



**Australian Government**  
**Inspector-General of Taxation**

# **Review into the Australian Taxation Office's administration of penalties**

**A report to the Assistant Treasurer**

**Inspector-General of Taxation**

**February 2014**



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21 February 2014

Senator the Hon Arthur Sinodinos AO  
Assistant Treasurer  
Parliament House  
Canberra ACT 2600

Dear Minister

**Review into the Australian Taxation Office's (ATO) administration of penalties**

I am pleased to present you with my report of the review into the ATO's administration of penalties.

I have made a recommendation for the Government to consider specific opportunities to improve the current tax penalty regime and encourage greater voluntary compliance. These opportunities include further stratification of the existing penalty regime and the compensation for time-value of money on unsustained penalties.

It should be noted that recommendations relating to penalties have also been made to the Government in earlier Inspector-General of Taxation (IGT) reviews, particularly the *Review into improving the self assessment system*. The Government may wish to consider all these recommendations as part of a broader review of the penalty regime.

I have also made nine recommendations to the ATO. These are aimed at improving its penalty decisions, guidance material and identification, collection and analysis of penalty information as well as taxpayer perceptions that penalties may be used as leverage to influence primary tax disputes. The ATO has agreed, in full, in part or in principle, with all of these recommendations. Where the ATO has disagreed, they have sought to address the underlying issues to the extent that they believe their resources allow.

I am grateful for the support, contribution and willingness of many who provided their time, expertise and experience in the conduct of this review.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Ali Noroozi', with a long horizontal line extending to the right.

Ali Noroozi  
Inspector-General of Taxation



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## EXECUTIVE SUMMARY

The Inspector-General of Taxation's (IGT) review into the Australian Taxation Office's (ATO) administration of penalties was prompted by concerns raised by taxpayers, tax professionals and their representative bodies. These concerns related to the legislative framework of the penalties regime, the adequacy of ATO guidance material, the level of and reasons for unsustained penalties and the perceived use of penalties as leverage to influence primary tax disputes. The majority of these concerns focussed on penalties relating to statements that taxpayers make to the ATO to fulfil their tax obligations. The IGT has also considered the ATO's collection and analysis of penalty information and related systems.

The IGT believes that the objective of the penalties regime to foster 'voluntary compliance' may be hindered by a lack of sufficient differentiation between a range of taxpayer behaviours, the inability to receive interest on money paid for unsustained penalties and the broad application of false or misleading statement penalties where no tax shortfall arises.

The IGT has made recommendation to Government to consider the above aspects of the penalty regime. The IGT has also noted that in doing so, it may be opportune for the Government to consider a broader review of the penalties regime, given the recommendations relating to penalties in earlier IGT reviews particularly the *Review into improving the self assessment system*.

Based on stakeholder concerns, the level of and reasons for unsustained penalties were a focal point of the review. The IGT has found that over the last three financial years, approximately 35 per cent of total penalties raised were later reduced. While adjustments of primary tax amounts may explain some of these reductions, a significant proportion (approximately 25 per cent of total penalties raised) appears to be due to unsustained penalty decisions. The review identified a number of underlying reasons including ATO officer capability to appropriately deal with facts and evidence, information not being provided to the ATO during audits and insufficient explanation of penalty decisions. The IGT has made a number of recommendations in this regard including that the ATO:

- ensure its officers engage effectively with taxpayers to collect the facts and evidence relevant to penalties at the time that they collect the same in relation to primary tax;
- develop a penalty decision making tool that provides officers with an analytical framework and assists them to collect all relevant evidence; and
- ensure ATO penalty decisions provide reasons that include the material facts and evidence, how the law was applied and an explanation of any disagreement with taxpayer contentions.

The use of penalties as leverage to influence primary tax disputes was another concern raised by stakeholders. While the ATO had made some changes to its processes to address such concerns, perceptions of leverage have persisted. The IGT has made recommendations aimed at addressing these perceptions, including that the ATO:

- only require taxpayers to pay penalty amounts after the dispute on the primary tax is resolved;
- delay discussion with taxpayers concerning any application of potential penalties until after any position papers are issued;
- clearly and concisely communicate to taxpayers the reasons for the ATO's ability or inability to reduce penalties and primary tax during settlement negotiations; and
- publish more statistical information on the quantum of penalties raised and adjusted.

The review also identified opportunities to improve the clarity and practicality of specific aspects of the ATO's penalty guidance and has made recommendations to:

- improve the guidance on voluntary disclosures and penalty remission;
- provide better examples of the law being applied to particular circumstances; and
- consolidate all publicly available penalty materials into a single location.

The ATO's collection and analysis of penalty information were also identified by the IGT as an area requiring improvement. It was observed that the ATO was unable to precisely determine the level of unsustainable penalty decisions, track changes to penalty decisions over the life of a taxpayer's case or understand the reasons for penalty decisions being imposed and the characteristics of non-compliant taxpayers at an enterprise-wide level. The IGT considers that such information would improve the ATO's understanding of the underlying reasons for taxpayer non-compliance and unsustainable penalty decisions and enable the ATO to fine-tune its strategies to promote voluntary compliance. The IGT has made recommendation that the ATO standardise its information collection on penalties and undertake systematic analysis of such information. The ATO has only partly agreed to these recommendations, largely due to what it believes are resource constraints.

Another recommendation with which the ATO has disagreed in part relates to increasing transparency by providing public access to all penalty decisions and associated reasoning. The IGT understands that the disagreement is largely due to resource constraints and that the ATO has sought to address the transparency issue to some extent by publishing the results of its quality assurance processes which assess the correctness of penalty decisions.

Overall, the IGT has made ten recommendations including one directed to the Government. The ATO has agreed in whole, part or principle to all of the recommendations directed to it. The effective implementation of these agreed recommendations should result in significant and enduring benefits.

# CHAPTER 1—BACKGROUND

## CONDUCT OF REVIEW

1.1 This is the Inspector-General of Taxation's (IGT) report of his review into the Australian Taxation Office's (ATO) administration of penalties. The report is produced pursuant to section 10 of the *Inspector-General of Taxation Act 2003* (IGT Act 2003).

1.2 During public consultation for the IGT's 2012–13 work program, a range of stakeholders raised concerns with the ATO's application of penalties in compliance activities. The IGT commenced this review in response to those concerns and pursuant to section 8(1) of the IGT Act 2003. The IGT undertook further community consultation to better understand these stakeholder concerns, which are reflected in the terms of reference issued on 22 November 2012 and reproduced in Appendix 1.

1.3 The IGT received a number of submissions from taxpayers, tax practitioners and their representative bodies amongst others. The IGT also met with interested stakeholders to understand their experiences and to discuss their submissions. The concerns generally focussed on penalties that relate to the statements that taxpayers make in fulfilling their tax obligations and may be grouped under the following four themes:

- the legislative framework of the current penalty regime, such as the stratification of penalty rates;
- the number and quantum of penalties that are reduced on internal and external review;
- the purported reasons for unsustainable ATO penalty decisions, such as ATO officer capability in dealing with evidentiary matters and the potential for penalties to be used as leverage in resolving primary tax disputes; and
- the clarity and accessibility of ATO advice and guidance on various aspects of penalty matters.

1.4 The IGT established a working group to discuss the potential solutions to the systemic issues identified in this review. This group comprised key tax practitioners and their representatives: Arthur Athanasiou, Thomsons Lawyers; John Avery, Australand; Michael Bersten, PricewaterhouseCoopers; Ron Jorgensen, Harwood Andrews Lawyers; Ashley King, Deloitte; Chen Leong, BHP Billiton; Frank O'Loughlin, Victorian Bar; Paul Stacey, Institute of Chartered Accountants in Australia; Glenn Williams, Ernst & Young; and senior ATO officials, led by the Second Commissioner – Compliance.

1.5 We greatly appreciate the generosity of the members of this working group in freely giving their time and expertise. Their involvement has greatly enhanced the outcomes of this review. It should be noted, however, that the views and recommendations expressed in this report are not necessarily those of individual

members of the working group. The views and recommendations were finalised by the IGT after deliberation and input from private sector representatives and the ATO.

1.6 The IGT review team also worked progressively with ATO senior management to distil the scope for improvement and to agree on specific actions to realise these improvements. Broader policy issues were also discussed with officers in the Attorney-General's Department and the Department of Finance and Deregulation.

1.7 In accordance with section 25 of the IGT Act 2003, the IGT provided the Commissioner of Taxation with the opportunity to make submissions on any implied or actual criticisms contained in this report.

1.8 All legislative references mentioned in this report are to Part 4-25 of Schedule 1 of the *Taxation Administration Act 1953* (TAA 1953) unless stated otherwise.

## PURPOSE AND DESIGN OF PENALTIES

1.9 Generally, the purpose of penalties is to promote the smooth running of social and economic structures by shaping desired behaviours and punishing undesirable behaviours. As such, the design of any particular penalty regime depends on the policy aims of the area of activity in which they are sought to be imposed, such as the areas of corporate governance, consumer protection or taxation.<sup>1</sup>

1.10 In the self assessment system established by the taxation laws, the administrative penalty regime is designed to encourage voluntary compliance with taxation obligations.<sup>2</sup> These obligations may be grouped into the following four categories:

- registration obligations – registration with the relevant authorities for various taxation obligations;
- lodgement obligations – timely lodgement of requisite taxation information or documents;
- reporting obligations – complete and accurate information to be reported, as well as the maintenance of supporting records; and
- payment obligations – the prompt payment of taxation liabilities.<sup>3</sup>

1.11 Tax administration penalties encourage a level of taxpayer compliance by setting out the consequences of not meeting the standard of conduct required to fulfil

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1 Australian Law Reform Commission, *Principled Regulation: Federal Civil & Administrative Penalties in Australia*, Report No 95 (2002) p 70.

2 Department of the Treasury, National Taxpayer Advocate, *2008 Annual Report to Congress – Volume Two* (2008) p 7.

3 Organisation for Economic Co-operation and Development, *Guidance Note Compliance Risk Management: Managing and Improving Tax Compliance* (OECD Publishing, 2004) p 7.

the relevant tax obligations.<sup>4</sup> There may be instances where some levels of non-compliance may be tolerated and not attract the imposition of penalties.<sup>5</sup>

1.12 In the self assessment system, determining whether taxpayers have complied with registration, lodgement and payment obligations may be a relatively easy exercise as non-compliance with these obligations are objectively observable events – for example, a taxpayer not lodging a specific form.

1.13 Determining non-compliance with reporting obligations, however, may be more complex as even simple economic transactions can involve considerable uncertainty about the correct interpretation and application of the tax law.<sup>6</sup> Furthermore, reporting obligations may require taxpayers to undertake complex tasks such as:

- concurrently interpreting various legislative provisions, administrative interpretations and the interactions between the two;
- making conclusions of fact that cannot be directly evidenced and can only be inferred from various pieces of evidence – for example, questions of residency, arm’s length and market value; and
- determining which facts and evidence should be considered in applying the law and their effect on the resulting outcomes.

1.14 Such complexities with reporting may be compounded by other factors such as the capability of the taxpayer and the nature and availability of reliable advice provided by the ATO and advisers.

## PRINCIPLES OF PENALTY REGIME DESIGN

1.15 The principles of penalty regime design in a self assessment environment have been reviewed in jurisdictions such as the United States of America (USA). In that jurisdiction, a task force was established to develop a fair, consistent and comprehensive approach to penalty administration. The task force issued a report in February 1989 that identified four broad principles for evaluating whether penalties encourage voluntary compliance,<sup>7</sup> namely fairness, comprehensibility, effectiveness and ease of administration.<sup>8</sup>

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4 Michael Doran, ‘Tax Penalties and Tax Compliance’ (2009) 46 Harvard Journal on Legislation 111, p 139.

5 Above n.3, p 7.

6 Above n.4, p 138.

7 See Executive Task Force for Internal Revenue Commissioner’s Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft) (1988) pp 9-10; Executive Task Force for the Commissioner’s Penalty Study, *Report on Civil Tax Penalties* (Working Draft of Chapters 1-4 and 8) (1988); Executive Task Force for the Commissioner’s Penalty Study, *Report on Civil Tax Penalties* (1989) pp 45-36.

8 The Internal Revenue Services incorporated these principles into Policy Statement P-1-18 (20 August 1998).

1.16 The first principle, fairness, consisted of three main components:

- horizontal equity – similarly treating taxpayers in substantially the same circumstances by reference to taxpayers' wilfulness of non-compliance, level of sophistication and prior compliance history;
- proportionality – the penalties reflect the culpability of taxpayers and the harm caused by their non-compliance; and
- procedural fairness – the regulator to provide opportunities for taxpayers to be heard on the issues before imposing penalties and carefully considering any mitigating facts and circumstances.<sup>9</sup>

1.17 The second principle, comprehensibility, requires taxpayers with various levels of education to be able to understand the conduct that is expected of them and the consequences for failing to meet those expectations. In cases where more than one penalty can apply to the same conduct, complexity may increase and influence the level of voluntary compliance.<sup>10</sup>

1.18 The third principle, effectiveness, requires the penalty to be severe enough to eliminate non-compliance without being so severe as to be difficult to enforce or perceived as disproportionate or unfair.<sup>11</sup> However, a penalty regime is likely to be more effective in encouraging voluntary compliance if it is graduated and based on taxpayers' efforts to correct any initial non-compliance, provided such graduations do not produce excessive complexity.

1.19 The fourth principle, ease of administration, allows the regulator to simply determine whether the penalty should be imposed and to exercise discretion in waiving the penalty if appropriate. It also requires the regulator to not provide overly detailed guidance or for the rules to be rigid.<sup>12</sup>

1.20 This task force report recognised that individual penalties and the penalty regime as a whole must effectively balance these four principles.<sup>13</sup>

1.21 To best understand how the application of these principles could be most effective in influencing taxpayer behaviours, there must be an appreciation of what motivates taxpayers to comply with their tax obligations.<sup>14</sup> The extensive but still unsettled literature coalesces around two models of taxpayer compliance—a deterrence model and a norms model.<sup>15</sup>

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9 Above n.2, pp 7-8.

10 Ibid, p 9.

11 Ibid, p 9.

12 Ibid, pp 9-10.

13 Task Force Report, *Making good decisions about tradeoffs is the key to a good penalty system* (1989), supra note 10, p III-10.

14 Above n.4, p 123.

15 Ibid, p 123.

## Deterrence model

1.22 The deterrence model argues that taxpayers will comply with their obligations where the expected benefits of compliance outweigh the expected costs of non-compliance.<sup>16</sup> As a result, this model implies that tax penalties should be high in order to increase the expected costs of non-compliance and thereby encourage taxpayer compliance.<sup>17</sup>

1.23 However, some have observed that the deterrence model is derived from a narrow view of taxpayer motivation as it assumes that tax compliance decisions are made by rational taxpayers who simply compare expected benefits to expected costs.<sup>18</sup>

## Norms model

1.24 The norms model argues that a substantial number of taxpayers comply with their obligations through adherence to social or personal norms,<sup>19</sup> such as reciprocal cooperation and trust. For example, a taxpayer who values integrity, honesty and the benefits of citizenship may feel guilt, shame or similar emotions if they do not meet their tax obligations.

1.25 This model accepts that the deterrence model accounts for some level of taxpayer compliance, however, the remaining level can only be attributed to social or personal norms.

1.26 The norms model implies governments should supplement tax penalties with other mechanisms aimed at inducing and reinforcing norms-based compliance.

1.27 Although a penalty regime may be designed on an appropriate balance of the above principles and a sound conceptual understanding of taxpayer motivations, voluntary compliance may not always be achieved in practice. In this respect, the application of behavioural science can assist.

## APPLICATION OF BEHAVIOURAL SCIENCE

1.28 Behavioural science generally seeks to establish working models, based on observations, which predict how certain people will behave in certain situations.

1.29 A key tool used is that of randomised controlled trials (RCTs), which collect qualitative and quantitative data to assess whether a model is useful in predicting behaviours. RCTs are used extensively in fields such as international development, medicine and business. Similarly, RCTs may be used to assess whether policies and strategies are effective in practice.

1.30 The broader adoption of behavioural science by governments may provide a means to enhance the effectiveness of regulation by indicating alternatives to

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<sup>16</sup> Ibid, p 112.

<sup>17</sup> Ibid, p 112.

<sup>18</sup> Ibid, p 112.

<sup>19</sup> Ibid, p 131.

state-imposed sanctions, such as the reframing of policy and regulatory responses.<sup>20</sup> For example, the UK Cabinet Office's paper, *MINDSPACE – Influencing behaviour through public policy*,<sup>21</sup> sets out a framework for policy design by considering the factors that influence behaviours.<sup>22</sup> Such approaches are also receiving greater interest from Australian government bodies.<sup>23</sup>

1.31 A limited number of studies have been conducted on aspects of penalty systems that may influence taxpayer behaviours. Although much of this body of work is based on the USA's system, these studies indicate that tax penalties are more effective in influencing behaviours where they include a threat of guilt feelings, rather than the threat of legal sanctions<sup>24</sup> as well as the magnitude of the penalty, rather than the probability of detection.<sup>25</sup> More recent studies, one of which is Australian-based, indicate that penalties are more effective in influencing behaviours when they are combined with educational efforts,<sup>26</sup> carefully tailored persuasive communication<sup>27</sup> or rewards.<sup>28</sup>

1.32 It is likely that behavioural science research, as a means of identifying factors that influence taxpayer behaviours and testing policy and strategy design, will become a fertile area in future.

## AUSTRALIAN TAXATION LAW ADMINISTRATIVE PENALTIES

1.33 Under the Australian laws, criminal, civil and administrative penalties may be imposed in response to different types of behaviour that result in failure to comply with relevant taxation obligations. As the overwhelming focus of stakeholders' concerns related to particular types of administrative penalties, this review examines aspects of those penalties with which concerns have been raised.

1.34 By way of background, an outline of the key legislative developments, legislative framework and administrative arrangements for particular tax administrative penalties are provided to contextualise the particular concerns examined in the following chapters.

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20 Department of Finance and Deregulation, *The utility maximising criminal: A behavioural approach to designing regulatory penalties* (2013) (un-published).

21 Cabinet Office, *Institute for Government, MINDSPACE – Influencing behaviour through public policy* (2010).

22 *Ibid*, p 8.

23 Above n.20.

24 Franklin Zimring, *Perspectives on Deterrence* (1971); Franklin Zimring and Gordon Hawkins, 'Deterrence: the Legal Threat in Crime Control' (1973) 3(5) *Contemporary Sociology* 454; Ann Witte and Diane Woodbury, *The Effect of Tax Laws and Tax Administration on Tax Compliance* (Working Paper, 1983); Richard Schwartz and Sonya Orleans, 'On Legal Sanctions' (1967) 34 *The University of Chicago Law Review* 274.

25 Betty Jackson and Sally Jones, 'Salience of Tax Evasion Penalties Versus Detection Risk' (1985) 6(2) *Journal of the American Taxation Association* 7.

26 Peggy Hite, 'Identifying and Mitigating Taxpayer Non-Compliance' (1997) 13 *Australian Tax Forum* 155-180 and Marjorie Kornhauser, 'A Tax Morale Approach to Compliance: Recommendations For the IRS' (2007) 8(6) *Florida Tax Review* 599 and Ken Devos, 'An Investigation Into Australian Personal Tax Evaders – Their Attitudes Towards Compliance And The Penalties For Non-Compliance' (2009) 19(1) *Revenue Law Journal* 36.

27 John Hasseldine, Peggy Hite, Simon James and Marika Toumi, 'Persuasive Communications: Tax Compliance Enforcement Strategies for Sole Proprietors' (2007) 24(1) *Contemporary Accounting Research* 171; Hite, above n.26, p 161.

28 Josef Falkinger and Herbert Walther, 'Rewards versus Penalties: on a New Policy on Tax Evasion' (1991) 19(1) *Public Finance Review* 67.

## Key legislative developments

1.35 Prior to the introduction of the income tax self assessment system in 1986, the ATO bore the risk of ensuring that the law correctly applied to the facts in assessments. This approach meant that the taxpayers' obligation was largely limited to making the required disclosures of facts. Under this system, administrative penalties relating to understatements of income tax were applied at a 200 per cent rate and were remitted on a case-by-case basis to a level which the ATO considered appropriate.

1.36 Upon the introduction of self assessment, the taxpayers' obligation was expanded to correctly apply the law to the facts. As a consequence, the pre-existing penalty regime was replaced in 1992 to align income tax administrative penalties with the standard of conduct required by the new system, namely 'reasonable care':

The changes to the penalty provisions are necessary because the current penalty standard no longer reflects what is required of taxpayers. Rather than making a full and true disclosure of all material facts to the Commissioner so that the Commissioner can actively assess a taxpayer's liability, taxpayers are now effectively required to determine their own taxable income. The new penalties set out the standards that taxpayers should meet in fulfilling their tax obligations in a self assessment environment. ... Generally, where taxpayers exercise reasonable care, and, for large items, have a reasonably arguable position, they will not be subject to penalties.<sup>29</sup>

1.37 The 1992 income tax self assessment penalty regime penalised taxpayers for exhibiting certain types of culpable behaviour such as lack of reasonable care, recklessness and intentional disregard of the tax laws. A penalty was also imposed if a taxpayer position was not reasonably arguable.<sup>30</sup>

## Uniform administrative penalty regime

1.38 In 2000, a 'uniform administrative penalty regime' was enacted to apply uniformly to all taxation laws. In effect, this regime:

- introduced new penalties for failure to fulfil the obligations arising from the then recently enacted Goods and Services Tax (GST) and related laws, as well as some obligations arising under the pre-existing laws;
- consolidated penalties arising in all taxation laws by grouping them together, removing duplication and standardising the relevant provisions;<sup>31</sup> and
- standardised the penalty rates and amounts for breaches of similar tax obligations arising under the different tax laws.<sup>32</sup>

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<sup>29</sup> Explanatory Memorandum, House of Representatives, Taxation Laws Amendment (Self Assessment) Bill 1992, p 71.

<sup>30</sup> Ibid, p 83.

<sup>31</sup> Explanatory Memorandum, House of Representatives, A New Tax System (Tax Administration) Bill (No. 2) 2000, para 1.2.

<sup>32</sup> Ibid, paras 1.8 and 1.12.

1.39 The uniform administrative penalty regime is currently contained in Part 4-25 of Schedule 1 to the TAA 1953 and has four main types of administrative penalties:

- penalties relating to taxpayer statements;<sup>33</sup>
- penalties relating to schemes;<sup>34</sup>
- penalties for failing to lodge returns and other documents on time;<sup>35</sup> and
- other miscellaneous penalties, such as failing to register or cancel registration and failing to issue a tax invoice.<sup>36</sup>

1.40 As this IGT review focuses primarily on penalties relating to taxpayer statements, the following sections outline those penalties and associated matters. There is also a brief discussion of penalties relating to schemes.

## **PENALTIES RELATING TO TAXPAYER STATEMENTS**

1.41 Penalties relating to taxpayer statements include those relating to making false or misleading statements, positions taken that are not reasonably arguable and failing to provide documents.<sup>37</sup>

### **False or misleading statement penalty**

1.42 Generally, a taxpayer<sup>38</sup> is liable for a false or misleading statement penalty if:

- the taxpayer or their agent makes a statement to the Commissioner;<sup>39</sup> and
- the statement is false or misleading in a material particular, whether because of things in the statement or omitted from the statement.<sup>40</sup>

1.43 In the ATO's view, a 'statement' is interpreted very broadly and can be anything disclosed to the Commissioner<sup>41</sup> for a purpose connected with a taxation law.<sup>42</sup> A statement may be made in many forms, including written, oral or electronic. For example, a statement may be made in correspondence, responses to requests for

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33 *Taxation Administration Act 1953*, sch 1, subdiv 284-B.

34 *Ibid*, sch 1, subdiv 284-C.

35 *Ibid*, sch 1, div 286.

36 *Ibid*, sch 1, div 288.

37 *Ibid*, sch 1, s284-10.

38 *Ibid*, sch 1, s284-25 and s284-75.

39 Also includes another entity exercising powers or performing functions under a taxation law.

40 *Taxation Administration Act 1953*, sch 1, s284-75(1).

41 Or a tax officer in the course of their duties.

42 Australian Taxation Office, *Administration of penalties for making false or misleading statements that result in shortfall amounts*, PSLA 2012/5, 25 January 2013, para 16.

information, a notice of objection, a request for an amended assessment, in answer to a questionnaire or in connection with an examination or investigation.<sup>43</sup>

1.44 The ATO considers that a statement is false if it is ‘contrary to fact or wrong’<sup>44</sup> and a statement is misleading if it ‘creates a false impression, even if the statement is true’.<sup>45</sup> The statement must also be false or misleading in a ‘material particular’,<sup>46</sup> which the ATO defines as ‘something that is likely to affect a decision regarding the calculation of [a taxpayer’s] tax-related liability or entitlement to a credit or payment’.<sup>47</sup>

1.45 In considering the application of false or misleading statement penalties, the ATO must ascertain the level of care that the taxpayer took in making the statement by reference to four different legislative standards of conduct<sup>48</sup> – reasonable care, failure to take reasonable care, recklessness and intentional disregard. These standards of conduct are described in further detail below.

### **Reasonable care and failure to take reasonable care**

1.46 A taxpayer is not liable to an administrative penalty for a statement that is false or misleading if the taxpayer took reasonable care in making the statement.<sup>49</sup> The ATO has publicly stated that there is no presumption that the false or misleading nature of a statement necessarily or automatically points to a failure to take reasonable care, the evidence must support the conclusion that the taxpayer’s attempt to comply has fallen short of the standard of care that would reasonably be expected in the circumstances.<sup>50</sup>

1.47 The ATO considers that whether a taxpayer took reasonable care in any particular case may be tested by the conduct that could be expected of a reasonable person in their position at the time of making the false or misleading statement. This test imputes the reasonable person with certain circumstances and characteristics of the taxpayer,<sup>51</sup> such as the taxpayer’s level of knowledge or understanding of the tax system, whether the taxpayer should have been aware of the correct treatment of the law and whether the taxpayer had made reasonable enquiries.<sup>52</sup> The actual intention of the person said to be at fault is not relevant.<sup>53</sup>

1.48 Importantly, a taxpayer will not be liable to a penalty where a false or misleading statement was made by a registered tax agent due to the agent’s lack of

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43 Ibid, para 18.

44 Ibid, para 21.

45 Ibid, para 22.

46 *Taxation Administration Act 1953*, sch 1, s284-75(1)(b).

47 Above n.42, para 23.

48 *Taxation Administration Act 1953*, sch 1, s284-90.

49 Ibid, sch 1, s284-75(5).

50 Australian Taxation Office, *Penalty relating to statements: meaning of reasonable care, recklessness and intentional disregard*, MT 2008/1, 11 July 2012, para 42.

51 Ibid, para 28.

52 Above n.42, para 49.

53 Above n.50, para 33.

reasonable care,<sup>54</sup> so long as the taxpayer provided all the relevant taxation information to the agent.<sup>55</sup>

### **Recklessness**

1.49 Recklessness is conduct that goes beyond mere carelessness or inadvertent behaviour by displaying a high degree of carelessness.<sup>56</sup> It is established where the taxpayer's behaviour falls significantly short of the standard of care expected of a reasonable person in the same circumstances as the taxpayer.

1.50 The test for determining whether a statement has been recklessly made is the same as the test for determining whether a taxpayer has failed to take reasonable care. However, it is the extent or degree to which the conduct of the taxpayer falls below that required of a reasonable person that underscores a finding of recklessness.<sup>57</sup>

1.51 The ATO considers that recklessness assumes that the behaviour in question shows disregard or indifference to a risk that is foreseeable by a reasonable person,<sup>58</sup> such as making a statement knowing that there is a real, as opposed to a fanciful, risk that the material may be incorrect. Recklessness may also mean that the taxpayer is grossly indifferent as to whether or not the material is true and correct in circumstances where a reasonable person would perceive a real risk.<sup>59</sup> Evidence of dishonesty is not a necessary element for conduct to be considered reckless.<sup>60</sup>

### **Intentional disregard of a taxation law**

1.52 Intentional disregard of a taxation law is established where the taxpayer has actual knowledge that the statement made is false. The ATO considers that the taxpayer must understand the effect of the relevant legislation and how it operates and makes a deliberate choice to ignore the law.<sup>61</sup>

1.53 Unlike the tests for a failure to take reasonable care or recklessness, the test for intentional disregard of the law considers the actual intention of the taxpayer.<sup>62</sup> Therefore, dishonesty is a factor.<sup>63</sup>

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54 *Taxation Administration Act 1953*, sch 1, s284-75(6).

55 *Ibid*, sch 1, s284-75(7) and s284-75(6).

56 Above n.50, para 99.

57 *Ibid*, para 101.

58 *Ibid*, para 102.

59 *Hart v. FC of T*, (2003) 131 FCR 2003; [2003] FCAFC 105, paras 33 and 43.

60 Above n.50, para 100.

61 *Ibid*, para 112.

62 *Ibid*, para 111.

63 *Ibid*, para 113.

## No reasonably arguable position (RAP) penalty

1.54 In addition to penalties for false or misleading statements, a penalty can also be imposed if:

- the taxpayer or their agent makes a statement to the Commissioner;<sup>64</sup>
- in the statement, an income tax law was treated as applying to a matter in a particular way that was not reasonably arguable;<sup>65</sup> and
- the shortfall that arises for not having taken a reasonably arguable position (RAP) is more than the greater of \$10,000 or 1 per cent of the income tax payable.<sup>66</sup>

1.55 A position is reasonably arguable if:

...it would be concluded in the circumstances, having regard to relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect.<sup>67</sup>

1.56 It has been suggested that this definition may mean that the RAP must relate to a contentious or unsettled area of law or a serious question about the application of settled law to the facts of a particular case.<sup>68</sup>

1.57 The ATO considers that the test for a RAP focuses solely on the merits of the position taken by analysing the law and applying it to the relevant facts. It is not a question of whether a taxpayer thinks or believes that its position is reasonably arguable, but simply whether it is reasonably arguable.<sup>69</sup>

### Potential penalties overlap

1.58 There is a question about the potential overlap regarding the no RAP penalty and the false and misleading statement penalties addressed earlier.

1.59 Potentially a statement could be both 'not reasonably arguable' and 'false and misleading' within the meaning of the relevant penalty provisions. In this event, on one view of the legislative provisions, two penalties might be applied to the one statement.

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<sup>64</sup> Or another entity exercising powers or performing functions under a taxation law.

<sup>65</sup> *Taxation Administration Act 1953*, sch 1, s284-75(1).

<sup>66</sup> *Ibid*, sch 1, s284-90(1).

<sup>67</sup> *Ibid*, sch 1, s284-15(1).

<sup>68</sup> Above n.31, para 1.22.

<sup>69</sup> Australian Taxation Office, *Shortfall penalties: administrative penalty for taking a position that is not reasonably arguable*, MT 2008/2, 24 July 2013, para 29.

## Failure to provide documents penalty

1.60 An administrative penalty may be imposed where a taxpayer fails to provide a return, notice or other document to the Commissioner by the day it is required where:

- that document is necessary for the Commissioner to determine the taxpayer's tax-related liability accurately; and
- the Commissioner determines the tax-related liability without the assistance of that document.<sup>70</sup>

## Calculating the amount of penalty in relation to taxpayer statements

1.61 Once the legislative standard of conduct has been identified by reference to the taxpayer's behaviours, the penalty amount must be calculated by:

- determining the base penalty amount;
- increasing and/or reducing the base penalty amount; and
- determining if remission is appropriate.

### Base penalty amount

1.62 The base penalty amount for a false or misleading statement penalty is calculated differently depending on whether a shortfall amount exists or not.<sup>71</sup> Generally, a 'shortfall amount' is the amount by which either a tax-related liability is less or a Commissioner's payment or credit is more, than it would have been if the statement was not false or misleading.<sup>72</sup>

1.63 Where a shortfall amount exists, the base penalty amount is calculated by multiplying the shortfall amount by a percentage which is determined by the relevant statement and taxpayer conduct.<sup>73</sup>

1.64 Where a shortfall amount does not exist, a penalty unit<sup>74</sup> is applied. The amount of the unit is determined by the taxpayer's conduct. Penalties relating to taxpayer statements where no shortfall arises were recently enacted in 2010.<sup>75</sup>

1.65 The base penalty amount for no reasonably arguable position penalties is 25 per cent of the shortfall amount.

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<sup>70</sup> *Taxation Administration Act 1953*, sch 1, s284-75(3).

<sup>71</sup> *Ibid*, sch 1, s284-90(1).

<sup>72</sup> *Ibid*, sch 1, s284-80.

<sup>73</sup> *Ibid*, sch 1, s284-90.

<sup>74</sup> Subsection 4AA(1) of the *Crimes Act 1914* provides that the value of one penalty unit is \$110 for contraventions occurring prior to 28 December 2012, and \$170 for contraventions on or after this date.

<sup>75</sup> *Taxation Laws Amendments (2010 Measures No 1) Act 2010*.

1.66 For a failure to provide documents penalty, the base penalty amount is 75 per cent of the tax-related liability that the Commissioner determined without the assistance of the required document.<sup>76</sup>

1.67 The relevant penalty percentages and penalty units and the types of taxpayer conduct to which they relate are set out in Table 1 below.

**Table 1: Relevant percentage rates and penalty units for penalties relating to taxpayer statements**

Type of penalty relating to a statement	Relevant standards of conduct or type of statement	Percentage rate	Penalty units
False or misleading statement	Intentional disregard of a taxation law	75%	60
	Recklessness as to the operation of a taxation law	50%	40
	Failure to take reasonable care to comply with a taxation law	25%	20
No reasonably arguable position	An income tax law was treated as applying in a particular way that was not reasonably arguable	25%	n/a
Failure to provide documents	Failure to provide documents to accurately determine the taxpayer's tax liability	75%	n/a

Source: IGT

1.68 The base penalty amount may be reduced to the extent that a taxpayer applies the law in accordance with:

- advice given to the taxpayer by or on behalf of the Commissioner;
- a general administrative practice; or
- a statement in a publication approved in writing by the Commissioner.<sup>77</sup>

### Increase or decrease in the base penalty amount

1.69 Once the base penalty amount has been determined, any circumstances justifying an increase or decrease in this amount are considered.<sup>78</sup>

1.70 The base penalty amount may be increased by an additional 20 per cent where the taxpayer:

- took steps to prevent or obstruct the Commissioner from finding out about the shortfall amount or the false or misleading nature of a statement; or

<sup>76</sup> *Taxation Administration Act 1953*, sch 1, s284-90.

<sup>77</sup> *Ibid*, sch 1, s284-90(1) and s284-224(1).

<sup>78</sup> *Ibid*, sch 1, subdiv 284-D.

- became aware of the shortfall amount or the false or misleading nature of a statement after the statement was made and did not tell the Commissioner about it within a reasonable time.<sup>79</sup>

1.71 In the ATO's view, preventing or obstructing the Commissioner from finding out about the shortfall amount or the false or misleading nature of a statement can include the following conduct:

- repeated failure or deferral by the taxpayer to supply information without an acceptable reason;
- providing false or misleading information or documents; and
- destroying records.<sup>80</sup>

1.72 The base penalty amount may also be increased by an additional 20 per cent where a base penalty amount was calculated for the same statement penalty.<sup>81</sup>

1.73 The base penalty amount may be reduced by 80 per cent<sup>82</sup> where a taxpayer voluntarily discloses sufficient information for the Commissioner to determine the shortfall amount, or the false or misleading nature of a statement, before the earlier of:

- a taxpayer being advised that an examination of their tax affairs is to be conducted; or
- the Commissioner publicly requesting voluntary disclosures to be made.<sup>83</sup>

1.74 Where a taxpayer makes a voluntary disclosure after being advised that an examination of their affairs is to be conducted, the base penalty amount will only be reduced by 20 per cent.<sup>84</sup> However, the Commissioner has discretion to treat disclosures as if they were made before the taxpayer was informed of such an examination<sup>85</sup> and, therefore, provide an 80 per cent reduction of the base penalty amount, instead of 20 per cent.

1.75 According to the ATO, a disclosure is voluntary when the Commissioner receives the information required in the approved form.<sup>86</sup>

### **Commissioner's discretion to remit**

1.76 The Commissioner may also exercise his unfettered discretion to remit all or part of an administrative penalty as a result of a taxpayer's request or on his own

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79 Ibid, sch 1, s284-220(1).

80 Above n.42, para 122.

81 *Taxation Administration Act 1953*, sch 1, s284-220(1)(c) to (e).

82 Note that the base penalty amount will be reduced by 100 per cent if the shortfall is less than \$1000.

83 *Taxation Administration Act 1953*, sch 1, s284-225.

84 Ibid, sch 1, s284-225(1).

85 Ibid, sch 1, s284-225(5).

86 Above n.42, para 140.

initiative.<sup>87</sup> Should the Commissioner partly remit or not remit the penalty at all, he must provide the taxpayer with written notice of his decision.<sup>88</sup>

1.77 The ATO requires its officers to consider certain matters in approaching the exercise of remission:

156. Tax officers must consider the question of remission in each case based on all of the relevant facts and circumstances and having regard to the purpose of the provision. Relevant matters to consider in approaching the issue of remission of penalty include:

- that the purpose of the penalty regime is to encourage entities to take reasonable care in complying with their tax obligations. Where the entity has made a genuine attempt to report correctly, it will generally be the case that no penalty applies because of the exercise of reasonable care, safe harbour or because the law was applied in the accepted way.
- remission decisions need to consider that a major objective of the penalty regime is to promote consistent treatment by reference to specified rates of penalty. That objective would be compromised if the penalties imposed at the rates specified in the law were remitted without just cause, arbitrarily or as a matter of course.

157. The discretion to remit penalties should be approached in a fair and reasonable way, including ensuring that prescribed rates of penalty do not cause unintended or unjust results.<sup>89</sup>

## PENALTIES RELATING TO SCHEMES

1.78 A penalty may also be imposed where:

- a taxpayer obtains a reduced tax-related liability or increased payment or credit under a scheme<sup>90</sup> (a scheme benefit); and
- that scheme benefit, although allowable under general tax law provisions, is cancelled due to the application of an adjustment provision.

1.79 Such a penalty is calculated in a similar manner as penalties relating to taxpayer statements above, with the following alterations:

- in the place of a shortfall amount a ‘scheme shortfall amount’ is quantified which is the amount by which the taxpayer’s liability is less than or payment or credit is more than it would have been but for the application of the adjustment provision;<sup>91</sup> and

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<sup>87</sup> *Taxation Administration Act 1953*, sch 1, s298-20.

<sup>88</sup> *Ibid*, sch 1, s298-20.

<sup>89</sup> Above n.42, paras 156-157.

<sup>90</sup> *Taxation Administration Act 1953*, sch 1, ss284-150 and 284-145.

<sup>91</sup> *Ibid*, sch 1, s284-150.

- the relevant percentage to be applied is 50 per cent, or 25 per cent if the taxpayer's position is reasonably arguable.<sup>92</sup>

1.80 There is potential for penalties relating to taxpayer statements and penalties relating to schemes to be applied to the same adjusted tax liabilities. The ATO states that if a taxpayer has a shortfall amount from participating in a scheme, the penalty will typically be assessed as a penalty relating to statements and a scheme penalty in the alternative.<sup>93</sup> This situation arises where the ATO raises assessments on alternative grounds, typically involving cases in which the ATO is uncertain whether an adjustment provision applies at the time of adjusting the taxpayer's assessment.<sup>94</sup>

1.81 Where a taxpayer has been involved in a scheme and makes a false or misleading statement in relation to that scheme, cumulative penalties may be applied.<sup>95</sup> However, the ATO states that it would only apply penalties cumulatively in exceptional cases, which 'is a matter of fact to be determined by considering [a taxpayer's] particular circumstances'.<sup>96</sup> In such a case, the Commissioner may exercise his discretion to remit the resulting cumulative penalty amount to a reduced penalty amount.<sup>97</sup>

## NOTIFICATION OF THE LIABILITY

1.82 Once penalties are calculated, the Commissioner is required to notify the taxpayer in writing of their liability to pay the penalty and the supporting reasons. No reasons are required if the Commissioner decides to remit the entire penalty.<sup>98</sup>

1.83 The payment of the penalty is due on the day specified in the notification but this date must be at least 14 days after the notice is given to the taxpayer.<sup>99</sup>

## RESOLVING DISPUTES OVER PENALTY DECISIONS

1.84 Taxpayers may dispute penalty decisions through various informal and formal options that are available to them.

1.85 The ATO has advised the IGT that its preference is to informally engage and resolve matters directly with taxpayers if the relevant audit has not been finalised.<sup>100</sup> In these circumstances, taxpayers are asked to contact the ATO as a first step when

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92 Ibid, sch 1, s284-160. Note that for income tax amounts adjusted by certain transfer pricing provisions, the relevant percentages to be applied are 25 per cent and 10 per cent respectively, see *ibid*, s284-145(2), s284-145(2A) and s284-160(b).

93 Australian Taxation Office, *Interaction between Subdivisions 284-B and 284-C of Schedule 1 to the Taxation Administration Act 1953*, PSLA 2008/18, 4 July 2011, paras 11.

94 *Ibid*, paras 30-31.

95 *Taxation Administration Act 1953*, sch 1, div 284; *Ibid*, para 32.

96 Above n.93, para 34.

97 *Ibid*, paras 15-16.

98 *Taxation Administration Act 1953*, sch 1, s298-10.

99 *Ibid*, sch 1, s298-15.

