Here, a taxpayer owns and runs a small business. The taxpayer keeps basic accounts for the business, from which they complete quarterly activity statements for GST. The statements are then checked by a second party to ensure they are correct before lodging. Due to a transposition error, a shortfall amount is identified during an audit.

The Commissioner concludes in *MT 2008/D1* that given the circumstances of the taxpayer, and the measures put in place by the taxpayer to ensure compliance, reasonable care has been taken. It would not be reasonable to expect small business to have more onerous procedures for checking the accuracy of activity statements.

Recklessness

Like the test for determining whether reasonable care has been taken, a finding of recklessness depends on an essentially objective test. *MT 2008/D1* outlines that the test for recklessness is identical to that for reasonably care. The only difference is the degree by which the standard is not met. Behaviour that falls significantly short of the standard of care expected of a reasonable person in the circumstances of the taxpayer will be reckless.

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3 (1978) 18 ALR 147 at 148 per Barwick CJ.
4 See, for example, *Hart v FCT* [2003] FCAFC 105 at paragraph 44.
5 98 ATC 2137

Recklessness assumes that the behaviour in question shows an indifference to a risk that is foreseeable by a reasonable person. Recklessness in this context means to include a tax statement material that a reasonable person in the circumstances of the taxpayer would know has a real risk of being incorrect.

Intentional disregard for the tax law

Intentional disregard for the tax law carries the highest of the three administrative penalties for false and misleading statements. As a result, a much more stringent test than that of reasonable care and recklessness is warranted.

The words of Division 284 indicate that a purely subjective test is applied to determine this. The actual intention of the taxpayer is the critical element in establishing liability. *MT 2008/D1* outlines that there must be *actual knowledge* that the statement made is false or misleading to attract a penalty under this provision. Intentional disregard for the tax law is likely to be rarely applied, given the added evidentiary burden of proving the subjective state of mind of the taxpayer.

A reasonably arguable position

The concept of a reasonably arguable position (RAP) was used in sections 226K (penalty tax where an unarguable position is taken) and 222C (which defined the expression "reasonably arguable") of the former penalties regime contained in Part VII of the *Income Tax Assessment Act 1936* (Cth) (ITAA 36).

The rationale for the RAP provisions was outlined by Hill J in *Walstern v FCT*[6]:

> *"…It is clear from the Second Reading Speech to the Taxation Laws Amendment (Self Assessment) Bill 1992… that while all taxpayers would be penalised if they fail to exercise reasonable care, it was thought appropriate… for taxpayers who made large claims, generally in excess of $10,000 to exercise greater care and to thus pay a greater penalty… The Minister assisting the Treasurer… said, inter alia:*
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> *'…The Government considers it appropriate that a more rigorous standard apply where the item at issue is very large… where the interpretation of the law for such items is in issue, we expect taxpayers to exercise more care; that is, the taxpayer must have a reasonably arguable position on the matter.'"*[7]

Accordingly, a taxpayer will be subject to a penalty under ss 284-75(2) and 284-90 where:

1. an entity or its agent makes a statement to the Commissioner or to an entity that is exercising powers or functions under a taxation law;
2. the statement treated an income tax law as applying to a matter in a particular way that is not reasonably arguable; and
3. the treatment causes a tax shortfall amount which is more than the greater of $10,000 or 1 per cent of the taxpayer's tax payable for the relevant year (or $20,000 and 2 per cent respectively in the case of trusts and partnerships).

The base penalty amount under s 284-90(1) for a penalty imposed under s 284-75(2) is 25 per cent of the shortfall amount, or the part of it that resulted from taking a position on the law that was not reasonably arguable.

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[6] [2003] FCA 1428 ("***Walstern***").
[7] Ibid at paragraph [106].

The test to determine whether a particular way of applying the law is reasonably arguable is set out in s 284-15(1). In essence, the test is whether, having regard to the relevant authorities, it would be concluded that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect. The use of the words "it would be concluded" has been held to mean that the test for a RAP is objective, with the taxpayer's subjective belief in the quality of their legal argument not being relevant.[8] The test has also been described as being whether, on balance, "the taxpayers argument can objectively be said to be one that while wrong, could be argued on rational grounds to be right".[9] Thus, the standard of a reasonably arguable position is more difficult to establish than that of reasonable care.

Despite the apparent objectivity of the test, a judgment call will be required to determine whether a taxpayer's argument "is about as likely to be correct as incorrect". Such judgement in essence imports an element of subjectivity into the test. Different minds could reasonably assess the same argument as having differing chances of success. In practice, the first "judge" of whether or not a taxpayer has a RAP will be the ATO, which can hardly be considered a disinterested party. Some taxpayers may therefore be concerned that the ATO will tend to take a "conservative" approach favouring its own position.[10] Despite the ability for a taxpayer to seek review of the decision to impose such a penalty through the AAT or the Courts, the considerable time, cost and effort involved in such a course of action may act as a deterrent to doing so.

