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Review of Legal Framework for Administration of the GST
Board of Taxation Secretariat
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Langton Crescent
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AUSTRALIA

15 September 2008

Dear Sir/Madam

Review of the Legal Framework for the Administration of the Goods and Services Tax

PricewaterhouseCoopers welcomes the Board of Taxation's review of the legal framework for the Administration of the Goods and Services Tax ("GST") law with its focus on reducing compliance costs and improving and removing any anomalies in the operation of the GST system.

Our comments below focus on a number of issues identified in the Board of Taxation's paper titled "Review of the Legal Framework for the Administration of the Goods and Services Tax" ("the BoT GST Paper"). We understand the Board of Taxation will not be reviewing the rate of GST or the scope and extent to which goods and services are subject to GST.

However, we note (and where relevant highlight) that in some cases, compliance costs are increased and the efficiency of the tax compromised because of certain design features and policy decisions reflected in the GST law. In particular, the GST treatment of vouchers, adjustments, refunds for tax overpaid and the financial acquisitions threshold, to some extent at least, touch on tax base issues. Nevertheless, we believe there are important issues in relation to these matters that should be considered by the Board of Taxation and the Government.

All references are to the *A New Tax System (Goods and Services Tax) Act 1999* ("the GST Act") as relevant and unless otherwise stated.

The design of Australia's GST

The OECD, in its report "Electronic Commerce: Taxation Framework Conditions"[1] noted that the broad taxation principles that guide governments in relation to conventional commerce should also apply to electronic commerce. The key principles identified by the OECD are as follows:

1. Neutrality – Business decisions should be motivated by economic rather than taxation considerations. Furthermore, taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation;
2. Efficiency - Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible;
3. Effectiveness and fairness - Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to the risks involved. Double taxation and unintentional non-taxation should be avoided, to the extent possible;
4. Certainty and Simplicity - The tax rules should be clear and easy to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted; and
5. Flexibility - The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

These principles are the hallmarks of a good tax system. The design of the Australian GST law is essentially consistent with these principles. However, in a number of instances, individual policy decisions or the interpretation of the GST law have created outcomes that are inconsistent with these principles.

[1] Electronic Commerce: Taxation Framework Conditions – a report by the Committee of Fiscal Affairs as presented to the Ministers at the OECD Ministerial Conference "A borderless World: Realising the Potential of Electronic Commerce" on 8 October 1998 [DAFFE/CFA(98)38REV2]

Our comments and recommendations that follow are made with these principles in mind. We are also mindful of the reasons for introducing the GST as part of the reform of the Australian taxation system. These reasons include each of the above principles and most importantly, improving the international competitiveness of Australian businesses by ensuring, to the extent possible, indirect taxation is not embedded in the price of our exports.

Submission

In relation to the matters raised in the BoT GST paper, we provide the following comments and recommendations:

Foreign entities and GST registration

Q1.4: Do foreign entities find the process of registration, cancelling registration, refunding and remission of GST easy to comply with? If not, how can the process be simplified and improved? Are there any anomalies that exist? If so, what changes are required to address them?

Background

Under the Australian GST system, an entity is entitled to register for GST purposes provided it carries on an enterprise. An enterprise is defined to include, among other things, any activity (or series of activities) undertaken in the form of a business. An entity that is registered for GST purposes in Australia is required to correctly account for GST on any taxable supply it makes and comply with other obligations under the GST law. With some relatively minor exceptions, registered entities are entitled to claim as a credit any GST paid on goods and services acquired in the course of its business ("input GST"), unless those acquisitions relate to making input taxed supplies.

Optional registration is not restricted to entities making taxable supplies in Australia. Rather, it is available to any entity carrying on an enterprise, anywhere in the world.

Outside of GST registration and the tourist refund scheme, no other general refund mechanism is available under the GST law for entities to recover input GST.

PwC view

Providing foreign businesses with a refund of input GST is consistent with the nature of Australia's GST - to tax final private consumption expenditure in Australia. It also enhances the international competitiveness of Australian business as it should entitle them to reciprocal refund rights in many other foreign jurisdictions, particularly in the European Union (where VAT rates are considerably higher than Australia). In our view, a foreign business's entitlement to a refund of Australian GST is an important feature of our GST system

However, the mechanism through which foreign businesses can access refunds of Australian GST could be considerably improved if the GST law provided a refund process that resides outside the GST registration process for foreign businesses that are not required to register.

The GST registration process creates the following compliance issues for foreign businesses:

1. the registration information requirements are difficult to comply with and should be unnecessary where the foreign business is registered for GST or VAT in their home country. Australian information requirements currently include the following:
    - disclosure of Directors residential addresses (some high profile executives are very uncomfortable providing such information for security reasons);
    - two forms of identification are required to be certified by the Australian embassy or consulate in the country of the Director. There are a number of logistical issues associated with this, such as the geographical location of the consulate or embassy (it may not be in the city or country of the Director) and the need to surrender passports for substantial periods of time (some Directors cannot do this); and
    - the need to appoint an Australian public officer is very difficult to do when the business has no presence in Australia.
2. By registering, any supply (no matter how small) that is connected with Australia will be subject to GST. Issuing tax invoices and accounting for Australian GST in these

circumstances is difficult as the registrant's systems and processes are generally configured to account for GST or VAT in their home country.

3. The ATO's broad interpretation of section 9-25(5) of the GST Act (the "connected with Australia" rules for services and intangibles), makes many foreign businesses reluctant to register for Australia's GST.