100 Inspector-General of Taxation, *Review into the Australian Taxation Office's use of early and Alternative Dispute Resolution* (2012) p 49.

correcting mistakes or disputing decisions. This informal step is generally considered a more efficient means to resolve disagreements.<sup>101</sup>

1.86 Large business taxpayers may also seek an internal review of audit position papers by ATO officers from outside the Compliance Group in certain circumstances. However, the ATO has advised that such a process does not include internal review of penalty positions.<sup>102</sup>

1.87 The tax laws also provide taxpayers with the means to object to penalty decisions which is a form of internal ATO review. The ATO requires an objection to be in writing, either in one of the forms provided by the ATO or in a letter.<sup>103</sup> The objection must be lodged within the later of:

- 4 years from the date the assessment was given to the taxpayer where the penalty is directly linked to an assessment of liability, such as a penalty relating to false or misleading statements; or
- 60 days from the date the penalty notification was issued to the taxpayer where the penalty is not linked to an assessment of liability.<sup>104</sup>

1.88 Taxpayers who are dissatisfied with the ATO's objection decision may also seek an external review of the decision by appealing to the Administrative Appeals Tribunal (AAT) or the Federal Court of Australia (Federal Court).<sup>105</sup> Taxpayers generally have 60 days from the date of the notice, advising the taxpayer of the ATO's objection decision in which to lodge such an appeal.<sup>106</sup> Taxpayers that appeal to the AAT or the Federal Court bear the burden of proving, on the balance of probabilities, that the penalty was 'excessive; or ... should not have been made or should have been made differently'.<sup>107</sup>

1.89 It is also possible for taxpayers to settle disputes concerning penalties, along with other matters that may be in dispute. ATO officers involved in settlement proceedings are required to follow the ATO's Code of Settlement Practice.<sup>108</sup> The ATO's Practice Statement *PSLA 2007/5* outlines key elements of the settlement process and prescribes the mandatory use of the Code of Settlement Practice by all tax officers

101 Australian Taxation Office, *Correct a mistake or dispute a decision* (20 September 2013)

<<http://www.ato.gov.au/General/Correct-a-mistake-or-dispute-a-decision/>>.

102 Australian Taxation Office communication to the Inspector-General of Taxation, 28 November 2013.

103 Australian Taxation Office, *How to object to a decision* (25 May 2013)

<[http://www.ato.gov.au/General/Correct-a-mistake-or-dispute-a-decision/Dispute-\(object-to\)-an-ATO-decision/How-to-object-to-a-decision/?anchor=P1590\\_99732#P1590\\_99732](http://www.ato.gov.au/General/Correct-a-mistake-or-dispute-a-decision/Dispute-(object-to)-an-ATO-decision/How-to-object-to-a-decision/?anchor=P1590_99732#P1590_99732)>.

104 Time limits are set out in section 14ZW to the *Taxation Administration Act 1953*; Australian Taxation Office, *Decisions you can object to, and time limits* (18 July 2013)

<[http://www.ato.gov.au/General/Correct-a-mistake-or-dispute-a-decision/Dispute-\(object-to\)-an-ATO-decision/Decisions-you-can-object-to,-and-time-limits/](http://www.ato.gov.au/General/Correct-a-mistake-or-dispute-a-decision/Dispute-(object-to)-an-ATO-decision/Decisions-you-can-object-to,-and-time-limits/)>.

105 *Taxation Administration Act 1953*, s14ZZ.

106 *Taxation Administration Act 1953*, s14ZZC and s14ZZN.

107 *Ibid*, s14ZZK and s14ZZO.

108 Australian Taxation Office, *Code of Settlement Practice* (23 September 2013)

<<http://www.ato.gov.au/General/Correct-a-mistake-or-dispute-a-decision/In-detail/Instructions-and-guides/Code-of-settlement-practice/>>.

in the settlement of taxation disputes.<sup>109</sup> Where the settlement involves a number of taxpayers, ATO officers are also required to follow the ATO's *PSLA 2007/6 Guidelines for settlement of widely-based tax disputes*.<sup>110</sup>

## **PENALTIES RELATING TO TAXPAYER STATEMENTS IN OTHER JURISDICTIONS**

1.90 Other jurisdictions with self assessment tax systems also impose penalties with the aim of encouraging voluntary compliance with taxation obligations. However, the design and application of these penalty regimes differ to Australia's in certain respects. The following sections briefly outline aspects of the penalty regimes relating to statements in New Zealand, the USA and the United Kingdom (UK).

### **New Zealand**

1.91 In New Zealand, a penalty of 20 per cent of the tax shortfall is imposed on taxpayers who do not take reasonable care in fulfilling their tax obligations.<sup>111</sup>

1.92 A penalty of 40 per cent of the tax shortfall is imposed where 'gross carelessness' is established. This standard involves taxpayer behaviours exhibiting a high degree of carelessness and disregard of the consequences. It is conduct that creates a high risk of a tax shortfall occurring, which would have been foreseen by a reasonable person in the same circumstances. Whether the taxpayer was unaware of being grossly careless or intended to be so is irrelevant.<sup>112</sup>

1.93 New Zealand's penalty for 'evasion' is established by taxpayer behaviours such as knowingly failing to make a legally required withholding of tax and knowingly obtaining a refund or payment of tax when you are not lawfully entitled to that refund or payment.<sup>113</sup>

1.94 New Zealand also adopts a concept similar to RAP, known as an 'unacceptable tax position'. An unacceptable tax position is one that fails to meet the standard of being about as likely to be correct as being incorrect. The penalty for a tax shortfall resulting from an unacceptable tax position is 20 per cent of the tax shortfall.<sup>114</sup>

1.95 In relation to remission, penalties for tax shortfalls in the New Zealand tax system may be reduced by 50 per cent if the taxpayer was not previously liable to pay

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109 Australian Taxation Office, *Settlements*, PS LA 2007/5, 12 June 2013.

110 Australian Taxation Office, *Guidelines for settlement of widely-based tax disputes*, PS LA 2007/6, 21 May 2012, para 1.

111 *Tax Administration Act 1994* (New Zealand), s141A; Inland Revenue, *Penalties and interest: Shortfall penalties – Not taking reasonable care* (26 March 2008) <<http://www.ird.govt.nz/how-to/debt/penalties/shortfall-penalties/sf-penalties-lack-care.html>>.

112 *Tax Administration Act 1994* (New Zealand), s141C; Inland Revenue, *Penalties and interest: Shortfall penalties – Gross carelessness* (30 August 2006) <<http://www.ird.govt.nz/how-to/debt/penalties/shortfall-penalties/sf-penalty-gross-carelessness.html>>.

113 *Tax Administration Act 1994* (New Zealand), s141E; Inland Revenue, *Penalties and interest: Shortfall penalties – Evasion* (26 March 2008) <<http://www.ird.govt.nz/how-to/debt/penalties/shortfall-penalties/sf-penalty-evasion.html>>.

114 *Tax Administration Act 1994* (New Zealand), s141B; Inland Revenue, *Penalties and interest: Shortfall penalties – Unacceptable tax position* (26 March 2008) <<http://www.ird.govt.nz/how-to/debt/penalties/shortfall-penalties/sf-penalties-unacceptable.html>>.

a similar penalty.<sup>115</sup> A penalty for a tax shortfall may also be reduced by 40, 75 or 100 per cent where a taxpayer has made a voluntary disclosure of all the details of the shortfall, depending on the type of penalty and when the voluntary disclosure was made.<sup>116</sup>

## United States

1.96 In the USA, penalties may apply when a taxpayer files a return that is inaccurate and the inaccuracy results from certain taxpayer behaviour.

1.97 According to the Internal Revenue Service (IRS), the two most common accuracy-related penalties are those based on the taxpayer's negligence or disregard of rules or regulations and the taxpayer's substantial understatement of income tax.<sup>117</sup> These penalties are 20 per cent of the net understatement of tax.<sup>118</sup> This penalty rate increases to 40 per cent in circumstances where tax is not fully reported on a return because the return contains gross valuation misstatements or there are non-disclosed non-economic substance transactions or undisclosed foreign financial asset understatements.<sup>119</sup>

1.98 The 'negligence or disregard of rules or regulations' penalty may be applied where a taxpayer's inaccurate reporting results from:

- negligence, which arises when a taxpayer fails to do what a reasonable person would do under the circumstances; or
- disregard of rules or regulations, which arises when a taxpayer fails to follow the appropriate law in completing the return.<sup>120</sup>

1.99 However, the reach of these penalties is limited in the following respects:

- negligence will not apply if the taxpayer's position has a 'reasonable basis', which is a 'significantly higher [standard] than not frivolous or not patently improper' and which generally exists when the position is based on one or more of the types of authorities set out in the Treasury Regulations;<sup>121</sup> and

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115 Inland Revenue, *Penalties and interest: Shortfall penalties – How penalties can be reduced or increased* (26 March 2008)

<<http://www.ird.govt.nz/how-to/debt/penalties/shortfall-penalties/sf-penalty-how.html>>.

116 *Tax Administration Act 1994* (New Zealand), s141G; *ibid*.

117 Internal Revenue Service, *Return Related Penalties* (24 January 2012) <[http://www.irs.gov/irm/part20/irm\\_20-001-005.html](http://www.irs.gov/irm/part20/irm_20-001-005.html)>, para 20.1.5.3.2.

118 26 USC § 6662 (United States).

119 *Ibid*.

120 LexisNexis, *IRC Section 662 Accuracy-Related Penalties* (28 August 2012)

<<http://www.lexisnexis.com/legalnewsroom/tax-law/b/federaltaxation/archive/2012/08/28/irc-section-6662-accuracy-related-penalties.aspx>>;

*Leuhsler v. Commissioner*, 963 F.2d 907 (6th Cir. 1992); *Above n.117*, para 20.1.5.7.1.

121 These regulations are the US Treasury Department's official interpretations of the Internal Revenue Code. See Internal Revenue Service, *Tax Code, Regulations and Official Guidance* (9 October 2013) <<http://www.irs.gov/Tax-Professionals/Tax-Code,-Regulations-and-Official-Guidance>>.

- a penalty for the taxpayer's disregard of rules or regulations will not apply if there is a reasonable basis for the taxpayer's position and the challenge to the rule or regulation is adequately disclosed with the tax return.<sup>122</sup>

1.100 The penalty for substantial understatement of income tax arises by mathematical calculation. In this respect, a substantial understatement penalty may be applied if the correct income tax liability for a taxable year exceeds the amount reported by the taxpayer by (i) the greater of 10 per cent or \$5,000 (\$10,000 for corporations) or (ii) in the case of corporations, \$10,000,000, if less than the amount in (i).

1.101 A taxpayer may avoid the substantial understatement penalty if 'the weight of the authorities supporting the treatment of the item is substantial in relation to the weight of the authorities supporting the contrary treatment' (that is, there is substantial authority for the taxpayer's position) or the taxpayer has disclosed the tax position and it has a reasonable basis. However, if the substantial understatement of income tax arises from a tax shelter, then these two defences do not apply.

1.102 A taxpayer may also avoid penalties arising from taxpayer negligence, disregard of rules or regulations and substantial understatement of income tax if there is 'reasonable cause' for the taxpayer's position and the taxpayer acted in 'good faith'.<sup>123</sup> A finding of 'reasonable cause' generally relies on the taxpayer's effort to report the proper tax liability, as well as other factors such as the taxpayer's experience, knowledge, education, and the reasonableness of the taxpayer's reliance on the advice of a tax advisor.<sup>124</sup>

1.103 The US penalty system also has other accuracy-related penalties, such as a 20 or 30 per cent penalty that may be applied to a reportable transaction understatement,<sup>125</sup> depending on whether the reportable transaction was properly disclosed,<sup>126</sup> and a 75 per cent penalty that is applied to the portion of an underpayment which is attributable to fraud.<sup>127</sup> In addition to the standards of accuracy referred to above, the following also provide exceptions to other penalties:

- a realistic possibility of the position being sustained on its merits; and
- an item's tax treatment being more likely than not the proper treatment.<sup>128</sup>

1.104 From the above, it is clear that, compared to the Australian penalties relating to taxpayer statements, overall, the US system has significantly more differentiation or stratification of the levels of taxpayer non-compliance.

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122 Above n.117.

123 Ibid., para 20.1.5.6.1.

124 Ibid, para 20.1.5.6.1.

125 26 USC § 6662A (United States).

126 Above n.117, para 20.1.5.3.2.

127 26 USC § 6663 (United States).

128 Above n.117, para 20.1.5.8.1.1; 26 USC § 6662 (United States); see also James W. Pratt *Federal Taxation 2013* (7th edition, 2013), p 2:44.

## United Kingdom

1.105 At a broad level, the UK has a similar administrative penalty regime for inaccurate tax returns to that of Australia. For example, the amount of such penalties is quantified by reference to the amount of primary tax shortfall and the various taxpayer behaviour tests.

1.106 Notwithstanding the broad similarity, there are substantial differences in how these penalty amounts are calculated.

1.107 The UK penalty rate for an inaccuracy in a return or other document will be one of six ranges that are determined by the type of behaviour and whether the correction was prompted by the taxpayer. Table 2 below shows the six penalty ranges.

**Table 2: United Kingdom penalty percentage ranges for inaccurate returns**

Type of behaviour	Unprompted Disclosure (%)	Prompted Disclosure (%)
Careless	0 to 30	15 to 30
Deliberate	20 to 70	35 to 70
Deliberate and concealed	30 to 100	50 to 100

Source: Her Majesty's Revenue and Customs.

1.108 The maximum rate of the relevant range is then reduced, by between 0 to 100 per cent of that rate, depending on the type of taxpayer's disclosure and assistance (such as, telling, helping and giving) provided to Her Majesty's Revenue and Customs (HMRC).<sup>129</sup> Other reductions which are unrelated to the taxpayer conduct are then considered – for example, where another penalty or surcharge has been applied on the same tax.

1.109 A taxpayer is regarded as 'careless' where the taxpayer has failed to take reasonable care. Careless behaviour varies between taxpayers. According to the HMRC's website, determining whether a taxpayer is careless involves examining what the taxpayer did or failed to do and asking whether a prudent and reasonable person would have done that or failed to do that in those circumstances.<sup>130</sup>

1.110 The behaviour of a taxpayer is deemed 'deliberate' where the taxpayer knew that a return or document was inaccurate when it was lodged. This is similar to intentional disregard of the law in the Australian tax penalty regime.

1.111 The behaviour of a taxpayer would be 'deliberate and concealed' if the taxpayer knew that the return was inaccurate and attempted to conceal the inaccuracy by taking active steps to hide it either before or after it was lodged.<sup>131</sup> Arguably, a similar outcome could be reached in Australia by increasing the penalty rate for

129 HM Revenue & Customs, *Penalties for inaccuracies in returns and documents* (August 2012) <[www.hmrc.gov.uk/compliance/cc-fs7.pdf](http://www.hmrc.gov.uk/compliance/cc-fs7.pdf)>.

130 HM Revenue & Customs, *CH81140 – Penalties for Inaccuracies: Types of inaccuracy: Careless Inaccuracy* <<http://www.hmrc.gov.uk/manuals/chmanual/ch81140.htm>>.

131 Above n.129.

intentional disregard of the law by 20 per cent on the basis that the taxpayer prevented or obstructed the Commissioner from finding out about the shortfall.

1.112 A penalty rate of up to 70 per cent is imposed in the UK if the inaccuracy is deliberate. This standard is established where the taxpayer knew that a return or document was inaccurate when it was sent. A penalty of up to 100 per cent would be imposed if the inaccuracy is deliberate and the person attempts to conceal it by taking active steps to hide the inaccuracy, either before or after it was lodged.<sup>132</sup>

1.113 Importantly, the UK also has a new administrative practice whereby a penalty arising from an inaccuracy caused by carelessness may be suspended if conditions can be agreed upon to prevent a similar inaccuracy occurring in future. This practice is known as a suspension of the penalty. When considering whether suspension is appropriate, HMRC will consider the person's compliance, the level of disclosure and the nature of the inaccuracy.<sup>133</sup> If at the end of the suspension period, the conditions have been met, the penalty is cancelled, otherwise it will need to be paid.<sup>134</sup>

1.114 In the UK, there is no equivalent penalty for failing to have a RAP.<sup>135</sup>

## **ATO'S APPROACH TO TAX ADMINISTRATION PENALTIES**

1.115 The ATO uses a range of strategies to encourage taxpayers to voluntarily comply with their tax obligations. Penalties, as noted earlier, are expected to influence taxpayer behaviour, however, they are not the only means of improving voluntary compliance. The ATO's Compliance Model and Taxpayers' Charter are other means through which the ATO seeks to influence taxpayer behaviour.<sup>136</sup>

### **The ATO Compliance Model**

1.116 The ATO's Compliance Model aims to influence taxpayer behaviours by aligning differentiated compliance strategies according to taxpayers' attitudinal and motivational factors. A visual representation of the ATO's Compliance Model is reproduced in Figure 1 below.

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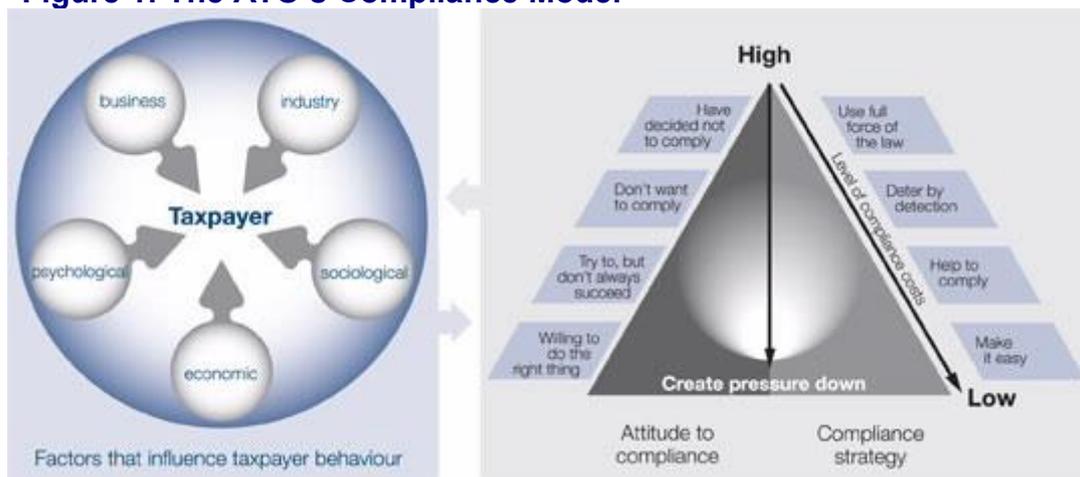
132 Ibid.

133 HM Revenue & Customs, *Briefing on new tax penalties* <<http://www.hmrc.gov.uk/about/new-penalties/faqs.htm#16>>.

134 HM Revenue & Customs, *Suspending penalties for careless inaccuracies in returns or documents* (April 2013) <[www.hmrc.gov.uk/compliance/cc-fs10.pdf](http://www.hmrc.gov.uk/compliance/cc-fs10.pdf)>.

135 HM Revenue & Customs, *CH81130 – Penalties for Inaccuracies: Types of inaccuracy: Inaccuracy despite taking reasonable care* <<http://www.hmrc.gov.uk/manuals/chmanual/ch81130.htm>>.

136 A suite of 9 Australian Taxation Office's documents, including, Australian Taxation Office, *Taxpayers' Charter – what you need to know* (14 August 2013) <<http://www.ato.gov.au/Print-publications/Taxpayers--charter---what-you-need-to-know/?default=&page=3>>.

**Figure 1: The ATO's Compliance Model**

Source: Australian Taxation Office.

1.117 The ATO expects its officers to behave on the presumption that taxpayers intend to be compliant and cooperative. According to the ATO's Compliance Model, such an approach is thought to promote self-regulation. However, if a taxpayer's behaviour demonstrates a different intention, the ATO escalates the intensity of compliance strategy.<sup>137</sup>

1.118 The ATO's approach of escalating compliance strategy depends upon an understanding of five factors that are considered to drive taxpayer behaviour: business, industry, sociological, economic and psychological factors (which is commonly referred to as the BISEP model). The greater the ATO's understanding of how these factors influence taxpayer behaviour, the more effective the compliance strategy the ATO can develop.<sup>138</sup>

### Taxpayers' Charter

1.119 The Taxpayers' Charter sets out the way the ATO will conduct itself in its dealings with taxpayers, including the application of penalties. The Taxpayers' Charter includes commitments such as:

- treating taxpayers fairly, reasonably and as being honest unless there are reasons to suggest otherwise;
- helping taxpayers understand their rights and obligations;
- explaining decisions made about the taxpayer and making it easy for taxpayer's to comply; and
- being accountable.<sup>139</sup>

137 Above n.1, p 111.

138 Tony Morris and Michele Lonsdale, *Translating the Compliance Model into Practical Reality* (2005) p 63.

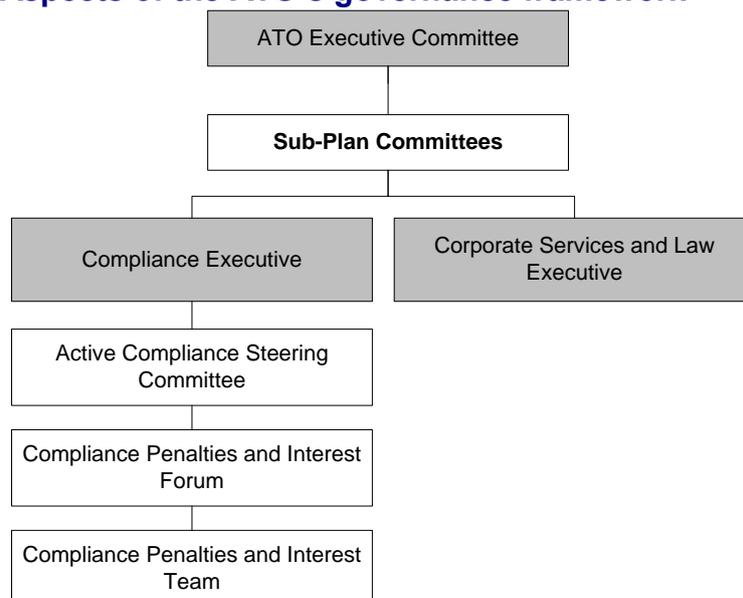
139 Above n.136.

## ATO'S GOVERNANCE AND MANAGEMENT OF TAX ADMINISTRATION PENALTIES

1.120 The ATO's governance and management of tax administration penalties may be understood through its governance and organisational structures, penalty decision making and quality assurance processes.

1.121 The central ATO governance and management framework as it relates to penalties administration is set out in Figure 2 below.

**Figure 2: Aspects of the ATO's governance framework**



Source: IGT.

### ATO Corporate Service and Law Executive and Compliance Executive

1.122 Administration of penalties is governed by the ATO's Sub-Plan Committees, primarily the Law Executive and the Compliance Executive. Advice and guidance on penalties are generally governed by the Law Executive. Penalty decision making in compliance activities is governed by the Compliance Executive.

1.123 The Compliance Executive is the peak executive decision making committee within the Compliance Group and oversees all aspects of the ATO's compliance programs.

1.124 The membership of the Compliance Executive comprises representatives of all Compliance Group business lines and the Compliance Support and Capability (CS&C) service line at the Deputy Commissioner level, amongst others. At the start of this IGT review, these business lines were the Aggressive Tax Planning (ATP), Indirect Taxes (ITX), Micro Enterprises and Individuals (MEI), Large Business and International (LBI), Small and Medium Enterprises (SME), Serious Non Compliance (SNC), Superannuation (SPR) and Tax Practitioner and Lodgement Strategy (TPALS) business lines. During the review the MEI, LBI and SME business lines were restructured to become the Small Business/Individual Taxes (SBIT), Public Groups

and Internationals (PGI) and Private Groups and High Wealth Individuals (PGH) business lines. Most references in this report are to the business lines that existed at the start of this review.

1.125 The Compliance Group business and service lines report regularly to the Compliance Executive. These business and service lines have their own governance and management processes which vary according to the specific line requirements. In addition to regular quality assurance reviews and related reporting, certain business lines have:

- penalty forums, such as the PGH and ITX business lines;
- an officer with experience in penalty decision making in each ATO site, such as the ITX business line; or
- have technical networks where penalty issues are discussed, such as the ATP and SNC business lines.

1.126 In addition, the ATO has advised that it currently has the following quality assurance processes in place:

- feedback loops between audit and objection officers;
- case call-overs for long running cases; and
- reviews by individuals or panels of some types of penalty decisions.

1.127 A number of other internal ATO bodies (such as the Active Compliance Steering Committee (ACSC) and Compliance Penalties and Interest Forum (CPIF)) support the Compliance Executive in relation to penalty matters.

### **ATO Active Compliance Steering Committee (ACSC)**

1.128 The ACSC was established to ensure that the ATO has consistent work practices, policies and procedures across the Compliance Group nationally, including those in relation to penalty matters.<sup>140</sup> It also has the role of reviewing and driving corporate initiatives and capabilities and monitoring performance of the Compliance Group.<sup>141</sup>

1.129 The ACSC consists of representatives from each of the Compliance Group's business lines and is chaired by the Active Compliance Capability and Improvement Leader, who is part of the CS&C service line mentioned earlier. This position has general responsibility for the ATO's 'Compliance Penalties'.

1.130 The Chair of the ACSC provides monthly updates to the Compliance Executive via a number of regular reports. The ACSC advises the Compliance

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<sup>140</sup> Australian Taxation Office, 'Active Compliance Steering Committee Charter' (4 February 2013), internal ATO document.

<sup>141</sup> Ibid.

Executive<sup>142</sup> and the ATO Executive about matters perceived to be of a high priority, which from time to time can include penalty matters.

### **ATO Compliance Penalties and Interest Forum (CPIF)**

1.131 The CPIF is a sub-group of, and reports directly to, the ACSC. It is an advisory group, established as a means to promote consultation, collaboration, co-design and consistency amongst the business lines in the administration of penalties.<sup>143</sup> As such, the CPIF is a means of identifying, discussing and jointly resolving significant penalty and interest charge issues that are of concern to the various business lines.<sup>144</sup>

1.132 The CPIF consists of representatives from each of the Compliance Group business lines as well as the CS&C service line and the Learning and Development unit. Representatives are expected to understand the legislation, policy and work practices, processes and procedures relevant to the work of their business line.<sup>145</sup> CPIF representatives generally run their business lines' internal networks relating to penalty issues (such as those in the ITX, SPR and SME business lines) or are members of their technical excellence networks and groups (such as those in the ATO Production and SNC business lines).

1.133 Attendance is not compulsory and meetings are scheduled monthly. A representative from other areas of the ATO may also be invited to participate in the CPIF where appropriate. The CPIF is chaired by the Executive Director of the Compliance Penalties and Interest Team (CPIT). This position has day-to-day responsibility for certain 'Compliance Penalty' policies and practices and reports to the Active Compliance Capability and Improvement Leader.

1.134 The CPIF reports to the ACSC following the end of each quarter on any decisions made by the CPIF and any penalty issues escalated from the CPIF.<sup>146</sup>

### **ATO Compliance Penalties and Interest Team (CPIT)**

1.135 The CPIT assists the Compliance Group to make consistent, high quality and consistent decisions concerning the administration of penalties and interest charges. In particular, the CPIT is the decision point for internal policy decisions on the treatment of penalties and interest charges and has the authority to make decisions on certain practice issues. As a result, the CPIT has 'ownership' of the ATO's practice statements law administration (PSLAs), which are the Commissioner's instructions to staff, on various aspects of penalty and interest matters.<sup>147</sup>

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142 The ATO Executive consists of the Commissioner, the three Second Commissioners and other senior executive roles nominated by the Commissioner.

143 Australian Taxation Office, 'Compliance Penalty and Interest Forum Charter' (21 February 2012), internal ATO document.

144 Ibid.

145 Ibid.

146 Ibid.

147 Australian Taxation Office, 'CPIT intranet and charter', internal ATO document.

1.136 The roles and responsibilities of the CPIT include:

- developing corporate compliance activity policy, practice and procedures in relation to penalties and interest issues – for example, developing PSLAs, public rulings, penalty methods, practices, training products and corporate management information systems;
- assisting in the development of communication to taxpayers regarding penalty and interest issues – such as web pages that relate to penalties;
- providing advice, support, tools, technical clearance and direction to business lines on their penalty and interest decisions – such as the development of A3 information sheets;<sup>148</sup>
- providing a single point of contact for responding to external reviewers and forums on penalty and interest issues; and
- contributing to computer system enhancements and implementation.<sup>149</sup>

1.137 The CPIT currently comprises three ATO officers and supports the Active Compliance Capability Improvement Leader.

### **Senior Executive Objections Reference Group**

1.138 Since 2012, the ATO has also maintained a senior executive Objections Reference Group which focuses senior management attention on reducing the rate of objections by understanding the drivers for objections. One of the focus questions for the reference group is how the ATO can improve decision making and penalty application processes.

### **ATO organisational structure**

1.139 During the review, the ATO's organisational structure changed. Prior to 1 July 2013, the ATO managed its administration of the tax system through four sub-plans:

- Compliance;
- Corporate Services and Law;
- Enterprise Solutions and Technology; and
- Operations.

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<sup>148</sup> Discussed further in Chapter 4.

<sup>149</sup> Above n.147.

1.140 After 1 July 2013, the ATO changed its organisational structure to consist of the following three groups:

- Compliance Group;
- People, Systems and Services Group; and
- Law Design and Practice Group.

1.141 The Compliance Group seeks to ensure that the tax and superannuation laws including related penalties,<sup>150</sup> have their intended effect. It does this by designing, implementing and maintaining compliance strategies, which aim to support and encourage voluntary compliance with the tax system.

### **ATO compliance business lines**

1.142 The ATO's Compliance Group is structured into separate business lines. The following eight business lines conduct compliance activities that may involve consideration of penalties:

- Public Groups and International (formerly Large Business and International (LBI));
- Private Groups and High Wealth Individuals (formerly Small and Medium Enterprises (SME));
- Small Business/Individual Taxpayers (formerly Micro Enterprises and Individuals (MEI));
- Aggressive Tax Planning (ATP);
- Indirect Tax (ITX);
- Serious Non-Compliance (SNC);
- Superannuation (SPR); and
- Tax Practitioner and Lodgment Strategy (TPALS).

1.143 The Compliance Group business lines' responsibilities include the day-to-day administration of penalties, such as applying penalties in the course of conducting compliance activities. Accordingly, each business line may implement its own policies, procedures and practices to identify, mitigate and resolve penalty related issues.

1.144 In addition to the eight business lines above, the Compliance Group also has a CS&C service line which provides support to the other business lines. A graphical

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150 Australian Taxation Office, 'Penalty Statistics 2011-12 – Some statistics on administrative penalties for Active Compliance' (28 August 2012), internal ATO document.

representation of the ATO's organisational structure and the Compliance Group is reproduced in Appendix 2.

## **ATO decision making process for penalties relating to taxpayer statements**

1.145 The application of penalties relating to taxpayer statements is generally considered during audits undertaken by the ATO. As part of the audit process, an ATO officer will determine whether or not the requirements for penalty imposition have been met. If it is concluded that a penalty should apply, the ATO officer is required to inform the taxpayer of the reasons and give the taxpayer an opportunity to present their views or further information to the ATO.<sup>151</sup>

1.146 The ATO has advised that in many cases, an interim penalty decision or position paper will be issued to the taxpayer and the taxpayer is invited to provide comment. A final written statement of the reasons for the penalty decision will follow and be provided to the taxpayer if a penalty is imposed.<sup>152</sup> The ATO has advised that in high volume work, the ATO does not send an interim penalty decision but will contact the taxpayer by phone or letter and invite the taxpayer to provide further information before making a final decision.

1.147 All ATO officers must follow the relevant law, ATO guidance and staff instructions in making decisions on false or misleading penalties. These include the following:

- Miscellaneous Taxation Ruling (MT 2008/1) – Penalty relating to statements: meaning of reasonable care, recklessness and intentional disregard;
- Miscellaneous Taxation Ruling (MT 2012/3) – Administrative penalties: voluntary disclosures;
- Miscellaneous Taxation Ruling (MT 2008/2) – Shortfall penalties: administrative penalty for taking a position that is not reasonably arguable;
- Taxation Determination (TD 2011/19) – Tax administration: what is a general administrative practice for the purposes of protection from administrative penalties and interest charges?;
- PSLA 2012/4 Administration of penalties for making false or misleading statements that result in shortfall amounts;

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151 Australian Taxation Office, 'IT large business specific audit', internal ATO document; Australian Taxation office, 'SME audit procedures', internal ATO document.

152 Australian Taxation Office, *Large business and tax compliance publication* (1 July 2013) <<http://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Large-business-and-tax-compliance-publication/>>; Australian Taxation Office, *Tax compliance for small-to-medium enterprises and wealthy individuals* (26 October 2012), <<http://www.ato.gov.au/General/Wealthy-individuals/In-detail/Compliance-information/Tax-compliance-for-small-to-medium-enterprises-and-wealthy-individuals/>>.

- PSLA 2012/5 Administration of penalties for making false or misleading statements that do not result in shortfall amounts; and
- ATO website information on penalties and interest.<sup>153</sup>

1.148 The ATO requires officers to take the purpose of the penalty regime<sup>154</sup> into account throughout the penalty decision making process. Officers are also required to take the following factors into account:

- principles underpinning the Compliance Model, including being fair to those who want to 'do the right thing', and being firm but fair with those choosing to disengage and avoid their taxation obligations;
- statements and principles in the Taxpayers' Charter, including that taxpayers should be presumed to have been honest, unless there is information which suggests otherwise;
- individual circumstances of the case, giving appropriate consideration to the background and experience of the taxpayer in a self assessment environment;
- conclusions about the taxpayer's behaviour should only be made where they are supported by facts and evidence, or where reasonable inferences can be drawn from those facts; and
- taxpayers should normally be contacted and given the opportunity to explain their actions before a penalty decision is made – the exceptions are those arising from the automated case actioning environments, such as data matching, or where the facts clearly show that the taxpayer is deliberately disengaged from the tax system.<sup>155</sup>

## Quality assurance for penalty decisions

1.149 The ATO has various quality assurance processes to assess penalty decisions, either prior to decisions being communicated to the taxpayer or thereafter. These processes include, but are not limited to team leaders, internal panels and the ATO's Integrated Quality Framework (IQF), which are outlined in further detail below.

### Team leader and internal panels

1.150 During this review, the ATO has advised that case officers do not make final penalty decisions but rather recommend penalty decisions to more senior officers,

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153 Australian Taxation Office, *Penalties and interest – correct a mistake or dispute a decision* (21 December 2012)

<http://www.ato.gov.au/General/Correct-a-mistake-or-dispute-a-decision/In-detail/Instructions-and-guides/Penalties-and-interest/?default=&page=1>.

154 To encourage taxpayers to take reasonable care in complying with their tax obligations in accordance with the ATO's guidelines, see above n.42, para 9.

155 Australian Taxation Office, *Administration of penalties for making false or misleading statements that do not result in shortfall amounts*, PSLA 2012/4, 25 January 2013 para 9; Above n.42, para 9.

such as their team leaders or technical advisors, for review and approval.<sup>156</sup>

1.151 Furthermore, the SME and SPR business lines both have technical panels which review certain penalties as part of their review of position papers or reasons for decisions before they are communicated to the taxpayer. In the case of the SME business line, penalties totalling more than \$1 million, amongst other issues, are reviewed by their technical panel.<sup>157</sup> The SPR business line has a Penalties Panel which reviews any case where the imposition of multiple penalties is being considered. For the ITX business line, a Penalties and Interest team reviews a selection of cases in which high penalty rates are imposed.

### **Integrated Quality Framework (IQF)**

1.152 The IQF is also used by the ATO to assess the level of corporate quality assurance of penalty decisions and the related decision-making process.<sup>158</sup>

1.153 The IQF relies on, amongst other things, random sampling of finalised cases (closed cases) and targeting of higher risk ongoing cases (open cases). The number of cases selected for assurance varies depending on the business lines and ATO compliance product concerned.

1.154 The IQF assesses cases according to nine ‘quality elements’, which include administrative soundness, integrity, correctness, appropriateness, effectiveness, transparency, consistency, timeliness and efficiency. An explanation of each of the quality elements and the standards is provided in Appendix 3. As a result, the IQF process rates the selected audit and review cases as either ‘very high’, ‘high’, ‘meets standards’, ‘aligned’ or ‘not aligned’. The ATO expects that 90 per cent of selected cases will be assessed as ‘meets standard’ or higher.

1.155 Once a case has been assessed under the IQF, an email, that includes the assessment results and issues identified, is sent directly to the relevant case officer, case approver, team leader and relevant directors. The ATO expects that the case owners and team leader will take any necessary corrective action for assessed cases and to mitigate any future re-occurrences. The team leader decides whether corrective action should be taken. It is expected that this decision will depend on the status of the case (open or closed) and the impact to the taxpayer or ATO.<sup>159</sup>

1.156 The business lines may also review the outcome of IQF assessments of penalty decisions and are expected to review in detail those cases rated ‘aligned’ or ‘not aligned’. The ATO expects that such cases will likely identify common issues and opportunities for improvement. Cases rated as ‘high’ and ‘very high’ are also reviewed

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156 Australian Taxation Office communication to the Inspector-General of Taxation, 15 January 2013; Note that there is also a small segment of work done by the ATO where a more senior officer is not the approver.

157 Australian Taxation Office, Issues to be reviewed by the SME Technical Panel, internal ATO document.

158 Australian Taxation Office, IQF, internal ATO document.

159 Australian Taxation Office, ‘Indirect Tax – Active Compliance Penalties report 1 July 2012 – 31 December 2012’ (26 February 2013), internal ATO document pp 8-9.

to determine if they can be used as models for developing systemic improvements. Each business line has specific procedures for addressing issues identified by the IQF.

1.157 The CPIT also reviews penalty cases quarterly where the penalty decision was rated as 'aligned' or 'not aligned' and informs the Active Compliance Capability Improvement Leader.

1.158 The ATO also compiles monthly, quarterly and bi-annual reports on quality improvement and assurance activities relating to active compliance cases generally. These reports are based on the IQF activities conducted by all business lines during the relevant period.<sup>160</sup>

## **PRIOR REVIEWS RELATING TO ATO'S ADMINISTRATION OF PENALTIES**

1.159 The ATO's administration of penalties has been the subject of public review previously. A summary of the more recent reviews and outcomes is provided below.

### **IGT's 2012 review into improving the self assessment system**

1.160 The IGT observed in his *Review into improving the self assessment system* that the penalty regime was intended for a pure self assessment model and required reconsideration in the light of recent changes to ATO compliance approaches, particularly those aimed at shifting compliance activities upstream to address risks earlier. Furthermore, significant numbers of unsustainable penalty decisions were also observed to have potentially arisen due to a lack of ATO compliance officer discipline in dealing with evidentiary matters for the level of penalty sought to be imposed.<sup>161</sup>

1.161 As a result, the IGT made a number of recommendations, including that:

- consideration be given to whether taxpayers should be deemed to have taken reasonable care where they have met the higher standard of a RAP;<sup>162</sup>
- consideration be given to whether the current threshold for RAP penalties should be increased to \$100,000 to relieve smaller taxpayers from incurring disproportionate compliance costs;<sup>163</sup>
- consideration be given to whether, in relation to the penalty for no RAP, the onus of proof for RAP penalties be placed on the ATO to impose a greater level of accountability for ATO penalty decisions;<sup>164</sup>
- consideration be given to whether taxpayers should be presumed to have taken reasonable care where they have consulted a registered tax agent and provided all the information that would be reasonably required to provide advice;<sup>165</sup>

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160 Australian Taxation Office, Quality improvement and assurance reports, internal ATO document.

161 Inspector-General of Taxation, *Review into improving the self assessment system* (2012).

162 Ibid, p 117 (Recommendation 4.5).

163 Ibid, p 112 (Recommendation 4.3).

164 Ibid, p 115 (Recommendation 4.4).

- the ATO should consider reducing penalties relating to a lack of RAP for taxpayers who have made relevant disclosures in reportable tax position schedules;<sup>166</sup> and
- the ATO improve its internal and public reporting on penalty case numbers, quantum, and remissions, by type of penalty.<sup>167</sup>

### JCPAA report recommendations

1.162 On 26 June 2008, the Federal Parliament’s Joint Committee of Public Accounts and Audit (JCPAA) tabled its report on an inquiry reviewing a range of taxation issues within Australia.<sup>168</sup> In relation to tax administration penalties, the inquiry considered the appropriateness of the penalty rates in Australia and the ATO’s consistency in applying penalties.<sup>169</sup>

1.163 As a result of its inquiry, the JCPAA recommended that the ATO increase its benchmarks for the technical quality reviews of penalty decisions amongst other things.<sup>170</sup>

### IGT’s 2005 review of penalties

1.164 In the IGT’s 2005 *Review into the Tax Office’s Administration of Penalties and Interest Arising from Active Compliance Activities*,<sup>171</sup> it had been observed that the ATO was conducting an internal review of penalties at the same time. The IGT, therefore, deferred more substantive consideration of this topic until after the ATO completed implementing any resulting recommendations from this internal review.

### Treasury’s 2004 Report on Aspects of Income Tax Self Assessment

1.165 On 16 December 2004, the Government released the *Report on Aspects of Income Tax Self Assessment* (ROSA report).<sup>172</sup> This report made a number of recommendations to improve the transparency of the penalty imposition process and to clarify the standard of care required by taxpayers, including that:

- the ATO revise its rulings on reasonable care and RAP, with a view to providing clearer guidance and further examples as to what conduct will, or will not, attract a penalty;
- the ATO explain more fully, for example in a ruling or Practice Statement, how it exercises the discretion to remit tax shortfall penalties;

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165 Ibid, p 111 (Recommendation 4.2).

166 Ibid, p 118 (Recommendation 4.6).

167 Ibid, p 109 (Recommendation 4.1).

168 Joint Committee of Public Accounts and Audit, *Report 410: Tax Administration* (2008).

169 Ibid, Chapter 6.

170 Ibid, p 148.

171 Inspector-General of Taxation, *Review into the Tax Office’s Administration of Penalties and Interest Arising from Active Compliance Activities* (2005).

172 Treasury, *Report on Aspects of Income Tax Self Assessment* (2004).

- where the ATO decides that a penalty applies and should not be remitted in full, it provides an explanation for its action; and
- the ATO further explain in a ruling or Practice Statement what understatements of liability it regards as immaterial for tax shortfall purposes.<sup>173</sup>

1.166 The ROSA Report also recommended legislative change to clarify the definition of when a matter is 'reasonably arguable' as well as abolishing penalty for a shortfall resulting from a failure to follow a private ruling. The then Government enacted legislation to give effect to these recommendations and also enacted a requirement for the Commissioner to supply taxpayers with reasons for penalty and remission decisions.