The RAP provisions are also only meant to apply when an entity treats an income tax law as applying in a particular way. The natural corollary of this is that a taxpayer cannot be penalised for not having a RAP where this is based upon an error of fact. This is confirmed in *MT 2008/D2*, with the example of the wrong asset class being accidentally selected when depreciating an asset, when the correct class was in fact known and intended to be applied, not giving rise to a penalty. However, not all errors of fact are created equal, as illustrated in Example 4 below.

<u>Example 4</u>

Assume that a taxpayer, T, collects stamps. T sometimes also trades the stamps he has with others, and also goes about selling stamps that he no longer wants or needs. Because of this, T believes that he is in business, and claims deductions for stamp purchases. The question of whether an entity is carrying on a business is one of fact and circumstance. If in fact T was not carrying on a business, but rather a hobby, no deduction would be allowed. Such an error would seem to be one of fact.

However, the Explanatory Memorandum attempts to distinguish between "primary facts" (such as a miscalculation) and "wrong conclusions of fact" (such as the question of carrying on a business). This position appears difficult to reconcile with the words used in Division 284. One possible interpretation could be that, by claiming a deduction and applying s 8-1 of the *Income Tax Assessment Act 1997* (Cth), the way the taxpayer has treated the "law" as applying to a "matter" has produced an incorrect tax liability. However, this still does not avoid the fact that the error is based in fact, not the application of the tax law. If the factual circumstance applied was correct, no error of law had been made. This brings to mind the often-difficult question addressed by the Federal Court reviewing decisions of the AAT on "questions of law".[11]

The interaction of reasonable care and RAP

The interaction of the above outlined penalty provisions must now be analysed. The differences between the two ideas can be illustrated, perhaps, by looking at the time that you assess whether you have taken reasonable care or whether you have a RAP. While reasonable care must be taken prior to the making of any statement, a RAP simply 'exists' independent of whether a taxpayer has formed a view as to whether they have a RAP or not, and is assessed at the point of time of making the relevant statement.

In a sense, all tax shortfalls arise from a false and misleading statement – usually being the understatement of taxable income on a taxpayer's tax return. Given that reasonable care is a defence to a false and misleading statement, can it also be said to be a defence to the lack of a RAP?

[8] Woellner, R. "Avoiding a bum RAP", *The Tax Specialist* (Vol 8 No 3) February 2005, p. 166 at p 172.
[9] *Spotlight Stores Pty Ltd & Anor v FCT* 2004 ATC 4264 at 4703.
[10] Woellner, above n 8, at p 173.
[11] See s 44(1) of the *Administrative Appeals Tribunal Act 1975* (Cth)

It has been put forward that the reasonable care exception in s 284-215 when read literally applies to a lack of a RAP.[12] Unfortunately, this is not the case. As a matter of proper construction, s 284-215(2) picks up the precise language of s 284-75(1), implying that it is intended only to apply to the false and misleading statement penalty provision in s 284-75(1). The Explanatory Memorandum also makes it clear the RAP provision is intended to act as a stand-alone penalty provision, despite the fact that any tax shortfall that arises will almost necessarily be the result of a false and misleading statement. *MT 2008/D2* confirms that the concept of reasonable care is not meant to have any bearing on penalties for lack of a RAP.

However, can a RAP still be influenced by whether reasonable care is taken? That is, if you have taken reasonable care should you have a RAP? It seems logical that this be so, as, if reasonable care is taken, it is more likely that a taxpayer will have turned their mind to the issues involved and have a RAP. However, a more contentious extension of this has emerged from the case law. In *Walstern*, Hill J put forward the proposition that an argument cannot be a RAP where there is a failure on the part of the taxpayer to take reasonable care.[13] In other words, a RAP can *only* be established if reasonable care is taken. This view appears to be at odds with the above view that the concepts of reasonable care and a RAP are completely separate and are not co-dependent. While it certainly is the case, as already noted, that when reasonable care is taken, a taxpayer is probably more likely to have a RAP, theoretically, the two concepts should be capable of being established (or not established) independent of each other. The Explanatory Memorandum seems to make clear that establishment of one is not required for establishment of the other. To allow the situation where a taxpayer can exercise reasonable care and not have a RAP (and thus be penalised), yet at the same time to automatically conclude that in the absence of reasonable care a taxpayer cannot have a RAP (again, and thus be penalised) unreasonably skews the provisions in favour of the Commissioner. Theoretically, a position should be capable of having the quality of a RAP while the taxpayer has not taken reasonable care.

Tax shortfalls

Although not expressly discussed so far, the existence of a tax shortfall is required before any of the above penalties apply. However, once a tax shortfall exists, is it possible for multiple penalty provisions to apply to it?

