



22 September 2008

Review of Legal Framework for Administration of the GST
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Dear Sir/Madam

Review of the Legal Framework for the Administration of GST

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to provide a submission to the Board of Taxation on its Review of the Legal Framework for the Administration of GST. Key areas of the GST system addressed in this submission are those which, in our view, require reforms to the GST law to achieve a reduction in compliance costs, simplify and improve the operation of the GST, or remove anomalies in its operation.

The Institute is the leading professional accounting organisation in Australia, representing over 48,000 members in public practice, commerce, academia, government and the investment community. The Institute's members are advisers to businesses at all levels, from small and medium sized businesses to the largest global corporations operating in Australia and overseas.

Based on the fundamental principle that GST is not a tax on income, business activities or Australian production but a consumption tax, the recommendations are specific reforms to the law which, in our view, will enable the GST system to better achieve the fundamental objective of taxing final private consumption expenditure. The result should be a more robust Australian GST system with reduced compliance costs and complexity.

Most significantly, we seek the practical operation of the GST system to achieve the economic object of neutrality to the extent possible.

Our detailed recommendations are set out below under the following broad headings:

1. Purpose and object
2. International
3. Going Concern and Farm Land
4. Creditable purpose
5. Enterprise and Non-enterprise activities
6. Property
7. Financial Services – Input tax relief and apportionment
8. Adjustments
9. Entities and Groups
10. Vouchers

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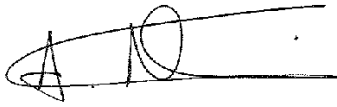
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11. Barter transactions
12. Incapacity
13. Administrative Environment
14. Basic Administrative Rules

The Institute looks forward to working with the Board of Taxation to achieve an appropriate outcome in relation to this Review. In the meantime, should you have any queries in relation to the above comments, please do not hesitate to contact me on (02) 9290 5623 or Donna Bagnall on (02) 9290 5761.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Ali Noroozi', written over a horizontal line.

Ali Noroozi
Tax Counsel

SUBMISSION ON REVIEW OF THE LEGAL FRAMEWORK FOR THE ADMINISTRATION OF GST

1. PURPOSE AND OBJECT

The Board of Taxation's ("the Board") Review of the Legal Framework for the Administration of GST (The "Issues Paper") states that:

"the Government has sought that any recommendations made by the Board be broadly revenue-neutral and that recommendations have regard to the design features of the GST as a multi-stage value-added tax and not undermine the integrity of the GST."

The Institute regards the Government's confirmation that Australia's GST is designed as a value-added tax ("VAT") to be significant to the matters at issue in this Review.

The Institute regards the introduction of GST in Australia and the abolition of many inefficient and distortive taxes as an economic process rather than tax reform.

The previous Government's *Tax reform, not a new tax, a new tax system*¹ confirmed Australia's GST is a VAT as follows:

"The new GST will be based on the "value-added tax" model adopted by nearly all OECD countries and more than 80 other countries around the world. It will be a tax of 10% on the consumption of most goods and services in Australia, including those that are imported, but it will not apply to exports of goods or services consumed outside of Australia.

The GST is a multi-stage tax.

*Registered businesses will charge GST when they sell (supply) goods or services to another business or a consumer. When calculating the amount to pay to the tax office, businesses will offset the tax paid on inputs This offset is referred to as an input tax credit. In this way, tax will be collected only on the value-added by each business in the production and distribution chain, with the tax being ultimately paid by a consumer. However, sales by one business to another will be effectively tax-free."*²

Even a cursory examination of the Australian publications foreshadowing, and the Parliamentary debates involving, the introduction of GST in Australia demonstrate that the objectives of the reform measures were focused on the economic efficiencies that would flow from the abolition of existing inefficient and distortionary indirect taxes and their replacement by a broadly based tax on private final consumption expenditure incorporating the credit-offset model of the European VAT. It is also clear that these economic efficiencies were to be obtained through a VAT model, because neutrality was an inherent feature of that tax system.

The Institute is concerned to ensure that the anomalies in the legislative scheme of GST or its interpretation and administration that run counter to these fundamental objectives be addressed in the recommendations made by the Board as a result of this review.

Once it is recognised (as in the terms of reference of this review) that the Australian system is designed as a VAT with similar economic design principles to the international model, the natural conclusion would be that the importance of neutrality should be better reflected in Australia's GST.

¹ *Tax reform, not a new tax, a new tax system* ("Australian White Paper"), August 1998.

² *Ibid*, p 80.

The neutrality in the international model arises through two fundamental features that are stated in Article 1 of the European Directive 2006/112/EC (the "Directive"). These principles underlying the tax are:

- the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged; and
- on each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components.

1.1. A general tax on consumption expenditure

The Court of Justice of the European Communities ("ECJ") has emphasized the importance of neutrality in the design of Europe's value-added tax.³ For example, the ECJ has stated:

"One of the principles on which the VAT system was based was neutrality, in the sense that within each country similar goods should bear the same tax burden, whatever the length of the production and distribution chain. ...

It is not, in fact, the taxable persons who themselves bear the burden of VAT. The sole requirement imposed on them, when they take part in the production and distribution process prior to the stage of final taxation, regardless of the number of transactions involved, is that, at each stage of the process, they collect the tax on behalf of the tax authorities and account for it to them."⁴

The above explanation of a VAT, and the prominence of the price for which a supply is made is reinforced by comments of the ECJ in *Landboden-Agrardienste GmbH & Co KG v Finanzamt Calau* - Case C-384/95 - where the Court emphasised that:

"VAT is not a tax on income but a tax on consumption. A taxable person's income is relevant for VAT purposes only if it constitutes the consideration for a supply of goods or services to a consumer."