## Other IGT reviews

1.167 Aspects of the tax administrative penalty regime and its administration have also been considered in the IGT reviews set out below.

1.168 In 2009, the IGT recommended in the *Review into aspects of the Tax Office's settlement of active compliance activities* that the ATO improve the evidentiary basis for penalty decisions, among other things.<sup>174</sup> The IGT also recommended that the ATO facilitate public understanding of the revenue impact of settlement cases by publicly reporting on an ongoing basis the aggregated amounts of penalties that were reduced in settlements.<sup>175</sup>

1.169 In his 2011 *Report into the Australian Taxation Office's large business risk review and audit policies, procedures and practices*, the IGT made two recommendations relating to penalties. The first recommendation was directed at improving transparency and taxpayer understanding of the ATO's interest and penalty decision-making processes by improving the quality and timeliness of its communication and engagement with taxpayers.<sup>176</sup> The second recommendation was directed at enhancing the voluntary disclosure process by ensuring that the ATO clearly communicates to the taxpayer, at the time of the disclosure in question or promptly afterwards, whether it accepts that the disclosure is voluntary.<sup>177</sup>

1.170 In 2012, the IGT recommended in his *Review into the ATO's use of benchmarking to target the cash economy* that the ATO should improve the robustness of correspondence audit penalty decisions by, for example, providing clearer staff guidance on the specific types of evidence which would tend to indicate the application of different penalties.<sup>178</sup>

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<sup>173</sup> Ibid, pp 39-47.

<sup>174</sup> Inspector-General of Taxation, *Review into aspects of the Tax Office's settlement of active compliance activities* (2009) p 26 (recommendation 16).

<sup>175</sup> Ibid, p 27 (recommendation 18).

<sup>176</sup> Inspector-General of Taxation, *Report into the Australian Taxation Office's large business risk review and audit policies, procedures and practices* (2011) p 156 (Recommendation 10.1).

<sup>177</sup> Ibid, p 156 (Recommendation 10.2).

<sup>178</sup> Inspector-General of Taxation, *Review into the ATO's use of benchmarking to target the cash economy* (2012) p 92 (Recommendation 6.1).

1.171 The IGT recommended in his 2012 *Review into the ATO's small and medium enterprise audit and risk review policies, procedures and practices* that SME officers improve the evidentiary basis for penalty decisions, amongst other things, by using the Facts and Evidence worksheet to develop technical positions.<sup>179</sup> The IGT also made a number of recommendations to improve staff technical capability and support, such as improving ATO officers' understanding of commercial and business issues and strengthening staff training (including the involvement of external experts).

1.172 Furthermore, penalties for failing to lodge returns were considered in the IGT's 2009 *Review into the non-lodgement of individual income tax returns*, which found that the penalty rates for non-lodgement of returns were very low and that increasing the penalty rates for high risk taxpayers should be considered.<sup>180</sup>

## ATO INTERNAL REVIEWS

1.173 In addition to these external reviews, the ATO has carried out two recent internal reviews relating to penalty administration.

1.174 On 28 February 2012, the ATO's Compliance Executive were presented with a number of findings from an internal review conducted on objections to decisions made in the MEI, SME and ITX business lines – the ATO's Objection Review Report. This report examined 82 instances in which the penalty and/or interest decision was disputed. Objections were allowed and penalties reduced in 40 of these cases for a number of reasons, including:

- provision of further evidence or advice at the objection stage;
- inadequate documentation of the taxpayer's contentions at audit; and
- the substantive issue being allowed in full.<sup>181</sup>

1.175 That report observed that:

Most penalty decisions were maintained on objection, however we need to increase our focus on skilling and quality control to improve the coherency of our documented penalty decisions. A new tax technical decision making skilling package has been developed for roll-out across Compliance and includes a new component on the principles for penalty imposition so we see improved technical decisions. Two business lines are currently piloting that package.<sup>182</sup>

1.176 Separately, the SME business line also undertook a review of its penalty decisions made from 16 August 2011 to 30 June 2012. The review identified 31 cases in

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<sup>179</sup> Inspector-General of Taxation, *Review into the ATO's compliance approaches to small and medium enterprises with annual turnovers between \$100 million and \$250 million and high wealth individuals* (2012) p 43 (Recommendation 2.14).

<sup>180</sup> Inspector-General of Taxation, *Review into the non-lodgement of individual income tax returns* (2009) p 9 (recommendation 5).

<sup>181</sup> Australian Taxation Office, 'Objection Review Report Draft' (21 February 2012), internal ATO document p 12.

<sup>182</sup> *Ibid*, p 4.

which the original penalty amounts had been changed as a result of disputation and selected 20 of those cases for further review.

1.177 This review found that in approximately 70 per cent of those 20 cases, the base penalty amount remained unchanged, suggesting that adjustment of the primary tax decision was the sole cause for the reduction in the penalty amount. However, for the remaining cases, the review identified that the base penalty amount had changed due to the following reasons:

- processing errors;
- 'harsh penalties' applied by ATO officers and penalty decisions not supported by evidence;
- questionable objection decisions; and
- new arguments or documents provided by the taxpayer.<sup>183</sup>

## **ATO IMPROVEMENT WORK**

1.178 In addition to that already mentioned, the ATO has advised that it has undertaken the following improvement work:

- increasing the focus on penalty decision making by such means as publishing penalty-specific tools to assist in making consistent high-quality decisions;<sup>184</sup> and
- delivering a number of penalty-related training packages, which cover such topics as penalties, quality note taking, decision making (delivered to 1,300 ATO officers) and active case management (delivered to 5,000 ATO officers).<sup>185</sup>

1.179 Details of the ATO's improvement work are discussed later in relevant sections of this report.

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183 Australian Taxation Office, 'S&ME Penalties Review: Update on Progress – November 2012' (November 2012), internal ATO document pp 6-9.

184 Australian Taxation Office, 'ATO Penalties Continuous Improvement Framework' (22 March 2013), internal ATO document.

185 Ibid.

## CHAPTER 2—ASPECTS OF THE PENALTY FRAMEWORK

2.1 This chapter discusses concerns with aspects of the penalty regime that were raised by stakeholders in response to this review. As noted in the previous chapter, the IGT has explored other aspects of the penalty regime and made a number of recommendations in previous IGT reviews to both the ATO and Government. In particular, in his *Review into improving the self assessment system*, a number of significant recommendations were made to which the then Government at the time either agreed or, agreed-in-principle including considering:

- whether the current threshold for RAP penalties should be increased to more appropriately balance the mischief for which they were intended to address against the compliance costs to small businesses and individuals;<sup>186</sup>
- amending the law, relating to no RAP penalties, to place the onus on the ATO to provide reason for why it considers the taxpayer's view could not be argued on rational grounds to be about as likely as not, or more likely to be correct;<sup>187</sup> and
- whether taxpayers should be deemed to have taken reasonable care where they have met the higher standard of a RAP.<sup>188</sup>

2.2 In considering the IGT recommendations referred to above, as well as those made in this report, it may be appropriate for the Government to conduct a broader review of the penalties regime.

### STAKEHOLDER CONCERNS

2.3 During the course of this review, stakeholders identified a number of concerns relating to aspects of the current penalty regime's legislative framework, including:

- stratification of penalties relating to taxpayer statements;
- the burden of proof and the ATO's 50:50 payment arrangements for tax debts whilst disputing assessments;
- the inability to receive interest for payment of unsustainable penalties; and
- uncertainty with the scope of false or misleading statement penalties where no tax shortfall arises.

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186 Above n.161, p 112 (Recommendation 4.3).

187 Ibid, p 112 (Recommendation 4.4).

188 Ibid, p 117 (Recommendation 4.5).

## STRATIFICATION OF PENALTIES RELATING TO TAXPAYER STATEMENTS

2.4 Particular concerns were raised in relation to the stratification of penalties for making false or misleading statements and for taking a tax position that is not reasonably arguable (penalties relating to taxpayer statements).

2.5 First, stakeholders considered it was unfair that the standard of conduct for failing to take reasonable care could encompass a broad range of behaviours with different levels of culpability, that is there is not sufficient differentiation for the level of care taken by the taxpayer and the taxpayer is not credited for such care if the standard of reasonable care is not met.

2.6 Secondly, stakeholders observed harsh outcomes arising from insufficient stratification of the no RAP penalty, as the penalty was effectively a 'cliff face'. If the RAP standard is not met, the strength of taxpayers' positions taken or the probative value of the information and evidence relied upon may not be considered in determining the amount of the applicable penalties, that is, the treatment of a position that just falls below the RAP standard could be the same as a position that falls far below it.

2.7 Stakeholders have also observed that some ATO officers assume that better resourced taxpayers ought to have self-assessed their tax positions with a high degree of accuracy and, therefore, any substantial adjustments would automatically attract a no RAP penalty.

2.8 Although stakeholders recognise that the increased stratification of penalties would introduce complexity, they consider that overall it would be more equitable (in terms of horizontal equity) and in keeping with the purpose of the penalty regime.

2.9 As mentioned in the previous chapter, penalties relating to taxpayer statements were originally introduced in 1992 to align penalties with the standard of conduct required in a self assessment environment. The information paper summarising the proposed introduction of those standards of conduct<sup>189</sup> did not explicitly rule out further calibration of the penalty rates to taxpayers' behaviours, however, it did indicate that the standards were static and further calibration of penalty rates to reflect taxpayers' specific circumstances would only occur in 'limited circumstances, for example, hardship'.<sup>190</sup> Furthermore, the paper implicitly sought to adopt a restricted remission power such that it will not be used for such calibration:<sup>191</sup>

Under the [previous] penalty system the Commissioner has the power to remit penalties to a level which he thinks appropriate under the circumstances. This will not be the case with the new penalty provisions, although the Commissioner will have power to amend

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189 Commonwealth of Australia, *Improvements to self assessment – priority tasks* (1991).

190 Ibid, pp 13 and 22.

191 Ibid, p 13.

any of the penalties on the basis of new information, or to waive the penalty in certain limited circumstances, for example hardship.<sup>192</sup>

2.10 The ATO's current approach to the use of the remission power, as set out in *PSLA 2012/5*, appears consistent with the view expressed in the information paper above<sup>193</sup> and is discussed further in Chapter 5.

## IGT observations

2.11 The measure of the effectiveness of a penalty regime is the extent to which it shapes taxpayer behaviours and improves voluntary compliance. In this respect, the IGT considers that one of the key components of an effective penalty system is that it is seen to be equitable in its application. This would include sufficient differentiation between the types of taxpayer behaviours so that those in substantial similar circumstances are treated in the same manner (horizontal equity).

2.12 The current legislative standard of conduct for the failure to take reasonable care penalty can cover a broad range of differing taxpayer behaviours and situations. For example, the same rate of penalty could be applied to taxpayers with minor isolated understatements who otherwise have good compliance histories, as those with significant multiple understatements whose behaviour falls just short of recklessness.

2.13 The combination of the range of taxpayer behaviours to which this penalty applies and the static base rate of the penalty itself may lead taxpayers to perceive inequitable outcomes and, in certain situations, may affect future voluntary compliance. Accordingly, there is potential to stratify the penalty for failure to take reasonable care to achieve greater horizontal equity for taxpayers.

2.14 In addition to the stratification of the failure to take reasonable care penalty, it has been argued that the no RAP penalty could be stratified according to the strength of taxpayers' positions. Such stratification is said to recognise that the application of the tax laws to different facts can be difficult and uncertainty can arise as to the strength of a particular position.

2.15 As discussed in Chapter 1, the USA penalty regime significantly differentiates between varying strengths of taxpayers' positions.<sup>194</sup> Australia's penalty regime could follow such an approach and adopt further differentiation. However, such further differentiation or stratification should be balanced with other objectives such as avoiding excessive complexity and facilitating ease of administration.

2.16 Stratification of the failure to take reasonable care penalty and the no RAP penalty could be achieved either administratively or legislatively. For example, the ATO could adopt a practice and issue public advice that it would adjust the rate of these two penalties depending on the level of care or the strength of the position taken respectively. It could also take into account other matters such as compliance history.

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<sup>192</sup> Ibid, p 13.

<sup>193</sup> Above n.42, paras 156-187.

<sup>194</sup> Above n.117, para 20.1.5.8.1.1; 26 USC § 6662 (United States); 'Federal Taxation' above n.128, p 2:44.

2.17 However, the ATO may be of the view that the legislation does not provide it with the discretion to reduce the penalty rates. It could be argued that the current legislative framework for the penalty regime provides the ATO with little scope to calibrate the penalty rates for different types of non-compliance unless the circumstances explicitly set out in law exists, such as certain aggravating or mitigating factors. Furthermore, although the ATO's public views indicate that it may use the remission power in limited circumstances for failure to take reasonable care penalties,<sup>195</sup> there appears to be no public view on whether it may use the remission power for no RAP penalties.

2.18 Given the above ATO position, it seems that any further differentiation or stratification of penalties relating to a statement would require legislative change.

2.19 It should be noted that there may be other penalties within the current regime that may benefit from further stratification. In this review, the IGT has focused on the stratification of false and misleading statement and no RAP penalties, as these were the main concerns raised by stakeholders.

2.20 In addition to further stratification of the penalty regime, the IGT is of the view that a mechanism for reducing penalty rates in appropriate circumstances is fundamental to promoting voluntary compliance. For example, in the UK, the penalty regime tailors the rate according to the degree of taxpayer cooperation and assistance in each specific case. HMRC is also authorised to suspend penalties if taxpayers meet certain conditions which ensures the taxpayer complies in the future. In contrast, Australia's penalty regime simply provides a reduction of either 20 per cent or 80 per cent of the penalty amount, depending on when a voluntary disclosure is made.

2.21 The IGT considers that the Government and/or the ATO could draw from approaches in other jurisdictions that better engender taxpayer behavioural change. In this respect, behavioural science and related randomised control trials, referred to in the previous chapter, may also assist in developing better mechanisms for promoting voluntarily compliance.<sup>196</sup>

## **INTEREST FOR UNSUSTAINED PENALTIES**

2.22 Stakeholders consider that the ATO's inability to pay interest on penalty amounts that are ultimately not sustained is inequitable and not conducive toward voluntary compliance.

2.23 The *Taxation (Interest on Overpayments and Early Payments) Act 1983* requires the Commissioner to pay interest to taxpayers where primary taxes were overpaid and a decision to reduce the amounts payable, amongst other things, is made in a subsequent review. However, this Act does not expressly provide for interest to be paid on overpayment of penalties which are subsequently reversed. It is also unclear whether taxpayers can obtain such a remedy under common law.

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<sup>195</sup> Above n.42, paras 155-187.

<sup>196</sup> Above n.21, p 8.

## IGT observations

2.24 The legislative intent as to why taxpayers are not paid interest on overpaid penalties is not clear and appears inconsistent with the approach to overpaid primary tax. Such a position is unlike that adopted in other jurisdictions, such as the US, where interest is generally paid on overpayments of subsequently abated penalties.<sup>197</sup>

2.25 The IGT considers that taxpayers should be entitled to compensation for the time value of monies used to pay unsustainable penalties. Such compensation enhances the tax system's fairness regarding the time value of money and would likely promote voluntary compliance of prompt payment obligations.

2.26 In making the recommendation below, the IGT has focused on the main issues of concern raised by stakeholders. However, there are other issues which could benefit from a broader review of the penalties regime which the Government may wish to consider as stated at the beginning of this chapter. Amongst such issues is the fundamental question of whether the legislative design appropriately encourages the conduct expected of taxpayers in fulfilling their taxation obligations. In this regard, specific examples worthy of review include the appropriateness of the penalty for making a false and misleading statement that does not result in a shortfall amount<sup>198</sup> and the remission of the 75 per cent penalty for failing to provide documents.<sup>199</sup>

### RECOMMENDATION 2.1

*The IGT recommends that the Government consider whether:*

- a) the current penalties regime is sufficiently stratified to treat taxpayers in substantially the same circumstances in the same manner;*
- b) penalties are appropriately aligned with the factors that influence taxpayer behaviours such as factors identified in work arising from behavioural science and related randomised control trials; and*
- c) taxpayers should be compensated for the time-value of money paid on unsustainable penalties.*

### ATO response

This is a matter for Government.

197 Internal Revenue Service, *Overpayment interest* <[http://www.irs.gov/irm/part20/irm\\_20-002-004.html](http://www.irs.gov/irm/part20/irm_20-002-004.html)>, paras 20.2.4.1 and 20.2.4.2; 26 USC § 6611 (United States).

198 *Taxation Administration Act 1953*, sch 1, s284-75(3).

199 *Ibid*, sch 1, s284-75(3).

## **BURDEN OF PROOF PROVISIONS AND 50:50 PAYMENT ARRANGEMENTS FOR TAX DEBTS WHILE DISPUTING PENALTIES**

2.27 The stakeholders' concerns focussed on the financial impact and the frustration that may result from the combined effect of the following:

- the current legislative burden of proof imposed on taxpayers has the potential to lead ATO officers to make decisions which are not sufficiently supported by facts and evidence; and
- taxpayers are required to pay the full, or at least 50 per cent, of the amount, including penalties, whilst disputing the ATO officers' decision.

2.28 The concerns arise from the notice of assessment being conclusive evidence of the making of an assessment.<sup>200</sup> Therefore, where the Commissioner amends a taxpayer's assessment as a result of an audit, the notice of assessment is presumed to be correct and the taxpayer can only seek to prove it to be otherwise through the review process under Part IVC of the TAA 1953.<sup>201</sup>

2.29 Where a taxpayer wishes to appeal an assessment to the AAT or the Federal Court, they bear the burden of proving, on the balance of probabilities, that the assessment was 'excessive; or ... should not have been made or should have been made differently'.<sup>202</sup>

2.30 There is no legislative requirement on the ATO to prove the facts supporting decisions made in assessments. However, generally, the ATO seeks to support its decisions with relevant facts and evidence. In relation to penalties, the ATO instructs its staff that no penalties should arise unless the ATO has facts and evidence to prove otherwise:

Penalty decisions must be supported by the available facts and evidence. Conclusions about the entity's behaviour should only be made where they are supported by facts, or where reasonable inferences can be drawn from those facts.<sup>203</sup>

2.31 Furthermore, the ATO has advised that officers should not assume that a false and misleading statement penalty automatically arises because of a shortfall:

There is no presumption that the false or misleading nature of a statement necessarily or automatically points to a failure to take reasonable care. In order for there to be a finding of a failure to take reasonable care, the evidence must support the conclusion that the entity's attempt to comply has fallen short of the standard of care that would reasonably be expected in the circumstances.<sup>204</sup>

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200 Ibid, sch 1, s298-30(3).

201 Above n.31, para 1.144.

202 *Taxation Administration Act 1953*, s14ZZK and s14ZZO.

203 Above n.42, para 45.

204 Ibid, para 46.

2.32 Currently, a taxpayer disputing an assessment is required by law to pay the resulting tax liabilities, including penalties, by the due date specified in the notice of assessment.<sup>205</sup> The due date is specified as being at least 14 days after the notice is given to the taxpayer.<sup>206</sup> If the amount remains unpaid after the due date, the ATO may take recovery action even if the taxpayer requested an internal review or lodged an objection or appeal. The ATO, however, states that it will only do so where:

- there are reasonable grounds to believe the revenue is at risk, for example, funds or assets are being dissipated;
- the tax debtor declines to supply additional facts or other material, within 28 days of the request, necessary for the determination of the objection; or
- the objection is considered to be frivolous or without merit by virtue of the fact that the law in relation to the matter in dispute is well-settled and the tax debtor is going against the weight of precedent cases.<sup>207</sup>

2.33 In appropriate circumstances, the ATO may enter into an arrangement with the taxpayer where only 50 per cent of the disputed tax debt has to be paid before the dispute is resolved (a '50:50 payment arrangement').<sup>208</sup> Such an arrangement may be entered on condition that:

- the Commissioner is satisfied that there is 'little or no risk';<sup>209</sup> and
- the taxpayer agrees to:
  - pay all undisputed debts and a minimum of 50 per cent of the disputed debt;
  - co-operate fully in providing any requested information necessary for the early determination of an objection, if applicable, within 28 days of the request or within another agreed timeframe set by the case officer; and
  - pay the whole of any subsequently arising tax liability which is not in dispute and for which no other deferral of legal action has been granted.<sup>210</sup>

## IGT observations

2.34 The IGT has previously made recommendation to reverse the onus of proof for no RAP penalties in his *Review into improving the self assessment system*.<sup>211</sup> The Government has agreed in principle with this recommendation stating that it would

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<sup>205</sup> *Taxation Administration Act 1953*, sch 1, s298-15.

<sup>206</sup> *Ibid*, sch 1, s298-15.

<sup>207</sup> Australian Taxation Office, *Recovering disputed debts*, PSLA 2011/4, 14 April 2011, para 43.

<sup>208</sup> *Ibid*, para 22.

<sup>209</sup> *Ibid*, para 11.

<sup>210</sup> *Ibid*, paras 22-23.

<sup>211</sup> Above n.161, p 115 (Recommendation 4.4).

'further consider this issue once additional information has been obtained by the ATO as part of proposed enhancements to the ATO's data and reporting systems'.<sup>212</sup>

2.35 The current approach to determining which party should bear the burden of proof is generally set out in the *Guide to Framing Commonwealth Offences, Infringement Notices and Enforcement Powers* (the Offences Guide).<sup>213</sup> Although the Offences Guide refers to criminal law, the factors in determining which party should bear that burden may also provide the framework and principles to help understand how the burden of proof should be considered in an administrative penalty context. The Offences Guide states:

Offence-specific defences reverse the fundamental principle of criminal law that the prosecution must prove every element of the offence. Therefore, a matter should only be included in an offence-specific defence, as opposed to being specified as an element of the offence, where:

- it is peculiarly within the knowledge of the defendant, and
- it would be significantly more difficult and costly for the prosecution to disprove than for the defendant to establish the matter.<sup>214</sup>

2.36 The Offences Guide indicates that a reversal of the burden of proof for tax administration penalties may be justifiable where the relevant matter requires evidence that is peculiarly within the taxpayer's knowledge and would be significantly more difficult and costly for the ATO to disprove than for the taxpayer to prove.<sup>215</sup>

2.37 It could be argued that placing the burden of proof on taxpayers should be the same for penalties and primary taxes as taxpayers have better understanding of facts involved.<sup>216</sup> However, the imposition of a penalty for a false or misleading statement, unlike a primary tax matter, may also be understood by taxpayers as a pejorative judgment on their behaviour and that it effectively requires them to prove their innocence.<sup>217</sup>

2.38 Under other areas of the law involving such judgments of behaviour, for example torts, the burden is placed on the person seeking to pursue remedies for another's culpable behaviours. This burden exists notwithstanding the fact that the respondent may be better placed to provide information about their behaviours.

2.39 Furthermore, although this burden technically arises on appeal, it can shape ATO auditor approaches to address shortcomings in the evidentiary basis for penalty

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212 Assistant Treasurer, 'Inspector-General of Taxation review into improving the self assessment system' (Press Release, No. 011, 13 February 2013).

213 Developed by the Criminal Justice Division of the Attorney-General's Department to assist officers in Australian Government departments to frame criminal offences, infringement notices, and enforcement provisions that are intended to become part of Commonwealth law.

214 Attorney-General's Department, *A Guide to Framing Commonwealth Offences, Infringement Notices and Enforcement Powers* (2011) p 50.

215 Ibid, p 50.

216 Italia, Maria, 'Taxpayers' in Australia Bear the Burden of Persuasion and Burden of Production' (2011) 7(1) *International Review of Business Research Papers*, p 234.

217 Dr Paul Lee, 'Don't Let Burden of Proof Shift to the Taxpayer' (2012) 3(23) *International Journal of Business and Social Science* p 237.

decisions. In these cases, it is incumbent upon the taxpayer to prove the basis for any remission of the penalty or that the application of the penalty itself is incorrect. There are ATO staff instructions that emphasise an expectation that penalty decisions will be supported by facts and evidence. However, this may not necessarily take place and may be a reason for a significant proportion of unsustainable penalty decisions being adjusted due to evidentiary issues as discussed in more detail in the next two chapters of this report.

2.40 Taxpayers may experience substantial adverse impacts arising from unsustainable penalty decisions, including commercial and other regulatory implications and damage to reputation. The ATO's administrative costs in correcting unsustainable penalty decisions may also be significant.

2.41 Furthermore, not all taxpayers can afford to resolve disputes in the AAT or the Federal Court, thereby limiting their access to external review. Recent research found that typical costs for an individual taxpayer tax dispute in the AAT can be substantial. It can be up to \$2,484 if the taxpayer does not engage professional assistance or up to \$6,684 with professional assistance.<sup>218</sup>

2.42 This research noted that personal costs of disputation represent a considerable barrier to accessing justice in tax cases involving lower disputed amounts.<sup>219</sup> The authors explained that:

Tax disputes in many cases can be characterised by the asymmetry between the individual taxpayer and the Australian Taxation Office (ATO) in terms of resources and power. Further, resolving tax disputes outside the ATO is a risky and costly process to individual taxpayers. In most cases, the implicit costs (loss of time) and explicit costs (monetary expenses) involved may be of sufficient magnitude to deter taxpayers from seeking independent tax dispute resolution. Thus, while an impartial tax dispute process does exist in Australia ... it can become ineffective in terms of actual accessibility.<sup>220</sup>

2.43 Where a taxpayer chooses to dispute and not pay the amounts until the relevant dispute is resolved, the ATO has stated that collection action is unlikely to be commenced before an objection, review or appeal is finalised, unless the circumstances of the case indicate an unacceptable level of risk.<sup>221</sup> Whilst this assurance is helpful, taxpayers feel that there is still some uncertainty as to whether the ATO will commence recovery action before the dispute is resolved.

2.44 A taxpayer may choose to minimise the above uncertainty by entering into a 50:50 payment arrangement. However, the taxpayer may still find it difficult to source the finances to pay 50 per cent of the liability. As a result, both alternatives may lead to increased perceptions of unfairness of the penalty regime, particularly when the

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218 Binh Tran-Nam and Michael Walpole, 'Access to tax justice: How costs influence dispute resolution choices' (2012) 22(3) *Journal of Judicial Administration* 3, p 25.

219 *Ibid*, p 4.

220 *Ibid*, p 4.

221 *Above n.207*, para 37.

taxpayer believes that the penalty decision is unsustainable or is later proved to be unsustainable.

2.45 The IGT believes that there are three options which would benefit from further consideration in addressing these issues:

- place the burden of proof on the ATO for all penalty decisions;
- establish a new base line penalty rate – for example, 10 per cent – where the burden of proof for penalty decisions is placed on the taxpayer and reverse this burden for any penalties imposed above this base line penalty rate; or
- suspend the requirement for taxpayers to pay the penalty amounts until after the dispute on the primary tax is resolved and require taxpayers with larger turnovers to pay the full amount of the disputed primary tax by the date due and taxpayers with smaller turnovers to pay half the amount.

2.46 The first option above proposes to place a legislative burden of proof on the ATO for all penalty decisions on the basis that it would automatically impose a greater level of accountability on the ATO auditor. However, as stated above, the relevant facts and evidence are better known to the taxpayer and in reversing the burden of proof in all cases may be inappropriate and may result in unnecessary additional costs.

2.47 The second option proposes to introduce a new base penalty amount that would operate, for example, where a taxpayer's failure to take reasonable care is based on a level of evidence that would only establish a prima facie case and not that which would satisfy the burden of proof on the balance of probabilities. Such a penalty would acknowledge the administrative costs in discharging an onus of proof on the balance of probabilities which can be disproportionate in cases where conclusive evidence has not been obtained. The percentage rate for this new baseline penalty could be set at a lower rate, for example 10 per cent. This reduced rate reflects the fact that the ATO would not bear the burden of proof. Furthermore, in order to minimise taxpayer and administrative costs in resolving disputes of such penalties, the penalty could be set to operate only after a minimum threshold amount is exceeded. Any penalty rate imposed above this new baseline rate would require the ATO to bear the burden of proof for defending penalty decisions in appeals.

2.48 The second option may be considered to better balance the costs and risks of the ATO and the taxpayer, however, it introduces additional complexity.

2.49 The last option proposes to suspend the requirement to pay the penalty portion of any disputed amounts until the dispute is resolved to relieve the financial pressure on taxpayers and assist in dispelling perceptions of penalties being used as leverage in primary tax disputes. This option does not introduce significant complexity and the impact on Government revenue is only one of timing. Accordingly, the IGT favours this option which the ATO could implement. However, if the Commissioner is of the view that the relevant legislation does not allow him to do so, the Government may consider giving such a power.

## **PENALTIES FOR MAKING FALSE AND MISLEADING STATEMENTS THAT DO NOT RESULT IN SHORTFALL AMOUNTS**

2.50 Stakeholders have expressed concerns that penalties for making false and misleading statements that do not result in shortfall amounts<sup>222</sup> have the potential to impose penalties grossly disproportionate to the relevant taxpayer behaviours. In these cases, taxpayers may be forced to rely on the ATO's preparedness to administer its power of remission to ensure equitable outcomes.

2.51 The 2010 explanatory memorandum for the no shortfall false and misleading statement penalties states that such penalties would 'provide a sufficient incentive for taxpayers to take care in the taxation statements they make'.<sup>223</sup> Without these penalties, it was thought that prosecution was the only means to address false and misleading statements that did not give rise to shortfalls.<sup>224</sup>

2.52 The no shortfall false and misleading statement penalties require the relevant false statement or omission to be a 'material particular'.<sup>225</sup> The legislation does not define the term 'material particular'. However, the explanatory memorandum to the uniform penalty regime, introduced in June 2000, indicates that a material particular ultimately affects a taxpayer's liability:

If something is included in, or left out of, a statement relating to a tax matter which, if known, would cause a taxation officer to determine a claim in another way, it will be a material particular. In short, if a matter is important enough to affect a decision relevant to determining a taxpayer's tax liability, the matter is to be regarded as material and must be disclosed correctly.<sup>226</sup>

2.53 As the above explanation precedes the enactment of the no shortfall false and misleading statement penalties in 2010, some uncertainty arises as to whether this penalty requires any connection between a taxpayer's statement and their liability.

2.54 Furthermore, the relevant ATO practice statement does not specifically limit the situations where a statement could be considered to be a 'material particular.' In the ATO's view, a statement is a 'material particular' if it:

- is made for a purpose connected with a taxation law;
- is relevant to a decision, power or function for which the statement is made;
- can be taken into account in the outcome of that decision or exercise of a power or performance of a function; and
- is not immaterial, inconsequential or trivial.

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<sup>222</sup> *Tax Laws Amendment (2010 Measures No 1) Act 2010*.

<sup>223</sup> Explanatory Memorandum, House of Representatives, *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* para 6.18.

<sup>224</sup> *Ibid*, para 6.10.

<sup>225</sup> *Taxation Administration Act 1953*, sch 1, s284-75(1).

<sup>226</sup> Above n.31, para 1.42.

40. The term 'material particular' refers to a relevant point, detail or circumstance concerning the purpose for which the statement was made. It is not necessary to establish the statement is one which must or actually will be taken into account in making a particular decision.<sup>227</sup>

2.55 In contrast, however, the seven examples provided in the ATO's practice statement indicate that statements are a 'material particular' where:

- they affect the criteria or factors for determining current and future tax liabilities, such as losses;
- they affect the eligibility for determining concessional tax treatment or liability to tax, such as ABN registrations, director penalty notices and GST invoices; or
- it should have been obvious to superannuation fund trustees that members' TFNs were invalid or incorrect.<sup>228</sup>

## IGT observations

2.56 As a principle, penalties should influence the conduct expected of taxpayers in fulfilling their taxation obligations. Reporting obligations for assessment purposes require taxpayers to ensure their liability is accurate and correct. However, such obligations should not be extended to all the information provided to the ATO unless there is a nexus in assuring the accuracy of a taxpayer's liability.

2.57 Without this nexus there is potential for penalties to be applied in circumstances that are disproportionate to the conduct. Such an approach can be contrasted with other regulatory areas, such as corporate governance, where penalties exist for false statements that do not affect companies' financial liabilities. However, those regimes are broadly designed to protect the interest of market participants so that they are not misled in making decisions with financial implications.

2.58 The ATO performs an important role of supporting taxpayers to accurately report and pay their tax liabilities. This role requires that taxpayers make full and accurate disclosures or statements. The penalties relating to statement provisions are generally aligned with the objective of encouraging accurate reporting as the penalty amount itself is a percentage of any resulting tax shortfall.

2.59 However, the no tax shortfall false and misleading statement penalties may have a broader impact than intended. Originally, the no tax shortfall penalties were targeted towards superannuation disclosure obligations but were subsequently expanded to include all false and misleading statements where no tax shortfall arises. The relevant extrinsic material does not provide any substantial guidance or insight into the legislative intent for this expansion.

2.60 The ATO's practice statement on no shortfall false and misleading statement penalties sets out broad factors to consider. However, these factors do not appear to

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<sup>227</sup> Above n.155, para 39.

<sup>228</sup> Ibid, paras 35-41, 154-179.

require the statement to be related to the assessment of a taxpayer's liability. By contrast, the explanatory memorandum for the uniform penalty regime indicates that such statements should be related to a taxpayer's 'claim'.

2.61 On the one hand, it may never be appropriate for a taxpayer to make a false or misleading statement to the Commissioner. However, a law that requires the Commissioner to apply penalties to any incorrect statement has the potential to impose liabilities in circumstances not directly related to the accuracy of taxpayers' self assessment of liabilities. For example, a view could be formed that the ATO's practice statement allows a penalty to be imposed where a taxpayer enters incorrect industry codes on their tax return. Although the statement is not a criteria or factor in determining tax liabilities or concessional treatments, it could be argued that the penalty arises because it is a case selection criterion for the Commissioner's active compliance activities.

2.62 In the IGT's view, the circumstances to which no tax shortfall penalties apply should be few and appropriately prescribed in the law. This could be incorporated into the Government's consideration of recommendation 2.1(b) above. However, in the absence of such consideration, the IGT is of the view that the ATO should provide greater clarity in this regard.

2.63 Furthermore, as stated above, the false or misleading penalty structure was originally designed to encourage taxpayers to ensure that they accurately self assessed their own tax liabilities. To the extent that penalties are to be a vehicle for encouraging taxpayers to ensure that all their statements relating to their tax affairs are accurate, the IGT is of the view that a more specific and targeted penalty structure directed at information disclosures from a broad administrative perspective should be considered.

## RECOMMENDATION 2.2

*The IGT recommends that the ATO:*

- a) not require taxpayers to pay penalty amounts until the dispute on the primary tax is resolved; and*
- b) provide public advice on the definition of 'material particular' for the no shortfall false and misleading statement penalties.*

### ATO response

Agree with recommendation 2.2(a)

Agree with recommendation 2.2(b)

The ATO will undertake a review of Law Administration Practice Statement PS LA 2012/4 Administration of penalties for making false or misleading statements that do not result in shortfall amounts, to determine if more practical examples to support the definition would provide improved clarity for taxpayers.



## CHAPTER 3—REPORTING AND ANALYSIS OF PENALTIES

### STAKEHOLDER CONCERNS

3.1 Stakeholders have raised concerns regarding experiences or perceptions that significant amounts of penalties raised in the ATO's compliance activities are reduced or reversed ('unsustained') on internal or external review inferring that such penalties should never have been imposed.

3.2 Stakeholders consider that challenging such decisions can be costly and impose personal and emotional pressures. For example, in the case of micro businesses, the penalties may be so large that the company may become insolvent if the penalty amount and the associated tax shortfall are required to be paid. Furthermore, they can damage taxpayers' reputation and livelihoods, such as the requirement for a company director to be a fit and proper person.

### AMOUNT OF UNSUSTAINED PENALTIES

3.3 An accurate picture of the level of unsustained penalties cannot be accurately obtained from the ATO reporting systems at present. The main reason is that penalties raised in each case are not tracked such that it is unclear how and when these penalties are treated in any subsequent reviews such as on objection or settlement. Furthermore, the ATO reported information on penalties are aggregates determined at a particular point in time, and as disputes can sometimes take years to resolve, there are possibilities for significant distortions.

3.4 Notwithstanding the above shortcomings, Table 3 below contains an estimate of the amount of unsustained penalties by collating the data recorded during the different types of review activities. This table also uses data from the last three financial years to minimise distortions that may be caused by extended periods of time elapsing between the date at which penalties were raised in compliance activities and the date at which those penalties may be reduced in review activities.

**Table 3: Amount and percentage of unsustained penalties by financial year**

Financial year	Total of penalties raised (in \$)	Total of penalties reduced (in \$)	% of penalties reduced
2010-11	1,314,342,496	406,495,128	31%
2011-12	1,449,405,023	374,953,248	26%
2012-13	1,490,000,000	688,607,950	46%
<b>Total</b>	<b>4,253,747,519</b>	<b>1,470,056,327</b>	<b>35%</b>

Source: Australian Taxation Office.

3.5 Table 3 above shows that on average over the last three financial years approximately 35 per cent (approximately \$1.47 billion) of total penalties raised were unsustained. It should be noted that this percentage may be higher as the data in this table does not include those penalties reduced in approximately 15,000 small business and individual objection cases.

3.6 There may be a number of reasons for the above unsustainable penalties such as the automatic reduction of those penalties which are calculated as a percentage of primary tax shortfalls when such primary tax is reduced.

3.7 The extent to which penalty amounts are automatically reduced can be identified by calculating the difference between the percentage of primary tax and penalties that were reduced in review activities. The smaller the difference between the percentages of the two, the more likely that penalties were reduced as an automatic consequence of reduced primary tax amounts.

3.8 The data for the last three years in Table 4 below shows that there was a difference of 9 percentage points between the proportion of primary tax and penalties that were reduced.

**Table 4: Proportion of primary tax and penalties reduced during review activities by financial year**

Financial year	Total primary tax raised and reviewed (in \$)	Total primary tax reduced (in \$)	% of reviewed primary tax that was reduced	Total of penalties raised and reviewed (\$m)	Total penalties reduced (in \$)	% of reviewed penalties that were reduced	Percentage point difference
2010–11	2,199,057,866	1,169,861,012	53%	856,941,078	406,495,128	47%	(6)
2011–12	1,598,218,370	728,432,820	46%	645,841,034	374,953,248	58%	12
2012–13	3,047,146,700	951,282,337	31%	1,376,998,905	688,607,950	50%	19
<b>Total</b>	<b>6,844,422,936</b>	<b>2,849,576,169</b>	<b>42%</b>	<b>2,879,781,017</b>	<b>1,470,056,327</b>	<b>51%</b>	<b>9</b>

Source: Australian Taxation Office.

3.9 The data in Table 4 above can also be disaggregated by the type of review activity. This disaggregated data is reproduced in Appendix 13 and shows that for the last three financial years:

- 40% of total penalties involved in objections were reduced whilst only 25% of primary tax was reduced, a 15 percentage point difference;
- 82% of total penalties involved in settlements were reduced whilst only 35% of primary tax was reduced, a 47 percentage point difference; and
- 45% of total penalties involved in litigation were reduced whilst only 64% of primary tax was reduced, a 19 percentage point difference.

3.10 The extent to which penalties are reduced as a result of reversed penalty decisions can be identified by examining the outcomes of review activities. However, the ATO's internal reporting on these outcomes is limited and it is unclear whether the outcomes reported relate to either disputes with the primary tax or penalties raised where cases involve both amounts.

3.11 The data available on the outcome of review activities in which the taxpayer only disputed the penalty decision is limited to objection decisions during the 1 July 2012 to 31 March 2013 period. This data is set out in Table 5 below and indicates that almost half (47%) of such objections are either allowed in full (21%) or allowed in part (26%) and that over one-third (40%) were disallowed:

**Table 5: Outcomes for penalty-only objections for the 1 July 2012 to 31 March 2013 period, by business line**

Outcome	Total cases	% of total
Allowed in full	85	2%
Allowed in part	104	26%
Commissioner's discretion exercised	3	1%
Commissioner's discretion part exercised	2	0%
Disallowed	161	40%
Invalid	31	8%
Withdrawn - settled	2	0%
Withdrawn - taxpayer	18	4%
Unknown	1	0%
<b>Total</b>	<b>407</b>	<b>100%</b>

Source: Australian Taxation Office.

## IGT observations

3.12 Developing a robust understanding of the extent and reasons for unsustainable penalty decisions would allow the ATO to identify and better address the cause. By allowing unsustainable decisions to persist, taxpayers will be deterred from voluntary compliance and perceptions of fairness may be eroded. Reporting on the number of penalty cases and the penalty amounts at various stages of a case's life cycle can also be used to measure the ATO's performance in maintaining sustained penalty decisions.

3.13 The IGT understands that the level of unsustainable penalty decisions cannot be precisely determined by the ATO. The assured figures provided in the Commissioner of Taxation's Annual Reports only set out those raised in audit and not those that are reversed on review. Also, the figures that the ATO internally compiles in relation to review activities, such as, objections, settlement and appeals, are not complete due to systems limitations, inconsistency of information collection and the infancy of recent improvements.

3.14 The preliminary estimates that may be derived from the available information indicate that between 26 per cent and 46 per cent of the total penalties raised are later reduced on internal or external review. Importantly, approximately 15,000 of the ATO's SBIT business line objection cases are not reflected in these reversal figures, indicating that the rate of reduction may be higher.

3.15 Although a number of reasons may explain these amounts of reductions, including the quality of the data that is collected by the ATO, these figures strongly suggest a significant proportion of initial penalty decisions are not sustained at the objection stage or at settlement.

3.16 In the absence of more specific data being collected and reported by the ATO, taxpayers may be justified in their perception that a significant proportion of penalties are being imposed at a high rate initially to coerce them to submit to the ATO view in

return for a reduction of penalties on a subsequent review. Without greater transparency and improved information capture, these claims or perceptions will persist.