   The ATO view is that any contractual obligation a non-resident has to provide services in Australia is sufficient for that entity to be making a supply that is connected with Australia (even where the services are physically provided by another entity in Australia and the recipient of the supply is a registered business). While this view prevails and the GST law remains in its current form, many foreign businesses will remain outside the GST system, forgoing refunds of GST they would otherwise be entitled to claim. We are happy to provide further information in relation to this matter if necessary.

   This matter has significant implications for the telecommunications, transport, information technology and professional services industries.

4. The restrictive nature of item 2 of subsection 38-190(1) of the GST Act means many foreign businesses are being charged GST in circumstances where that should not be necessary. Consequently, the foreign recipient will need to register in order to recover input GST. This is a common issue under global supply contracts. The industries mentioned in (3) above and the financial services industry are affected by this provision. We are happy to provide further information in relation to this matter if necessary.

5. The process of cancelling registration is inefficient as once the non-resident entity has registered, it must wait at least 12 months before deregistering. This rule and the onerous registration information requirements discourage many foreign businesses from registering to recover the input GST, particularly in relation to one-off transactions.

PwC recommendations

To address the issues raised above, we recommend the following:

1. A refund regime that is independent of the GST registration process and associated GST compliance requirements, for entities that do not have an Australian permanent establishment and are not making taxable supplies in Australia.
2. Less stringent rules under an independent refund regime (as recommended in (1) above) in relation to identification requirements and documentation required to access refunds of input GST.
3. If the current system is maintained, a change to the current "12 month deregistration rule" where foreign entities are registered only to recover input GST incurred in circumstances involving few or one-off transactions.
4. The breadth of section 9-25(5) and the application of item 2 of subsection 38-190(1) should be reviewed to reduce the number of non-resident entities unnecessarily liable for, or incurring, Australian GST.

Voluntary reverse charge

Q1.6: Do the current arrangements for the voluntary reverse charge mechanism operate effectively to enable their use by non-resident entities? If not, how could their operation be improved?

Background

Division 83 of the GST Act allows a non-resident that makes taxable supplies in Australia (but not through a permanent establishment) to enter into an agreement with a registered recipient, such that the recipient will account for GST on the supplies made by the non-resident and the non-resident will not be so obligated.

PwC view

The purpose of Division 83 is to provide an option for non-residents making taxable supplies in Australia to remain outside the Australian GST system, provided they do not make supplies through an Australian permanent establishment. However, the effectiveness of Division 83 is often compromised by the need for the non-resident to register regardless, because they are incurring input GST.

A refund mechanism that sits outside the registration process would assist in keeping non-resident suppliers outside the system and further facilitate the application of Division 83.

Further, Division 83 is often compromised because the recipient is reluctant to take on the responsibility for accounting for GST. If the requirement to account for GST only arises if the recipient is not entitled to full input tax credits in relation to the supply (which would be the vast majority of instances), many more entities may make use of this provision. As Division 83 is a "reverse charge mechanism", an obligation for the recipient to account for GST only if it is not entitled to full input tax credits is consistent with Division 84 (another reverse charge provision).

Alternatively, the government should consider amending section 9-25 of the GST Act (the connected with Australia rules) to ensure that a non-resident entity does not make a supply that is connected with Australia if the recipient is registered for GST purposes in Australia. Such a change would be consistent with section 8 of the New Zealand GST law. We also note that Division 83 should no longer be necessary in these circumstances, however, Division 84 (the general reverse charge rule) should be amended to apply to both goods and services acquired from a non-resident.

We are happy to provide further information in relation to this "solution", if necessary.

PwC recommendations

To address the issues raised above, we recommend the following:

1. A refund regime for entities that do not have an Australian permanent establishment, that resides outside the GST registration regime.
2. Division 83 should be amended to require the registered recipient to account for GST only in circumstances where the recipient acquires the supply for the purpose of its Australian enterprise, but not solely for a creditable purpose. Alternatively, section 9-25 of the GST Act should be amended to ensure a non-resident entity does not make a supply that is connected with Australia if the recipient is registered for GST purposes in Australia.

Contra transactions

Q1.17: Is the current treatment of contra transactions for GST purposes appropriate? If not, what changes could be made to improve their treatment and minimise compliance costs?

Background

Where registered businesses supply taxable goods and services in exchange for other taxable goods and services ("a contra transaction"), the GST law provides that each party is making a taxable supply. In these circumstances, GST is payable by both parties on the market value of the consideration, received in exchange for the relevant supply.

Output GST must be brought to account in the tax period in which the supplier issues an invoice or receives full or part payment (in monetary or non-monetary form) for the supply, whichever occurs first.

Tax invoices must be issued within 28 days of request and input tax credits may only be claimed in the tax period in which the recipient holds a tax invoice.

PwC view

Contra transactions often arise in the context of marketing initiatives, including sponsorship. In these circumstances, generally both parties are registered and entitled to full input tax credits. Often the non-monetary components of such arrangements are not recognised as revenue or expenditure. Consequently, the GST requirements may be inconsistent with the accounting treatment of such "arrangements", resulting in tax invoices being raised and subsequently "backed out" of the system. This is generally an unnecessary compliance cost with no overall impact on tax collection as the arrangements are "wash" transactions.

It is also common for defective goods to be exchanged for reconditioned or new goods under repair and maintenance contracts, particularly in relation to industrial equipment. Under these arrangements, the defective goods in question are often reconditioned for future use. Such arrangements generally result in the repairer having to account for GST on the cash received for the supply plus the market value of the defective part received from the customer. The customer must account for GST on the market value of the goods and services received in exchange for the defective part.