Very similar observations were made by the New Zealand High Court in *NZ Refining Co Ltd v CIR*⁵ where government subsidies were also involved:

The scheme of the legislation is clearly directed to taxing all forms of value received by the taxpayer for services supplied. However, and importantly in my view, apart from the deeming provisions contained in the 1991 amendment it is not directed to taxing what I loosely term receipts which are properly referable simply to the carrying on of a business or taxable activity. It is a particular result or consequence of the activity, namely the supply of (here) a service, which is taxable."

The leading ECJ case on the necessary relationship between the activities of a trader and the payments received by the trader involves a busker. In *Tolsma v Inspecteur der Omzetbelasting Leeuwarden*⁶ the ECJ stated:

"It follows that a supply of services is effected 'for consideration' within the meaning of art 2(1) of the Sixth Directive, and hence is taxable, only if there is a legal relationship between the provider of the service and the recipient pursuant to which there is reciprocal performance, the remuneration received by the provider of the service constituting the value actually given in return for the service supplied to the recipient." (the "Tolsma Principle")

³ The requirements for which are set out in the European Council Directive 2006/112/EC.

⁴ *Elida Gibbs Ltd v Customs and Excise Commissioners*, (Case C-3174/94).

⁵ (1995) 17 NZTC 12,307

⁶ (Case C-16/93)

The recent High Court decision in *Reliance Carpet*⁷, however, indicates that in designing the Australian legislative scheme, the law may not reflect its purpose and object as a general tax on consumption.

In rejecting the Europe and New Zealand requirement for consideration to be paid “for” a supply of goods or services, the High Court observed:

*“An important point respecting the nature of the GST was made as follows by the Full Court of the Federal Court in Sterling Guardian Pty Ltd v Commissioner of Taxation*⁸:

“In economic terms it may be correct to call the GST a consumption tax, because the effective burden falls on the ultimate consumer. But as a matter of legal analysis what is taxed, that is to say what generates the tax liability (and the obligations of recording and reporting), is not consumption but a particular form of transaction, namely supply ...”

*By way of contrast to the Australian system, counsel for the Commissioner referred to Art 2(1) of the first Council directive*⁹ *on the harmonisation of legislation of member states of the European Community concerning turnover taxes; this indicates that VAT is a general tax on the consumption of goods and services.”*

The High Court preferred the view that, under the Australian GST law it was sufficient for a payment to be received “in connection with” a supply by the taxpayer” rather than the relevant supply being “for consideration” as is the case in the European model.

The Institute considers that the fundamental difference in interpretation strikes at the heart of the concept of the GST being a tax on consumption expenditure. In our view, the approach advocated by the Commissioner and accepted by the High Court, creates major compliance difficulties due to the uncertainty as to the nature of the connection required for a business to generate a tax liability. As a simple illustration of the uncertainty caused, one only needs to enquire whether Mr. Tolsma would be liable to GST in Australia on his takings and if not, on what basis taxpayers are to self assess this broad “in connection with” test that the High Court has approved.

The inefficiencies and anomalies that this interpretation causes are explored further throughout this submission.

The Institute recommends that the GST law be amended to reflect the need for the law to be interpreted as a general tax on consumption and that:

- ***to support this underlying object, the GST law contains an objects clause or preamble similar to the Article 1 of the Directive; and***
- ***in relation to the connection required for a supply to be made for consideration, such amendment to the law be made so as to ensure that the relevant relationship is achieved as per the Tolsma principle.***

1.2. “Not taxing business inputs” – neutrality by credit offset

A fundamental object of the GST system is stated to be relieving tax from business inputs.

A significant part of the neutrality of the VAT system is derived from the credit-offset mechanism. The ECJ put the importance of this mechanism in the following terms:

“It should be noted, to begin with, that the deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all its economic activities.

⁷ *Commissioner of Taxation v Reliance Carpet Co Pty Limited*, [2008] HCA 22

⁸ (2006) 149 FCR 255 at 258.

⁹ Directive 67/227.

*The common system of VAT, consequently ensures complete neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT.*¹⁰

The Australian Full Federal Court has confirmed that Australia's GST is a VAT and the significance of both the credit-offset system and the tax applying to private final consumption expenditure:

"The GST is, in essence, the tax known in most countries as value added tax, a name which, perhaps, best describes the essence of the tax. The characteristics of a value added tax were aptly described by the European Court of Justice in Dansk Denkavit ApS v Skatteministeriet [1994] 2 CMLR 377 at 394-5 as being that it:

'applies generally to transactions relating to goods or services; it is proportional to the price of those goods or services; it is charged at each stage of the production and distribution process; and finally it is imposed on the added value of goods and services, since the tax payable on a transaction is calculated after deducting the tax paid on the previous transaction.'

*These characteristics are displayed in the Australian legislation by the 'output tax' being levied, in effect, upon substantially all supplies (referred to in the GST Act as 'taxable supplies') being generally, although not exclusively, supplies of goods or services made by a registered person, or person required to be registered, for consideration ... and the deduction referred to in Dansk (popularly known as an 'input tax credit') being given to a registered person, or person required to be registered, who makes a creditable acquisition, as that expression is defined."*¹¹

Hill J, in the Full Federal Court showed his admiration for the design of the credit-offset mechanism in a value-added tax, in the following terms when, in *HP Mercantile Pty Ltd v FCT*, he said:

*"The genius of a system of value added taxation, of which the GST is an example, is that while tax is generally payable at each stage of commercial dealings ("supplies") with goods, services or other "things", there is allowed to an entity which acquires those goods, services or other "things" as a result of a taxable supply made to it, a credit for the tax borne by that entity by reference to the output tax payable as a result of the taxable supply. That credit, known as an input tax credit, will be available, generally speaking, so long as the acquirer and the supply to it ... satisfied certain conditions, the most important of which, for present purposes, is that the acquirer made the acquisition in the course of carrying on an enterprise and thus, not as consumer. The system of input tax credits thus ensures that while GST is a multi-stage tax, there will ordinarily be no cascading of tax. It ensures also that the tax will be payable, by each supplier in a chain, only upon the value added by that supplier."*¹²

In this light, it is curious that that the ATO has not interpreted the GST law and the role of the so-called "creditable purpose" test with the "no cascading" philosophy (refer to the discussion of creditable purpose below).