## PENALTIES RAISED IN MARKET SEGMENTS

3.17 The ATO's internal reports show that over the 2010–11 and 2011–12 financial years, approximately 1.8 million active compliance activities raised a total of \$17.9 billion in primary tax and \$2.7 billion in penalties. Table 6 below disaggregates these penalty amounts by taxpayer market segment:

**Table 6: Total penalties raised by market segment**

Market segment	2010-11 financial year	2011-12 financial year	Total penalties raised	% of total
Large business	235,939,706	290,021,596	525,961,302	19%
SME	204,921,503	234,236,062	439,157,565	16%
Micro	694,110,927	709,433,149	1,403,544,076	51%
Government	27,844	78,974	106,818	0%
Not for profit	4,843,527	15,587,766	20,431,293	1%
Individuals	156,630,464	192,815,049	349,445,513	13%
<b>Total</b>	<b>1,296,473,971</b>	<b>1,442,172,596</b>	<b>2,738,646,567</b>	<b>100%</b>

Source: Australian Taxation Office.<sup>229</sup>

3.18 The micro market segment constituted the largest proportion of total penalties raised, accounting for just over half of total penalties raised over these two years. The remaining penalties raised can be attributed in similar proportions to the individuals, large and SME market segments.

3.19 The fact that the quantum of the penalties raised is so much greater in the micro business market segment than in the large business market segment may be attributed to the latter being better equipped to comply with their obligations. Alternatively, it could also be argued that micro businesses are often not in a position or are reluctant to challenge ATO decisions.

3.20 Table 7 disaggregates the total penalties raised by type of tax obligation, or 'revenue product', such as income tax, Pay-As-You-Go withholding (PAYG(W)) and Superannuation (SPR) Guarantee, for the 2010–11 and 2011–12 financial years. As expected, income tax accounts are by far the largest amounts of penalties raised and together with GST comprise approximately 91 per cent of total penalties raised.

<sup>229</sup> Above n.150, p 4.

**Table 7: Total penalties raised by revenue product**

Revenue Product	2010-11	2011-12	Total penalties raised	% of total
Excise Revenue	3,003,807	7,677,221	10,681,028	0%
Excise Transfer	16,352,787	2,078,315	18,431,102	1%
GST	223,777,923	338,561,094	562,339,017	21%
PAYG (W)	55,165,494	75,673,161	130,838,655	5%
Income Tax	966,666,287	958,591,220	1,925,257,507	70%
SPR Guarantee	29,864,049	50,982,634	80,846,683	3%
Luxury Car Tax/ Sales Tax	135,726	7,255,546	7,391,272	0%
Administrative Penalties	13,200	35,200	48,400	0%
Other Penalties	1,494,697	1,318,206	2,812,903	0%
<b>Total</b>	<b>1,296,473,970</b>	<b>1,442,172,597</b>	<b>2,738,646,567</b>	<b>100%</b>

Source: Australian Taxation Office.<sup>230</sup>

3.21 Each ATO business line has its own compliance focus, such as the type of taxpayer or type of tax obligation. Table 8 below disaggregates the total amount of penalties raised by ATO business line:

**Table 8: Total penalties raised by ATO business line**

BSL	2010-11	2011-12	Total penalties raised	% of total
ATP	14,032,123	17,688,203	31,720,326	1%
OTHER	1,650,640	2,651,938	4,302,578	0%
ITX	205,438,564	263,058,344	468,496,908	17%
LBI	209,019,854	290,296,122	499,315,976	18%
MEI	92,367,408	140,493,006	232,860,414	9%
SME	275,633,661	250,165,970	525,799,631	19%
SNC	97,998,808	134,857,049	232,855,857	9%
SPR	27,910,160	36,434,900	64,345,060	2%
TPALS	372,422,753	306,527,065	678,949,818	25%
<b>Total</b>	<b>1,296,473,970</b>	<b>1,442,172,597</b>	<b>2,738,646,567</b>	<b>100%</b>

Source: Australian Taxation Office.<sup>231</sup>

3.22 As Table 8 above shows, the LBI, SME, ITX and TPALS business lines generally raise the greater amounts of penalties. This may be due to the fact that the LBI and SME business lines deal with taxpayers with larger turnovers, the ITX business line deals with the indirect taxes of all Australian businesses and the TPALS business line deals with lodgement obligations amongst others.

<sup>230</sup> Ibid, p 4.

<sup>231</sup> Ibid, p 3.

3.23 The MEI business line, which generally focuses on compliance income tax obligations, also raises a significant amount of tax liabilities. However, compared to the amount of penalty raised in the micro enterprise market segment, this amount is relatively small. The difference in penalty amounts raised may indicate that penalties raised in the micro enterprise market segment are for penalties relating to statements and lodgement obligations.

3.24 The total penalties raised can also, to a limited extent, be disaggregated by penalty type. It should be noted, however, that this data could only be provided for the period 1 July 2011 to 30 April 2012, which is approximately 50 per cent of total penalties raised in the 2011–12 financial year. Furthermore, this data is not broken up by taxpayer market segment. Table 9 below sets out this data:

**Table 9: Selected penalties raised by penalty type**

Penalty type	Number	Amount (\$)	% of total amount
Failure to lodge	138,407	79,213,200	11%
Failure to take reasonable care	42,896	170,609,160	23%
Recklessness	3,835	86,278,182	12%
Intentional disregard of a taxation law	886	129,630,143	17%
Shortfall penalty – other	137	18,828,833	3%
No reasonably arguable position	235	68,135,939	9%
Scheme penalties	81	84,657,323	11%
Failure to provide a document	2,790	107,451,050	14%
Other penalties	115	251,350	0%
<b>Total</b>	<b>189,382</b>	<b>745,055,180</b>	<b>100%</b>

Source: Australian Taxation Office.<sup>232</sup>

3.25 Table 9 above shows that the greatest proportion of penalties raised were those relating to taxpayer statements, namely for failure to take reasonable care, recklessness, intentional disregard of a taxation law and no reasonably arguable position. The table also shows the penalty most frequently imposed was that for failing to lodge on time.

## IGT observations

3.26 The ATO currently collects some information on the penalties it raises, such as the total amounts by business line, market segment and revenue product. Whilst it is important to know the amount of penalties that the ATO is raising, it is equally important to have a greater understanding of the common drivers for penalties to assist the ATO to understand the nature of underlying taxpayer non-compliance and fine-tune its strategies towards achieving the penalty regime's purpose of encouraging voluntary compliance.

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<sup>232</sup> Ibid, p 6.

3.27 For example, over half of the penalties raised are imposed on micro enterprises. Such a high level of penalty imposition indicates a need for ATO focus to alleviate causal factors and assist these businesses to more easily comply voluntarily so that the costs and time expended on tax compliance activities may be redirected to entrepreneurial activities that assist businesses' productivity.

3.28 Accordingly, improved recording and reporting would provide useful qualitative and quantitative information that gives useful insights about taxpayer behaviour, as well as the effectiveness of penalties and the ATO's administration of the taxation laws in shaping taxpayer behaviour.

3.29 Currently, the ATO records net liabilities arising from all penalty decisions for financial reporting purposes. Its data collection is limited in relation to the number and amounts of the different types of penalties raised and remitted. It is, therefore, difficult to establish the types and amounts of penalties that are most frequently imposed and the reasons for their imposition. Furthermore, the ATO does not currently have the capability to provide corporate reports on the types of penalties imposed and remitted in compliance activities.<sup>233</sup> More information on the ATO's collection and reporting of data is provided in Appendix 13.

3.30 The ATO has started to capture more information with the aim of identifying and understanding the major reasons for initial audit decisions being changed on objection. Due to limitations with the information that is being collected, however, little insight can be gleaned from the figures on the underlying reasons for penalty imposition and subsequent adjustments to penalty decisions. An example of a limitation is that the template, which ATO objection officers are required to answer on the Siebel Case Management system, does not capture penalty-specific information. As a result, information on the reasons for unsustainable penalties can only be extracted by isolating objection cases which deal with penalties only. This process excludes valuable information about those objection cases which involve both primary tax adjustment and penalty decisions. Furthermore, it does not capture information on other review activities in which penalty decisions may be adjusted, such as on settlement and only represents a small percentage of the total number of penalty cases that are subject to review.

3.31 The IGT also observed that ATO business lines have not consistently collected information on penalties, particularly in relation to the standard of conduct exhibited by taxpayers for false and misleading statement penalties. Such information would allow the ATO to distinguish between cases where the penalty amount was reduced as an automatic result of the primary tax amount being reduced from those where the penalty decision has been reversed.

3.32 In this respect, standard data definitions and input would ensure the same information is being collected on penalties across the ATO, irrespective of the type of audit or review activity. The reasons for penalty decisions being imposed and

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<sup>233</sup> Ibid; Australian Taxation Office communication to the Inspector-General of Taxation, 5 December 2013.

subsequently changed are also another important piece of information that must be captured.

3.33 Tracking the various penalty decisions that are made at different stages of audit or review activity after implementing standard data definitions should provide a complete and consistent end-to-end and case-by-case reporting facility that delivers substantial insights into the underlying causes of unsustained penalty decisions and facilitates the development of effective strategies to address them.

3.34 Even within the current limitations, the ATO could also take a staged approach to improve penalty information collection. Such an approach may include the capture of:

- the type of penalties that are being raised and the frequency of their imposition;
- the areas of tax law or nature of the issues that commonly attract penalties;
- changes in taxpayer behaviour subsequent to the imposition of penalties; and
- the common characteristics of taxpayers that attract penalties, such as the size of the relevant taxpayers and the industry in which they operate.

3.35 Although such information would be limited to those areas in which the ATO conducts compliance activities, the IGT is of the view that it would usefully measure the effectiveness of the ATO's compliance processes in identifying risks and influencing taxpayer behaviours. Accordingly, this information would better inform the design of its compliance strategy and reduce administrative costs by focusing on those areas that would better foster voluntary compliance.

3.36 In the longer term, the ATO will need to ensure that further information is captured, such as that for penalties relating to taxpayer statements including taxpayer behaviours and how these were inferred from the material facts and evidence, the type of penalty imposed, the remission decision and the reasoning for the penalty and remission decisions.

3.37 Once the above information is captured, it is important that the ATO report it publicly to improve accountability in respect of the sustainability and consistency of penalty decisions and dispel any incorrect perception of leverage.

3.38 There is also some information that is already captured but not reported. For example, the ATO does not currently report penalty decisions made in position papers or those later reduced or remitted when audits are concluded. Reporting such figures appropriately would provide a better understanding of the ATO-taxpayer interaction in and around the time the position paper is discussed. Given the adverse impacts of unsustained penalties around this stage of compliance activities, the IGT considers such reporting would promote transparency and improvements in ATO-taxpayer engagement.

3.39 System improvements may also need to be implemented to provide direct search and retrieval of relevant data. In this respect, the ATO could examine information management approaches taken by other organisations in relation to the

application of law involving dynamic standards and inferences based on facts and evidence.<sup>234</sup>

3.40 Importantly, the information collected and reported must be analysed to identify underlying patterns or trends in taxpayer behaviour and the areas requiring increased taxpayer attention to develop practical improvements. The strategies developed by the ATO could then be tested through a number of methods, such as randomised controlled trials, to ensure effective outcomes are achieved.

### RECOMMENDATION 3.1

*The IGT recommends that the ATO:*

- a) systematically collect and analyse a broad range of penalty information (including the type of taxpayer behaviour observed, the relevant percentage rate of penalty and the decision itself) to identify patterns of taxpayer behaviours that drive non-compliance and develop strategies to address those patterns;*
- b) utilise standard data definitions and input for recording and reporting on all decisions for penalties relating to taxpayer statements, including the reasons for each penalty's imposition and any subsequent adjustments;*
- c) improve its penalty reporting systems to track changes to penalty decisions at a case level over the life of the case, namely from an initial decision through to resolution; and*
- d) publish a broad range of statistical information and measures in respect of penalty decisions, including penalty imposition and reductions on a business line basis.*

#### ATO response

Agree in part with recommendation 3.1(a)

The ATO agrees with the objective of the recommendation that compliance strategies that address identified patterns of non-compliant behaviour will generally achieve more effective outcomes.

There is significant ongoing work in the area of information gathering and analysis of compliance behaviour and strategy including behavioural economics. An analysis of penalty information forms part of the work addressing a variety of aspects of compliance behaviour. The ATO will continue to look for further opportunities to use available penalty information but does not propose to undertake a specific program of work.

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<sup>234</sup> Such as the 'sentencing table' used by the Public Defenders office, the 'sentencing database' developed by the Judicial Commission of New South Wales, and the 'sentencing database' maintained by Legal Aid Queensland.

Agree in part with recommendation 3.1(b)

The ATO agrees to report the following data items relating to penalty decisions:

- case numbers and quantum for imposition of primary tax and shortfall penalties, and
- objection adjustments and aggregated settlement and litigation adjustments.

Reporting of these items is planned to progressively commence from 1 July 2014.

The ATO disagrees with the recommendation to have further standard data for subsequent adjustments due to the required system changes and impacts on productivity due to the keying of the data for a large number of simple and high volume objections cases. Similar information could be obtained using a sampling methodology.

Agree in principle with recommendation 3.1(c)

The ATO agrees with the objectives of the recommendation to track changes to penalty decisions at a case level over the life of a case. Reporting of this nature will require significant changes to information technology systems and business processes. The system changes will be subject to prioritisation on the ATO Information Technology Forward Program of Work.

The ATO notes that reporting from source systems in the enterprise reporting project (progressively implemented from 1 July 2014) may be the first step in this process and the ATO will evaluate opportunities for further systems changes once the project is implemented.

Agree in part with recommendation 3.1(d)

The ATO agrees to publish the following information upon finalisation of the enterprise reporting project (see response to recommendation 3.1(b)):

- the number and value of penalties imposed for false or misleading statement and for not having a reasonably arguable position; and
- the number and value of adjustments that occur to imposed penalties as a result of objections, settlements and litigation.

The ATO does not agree to report this information on a business line basis. This is because work types and market segments managed within each of the business lines continue to change over time and may continue to do so, resulting in limited usefulness for the development of trend data and comparative analysis.

The ATO does not propose to undertake a program of work for additional reporting. The ATO notes the significant staff costs involved in keying further data in addition to the limited system deployment capacity to deliver all of the items noted in the report.

## CHAPTER 4—PENALTY DECISION MAKING AND UNSUSTAINED PENALTY DECISIONS

### STAKEHOLDER CONCERNS

4.1 Stakeholders were concerned that many decisions to raise penalties relating to taxpayer statements had later been reversed ('unsustained') due to ATO officers:

- not having sufficient capability to deal with facts and evidence to formulate sustained decisions;
- not requesting relevant information in the first instance such that new information or arguments are provided after finalisation of audits and raising of penalties;
- insufficiently explaining the reasons for their penalty decisions; and
- using penalties as a means to leverage resolution of primary tax disputes.

4.2 Each of the suggested stakeholder reasons for unsustained penalty decisions are discussed in separate sections below.

### DEALING WITH FACTS AND EVIDENCE TO FORMULATE SUSTAINED PENALTY DECISIONS

4.3 Stakeholders have asserted that some ATO officers lack the capability to appropriately deal with facts and evidence to formulate sustainable penalty decisions. The conduct that has led them to this conclusion include ATO officers:

- not collecting all relevant evidence to support penalty decisions or inadequately documenting taxpayers' contentions at audits;<sup>235</sup>
- not considering all collected evidence,<sup>236</sup> using irrelevant evidence, inadequately considering the weight of evidence and not sufficiently testing the reliability of the evidence;<sup>237</sup>
- not determining what action a reasonable person would have taken in circumstances such as where the law and its application is complex;
- in determining base penalty amounts, taking into account taxpayer behaviours or actions post-lodgement of the relevant tax return such as the taxpayer not

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235 Australian Taxation Office, 'Quality Improvement and Assurance Monthly Report June 2011', internal ATO document

236 Ibid, p 27.

237 Australian Taxation Office, 'ATO Opportunity for improvement' (23 June 2011), internal ATO document p 3.

providing written analyses of relevant facts that were not canvassed in the ATO's position papers; and

- raising higher base penalty amounts in certain compliance projects, such as those on Employee Share Schemes, without appropriate consideration.

4.4 The ATO material, provided in Appendix 4, also indicates that over one-third of ATO penalty decisions were reversed on objection due to ATO officer conduct, including:

- not seeking or requesting critical information or supporting evidence;
- inadequately analysing the facts or evidence; and
- incorrectly applying the relevant law or ATO view to the facts and evidence that was available during the audit.

4.5 An area of concern as observed by the ATO is that some officers have insufficient ability to link evidence with taxpayer behaviours:

The link between facts and evidence and the behaviour it infers is not always made by staff. The penalty representative commented on the fact that the information is often in the cases but the inference to behaviour is not always made. The concept of translating facts and evidence into a behaviour seemed to be a revelation to some and put things into perspective for them. This indicates that more emphasis needs to be placed on this aspect in training packages. (Both [in relation to] facts and evidence and penalties).<sup>238</sup>

4.6 Furthermore, internal ATO material indicates that where some ATO officers are faced with complexities in dealing with facts and evidence or are not actively managing their case, those officers may run out of time and be left without compelling facts on which to base penalty decisions. These officers may then use the available facts to make a penalty decision which unfortunately may have been incorrect and/or based on irrelevant evidence.<sup>239</sup>

4.7 Such internal ATO material has also observed that officers may assume that the fact that a case has been selected for audit by the ATO implies that reasonable care has not been taken and therefore consider a penalty must apply. This assumption was thought to indicate a tendency by some staff to determine the penalty first and look for evidence to support it later.<sup>240</sup>

4.8 The ATO has advised that the means to address the above concerns is through relevant, timely and appropriate guidance material, internal procedures and decision making tools as well as training. These are outlined in the following sections.

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<sup>238</sup> Ibid.

<sup>239</sup> Australian Taxation Office, 'Compliance Penalties and Interest Forum Minutes' (14 December 2012), internal ATO document p 4.

<sup>240</sup> Above n.237, p 3.

## ATO guidance material

4.9 The ATO's staff instructions require its officers to consider the facts and evidence in making penalty decisions:

...penalty decisions must be supported by the available facts and evidence. Conclusions about the entity's behaviour should only be made where they are supported by facts, or where reasonable inferences can be drawn from those facts.<sup>241</sup>

4.10 Furthermore, ATO officers are required to have considered the individual circumstances of the case, giving appropriate consideration to the background and experience of the taxpayer.<sup>242</sup> Statements similar to the above are also made in the ATO's internal guidance and training materials, a list of which is provided in Appendices 9 and 10.

## ATO procedures, decision making tools and materials

4.11 Certain ATO business lines provide specific procedures on how to conduct a review or audit, with specific sections on penalties. For example, the ATO's procedures for making penalty decisions in large business audits stresses the importance of gathering sufficient facts, evidence and taxpayer contentions to incorporate into the case's fact and evidence worksheet. ATO officers are also required to consider the taxpayer's behaviour, compliance history, degree of cooperation, voluntary disclosures and delays<sup>243</sup> and, where penalties are imposed, comprehensive statements of reasons for penalty decisions must be produced.<sup>244</sup>

4.12 As discussed in Chapter 1, the ATO's procedures also require all penalty decisions to be reviewed by another officer and, for certain penalty decisions, by an internal panel. These pre-issue quality assurance checks are aimed at ensuring penalty decisions are of the expected quality prior to the decision being communicated to the taxpayer.

4.13 The ATO has recently provided its staff with a number of A3 information sheets to outline key points to consider in making penalty decisions. These A3 information sheets are reproduced in Appendix 9 and reiterate the need for facts, evidence and reasonable inferences to support penalty decisions:

Facts, evidence and reasonable inferences must exist to determine that the entity and agent did not take reasonable care. If they do not exist, the entity has taken reasonable care or is presumed to have taken reasonable care.

If based upon the facts and evidence we have a 'border line call', we should gather more information or give the entity the benefit of the doubt and determine reasonable care, rather than assess as a failure to take reasonable care.<sup>245</sup>

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241 Above n.42, para 9.

242 Ibid, para 9.

243 'IT large business specific audit', above n.151.

244 Ibid.

245 Australian Taxation Office, 'Shortfall penalty for making a false or misleading statement' (18 May 2012), internal ATO document.

4.14 The ATO also provides its officers a guide to determining compliance related behaviours. This guide contains a number of questions which prompt ATO officers to consider in determining the base penalty amounts and provides the following guidance:

- Gather facts and evidence relevant to your decision. Talk to the taxpayer or their agent, if appropriate. Check ATO systems for information.
- Do not wait until the end of the audit or review to obtain information for the penalty decisions. Ask at the earliest appropriate opportunity.
- Be prepared to discuss the facts and evidence with the taxpayer, or their representative.
- Document the contentions they raised and respond to them in your reasons for decision.
- Use false or misleading statement penalty Facts and Evidence Worksheet [discussed below] when you are required to do so.<sup>246</sup>

4.15 The ITX business line also provides its officers with a Behavioural Observation record. This record focuses officers' attention on the information needed to identify the level of care taken by taxpayers by posing questions under the following four different categories:

- experience and background of the taxpayer;
- preparation of the business activity statement;
- how the shortfall arose; and
- behaviours of tax agents and service providers.

4.16 The full list of questions in the Behavioural Observation record for each of the above categories is reproduced in Appendix 10.

4.17 The SBIT business line also provides its officers with a penalty decision making tool specific to audits that are conducted on employers' tax obligations – the employer obligation penalty wizard. This tool determines the penalty and produces a statement of reasons after the ATO officer has entered certain factual information in response to prompted questions. However, the ATO considers that this tool is only useful for more simplistic penalty issues and not those involving considerable judgement.

4.18 In the conduct of reviews or audits that are complex,<sup>247</sup> contentious or otherwise involves a high probability of dispute or litigation,<sup>248</sup> the ATO requires

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<sup>246</sup> Australian Taxation Office, 'A guide to determining compliance related behaviour', internal ATO document. ITX also have a Behavioural Observation record that has some specific items for ITX.

officers to complete a facts and evidence worksheet which assists ATO officers to, amongst other things:

- determine the material facts and relevant evidence required to support penalty decisions;
- improve the understanding and transparency of ATO officers' reasoning on relevance of the facts and evidence relied upon in decisions; and
- quickly narrow the issues in dispute.<sup>249</sup>

4.19 The ATO has advised that it would undertake ongoing quality assurance assessments through its Integrated Quality Framework (IQF) to ensure that ATO officers are using and completing the facts and evidence worksheet appropriately:

IQF should ensure, where mandated, that [facts and evidence worksheets] are completed effectively and progressively with relevant, quality, case information throughout the audit process, in accordance with policy.<sup>250</sup>

4.20 The ATO has also advised the IGT that it is currently developing a model facts and evidence worksheet that will assist officers to better complete the worksheet by illustrating the ATO's 'expectations and what a quality, populated worksheet looks like.'<sup>251</sup> The ATO's current facts and evidence worksheet is reproduced in Appendix 11.

### **ATO training relating to penalty decision making**

4.21 The ATO provides a number of training packages relating to penalty decision making. Many of these packages are delivered at a fundamental level and are electronically self-directed. In particular, the ATO provides six training packages which are either directly related to penalties generally or those penalties relating to taxpayer statements being:

- penalties and interest charges – overview;
- penalty – no shortfall for false or misleading;
- penalty – false or misleading statements;
- penalty – safe harbour – exemption from false or misleading statements;

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247 For example, large business audits. See Australian Taxation Office, 'Guidelines for LB&I on the use of the facts and evidence worksheet templates', internal ATO document.

248 For example, comprehensive risk reviews in the PGH business line where there is a risk of dispute or litigation or involves other contentious issues. See Australian Taxation Office, 'Guidelines for PGH officers on when to use the facts and evidence worksheet for audits', internal ATO document.

249 Australian Taxation Office, 'Facts and Evidence worksheet (FEW)' (27 February 2012), internal ATO document.

250 Ibid.

251 Australian Taxation Office, 'Office Minute: Objection Review – agreed continuous improvements' (23 February 2012), internal ATO document p 3; Australian Taxation Office, 'Active Compliance – Penalties Improvement Work Program' (1 March 2013), internal ATO document; Australian Taxation Office, 'Continuous Improvements – Progress as at 1 March 2013' (1 March 2013), internal ATO document.

- penalty – base penalty amount adjustments; and
- penalty for not having a RAP.

4.22 The ATO also provides training packages relating to the use of evidence in decision making, including the following:

- evidence – an introduction;
- evidence – overview risks and issues worksheet;
- evidence – facts and evidence worksheet workshop;
- evidence – facts and evidence and chronology worksheet;
- evidence – analysis and interviewing; and
- evidence – analysis of taxpayer response.

4.23 It is important to note that the ATO's training material identifies the following key messages regarding evidence:

If there is no piece of evidence to support a fact then it is an assertion rather than a fact, which in most situations will not be useful. Assertions and assumptions have a limited place in ATO decision-making. You may need to obtain further information or evidence.<sup>252</sup>

4.24 The ATO has advised<sup>253</sup> that it is proposing to develop a new penalty decision making training package focused at an intermediate level. The outline of the content provided to the IGT suggests that this package would assist ATO officers to:

- differentiate between the standards of care for false and misleading statement penalties;
- determine what facts may be relevant to making penalty decisions, such as the difference between those facts relevant to the primary tax issue and those facts relevant to the penalty issue; actions of taxpayers in connection with making statements and those actions during audits; and, distinguishing irrelevant facts;
- identify factors that would allow the reduction or increase of base penalty amounts; and
- utilise a legal reasoning model to apply facts to penalty decisions and reference the facts and evidence in written explanations.

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252 Australian Taxation Office, 'Decision making – Compliance BSLs: Learner guide' (17 January 2011), internal ATO document p 50.

253 Australian Taxation Office, 'Office Minute: Objection Review – agreed continuous improvements' (23 February 2012), internal ATO document.

4.25 Other relevant ATO training includes that recently provided on active case management and technical decision making which helps officers to focus on the sequencing of questions on penalty issues during compliance activities.

### **IGT observations**

4.26 Decision making on certain penalties, such as those relating to statements, can be complex for a number of reasons.

4.27 Firstly, the law requires ATO officers to make inferences about a taxpayer's actions and circumstances at the time the statement was made. This process may require considerable analysis of various pieces of evidence, none of which, in isolation, is conclusive proof of those standards of conduct required by the law. Such an analysis involves finely balanced assessments of the reliability and probative value of the evidence, as well as the resolution of any competing inferences that can be drawn from the evidence.

4.28 Secondly, there may be difficulties in gathering evidence establishing the taxpayer behaviours and circumstances at the time that the statement was made which may have been made many years prior.

4.29 Thirdly, although the standard of reasonable care is a settled legal concept, it requires a complex construction involving a hypothetical person with similar attributes and circumstances to the taxpayer at the relevant time.

4.30 Notwithstanding these complexities, the IGT considers there are opportunities to improve ATO officers' capability in appropriately dealing with facts and evidence in penalty decision making.

### **Penalty decision database**

4.31 The IGT considers that one of the difficulties ATO officers face is that they have limited access to previously made penalty decisions and precedents. Without access to such material, officers form their own impressions of good decision making.

4.32 Although the ATO has made numerous penalty decisions over the years, ATO officers cannot easily access these decisions. The IGT considers that the capture and access to these decisions and associated reasoning, including the relevant facts and evidence relied upon, in an easily searchable and retrievable database would be invaluable to ATO officers. Such dissemination of corporate knowledge would assist existing and new staff to elicit principles and guide them to better decision making.

4.33 It would also be useful to provide public access to the above proposed database. The IGT is of the view that providing such access (in a form that addresses privacy and secrecy issues – such as is already done with private rulings) would provide transparency and accountability and thereby increase the confidence of taxpayers and their advisors in the ATO's penalty decisions. It is possible that initially, some taxpayers and ATO officers may seek to support positions by cases at the extremities. However, this may lead to better and more consistent decisions in the long term.

4.34 Furthermore, some form of precedent or examples of better quality decisions could be extracted from such a database by an ATO penalty specialist group. As the CPIT already undertakes reviews of samples of high quality penalty decisions made within the ATO, it may be best placed to perform this function and make it available to relevant ATO officers.

### **Penalty decision making tools**

4.35 As mentioned earlier, the ATO has already developed specific penalty decision making tools that can assist its officers to appropriately deal with facts and evidence during compliance activities, for example, tools that prompt officers to seek penalty-related evidence. Some of these tools have been introduced recently and, if used and understood correctly, would go some way to addressing some of the concerns outlined above.

4.36 Many of the remaining concerns could be addressed by improving the quality of analysis on the relevant facts and evidence when officers determine standards of conduct and infer taxpayer behaviours. There are difficulties in designing tools to achieve this aim as this type of analysis does not lend itself to prescriptive formulae. Furthermore, merely providing ATO officers with typical factual matrices with corresponding conclusions may discourage officers from performing the required analysis.

4.37 However, the IGT is of the view that an enterprise-wide penalty decision making tool could be developed to assist all ATO officers. Such a tool, at the very least, should provide a strong framework for conducting the necessary analysis, prompt officers to ensure all relevant evidence is obtained and appropriately considered, and the reasoning for the inferences drawn from the evidence are contemporaneously and cogently documented. It should also provide the basis for more efficient and effective internal pre-issue quality assurance of penalty decisions.

4.38 The IGT considers that this penalty decision making tool would be most useful where it is tailored for different areas of the ATO as different areas deal with different types of issues and behaviours. For example, the ITX business line's behavioural observation record could be incorporated into this tool for that business line as it is useful in drawing out, recording and gathering the material facts and relevant evidence in the context of a transactional-based tax.

4.39 The IGT believes that other business lines could also consider tailoring the penalty decision making tool to suit the peculiarities encountered in their business line. However, any tailoring should ensure that the fundamental objectives of the penalty decision making tool are maintained.

### **Consolidating penalty decision material**

4.40 ATO officers may not always be aware of all the penalty decision making material that is available to them, given the volume and breadth of information available on the ATO's intranet. Much of the reference material on penalties is currently presented in a passive form on the ATO's intranet under an area for 'work processes'.

4.41 Through the use of technology, the range of available material may be seamlessly linked together, providing a single source of formal and informal information for penalties. The ATO has moved towards such an approach on other tax topics, such as transfer pricing, through its *e-wiki*. The ATO's *e-wiki* is an online portal, accessible to all ATO staff which allows many users to add and edit content on a particular subject matter. The *e-wiki* may also be an effective means to capture, collate and access knowledge across the ATO on penalty issues. For example, existing formal ATO guidance could be accessed from hyperlinks on the *e-wiki* and informal material, such as that developed as a result of ATO officers sharing and commenting on one another's experiences and insights, could be captured on the *e-wiki* itself. In this respect, the *e-wiki* would facilitate interactive dialogues between officers and sharing of best practice on a real time basis.

4.42 Furthermore, to reduce the risk that ATO officers may not adopt the *e-wiki* and use it to its full potential, there is a need for a small team to actively manage the *e-wiki* to ensure its relevance, maximise its useability and reinforce its use by updating it regularly and moderating the content that is submitted to the *e-wiki*. The CPIT may be best placed to carry out such work given their knowledge and experience with penalty issues.

## Training

4.43 As stated earlier, the ATO has developed training packages that aim to provide ATO officers with an understanding of the core penalty concepts and to improve officers' ability to deal with facts and evidence. The ATO is also proposing to develop a new penalty training package focused at an intermediate level.

4.44 There is a risk that the expected outcomes of training materials will not be achieved if the penalty aspect is considered merely as a component of wider decision making for determining a taxpayer's liability. Gathering evidence and making penalty decisions relating to statements always requires ATO officers to turn their mind to the standards of conduct or strength of position set out in the law. In this sense, it is a discipline worthy of specific training.

4.45 ATO officers have indicated that interactive case study based training would provide inexperienced officers with a greater level of capability where it was facilitated by experienced ATO penalty specialists.<sup>254</sup> The IGT supports this approach, as developing the required analytical skills is more likely to improve when tested under direct supervision of an experienced officer. The IGT considers that interactive case based training should be incorporated in the suite of new ATO penalty training packages.

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<sup>254</sup> Australian Taxation Office, 'Compliance Penalties and Interest Forum Minutes' (28 September 2012), internal ATO document.

4.46 The IGT also considers that interactive case studies would best include cases which seek to address the reoccurring reasons for unsustained penalty decisions, for example:

- cases which contain relevant and irrelevant facts and evidence, to improve ATO officers' capability in distinguishing between those different facts and evidence;
- cases which have incomplete and ambiguous information, to improve ATO officers' capability in testing evidence and ensuring that relevant evidence is being collected; and
- cases in which different conclusions can be drawn from the evidence, to improve ATO officers' capability in weighing up the strengths and weaknesses for the competing arguments to arrive at appropriate decisions.

4.47 Another useful training tool for ATO officers would be to compare examples of good penalty decisions with better penalty decisions. Such examples should be accompanied by an explanation of what aspects of the decisions distinguish the two. Such information could also be provided on the ATO's internal *e-wiki*.

4.48 It is important to remember that understanding the concepts in a learning environment is different to applying those concepts to actual cases. This is particularly true in circumstances where ATO officers are required to elicit and consider evidence in a potentially adversarial and uncertain environment.

4.49 The IGT also considers that training should provide a similar experience to the work that is likely to be encountered – for example, only providing incomplete facts and evidence and asking the officer what they would do to determine whether more evidence was needed and how they would formulate and document their decision. Any formal training would also be best followed up immediately with practical application, such as running cases on routine issues under the direct supervision of experienced ATO officers. This on-the-job training would better consolidate the earlier training received and ensure that the new knowledge is applied in practice and retained.

#### **RECOMMENDATION 4.1**

*The IGT recommends that for penalties relating to taxpayer statements, the ATO:*

- a) capture and provide public access to all penalty decisions and associated reasoning, including the relevant facts and evidence relied upon, in an easily searchable database;*
- b) extract and make available, to relevant ATO officers, precedent or examples of high quality penalty decisions from the above database;*
- c) develop a penalty decision making tool which requires ATO officers to collect all relevant evidence and provides them with an analytical framework;*

### **RECOMMENDATION 4.1 (CONTINUED)**

- d) establish a penalties 'e-wiki' and ensure that appropriate resourcing is made available to reinforce its use and actively manage the content on an ongoing basis; and*
- e) incorporate into its penalty training packages interactive case based studies, use examples of penalty decisions of different quality and ensure follow up with on-the-job training under direct supervision of experienced ATO penalty decision makers.*

#### **ATO response**

##### **Disagree with recommendation 4.1(a)**

The ATO disagrees with the recommendation on the basis that it considers decision reports that have had relevant identifiers removed will in the main be of limited utility to taxpayers in understanding the specific factors that led to a particular decision. In addition, implementation of this recommendation would require the development of a new and large database and a significant number of staff being assigned to remove taxpayer identifiers to maintain taxpayer privacy on an estimated 60,000 to 100,000 decisions per year.

The ATO agrees with the objective of the recommendation to increase transparency regarding penalty decisions and will publish results of its quality assurance processes that assess the correctness of penalty decision on a quarterly basis.

##### **Agree with recommendation 4.1(b)**

##### **Agree in principle with recommendation 4.1(c)**

ATO officers are required to gather all relevant information to enable a penalty decisions to be made during an audit or risk review. Tools exist for this process and the ATO will assess if there is an opportunity to develop further tools to assist with evidence gathering, decision making and/or report writing that are appropriate for different types of cases.

##### **Agree in part with recommendation 4.1(d)**

The ATO agrees to review and make improvements to online resources for staff in relation to penalty decision making. The platform and delivery options will be developed in the context of the broader corporate approach to providing online policy and practice information for ATO staff.

##### **Agree with recommendation 4.1(e)**

## INFORMATION NOT PROVIDED DURING AUDIT

4.50 The ATO and stakeholders indicated that another reason for unsustainable penalties was due to information not being provided to ATO officers during audits.<sup>255</sup>

4.51 Stakeholders acknowledged that some taxpayers may not be as cooperative or be in a position to provide requested material. However, stakeholders also considered that lack of sufficient ATO officer communication with taxpayers was the reason for information being provided after the conclusion of the audit. In this respect, taxpayers expressed frustration with the lack of opportunities afforded by ATO officers, and in some cases resistance, to discuss the relevant issues to enable both parties to better understand each other's position and identify relevant information to correct any misunderstandings prior to a penalty decision being made.

4.52 ATO information, set out in Appendix 4, indicates that over one-fifth of penalty-only objection cases since 1 July 2012 (21.69% or 41 of 189 cases) were allowed in full or in part due to information requested during audit being provided after the audit was finalised. Furthermore, the information in Appendix 4 also indicates that approximately one per cent of penalty-only objection cases (2 of 189 cases) were allowed in full or in part due to the audit being finalised without the auditor requesting critical information during the audit. Whilst one per cent may not seem significant, as stated in the previous chapter, the ATO's recording of data in this regard has had its limitations and stakeholder concerns cannot be dismissed by relying on this low percentage alone.

4.53 The law does not prescribe how the ATO is to communicate with taxpayers before a penalty decision is made.<sup>256</sup> However, the ATO requires its officers to contact taxpayers and understand their actions before such a decision is made:

9. The following principles should be taken into account throughout the application of the administrative penalty process including any process of review under Part IVC or other reviews undertaken:

...the entity should normally be contacted and given the opportunity to explain their actions before a decision to assess penalty is made. Exceptions to this position are the automated case actioning environment (that is, data matching) or where the facts clearly show that the entity is deliberately disengaged from the tax system.<sup>257</sup>

4.54 The ATO also requires its officers to tell taxpayers the reasons for any penalty decision and afford the taxpayers an opportunity to discuss the decision:

- tell taxpayers the reasons for any penalty decision and give the taxpayer an opportunity to present their views, discuss the merits of the case and explain any mitigating factors;<sup>258</sup> and

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<sup>255</sup> Above n.181, p 12.

<sup>256</sup> *Taxation Administration Act 1953*, sch 1, s298-10.

<sup>257</sup> Above n.42, para 9.

<sup>258</sup> Australian Taxation Office, 'Large business', above n.152; 'Small-to-medium enterprises', above n.152.

- contact taxpayers when considering a penalty decision to give them the opportunity to explain their actions before a penalty decision is made, unless the tax shortfall was assessed in data matching or the facts show that the taxpayer deliberately disengaged.<sup>259</sup>

4.55 It is also important to note that the ATO has advised the IGT that, generally, there would be no penalty if the ATO is unable to identify evidence which infers the relevant taxpayer behaviours contemplated by the legislation. This approach can cause difficulties in cases where taxpayers are not contactable and the circumstances concerning the relevant statements are unable to be established. Not imposing a penalty in these circumstances might be seen by some as potentially supporting a taxpayer who may not have exhibited expected behaviour. In this respect, the ATO has outlined a number of strategies to assist its officers in dealing with un-cooperative taxpayers during the audit process, including:

- the use of information sources other than the taxpayer, such as the ATO database;
- the use of formal access powers to require the taxpayer to provide the information; and
- considering whether the taxpayer's behaviour is relevant to a decision to increase the penalty.<sup>260</sup>

### **IGT observations**

4.56 Taxpayers may provide new material or information after audits are completed for a number of reasons. Although some of these reasons may be outside of the ATO's control or influence, the IGT considers that the manner in which ATO officers communicate with taxpayers during the information gathering process has a significant influence on taxpayers' ongoing engagement and willingness to provide information.

4.57 The IGT considers that effective communication between the taxpayers and ATO officers would improve the robustness of initial penalty decisions as regular discussion allows the ATO to continually elicit information from taxpayers that is material to making penalty decisions and before such decisions are finalised. Effective communication also allows taxpayers to achieve better understanding of the ATO's concerns and reasons for penalty decisions. With this better understanding, taxpayers and their representatives can provide the ATO with information to address any misunderstandings and gaps.

4.58 Effective communication also provides a valuable opportunity to build trust in ATO administration and, ultimately, influence tax compliance in the future. Where there is a breakdown in communication, unnecessary time and resources are expended reviewing penalty decisions that were based on incomplete information.

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<sup>259</sup> Above n.42, para 9.

<sup>260</sup> Above n.252, p 28.

4.59 Accordingly, the IGT is of the view that the ATO should, whenever possible, provide taxpayers with an opportunity to present information during the audit, by discussing the scope, appropriateness and relevance of the information requested.

4.60 The IGT has mentioned in a number of previous reviews the approach the ATO should adopt in relation to information gathering.<sup>261</sup> For example, the IGT's *Review into the Australian Taxation Office's use of early and Alternative Dispute Resolution*, outlined a number of principles in relation to discussing scope, relevance and appropriateness of requests with taxpayers, ensuring taxpayers understand the reasons for the requested information and working with them to minimise impact and cost where documents may be difficult to obtain.<sup>262</sup>

4.61 The IGT is of the view that the above principles are also relevant to penalty matters and that facts and evidence relating to penalties should be obtained at the same time as material relating to primary tax issues is sought. However, as discussed later in this chapter, ATO officers should not commence discussion about imposition of potential penalties until after the final position paper has been issued.

4.62 It is acknowledged that many of the above principles have already been captured in ATO guidance, particularly in the ATO's new guidance on information gathering<sup>263</sup>. However, the issue has become one of enforcement, that is, ensuring that relevant ATO officers follow such guidance in every instance. In the IGT's view, this may be achieved through the pre-issue quality assurance checks which are conducted before finalising penalty decisions.

## RECOMMENDATION 4.2

*The IGT recommends that the ATO ensure that during compliance activities its officers engage and communicate effectively with taxpayers to collect the facts and evidence relevant to penalties at the same time that they collect such material on primary tax.*

### ATO response

The ATO agrees with recommendation 4.2

## EXPLAINING ATO PENALTY DECISIONS

4.63 Stakeholders were concerned that in some cases, taxpayers' understanding of penalty decisions were hindered because ATO officers did not cogently or succinctly explain the reasons for penalty decisions, for example, by not explaining how the taxpayer's evidence was treated.

4.64 Recent ATO internal quality assurance work shows that over 15 per cent of cases assessed (9 of 58 cases) had failed to meet the ATO's standard for accurately and

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261 Above n.176; above n.179; above n.100.