This can be extremely inefficient, particularly where both parties are registered and entitled to claim full input tax credits. In one case, a client of our firm employs 5 people to manage the GST part of this process.

Apart from the staff and overhead costs incurred in complying with this requirement, the cost of "getting it wrong" can be significant as there will generally be a disconnect between the time output GST is required to be brought to account and an input tax credit can be claimed (i.e. when the recipient is holding the tax invoice). This can result in significant GIC and penalty costs yet there is no overall impact on tax collection (as the arrangement is generally a "wash").

PwC recommendations

In our view, the GST law should be amended to provide the Commissioner with the discretion to allow parties to offset the consideration for supplies where there is no overall impact on GST

collections and the accounting treatment does not require the parties to value the exchange of the relevant goods and services.

Holding companies

Q2.1: Does the GST law apply in relation to different entities in a way that is streamlined and reduces compliance costs? Are there ways in which it could be improved and any anomalies removed?

Background

Many holding companies do not conduct an "enterprise" for GST purposes as they merely hold shares and other passive investments, and do not conduct activities "in the form of a business". If an entity is not conducting an enterprise, they will not be entitled to register for GST purposes.

PwC View

Many holding companies incur substantial costs, particularly if they are the contracting party for services associated with a merger or acquisition. The inability to register can result in significant input GST being irrecoverable, particularly in relation to large transactions.

Currently, many holding companies are entering into transactions with associated entities, effectively to create a series of circumstances that would allow the ATO to accept that the entity is conducting activities in the form of a business and thereby allow them to register. Putting in place such arrangements is not without risk from a tax perspective as the general anti-avoidance provisions of the GST law are broad and the reason such services are provided may often have a significant tax benefit (such as being able to register and recover GST). Further, the raison d'être of many holding companies is to hold shares in other entities and to monitor the performance and operation of those companies. It is generally not the role of a holding company to provide services to other companies in which it holds shares.

It is a curious outcome that companies can group for GST purposes on the basis of shares being held by the a common entity (such as a holding company), yet the company holding the shares

may not be a member of the GST group because it cannot register for GST purposes. In our view, this is an unsatisfactory outcome and a matter that should be redressed.

PwC recommendation

We recommend that the GST law be amended to allow a company that has at least a 90% stake in another company that is registered for GST purposes, to be entitled to register for the purposes of being a member of a GST group, even if it may not be conducting an enterprise.

Vouchers

Q2.12: Do the GST voucher provisions operate effectively? If not, what changes should be made?

Background

The supply of a voucher that entitles the holder to supplies up to the value stated on the voucher is not subject to GST. However, GST is payable on the face value of such vouchers, on redemption.

PwC view

Vouchers are the source of a number of problems in the GST law, primarily because they come in many forms, can be supplied through a distribution chain at a discount to its face value (including being sold by retailers at a discount to its face value) and are supplied for consideration to be used as consideration for the supply of other goods and services.

Vouchers are effectively a means of stored value and Division 100 of the GST Act recognises this by not taxing the supply of the voucher but rather taxing its "use" as consideration for the supply of goods and services. However, the ATO does not consider all "vouchers" to be covered by Division 100. A voucher that entitles the holder to a discount off the price of goods and services and a voucher that entitles the holder to specific goods and services are generally not covered by Division 100. As such these "non-division 100 vouchers" are taxed on supply and not on redemption.

This raises the issue of neutrality. Two "vouchers" with similar features may have a different GST result. If the outcome was a matter of timing only, though not perfect, the result would not be so bad. Unfortunately, that is not the case.

Division 100 has two features that make it unique in the GST law. Firstly, the consideration on redemption of a Division 100 voucher is the face value of the voucher. That is the case regardless of the amount for which the voucher was originally sold by the entity making the supply for which it will be redeemed. In fact, GST is often required to be brought to account on an amount greater than the amount paid by the consumer.

The second unique feature of Division 100 is that Division 21 (the Bad Debts provision) may not apply to give relief to the entity making the supply for which the voucher is redeemed. Each of these is addressed in more detail below.

In many cases, vouchers such as phone cards are sold through a distribution chain for an amount that is at a substantial discount to its face value. Currently, telecommunications carriers are accounting for GST at an effective rate substantially greater than 10% (as they are paying GST on the margin of the distributors as well as their own). Any other "wholesaler" of Division 100 vouchers who is obligated to honour their presentation as consideration for a subsequent supply will be in a similar position as the telecommunications carriers, unless they change the nature of the voucher to take it outside Division 100.

Major retail stores sell "gift vouchers" at a discount to its face value, particularly to loyalty program operators. These stores are required to account for GST on the face value of the voucher even though no one in the commercial chain paid that amount for the voucher. This is clearly inconsistent with the nature of a GST being a tax on final private consumption commensurate with the amount paid (or payable) by the consumer for the goods and services consumed.

Division 21 provides an entity with a decreasing adjustment if it makes a taxable supply and does not receive all or part of the consideration for that supply and the debt is subsequently written off. Unfortunately, the consideration that was not received by the supplier relates to a non-taxable supply (of the voucher). Section 100-12 provides that the consideration for the supply on

redemption of the voucher (i.e. the taxable supply) is the face value of the voucher. Section 100-12 does not cross reference to the amount received by the supplier of the voucher because its purpose is to deem the consideration (rather than the taxable amount) to be the face value of the voucher.