By way of example, the ECJ in the case of *Kretztechnik AG v Finanzamt Linz* (Case C-465/03) confirmed that, under the (then) Sixth Directive in the European Union ("EU"), input tax credits are available for the VAT component of capital raising costs – to the extent that the company's activities involve making VAT taxable supplies.

The background and findings of the ECJ in *Kretztechnik* are significant to Australia's GST in both policy and principle. The decision emphasizes the importance of the principle of input tax relief in a VAT and that relief should be granted where costs are incurred for the purposes (and are a cost component) of transactions that are taxed under the VAT system.

¹⁰ *Abbey National plc v Customs and Excise Commissioners*, (Case C-408/98).

¹¹ *ACP Publishing Pty Ltd v FCT* [2005] FCAFC 57.

¹² *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at para 13.

In finding that input tax relief was available for the capital raising costs incurred by Kretztechnik, the Court observed that:

“the right of deduction provided for in Articles 17 to 20 of the Sixth Directive is an integral part of the VAT system and in principle may not be limited. It must be exercised immediately in respect of all the taxes charged on transactions relating to inputs ...

The deduction system is meant to relieve the trader entirely from the burden of VAT payable or paid in the course of all his economic activities. The common system of VAT consequently ensures complete neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT”

Unfortunately, in the Australian context, it seems that the legislative form of Australia’s credit offset provisions (in the Commissioner’s view) require the denial of input tax relief if there is a direct or indirect relationship to an input taxed supply. This relationship will determine an input tax cost (it is said) even though the costs in question are, as a matter of commercial and business objectives, inputs to taxable or GST-free supplies.

To work effectively the GST law must ensure that, where the acquisitions of goods or services are a cost component of taxable output, relief must be granted to ensure that efficiency of the tax system is protected.

The operation of the credit offset provisions is fundamental to the efficiency to the GST system. It is apparent that in interpreting the Australian law, the legislative scheme is not being interpreted in a way that is consistent with the design and operation of the tax as a VAT.

The Institute recommends that the GST law be amended to reflect the importance of input tax relief through a preamble or objects clause along the lines of the Council Directive such as:

“on each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components.”

2. INTERNATIONAL

The GST treatment of cross-border transactions is an area of particular concern for the professional and industry groups both within and outside Australia.

The broad extra-territorial scope of the Australian GST provisions creates impractical outcomes and compliance difficulties for taxpayers in all industries. Service industries which remain particularly affected include Information Technology (IT), professional services, and transport and logistics.

The outcome, across the board, should be a GST system that:

- only requires non-residents to register and account for GST where they have an establishment in Australia (as in the UK); and
- does not impose a cost on cross-border services for either Australian suppliers or non-residents as a result of exported services, which although physically provided in Australia, do not involve ‘private final consumption expenditure’ in Australia.

The Institute recommends that as a matter of principle the Australian GST system should not be subjecting suppliers and non-residents to GST where the consequence is that non-residents have to enter into the GST net by registering to recover the GST that would otherwise be claimable by an Australian registered enterprise.

This was the policy of the law from the outset and should not represent a change to the tax base.

2.1. GST liabilities and registration obligations of non-residents

2.1.1. Supplies connected with Australia

Paragraph 9-25(5)(a) of the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act) provides that supplies are connected with Australia if they are the supply of “things other than goods or real property” and “the thing is done in Australia”.

The Commissioner has broadly interpreted this provision in public ruling GSTR 2005/6 and takes the view that a non-resident who is contractually obligated to provide services in Australia is making a supply that is connected with Australia. The Commissioner maintains this view even if the non-resident arranges for the relevant services to be provided by a sub-contractor in Australia.

This expansive view of the scope of paragraph 9-25(5)(a) creates unintended consequences, including narrowing the operation of Division 84. Division 84 is the mechanism which is specifically designed to capture GST on the value of services imported from a non-resident for consumption in Australia. However, the GST net is being cast unnecessarily wide to capture non-residents with no physical presence in Australia and who are dealing with registered Australian businesses. GST obligations are being imposed on these foreign businesses to register and account for Australian GST liabilities and claim back GST credits. This causes a significant compliance burden which seems unnecessary given that there is little or no net effect on the revenue.

For non-residents who do not have any physical presence in Australia, this obligation arises in many cases unbeknown to them due to the ‘extra-territorial’ reach of the GST Act. This is because there has been no presence in Australia which could reasonably identify and alert the non-resident to the tax obligation that has been triggered in Australia. This is one reason for which international businesses set up local subsidiaries or branches - so that they can account for the Australian tax obligations of operations physically conducted in Australia.

The Institute recommends that subsection 9-25(5) be amended to apply only to non-residents that make supplies:

- ***Through an enterprise carried on in Australia through a place of business; or***
- ***Where the activity is carried out in Australia and the recipient of the supply is not registered for Australian GST.***

This approach is similar to the New Zealand “place of supply” rules and is an extension of the voluntary reverse charge regime contained in Division 83.

As an alternative, should the above solution not resonate with the Board of Taxation, the Institute recommends that measures be implemented to enable non-residents with no physical establishment in Australia be able to appoint resident Australian entities to account for their tax obligations in their absence.

We suggest that the notion of a “fiscal representative” that exists in some European jurisdictions could be used as a model. In some countries, a fiscal representative must be appointed by any entity that has tax obligations in the in the jurisdiction but does not have an establishment in the jurisdiction. Once appointed by a person, the fiscal representative takes responsibility for meeting the tax obligations of the non-resident appointing entity.

For a more detailed analysis of the above issues, please refer to our submission, dated 4 July 2006, to the Department of Treasury.