262 Above n.100, p 32.

263 Australian Taxation Office, *Our approach to information gathering* (3 December 2013) <

<http://www.ato.gov.au/General/ATO-policy-and-guidelines/In-detail/Information-gathering/Our-approach-to-information-gathering/>>.

clearly explaining penalty decisions (the ‘transparency’ standard).<sup>264</sup> In these cases the ATO considered that the final letter could have been better edited for clarity and some taxpayer behaviours were not documented in the letter.<sup>265</sup> Other ATO materials also indicate that the explanations for penalty decisions could be improved.<sup>266</sup> For example, the Superannuation business line undertook a cross capability workshop in November 2012 which recommended a review of the final penalty consideration letters that are issued to taxpayers, with a view to improving the simplicity of the language and the clarity of the decision making process.<sup>267</sup>

4.65 In relation to the content of written reasons for penalty decisions, the ATO requires its officers to:

... set out the findings on material questions of fact and refer to the evidence or other material on which those findings were based.<sup>268</sup>

4.66 The ATO’s draft decision making training package provides further detail on the content for written reasons for penalty decisions and advises its officers to not only state the officer’s conclusions and list the facts and matters taken into account, but also:

... assess the relevant facts and indicate either expressly or by necessary implication, how the reasoning process took account of each fact and element of the applicable law or ATO view.<sup>269</sup>

4.67 ATO internal guidance also asserts that further taxpayer input be accepted:

Be prepared to take further input and submissions from taxpayers on the penalty amount to be imposed in their circumstances, given the behaviours that gave rise to the shortfall and to explain your final decision coherently in accordance with the facts, evidence, the law and ATO penalties policy.<sup>270</sup>

4.68 The ATO also provides guidance on how taxpayer contentions should be addressed in the reasons for penalty decisions:

In your reasons you can make statements to the effect that ‘we’ (the ATO) agree or disagree with the taxpayer’s contention with the reason. If, for example, we disagree you can explain the reason in terms of a difference in the nature or relevance of particular facts. Be specific. We may have gathered facts and evidence that are different to the taxpayer’s facts and evidence and we prefer ours for good reason. The taxpayer may not

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264 Australian Taxation Office, ‘Quality Improvement and Assurance Quarterly Report: this report is based on quality activities conducted by AC Capability during the quarter October – December 2012’ (25 February 2013), internal ATO document p 16.

265 Australian Taxation Office, ‘Penalties – Continuous improvement quarterly report October to December 2012’ (1 February 2013), internal ATO document.

266 Australian Taxation Office, ‘Compliance Penalties and Interest Forum Minutes’ (7 March 2013), internal ATO document.

267 Above n. 264, p 10.

268 Above n.42, para 189.

269 Australian Taxation Office, ‘Decision-making for compliance staff: Learner guide – Draft’ (17 October 2011), internal ATO document.

270 Australian Taxation Office, ‘False or misleading statement penalty three step process’, internal ATO document; Australian Taxation Office, ‘Penalty: three step process’, internal ATO document.

be applying the ATO view, preferring their interpretation of the applicable law. In the latter case our reason would be that the taxpayer's interpretation is different to the ATO view and we only apply the ATO view.<sup>271</sup>

## IGT observations

4.69 The ATO has policies and procedures in place which require penalty decisions to include material facts and evidence and, in some cases, 'comprehensive reasons'.<sup>272</sup> However, taxpayers as well as the ATO's quality assurance work have identified that ATO officers' explanations of penalty decisions can be improved.

4.70 In the IGT's view, the reasons for penalty decisions should succinctly:

- state the findings on material questions of fact and refer to the evidence on which those findings were based;
- provide reasoning by demonstrating how the law was applied to the facts; and
- explain any disagreement with taxpayer contentions.

4.71 Such ATO guidance is given in the ATO's draft training package. However, the IGT considers that elevating such guidance into the ATO's staff instructions will assist to improve the overall standard of explanations for penalty decisions.

4.72 The IGT has also observed that some written explanations for penalty decisions comprise several pages. Taxpayers in some market segments insist on detailed explanations for penalty decisions so that they may be able to appropriately consider their review options. However, other taxpayers have found the detailed explanations confusing and have had to seek professional advice to understand the implications and options open to them. The IGT considers that, although it is important to set out the ATO officer's reasoning in detail, the precise form of the disclosure may need to be tailored to a particular market segment.

4.73 By way of example, a short form disclosure that succinctly and clearly sets out the key components of a penalty decision, including the behaviours observed by the officer and how these were inferred from the facts and evidence might be helpful for micro businesses and individuals. This form of disclosure may be in the form of a standard template tailored to meet the needs of the relevant market segment. However, more detailed explanation can be provided on request.

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<sup>271</sup> Above n.252, p 57.

<sup>272</sup> 'IT large business specific audit', above n.151.

**RECOMMENDATION 4.3**

*The IGT recommends that the ATO ensure that any written communication to taxpayers in relation to penalty decisions:*

- a) states the findings on material questions of fact and refers to the evidence on which those findings were based;*
- b) demonstrates how the law was applied to the facts;*
- c) explains any disagreement with taxpayer contentions; and*
- d) is tailored to the needs of the relevant market segment.*

**ATO response**

The ATO agrees with recommendation 4.3

**PENALTY AS LEVERAGE TO RESOLVE PRIMARY TAX ISSUES**

4.74 Submissions asserted that penalties were used as leverage to resolve primary tax issues where ATO officers suggested to taxpayers:

- before issuing position papers in audits, that penalties may be imposed without indicating any reasons for this suggestion; or
- after issuing position papers, that any penalty amounts that were imposed may be reduced if the taxpayer discontinued or settled their dispute with the ATO's view on the primary tax issue.

4.75 In conducting audits of individuals, SMEs and large businesses, the ATO requires its officers to evaluate taxpayers' compliance risks by collecting information,<sup>273</sup> and determining their views on both primary tax and penalty issues.<sup>274</sup> These officers then make recommendations to their team leaders or senior officers on the decisions that they consider should be made on these issues.<sup>275</sup> Where such approvals have been provided, the decisions, together with the ATO's reasoning, are communicated to taxpayers either by 'presenting' this information to them or by

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273 Australian Taxation Office, 'IT SME audit comprehensive – Contact client and request information', internal ATO document; Australian Taxation Office, 'IT large business comprehensive audit – Obtain relevant information', internal ATO document; Australian Taxation Office, 'Contact client/taxpayer and request information – SBIT', internal ATO document.

274 Australian Taxation Office, 'IT large business comprehensive audit – Establish and evaluate risks', internal ATO document; Australian Taxation Office, 'IT SME audit comprehensive – Address the risks and Sign off recommendations', internal ATO document; Australian Taxation Office, 'Address risks – SBIT', internal ATO document.

275 Australian Taxation Office, 'IT SME audit comprehensive – Sign off decisions', internal ATO document; Australian Taxation Office, 'IT large business comprehensive audit – E-18 Obtain approval of initial risk outcomes for income tax (Large)' (17 October 2013), internal ATO document; Australian Taxation Office, 'Sign off recommendations – SBIT', internal ATO document.

providing initial position papers.<sup>276</sup> If taxpayers provide any new information in response, ATO officers are required to update their decisions to take into account the new information<sup>277</sup> and seek further approval. Where such further approval is given, a finalisation letter is sent out to the taxpayer.<sup>278</sup>

4.76 ATO officers in large business audits are also required to communicate and manage the ATO's position on penalties in a process that is separate to the ATO's position on primary tax issues.<sup>279</sup> The ATO has advised that this communication should 'ideally [occur] at the same time [that] the final audit position [on the primary tax issue] is communicated' to the taxpayer.<sup>280</sup> Irrespective of when the ATO formally advises taxpayers of the potential imposition of penalties, ATO officers are required to have had an 'ongoing dialogue' with taxpayers on the topic of penalties throughout the audit so that 'the final decision should present them with no surprises'.<sup>281</sup> Stakeholders have raised concerns that there is a potential that taxpayers may be coerced into resolving disputes on terms favourable to the ATO where penalty discussions between ATO officers and the taxpayers begin early in the audit process. However, the ATO is of the view that such potential is minimised as most penalty decisions are reviewed by team leaders prior to such decisions being made and communicated to taxpayers.<sup>282</sup> Certain penalty decisions, such as those in the SNC business line, are also required to be reviewed by ATO technical panels.<sup>283</sup>

4.77 In relation to settlement negotiations, the ATO has prohibited its officers from threatening to impose penalties as a lever to settle cases:

52. It is ATO policy that officers must never use threats, either implied or actual, of imposing penalties or interest as a lever to settle cases (see, for example, *Caratti v. Deputy Commissioner of Taxation* 93 ATC 5192; (1993) 27 ATR 448).<sup>284</sup>

4.78 The ATO instructs its staff that 'wherever possible, agreement should be reached in respect of the substantive issues before officers consider settlement of penalties' and<sup>285</sup> then the remission of penalties must be determined on the merits of

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276 Australian Taxation Office, 'IT SME audit comprehensive – Finalise ATO position', internal ATO document; Australian Taxation Office, 'IT large business comprehensive audit – Present ATO findings to taxpayer' (8 November 2013), internal ATO document; Australian Taxation Office, 'Finalise ATO position – SBIT', internal ATO document.

277 Australian Taxation Office, 'Finalise ATO position', *ibid*; Australian Taxation Office, 'Present ATO findings to taxpayer', *ibid*; Australian Taxation Office, 'Finalise ATO position – SBIT', *ibid*.

278 Australian Taxation Office, 'Sign off decisions', above n.275; Australian Taxation Office, 'IT SME audit comprehensive – Communicate the outcomes to the client', internal ATO document; Australian Taxation Office, 'IT large business comprehensive audit – Sign-off risk case outcomes', internal ATO document; Australian Taxation Office, 'IT large business comprehensive audit – Communicate outcomes to taxpayer', internal ATO document; Australian Taxation Office, 'Sign off case – SBIT', internal ATO document; Australian Taxation Office, 'Communicate the outcomes to the client/taxpayer – SBIT', internal ATO document.

279 Australian Taxation Office, 'Present ATO findings to taxpayer', above n.276.

280 Australian Taxation Office, 'IT large business comprehensive audit – Manage position paper process' (7 November 2013), internal ATO document.

281 *Ibid*.

282 Australian Taxation Office communication to the Inspector-General of Taxation, 15 January 2013.

283 *Ibid*.

284 Above n.108, para 52; Australian Taxation Office, 'False or misleading statement penalty three step process', internal ATO document.

285 Above n.108, para 48.

the case and in accordance with the ATO's policy documents.<sup>286</sup> However, the ATO appreciates that as a matter of practical reality, cases will arise where penalty and interest charges could properly be considered as part of the settlement of the case,<sup>287</sup> such as in circumstances where:

- the cost of litigating (including internal ATO costs) is out of proportion to the possible benefits, having regard to the prospects of success (including collection of the tax), and likely award of costs, assessed as objectively as possible;
- there are complex factual or quantum issues in contention, or evidentiary difficulties, or there is genuine uncertainty as to the proper application of the law to the facts, sufficient to make the case problematic in outcome or unsuitable for resolution through the AAT or courts, (for example, where the issue is peculiar to the particular taxpayer, and the opposing positions are each considered reasonably arguable.) This is particularly so where the settlement includes an agreed approach for future income years; [or]
- ... unique or special features exist which make it unsuitable for resolution through litigation, for example, a dispute about the valuation of a unique asset.<sup>288</sup>

## IGT observations

4.79 In the IGT's view, the potential for penalties to be used as a means to coerce resolution of tax disputes in the ATO's favour will be reduced through the effective implementation of the above recommendations, including:

- recommendation 2.2(a) which is aimed at reducing the financial pressure that unsustainable penalties place on taxpayers by not requiring payment of penalty amounts until disputes on the primary tax are resolved;
- recommendation 3.1(d) seeks to improve the transparency through the public release of statistical information on penalty imposition and adjustments on an ATO business line basis; and
- recommendation 4.1 is directed at improving ATO officer capability and providing further transparency and confidence in the system through a public database which captures all penalty decisions and associated reasoning.

4.80 During the course of this review further considerations were given to addressing any potential or taxpayer perceptions of penalties being used as leverage in broader tax disputes. Some stakeholders have observed that such perceptions may persist as long as the same ATO officer, who forms the technical view on the substantive matter, is also responsible for the penalty decision. In particular, taxpayers may perceive that any disagreements with the ATO officer's views may influence the penalty decision or that the officer may have a natural inclination to support the merits

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<sup>286</sup> Ibid, para 50.

<sup>287</sup> Ibid, para 51.

<sup>288</sup> Ibid, para 26.

of their position on primary tax issues by imposing penalties. For example, taxpayers may consider an officer reluctant to acknowledge that the taxpayer's position is reasonably arguable to avoid conceding that their own technical position may not be absolute.

4.81 During the review, the following three options were proposed to address these perceptions arising before the ATO's position paper is issued:

1. allow ATO officers to consider the penalty issue only after the primary tax matter has been resolved;
2. allow ATO officers to collect information pertaining to both primary tax and penalties during audits, but allocate the penalty decision making authority to an independent ATO officer; or
3. allow ATO officers to make decisions on both primary tax and penalty issues, but a discussion regarding any application of potential penalties should not commence until after a final position paper on the primary tax issue has been issued.

4.82 The first option would extend the information gathering process and increase taxpayer compliance costs. The second option would require more ATO resources and good co-ordination between the relevant ATO officers. This may prolong the process and may not entirely dispel perceptions of leverage given the communications that are likely to take place between the ATO officers.

4.83 In the IGT's view, the third option is preferred as it would enable taxpayers to focus their attention on the primary tax issues unencumbered by suggestions of potential penalty imposition. This option would not prevent ATO officers from collecting information pertaining to penalties during the course of an audit. Taxpayers would be informed that the information being sought is relevant for determining any penalties that may be applicable without entering into any discussions.

4.84 In settlement negotiations, taxpayers may also perceive that penalties have been raised as 'bargaining chips' where ATO officers appear more willing to consider reducing penalties rather than primary tax. It should be acknowledged that ATO officers may have more scope to negotiate on penalties relating to taxpayer statements as these penalties may pose more litigation risk due to the complex evidentiary requirements associated with reasonable care and RAP.

4.85 It is possible that taxpayer perceptions that penalties are used as leverage in settlement negotiations may be due to ATO officers using imprecise language such as 'we can negotiate on penalties, but not on primary tax.' These types of taxpayer perceptions may be reduced if fuller and more considered explanations are provided to the taxpayer.

## **RECOMMENDATION 4.4**

*The IGT recommends that the ATO ensure its officers:*

- a) in cases where a position paper is to be issued, discussions regarding any application of penalties should not commence until after the position paper has been issued; and*
- b) clearly and precisely communicate reasons for the ability or inability to reduce penalties and primary tax to the taxpayer during settlement negotiations.*

### **ATO response**

Agree with recommendation 4.4(a)

The ATO will reserve discussions regarding the penalty decision (in all cases except for high volume cases or those with low complexity) until after a position paper on primary tax has issued or after the response to an interim position paper has been considered and a final position is ready to be issued to the taxpayer.

Where a taxpayer makes a request to discuss potential penalties at an earlier stage of the audit, the ATO would commence discussions.

The ATO does not expect this practice to prevent the gathering of information and evidence relevant to penalties throughout the audit in accordance with recommendation 4.2.

Agree with recommendation 4.4(b)



## CHAPTER 5—ADVICE AND GUIDANCE

### STAKEHOLDER CONCERNS

5.1 Stakeholders have expressed concerns regarding the ATO's existing guidance on penalties. They consider that improved guidance is needed in a number of specific areas including:

- taxpayer voluntary disclosures;
- the remission provisions;
- better examples of the application of the law in particular circumstances; and
- consolidation of all materials into a single source of guidance.

### TAXPAYER VOLUNTARY DISCLOSURE ISSUES

5.2 Stakeholders considered that greater clarity of the ATO's administration of the voluntary disclosure provisions is needed to address concerns that:

- affected taxpayers are unable to access the 80 per cent reduction under the voluntary disclosure provisions as they are not always aware that an audit (or 'examination') has been commenced because, for example, they are the subject of frequent ATO examination;
- ATO officers, in some cases, require taxpayer admissions of primary tax liabilities before taxpayer disclosures are accepted as 'voluntary'; and
- ATO officers require taxpayers to provide voluminous amounts of information before such disclosures are accepted as 'voluntary'.

5.3 As stated in Chapter 1, the voluntary disclosure provisions provide two rates of penalty reduction. First, there is an 80 per cent penalty reduction if the disclosure is made before a taxpayer is advised that an 'examination' of their tax affairs is to be conducted.<sup>289</sup> Secondly, a 20 per cent reduction may arise if the disclosure is made after such advice and the disclosure was not otherwise known by the ATO, saving the latter substantial time or resources.<sup>290</sup> Hence, it is imperative that the taxpayer is made aware when the examination commences.

5.4 The ATO considers that the term 'examination' means any examination of a taxpayer's affairs<sup>291</sup> which is 'more than the routine processing of forms or

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<sup>289</sup> Or the Commissioner exercises his discretion to treat a voluntary disclosure made after being advised of the examination as if it had been made before being so advised; *Taxation Administration Act 1953*, sch 1, s 284-225(5).

<sup>290</sup> Australian Taxation Office, *Administrative penalties: voluntary disclosures*, MT 2012/3, 11 July 2012, para 103.

<sup>291</sup> *Ibid*, paras 48-49.

applications,<sup>292</sup> for example, audits, risk reviews and other similar activities.<sup>293</sup> The ATO has stated that it will treat taxpayers as having been told that an examination is to be conducted when the ATO first makes contact with them or their agent in this regard – such contact may be made orally or in writing.<sup>294</sup>

5.5 A taxpayer may make a disclosure after being told that an examination is to be conducted and the Commissioner has a discretion to treat such a disclosure as if it was made before the taxpayer was told of the examination.<sup>295</sup> The exercise of this discretion results in an 80 per cent penalty reduction. The ATO has stated that, as a general rule, the discretion will be exercised in certain circumstances including:

- (i) where the Commissioner is merely identifying and/or assessing risks, for example a risk review, notwithstanding that this is considered to be an examination; [and]
- (ii) where the disclosure is not within the scope of the examination as notified to the entity (that is, it is outside the risk(s) or issue(s) covered by the examination).<sup>296</sup>

5.6 In relation to the level of information a taxpayer needs to provide to be eligible for the voluntary disclosure penalty reductions, the relevant ATO tax ruling states:

105. The entity does not need to disclose the precise amount of the shortfall amount or scheme shortfall amount. The Revised Explanatory Memorandum to the A New Tax System (Tax Administration) Bill (No. 2) 2000 states, at paragraph 1.129, that 'telling the Commissioner about the shortfall will require a taxpayer to disclose the relevant facts and other information to enable the Commissioner to adjust the tax-related liability.' There may be circumstances where it is not practicable for the entity to quantify every adjustment required, or the resulting shortfall amount or scheme shortfall amount. In these circumstances, it will be sufficient if the entity has done everything reasonably necessary to enable or assist the Commissioner to determine the shortfall amount or scheme shortfall amount, even if some further matters of detail still need to be clarified.

106. In the context of false or misleading statements that do not result in a shortfall amount, the entity will be required to disclose sufficient information to enable the Commissioner to:

- correct the false or misleading statement; and/or
- rectify any decisions made or action taken as a consequence of the entity making the false or misleading statement.<sup>297</sup>

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292 Ibid, para 51.

293 Ibid, para 49.

294 Ibid, para 74.

295 *Taxation Administration Act 1953*, sch 1, s284-255(5).

296 Above n.290, para 133 and para 152 (example 16).

297 Ibid, para 105.

5.7 The ATO's website also provides guidance on the amount of information needed, however, it is expressed differently to the ruling above. The relevant webpage states that voluntary disclosures should include:

- the amount of each adjustment required, or sufficient information to allow the Commissioner to readily determine the amount of each adjustment, and
- any other relevant information which will assist the Commissioner in determining the correct amount of tax-related liability, payment or credit.<sup>298</sup>

5.8 Even where additional information is sought later in the process, the ATO requires its officers to treat taxpayer voluntary disclosures as sufficiently complete where that additional information is provided within a reasonable time.<sup>299</sup> Overall, the ATO requires its officers to exercise sound judgment in the completeness of any voluntary disclosure.<sup>300</sup>

## IGT observations

5.9 Penalty reductions for voluntary disclosures are aimed at encouraging taxpayers to make disclosures before 'it becomes obvious that ATO activity is about to uncover a shortfall amount'<sup>301</sup> and therefore save a significant amount of time and resources.<sup>302</sup>

5.10 The ATO will generally exercise discretion to treat voluntary disclosures made before the end of a risk review as eligible for the 80 per cent penalty reduction as such reviews are merely identifying or assessing risks.<sup>303</sup> However, where a taxpayer provides certain information after a review has been finalised but before an audit is commenced, a 20 per cent penalty reduction is available.

5.11 Taxpayers are generally notified that an audit will commence at the time the risk review is finalised. In some cases, however, audit notification may be delayed or the issues identified in the risk review may not be the subject of an immediate audit but may become subject of an audit at a later point in time. The IGT is of the view that voluntary compliance can be further encouraged by making the 80 per cent reduction available until the taxpayer is notified of an audit of the issues in question.

5.12 The IGT also considers that there are a number of areas where clearer communications on the treatment of voluntary disclosures is needed. First, different views may be formed on whether a voluntary disclosure was properly made due to long periods of time elapsing between a taxpayer making a voluntary disclosure and

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298 Australian Taxation Office, *Voluntary disclosures – approved form* (24 August 2013) <

<http://www.ato.gov.au/Business/Small-business-benchmarks/In-detail/Related-information/Voluntary-disclosures---approved-form/>>.

299 Above n.42, para 150.

300 Ibid, para 147.

301 Above n.290, para 29.

302 Ibid, para 24 and 102.

303 Ibid, para 133.

the ATO officer considering whether that disclosure would reduce any penalties when making a penalty decision at the end of an examination.

5.13 To prevent disagreements, the IGT considers that ATO officers should clearly inform taxpayers whether they agree that a full voluntary disclosure has been made at the time the taxpayer provides that information or promptly thereafter. Taxpayers could be informed in a number of ways, but any such communications should be confirmed in writing. A recommendation to this effect was made in a previous IGT review, *Report into the Australian Taxation Office's large business risk review and audit policies, procedures and practices*.<sup>304</sup> Although that review was limited to audits of large businesses, the IGT considers that this approach should be applied in all market segments and all disclosures eligible for a penalty reduction. The IGT considers that this approach should be documented in the relevant ATO ruling.

5.14 In addition, the ATO should improve its public guidance regarding the nature and level of information necessary to qualify for the voluntary disclosure penalty reductions. Without further guidance, a statement such as 'everything reasonably necessary'<sup>305</sup> may appear too vague and lead officers into error by thinking that more information needs to be provided by the taxpayer than is necessary.

5.15 Secondly, an inability to ascertain the commencement of audits for voluntary disclosure purposes may affect taxpayer compliance and perceptions of fairness as taxpayers may miss opportunities to avail themselves of the 80 per cent reduction in penalties.

5.16 Currently, the ATO provides a date by which voluntary disclosures may be made in its review and audit notification letters. Extracts of the relevant wording have been reproduced in Appendix 12.<sup>306</sup> However, where an audit is preceded by a risk review, the ATO does not provide a date for voluntary disclosure purposes in its audit notification letters. The IGT is of the view that the ATO should provide the timeframes for voluntary disclosure purposes in all audit notification letters and the potential penalty reductions that may apply.

5.17 Thirdly, where a risk review becomes more than merely identifying and assessing risks, taxpayers may lose their opportunity to benefit from an 80 per cent reduction in penalties. This opportunity can be unfairly lost where prior notification of the change is not given. Accordingly, the IGT is of the view that the ATO could better inform taxpayers when an examination becomes one that is not 'merely identifying and assessing risks'.

5.18 Fourthly, specific concerns have been raised by taxpayers, who have been subjected to real-time compliance activities, regarding when voluntary disclosures should be made. For example, the ATO has stated that it would accept voluntary

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304 Above n.176, p 156 (Recommendation 10.2).

305 Above n.290, para 105.

306 Australian Taxation Office, 'Active Compliance Steering Committee Submission Paper – Voluntary disclosure – standard notification paragraphs' (18 October 2012), internal ATO document.

disclosures during the finalisation of PCRs,<sup>307</sup> however, it is unclear whether the Commissioner would apply the 20 per cent penalty reduction or exercise the discretion mentioned earlier to provide an 80 per cent penalty reduction. It is also unclear how such disclosures would be considered when applying penalties relating to taxpayer statements that do not give rise to shortfall amounts. The IGT is of the view that greater clarity on the application of the voluntary disclosure provisions in such circumstances is needed. Similarly more clarity is needed on whether disclosures made in Annual Compliance Arrangements and Advance Pricing Arrangements can be treated as voluntary disclosures during a subsequent audit.

5.19 Another difficulty arises where ATO officers require taxpayers to admit liability before accepting relevant disclosures as voluntary. In these circumstances, such admissions may hamper the ability of the taxpayer's legal representative to argue a contrary position in subsequent external review activities.

5.20 The relevant ATO staff instructions make it clear that admissions of liability are not necessary for making voluntary disclosures.<sup>308</sup> However, it appears that some ATO officers are not complying with these instructions. In the IGT's view, one way to improve ATO officer compliance with these instructions would be to increase taxpayer awareness.

## RECOMMENDATION 5.1

*The IGT recommends that the ATO:*

- a) amend its guidance material to ensure that the 80 per cent penalty reduction is applied when voluntary disclosures are made after a risk review but before the notification of an audit;*
- b) require ATO officers to clearly communicate whether a voluntary disclosure has been accepted or not together with any applicable penalty rate reduction at the time, or promptly after, the disclosure is made;*
- c) improve its public guidance on the nature and level of information necessary to qualify for voluntary disclosure penalty reductions;*
- d) review all audit notification letters with a view to provide greater clarity as to the timeframes available to make voluntary disclosures and the potential penalty reductions that may apply;*
- e) require ATO officers to inform taxpayers when an examination becomes one that is more than 'merely identifying and assessing risks' and specify any applicable penalty reduction rates for voluntary disclosure purposes;*

307 Above n.152, p 43.

308 Above n.290, para 108; above n.31, para 1.127.

## **RECOMMENDATION 5.1 (CONTINUED)**

- f) provide public guidance on the application of the voluntary disclosure provisions to real-time compliance activities, Annual Compliance Arrangements and Advance Pricing Arrangements; and*
- g) improve taxpayer awareness that an admission of liability is not needed to access the penalty reductions.*

### **ATO response**

Agree with recommendation 5.1(a)

The ATO will amend its guidance material on voluntary disclosures to:

- apply the 80% reduction in these circumstances,
- include specific examples to clarify the meaning of 'notification of an audit', including where there is a delay between a risk review being finalised and notification of an audit, and
- describe where the 80% reduction may not apply, such as deliberate concealment of information in a risk review.

Agree in part with recommendation 5.1(b)

The ATO agrees to acknowledge receipt of voluntary disclosures either orally or in writing for all cases except those undertaken in a high volume environment.

Where further information is required to verify the correct application of the law and assessment of the shortfall amount, the ATO will notify taxpayers that a decision regarding the rate of any penalty reduction would be reserved until all information has been provided and examined.

Where the taxpayer has attempted to make a voluntary disclosure but has not provided information in the approved form, the ATO will continue with its existing practice to contact the taxpayer and give an opportunity to make a voluntary disclosure in the approved form.

Agree with recommendation 5.1(c), 5.1(d), 5.1(e), 5.1(f) and 5.1(g)

## **PENALTY REMISSION ISSUES**

5.21 Submissions considered that improved guidance on the ATO's discretion to remit penalties was needed to address the following concerns:

- the ATO rarely exercising the discretion prior to a penalty being raised; and
- the ATO imposing lengthy, costly and inconsistent processes on taxpayers to obtain penalty remission.

5.22 The ATO has recently released Practice Statements that contain substantive guidance on the Commissioner’s remission discretion with respect to penalties for making false or misleading statements in *PSLA 2012/4* and *PSLA 2012/5*.<sup>309</sup> It has also issued *PSLA 2011/30* relating to scheme penalties.<sup>310</sup>

5.23 *PSLA 2012/5* states that tax officers must consider the question of remission in each case based on all the relevant facts and circumstances and having regard to the purpose of the provision.<sup>311</sup> The following are matters the ATO considers relevant in approaching the issue of remission:

- that the purpose of the penalty regime is to encourage entities to take reasonable care in complying with their tax obligations. Where the entity has made a genuine attempt to report correctly, it will generally be the case that no penalty applies because of the exercise of reasonable care, safe harbour or because the law was applied in the accepted way.
- remission decisions need to consider that a major objective of the penalty regime is to promote consistent treatment by reference to specified rates of penalty. That objective would be compromised if the penalties imposed at the rates specified in the law were remitted without just cause, arbitrarily or as a matter of course.

157. The discretion to remit penalties should be approached in a fair and reasonable way, including ensuring that prescribed rates of penalty do not cause unintended or unjust results.<sup>312</sup>

5.24 *PSLA 2012/5* also contains a number of factors that are considered not to be relevant when determining whether to remit penalties. These irrelevant factors include the unrelated circumstances of the taxpayer or the tax agent, such as current illnesses after a statement was made and the taxpayer’s capacity to pay the penalty.<sup>313</sup>

5.25 Further, *PSLA 2012/5* sets out the following examples of the circumstances in which the remission discretion could be exercised:

- the mechanical process of the law may otherwise result in an unjust outcome;<sup>314</sup>
- the taxpayer has taken reasonable care but is liable to a penalty because, for example, of the reckless actions of their registered agent (such that the safe harbour exemption does not apply);<sup>315</sup>
- double penalty may be avoided in the case of trustees/beneficiaries;<sup>316</sup>

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309 Above n.42, paras 155-180; above n.155.

310 Australian Taxation Office, *Remission of administrative penalties relating to schemes imposed by subsection 284-145(1) of Schedule 1 to the Taxation Administration Act 1953*, PSLA 2011/30, 15 December 2011.

311 Above n.42, para 156.

312 Above n.42, paras 156-157.

313 *Ibid*, paras 184 – 186.

314 *Ibid*, para 159.

315 *Ibid*, paras 161-163.

- imposing multiple penalties would otherwise result in an unjust outcome;<sup>317</sup> and
- there are mitigating circumstances. For example, a shortfall amount may represent an amount of tax deferred rather than permanently avoided.<sup>318</sup>

5.26 Another ATO practice statement, *PSLA 2011/30* which addresses penalties relating to schemes, also refers to the remission discretion in section 298-20<sup>319</sup> and provides additional guidance on the exercise of the remission discretion. The practice statement is framed in terms of three guiding principles being:

- so there is consistent treatment of penalty rates – the penalty rate is set by law and remission without just cause, arbitrarily or as a matter of course may compromise consistent treatment of penalty rates;
- where it is fair and reasonable to do so; or
- to treat entities in like circumstances consistently.<sup>320</sup>

5.27 The practice statement also states that ATO officers should consider whether the penalty outcome is harsh, within the framework of the Compliance Model and the Taxpayers' Charter, having regard to whether:

- the taxpayer made a genuine attempt to comply with their tax obligations considering their personal circumstances, that is, they took all reasonable and sensible steps to avoid entering into a tax avoidance scheme; and
- the taxpayer has a good compliance history; or
- an unjust outcome results for the taxpayer as a result of imposition of the schemes penalty or if the penalty is not remitted.<sup>321</sup>

5.28 The law does not prescribe when the Commissioner should consider whether penalties should be remitted. However, the ATO requires officers to determine if remission is appropriate before notifying taxpayers of the liability to pay the penalty.<sup>322</sup> The ATO's internal guidance material also provides the following:

To finish the assessment process we make a remission decision, referencing any facts and evidence that support the decision and the appropriate policy document.<sup>323</sup>

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316 Ibid, paras 164-165.

317 Ibid, paras 166-168.

318 Ibid, paras 173-176.

319 *Taxation Administration Act 1953*, sch 1, s298-20.

320 Above n.310, para 15.

321 Ibid, para 17.

322 Above n.42, para 11.

323 Above n.284.

5.29 The ATO expects any taxpayer submissions on the exercise of the remission discretion either to have been made during the audit process or as part of an objection to the imposition of penalties.<sup>324</sup>

### IGT observations

5.30 It could be argued that *PSLA 2012/5* discourages ATO officers from exercising the discretion to remit penalties as little guidance is provided with respect to the factors that should be considered with a limited number of specific examples. Furthermore, *PSLA 2012/5* does not include a number of factors that should be considered and are listed in the relevant explanatory memorandum, such as a taxpayer's particular circumstances and compliance history and tailoring the penalty to secure improvements in compliance behaviour.<sup>325</sup>

5.31 In contrast, a different practice statement, *PSLA 2011/30*, provides positive aims for the exercise of the discretion together with an analytical structure. *PSLA 2011/30* also appears more consistent with the relevant explanatory memorandum as it requires ATO officers to consider:

- whether the taxpayer has a good compliance history;<sup>326</sup>
- whether a taxpayer made a genuine attempt;<sup>327</sup>
- how the taxpayer's personal circumstances are relevant;<sup>328</sup> and
- any relevant unjust outcome.<sup>329</sup>

5.32 In the IGT's view, *PSLA 2012/5* should be reviewed to provide analytical, structured and clearer guidance with examples to facilitate the exercise of the discretion in appropriate circumstances. Care should be taken to ensure that any additional guidance does not inadvertently result in a narrowing of the discretion.

5.33 Practically, situations may arise in an audit context where the taxpayer does not dispute the primary tax that is adjusted but seeks remission of a penalty. In these circumstances, the ATO requires the taxpayer to lodge a formal objection. Using such a process for penalty remission may impose unnecessary costs. The IGT considers that the ATO should provide a simplified process for such taxpayer-initiated requests for remission of penalties. This would be in keeping with the ATO's previous work in moving towards a more differentiated approach to objection processing.<sup>330</sup>

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324 Australian Taxation Office communication to the Inspector-General of Taxation, 28 November 2013.

325 Above n.31, para 1.140

326 Above n.310, paras 37-38.

327 Ibid, paras 19-20 and 29.

328 Ibid, paras 30-33.

329 Ibid, paras 39-41.

330 Inspector-General of Taxation, *Review into the underlying causes and the management of objections to Tax Office decisions* (2009) p 7.

## RECOMMENDATION 5.2

*The IGT recommends that the ATO review its public advice and guidance on the Commissioner's penalty remission power to ensure that:*

- a) similar to the approach adopted in PSLA 2011/30, the advice and guidance sets out an objective or purpose for the exercise of the discretion, includes both the positive and negative factors to be considered and provides an analytical structure with examples; and*
- b) the advice and guidance sets out a simplified objection process by which taxpayers may seek remission.*

### ATO response

The ATO agrees with recommendation 5.2(a)

The ATO agrees with recommendation 5.2(b)

The ATO will undertake a review of its existing objection processes, including the approved form, with a view to identifying opportunities to improve the taxpayer experience. The ATO notes that while there may be opportunities to further streamline processes, the information required by the taxpayer to enable a review of the remission decision would not change.

## BETTER EXAMPLES OF THE APPLICATION OF THE LAW IN PARTICULAR CIRCUMSTANCES

5.34 Stakeholders have also stressed the need for clarity of the ATO's guidance with respect to specific areas and in particular have requested examples to be provided to demonstrate application of the law in more finely balanced circumstances. These specific areas include:

- the application of the reasonable care standard where tax advice was properly sought or where non-tax advice, such as valuations, was different to the ATO's or was provided on immaterially different facts to those implemented;
- behaviour that falls significantly short of the standard of care, amounting to recklessness;
- penalty adjustments for treating the law as applying in an accepted way pursuant to section 284-224 of Schedule 1 to the TAA where the taxpayer relies on statements of general application;<sup>331</sup> and
- the length of time the ATO considers is 'reasonable' for the purpose of applying PSLA 2007/11 Administrative treatment of taxpayers affected by announced but unenacted legislative measures which will apply retrospectively when enacted

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<sup>331</sup> Taxation Administration Act 1953, sch 1, s284-224.

where a legislative proposal has encountered significant delays before enactment.

### **IGT observations**

5.35 Voluntary compliance is engendered where taxpayers can easily identify and clearly understand what behaviours are expected of them, especially in circumstances involving finely balanced issues.

5.36 It could be argued that providing specific examples illustrating the ATO's decisions on more finely balanced issues would address areas of uncertainty for taxpayers. However, care would need to be exercised in drawing analogies from such examples as subtle changes in facts may lead to different outcomes. Therefore, such guidance would need to provide a range of examples to provide a full picture.

5.37 The IGT considers that the effective implementation of recommendation 4.1 to provide public access to a database of all penalty decisions would provide taxpayers with actual examples in a range of circumstances and thereby address the above stakeholder concerns.

5.38 Furthermore, the concern relating to the application of reasonable care to the provision and reliance on valuation advice is an issue that the IGT will consider in his current review of valuation matters.

### **CONSOLIDATION OF ALL MATERIALS**

5.39 Stakeholders also expressed concern that significant time and effort is needed to determine taxpayers' exposure to penalties as the relevant ATO advice and guidance is fragmented across a number of different documents, which are listed in Appendix 7.

### **IGT observations**

5.40 In the IGT's view, consolidating all publicly available advice and guidance on penalties in one location and providing public access to this consolidated material would greatly assist taxpayers to identify and understand what is expected of them and the context in which those expectations exist. Such material could be consolidated by linking the relevant material to a single electronic access point. The US Inland Revenue Service's electronic Penalty Handbook provides an example of how such material may be consolidated and published.<sup>332</sup>

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332 Internal Revenue Service, *Introduction and Penalty Relief* (25 November 2011) <[http://www.irs.gov/irm/part20/irm\\_20-001-001r.html](http://www.irs.gov/irm/part20/irm_20-001-001r.html)>.

### **RECOMMENDATION 5.3**

*The IGT recommends that the ATO consolidates all publicly available advice and guidance on penalties in one location and provide public access to it.*

#### **ATO response**

The ATO agrees with recommendation 5.3

# APPENDIX 1—TERMS OF REFERENCE AND SUBMISSION GUIDELINES

## BACKGROUND

Penalty regimes are designed to be a deterrent, setting the standards of expected taxpayer behaviour and encouraging taxpayers to voluntarily comply with the law.<sup>333</sup> The effectiveness of the penalty laws is dependent on the way in which the relevant administrator applies the rules and exercises its discretions.<sup>334</sup>

The Australian Taxation Office (ATO) is responsible for the administration of a wide range of penalties. The ATO considers that the standard behaviour expected of taxpayers is generally met where taxpayers '*take reasonable care in complying with their tax obligations*'.<sup>335</sup> It is important that the penalty regime is administered in accordance with these laws and appropriately takes into account taxpayer circumstances.

During the recent consultation on the Inspector-General of Taxation's (IGT) work program, stakeholders raised a number of concerns with the ATO's administration of penalties.

The ATO's administration of penalties is not a new area of stakeholder concern. It has been raised by various bodies, including the Federal Parliament's Joint Committee of Public Accounts (JCPA) in 1993,<sup>336</sup> the Australian National Audit Office (ANAO) in 2000,<sup>337</sup> and the Treasury in 2004.<sup>338</sup> The IGT has also considered aspects of penalties in previous reviews over a range of different areas of tax administration.<sup>339</sup>

The recent concerns raised may be summarised as follows:

- **Purpose of the penalty regime and the ATO's approach** – insufficient stratification of the penalty regime coupled with the purpose of the regime not being reflected in the ATO's administration of the regime – for example, perceptions that penalties can be imposed at unreasonably high levels to leverage settlement negotiations;
- **Sustainability, technical capability and oversight** – a significant proportion of initial penalty decisions are reduced on internal and external review, indicating potential capability gaps or a lack of due process in penalty decision making;
- **Transparency and consistency** – lack of transparency in ATO penalty decisions; and

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333 Above n.172, p 39.

334 Above n.1, p 131.

335 Above n.42, para 9.

336 JCPA, *An Assessment of Tax, Report No. 326*, (November 1993).

337 ANAO, *Administration of Tax Penalties*, (2000).

338 Above n.172, p 39.

339 For example: above n.171; above n.174; above n.178; above n.179.

- **Engagement and communication** – effectiveness of ATO engagement and communication as well as timeliness of decision making.

The IGT review seeks to establish the underlying reasons or causes for these concerns and identify opportunities for improvement.

## **TERMS OF REFERENCE**

In accordance with subsection 8(1) of the Inspector-General of Taxation Act 2003, the IGT will review the ATO's administration of penalties, with a particular focus on:

### **The purpose of the penalty regime and the ATO's approach**

1. *The purpose of the penalty regime, including the current stratification of penalty categories.*
2. *The alignment of the ATO's administration of the penalty regime with the underlying purpose of the regime.*

### **Sustainability, technical capability and oversight**

3. *The sustainability of penalty decisions and reasons for any unsustainable decisions.*
4. *The technical capability of ATO officers making penalty decisions and related support available to them, such as ATO guidance, training and technical material.*
5. *The oversight and governance of penalty decision making, including the effectiveness of management review and quality assurance processes.*

### **Transparency and consistency**

6. *The adequacy of publicly available information on the ATO's approach to the administration of penalties.*
7. *The transparency of penalty decisions, including the means by which the public can be assured of the consistency of such decisions.*

### **Engagement and communication**

8. *The effectiveness of ATO engagement and communication in minimising delays and taxpayer compliance costs relating to penalty decisions, including the:*
  - *appropriateness and timing of communication with taxpayers and their advisers;*
  - *approaches taken in information and evidence gathering;*
  - *adequacy of information provided to enable taxpayers and their advisers to understand the ATO's position and the reasons for penalty decisions; and*
  - *opportunities afforded to taxpayers and their advisers to address ATO concerns, such as the avenues or processes available for dispute resolution.*

## Impacts

9. *The impacts that the ATO's administration of the penalty regime may have on taxpayers and their advisers.*

## SUBMISSION GUIDELINES

It is envisaged that your submission will address the terms of reference above and have two parts, being:

- your experiences with the ATO's administration of penalties; and
- your ideas on opportunities for improvement.

### Your experiences with the ATO's administration of penalties

In the first part of your submission, it is important to provide a detailed account of specific ATO practices and behaviours that, in your view, impact upon the timely, efficient and effective resolution of penalty matters.