PwC recommendations

To address the issues raised above, we recommend the following:

1. Division 100 should be reviewed with a view to redrafting in a manner consistent with the principal of neutrality and the fundamental nature of a GST/VAT system. That is, no supplier should pay GST on an amount greater than the revenue they receive for a supply.
2. If the Government wants to secure GST on the margin of distributors of Division 100 vouchers, the GST law should specifically provide a mechanism for applying GST on those margins, rather than seeking to recover it through another party.
3. Division 100 should provide bad debt relief to suppliers that accept Division 100 vouchers in exchange for goods and services where they do not receive payment for the supply of the vouchers.

The Financial Acquisitions threshold

Q2.13: Does the financial acquisitions threshold operate effectively and minimise compliance costs for affected taxpayers? If not, what changes should be made to simplify it and reduce compliance costs?

Background

Certain financial supplies are input taxed, for GST purposes. Entities are not entitled to claim credits for GST incurred on acquisitions relating to the making of input taxed financial supplies. However, the GST law provides a specific test, the financial acquisitions threshold ("FAT") test, which is designed to ensure that entities making "incidental" financial supplies in the course of their business are not denied input tax credits.

The current test must be carried out on a monthly basis, and requires consideration of both the preceding 12 months (including the current month) acquisitions, and an estimate of the future 12 months acquisitions (including the current month). Where either of these thresholds is exceeded, input tax credits relating to financial supplies will be denied.

PwC view

The input taxed treatment of financial services (or any goods and services for that matter) creates the potential for a cascading of GST. Short of making financial services GST-free, this outcome is widely accepted as a consequence of the difficulty of applying a consumption tax, such as GST, to financial services (particularly, intermediary services provided by organisations such as financial institutions).

The FAT should ensure that any denial of input tax credits is restricted only to those entities that make substantial input taxed supplies. In the case of entities making financial supplies, we contend that any denial of input tax credits should be restricted to those entities in the business of, and licensed to make, supply financial supplies that are input taxed.

In our view, entities that almost exclusively make taxable or GST-free supplies and are not in the business of making financial supplies should not be denied input tax credits. In particular, where fully taxable entities acquire other taxable businesses by way of a share acquisition, it makes little sense to deny those entities credits for input GST. A denial of credits in such circumstances will inevitably result in a cascade of GST, the outcome of which will be double taxation or embedded GST in the price of exported goods.

The current FAT test gives rise to a number of other issues:

- The threshold amount has not been increased since the introduction of GST. In contrast (for example), the registration threshold was recently increased by 50%. The current threshold is denying credits to an increasing range of small and medium enterprises.

- The requirement for the FAT test to be carried out monthly is onerous. It is unlikely that even large corporations have the resources, or technical expertise to carry out both past and future

calculations monthly. Smaller enterprises would struggle to even understand the test.

- The monthly calculation requirement applies regardless of whether a taxpayer lodges BASs on a quarterly basis (or even annually if they are a small taxpayer).

- The requirement to estimate a FAT calculation for the future 11 months is a source of potential dispute with the ATO. While 'actual' calculations can evidence whether the FAT has been exceeded, an estimate of acquisitions a taxpayer is likely to make over the next 11 months that may relate to future financial supplies is difficult to determine let alone evidence.

In our view, the FAT test as currently drafted, is impractical. To a large extent it is ignored by taxpayers, and is a constant matter raised by the Taxation Office during audits.

PwC recommendations

To address the issues raised above, we recommend the following:

1. The supply and acquisition of a controlling interest in a company should be outside the scope of the Australian GST law. In that way, input GST should be fully recoverable for an entity that makes only taxable or GST-free supplies. Entities that make input taxed and taxable supplies should be entitled to apply their general apportionment methodology to recover some of the input GST associated with a sale or acquisition of shares.

2. If it is necessary to leave the FAT as currently drafted, the threshold amount should be increased to at least $100,000 of input tax credits, or 20% of total credits.

3. The 'future acquisitions threshold' should be abolished, so taxpayers are only required to carry out a single calculation based on actual numbers.

4. Consideration should also be given to allowing an annual calculation, with (for example) an increasing adjustment prescribed where it is determined that the FAT was exceeded during the year.

Adjustments

Q3.1: Are the adjustment provisions easy to understand and are adjustments easy to make? What impediments, if any, are there to making adjustments? Are the method statements or formulae specifying how to work out adjustments sufficiently clear? If not, how could they be modified?

Background

Division 129 of the GST law provides a mechanism for calculating adjustments resulting from a change in use of acquisitions. When acquisitions are made, a taxpayer making both input taxed and taxable/GST-free supplies will claim a proportion of input tax credits (usually on the first BAS after receiving a tax invoice), depending upon their assessment of intended use of the acquisition.

However, over time their actual use of the acquisition may differ. Division 129 provides thresholds over which such adjustments are required, and also the number of adjustment periods (from one up to ten) for different values. These thresholds and adjustment periods vary depending upon whether an acquisition related to making financial supplies or not.

PwC view

This is one of the most problematic areas of the GST legislation, with the following being some of the more serious issues:

The calculation formula

The calculation formula in the 'Method statement' in section 129-40(1) is complex, uncertain in its scope, and open to interpretation, particularly in cases of more than one adjustment period.

A particular issue relates to acquisitions to which multiple adjustment periods apply. For example, if a photocopier is acquired by an entity supplying of residential accommodation for $11,000, the acquirer would be required to make GST adjustments, potentially over five adjustment periods. If in the first adjustment period, the 'actual use' of the photocopier changes, an adjustment should be made on the June BAS for that year. If no further change in use occurs over the next 4 years, there is confusion as to whether the change in use in the first period is simply reflected (as a one

off adjustment) in the first June BAS, or whether it needs to be accounted for progressively over the next four as well. This is a fundamental issue which remains unclear.