2.1.2. GST registration process

We have ongoing concerns about the complexity involved in obtaining a GST registration number for non-resident entities. In particular:

- the requirements concerning Proof of Identity (POI) documentation are extremely onerous and impractical for Directors who are based all around the world, and often in very isolated locations. The requirement to have every Director's passport certified by an Australian Embassy, High Commission or Consulate is not pragmatic, and is often physically impossible for certain Directors to comply with. This creates inordinate delays in the process of obtaining a GST registration for a non-resident entity which is often an urgent imperative.
- the requirement for a Proof of Enterprise (or similar) document from the non-resident's tax authority of its country of residence is another requirement that can create significant delays. No resident entity must first establish that they are carrying on an enterprise prior to obtaining a GST registration.

These delays can materially impact the ability to efficiently undertake and complete cross-border investment transactions for non-residents. Similarly, these delays prevent the timely remittance of GST liabilities, thereby requiring non-residents further expenses in having to make submissions to the ATO to obtain remission of general interest charges and in some cases, penalties. Implementation of the "fiscal representative" notion may ameliorate the difficulties in the non-resident GST registration process as it may reduce the level of GST registration documentation that the ATO requires from non-residents to maintain the integrity of the revenue.

The Institute recommends the adoption of a revised minimum level of documentary requirements that will be reasonable and efficient for non-residents to provide, having regard to the risks to the revenue.

In this regard, the Institute observes that registration, of itself, does not represent a risk to the revenue and that any arrangements ought to be aimed at ease of compliance and administration as well as the revenue risks and legitimate entitlement to relief.

2.2. GST treatment of supplies to non-residents

Due to the broad application given to subsection 38-190(3) in GSTR 2005/6, a number of supplies made by Australian businesses to non-residents are likely to be subject to GST. In many instances, the non-resident is able to register for Australian GST purposes and obtain a refund of the GST so charged.

However, the result of expanding the tax to apply to such a broad range of supplies made to non-residents has the undesirable economic consequence that:

- Non-residents may refuse to pay the GST component to the Australian supplier, resulting in a tax payable by the Australian supplier on its production – contrary to the fundamental principle of Australia's GST.
- Uncertainty and risk may arise for Australian suppliers as to the circumstances in which tax is properly payable on supplies to a non-resident.
- There is a likelihood that, where a non-resident consents to pay the higher price to the Australian supplier it chooses not to subject itself to the compliance cost of seeking a refund. Consequently, the price of Australian services is higher as a result of an inappropriate application of GST. This is a deadweight cost in economic terms.
- The non-resident perceives the Australian price as being higher than that in other jurisdictions and sources the services elsewhere.

- The non-resident chooses to enter the system to lodge Business Activity Statements (BAS) on a regular basis and claim the refund. This produces additional compliance costs for the Australian supplier, the non-resident and administrative cost and risk to the Australian revenue.

While we accept the need for a provision that attacks arrangements which might circumvent the tax base, the present broad operation of subsection 38-190(3), in the vast majority of cases, taxes business inputs of non-residents. As such, the design feature is at odds with the fundamental aims of Australia's GST and produces economic inefficiencies, compliance costs and risks.

The Institute recommends that the GST-free provisions of the GST law be amended to ensure that, as a matter of principle, no GST should apply to a supply that is made by a registered taxpayer to a non-resident customer if:

- ***the non-resident customer has no obligation to register for GST in Australia but would otherwise be entitled to input tax relief for the supply made to it; or***
- ***the supply is "provided to" an entity that enjoys the supply in Australia and that entity is reasonably likely to have been entitled to input tax relief if it had made the acquisition.***

Once again, please refer to our submission, dated 4 July 2006, to the Department of Treasury, for further discussion on the above issues.

3. GOING CONCERN AND FARM LAND

3.1. Going concern GST-free

The policy intent of treating the supply of going concerns as GST-free is two-fold: the interests of simplicity and the alleviation of cash flow burdens. Sales of going concerns or of the assets of a business generally have the following four elements:

- The value of the transaction is generally very high, making any GST payable a cash flow problem. The transaction occurs at a time when one or both parties may be financially vulnerable;
- The purchaser will be entitled to relief for any tax payable by the vendor because it is the enterprise that is being conveyed;
- For the parties to the sale, the transactions are not routine and occur irregularly, hence the risk of compliance error is higher;
- The features of the transaction are generally more difficult to understand and the GST requirements more difficult to comply with.

It is apparent at the outset that the purpose of the concession is to simplify sales of business assets and their cash flow consequences for the benefit of business. Nonetheless, the concession has been limited to "going concerns", as defined, meaning that distinctions are drawn between supplies of going concerns and business type supplies that of themselves do not qualify for relief, such as:

- goodwill;
- business assets; and
- business property sold with vacant possession.

Australia and New Zealand have exacerbated the complexity by seeking to define the term "going concern". It is this definition, requiring "all things necessary" and a single supplier and recipient, that gives rise to complexities and inefficiencies that, the Institute submits, are unnecessary and unproductive.

The aim of the concession “is clearly one of convenience” but this purpose is frustrated by the narrow manner in which it is defined. Consequently, anecdotal evidence suggests that some large businesses are reluctant to use the concession because it is too uncertain and excessively complex. Further, contracts involving the concession are often complicated by intricate GST recovery clauses and indemnity clauses in the event that the going concern exemption is not achieved.