You should provide a timeline setting out all the relevant events such as key interactions with the ATO, your advisers and other parties.

The following questions are provided to assist you to outline your experience with the ATO on penalty decisions.

#### *Outline of experience with the ATO*

- Q1. *Prior to the commencement of the audit or other compliance activity, what actions did you take to mitigate the potential application of penalties against you, such as seeking tax advice and making voluntary disclosures?*
- Q2. *Please provide a timeline of events and outline your experience with the ATO's administration of penalties, by addressing the following:*
  - a. *At what stage in the audit process was the initial ATO penalty decision made? Was it before, during or after the substantive primary tax issue was resolved? Was it covered in the ATO's position paper?*
  - b. *What reasons did the ATO give for the decision and what evidence did it offer in support of these reasons?*
  - c. *Did you agree with the ATO's decision? If you disagreed, what were your reasons?*
  - d. *What opportunities were you afforded to address the ATO's decision? What actions did you take (for example, correspondence, submissions, or objections)? Did you provide further evidence? If so, did the ATO ask for this evidence previously?*
  - e. *What was the ATO's response to these steps? Did the ATO change its*

*initial penalty decision? If so, what were these changes and what reasons were you given?*

- f. If the penalty issues were resolved during settlement, please provide an account of how resolution was achieved and how it affected the entire settlement process. With the benefit of hindsight, what are your views on the sustainability of the initial penalty decision?*
- g. Did you appeal the ATO's penalty decision? If so, was the ATO's initial penalty decision ultimately sustained? What reasons were given?*
- h. Did you engage in any form of alternative dispute resolution with the ATO on the issues? If so, did the ATO offer this opportunity or was it initiated by you?*

*Q3. Do you believe the ATO's communication and engagement was effective in minimising timeframes and your compliance costs? Did it lead to an efficient and effective resolution of your matter? Please explain your view.*

*Q4. Please specify and quantify, where possible, any adverse impacts that you may have suffered as a result of your dealings with the penalty matter in question – for example, financial and reputational impacts? How could they have been avoided or minimised?*

*Q5. What positive ATO practices and behaviours did you observe and how did they contribute to timely resolution?*

*Please provide copies of all relevant documents and materials that may assist in relation to the above questions.*

## **Your ideas for improving the administration of penalties**

In the second part of your submission, you are invited to identify opportunities to improve the ATO's administration of penalties.

These opportunities could include alternative actions, practices or behaviours which, in your view, could minimise the adverse aspects of ATO practices of concern, and ideally lead to better outcomes for all parties.

Set out below are questions to help you outline your ideas for improvement.

### ***The purpose of the penalty regime and the ATO's approach***

- Q1.. What is the purpose of the penalty regime in the tax system?*
- Q2. Could the penalty regime be improved to better achieve its purpose? If so, what improvements could be made? How would these changes impact on taxpayers and the ATO? What trade offs would be involved? Please explain your views.*
- Q3. Does the current penalty regime have any framework constraints that restrict more efficient administration? For example, does the Commissioner's discretion to remit penalties provide sufficient graduation of different levels of culpability?*

*Please explain your views.*

- Q4. *Are there improvements that could be made to the ATO's administration of the penalty regime? How would these differ from current practice? Please explain your views.*
- Q5. *At what stage in the process should ATO penalty decisions be made? Should they be made before, during or after the time at which the substantive primary tax issue is determined? Please explain your views.*
- Q6. *Are there alternative models or approaches that should be considered for improving penalty decision making? What are these? You may wish to refer to any knowledge or experience you have of other tax jurisdictions.*

### ***Sustainability, technical capability and oversight***

- Q7. *How can the ATO improve the sustainability of its penalty decisions? Please provide your views.*
- Q8. *Is there sufficient ATO advice, guidance, training and technical support given to ATO officers making penalty decisions? Please explain your views.*
- Q9. *Could the ATO improve its oversight or governance for penalty decisions and what impact would this have on the ATO's resourcing? Please explain your views.*

### ***Transparency and consistency***

- Q10. *Do you believe the ATO could better demonstrate consistency of penalty decision making? If so, what information should be disclosed and in what manner? What impacts would this have on taxpayers, their advisers and the ATO? You may wish to refer to systems adopted in other areas.*

### ***Engagement and communication***

- Q11. *Could the ATO improve its engagement and communication with taxpayers? If so, what changes could be made? How would these help to reduce compliance costs and timeframes?*

## **LODGEMENT**

The closing date for submissions is 21 December 2012. Submissions may be sent by:

Post to:           Inspector-General of Taxation  
                      GPO Box 551  
                      SYDNEY NSW 2001

Email to:         penalties@igt.gov.au

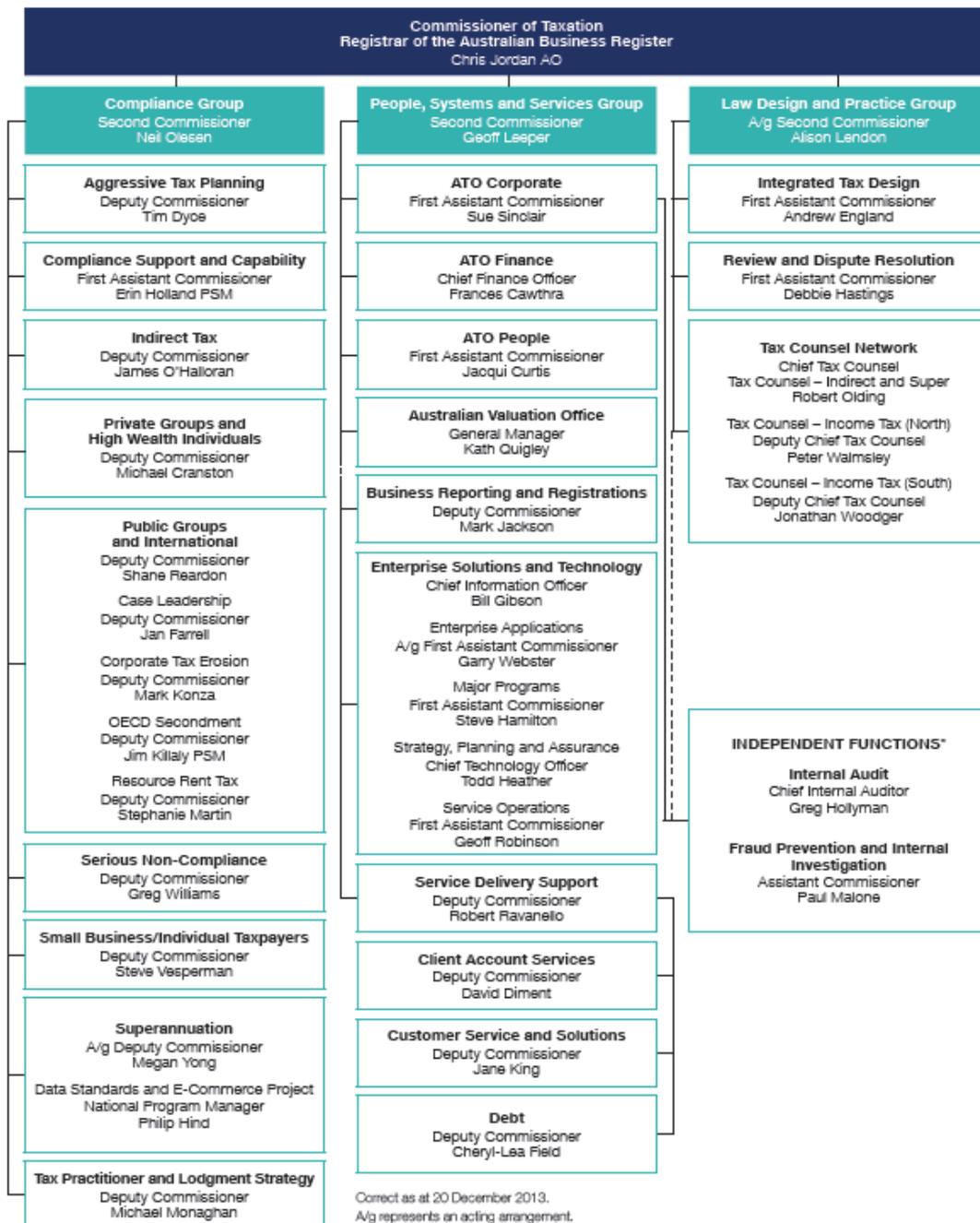
## **CONFIDENTIALITY**

Submissions provided to the IGT are in strict confidence. This means that the identity of taxpayers and advisers or any related information contained in submissions will not be made available to any other person, including the ATO. Sections 23, 26 and 37 of the IGT Act 2003 safeguard the confidentiality and secrecy of such information provided to the IGT – for example, the IGT cannot disclose the information as a result of a Freedom of Information (FOI) request, or as a result of a court order. Furthermore, if such information is the subject of client legal privilege (or legal professional privilege), disclosing that information to the IGT will not result in a waiver of that privilege.

## **FURTHER INFORMATION**

For further information you can visit the IGT's website at [www.igt.gov.au](http://www.igt.gov.au).

# APPENDIX 2—THE ATO'S ORGANISATIONAL STRUCTURE, POST 1 JULY 2013



JS 30032

Source: Australian Taxation Office.

## APPENDIX 3—THE IQF'S QUALITY ELEMENTS

A3.1 As noted in Chapter 1, the ATO's IQF assesses case work according to nine 'quality elements'. These are explained below.

- Administrative Soundness is concerned with assuring ATO products and processes comply with administrative law requirements, principles and policy, meet internal and community standards of conduct and will be able to withstand external scrutiny.
- Integrity is a measure of ATO ethical standards and how they are applied in ATO products, processes and decisions. It is a measure of ATO relationships with taxpayers and the wider community and how well the ATO conforms to the Taxpayers' Charter principles. The level of integrity is thought to shape community confidence in the tax system.
- Correctness is concerned with ensuring that decisions and/or actions comply with the ATO view.
- Appropriateness to taxpayers' requirements and circumstances involves ensuring that the ATO understands taxpayers' situations, identifies all their issues, and responds to them clearly in a manner they understand and which addresses their needs.
- Effectiveness relates to the extent to which ATO decision making processes have supported ATO strategy and vision, positively impacted on the risks associated with the product or client relationship and have enhanced the taxpayer experience.
- Transparency is concerned with ensuring the ATO is open and honest in its actions, that its processes and decisions are accessible and that explanations are accurate and clear on their face that inform clients of their review rights.
- Consistency provides assurance that the ATO will treat taxpayers and taxpayer groups in an equivalent fashion when presented with similar circumstances, whilst recognising that the ATO can legitimately differentiate to take account of individual factors. Consistency is measured in respect of ATO decision making processes and practices as well as in ATO decisions.
- Timeliness relates to the appropriateness and efficiency of the processes and interactions within the cycle time of the case or product output. In the context of decisions, timeliness relates to ATO ability to promptly provide advice, decisions, outputs or results.
- Efficiency of decision making processes is concerned with ensuring appropriate use is made of ATO resources and that positive outcomes are reached in the most expeditious and cost-effective manner.

## APPENDIX 4—REASONS FOR ADJUSTED PENALTY-ONLY OBJECTION DECISIONS

A4.1 Table 10 below shows those objections where only the penalty decision was in dispute and an adjustment to the amount of the penalty liability was made as a result of that dispute.

**Table 10: Reasons for adjusted penalty only objection decisions, from 1 July 2012 to 31 March 2013, by business line**

Reasons	ITX	LBI	ME	SME	SPR	Other	Total	% of Total
ATO application of law to fact changed	26	1	3	3	5		38	19.39
ATO fact / analysis / calculation adjustment	27		1	3	6	2	39	19.9
Audit further information not requested					2		2	1.02
Audit further information received	19		15		7		41	20.92
Client - other	3		3	4	16		26	13.27
Disallow - new argument / evidence (a)				2			2	1.02
Not required			1		2		3	1.53
Unforseen facts or evidence	10		3	2	30		45	22.96
<b>Total</b>	<b>85</b>	<b>1</b>	<b>26</b>	<b>14</b>	<b>68</b>	<b>2</b>	<b>196</b>	<b>100</b>
<b>% of Total</b>	<b>43.37</b>	<b>0.51</b>	<b>13.27</b>	<b>7.14</b>	<b>34.69</b>	<b>1.02</b>	<b>100</b>	

(a) Although under the heading 'Disallow', these cases were identified as 'withdrawn-settlement'.

Source: Australian Taxation Office.

A4.2 Table 11 below shows those objections where only the penalty decision was in dispute and comprises cases where an adjustment to the amount of the penalty liability was made as well as cases where no such adjustment was made.

**Table 11: Reasons for penalty only objection decisions, from 1 July 2012 to 31 March 2013, by business line**

Reasons and outcomes	ITX	LBI	MEI	SME	SPR	Other	Total	% of Total
<b>ATO application of law to fact changed</b>	<b>26</b>	<b>1</b>	<b>3</b>	<b>3</b>	<b>5</b>	<b>0</b>	<b>38</b>	<b>9.34</b>
Allowed in full	10	1	0	2	1	0	14	3.44
Allowed in part	15	0	1	1	3	0	20	4.91
Commissioner discretion exercised	0	0	2	0	0	0	2	0.49
Commissioner discretion part exercised	1	0	0	0	1	0	2	0.49
<b>ATO fact / analysis / calculation adjustment</b>	<b>28</b>	<b>0</b>	<b>1</b>	<b>3</b>	<b>6</b>	<b>2</b>	<b>40</b>	<b>9.83</b>
Allowed in full	13	0	0	2	3	0	19	4.67
Allowed in part	14	0	1	1	3	2	20	4.91
Withdraw n - taxpayer	1	0	0	0	0	0	1	0.25
<b>Audit further information not requested</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>2</b>	<b>0</b>	<b>2</b>	<b>0.49</b>
Allowed in full	0	0	0	0	1	0	1	0.25
Allowed in part	0	0	0	0	1	0	1	0.25
<b>Audit further information received</b>	<b>21</b>	<b>0</b>	<b>15</b>	<b>0</b>	<b>9</b>	<b>0</b>	<b>45</b>	<b>11.06</b>
Allowed in full	11	0	4	0	1	0	16	3.93
Allowed in part	8	0	11	0	6	0	25	6.14
Disallow ed	2	0	0	0	2	0	4	0.98
<b>Client - other</b>	<b>5</b>	<b>0</b>	<b>5</b>	<b>4</b>	<b>20</b>	<b>0</b>	<b>34</b>	<b>8.35</b>
Allowed in full	3	0	1	3	10	0	17	4.18
Allowed in part	0	0	2	0	6	0	8	1.97
Commissioner discretion exercised	0	0	0	1		0	1	0.25
Disallow ed	2	0	2	0	3	0	7	1.72
Invalid	0	0	0	0	1	0	1	0.25
<b>Disallow - new argument /evidence</b>	<b>19</b>	<b>0</b>	<b>10</b>	<b>2</b>	<b>10</b>	<b>4</b>	<b>45</b>	<b>11.06</b>
Disallow ed	19	0	10	0	10	4	43	10.57
Withdraw n – settled		0	0	2		0	2	0.49
<b>Disallow – no new argument / evidence</b>	<b>49</b>	<b>0</b>	<b>12</b>	<b>7</b>	<b>31</b>	<b>5</b>	<b>104</b>	<b>25.55</b>
Disallow ed	49	0	12	7	31	5	104	25.55
<b>Not required</b>	<b>14</b>	<b>0</b>	<b>2</b>	<b>1</b>	<b>36</b>	<b>1</b>	<b>54</b>	<b>13.27</b>
Unknow n	0	0	0	0	1	0	1	0.25
Allowed in full	0	0	1	0	1	0	2	0.49
Allowed in part	0	0	0	0	1	0	1	0.25
Disallow ed	0	0	0	0	3	0	3	0.74
Invalid	8	0	1	1	20	0	30	7.37
Withdraw n – taxpayer	6	0	0	0	10	1	17	4.18
<b>Unforeseen facts or evidence</b>	<b>10</b>	<b>0</b>	<b>3</b>	<b>2</b>	<b>30</b>		<b>45</b>	<b>11.06</b>
Allowed in full	8	0	0	1	7		16	3.93
Allowed in part	2	0	3	1	23		29	7.13
<b>Grand Total</b>	<b>172</b>	<b>1</b>	<b>51</b>	<b>22</b>	<b>149</b>	<b>12</b>	<b>407</b>	<b>100</b>

Source: Australian Taxation Office.

## APPENDIX 5—DESCRIPTION OF REASONS FOR OBJECTION DECISIONS

A5.1 The descriptions of reasons for the ATO's objection decisions are set out below.<sup>340</sup>

- ATO application of law to fact changed – the audit decision was the result of incorrectly applying the ATO view to the facts and evidence available during the audit. For example, the audit decision was based on applying an ATO view which was not current or not recognising that particular facts or evidence was relevant in applying the ATO view.
- ATO fact/analysis/calculation adjustment – the audit decision was based on facts or evidence that were not adequately analysed. For example, the audit decision did not correctly identify and analyse facts and/or transactions provided by the taxpayer.
- Audit further information received – information requested at audit is provided after the audit is finalised – either with the objection or during the course of the objection.
- Audit further information not requested – the audit decision was made without the auditor requesting critical information during the audit. For example not enough questions were asked to determine behaviour in applying an administrative penalty.
- Disallow new argument/evidence – the objection was lodged with a new technical argument, but was still disallowed.
- Disallow no new argument/evidence – the objection provides no new argument or evidence to that previously provided during audit. For example, the taxpayer simply repeats that they do not agree with the established ATO view.
- Unforeseen facts or evidence – the objection was lodged with new facts or evidence that the auditor could not have anticipated because the taxpayer was co-operative during the audit and the auditor would have believed that all existing/available information had been supplied. For example, the taxpayer produces documents that conflict with documents previously provided.

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<sup>340</sup> Australian Taxation Office, 'Objection intelligence' (9 August 2013), internal ATO document.

## APPENDIX 6—CURRENT AND PROPOSED COMPOSITION OF LEARNING SUITES RELATED TO PENALTY DECISION MAKING

A6.1 As outlined in Chapter 4, the ATO has a number of current and proposed learning suites relating to penalty decision making. The titles of these suites are listed in the tables below together with a short description and the relevant level of experience expected of attendees.

**Table 12: Composition of common current learning suites related to penalty decision making**

	Foundation		Intermediate	
	Title	Description	Title	Description
Penalties	Penalties & interest charges-overview	Introduction to the penalty and interest charge regime		
	Penalty-no reasonably arguable position	Penalty where there is no reasonably arguable position	Penalty decision making — Intermediate (Under development)	Builds on existing knowledge for learners to practice penalty decision making skills
	Penalty-base penalty amount adjustments	Reduction or increasing of a base penalty amount		
	Penalty-failing to provide documents	Penalty where a taxpayer fails to provide a document		
	Penalty-false or misleading statements	Penalty where a taxpayer makes a false or misleading statement		
	Penalty-no shortfall false or misleading	Penalty where a taxpayer makes a false or misleading statement		
	Penalty-safe harbour-failure to lodge exemption	Safe harbour exemption from failure to lodge on time penalties		
	Penalty-safe harbour-false or misleading	Safe harbour exemption: making a false or misleading statement		
Decision making	Decision-making-introduction	Introduction to decision-making in the ATO		
	Making quality technical decisions	Technical decision elements including the legal reasoning models and compliance model		
	Decision making: Compliance	Addresses key decision making issues in Compliance		
Information gathering	Access & information gathering — introduction	Introduction to the ATOs access and information gathering powers		
	Access & information gathering — field	Using access & information gathering powers and relevant policies, procedures and law		
	Access & information — challenges	Common access & information gathering challenges faced by ATO officers		

	Foundation		Intermediate	
	Title	Description	Title	Description
<b>Evidence</b>	Evidence—an introduction	Introduction to evidence concepts including types of evidence, admissibility and basic evidence handling practices		
	Evidence—overview risks & issues worksheet	Introduction to the risks and issues worksheet	Evidence — facts & evidence worksheet workshop	A workshop to enable auditors to use the facts & evidence worksheets and related products.
	Evidence—facts & evidence chronology worksheet	Introduction to the facts & evidence and chronology worksheets	Evidence — analysis & interviewing	Workshop based on an end-to-end case study providing a simulated experience for learners
	Evidence—analysis of taxpayer response	Analysis of the taxpayer response worksheet and mapping the process		

Source: Australian Taxation Office.

**Table 13: Proposed common current learning suites related to penalty decision making**

	Foundation		Intermediate	
	Title	Description	Title	Description
<b>Penalties</b>	Penalties & interest charges-overview	Introduction to the penalty and interest charge regime		
	Penalty-no reasonably arguable position	Penalty where there is no reasonably arguable position	Penalty decision making — Intermediate	Builds on existing knowledge for learners to practice penalty decision making skills
	Penalty-base penalty amount adjustments	Reduction or increasing of a base penalty amount		
	Penalty-failing to provide documents	Penalty where a taxpayer fails to provide a document		
	Penalty-false or misleading statements	Penalty: taxpayer makes a false or misleading statement		
	Penalty-no shortfall false or misleading	Penalty: taxpayer makes a false or misleading statement		
	Penalty-safe harbour-failure to lodge exemption	Exemption from failure to lodge on time penalties		
	Penalty-safe harbour-false or misleading	Exemption: making a false or misleading statement		

Source: Australian Taxation Office.

*(continues next page)*

Table 13 (continued)

	Foundation		Intermediate	
	Title	Description	Title	Description
Decision making	Decision-making– introduction	Introduction to decision-making in the ATO		
	Technical decision-making– introduction	Technical decision elements including legal reasoning models	Decision making: compliance	Builds on existing knowledge & addresses key decision making issues
	Technical decision-making: application	Application of the ATO model of legal reasoning		
Information gathering	Information gathering-Context	This topic sets the context and covers why we gather information		
	Information gathering-How we gather	How we gather information. covers informal & formal information gathering/ access	Information gathering advisors' workshop	A workshop designed for Information gathering advisors.
	Information gathering-Planning	How & what information we gather; planning your information gathering strategy	Information gathering — Disputes	Access challenges including LPP, AC, CBD, case law & decisions, collateral attack — ADJR, FOI
	Information gathering-Collection	Collecting the information; preparation, planning, having the conversation /interview	Information gathering — Formal interviews	Completing notices, preparing, conducting, protocols, challenges admin, mechanics, rights & limits
	Information gathering-team learning	End to end case studies — putting it all into practice	Information gathering — Immediate access	Planning your access visit or request – immediate access in greater detail.
	Information gathering-Formal notices	Completing a formal notice.	Information gathering — International	Gathering evidence from International sources
	Information gathering-Challenges	Awareness level of access rights and limitations and issues that may arise	Information gathering — Government & others	Gathering information from other government bodies & large third parties
	Information gathering — e-information	Accessing electronically stored information, taxpayer record keeping requirements,		
Evidence	Evidence — an introduction	Introduction to evidence concepts including types, admissibility & handling		
	Evidence — overview risks & issues worksheet	Introduction to the risks and issues worksheet	Evidence — facts & evidence worksheet workshop	A workshop for auditors to use facts & evidence worksheets & related products.
	Evidence — facts & evidence chronology worksheet	Introduction to the facts & evidence and chronology worksheets	Evidence — analysis & interviewing	Workshop with an end-to end case study simulating an experience for learners
	Evidence — analysis of taxpayer response	Analysis of the taxpayer response worksheet		

Source: Australian Taxation Office.

## APPENDIX 7—ATO ADVICE AND GUIDANCE ON PENALTIES

A7.1 As outlined in Chapter 5, the ATO publishes a range of material on penalties. The main materials are listed below.

### Tax Rulings

- TR 2001/3 – Income tax: penalty tax and trusts
- TR 94/7 – Income tax: tax shortfall penalties: guidelines for the exercise of the Commissioner’s discretion to remit penalty otherwise attracted
- MT 2012/3 – Administrative Penalties: voluntary disclosure
- MT 2011/1 – Miscellaneous taxes: application of penalties and interest charges to the Commonwealth, States, Northern Territory and Australian Capital Territory
- MT 2008/2 – Shortfall penalties: administrative penalty for taking a position that is not reasonably arguable
- MT 2008/1 – Penalty relating to statements: meaning of reasonable care, recklessness and intentional disregard

### Tax Determinations

- TD 2011/19 – Tax administration: what is a general administrative practice for the purposes of protection from administrative penalties and interest charges

### PSLAs

- PSLA 2012/5 – Administration of penalties for making false or misleading statements that result in shortfall amounts
- PSLA 2012/4 – Administration of penalties for making false or misleading statements that do not result in shortfall amounts
- PSLA 2011/30 – Remission of administrative penalties relating to schemes imposed by subsection 284-145(1) of Schedule 1 to the Taxation Administration Act 1953
- PSLA 2011/19 – Administration of penalties for failing to lodge documents on time
- PSLA 2011/12 – Administration of general interest charge imposed for late payment or under estimation of liability
- PSLA 2011/2 – Administration of penalties for the non-electronic notification (NEN penalty) and non-electronic payment (NEP penalty)

- PSLA 2008/18 – Interaction between Subdivision 284-B and 284-C of Schedule 1 to the Taxation Administration Act 1953
- PSLA 2008/3 – Provision of advice and guidance by the Australian Taxation Office
- PSLA 2007/22 – Remission of penalty for failure to withhold as required by Division 12 of Schedule 1 to the Taxation Administration Act 1953
- PSLA 2007/6 – Guidelines for settlement of widely-based tax disputes
- PSLA 2007/4 – Remission of penalty for failure to comply with GST registration obligations
- PSLA 2007/3 – Remission of penalty for failure to comply with obligations in relation to tax invoices, adjustment notes or third party adjustment notes
- PSLA 2006/8 – Remission of shortfall interest charge and general interest charge for shortfall periods
- PSLA 2005/2 – Penalty for failure to keep or retain records
- PSLA 2003/11 – Remission of penalty for failure to withhold as required by Division 12 in Schedule 1 to the Taxation Administration Act 1953
- PSLA 2002/8 – Administration of penalties under the new tax system
- PSLA 2000/9 – Remission of penalties under the new tax system

### **Website pages**

- ATO Overview – About penalties and interest charges ATO website <<http://www.ato.gov.au>>
- Code of settlement practice website <<http://www.ato.gov.au>>

### **ATO Receivables Policy**

- Receivables policy (Archived) (see Part G) <<http://www.ato.gov.au>>

## **APPENDIX 8—ATO INTRANET GUIDANCE MATERIAL**

A8.1 As outlined in Chapter 4, ATO officers may refer to a range of internal guidance material to assist them in making penalty decisions. These are accessed through the ATO's intranet and are listed below.

### **Large Business and International**

- LB&I Penalty and interest reporting guide

### **Small and Medium Enterprises**

- S&ME Penalty and interest decision report and guide
- S&ME Voluntary disclosures and penalty remission for S&ME Review products
- S&ME Penalty and interest decision report guide for false or misleading statements made before 4 June 2010
- S&ME Penalty and interest decision report guide for statements made on or after 4 June 2010
- S&ME Differences between PS LA 2006/2 and new PSLA for false or misleading statement penalty on shortfall amounts

### **Micro Enterprises and Individuals**

- ME&I E-22 Consider penalty and charges imposition and remission
- ME&I High risk refund – safe harbour consideration

### **Superannuation**

- SPR Administrative penalty and remission decision checklist – False or misleading statements prior to 4 June 2010
- SPR Safe harbour reporting – Code of conduct spreadsheet
- SPR Administrative penalty and remission decision checklist – False or misleading statements made on or after 4 June 2010 that does result in tax shortfall
- SPR False or misleading statement no shortfall penalty: Referral process
- SPR 284-75 no shortfall false or misleading penalty referral process flowchart
- SPR The Penalty and Interest Network (PIN)

## **Serious Non-Compliance**

- SNC False or misleading statement referral flowchart
- SNC False or misleading statement prosecutions

## **Indirect Taxes**

- ITX Standard penalty text for false or misleading statements resulting in a shortfall
- ITX Standard Penalty Text for false or misleading statements that do not result in a shortfall
- ITX AS administrative penalty calculation tool
- ITX Penalties index
- ITX Administrative penalty for false or misleading statements guide
- ITX Penalties relating to statements – step by step guide for Indirect Tax
- ITX Penalty imposition form
- ITX Exemption from administrative penalty for false or misleading statement (known as 'safe harbour')
- Administrative penalty for false or misleading statements
- Penalties relating to statements – step by step guide for Indirect Tax
- Penalty Flowchart
- Indirect Tax practice note 2010/01 – approval of case decisions
- Indirect Tax penalty and interest contact list (PIP, Indirect Tax branch penalty representatives and Central Technical Support advisers)

## **Compliance Support and Capability**

- CS&C Penalties and the impact of the Taxpayers' Charter and Compliance Model – case studies (MEI IA)
- CS&C Imposing tax shortfall penalty (MEI IA)
- CS&C Determining the appropriate level of tax shortfall penalty
- CS&C Remission of tax shortfall penalty (MEI IA)
- CS&C Income tax assessments, penalties and interest
- CS&C Miscellaneous administrative penalties
- CS&C A guide to determining compliance related behaviour

- CS&C Administrative penalties method
- CS&C Imposition and remission of miscellaneous administrative penalties
- CS&C Imposition and remission of shortfall penalty
- CS&C Voluntary disclosure ACAP (2009/3)
- CS&C No shortfall administrative penalty method
- CS&C False or misleading statement penalty – overview
- CS&C Objection to an administrative penalty – no shortfall amount (No shortfall penalty) job aid (SPR IA)
- CS&C Three-step process for assessing false or misleading statement penalties

### **Enterprise-wide**

- Administrative Penalties – 01 – current
- Impose/remit penalties – interest 1984 – 2000
- Failure to withhold
- Miscellaneous administrative penalties
- No shortfall administrative penalty method – current

# APPENDIX 9—ATO PENALTY A3 INFORMATION SHEETS

A9.1 As outlined in Chapter 4, the ATO recently provided its staff with a number of A3 information sheets to outline key points to consider in making penalty decisions. These are reproduced below.

**Figure 3: A3 information sheet — False or misleading statement penalty — three step process**

 <b>Shortfall penalties – liability, imposition, reduction, remission, and recording</b>	
 <b>Step 1</b>	<p>PS LA 2012/5 explains the circumstances in which a taxpayer becomes liable to a penalty for a false or misleading statement that results in a shortfall and how the penalty, including any remission, is assessed. The PS lists the three main steps involved in administering penalties relating to statements. Each step has a number of elements</p>
 <b>Step 2</b>	<p>The decisions made in steps 1 and 2 must be supported by facts and evidence and show how they are applied to the elements of the law. The facts and evidence we gather to support the decision may not occur in the order listed in the steps but generally follow this order. Please refer to PS LA 2012/5 for further information</p>
 <b>Step 3</b>	<p>PS LA 2012/5 explains the circumstances in which a taxpayer becomes liable to a penalty for a false or misleading statement that results in a shortfall and how the penalty, including any remission, is assessed. The PS lists the three main steps involved in administering penalties relating to statements. Each step has a number of elements</p>
<p><b>Step 1</b> Determine if a penalty is imposed by law. Document the reasons a penalty is imposed by law and record in the appropriate ATO record-keeping system.</p>	<p><b>1. Conditions that establish liability</b> Confirm:  <ul style="list-style-type: none"> <li>that a statement made about a tax related matter was false or misleading in a material particular (whether because of statements made or omitted)</li> <li>the statement was made to the Commissioner or an entity exercising powers or performing functions under a taxation law</li> <li>there is a shortfall amount for the relevant period</li> <li>who is liable to the penalty</li> </ul>                 2. Conditions that remove liability  <ul style="list-style-type: none"> <li>the taxpayer and/or their agent took reasonable care (Note – it is for the Commissioner to show that the taxpayer failed to take reasonable care and not for the taxpayer to prove that they did)</li> <li>the statement falls under ‘safe harbour’</li> </ul> </p>
<p><b>Step 2</b> Assess the amount of the penalty. Document the reasons for decisions that result in the assessment of the penalty and record the details of each step in the assessment.</p>	<p><b>1. Work out the base penalty amount (BPA)</b>  <ul style="list-style-type: none"> <li>Work out the BPA by applying the relevant percentage to the shortfall amount. The relevant percentage is established by determining the level of care taken by the taxpayer and/or their agent in connection with making the statement.</li> <li>The following BPAs will apply if the taxpayer/their agent’s behaviour is classified as:                             <ul style="list-style-type: none"> <li>failure to take reasonable care = 25% of the shortfall amount</li> <li>recklessness = 50% of the shortfall amount</li> <li>intentional disregard = 75% of the shortfall amount</li> </ul> </li> </ul> <b>2. Increase and/or reduce the BPA</b>  <ul style="list-style-type: none"> <li>After calculating the BPA, document whether or not the facts and evidence support an increase and/or a reduction in the BPA (including whether the voluntary disclosure discretion should be exercised)</li> </ul>                 3. Consider remission of the penalty  <ul style="list-style-type: none"> <li>Make a remission decision, referencing any facts and evidence that support the decision and PS LA 2012/5</li> </ul> </p>
<p><b>Step 3.</b> Advise the taxpayer of the liability and the reasons for the decision. <b>Ensure that the reasons for the decision and proof that it was provided to the taxpayer are documented in the relevant ATO record-keeping system.</b></p>	<p>1. Explain the reasons for the decision to the taxpayer in writing and in an appropriate manner                  2. Issue a notice of assessment to notify the taxpayer of any liability                  – If there is no liability, we must still advise the taxpayer of the penalty outcome, providing sufficient detail to ensure clarity and the taxpayer’s understanding</p>

Source: Australian Taxation Office.

**Figure 4: A3 information sheet — Shortfall penalty for making a false or misleading statement — behaviours**



**Shortfall penalty for making a false or misleading statement**

An entity makes a false or misleading statement in a material particular when they or their agent provides us with incorrect information, omits information or provides information, which creates a false impression.

The statement is false or misleading regardless of whether it is an inadvertent mistake or a deliberate error. Where such a statement is in a tax return, activity statement or other similar document, it can result in a shortfall amount.

False or misleading statement penalty may be imposed on such statements. We must consider the entity's circumstances in connection with making the statement. Our penalty decisions must be made on the basis of the relevant facts and evidence.

Actions that occur after the statement was made, such as during an audit, are not considered in determining the culpability or base penalty amount.

Different behaviours may apply to different parts of a shortfall amount.

**Behaviours**

<p><b>Reasonable care – '0%' No Penalty</b></p> <ul style="list-style-type: none"> <li>• In making a statement, 'reasonable care' means giving appropriately reasonable attention to complying with the obligations under taxation law.</li> <li>• If an agent lodges the statement, both the entity and the agent need to take reasonable care for there to be no liability to a penalty (unless safe harbour applies).</li> <li>• The greater the risk involved in making the statement, the greater the level of care expected. The size of the shortfall or the proportion of the shortfall to the overall tax payable is one indicator of overall tax risk.</li> <li>• Reasonable care is not an overly onerous test for entities.</li> <li>• For businesses reasonable care will include setting up appropriate record keeping systems and procedures, training staff and doing assurance checks.</li> </ul> <p><b>We:</b></p> <ul style="list-style-type: none"> <li>• compare what an entity has done with what we would expect a 'reasonable, ordinary person' in the same circumstances to have done.</li> <li>• take into account factors relevant to the entity such as their age, health, education, knowledge, skill and experience - one entities 'reasonable attempt' will be different to another's.</li> <li>• expect registered agents to show higher levels of reasonable care because of their levels of education, knowledge, skill and experience</li> <li>• consider the complexity of the law.</li> </ul>	<p><b>Failure to take reasonable care – 25% of shortfall amount</b></p> <ul style="list-style-type: none"> <li>• As with reasonable care, we compare what an entity or agent has done with what we would expect a reasonable person in the same circumstances to have done.</li> <li>• A failure to take reasonable care is where reasonable care has not been taken, but neither the entity nor the agent has been reckless or intentionally disregarded the law.</li> <li>• Failure to take reasonable care is not a 'default' position. We do not presume that a shortfall amount caused by a false or misleading statement necessarily or automatically points to a failure to take reasonable care.</li> <li>• Facts, evidence and reasonable inferences must exist to determine that the entity and agent did not take reasonable care. If they do not exist, the entity has taken reasonable care or is presumed to have taken reasonable care.</li> <li>• If based upon the facts and evidence we have a 'border line call', we should gather more information or give the entity the benefit of the doubt and determine reasonable care, rather than assess as a failure to take reasonable care.</li> </ul>	<p><b>Recklessness – 50% of shortfall amount</b></p> <ul style="list-style-type: none"> <li>• Recklessness is behaviour which falls significantly short of the standard of care expected of a reasonable person in the same circumstances as the entity. It is gross carelessness.</li> <li>• Recklessness assumes that the behaviour in question shows a disregard of the risk or indifference to the consequences that are foreseeable by a reasonable person (taking into account the entity's agent's particular circumstances and experience).</li> <li>• However, the entity or agent does not need to actually realise the likelihood of the risk for it to be reckless.</li> <li>• The actual intention of the entity is of no relevance. Dishonesty is not an element of establishing recklessness.</li> <li>• To determine recklessness, the degree of the risk and the gravity of the consequences need to be weighed in forming a conclusion.</li> </ul>	<p><b>Intentional disregard – 75% of shortfall amount</b></p> <ul style="list-style-type: none"> <li>• Intentional disregard of the law is something more than reckless disregard or indifference to a taxation law.</li> <li>• Intention of the entity is a critical element – there must be actual knowledge that the statement made is false.</li> <li>• The entity must understand the effect of the relevant legislation and how it operates in respect of the entity's affairs and make a deliberate choice to ignore the law.</li> <li>• Dishonesty is a requisite feature.</li> <li>• Evidence of the entity's intention must be found through direct evidence or by inference from all the surrounding circumstances, including the conduct of the entity.</li> </ul>
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**This document is a summary only.**

Case officers must read and use MT 2008/1 *Penalty relating to statements: meaning of reasonable care, recklessness and intentional disregard* when making decisions on behaviours.

For information and examples on:

- reasonable care and failure to take reasonable care see paragraphs 27 to 98
- recklessness see paragraphs 99 to 108
- intentional disregard see paragraphs 109 to 116.

Source: Australian Taxation Office.

18 May 2012

Unclassified

Figure 5: A3 information sheet — Reasonably arguable position



## Reasonably arguable position

A taxpayer is liable to a penalty if they treated the income tax law or minerals resource rent tax law as applying in a particular way that was not reasonably arguable. That is, taxpayers are expected to have a reasonably arguable position (RAP). If they do not, the penalty of 25% of the shortfall amount will apply under section 284-75(2) of schedule 1 to the TAA 53.

RAP applies only to statements where the shortfall amount exceeds certain reasonably arguable position thresholds.

'Reasonably arguable' is the standard applied to the position taken by a person on a question of interpretation, including a conclusion of fact. It requires the treatment of a tax law to be about as likely to be correct as it is incorrect.

The RAP test does not require the taxpayer's position to be the 'better view'. The taxpayer's argument should be cogent, well-grounded and considered in its persuasiveness.

The reasonably arguable position is an objective standard involving an analysis and application of the law to the relevant facts. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether an entity has a reasonably arguable position.

Authorities for reasonably arguable position include:

- a taxation law
- material not forming part of the Act but which may help to determine the meaning of the law, such as explanatory memoranda and second reading speeches
- a decision of a court (whether or not an Australian court), the Administrative Appeals Tribunal (AAT) or a Taxation Board of Review
- a public ruling.

An opinion expressed by an accountant, lawyer or advisor is not a relevant authority. However, the authorities used in the opinion may support the position taken by the taxpayer.

For there to be a RAP, the position must be on a contentious area of the law where the relevant law is unsettled or where the principles of the law are settled, but there is a serious question about the application of those principles to the circumstances of the particular case.

Generally, where the shortfall amount was caused by a primary error of fact or error of calculation, penalty for not having a RAP will not apply. Such errors may be a failure to take reasonable care. Conclusions of fact may be subject to penalty for not having a RAP.

**This document is a summary only.**  
Case officers must read and use MT 2008/2 *Shortfall penalties: administrative penalty for taking a position that is not reasonably arguable* when making decisions on RAP.

## RAP and false or misleading statements

RAP imposes a higher standard than that required to demonstrate reasonable care. Because of this difference, an entity may not have a reasonably arguable position, despite having satisfied the reasonable care test. If a taxpayer has established a RAP, usually they have taken reasonable care. (See the Decision Impact Statement on *Shin* for more information.)

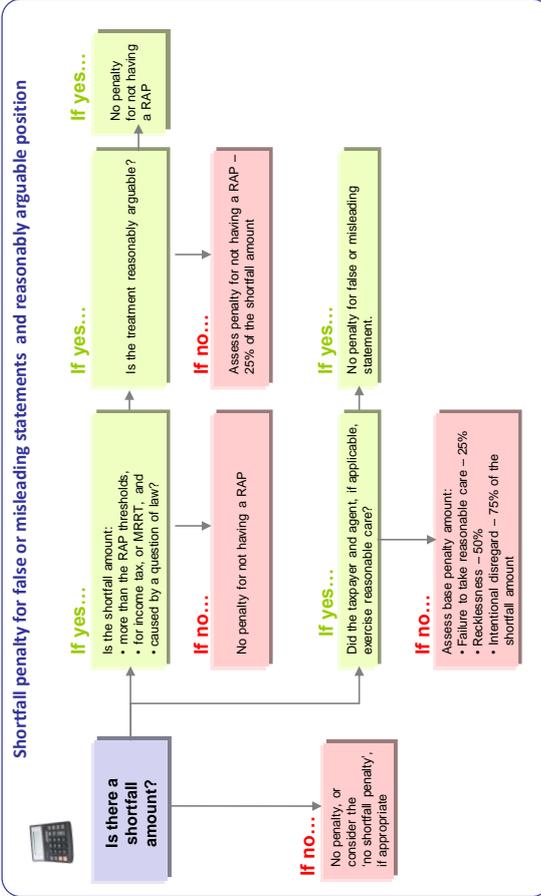
The tests for RAP and reasonable care are parallel, not hierarchical, tests.