In our view, the formula used to calculate change of use should be reviewed to clearly deal with the following circumstances:

- where there is a one off change of use that requires the claiming (or non-claiming) of input tax credits to be adjusted; and
- where an asset has been acquired partially for a creditable purposes and experiences multiple changes over the relevant adjustment periods. In this case, we contend there should be a de minimus threshold before an adjustment is necessary (e.g. the relevant recovery rate is more or less than 20% of the rate claimed on the original BAS).

The threshold amounts and the number of adjustment periods

The threshold amounts and the number of related adjustment periods have not been reconsidered since the introduction of GST. In the case of acquisitions that do not relate to 'business finance' (i.e. making financial supplies), the Division 129 adjustment threshold is $1,000 (excluding GST). Therefore, an entity acquiring goods and services to be used to make input taxed supplies (other than financial supplies) is required to track each acquisition greater than $1,000 for two adjustment periods (this may effectively be over three years). This is a very low value in the context of these provisions.

There seems no sound policy reason for the disparity between the threshold amounts and number of adjustment periods between financial supply providers and non-financial supply providers. The cost of properly complying with this provision is significant.

Adjustment periods

The first 'adjustment period' for the purposes of section 129-20 of the GST Act can be anywhere between 12 months and one day and 23 months and 29 days after the date an acquisition is made. This adds an unnecessary layer of complexity to the provisions and often creates confusion and administrative difficulties for taxpayers.

Intended scope of Division 129

The policy intention of Division 129 points to tracking the use of 'assets', which may (for example) be transferred between different elements of an enterprise with different levels of creditable purpose'. This would also be consistent with similar provisions in other tax jurisdictions, notably the European Union. However, Division 129 simply refers to 'acquisitions', and as such applies to all acquisitions over a certain amount.

In our view, Division 129 should only apply to acquisitions 'capitalised' for accounting purposes. This complements the accounting treatment as such acquisitions are separately identified over a series of financial years for depreciation purposes.

Conclusion in relation to Division 129

In practice, Division 129 gives rise to considerable confusion among taxpayers and Taxation Officers, neither of whom have any definitive guidance on how it applies. Anecdotally, it appears many large taxpayers ignore the tests, on the basis that resulting increasing and decreasing adjustments are likely to approximately net off. In practice, Taxation Officers conducting audits appear to accept this treatment in most cases.

In cases where taxpayers attempt to undertake the required calculations, the administrative burden of doing so is onerous. Existing accounting and financial systems are not set up for the type of tracking (and variable time periods) required by Division 129. To construct (and maintain) new systems is costly and resented by taxpayers.

For most taxpayers, it is generally the case that increasing and decreasing adjustments will approximately net off. The result is that considerable effort is typically undergone in reaching a minimal net adjustment. This result, from the point of view of the revenue gained, is entirely incommensurate with the resources and costs incurred in administration.

PwC recommendations

To address the issues raised above, we recommend the following:

1. Consideration should be given as to whether the cost and complexity of a general provision such as Division 129 is justified, given the relatively low net adjustments made. If anti-avoidance is one of the policy justifications for the provision, consideration should be given addressing the matter through Division 165 (general anti-avoidance), or an additional 'adjustment event' in Division 19.

2. The formula used to calculate change of use should be reviewed to clearly deal with the following circumstances;
    - where there is a one off change of use that requires the claiming (or non-claiming) of input tax credits to be adjusted; and
    - where an asset has been acquired partially for a creditable purposes and experiences multiple changes over the relevant adjustment periods. In this case, we contend there should be a de minimus threshold before an adjustment is necessary (e.g. the relevant recovery rate is more or less than 20% of the rate claimed on the original BAS).

3. Division 129 should only apply to acquisitions 'capitalised' for accounting purposes.

4. If the adjustment is to be retained in the same format, the threshold amounts and resulting adjustment periods should be reconsidered having regard to the burdens they impose. In particular, the minimum value tracked should be increased to $50,000 for all parties, and no more than five adjustment periods (all of 12 months) should be imposed.

Correcting GST mistakes

Q3.7: Does the process for correcting GST mistakes encourage taxpayers to accurately determine their liability, whilst imposing the lowest practical compliance costs? Is there a need to change the operation of the law with regard to correcting GST mistakes to meet the above objectives? If so, what changes should be made?

Background

A taxpayer may make errors in BASs due to clerical mistake or incorrect application of the GST law to a transaction. Generally, where such errors occur, the taxpayer is required to amend the BASs for the tax periods in which the errors occur.

However, the ATO will allow a taxpayer to correct such a mistake in the BAS for the next tax period, in the following circumstances:

- If the taxpayer has a turnover greater than $500 million and less than $1 billion – the underpayment is less than 3 months old and the amount is less than $50,000;
- If the entity's turnover is greater than $1 billion, the underpaid amount increases to $300,000 (the debt must still be less than 3 months old).[2]

PwC view

In our view, the current limits for correcting GST mistakes on subsequent BASs are too low. The GST is a self assessing tax. The cost of compliance to business is considerable. The cost (to the ATO and government) of detecting non-compliance is also considerable.

It is in the Government's interest to allow businesses to correct honest mistakes without penalty (or interest) where those errors have been detected without prompting by the ATO. Such a concession will actively encourage voluntary compliance and is likely to result in a net revenue gain to the Government as taxpayers are more likely to review their GST compliance more regularly.