The Institute considers that the current legislation and its interpretation produces inappropriate results in the following areas:

- GST-free treatment is limited to transactions that satisfy the “going concern” definition¹³. The particularity of the wording of the definition leads to a restrictive interpretation of the cases to which the concession can be accessed. The narrow operation of the concession has the result of creating uncertainty in its application and hence inefficiencies that might be avoided if the concession were given broader operation. Particular examples of the uncertainty and restrictive operation of the concession are:
 - Where the assets that comprise the “enterprise” that is supplied as a going concern (as that term is understood commercially) are conveyed to the purchaser by a number of different entities, the section may not apply to allow each of those supplies to be GST-free;
 - Where a business is sold to more than one purchaser, but the arrangement is one that conveys the entire operating business and its assets as a going concern, the supplies may not qualify for GST-free treatment as there is more than one purchaser;
 - While, from a commercial and practical business perspective, a vendor may sell its business and its goodwill such that the business can continue to be carried on by the purchaser, the sale of the business may not qualify for GST-free treatment if some of the business assets are not transferred to the purchaser and these assets are regarded as being “necessary for the continued operation” of the business being sold;
 - If premises are seen as necessary to the continued operation of an enterprise, the supplier is required to supply the premises (or alternative, suitable premises) to the purchaser even if the purchaser does not want the premises.

3.2. Division 135 “claw back”

Division 135 is another major source of complexity and anomaly in the treatment of going concerns. On its face, Division 135 produces adjustments for purchasers of going concerns that are inconsistent with its apparent purpose, such as:

- Increasing adjustments will apply even if the parties do not agree to treat a supply as GST-free;
- For assets that would be otherwise input taxed, e.g. residential premises or a loan portfolio, an adjustment of 10% of the value of the asset would be required even though no tax would have been payable on the supply if going concern status was not obtained;
- The formula in the Division calculates the adjustment as a proportion of the purchase price of the relevant going concern supply by reference to the “price” of the GST-free and taxable supplies to be made or made by the purchaser through the enterprise. This formula does not reflect the “use” of the asset for the relevant creditable purpose. The “claw back” should be calculated with reference to:

¹³ The definition of “a supply of a going concern” in section 38-325 of the GST law reflects, in general terms, the elements of a going concern for commercial purposes – i.e. the vendor transfers all things necessary for the continued operation of the enterprise and carries on the enterprise until the day of the sale

- the GST that would have been payable on the acquisition of the asset if it were not GST-free; and
- its “application” for a non-creditable purpose.

3.2.1. Division 135 and farm land

Division 135 also applies to the acquisition of “farm land” as a GST-free supply. This GST-free provision contained in section 38-480 is a mandatory GST-free provision as opposed to the elective “going concern”. Consequently, it could be seen as unfair that a punitive Division 135 adjustment would apply to a mandatory GST-free acquisition of farm land with (for example) input taxed employee residential accommodation involved.

3.3. Voluntary reverse charge

The combined effect of Subdivision 38-J, section 38-480 and Division 135 is to “merge” the tax effects of the transaction for the vendor and purchaser – i.e. GST on sale and input tax credit on purchase.

The only occasion where, in the Institute’s view, the policy requires a net tax outcome is if the purchaser would not be entitled to full GST relief if the sale had been taxable (this is the role of Division 135 – to generate a positive tax outcome if the purchaser does not have a fully creditable purpose).

We also observe that the interpretation of the “going concern” concession is frustrated by the difficulty in discerning (from its legislative terms) why it is limited to “going concerns” as defined. A broad or purposive interpretation is thus, supplanted by a literal approach that creates uncertainty and anomalies.

The Institute recommends that a more appropriate and elegant mechanism is to adopt a “voluntary reverse charge” to the sale, rather than grant GST-free status and an input tax claw-back mechanism.

Further, the Institute recommends that the reverse charge replace the GST-free status of both section 38-480 and Subdivision 38-J. In relation to the latter, the Institute does not favour the retention of the uncertainty surrounding the present “going concern” definition and recommends that a reverse charge be available for supplies of substantial capital assets of a (or a substantial part of) business. The identification of substantial assets would be addressed by setting a minimum threshold value of say \$6 million (exclusive of GST).

A reverse charge mechanism is equivalent to the existing GST-free concession in the following respects:

- Both parties to the transaction must be registered or required to be registered;
- The parties must agree to the arrangement;
- The arrangement must be specified with particularity;
- The effect is that no tax is paid by the vendor but a positive GST liability arises for the purchaser to the extent that the acquisition is not made for a creditable purpose.

On the other hand, a reverse charge has the following advantages over the existing regime:

- The existing status of the transaction is not changed (i.e. input taxed supplies or GST-free supplies remain to be treated as such);
- The drafting flaws and revenue risks contained in the clumsy Division 135 can be avoided.

- The subsequent application of the GST law to supplies can be handled by the normal provisions of the law (e.g. the adjustment provisions and the like can apply);
- Because the reverse charge preserves the tax status of supplies that come within its purview, the limitation to “going concern” as defined can be avoided. A broader set of “business assets” can be contemplated, thus securing a greater integrity and certainty than under the present regime.

4. CREDITABLE PURPOSE

4.1. Policy of input tax relief

The concept of “creditable purpose” is the mechanism designed to achieve input tax relief in the Australian GST. As input tax relief is the fundamental notion in a VAT, it is critical that the mechanism be clear in its operation and consistent in its application throughout the GST law. If not, the ultimate policy objective of Australia’s GST to tax final private consumption expenditure in Australia will be frustrated and cascading of tax will occur.

In the Institute’s opinion, there is a general theme underlying the ATO’s administration of the GST that runs counter to the fundamentals of the “creditable purpose” concept and of what enquiry is necessary to determine whether input tax relief is available. This issue has major flow-on consequences for the operation of many other provisions in the GST law, such as the associate provisions in Division 72, the Division 75 margin scheme, the Division 70 Reduced Input Tax Credits regime, the Division 84 reverse charge mechanism and the adjustment provisions in Divisions 129 to 141.

The “creditable purpose” test has two limbs:

- whether the acquisition or importation is made in carrying on an enterprise (positive limb); and
- whether the acquisition relates to making supplies that would be input taxed (negative limb).

As indicated above, the Institute considers that the principle to be adopted in determining whether an acquisition is eligible for input tax relief under this test is to enquire whether the acquisition is priced into, or is a cost component of, an activity of the enterprise other than an input taxed activity.