### False or misleading statement penalty:

- applies to all shortfall amounts
- reflects what is reasonable in the taxpayer's circumstances
- is not an overly onerous test, but is not a minimum standard
- does not automatically follow that where a taxpayer has a RAP the taxpayer took reasonable care
- has safe harbour provisions for failure to take reasonable care.

### RAP:

- applies to income tax and minerals resource rent tax only
- is a higher, but not hierarchical, test compared to reasonable care
- is objective – focuses on the merits of the position
- does not require the taxpayer to have 'the better view'; personal circumstances are irrelevant
- generally requires research to reach the position
- is a higher standard than reasonable care.



Source: Australian Taxation Office.

## Figure 6: A3 information sheet — Administrative penalties — voluntary disclosure — useful information



### Administrative penalties - voluntary disclosure – useful information

#### Purpose

The purpose of the voluntary disclosure provision is to encourage entities to make voluntary disclosures by giving a reduction in the penalty that would otherwise be imposed.

It provides substantial incentives for entities to review their affairs and make a voluntary disclosure prior to notification of an examination. It allows for the same reduction in some circumstances after notification of an examination in some cases. Otherwise, a lower reduction may apply for disclosures made after notification of an examination.

Voluntary disclosures help with tax administration as they can save the ATO time and resources.

#### What is an examination?

An 'examination' for the purposes of section 284-225 of Schedule 1 of the TAA 1953 is an examination of the entity's affairs relating to a taxation law.

Risk reviews and audits are examinations. An examination does not include educational activities, such as bulk mail out of reminder letters. An examination is not limited to active compliance activities.

The notification of the examination must specify the 'period' under examination. For shortfall amounts and scheme shortfall amounts this will usually be an accounting period. For statements not resulting in a shortfall amount it may be any period, such as a the day the statement was made.

#### What is a voluntary disclosure?

A voluntary disclosure is where the entity tells the Commissioner or discloses information in the approved form, which enables the Commissioner to determine a shortfall amount, scheme shortfall amount or the false or misleading nature of a statement that doesn't result in a shortfall. The approved form is a list of required information.

An entity is not required to disclose the precise shortfall amount or scheme shortfall amount. However, the entity must disclose the relevant information to enable the Commissioner to adjust the tax-related liability or correct the false or misleading statement. In the absence of sufficient details, it would not be accepted that a voluntary disclosure has been made.

#### What is not a voluntary disclosure?

A disclosure will not be regarded as being made voluntarily if the entity merely:

- agrees with information we have already identified and advised them of the information

- confirms a shortfall amount or lesser shortfall amount
- provides requested documents to the Commissioner or answers questions or provides cooperation and assistance during the conduct of an examination
- responds to a questionnaire containing direct questions to determine the shortfall amount.

A disclosure will not be regarded as being made voluntarily where the facts or reasonable inferences indicate that the entity:

- was aware of the shortfall amount, scheme shortfall amount or the false or misleading statement and
- would have been highly unlikely to have made the disclosure had they not become aware that the Commissioner had uncovered, or was about to uncover the shortfall amount or statement (including where an entity intentionally disregarded a taxation law).

However, suspicion they wouldn't have come forward, had they not been notified of an audit does not of itself mean the disclosure was not made voluntarily.

#### The extent of the voluntary disclosure

Where a voluntary disclosure is made the reduction in the base penalty amount is determined by the timing of the disclosure and the details of the disclosure, as shown in the Table overleaf.

If a voluntary disclosure is made for one accounting period or statement, the reduction in the BPA is only for that period and is not applied to other periods with the same issue in the audit.

If we have advised of a shortfall amount and the entity discloses a larger amount, the reduction is only for the difference, that is, the amount greater than originally advised.

**This document is a summary only.**

**You must refer to *Miscellaneous Taxation Ruling MT 2012/3 Administrative penalties: voluntary disclosures***

Unclassified 18 April 2012

Source: Australian Taxation Office.

Figure 7: A3 information sheet — Reasonable care in making statements



Page 1 of 4

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## Reasonable care in making statements — Introduction



A taxpayer makes a false or misleading statement when they or their agent provide us with incorrect information or omits information when making a statement. It does not matter whether the false or misleading statement is an inadvertent mistake or a deliberate error. Where the statement is in a tax return, activity statement or other document, it can result in a shortfall amount.

Where a false or misleading statement in a material particular is made, the taxpayer is liable to an administrative penalty unless an exception applies. One exception is where reasonable care is taken. **The taxpayer is not liable to this penalty if the taxpayer, and their agent (if relevant), took reasonable care in connection with the making of the statement.**

### What does the ATO mean by reasonable care?



In making a statement, 'reasonable care' means giving appropriately serious attention to comply with the taxation law.

We:

- compare what a taxpayer has done with what we expect a 'reasonable ordinary person' in the same circumstances would have done
- take into account the taxpayer's age, health, education, knowledge, skill and experience - one taxpayer's 'reasonable attempt' will be different to another's
- expect registered agents to show higher levels of reasonable care because of their levels of education, knowledge, skill and experience. We work out what is reasonable care for a tax or BAS agent by comparison with what is expected of similar agents in the circumstances.

Miscellaneous Taxation Ruling MT 2008/1 provides a more detailed explanation of the meaning of reasonable care for making statements.

### Taxpayers taking reasonable care



In taking reasonable care:

- a taxpayer complies with their taxation obligations by giving appropriate attention to those obligations
- a taxpayer's knowledge, education, experience are relevant considerations in determining the effort made to comply
- a taxpayer should not find it overly onerous
- going to a tax or BAS agent does not, in itself, amount to reasonable care, although it counts towards it for the taxpayer.

If the taxpayer and their agent have taken reasonable care to comply with the taxation obligations to report information correctly, there is no penalty. The taxpayer will be liable to the penalty where their agent fails to take reasonable care even though the taxpayer took reasonable care, and vice versa, unless 'safe harbour' applies. Later we explain safe harbour, which involves a taxpayer's registered agent not taking reasonable care and its effect on any administrative penalty for a taxpayer.



In *Gupta v FC of T* [2002] AATA 1301, the Administrative Appeals Tribunal (AAT) explained that assistance from a source which may not be competent does not remove the responsibility for reasonable actions from the taxpayer (paragraph 21).

In *MLC Limited & Anor. v FC of T* [2002] FCA 1491 Hill J. said: 'A taxpayer who relies upon expert advice ... where the advice is held generally in the industry and does not conflict with any statement made by the Commissioner and indeed is confirmed by enquiry of the ATO is not required to obtain a ruling to guard against an allegation that the taxpayer has not exercised due care.' (paragraph 53).

In *Case 34/85 (Case 10,221) 95 ATC 319*; (1995) 30 ATR 1342 the AAT explained that the standard of care for a tax agent is higher than for an average taxpayer. Prudent tax agents should make reasonable enquiries regarding the accuracy of the information provided. Tax agents have the knowledge, ability and resources to make enquiries on application of the law when uncertainty arises. (paragraph 23).

Unclassified

18 May 2012

Source: Australian Taxation Office.

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# Reasonable care in making statements – Overview

## What are the obligations for taxpayers?

We expect non-business taxpayers to:

- keep proper records of their taxation affairs
- use material published on [ato.gov.au](http://ato.gov.au) or advice products from the ATO in a reasonable way and seek help if they don't understand it
- check documents before they lodge them.

▶ Taxpayers that diligently follow e-tax instructions usually have taken reasonable care.

We expect business taxpayers to:

- have appropriate record-keeping systems, which may be different for different businesses. For example, providing and keeping invoices and doing a bank reconciliation would be a part of the minimum requirements.
- set up other procedures which may include some or all of the following:
  - run regular internal audits
  - provide manuals
  - train or supervise staff, or ensure people dealing with procedures are appropriately trained.
- use ATO products or other suitable material to understand how to treat tax matters, and seek advice if they are unsure
- use their knowledge, experience and skill to understand how to treat tax matters
- take extra care with new or extraordinary transactions.

We expect taxpayers using an agent (not limited to tax and BAS agents) to:

- give all relevant information to their agent, including telling the agent about any extraordinary event
- answer correctly the questions their agent asks
- ask their agent reasonable questions in the circumstances, for example, if the matter appears strange
- check that the statements are correct – only sign a document after reading it and asking questions, if needed.

## What are the obligations for tax and BAS agents?

We expect registered tax agents and BAS agents to:

- use their skills, knowledge and experience to take reasonable care for their clients to determine the correct view of the law or the facts of the case
- make reasonable enquiries about the information provided, especially information which appears to be incorrect or incomplete
- make reasonable enquiries or seek advice where required
- exercise the common law duty of care owed to their clients.

## What changed with the Tax Agents Services provisions?

The *Tax Agents Services Act 2009* (TASA) does not affect what is reasonable care for penalty for false or misleading statements or how it is assessed by us. The ATO determines what is reasonable care for taxation matters using MT 2008/1. Reasonable care for the purposes of the TASA is determined by the Tax Practitioners Board, but is very similar to the ATO view.

The TASA introduced other obligations which align with reasonable care. In the code of professional conduct, registered agents must take reasonable care:

- in ascertaining a client's state of affairs where it is relevant to a statement for the client
- to ensure that taxation laws (those laws administered by the Commissioner) are applied correctly to the circumstances in providing advice to a client.

## What is safe harbour?

Safe harbour is an informal name for a provisions when the taxpayer is not liable to false or misleading statement penalty where:

- the statement is made on or after 1 March 2010 by a registered tax agent or BAS agent to the ATO
- the agent failed to take reasonable care, but was not reckless nor intentionally disregarded the law, and
- the taxpayer provided 'all relevant taxation information' (the words used in taxation law) – this means complete and correct.

It is irrelevant that a taxpayer genuinely believes they provided all relevant taxation information required or took reasonable care in providing the information, if they did not. It is an objective test.

We bring safe harbour to the taxpayer's attention in letters, audits and reviews. In desk and field audits, we ask questions which may determine if safe harbour applies. We do not mention safe harbour during audits where refunds are held, unless the taxpayer or agent suggests it could apply.

Taxpayers have the burden of proof to show they provided all relevant information.

## Penalties

We do not presume that a shortfall amount caused by a false or misleading statement necessarily or automatically points to a failure to take reasonable care.

Where we determine that reasonable care was not taken we consider what level of behaviour occurred. This may be a failure to take reasonable care, recklessness or intentional disregard of the law. Different behaviours may apply to different parts of the shortfall amount.

The penalty will depend on the facts and circumstances of the case and the people involved in making the statement. We use the information available to us about the type of mistake, the complexity of the law and information about the taxpayer. We will gather or seek to gather further information on why the error occurred and the attempts the taxpayer, tax or BAS agent took to make a correct statement.

▶ Reasonable care may apply where:

- a transcription error occurs in lodging invoices, but the taxpayer has appropriate accounting systems, there is no systemic problem and the amount of the error is not significant
- moneys were distributed to a taxpayer from a trust, but they were unaware of the distribution
- the taxpayer made a genuine and earnest attempt to follow ATO guides
- a taxpayer is ill, undergoing treatment and, because of the stress and lack of time, an oversight occurred
- a taxpayer sought advice from a tax or BAS agent, provided correct information, and asked questions to ensure they understood the advice; however, the agent's advice was incorrect.

▶ A few examples where reasonable care may not apply are:

- taxpayer does not report capital gains – sometimes they overlook the sale, others do not understand that shares or other property are subject to capital gains and do not advise their agent of the sale and the agent does not ask
- taxpayers and registered tax agents claim a full deduction for an item when it is only partially used for business purposes
- information most favourable to the tax or BAS agent, the agent chooses to use the information most favourable to the taxpayer without any further investigation
- taxpayers and BAS agents claim GST credits without invoices, where GST was not included or the transaction did not occur
- taxpayers report a nil amount for GST or PAYG withholding amounts where they cannot afford to pay it

The false or misleading statement provisions were expanded in June 2010 and now apply to statements that do not result in shortfall amounts. The details and examples in this document refer to shortfall amounts, but the principles will apply to no shortfall amounts.

## How is reasonable care different to reasonably arguable position?

For income tax and minerals resource rent tax, in addition to taking reasonable care, the taxpayer's statements must treat the law in a way that is reasonably arguable, that is, have a reasonably arguable position (RAP). To do this the position must be as likely to be correct as incorrect, or is more likely to be correct than incorrect. A penalty can apply if there is not a RAP.

The tests for RAP and reasonable care are parallel, not hierarchical, tests. A flowchart showing this is on the page 4.

### Reasonable care:

- applies to all shortfall amounts
- reflects what is reasonable in the taxpayer's circumstances
- is not an overly onerous test
- does not automatically follow where a taxpayer has a RAP
- safe harbour only applies to a penalty for failure to take reasonable care.

### RAP:

- applies to income tax only
- is a higher, but not hierarchical, test than reasonable care
- is objective – focuses on the merits of the position
- personal circumstances are irrelevant
- generally requires research to reach the position
- by determining a RAP usually reasonable care is taken.

Source: Australian Taxation Office.

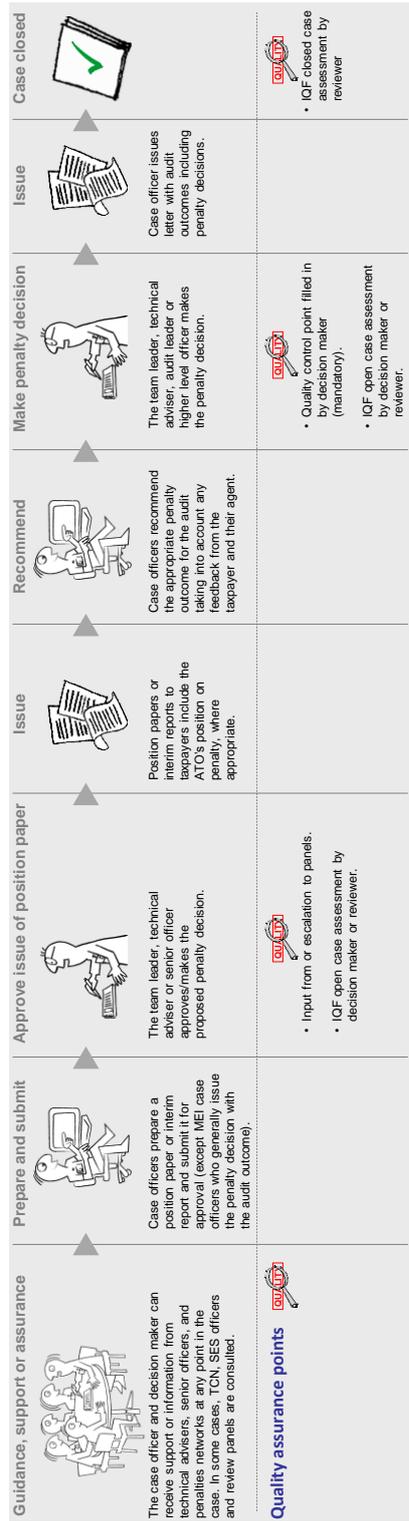
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## Reasonable care in making statements – Quality frameworks



“Our quality frameworks review our administrative penalty decisions and identify issues for improvement.”

### Who makes decisions on administrative penalty?



### What are our checks and balances?

#### Integrated quality framework (IQF):

IQF is a corporate quality assurance process, which relies on random sampling of finalised cases and targeting of higher risk cases in ongoing cases. The number of cases selected for assurance varies according to BSL and product.

#### In IQF:

- assessments are undertaken during the audit (open cases) and after finalisation of the audit (closed cases)
- open case assessments are often chosen to target an identified risk and are chosen at the discretion of the BSL
- closed case assessments are chosen randomly
- review and audit cases are assessed against the IQF criteria for the tax adjustment decision, the penalty decisions and the interest decision
- IQF assessors for closed cases are independent of the case officers and decision makers
- open cases, the IQF assessor may be the decision maker or an independent person who provides feedback before the audit is finalised
- feedback is sent by the assessors directly to both the case officer and their audit/team leader (if it is a different person)
- the results of the assessments are recorded in a database and examined by each BSL and the Active Compliance Capability to identify systemic issues and opportunities for improvement (OFI)
- OFIs are reviewed and assessed, and may be acted upon given resources and priorities.

### What are our feedback loops?

#### We:

- listen to and act on what taxpayers, industry, tax professionals and their forums have to say about our penalty decisions
- actively seek out feedback on specific penalties issues from external stakeholders
- action and learn from our community feedback by implementing improvements
- act on complaints directly
- review the quality of our penalty decisions and decision making through corporate reporting and within BSL reporting
- act on the outcome of our cases before the courts and Administrative Appeals Tribunal
- provide feedback to our case officers on their audit decisions, including penalty decisions, when reviewing audit activities for other purposes, for example, at case call-overs
- require case officers to provide feedback to their officers of the reasons of objections to their penalty decisions, and, in some cases, prior to the objection decision
- look at broader trends and problems to find opportunities for improvement in our penalty decisions.

#### Siebel quality control points:

- are a flag for the decision maker to assess the case, including the penalty decision
- require the decision maker to consider if certain actions have been taken, for example, if there is sufficient evidence to support the penalty decision
- are mandatory
- allow the decision maker to approve the case to proceed
- allow the case to be returned to the case officer to either implement the decision or take corrective action.

#### Corporate escalation processes:

- are options for formal and informal escalation of interpretative, administrative and discretionary issues on administrative penalties and law to include step by step penalty decision making.

#### Other checks and balances:

- authorisations and delegations
- BSL and corporate penalty and interest networks
- specialist panels set up to review cases
- other processes, for example, in case call-overs we look out for the causes of delay and error.

#### Quality criteria and assessment levels

We use nine quality criteria to assess audit and review cases in IQF. These are:

- administrative soundness
- integrity
- correctness
- appropriateness
- effectiveness
- transparency
- consistency
- timeliness
- efficiency.

#### We rate audit and review cases as:

- very high
- high
- meets standards
- aligned
- not aligned.

BSLs review results of cases below 'meets standards' to see if there are business line issues and to find OFIs. The Compliance penalties team reviews the results for the Compliance Capability to see if there are systemic issues and to find and act on issues across the capability.

High and very high rated cases are reviewed to see if they can be used for model cases or systemic improvement.

## **APPENDIX 10—ITX BEHAVIOURAL OBSERVATION RECORD**

A10.1 As outlined in Chapter 4, the ITX business line provides its officers with a behavioural observation record. This record focuses officers' attention on the information needed to identify the level of care taken by taxpayers by posing the following questions.

### **Experience and background of the taxpayer**

- How long has the taxpayer been in business (details – business type etc)?
- Does the taxpayer have any professional qualification?
- What is the size of the taxpayer's business?
- Do they have access to resources (in-house accounting, employee, TAG) etc?
- What is the taxpayer's knowledge of the tax law/GST law? (for example knowledge on what needs to be reported in the BAS, how the transaction should be classified or treated, when they can claim credits and when they have to pay GST)
- Has the taxpayer read any Tax Office publications regarding GST in paper form or on the website?
- Do you believe that the taxpayer has made a genuine attempt to comply with their GST obligations? How/Why?
- What is the taxpayer's compliance history?
- Has the taxpayer experienced any difficulties in meeting tax obligations in the past?
- What steps, if any, has the taxpayer taken recently to improve future compliance (for example systems/procedure reviews)?

### **Preparation of the business activity statement**

- Who prepares the BAS for lodgement? (Self/TAG/Employee/Other (specify))
- Who lodged the BAS?
- What date was the BAS lodged? (If lodged on or after 1/3/10 Safe Harbour provisions may apply).
- Is the TAG/Service provider registered? If yes what is their registration number?
- Was the BAS checked and signed by the taxpayer before it was lodged?

- Specify what information was provided to TAG/Service Provider and in what format (for example source documents or spreadsheet, etc).
  - If employee/taxpayer prepares and lodges the BAS?
  - How many employees do they employ in their accounts section?
  - Do employees perform multiple tasks, such as accounts payable and receivable as well as BAS reporting?
  - What is the employee's expertise in preparation of the BAS?
  - What training have they received in relation to GST to enable them to determine the correct treatment of the transactions?
  - What controls are put in place to check the BAS figures?
  - Did the taxpayer obtain assistance from TAG/Service Provider?

### **How the shortfall arose**

- How was the shortfall identified? When and by whom?
- How and why did the shortfall occur? (For example ask the taxpayer the leading question on why certain transactions were not reported, why the transactions were reported in a manner such that it gives rise to a shortfall, or why credits were claimed on certain transactions which the taxpayer was not entitled to.)
- How often do transactions of this nature and/or magnitude occur?
- How did the taxpayer treat the transaction/s for income tax purposes?
- How was the decision to treat the transaction/s in this manner made? And by whom?
- Was there any uncertainty regarding the issue at the time the decision was made? If yes, how was this uncertainty resolved?
- Did the taxpayer seek any advice from anyone when making the decision? (For example from a tax agent, solicitor or from business associates, etc.) If so, please provide evidence of what advice was received.
- If advice was sought, what information was given to the advisor? What documents were considered in the discussions?
- Did they contact the ATO to seek clarification of the issues prior to making the statement (decision)? If so, please provide evidence of what advice was received.
- What steps, if any, did the taxpayer take to rectify any mistakes after becoming aware of it or prevent it reoccurring in the future?

- Can the taxpayer provide any ‘mitigating’ reasons as to why the shortfall occurred?

### **Behaviours of tax agent/service provider**

- How long has the taxpayer been the representative’s client?
- Which returns does the representative prepare for the taxpayer? BAS, Income Tax, FBT, others – and for how long?
- What other services does the representative provide to this taxpayer?
- What information did the taxpayer provide to the representative for the relevant period in which the shortfall has been identified? What information does the taxpayer normally provide? (For example cashbook, tax invoices, computer records, cheque book, deposit book, etc.)
- What steps, if any, did the representative take to verify that the information provided by the taxpayer was complete and accurate? What steps have they taken in the past to verify information provided?
- If the taxpayer did not provide source documents to the representative why was the representative satisfied with just the summary?
- To what degree is the representative satisfied that the taxpayer has appropriate record keeping systems and procedures? What gives them this degree of satisfaction?
- What advice did the representative provide to the client?
- Do the ‘safe harbour’ provisions apply? Why?

## APPENDIX 11—FACTS AND EVIDENCE WORKSHEET

A11.1 As mentioned in Chapter 4, ATO officers use a Facts and Evidence Worksheet in their case work, which is reproduced below.

Review period:

Law: As at [DD/MM/YYYY being the relevant year of income or point in time]

Issue: [Define the issue you're examining in relation to the taxpayer]

Section or other authority	Element to be established	Facts relied upon (List the facts as a series of dot points and do not outline the ATO position in this column)	Evidence which establishes the facts (Reference to document and file where relevant)	ATO position or additional information/facts and evidence to be obtained or steps to be taken to arrive at the ATO position.

Source: Australian Taxation Office.

## **APPENDIX 12—VOLUNTARY DISCLOSURE PARAGRAPHS USED IN CORRESPONDENCE TO TAXPAYERS**

A12.1 As mentioned in Chapter 5, the following are the ATO's standard paragraphs relating to voluntary disclosures that it uses in its audit and review notification letters.

### **Audit notification letter — not preceded by a review**

We recommend that you take this opportunity to review your records. If you find that you have made an error or omission, please advise <Officer's Name> of the details in writing by <date >. You will need to provide sufficient information for us to work out the shortfall amount. If you do this, any penalty that would otherwise apply to the shortfall amount disclosed may be reduced by 80%.

If you identify an error after this date, we also encourage you to disclose that issue as soon as possible. You may still receive a 20% reduction in penalties where you make a voluntary disclosure after that date if it saves us significant time and resources.

### **Audit notification and meeting letter — not preceded by a review**

We recommend that you take this opportunity to review your records. If you find that you have made an error or omission, please advise <Officer's Name> of the details in writing at the meeting on <date >. You will need to provide sufficient information for us to work out the shortfall amount. If you do this, any penalty that would otherwise apply to the shortfall amount disclosed may be reduced by 80%.

If you identify an error after this date, we also encourage you to disclose that issue as soon as possible. You may still receive a 20% reduction in penalties where you make a voluntary disclosure after that date if it saves us significant time and resources.

### **Audit notification letter — escalated from review**

You have an opportunity to review your records to identify any errors or omissions you made. If you notify us of these errors or omissions with enough information for us to determine the shortfall amount, any penalties that apply may be reduced by 20%. The reduction is dependent on saving the ATO significant time and resources. This is more likely if a voluntary disclosure is made early in the audit.

If you identify errors or omissions for issues or periods outside of the audit as described to you, you also may make a voluntary disclosure. If we can determine the shortfall amount from the information provided, the penalty, if any, will be reduced by 80%.

### **Review letter**

You have an opportunity to review your records to identify any errors or omissions you have made. If you make a voluntary disclosure while the risk review is ongoing any penalties that apply would be reduced by 80%. To make a voluntary disclosure you need to provide us with sufficient information to determine a shortfall amount.

## APPENDIX 13—RAISING PENALTIES AND RELATED RECORDING, REPORTING AND DATA

### RAISING PENALTIES

A13.1 The application of some penalties is straight forward and may require little ATO enquiry. For example, where a taxpayer fails to lodge a required document on time, certain penalties would apply.

A13.2 In other instances, such as penalties relating to taxpayer statements, the ATO has to make inquiries to determine whether the imposition of penalties is appropriate and if so determine any mitigating circumstances which should reduce its quantum.

### Recording and reporting penalties raised

A13.3 The ATO expects its officers to record the information obtained and used in making penalty decisions on the ATO's case and work management systems. The ATO system used to record this information depends on the type, stage of activity, complexity and the ATO business line in which that work is carried out.

A13.4 Information that quantifies the liabilities resulting from penalties (financial information) is also recorded on the ATO's various 'Client Account' systems, such as Integrated Core Processing (ICP), ATO Integrated System (AIS), Instalment Processing System (IPS) and Corporate Penalty Systems (CPS). In particular, the AIS and the ICP systems are the ATO's accounting systems that determine taxpayers' integrated liabilities from a range of different ATO systems and automatically post the amounts to taxpayers' running balance accounts (RBA).

A13.5 Table 14 below shows the various ATO systems used to record and report such information.

**Table 14: 2012–13 ATO systems for penalty recording and reporting**

ATO activity	Type of information recorded	Recording and reporting system
Active Compliance	Case Management	Siebel Case Management
		Siebel Work Management
		Automated Work Allocation (AWA)
		WinCas
		Receivables Management System (RMS)
	Financials	Siebel Case Management
		Client Accounts

Source: Australian Taxation Office.

A13.6 The Siebel Case Management system is used in all ATO business lines for audits which are more complex and less routine and records case-related information, including, the relevant facts obtained during the audit and reasons for decisions.

Various types of information are manually input to the system at the end of audits, including the type and amount of penalties imposed and the reasons for any increases or decreases in rates as well as any amounts remitted. Some cases may involve multiple penalty decisions. This system records different types of false or misleading statement penalties imposed for each year, however, any increases, decreases or remissions to any of these penalties are consolidated.

A13.7 The Siebel Work Management system is used for routine, simple and high volume types of work, such as the MEI business line's pre-issue reviews of income tax refunds and other forms of letter-based audits. In relation to penalty decisions, only the total amount of penalties imposed are manually input to the system at the end of an audit. As a result, the ATO is unable to determine the type of penalty that was imposed and the reasons for the imposition from recorded data.

A13.8 The Automated Work Allocation (AWA) system is used by the ATO's Indirect Tax (ITX) business line in undertaking Business Activity Statement (BAS) audits. Once a decision has been made in these cases to impose a penalty, the ITX Penalties and Interest Practice Team inputs the penalty amount and type into the ATO's CPS. However, other information about penalties is not recorded. The AWA system is simply used to manage internal referrals of cases.

A13.9 Once an audit is finalised and a penalty raised, the Client Account Services business line inputs penalty amounts into the ATO's ICP system,<sup>341</sup> unless the penalty relates to a BAS in which case, the ITX Penalties and Interest Practice Team inputs the relevant amounts into the AIS via the CPS.

A13.10 To address the risk that the amounts recorded in the Siebel Case Management system may not reconcile with the amounts recorded in AIS and ICP, the ATO expects its officers to view taxpayers' Notices of Assessment before closing audit cases in the Siebel Case Management system so that any discrepancies can be rectified.

A13.11 For internal reporting purposes, information from the case and work management systems is gathered by the Active Compliance Governance Team and compiled for inclusion in monthly reports to the Compliance Executive.

A13.12 Data recorded in the AIS and ICP systems are used to publicly report financial details of penalties raised.

### **Amount of penalties raised**

A13.13 According to the Commissioner of Taxation's 2011–12 Annual Report, the ATO undertook 6,918,304 active compliance activities, raised approximately \$8.9 billion in tax and applied approximately \$2.4 billion in penalties and interest. According to the ATO's internally generated reports, of this \$2.4 billion, approximately \$1.4 billion (or 58.33%) relates to penalties. It should be noted that the

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<sup>341</sup> Some MEI staff may also key the amounts into the ICP system.

penalty figures are aggregates and 'net' of any remission and do not include any subsequent penalty adjustments due to internal or external review.<sup>342</sup>

A13.14 The ATO has advised that care should be exercised when examining such annually aggregated figures as a small number of cases involving large amounts may take a number of years to resolve and therefore cause distortions.

A13.15 Table 15 below provides primary tax, interest and penalties raised over the last two financial years. As the ATO's Annual Reports do not break up penalties and interest, the table also includes data from internal reports. Similar to the Annual Report, this data does not reflect any remission or subsequent adjustments due to internal or external review.

**Table 15: Number of active compliance activities and amounts of primary tax liabilities, penalties and interest raised from 1 July 2010 to 30 June 2013**

Financial year	Total active compliance activities <sup>^</sup>	Number of activities with a liability impact <sup>^^</sup>	Total tax liabilities (\$m) <sup>^</sup>	Primary tax liabilities (\$m) <sup>^</sup>	Penalties (\$m) <sup>^^^</sup>	Interest (\$m) <sup>^^^</sup>
2010-11	7,972,504	973,085	11,326	9,011	1,313	1,001
2011-12	6,918,304	906,475	11,300	8,900	1,449	979
2012-13	6,200,000	Not available	12,176	9,353	1,490	1,333
<b>Total</b>	<b>21,090,808</b>	<b>1,879,560</b>	<b>34,802</b>	<b>27,264</b>	<b>4,252</b>	<b>3,313</b>

Note: There is a discrepancy of \$27m (1 per cent difference) of the penalty and interest figures for the 2011-12 year between the Commissioner of Taxation's Annual Report and the ATO's internal reports.

(<sup>^</sup>) Source: Commissioner of Taxation Annual Report.

(<sup>^^</sup>) Source: ATO's internal Business lines penalty and interest break up report.

(<sup>^^^</sup>) Source: ATO's internal Penalty and Interest break up report.

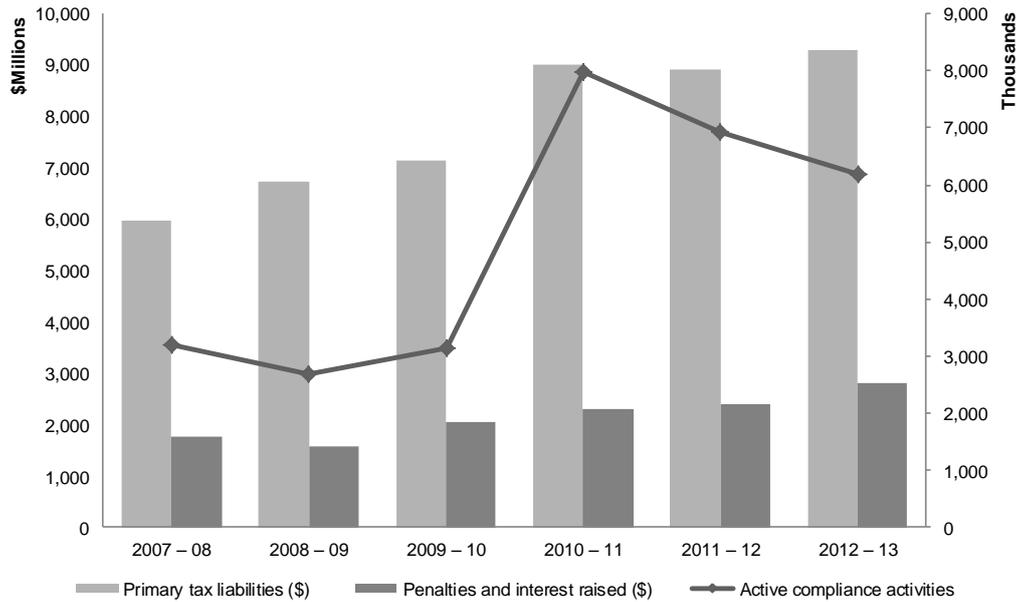
A13.16 The data in Table 15 above shows:

- those compliance activities which resulted in average adjustments of \$12,037 in total liabilities – comprising \$9,529 in primary tax, \$1,469 in penalties and \$1,053 in interest;
- the total amount of penalties comprises approximately 12 per cent of the total tax liabilities raised over the last two years; and
- the ratio of total penalties to total primary tax liabilities is 3:20, or 15 per cent.

A13.17 Figure 8 below visually represents the number of compliance activities and amount of primary tax liabilities, penalties and interest raised over the last six years.

342 Australian Taxation Office, 'Compliance Penalties and Interest Forum minutes' (29 June 2012), internal ATO document, p 4.

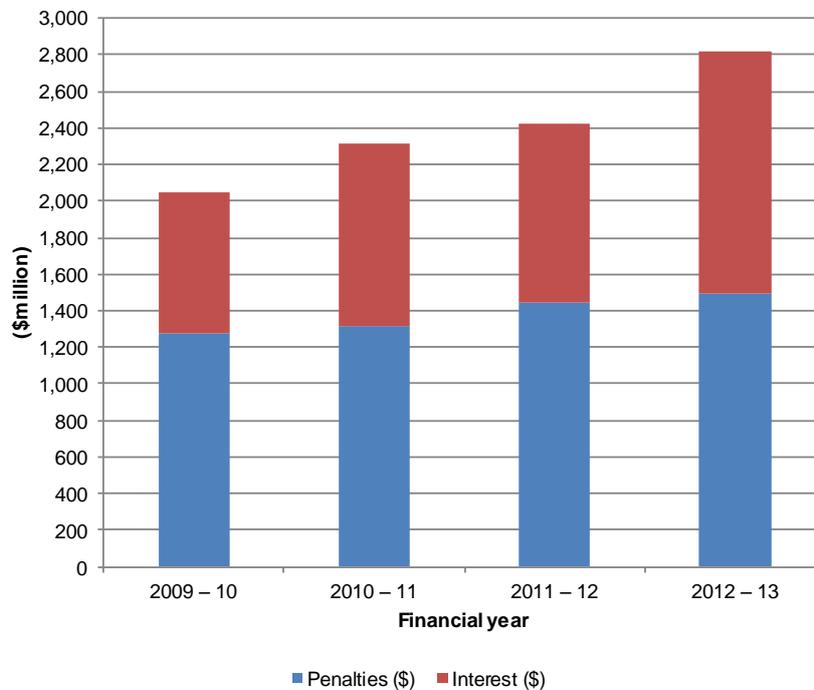
**Figure 8: Number of active compliance activities and amount of primary tax liabilities, penalties and interest raised from 1 July 2007 to 30 June 2013**



Source: Commissioner of Taxation Annual Reports.

A13.18 Figure 9 below disaggregates the above penalty and interest amounts and shows that the amounts of both penalties and interest raised have steadily increased over the last three financial years.

**Figure 9: Amount of penalties and interest raised from 1 July 2009 to 30 June 2013**



Source: Australian Taxation Office.

A13.19 The aggregated penalty and interest amounts shown in Figure 9 above may also be disaggregated into the following sub-groups, being:

- ATO business line;
- market segment;
- revenue product; and
- to a limited extent, penalty type.

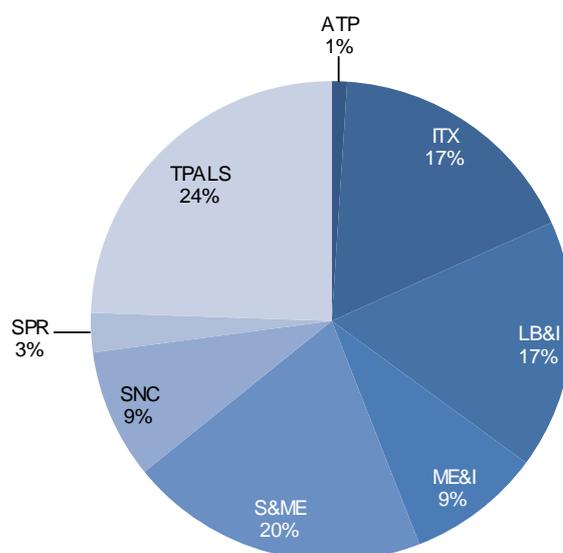
A13.20 Each sub-group is discussed separately below in the sections that follow.

### Total penalties raised by ATO business line

A13.21 Each ATO business line has its own compliance focus, which may involve different types of compliance activities and different types of penalties.

A13.22 Figure 10 below shows the proportion of total penalties each business line has raised from the 2010–11 financial year to YTD (October 2012).

**Figure 10: Total penalties raised by ATO business lines from 1 July 2010 to October 2012**



Source: Australian Taxation Office.

A13.23 The LBI, SME, ITX and TPALS business lines generally raise the greater amounts of penalties. The LBI and SME business lines deal with taxpayers with larger turnovers and the ITX business line deals with the indirect taxes of all Australian businesses. The TPALS business line deals with lodgement obligations amongst others.

A13.24 The MEI business line also raises a significant amount of tax liabilities. A significant proportion of its compliance activities are data matching in which penalties are not routinely applied.

A13.25 Table 16 below shows the amounts of penalties raised and the ratio of penalties to total liabilities by ATO business line from 2010–11 to YTD (October 2012).

**Table 16: Total tax liabilities and penalties raised from 1 July 2010 to October 2012**

2010-11	TOTAL	ATP	ITX	LB&I	ME&I	S&ME	SNC	SPR	TPALS
Penalties raised \$m	1,296	14	205	209	92	276	98	28	372
Tax Liabilities raised \$m	8,725	24	2,053	1,182	1,346	865	175	341	2,635
Total Liabilities raised \$m	11,014	47	2,266	1,814	1,535	1,447	374	417	3,009
Ratio of Penalties to Total Liabilities	12%	30%	9%	12%	6%	19%	26%	7%	12%
2011-12	TOTAL	ATP	ITX	LB&I	ME&I	S&ME	SNC	SPR	TPALS
Penalties raised \$m	1,442	18	263	290	140	250	135	36	307
Tax Liabilities raised \$m	9,173	10	1,723	1,264	1,760	1115	193	585	2,441
Total Liabilities raised \$m	11,594	29	1,997	1,957	2,067	1,631	416	665	2,749
Ratio of Penalties to Total Liabilities	12%	60%	13%	15%	7%	15%	32%	5%	11%
Year to Date October 2012	TOTAL	ATP	ITX	LB&I	ME&I	S&ME	SNC	SPR	TPALS
Penalties raised \$m	403	0	73	28	50	104	41	19	88
Tax Liabilities raised \$m	2,561	2	384	260	445	460	91	171	750
Total Liabilities raised \$m	3,185	2	457	333	531	653	172	199	838
Ratio of Penalties to Total Liabilities	13%	6%	16%	8%	9%	16%	24%	10%	11%

Note: Penalties raised include those for false or misleading statements, failure to lodge and promoter penalties. Interest is included in Total tax liabilities.

Source: Australian Taxation Office.<sup>343</sup>

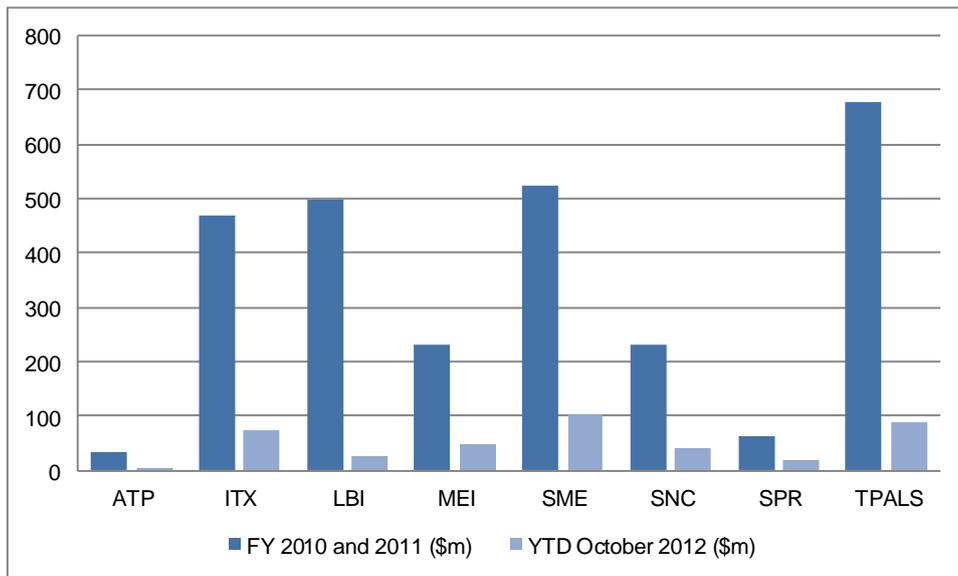
A13.26 The penalties data in Table 16 is also visually presented in Figure 11 and Figure 12 below.

A13.27 Figure 11 shows the penalties raised by business lines and Figure 12 shows the percentage of total penalties that form part of the total tax liabilities.

A13.28 Figure 12 shows that of the total tax liabilities raised, the ATP and SNC business lines have raised the greatest proportions of penalties (42 per cent and 29 per cent respectively). Conversely, of the total tax liabilities raised, the lowest proportions of penalties were raised by the MEI and SPR business lines (6 per cent for both). This information is reflective of the fact that the ATP and SNC business lines would be expected to deal with higher levels of taxpayer culpability.