PwC recommendations

We recommend that taxpayers be allowed to correct mistakes on a subsequent BAS, where the underpayment was less than a certain percentage of its sales in the previous 12 months, it was an honest mistake and the adjustment was not prompted by ATO action.

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[2] Various limits apply for entities with an annual turnover less than $500 million – refer ATO Fact Sheet "Correcting GST Mistakes" and PS LA 2002/8, paragraphs 33 to 41.

GST refunds

Q3.8: Are there any issues with the operation of the restriction on refund provision which need to be addressed to minimise the compliance costs of affected parties?

Background

Pursuant to section 105-65 of the Taxation Administration Act 1953 ("TAA"), if a taxpayer has overpaid an amount of GST because a supply was incorrectly treated as a taxable supply, the Commissioner need not give the taxpayer a refund of the GST overpaid if:

(a) he is not satisfied that the recipient has been reimbursed a corresponding amount, or

(b) the recipient is registered or required to be registered

PwC view

In our view it is generally understandable that the ATO would not refund GST overpaid where the GST has been passed on to a registered person who has subsequently claimed a full input tax credit in relation to the GST so charged. However, the discretion provided to the Commissioner not to refund GST overpaid by a taxpayer is considerably broader than that circumstance.

If the recipient is registered but not entitled to full input tax credits (most financial institutions making input taxed supplies are registered), the Commissioner may still deny a refund of GST to the supplier, even if the GST overpaid has been reimbursed to the recipient. This is manifestly unfair and a decision to refund should not be a matter of discretion by the Commissioner. In our view, if a supplier overpays GST and reimburses the recipient for the amount (or part thereof) overpaid, the Commissioner should be obligated to refund the GST overpaid to, and reimbursed by, the supplier.

Furthermore, section 105-65 of the TAA currently requires the supplier to reimburse the recipient for GST overpaid. If the recipient is unregistered for GST purposes, the government will benefit through a windfall gain. In our view, this is an unfair and inappropriate outcome. In our view, the fair and appropriate outcome for GST overpaid by a supplier in circumstances where GST has been passed on to a recipient who cannot be identified, is that the supplier should be entitled to a

refund of GST overpaid provided that amount has been "reimbursed" to customers through future reduction in prices.

PwC recommendations

To address the issues raised above, we recommend the following:

1. Where a supplier overpays GST and reimburses the recipient for the amount (or part thereof) overpaid, the Commissioner should be obligated to refund the GST overpaid to, and reimbursed by, the supplier.
2. A supplier should be entitled to a refund of GST in circumstances where the GST has been passed on to a recipient who cannot be identified, provided that amount has been "reimbursed" to customers through a future reduction in prices.

Rulings

Q4.1: Is there a need for the broader rulings regime to apply to GST, or is it appropriate that it is treated separately? If there is a need for the broader rulings regime to apply to GST, would there be a need for any GST specific adaptations to take account of GST being a transaction based tax? If yes, what would be needed?

Background

The Government has previously recognised that a rulings system, binding on the Commissioner, gives taxpayers a greater measure of certainty and fairness.[3]

The only legislative reference to GST rulings is to be found in section 105-60 in Schedule 1 to the TAA. Section 105-60 applies to a taxpayer if:

- the Commissioner alters a previous ruling that applied to the taxpayer; and

[3] P Baldwin, Minister for Higher Education and Employment Services and Minister Assisting the Treasurer, Second Rreading Speech, Taxation Laws Amendment (Self Assessment) Bill 1992, 26 May 1992, Vol H of R 184 at 2774 - 2775

- relying on the previous ruling, the taxpayer underpaid a net amount or an amount of indirect tax, or the Commissioner overpaid an amount under section 35-5 of the GST Act, in respect of certain supplies and acquisitions that happened before the alteration.

There are rules for deciding whether a ruling applies to a taxpayer, or whether a ruling has been altered:

- a private ruling only applies to the entity to whom it was given;
- so far as a private ruling conflicts with an earlier public ruling, the private ruling prevails;
- so far as a public ruling conflicts with an earlier private ruling, the public ruling prevails;
- an alteration that a later ruling makes to an earlier ruling is disregarded so far as the alteration results from a change in the law that came into operation after the earlier ruling was given.[4]

There are likely to be numerous cases where a taxpayer with a private ruling will be unaware that a later public ruling has altered the previous ruling.

PwC view

Public rulings

Eight years after the introduction of GST, the overall standard of public GST rulings continues to be high and demonstrate a high level of technical expertise and clarity. In 2001 the Auditor-General found that the processes for the production of public rulings of high technical quality operated effectively overall.[5] He concluded that 'the mechanisms in place for public rulings substantially provide for consistent and fair treatment for taxpayers'.[6] One area of concern identified by the Auditor-General was the time taken to produce some types of public rulings, which inhibited their usefulness.

The time taken between draft and final rulings continues to be of concern. By way of example, GSTR 2003/D7 relating to s38-190(3) issued in draft on 19 December 2003, while GSTR 2005/6 issued in final on 14 December 2005. Rather than resolve issues, GSTR 2005/6 has created

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[4] *Taxation Administration Act 1953* (Cth), s105-60(3).
[5] Australian National Audit Office ('ANAO'), The Australian Taxation Office's Administration of Taxation Rulings (2001), para 12. See also ANAO, Administration of Taxation Rulings Follow-up Audit (2004).
[6] Id, at para 17.

greater uncertainty for many industries operating with global contracts. Many of these issues are currently the subject of discussion with the ATO and government and the issue of retrospective adjustments yet to be resolved.