The ATO takes the view that a tax shortfall can be divided into different parts caused by different actions, and that these components of the total shortfall can be separated and penalised under different provisions.[14] For example, one part of a shortfall may have been caused by a lack of reasonable care, while another part by not having a RAP. Consider, for example, Example 2 discussed above. It may be the case that a shortfall is deemed to arise because the taxpayer has withheld relevant information from his tax agent and thus has not exercised reasonable care, while the tax agent did not have a RAP in assuming the payments were bone fide redundancy payments. In this scenario, the shortfall, and thus penalty, may be apportioned between the two actions. This situation has been described as being akin to two cricketers shouting "yours!" at each other when a ball ripe for a catch is approaching, and letting the ball fall between the two of them.[15]

There are inherent difficulties in taking such an approach. It may be the case that different behaviour led to specific different tax shortfalls in a single assessment – such as where a lack of reasonable care caused an understatement of wages causing a shortfall, while a lack of a RAP due to incorrect treatment of the income included in a tax return caused a further shortfall. However, how can it be said that differing parts of a shortfall are created by actions attracting different penalties where the totality of actions led to a single tax shortfall? The ATO seems to think such a course is possible.

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12 Woellner, above n 8, at p 171.
13 [2003] FCA 1428
14 Woellner, above n 8, at p 170.
15 Phillips, I. "Part 2 - The Reasonable Taxpayer's Care", *Taxation In Australia* (Vol 27 No 11) June 1993, p 621 at p 625.

Even discounting the difficulties that arise as a result of trying to dissect a tax shortfall into differing parts, there is still no logical way of relating part of the taxable income shortfall to the part of the tax shortfall under a system where income is subject to progressive tax rates.[16] If the taxable income shortfall in question would have been taxed at more than one marginal rate, how is it determined in which order the shortfalls are to be penalised? Possibly the Commissioner would take the view that the highest rate of penalty tax should be applied to income taxed at the highest rate. However, such an approach is arbitrary with no reasonable foundation in the legislation to do so.

Case study: an unarguable position while taking reasonable care?

As outlined, the reasonable care and RAP provisions apply different standards of care. The RAP provisions apply a purely objective test, while the test for reasonable care includes a subjective element, and thus is seen to be more lenient. Given that reasonable care does not apply to a RAP, this raises the possibility for a taxpayer to have made a false and misleading statement, albeit while taking reasonable care, and yet still be penalised for not having a reasonably arguable position.

Assume, for example, there is a taxpayer, T. T completed secondary school, but never undertook tertiary education. T has worked in various jobs over the years, eventually establishing a small business selling fruit and vegetables. The business is a cash business, with relatively simple procedures required to account for income. Eventually, T decides to sell the business.

T then purchases a company that carries on a small business – a fruit and vegetable wholesaler. The company at the time of purchase carries doubtful debts of approximately $100,000. Upon taking over the company, T decides to significantly expand the product range, such as not only selling fruit and vegetables, but also selling other grocery lines to small retailers and enter new markets. Come tax time, T goes to prepare the company's tax return. He has been unable to collect any of the debts owed to the company by former customers, and decides to write them off as bad debts. Having previously owned a business, T believes these debts are tax deductible. However, T goes to see a tax adviser (who is not his tax agent as T lodges his own and the company's returns) to confirm given their large size. T is advised that he'll be fine and that the debts are tax deductible. As a result, T makes little taxable income in that year.

Two years later, the ATO audits T and an amended notice of assessment is issued to him, on the basis that the bad debts were not deductible – neither the continuity of ownership test (COT) or the same business test (SBT) were satisfied.

Arguably, reasonable care has been taken by T. A reasonable person in the position of T would have acted as he did: he sought tax advise. T does not have any specialist tax knowledge, however is familiar with general practice from his previous business. T believed the debts to be deductible based on prior experience, however due to the large nature of the deduction, sought advice. T also provided all relevant information to his adviser, and thought he was being prudent by seeking the advice. T has no reason to doubt the advice received from his adviser, as he had not had problems with the adviser in the past.

However, the position taken by T is also likely to be an unarguable one. It is doubtful that T's argument that the debts are deductible is a RAP, as the likelihood of satisfying the SBT is low given the change in operations, while the COT clearly cannot be satisfied in these circumstances.

I'll leave you with the question, is this a fair outcome? Should the penalty regime penalise a person, who, even by the Commissioner's own account, has taken all reasonable care in preparing his or her tax return? Such a situation helps highlight the potential inadequacies or the administrative penalty regime, and the flaw in policy that the same behaviour can be condoned by one part of the regime, while punished by others. While the policy behind the differing standards is that extra care should be taken when dealing with more significant sums of money, such policy is necessarily already built into the standard of reasonable care – it would not be reasonable for a taxpayer to afford the same level of research or advice to both relatively insignificant and significant sums of money. The current approach is almost analogous to the left hand giving you a treat, while the right hand steals your wallet…

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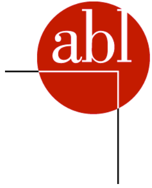
[16] Irving, K. "Part VII Penalties - The Shortfalls of Self-Assessment", *Taxation In Australia* (Vol 28 No 2) August 1993, p 101 at p 101.



If you have any questions regarding the content of this paper, please contact Paul Sokolowski, Partner, (03) 9229 9344.

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