In determining what activity an input is priced into or is a cost component of, the Institute submits that it is necessary to enquire as to the purpose of the entity (the business ends) at which the acquisition is directed. Questions such as whether the acquisition is incidental and relevant to a particular activity or is made in the course of an activity will be relevant here.

In assessing the purpose in this context, overcoming the mischief at which the notion of input tax relief is directed should be compelling. Division 11 is directed at providing relief from the cascading of tax, i.e. where input tax costs from a relevant acquisition are priced into an output that is also taxed. The contextual interpretation approach requires that this mischief be borne in mind in determining the character of the relationship required to justify input tax relief.

This means that where the purpose of a business is to make taxable supplies, input tax relief must be provided to avoid the mischief of cascading tax.

Division 11 expressly extends to providing input tax relief for any acquisition made in carrying on an enterprise, provided that the relevant acquisition is not priced into an output that is input taxed. This creates the need to determine the purpose of the enterprise in undertaking a particular activity and in making a particular acquisition in connection with activity.

Only if the business ends served by an activity are input taxed should input tax relief be denied.

4.2. ATO view on “creditable purpose”

In the public ruling GSTR 2008/1, the Commissioner has set out his views on “creditable purpose”. However, in the Institute’s opinion, the ATO continues to apply an inadequate view of the anti-cascading principle in determining whether an input tax credit entitlement exists for an enterprise.

The ATO’s approach is creating a major unintended inefficiency in the GST system, due to a cascade of tax occurring as GST costs are embedded in taxable outputs. Examples of this are discussed further below at 4.3 ‘Practical implications of ATO view’.

One of the Institute’s primary concerns is with the ATO’s interpretation of the word “relates” in the second (negative) limb of the two-part “creditable purpose” test, i.e. whether the acquisition relates to making supplies that would be input taxed. The ATO’s interpretation solely relies on the literal term “relate”, without regard to ensuring that it is read in light of the fundamental policy of eliminating cascading of the tax as discussed above.

In GSTR 2008/1, the ATO states that the test does not require tracing to a specific supply, but nevertheless, “it requires some form of connection to the supplies that the entity makes, made or intends to make”. In the ATO’s view, a sufficient connection exists “if, on an objective assessment of the surrounding circumstances, the acquisition is used, or intended to be used, solely or to some extent for the making of supplies that would be input taxed.”

The Commissioner proceeds to provide a series of examples which illustrate the application of a “connection” test which relies on the first or primary supply that the enterprise makes, rather than the ultimate supply which was the object or end of making the acquisition.

The approach adopted by the ATO seems to be a superficial search for the first technical supply made by an enterprise, rather than a deeper search for the ultimate supply that was the commercial driver for the acquisition. There seems to be a fundamental problem with the former approach as it does not have regard to, nor consequently achieve the policy objectives of the GST. In addition, it runs counter to principles established in international VAT case law. This is discussed further below in the context of capital raising costs.

As discussed above, the Institute considers that, in determining whether an acquisition is eligible for input tax relief, the enquiry is whether the acquisition is priced into or a cost component of an activity of the enterprise other than an input taxed activity. This means that where the purpose of a business is to make taxable supplies, input tax relief must be provided to avoid the mischief of cascading tax. Only if the business ends served by an activity are input taxed should input tax relief be denied.

4.3. Practical implications of ATO view

As mentioned above, the practical implications of the ATO’s view are that a cascading of tax is created from embedded GST being priced into taxable outputs. This unintended consequence is a major inefficiency in the GST system, i.e. a mischief is created that a multi-staged tax was intended to remove.

A pertinent example which demonstrates the significant impact of the ATO’s interpretation of “creditable purpose” is in the treatment of capital raising costs.

4.3.1. Capital raising costs

In *Kretztechnik AG v Finanzamt Linz* (Case C-465/03), the ECJ confirmed that under the Sixth Directive in the EU, input tax credits are available for the VAT component of capital raising costs to the extent that the company’s activities involve making VAT taxable supplies.

All countries in the EU now treat capital raising costs as an overhead of the business concerned, giving rise to input tax relief to the extent of the taxable activities of those businesses.

The ATO, by contrast, maintains the view that the capital raising costs (other than by borrowing) are not creditable for fully taxable businesses. The ATO regards the costs as only “connected” or “relating to” the first or primary supply, being the input taxed share issue. Similarly, corporate acquisition costs are denied input tax relief on the basis that such costs are regarded as “relating” to the acquisition-supply of acquiring shares in the target company.

The background and findings of the ECJ in *Kretztechnik* are significant to Australia’s GST in both policy and principle. The decision emphasises the importance of the principle of input tax relief in a VAT and that relief should be granted where costs are incurred for the purposes (and are a cost component) of transactions that are taxed under the VAT system.

In the Australian context, this is the equivalent of the proposition that the costs of issuing shares have as their relevant purpose the object of raising capital for use in the enterprise of the taxpayer. The relevant purpose when determining the “creditable purpose” of the taxpayer is the business ends at which the costs were directed – in this case raising funds for use in the business.

The “borrowing costs” exception, which was inserted by an amendment, grants input tax relief for costs associated with borrowing where the use of the funds is for making non-input taxed supplies. This provision reflects a policy that is consistent with the international VAT model as described in *Kretztechnik*, i.e. costs associated with capital raising should be afforded input tax relief according to the nature of the activities carried on by the company raising capital and not by reference to the classification of the share issue (or recipient of the share issue).

The Institute submits that the ATO’s view produces an inappropriate GST outcome and one which was unintended by the GST policy-makers and the GST legislative drafters who were charged with enacting that policy. This undesirable feature of the Australian GST law promotes distortions and improperly limits input tax relief. There is a resultant cascade of input taxation that does not occur in the international value added tax model.