An extended period of uncertainty, and the unfair burden this places on taxpayers, hardly needs elaboration. The complexity of some GST issues is a daily problem for taxpayers. And it is precisely because an issue is complex that a measure of certainty is required. It is cold comfort for the taxpayer who gets it 'wrong' to be told that the Commissioner will take this into consideration in remitting penalties. The primary liability is often in practice irrecoverable from a consumer, and the taxpayer suffers a very real loss.

Given the need for certainty by taxpayers with numerous day to day transactions, a taxpayer should be allowed to rely upon a draft ruling six months after its release if the final ruling has not issued by that date. Where matters are subject to consideration for law changes, the Commissioner should use his administrative powers to issue an "interim" position (even if that is contrary to the Commissioner's interpretation of the relevant provisions) that allows industries to self assess appropriately while the relevant provisions can be contemplated by Treasury and Government.

Under the public rulings program, the Commissioner makes very limited use of "safe harbours". A safe harbour is an accepted position a taxpayer may adopt in certain circumstances that will provide certainty of GST treatment.

For example, an entity that makes input taxed supplies is not entitled to claim a credit for GST incurred on goods and services acquired to make those supplies. Where such an entity makes both taxable and input taxed supplies, the taxpayer must adopt a fair and reasonable basis to apportion costs that cannot be directly attributable to a particular output (i.e. a supply). What is "fair and reasonable" in these circumstances is a matter of considerable debate. In our view, the Commissioner should provide "safe harbour" values or methodologies in these circumstances that taxpayers can adopt without fear of adjustment at the time of an audit. We are happy to discuss or provide more detail on this concept, if you wish.

Private rulings

The overall standard of private GST rulings is variable and often stands in marked contrast to public GST rulings, no doubt because of the vast number of private ruling requests received by the Commissioner. For this reason, the mechanism for reviewing a private GST ruling is of great importance, and yet there exists no formal review rights.

The issue of a private GST ruling does not give rise to objection and appeal rights, nor does it give rise to rights under the *Administrative Decisions (Judicial Review) Act 1977*.[7] One means of challenging a private ruling is to invoke the assessment process by requesting a special assessment, and then proceed to objection and appeal.[8] Another means is to seek declaratory relief.

One very real consequence of a lack of appeal rights is that it becomes very difficult to obtain certainty in relation to proposed transactions. You cannot enliven the objection and appeal process by requesting a special assessment as there is nothing to assess in relation to a proposed transaction. It would also be difficult to obtain a declaration in relation to a proposed transaction as it is not the role of the courts to provide advisory opinions.

In our view the government should amend the GST law to provide formal review rights in respect of private GST rulings, especially in relation to proposed transactions. The simplest path is to extend the private binding ruling regime to GST.

PwC recommendations

To address the issues raised above, we recommend the following:

1. The Commissioner should allow a taxpayer to rely upon a draft ruling six months after its release if the final ruling has not issued by that date.
2. The Commissioner should use his administrative powers to issue an "interim" position (even if that is contrary to the Commissioner's interpretation of the relevant provisions) that allows

[7] See *Hutchins v DFC of T* (1994) 94 ATC 4,443.
[8] See *Taxation Administration Act 1953* (Cth), ss 22-23.

industries to self assess appropriately while the relevant provisions can be contemplated by Treasury and Government.

3. The Commissioner should provide "safe harbour" values or methodologies in circumstances where the GST law does not provide certainty, particularly in relation to the apportionment of cost associated with taxable and input taxed supplies.

4. The Government should amend the GST law to provide formal review rights in respect of private GST rulings as a means of supporting taxpayers in a self-assessment environment, especially in relation to prospective transactions.

5. To improve on the current rulings system, we encourage greater use of safe harbour rules that are easy to apply for taxpayers. For example, the "fair and reasonable" criteria in relation to apportionment methodologies can be supplemented with safe harbour provisions which provide a list of percentages that can be applied to certain entity types or certain situations.

The General Interest Charge

Q4.12: ... Are any changes to the current GIC arrangements with regard to the GST desirable?

Background

Liability to the General Interest Charge (GIC) is dealt with by section 162-100 of the GST Act. The GIC is automatically imposed and worked out in accordance with section 8AAC of the TAA, and the general discretionary power to remit is in section 8AAG of the TAA.

The rate of GIC is set at 7 percentage points higher than the 90 day Bank Bill rate.

PwC view

The GIC provides a case study in conceptual confusion between culpability and compensation. Conceptually, the penalty regime ought to be directed towards culpability while the GIC regime ought to be directed towards compensating the revenue for the time value of money.

This distinction is well articulated in the ROSA report:

> 'An interest charge is ill suited to such a *de facto* penalty role, imposing an uncertain effect that depends significantly on factors other than the size of the shortfall and the degree of culpability. In particular, the effect of imposing a penalty interest on shortfalls would depend on the period taken for the shortfall to be identified and the rate at which the taxpayer would voluntarily have borrowed a similar amount. Furthermore, the perception that taxpayers are being penalised twice for the same offence, or being penalised where it was decided that no culpability penalty should apply, is undesirable.'[9]

The ATO has articulated the rationale for the GIC to be:

- to act as an incentive for payment of liabilities by their due date;
- to ensure that taxpayers who fail to fulfil their payment and return or statement obligations do not receive an advantage over those who meet their tax liabilities in full by the due date; and
- to compensate the community for the impact of late payments.[10]

In practice, however, there arise numerous examples where the GIC operates as a de facto penalty regime. The Practice Statement dealing with the remission of GIC, among other things, reinforces this view by seeking to make the taxpayer's compliance history a relevant consideration in certain circumstances.[11]