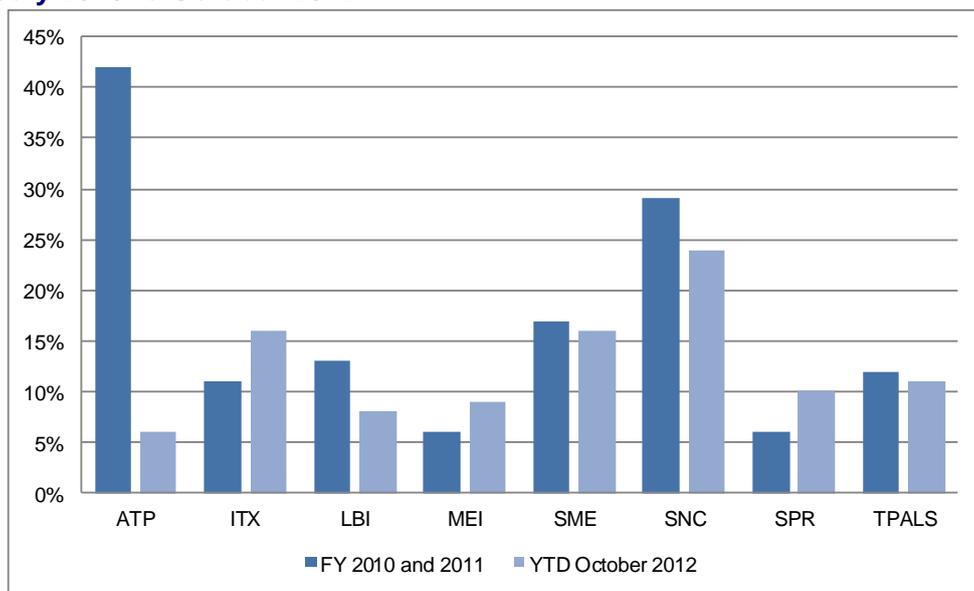
343 Australian Taxation Office, 'Active Compliance: Rates of Penalties Imposed' (21 December 2012), internal ATO document.

**Figure 11: Total penalties raised by business lines from 1 July 2010 to October 2012**



Source: Australian Taxation Office.

**Figure 12: Percentage of total penalties forming part of total tax liabilities from 1 July 2010 to October 2012**



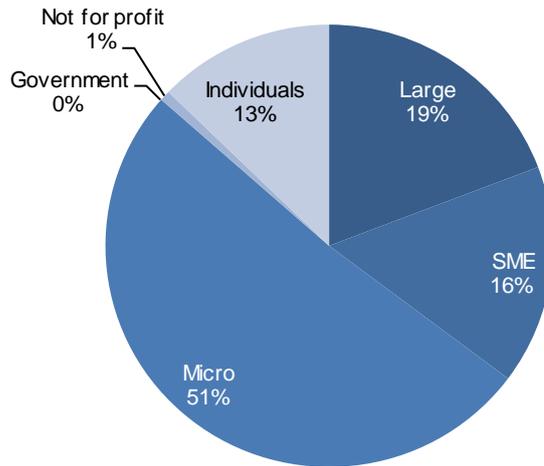
Source: Australian Taxation Office.

### Total penalties raised by market segment

A13.29 Each taxpayer market segment may involve tax compliance issues that are particular to that segment and, therefore, may attract different types of penalties. The ATO has advised that its figures on market segments will be different to the figures on business lines since business line figures do not always relate to a particular market segment—for example, the ITX business line deals with taxpayers across the micro, SME and large business market segments.

A13.30 Figure 13 below shows the proportion of penalties raised by market segment for both the 2010–11 and 2011–12 financial years combined. This figure shows that the micro market segment constituted the largest proportion of total penalties raised, accounting for just over half of total penalties raised over these two years. The remaining penalties raised can be attributed in similar proportions to the individuals, large and SME market segments.

**Figure 13: Total penalties raised from 1 July 2010 to 30 June 2012 by market segment**



Source: Australian Taxation Office.<sup>344</sup>

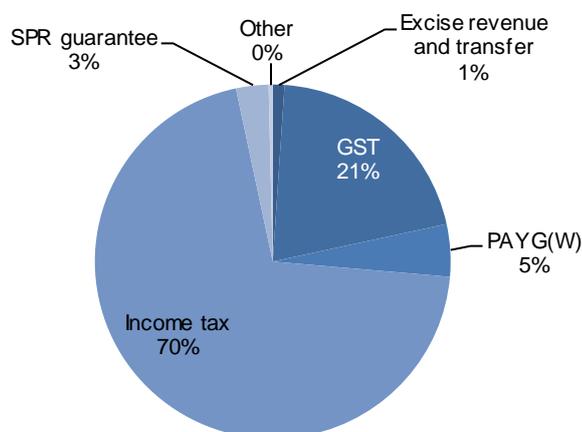
### Total penalties raised by ATO revenue product

A13.31 ‘Revenue products’ is an ATO reference to the various types of taxes or tax and superannuation obligations and include income tax, Pay-As-You-Go withholding (PAYG(W)) and Superannuation Guarantee (SG).

A13.32 Figure 14 that follows shows the proportion of total penalties raised by revenue product for the 2010–11 and 2011–12 financial years. The figure demonstrates that income tax accounts for the largest amounts of penalties raised and, together with GST, comprise approximately 91 per cent of total penalties raised.

344 Above n.150.

**Figure 14: Total penalties raised from 1 July 2010 to 30 June 2012 by ATO revenue product**



Source: Australian Taxation Office.<sup>345</sup>

### Total penalties raised by penalty type

A13.33 The total penalties raised can be disaggregated by penalty type. Having a greater understanding of the proportion and amount of each type of penalty imposed provides some insight into the nature of underlying taxpayer non-compliance.

A13.34 The ATO does not currently have corporate reporting on the types of penalties imposed in compliance activities as some of their systems do not record this information.<sup>346</sup> As a result, it is difficult to establish the types of penalties that are imposed most often and the amounts of different types of penalties raised. However, incomplete data on penalty types and numbers was obtained from the ICP system. Due to the incompleteness of the information, however, caution should be exercised in drawing conclusions.

A13.35 Table 17 below presents the ICP data on the penalty amounts and numbers raised during audits by penalty type. This table shows that the greatest proportion of penalties raised by value were for making a false or misleading statement and for taking a position that was not reasonably arguable and the most frequently imposed penalty was that for failing to lodge on time.

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<sup>345</sup> Ibid.

<sup>346</sup> Ibid, p4.

**Table 17: ATO's ICP system data on penalties raised by penalty type from 1 July 2011 to 30 April 2012**

Penalty type	Amount (\$)	Number
<b>Failure to lodge penalties</b>		
Penalty for failure to lodge on time - large	200,115	95
Penalty for failure to lodge on time - medium	4,244,920	3,995
Penalty for failure to lodge on time - small	74,768,165	134,317
<b>False or misleading statement penalties</b>		
Shortfall penalty relating to a failure to take reasonable care	170,609,160	42,896
Shortfall penalty relating to recklessness	86,278,182	3,835
Shortfall penalty relating to an intentional disregard of a taxation law	129,630,143	886
Shortfall penalty – other	18,828,833	137
<b>No reasonably arguable position penalties</b>		
Shortfall penalty relating to a position that is not reasonably arguable	68,135,939	235
<b>Scheme penalties</b>		
Shortfall penalty relating to a scheme shortfall	83,685,260	73
Shortfall penalty where a reasonably arguable scheme adjustment provision does not apply	965,687	3
Shortfall penalty where a reasonably arguable scheme transfer pricing adjustment does not apply	6376	5
<b>Failure to provide a document penalties</b>		
Penalty for failure to provide a document as required	107,451,050	2,790
<b>Other penalties</b>		
Penalty for failure to give a compulsory release authority	244,200	111
Penalty for failure to give a statement of a released excess contributions liability	550	1
Penalty for failure to release excess contributions	6600	3
<b>Total</b>	<b>745,055,180</b>	<b>189,382</b>

Source: Australian Taxation Office.<sup>347</sup>

## UNSUSTAINED PENALTIES

A13.36 Once raised, a penalty may also be reduced or become 'unsustained' through the following means:

- automatic remission of a penalty, which may occur at the same time as making a penalty decision, but before the taxpayer is notified of the potential liability to the penalty;
- internal review of an ATO officer's penalty decision, which may be made by an independent ATO officer at the request of taxpayers in certain circumstances;

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<sup>347</sup> Ibid.

- objection to a penalty decision, which is a form of internal review of ATO assessments provided by the tax laws;
- appeal to the AAT or Federal Court in relation to disallowed objection decisions, which are forms of external review provided by the tax laws;
- settlement between the taxpayer and the ATO in relation to the penalty amounts; and
- as an automatic consequence of the liability to primary taxes being reduced – for example, where certain penalties are calculated as a percentage of tax liability shortfall amounts, the penalty amount will reduce in proportion to the adjusted primary tax amount even though the basis for the penalty itself is not challenged.

### Recording and reporting unsustainable penalties

A13.37 The ATO records and reports on the penalties reduced as a result of internal and external review, as well as an automatic consequence of the liability to primary taxes being reduced.

A13.38 The various recording and reporting systems used by the ATO throughout review activities are listed in Table 18 below. Descriptions of these systems are outlined earlier in this Appendix under the 'Recording and reporting penalties raised' section.

**Table 18: ATO systems for recording and reporting on reviewed penalties**

ATO activity	Type of information recorded	Recording and reporting system
Internal and external review	Case Management	Siebel Work Management
		Siebel Case Management
	Financials	Client Accounts
		Siebel Case Management

Source: Australian Taxation Office.

A13.39 The ATO only recently started recording all the objection, settlement and litigation activities on Siebel Work or Case Management (settlements from 1 July 2011 and objections and litigation from 1 July 2012). Information on penalties during these activities is collected in templates that ATO officers are required to complete at the activity's conclusion. However, not all of these templates require ATO officers to provide information on penalties. For example, objection work recorded on the Siebel Work Management system does not require ATO officers to input information on penalties at the conclusion of an objection.

A13.40 Each Compliance Group business line of the ATO generates specific reports, many of which contain various levels of details on penalties. However, the ATO does not have a centralised process for extracting data and generating reports that provide the treatment of penalties over the life of a given case.

A13.41 Furthermore, the penalty information from these case and work management systems is not used in the Commissioner's Annual Reports. The ATO has advised the IGT that as there is an obligation to report debts raised for financial accounting purposes, the penalty figures are sourced from the ATO's accounting systems, ICP and AIS.<sup>348</sup>

A13.42 Since 1 July 2012, however, the ATO has adopted a new reporting tool known as the 'Objections Cube'. This tool extracts the reasons for all objection decisions that are recorded in Siebel Case Management and compiles relevant reports. These reports are expected to provide a clearer understanding of why audit decisions become unsustainable, amongst other outcomes.

A13.43 There are limitations to the Objections Cube data as the system cannot distinguish whether the reason for the objection outcome relates to the primary tax or the penalty matter. Furthermore, there is no validation of the data, which is currently input manually, and the data may also be subject to change due to cases being re-opened.

A13.44 The reports generated by the Objections Cube are ultimately reviewed by the senior executives responsible for the Objections Reference Group, as mentioned in Chapter 1.

### **Level of unsustainable penalty decisions**

A13.45 To reconcile unsustainable penalty decisions with the initial penalty decisions, each taxpayer's case needs to be tracked from the initial penalty decision through all the stages of review. However, the inherent limitations with the ATO's recording and reporting systems prevent such identification, namely the inconsistent types of information collected when a penalty decision is dealt with in different areas of the ATO.

A13.46 An estimate of the level of unsustainable penalties can be ascertained by collating the reports that aggregate the information produced at each stage of a dispute resolution process. Although these figures cannot be reconciled on an individual case-by-case basis, an indicative comparison on an aggregated basis may be made, albeit with an inherent time lag between penalties raised in audits and reversals made on review.

A13.47 Table 19 below collates the various aggregated ATO reporting data produced for the last three financial years at each stage of a dispute resolution process, namely, the objection, settlement and litigation stages. There are a number of qualifications, however, that need to be taken into account in relation to this data being that it:

- only includes disputed cases in which penalties were raised;
- includes duplication of settlements data, due to different reports containing the same information;

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<sup>348</sup> Australian Taxation Office communication to the Inspector-General of Taxation, 20 February 2013.

- does not include approximately 15,000 objection cases in the MEI business line, due to the relevant system, Siebel Work Management, not recording penalty information on those cases; and
- does not include data on objections before 1 July 2012.

**Table 19: Percentage of primary tax liabilities and penalties reduced on review, by financial year**

Financial year	Total primary tax liability imposed	Total penalties imposed	Total primary tax liabilities reviewed	Total primary tax liabilities reduced	% of reviewed primary tax liabilities reduced on review	% of total primary tax liabilities reduced on review	Total penalties reviewed	Total penalties reduced	% of reviewed penalties reduced on review	% of total penalties reduced on review
2010-11	9,011,000,000	1,314,342,496	2,199,057,866	1,169,861,012	53	13	856,941,078	406,495,128	47	31
2011-12	8,900,000,000	1,449,405,023	1,598,218,370	728,432,820	46	8	645,841,034	374,953,248	58	26
2012-13	9,353,000,000	1,490,000,000	3,047,146,700	951,282,337	31	10	1,376,998,905	688,607,950	50	46

Source: Australian Taxation Office.

A13.48 Table 19 shows that for the 2010–11, 2011–12 and 2012–13 financial years, the ATO reduced approximately:

- 53 per cent of primary tax liabilities and 47 per cent of penalties for cases reviewed in the 2010–11 financial year;
- 46 per cent of primary tax liabilities and 58 per cent of penalties for cases reviewed in the 2011–2012 financial year; and
- 31 per cent of primary tax liabilities and 50 per cent of penalties for cases reviewed in the 2012–2013 financial year.

A13.49 As noted, caution needs to be exercised in interpreting the data. At this level of aggregation, the percentage outcomes for penalty decisions themselves may have various underlying drivers. As mentioned earlier, where the primary tax liability is reduced, penalties that are calculated as a percentage of shortfall amounts are reduced proportionally. This reason could explain the similar percentage of penalties allowed in cases reviewed by the ATO. It may also be the case that there is a range of interactions within the data that are not obvious without improvements to the data quality.

A13.50 Table 19 shows a significant percentage of the total penalties raised are reduced on review – 31 per cent in 2010–11, 26 per cent in 2011–12 and 46 per cent in 2012–13. As this table includes all penalties raised but not all penalty amounts reduced, this percentage may be higher. Aggregating amounts over a five year or longer period would also help to reduce the effect that any cases involving large amounts may have.

A13.51 Table 19 also shows a significant difference between the primary tax liabilities and penalties reduced when viewed as a percentage of total primary tax liabilities and penalties raised.

A13.52 The following tables provide further detail by disaggregating the data in Table 19 into the specific stages of a review activity, namely the objection, settlement and litigation stages. These tables also quantify the difference between the percentages of penalties reduced with that of primary tax reduced.

**Table 20: Percentage of primary tax and penalty allowed after objections, by financial year**

Financial year	Primary Tax			Penalty			Difference in %
	Original primary tax for objection cases	Primary tax allowed at objection	%	Original penalty for objection cases	Penalty allowed at objection	%	
2010-11	775,226,850	204,135,641	26	333,685,725	158,536,712	48	21
2011-12	775,226,850	204,135,641	26	333,685,725	158,536,712	48	21
2012-13	1,362,702,664	331,480,767	24	811,648,884	279,218,788	34	10

Source: Australian Taxation Office.<sup>349</sup>

**Table 21: Percentage of primary tax and penalty allowed after settlement, by financial year**

Financial year	Primary Tax			Penalty			Difference in %
	Original primary tax for settlement cases	Primary tax allowed at settlement	%	Original penalty for settlement cases	Penalty allowed at settlement	%	
2010-11	777,867,023	251,973,604	32	201,498,549	161,131,436	80	48
2011-12	301,446,322	93,330,496	31	131,112,091	85,021,806	65	34
2012-13	1,328,406,546	496,000,323	37	355,854,353	318,947,128	90	52

Source: Australian Taxation Office.

**Table 22: Percentage of primary tax and penalty allowed after litigation, by financial year**

Financial year	Primary Tax			Penalty			Difference in %
	Original primary tax for litigation cases	Primary tax allowed at litigation	%	Original penalty for litigation cases	Penalty allowed at litigation	%	
2010-11	1,421,190,843	917,887,408	65	655,442,529	245,363,692	37	-27
2011-12	521,545,199	430,966,683	83	181,043,217	131,394,730	73	-10
2012-13	356,037,490	123,801,247	35	209,495,668	90,442,035	43	-8

Source: Australian Taxation Office.

A13.53 The above tables indicate that for the 2010-11, 2011-12 and 2012-13 financial years in objections and settlements, the amount of penalties reduced were greater than the amount of primary tax liabilities reduced.

<sup>349</sup> The ATO has advised that in 2010-11 the objection figures are unavailable and the 2011-12 figures have been used as an estimate for the figures in 2010-11. It is possible that a lower or higher percentage from 2012-13 could apply. Care needs to be taken when using these figures to examine trends.

A13.54 The sections that follow provide further detail on the level of unsustainable penalties at various stages of review activity, namely, objection, settlement and appeal.

## Objections

A13.55 Where a taxpayer is dissatisfied with an assessment, including a penalty decision, they may lodge an objection against it.<sup>350</sup> Objections can relate to tax adjustments, tax adjustments and penalties, or solely penalties.<sup>351</sup>

A13.56 According to the ATO's *Your case matters* publication, in the half year 1 July to 31 December 2012, around 350,000 review and audit activities were completed. Over 226,000 resulted in an amended assessment, giving rise to 16,500 objections (or 7.3%).<sup>352</sup>

### Total objections by number and variance

A13.57 Table 23 below sets out the total number of taxpayer objections, together with the primary tax liabilities and penalties originally raised, disputed and allowed at objection from 1 July 2012 to 30 June 2013 by ATO business line.

A13.58 It should be noted that the information in the following tables relate solely to the Siebel Case Management system. As mentioned above, this system is used for complex, less routine and lower volume work and therefore detailed financial information as well as other information of varying degrees of quality is collected – for example, reasons for objections and the financial outcomes of objections.

A13.59 On the other hand, the Siebel Work Management system, which is used solely for routine, simple and high volume type work does not record any financial information. According to the ATO, there are approximately 15,000 low value cases recorded in this system which have not been included in the tables that follow under this section of the report.

A13.60 Also, information prior to 1 July 2012 could not be provided by the ATO as no corporate reporting on objections existed on the Siebel Case Management system prior to this date.

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350 *Income Tax Assessment Act 1936*, s175A and Part IVC.

351 Australian Taxation Office, *Your case matters: Tax and superannuation litigation trends*, (3rd ed, 2013) p 6.

352 *Ibid.*

**Table 23: Total objections, from 1 July 2012 to 30 June 2013 by business line**

BSL	Number	Original primary tax liabilities raised (\$)	Primary tax liabilities allowed (\$)	Primary tax liabilities allowed (%)	Original penalties raised (\$)	Penalties allowed (\$)	Penalties allowed (%)	Difference between primary tax liabilities and penalties allowed (percentage points)
ATOP	2	36,207	510	100	29,863	-	0	-100
ATP	90	7,031,921	264,596	6	13,231,209	37,011	0	-6
CSC	7	5,710,636,245	7,969,670	1	2,520,517	2,520,517	100	99
ITX	2,192	293,346,091	57,816,261	23	119,808,255	28,166,042	24	1
LBI	112	14,786,532,317	313,750,574	10	95,002,920	51,424,080	54	44
MEI	1,243	197,579,857	21,851,880	12	108,670,376	12,528,773	11	-1
SME	341	758,148,897	100,800,076	30	119,745,681	15,515,473	13	-17
SPR	2,608	97,750,133	19,753,681	26	15,081,409	4,568,432	37	11
<b>Total</b>	<b>6,595</b>	<b>21,851,061,667</b>	<b>522,207,247</b>	<b>11</b>	<b>474,090,230</b>	<b>114,760,328</b>	<b>25</b>	<b>14</b>

Source: Australian Taxation Office.

A13.61 The difference between the percentage of primary tax liabilities allowed (primary tax variance) and percentage of penalties allowed (penalty variance) assists in determining the extent to which penalties are reduced as an automatic consequence of a reduction in primary tax liabilities. If the sole reason for penalties being reduced on objection was due to a reduction in the primary tax, these percentages would be the same and therefore the difference between these two figures would be zero.

A13.62 According to Table 23 above, and discounting those business lines dealing with small numbers of cases, a large proportion of penalties were reduced in the LBI business line (54%). This business line also recorded significant differences between the primary tax and penalty variances.

A13.63 A recent publication also mentions that an increased use of data matching and refund checking has resulted in a large increase in objections in recent years, with a proportion relating only to penalties and interest.<sup>353</sup>

### **Objection cases with penalty amounts by number and variance**

A13.64 In order to better determine the extent to which penalties are reduced due to unsustainable penalty decisions, Table 24 below removes from the total objection population those objection cases with no penalty amounts. The remaining population, therefore, comprises those objection cases with penalty amounts, although the penalty decision may or may not be the subject of dispute. The data in Table 24 shows that the majority of such objection cases arose from the ITX, SPR and MEI business lines.

353 Australian Taxation Office, *Your case matters 2012: Tax and superannuation litigation trends* (2nd ed, 2012) p 6.

A13.65 Table 24 also shows that, excluding those business lines that only deal with small numbers of cases, a significant amount of penalties was reduced at objection in the LBI (54%), SPR (30%), ITX (24%) and SME (13%) business lines.

A13.66 These business lines also recorded significant differences between the primary tax and penalty variances. Excluding those business lines that only deal with small numbers of cases, the following business lines show a significant difference between the primary tax and penalty reduced, namely LBI (26%), SPR (12%), ITX (6%) and SME (6%).

**Table 24: Objection cases with penalty amounts, from 1 July 2012 to 31 March 2013 by business line**

BSL	Number	Original primary tax liabilities raised	Primary tax liabilities allowed	% of primary tax liabilities allowed	Original penalties raised	Penalties allowed	% of penalties allowed	Difference between primary tax liabilities and penalties allowed (percentage points)
ATOP	1	33,181	0	0	29,863	0	0	0
ATP	32	3,328,548	134,892	4	13,231,209	37,011	0	-4
CS&C	2	0	0	-	2,520,517	2,520,517	100	100
ITX	986	209,757,384	37,311,805	18	119,808,255	28,166,042	24	6
LBI	10	177,397,900	49,465,861	28	95,002,920	51,424,080	54	26
MEI	341	158,368,706	16,293,715	10	108,670,376	12,528,773	12	1
SME	119	269,130,565	18,595,353	7	119,745,681	15,515,473	13	6
SPR	647	47,016,570	8,408,017	18	15,081,409	4,568,433	30	12
Total	2,138	865,032,855	130,209,642	15	474,090,230	114,760,328	24	9

Source: Australian Taxation Office.

### Penalty-only objections by number and variance

A13.67 In order to better understand the extent of penalty variance arising from unsustainable penalty decisions, those objection decisions in which primary tax was disputed need to be extracted. Table 25 below extracts from the Table 24 data above, those objections where only the penalty decision was in dispute – penalty-only objections (being 407 of the 6595 objection cases set out in Table 23).

A13.68 Table 25 shows that the majority of penalty-only objections arose from the ITX (42.26% of total objections), SPR (36.61%) and MEI (12.53%) business lines.

A13.69 However, in terms of the amount of penalty disputed in these penalty-only objection cases, most of this amount arose from the SME (56.32%), LBI (20.14%) and ITX (15.23%) business lines. Whilst there was only one case that was objected to in the LBI business line, the amount involved was comparatively large.

A13.70 Table 25 also indicates that whilst ITX, SPR and MEI business line penalty decisions may be subject to the largest number of penalty-only objection cases, by

value the largest proportion of penalty-only objections arose from the SME, LBI and ITX business lines.

A13.71 Furthermore, Table 25 shows that in a number of business lines a significant amount of penalties was reduced at objection, namely the CS&C (100%), LBI (100%), ITX (43.15%), SPR (36.93%) and SME (20.01%) business lines. However, in the CS&C and LBI business lines, only one objection was made where the penalty was the only issue in dispute.

**Table 25: Penalty-only objections from 1 July 2012 to 31 March 2013 by business line**

BSL	Number	% of total number	Original penalty raised (\$)	Penalty disputed (\$)	% of total penalty disputed	Penalty allowed (\$)	% of disputed penalty allowed
ATOP	1	0.25	29,863.00	29,863.00	0.05	-	0
ATP	10	2.46	55,140.95	55,140.95	0.09	639	1.16
CS&C	1	0.25	1,847,641.00	1,847,641.00	2.91	1,847,641	100
ITX	172	42.26	9,735,820.53	9,665,909.43	15.23	4,171,111	43.15
LBI	1	0.25	12,777,892.00	12,777,892.00	20.14	12,777,892	100
MEI	51	12.53	1,302,605.54	1,303,839.92	2.05	100,157	7.68
SME	22	5.41	35,720,993.39	35,735,993.47	56.32	7,150,967	20.01
SPR	149	36.61	2,063,532.37	2,032,283.50	3.2	750,549	36.93
Total	407	100	63,533,488.78	63,448,563.27	100	26,798,955	42.24

Source: Australian Taxation Office.

### Penalty-only objections by outcome

A13.72 Table 26 below shows that a large proportion of penalty-only objections are either allowed in full (20.88%) or allowed in part (25.55%). Together, these figures represent a total of 46.43 per cent of the total number of penalty-only objections for the 1 July 2012 to 31 March 2013 period. The data also identified that 39.56 per cent of penalty-only objections were disallowed. A number of other reasons were provided for the remaining 14.01 per cent of these objections.

**Table 26: Outcomes for penalty-only objections, from 1 July 2012 to 31 March 2013 by business line**

Final outcome	ATOP	ATP	CSC	ITX	LBI	MEI	SME	SPR	Total	%
Allowed in full			1	45	1	6	8	24	85	20.88
Allowed in part		1		39		18	3	43	104	25.55
Commissioner's discretion exercised						2	1		3	0.74
Commissioner's discretion part exercised				1				1	2	0.49
Disallowed	1	8		72		24	7	49	161	39.56
Invalid				8		1	1	21	31	7.62
Withdrawn - settled							2		2	0.49
Withdrawn - taxpayer		1		7				10	18	4.42
Unknown								1	1	0.25
Total	1	10	1	172	1	51	22	149	407	100

Source: Australian Taxation Office.

## Settlements

A13.73 A settlement can occur at any time in the compliance verification and dispute resolution cycle. If a settlement is concluded, ATO officers are required to record the basis for, and the financial outcomes of the settlement. The ATO has advised that an unquantifiable number of settlements in the data below have also been included in the objections and appeals data.<sup>354</sup>

A13.74 Tables 27, 28 and 29 below show the amount of pre-settlement penalties (that is, the ATO's position on commencement of settlement negotiations) and the amount of penalties imposed post settlement for three separate financial years. Tables 27, 28 and 29 exclude cases that did not consider penalties.

A13.75 Tables 27, 28 and 29 indicate that for the 2010–11, 2011–12 and 2012–13 financial years, there was a high proportion of penalty variance in settlements across all business lines. These tables also show a marked difference between the penalty variance and primary tax variance. The percentage of this difference may be different to that set out in the tables as the ATO has not included in these settlement figures the monetary impact of any agreement not to claim carried forward losses, interest on overpayment and interest charge deductions.

A13.76 In the 2012–13 financial year, pre-settlement penalties were reduced by 83 per cent on average compared with an average pre-settlement primary tax reduction of 36 per cent. In the 2011–12 financial year, on average, pre-settlement penalties were reduced by 65 per cent in settlement and pre-settlement primary tax liabilities were reduced by 31 per cent – a difference of 34 percentage points. In the 2010–11 financial year, the level of pre-settlement primary tax liabilities that was reduced was similar to the 2011–12 financial year, at 32 per cent. However, in that year, the level of pre-settlement penalties was reduced by 80 per cent – a difference of 48 percentage points. The ATP, LBI and SME business lines have also maintained large differences in the penalty and primary tax variance across the three financial years.

**Table 27: Total amount of pre and post settlement primary tax and penalties, from 1 July 2012 to 30 June 2013 by business line**

BSL	Number	Pre-settlement primary tax	Primary tax allowed	%	Pre-settlement penalty	Penalty allowed	%	Difference in %
ATP	6	362,424	-	0	181,212	144,970	80	80
ITX	12	4,389,551	3,146,598	72	5,766,685	4,746,410	82	11
L&P	61	29,399,589	13,855,282	47	20,180,830	19,005,569	94	47
LBI	10	1,111,009,279	344,816,562	31	286,344,668	229,998,630	80	49
MEI	13	5,269,744	1,783,383	34	4,070,256	2,648,031	65	31
SME	100	330,637,715	165,617,121	50	97,039,418	87,811,086	90	40
SNC	9	10,437,052	3,094,378	30	6,769,277	4,682,509	69	40
SPR	2	86,883	-	0	51,444	51,444	100	100
<b>Total</b>	<b>213</b>	<b>1,491,592,238</b>	<b>532,313,324</b>	<b>36</b>	<b>420,403,791</b>	<b>349,088,650</b>	<b>83</b>	<b>47</b>

Source: Australian Taxation Office.

354 Australian Taxation Office communication to the Inspector-General of Taxation, 18 February 2014.

**Table 28: Total amount of pre and post settlement primary tax and penalties, from 1 July 2011 to 30 June 2012 by business line**

BSL	Number	Pre-settlement primary tax	Primary tax allowed	%	Pre-settlement penalties	Penalty allowed	%	Difference in %
ATP	43	2,987,365	43,539	1	1,325,485	808,278	61	60
ITX	8	4,584,051	1,123,178	25	4,911,906	2,058,273	42	17
LBI	3	61,828,045	19,817,601	32	18,993,947	12,060,723	63	31
MEI	26	8,150,661	2,523,393	31	5,362,212	4,178,797	78	47
SME	44	181,591,279	53,977,221	30	73,397,759	51,264,464	70	40
SNC	39	42,263,701	15,826,354	37	27,110,882	14,641,370	54	17
SPR	2	41,221	19,209	47	9,900	9,900	100	53
<b>Total</b>	<b>165</b>	<b>301,446,322</b>	<b>93,330,496</b>	<b>31</b>	<b>131,112,091</b>	<b>85,021,806</b>	<b>65</b>	<b>34</b>

Source: Australian Taxation Office.

**Table 29: Total amount of pre and post settlement primary tax and penalties, from 1 July 2010 to 30 June 2011 by business line**

BSL	Number	Pre-settlement primary tax	Primary tax allowed	%	Pre-settlement penalty	Penalty allowed	%	Difference in %
ATP	119	13,473,113	347,733	3	6,514,774	4,623,409	71	68
EXC	1	924,114	924,114	-	231,028	231,028	100	-
GST	25	9,310,575	7,534,587	81	2,529,275	1,852,220	73	-8
LBI	10	663,105,297	217,790,980	33	163,025,858	134,855,736	83	50
MEI	19	15,507,124	7,691,253	50	3,190,426	1,820,045	57	7
SME	20	44,079,488	7,825,335	18	13,184,642	8,892,546	67	50
SNC	17	31,467,313	9,859,603	31	12,822,546	8,856,452	69	38
<b>Total</b>	<b>211</b>	<b>777,867,023</b>	<b>251,973,604</b>	<b>32</b>	<b>201,498,549</b>	<b>161,131,436</b>	<b>80</b>	<b>48</b>

Source: Australian Taxation Office.

## Appeals

A13.77 Taxpayers may appeal objection decisions to the AAT and the Federal Court. The appeals may be concluded either by the Tribunal or Court hearing the case and handing down a decision, or, by agreement between the parties prior to this hearing. The ATO records the outcomes at both of these stages separately – ‘cases finalised at hearing’ and ‘cases finalised prior to hearing’, respectively.

A13.78 Table 30 below shows the total number of appeal cases finalised at hearing, the number of primary tax and penalty dispute cases and the amount of primary tax liabilities and penalties finalised by business lines from 1 July 2010 to 30 June 2013. Table 31 provides similar information but in relation to appeal cases that were finalised prior to hearing.

A13.79 Tables 30 and 31 show that a substantial proportion of penalties were reduced in a number of business lines within the ATO, both prior to hearing and at hearing. The business lines with the greatest proportion of penalty reductions were ATP (88% prior to hearing), MEI (44% prior to hearing) and SME (56% prior to hearing). These

business lines have also shown consistently large differences in the penalty and primary tax variance in both financial years.

**Table 30: Total amount of pre and post litigation primary tax liabilities and penalties from 1 July 2010 to 30 June 2013 by business line (cases finalised at hearing)**

BSL	Number	Original primary tax liabilities (\$)	Primary tax liabilities reduced (\$)	Primary tax liabilities reduced %	Original penalties raised (\$)	Penalties reduced (\$)	Penalties reduced %	Difference between primary tax liabilities and penalties reduced (percentage points)
ATP	17	24,846,351	8,562,948	34	8,812,882	1,420,768	16	-18
EXC	7	15,800,711	-	0	2,960,907	1,101	0	0
GST	40	39,695,609	4,279,566	11	14,834,315	663,506	4	-6
L&P	2	3,129,882	-	0	4,097,480	7,219	0	0
LB&I	28	1,503,014,195	1,205,436,127	80	607,106,408	278,313,976	46	-34
MEI	70	100,247,302	37,472,637	37	59,712,953	24,368,693	41	3
SME	23	29,515,651	9,431,726	32	21,267,267	7,157,245	34	2
SNC	5	14,623,689	12,306,944	84	6,632,512	4,507,843	68	-16
SPR	44	17,724,528	1,248,318	7	5,382,825	964,357	18	11
CSC	1	25,945	3,097	-12	-	4,786	-	-
ITX	9	471,410	49,850	11	191,467	15,155	8	-3
<b>Total</b>	<b>246</b>	<b>1,749,095,272</b>	<b>1,278,785,016</b>	<b>73</b>	<b>730,999,015</b>	<b>317,415,077</b>	<b>43</b>	<b>-30</b>

Source: Australian Taxation Office.

**Table 31: Total amount of pre and post litigation primary tax and penalties from 1 July 2010 to 30 June 2013 by business line (cases finalised prior to hearing)**

BSL	Number	Original primary tax liabilities (\$)	Primary tax liabilities reduced (\$)	Primary tax liabilities reduced %	Original penalties raised (\$)	Penalties reduced (\$)	Penalties reduced %	Difference between primary tax liabilities and penalties reduced (percentage points)
ATP	118	38,387,562	21,232,006	55	26,134,961	23,032,817	88	33
CS&C	5	1,077,686	256,614	24	431,074	218,402	51	27
EXC	9	3,974,135	3,575,501	90	644,142	524,752	81	-9
GST	167	83,134,624	13,655,552	16	47,807,914	14,168,305	30	13
ITX	6	121,218	91,393	75	648,090	126,054		
L&P	9	3,515,419	512,042	15	2,531,401	410,527	16	2
LB&I	14	100,928,129	47,567,933	47	30,425,386	12,496,027	41	-6
MEI	396	112,312,460	40,053,332	36	66,287,028	28,963,433	44	8
OCOM	2	521,845	360,194	69	68,297	52,132	76	7
SME	140	151,679,357	52,089,892	34	101,208,586	56,546,480	56	22
SNC	46	50,538,784	13,662,849	27	36,524,030	13,093,820	36	9
SPR	35	3,487,042	813,015	23	2,271,490	128,694	6	-18
<b>Total</b>	<b>947</b>	<b>549,678,259</b>	<b>193,870,323</b>	<b>35</b>	<b>314,982,399</b>	<b>149,761,443</b>	<b>48</b>	<b>12</b>

Source: Australian Taxation Office.

## Appeals by outcome

A13.80 Table 32 below shows the number of cases and the amount of penalties disputed and finally imposed at litigation, both before and after the matter was heard, by outcome. This table excludes cases that did not involve penalty amounts.

A13.81 Table 32 indicates that 29.17 per cent of appeal cases were either conceded or abandoned by the ATO or a decision was found, fully or partly, in favour of the taxpayer. Furthermore, penalties were reduced by an average of 70.18 per cent when it was settled and 34.88 per cent when the decision was part favourable to the ATO.

**Table 32: Number of appeal cases and amounts of penalty disputed and finalised from 1 July 2010 to 30 June 2013 by outcome**

Decision	Year	Number	Penalties disputed (\$)	% of Grand total	Penalties finally imposed (\$)	Penalty variance (%)
Conceded or abandoned by ATO	2010-11	28	4,343,383		1,531,093	35.25
	2011-12	59	8,124,035		34,959	0.43
	2012-13	87	21,724,408		70,539	0.32
	<b>Total</b>	<b>174</b>	<b>34,191,826</b>	<b>1.66</b>	<b>1,636,590</b>	<b>4.79</b>
Conceded or abandoned by taxpayer	2010-11	68	40,393,294		29,452,035	72.91
	2011-12	76	32,065,425		32,059,250	99.98
	2012-13	82	56,946,326		56,908,846	99.93
	<b>Total</b>	<b>226</b>	<b>129,405,044</b>	<b>6.29</b>	<b>118,420,130</b>	<b>91.51</b>
Settled	2010-11	204	61,270,384		19,335,475	31.56
	2011-12	137	29,487,034		6,808,057	23.09
	2012-13	206	60,628,112		18,996,767	31.33
	<b>Total</b>	<b>547</b>	<b>151,385,530</b>	<b>7.36</b>	<b>45,140,299</b>	<b>29.82</b>
Decision favourable to ATO	2010-11	41	87,481,320		58,592,835	66.98
	2011-12	36	10,072,666		10,070,860	99.98
	2012-13	89	67,337,438		40,559,971	60.23
	<b>Total</b>	<b>166</b>	<b>164,891,424</b>	<b>8.01</b>	<b>109,223,667</b>	<b>66.24</b>
Decision favourable to taxpayer	2010-11	14	1,650,877		1,559,354	94.46
	2011-12	12	99,901,538		0	0.00
	2012-13	10	1,213,202		1,086,260	89.54
	<b>Total</b>	<b>36</b>	<b>102,765,618</b>	<b>4.99</b>	<b>2,645,614</b>	<b>2.57</b>
Decision part favourable to ATO	2010-11	14	460,303,271		299,608,046	65.09
	2011-12	17	1,392,519		675,362	48.50
	2012-13	13	1,646,183		1,431,250	86.94
	<b>Total</b>	<b>44</b>	<b>463,341,973</b>	<b>22.52</b>	<b>301,714,658</b>	<b>65.12</b>
<b>Grand Total</b>		<b>1193</b>	<b>2,057,771,003</b>		<b>1,155,925,325</b>	<b>56.17</b>

Source: Australian Taxation Office.

## APPENDIX 14—ATO RESPONSE



Australian Government  
Australian Taxation Office

SECOND COMMISSIONER OF TAXATION

Mr Ali Noroozi  
Inspector-General of Taxation  
GPO Box 551  
SYDNEY ACT 2001

Dear Ali

### Review into the Australian Taxation Office's administration of penalties

Thank you for the opportunity to comment on the final draft of your report on the review into the Australian Taxation Office's administration of penalties.

We welcome your constructive feedback and note that a number of your recommendations are aimed at achieving greater transparency in the way the ATO applies penalties.

We agree either fully, in principle or in part with nine of the ten recommendations, noting that many of the recommendations have multiple parts. However we disagree with one aspect of one recommendation. I also note that recommendation 2.1 is a matter for Government.

Specifically, in relation to recommendation 4.1(a), while we agree with the objective of the recommendation to increase transparency in the way the ATO applies penalties, we are unable to agree with the particular recommendation. We are not convinced that the recommendation would deliver the hoped for benefits, and the costs of maintaining the database in a way that secures the privacy of the information would be significant, especially given the significant volume of penalty decisions each year. However in lieu of this, we have suggested some alternative information that we could publish that we think could complement your other recommendations.

Our detailed response to your recommendations, including the updated recommendations, is attached at *Annexure 1*.

Finally, I would like to acknowledge the efforts of all involved in undertaking this review.

Yours sincerely

James O'Halloran  
Acting Second Commissioner  
Australian Taxation Office  
17 February 2014

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[To minimise space, the annexure to the ATO's response has not been reproduced here, but has been inserted into the text of this report underneath each of the recommendations to which that text relates.]

## ABBREVIATIONS

AAT	Administrative Appeals Tribunal
ACSC	Active Compliance Steering Committee
AGS	Australian Government Solicitor
ALRC	Australian Law Reform Commission
ANAO	Australian National Audit Office
ATO	Australian Taxation Office
ATP	Aggressive Tax Planning
BISEP	Business Industry Sociological Economic Psychological
BSLs	Business and Service Lines
CPIF	Compliance Penalties and Interest Forum
CPIT	Compliance Penalties and Interest Team
CS&C	Compliance Support and Capability
Federal Court	Federal Court of Australia
GST	Goods and Services Tax
HMRC	Her Majesty's Revenue and Customs
IGT	Inspector-General of Taxation
IGT Act 2003	Inspector-General of Taxation Act 2003
IRS	Internal Revenue Service
ITX	Indirect Tax
IQF	Integrated Quality Framework
JCPAA	Joint Committee of Public Accounts and Audit
LBI	Large Business and International
MEI	Micro Enterprises and Individuals
MT	Miscellaneous Taxation Ruling
OECD	Organisation for Economic Co-operation and Development

OFI	Opportunity For Improvement
PAYG(W)	Pay As You Go Withholding
PCRs	Pre-Lodgement Compliance Reviews
PGH	Private Groups and High Wealth Individuals
PGI	Public Groups and International
PSLA	Practice Statement Law Administration
RAP	Reasonably Arguable Position
RCTs	Randomised Controlled Trials
ROSA	Report on Aspects of Income Tax Self Assessment
SBIT	Small Business/Individual Taxes
SME	Small and Medium Enterprises
SNC	Serious Non Compliance
SPR	Superannuation
TAA 1953	Taxation Administration Act 1953
TD	Taxation Determination
TPALS	Tax Practitioners and Lodgement Strategy
UK	United Kingdom
US	United States of America