The Institute recommends an amendment to the GST law that gives full effect to the input tax relief notion that underpins the GST as a multi-stage tax. This could be done by enacting a clarifying provision to define “relates” in the negative limb of “creditable purpose” in terms of the business purpose or end of making input taxed supplies. At the very least, the Institute seeks an amendment to the GST law to grant specific input tax relief for capital raising, share buy-backs and corporation acquisitions.

5. ENTERPRISE AND NON-ENTERPRISE ACTIVITIES

The technique employed in Australia’s GST to distinguish “business” sales by a registered GST taxpayer from non-business sales is found in the connective phrase “in the course or furtherance of” an enterprise.

On the other hand, the manner in which the “business” purpose of making acquisitions is distinguished from “non-business” acquisitions is through the phrase “in carrying on” an enterprise.

It is apparent that the use of an asset otherwise than in carrying on an enterprise ought to be a use or “deemed supply” not made in the course or furtherance of an enterprise.

From a design and policy perspective, the question is whether the object of the law is to deny input tax relief for assets consumed for non-enterprise purposes or, rather, to subject the “consumption” to tax at market value.

The matter gives rise to a question of the proper operation of Division 72 and its interaction with Divisions 11 and 129.

The Institute considers that the legislative scheme requires clarification in this regard. We raised the issue for consideration by the National Tax Liaison Group – GST subcommittee (“NTLG / GST”) over 12 months ago in the following terms:

“Many circumstances exist where an owner will make acquisitions of goods and services that are either provided to its subsidiary (including trusts or partnerships in which it has an interest) or result in supplies made to the subsidiaries. The situation is illustrated in the Total Holdings case where the taxpayer succeeded in obtaining income tax deductions for costs incurred for the purpose of increasing the amount of dividends that it was likely to earn from its subsidiary.

If a taxpayer chooses to bear costs that enhance the profitability of its subsidiary, it is arguable that the acquisitions it makes are not eligible for input tax credits to that extent. However, the Commissioner takes the view that in most circumstances, meeting the costs of items for the benefit of subsidiaries constitutes a supply made to the subsidiary in the course or furtherance of the taxpayer’s enterprise such that Division 72 deems the “supply” to be made for market value.

It is unclear whether the Commissioner will then allow full input tax relief based on this “deemed” supply.

*This question also involves the manner in which “market value” might be ascertained. It seems clear from the income tax cases in this regard that the market value is ascertained by reference to the actual market in which the transaction takes place (see for example, *Edge v CIR*, [1958] NZLR 42). The Commissioner has not indicated whether, where the supplier is an owner whose purpose is to benefit directly from its actions of supporting its subsidiaries, the proper market to consider is the market of the taxpayer as owner and not as an arm’s length party. It is significant, it is submitted, that the question is what is market value not what is an arm’s length price.*

Where a taxpayer makes acquisitions for the purpose of relieving its subsidiary from costs with the aim of benefiting from higher distributions, the taxpayer ought to be denied input tax relief to that extent. Division 72 should not operate to deem a higher price than that charged if the charge or lack thereof is capable of explanation on the basis that the taxpayer is an owner and aims to take its profit as distribution rather than service fee.

Further, it would seem to be a strange result if a taxpayer who acquired goods or services without a relevant creditable purpose was merely denied input tax credits for the acquisition yet is taxed on market value of supplies made to associates on a subsequent supply of those goods or services. It is noteworthy that the Australian GST merely “claws back” input tax credits for non-enterprise, private or input taxed acquisitions or subsequent application of assets (Divisions 11 and 129), the sale of acquisitions (Divisions 130 and 132) and the cessation of registration (Division 138) but taxes market value of supplies to associates at less than market value if the supply is made in the course or furtherance of an enterprise. Schenk and Oldman discuss this feature of a value added tax in their book, “Value Added Tax a Comparative Approach” at pages 102-106 and 122-124.

*The recent *Investrand BV* case in the ECJ illustrates that costs may be incurred in relation to subsidiaries for a non-enterprise purpose where input tax relief is not available. The draft ruling GSTR 2007/D1 and other rulings on benefits taken from partnerships do not seem to deal with the distinction between non-enterprise use of assets (e.g., to benefit subsidiaries) and “supplies made in the course or furtherance of an enterprise”.*

However, the ATO has adopted an interpretation that regards many “non-enterprise” uses of assets as being made in the course or furtherance of the enterprise.

The difficulty and inconsistency of approach adopted by the ATO in relation to Divisions 11, 72 and 129 is illustrated in GSTR 2003/13, GSTR 2004/6, GSTD 2008/D2 and GSTR 2008/D2 as follows:

- The use of a motor vehicle by a partner for his private purposes gives rise to the denial of input tax credits but not a supply in the course or furtherance of the partnership enterprise to the partner;
- The carrying out of a private conveyance for a partner of a firm of conveyancers for no consideration is a deemed supply for market value but no mention is made of the use of partnership assets for non-creditable purposes;
- The gift of carpets by a partner in a partnership to the partnership is a supply in the course or furtherance of the carpet business of the partner but no mention is made of the non-creditable use of the carpets;
- The gift of a licence to use one floor of leased premises to a partner in a partnership for his private purposes is a supply made in the course or furtherance of a partnership business and taxable at market value but no mention is made of the non-creditable use of the premises;
- The gift of furniture of a partnership to a partner for her private use is a non-creditable application of the furniture but no mention is made of the possibility of a supply made to an associate and the operation of Division 72;
- The distribution in specie of business assets by a trust to beneficiaries is regarded as a supply made in the course or furtherance the trust's enterprise but no mention is made of the non-creditable purpose;
- The distribution in specie of land held by a partnership as a partnership asset to a partner is regarded as a supply made by the partnership in the course or furtherance the partnership enterprise but no mention is made of the non-creditable purpose.