Wash transactions

A GST 'wash' transaction is an expression used to describe the situation where a GST-registered supplier wrongly treats a taxable GST supply as non-taxable, hence underpaying its GST. However, the supply in question is made to a recipient who is registered for GST and would have been entitled to claim back from the ATO a full input tax credit if the transaction had been correctly

[9] Report on Aspects of Income Tax Self Assessment (ROSA), 16 December 2004, at 52; see also Inspector-General of Taxation, Review into the Tax Office's Administration of Penalties and Interest Arising from Active Compliance Activities, 18 May 2005, at para 3.16.
[10] PS LA 2006/8, at para 1.
[11] PS LA 2006/8, at paras 84 and 120.

treated as taxable by the supplier. The term 'wash' refers to the fact that the effect on primary GST revenue is neutral.'[12]

The GST is designed to have a self-policing element and an audit trail. We accept and understand this was a deliberate policy choice. If business to business transactions were meant to be ignored, we could have had a retail sales tax or an 'additive' GST. But we do not, so business to business transactions matter.

Nevertheless, if the effect on primary GST revenue is neutral there is little need to compensate the revenue for the time value of money. The imposition of any GIC in these circumstances is penal in nature. Remission in full is therefore in principle generally warranted. To do otherwise is inequitable.

The remission of GIC in all other wash transactions is governed by a Practice Statement, PS LA 2003/2, in which the GIC will only be remitted to the base rate. Even then, other factors are taken into account, such as the taxpayer's compliance history. These other factors could only ever be relevant to culpability and are, in our view, misplaced.

It is therefore recommended that the GST law remit GIC in full on wash transactions unless there are special circumstances to do otherwise.

Pre-amended assessment interest

A distinction can be drawn between pre-amended assessment interest and post-amended assessment interest. As noted by the Inspector-General of Taxation,

> 'in the pre-amended assessment period a taxpayer may not be aware that there is an underpayment of tax. In fact, a taxpayer may genuinely believe that they have complied with all their taxation obligations under the self assessment regime. In such a situation it is unclear how the imposition of the interest charge in full without remission can serve to discourage the taxpayer from using the tax system as an unsecured mechanism for

[12] PS LA 2006/8 at para 119.

> borrowing. Rather, it would be assumed that such a compliance effect would be more relevant in circumstances where a taxpayer has intentionally not complied with their taxation obligations or has delayed in the payment of tax.'[13]

The Inspector-General went on to say that,

> 'in this context, the imposition of the interest charge in full without remission during the pre-amended assessment period can have a punitive-like effect even though the taxpayer's circumstances do not warrant such an outcome.'[14]

This issue has been dealt with specifically in the income tax context by the introduction of a Shortfall Interest Charge (SIC) for amendments to the year of income ended 30 June 2005 and later years. It is a specific acknowledgement that taxpayers who are genuinely unaware of the shortfall may be unable to take any steps to reduce their exposure to GIC. The SIC is at a lower rate than the GIC and its purpose is to neutralise any advantage over others who pay the tax properly owing at the appropriate time.[15]

There seems no reason in principle why a SIC directed towards the pre-amended assessment period in an income tax context should be any less desirable in the GST context. It is inequitable to treat taxpayers differently, albeit in different taxation regimes, when their circumstances are in principle identical. It is also odd for taxpayers to have a Running Balance Account, a single liability across all federal taxes, which in like circumstances calculates SIC on one part of the balance and GIC on another.

We recommend that legislative change be effected to extend the SIC regime to GST shortfalls in the pre-amended assessment period.

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[13] Inspector-General of Taxation, Review of the Remission of the General Interest Charge for Groups of Taxpayers in Dispute with the Tax Office, 5 August 2004, para 2.28
[14] Id at para 2.29.
[15] PS LA 2006/8 at paras 27-29.

Appealing the GIC

Currently, taxpayers seeking a review of the level of GIC charged by the ATO can only do so by making an application for judicial review in accordance with the terms of the *Administrative Decisions (Judicial Review) Act 1977*. This is a costly and lengthy process.'[16]

In the context of income tax, the ROSA Report recommended that

> 'where unremitted shortfall interest exceeds 20% of the tax shortfall, the taxpayer should be entitled to object to the decision not to remit. Objection decisions should be subject to review and appeal where the shortfall interest remaining after determination of the objection exceeds 20% of the tax shortfall.'[17]

We recommend that legislative change be effected to extend objection and appeal rights to decisions to remit GIC on GST shortfalls where the interest amount exceeds 20% of the shortfall.

PwC recommendations

To address the issues raised above, we recommend the following:

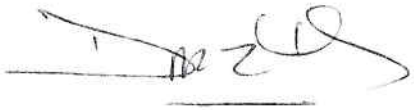
1. The GST law remit GIC in full on wash transactions unless there are special circumstances to do otherwise.
2. Legislative change be effected to extend the SIC regime to GST shortfalls in the pre-amended assessment period.
3. Legislative change be effected to extend objection and appeal rights to decisions to remit GIC on GST shortfalls where the interest amount exceeds 20% of the shortfall.

[16] Inspector-General of Taxation, Review of the Remission of the General Interest Charge for Groups of Taxpayers in Dispute with the Tax Office, 5 August 2004, para 2.114.
[17] ROSA, at 57.

PRICEWATERHOUSECOOPERS

Please feel free to contact either Denis McCarthy on (02) 8266 5229 or Kevin O'Rourke on (02) 8266 3114 if we can be of any further assistance.

Yours sincerely



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