The above illustrates that the present legislative regime and the Commissioner's interpretation of it are too uncertain to be capable of ready compliance. The clear policy is that, where there is a non-creditable application of an asset, input tax credits are clawed back. A general design rule that taxes a "non-enterprise" supply at full market value is inconsistent with the legislative scheme and the underlying policy to tax consumption expenditure rather than the value of consumption.

The Institute recommends that the anomalies, uncertainties and inefficiencies arising from the interaction between Divisions 11, 72 and 129 be addressed in the following way:

- ***The replacement with the "in course or furtherance" terminology with "carrying on an enterprise" to ensure that there is symmetry between sections 9-5 and 11-15;***
- ***The repeal of Division 72 and its replacement with a provision that links the use of assets for the benefit of other entities (whether or not associates) to the "claw back" of input tax credits;***
- ***An adjustment mechanism be available to negate the claw back of credits where the acquirer of the benefit would otherwise be entitled to an input tax credits for it (refer, for example Section 21A of the Income Tax Assessment Act 1936).***

6. PROPERTY

6.1. “Residential premises”

With respect to “residential premises”, the Institute considers that it is vital from a policy perspective to pursue the following two objectives:

- To achieve neutrality between home owners and renters; and
- To tax the value added since 1 July 2000 in the course of a GST registered enterprise in respect of the supply of new residential premises, or residential premises not to be used predominantly for residential accommodation.

In many instances, the application of the residential premises rules in the GST Act is non-problematic, however, more complex boundary issues arise where residential premises come in and out of the GST registration system, and where residential premises are supplied for non-residential purposes.

We consider that the ATO’s view to look only at the physical construction of the premises, and not to the objective “expected use” of the premises is flawed. It creates undesired outcomes, which result in the above two objectives not being met.

The meaning of “residential premises” should be interpreted in accordance with its definition in the GST Act, and also in the context of the operative taxing provisions in which it appears. Sections 40-35, 40-65 and 40-70 of the GST Act, which apply to certain supplies of “residential premises”, are each qualified by the further requirement that the residential premises must “be used predominantly for residential accommodation” before a supply is input taxed.

It is submitted that the words “to be used predominantly for residential accommodation” must be given some meaning. The current ATO’s view effectively gives no meaning to these words, but simply looks at the physical construction of the premises, i.e. at whether the premises are residential premises.

As pointed out by the Supreme Court of New South Wales in *Toyama Pty Ltd v Landmark Building Developments Pty Ltd* [2006] NSWSC 83 at para 93, “it does not accord with the natural meaning of section 40-35(2)(a) or section 40-65(1) [or section 40-70(1)(a)] to determine the question whether residential premises are to be used predominantly for residential accommodation, solely by reference to the physical construction of the premises.” Nor should the fittings or furnishings of premises be determinative. The drafting recognises that a building constructed as a residence may be put to dual or multiple uses, and as such, “the construction of the premises cannot be determinative of their intended or expected use”.

The Institute considers that the legislative scheme requires an objective determination of the use to which the premises are to be put by the recipient of the supply. This means that the GST classification of premises requires regard to be had, firstly, to the characteristics of the premises to determine whether it is residential premises and, secondly, to the use of the premises as marketed by the supplier, the identity of the recipient and the intended use of the premises by the recipient as reflected in the supply transaction.

This approach is akin to the wholesale sales tax “goods marketed for use” concept. However, the Institute does not advocate a return to the wholesale sales tax system of requiring suppliers to rely on conditional exemption certificates of intended use furnished by purchasers.

The Institute considers that it is not appropriate or safe to use a purely subjective test, i.e. the subjective intention of the recipient. If so, GST registered residential property vendors would face the uncertainty that the sale of their otherwise input taxed residential property could be taxable because of an unknown intention by the purchaser to demolish the property or to use it for commercial purposes.

The Institute's proposed approach is in line with the interpretation applied by Justice White in *Toyama*, in which his Honour held that the appropriate test is both a subjective and objective one to determine the likely future use of the premises:

*"[The expression] require[s] a prediction as to the future use of the premises. The most important factor in such a prediction is the intention of the future owner or lessee of the property. In the case of a lease, the question of how the property is to be used in the future will usually be determined by the terms of the lease. In the case of a sale, the likely future use of the property will probably depend on the purchaser's intentions, to be **assessed having regard to objective circumstances** such as the physical condition of the premises, the zoning or any restrictive covenants."*

The Institute submits that this approach of making a prediction as to how the premises will be used meets the policy objectives stated above, being to achieve neutrality between owners and renters, as well as taxing the value added in the course of a GST registered enterprise in respect of the supply of new residential premises, or are residential premises not to be used predominantly for residential accommodation.

In *Toyama*, Justice White went on to say:

*"As explained in *Marana v Federal Commissioner of Taxation* (at [35], [36] and [38], 197-198), the purpose of sub-divisions 40-B and 40-C of the Act was to benefit homeowners who are selling their homes, and to treat persons who are renting a house on the same footing as a person who owns a house. The provisions were intended to operate for the benefit of homeowners and those who rented their homes.*

It would be inconsistent with that purpose if a lease of a house to a real estate agent, which provided that the premises could only be used as a real estate agency, was input taxed because no changes had been made to the physical structure of the house, which could equally be used as a residence. This would equally be so if the house was sold empty, or was furnished as a residence. In the same way, in the circumstances of this case, the rulings of the Australian Taxation Office and the argument of Landmark, if correct, would give s 40-65 an operation which is inconsistent with its intended purpose. Neither Landmark, nor the trustees, nor Concrete Pty Ltd was a homeowner or home occupier whom Parliament intended to benefit."

While the Institute considers that the legislative scheme supports the construction described above, amendment to the law appears necessary to avoid the uncertainty, risk and anomalies arising from the current provisions.

The Institute recommends that the law be amended to give effect to taxing the value added since 1 July 2000 in the course of a GST registered enterprise in respect of the supply of new residential premises, or residential premises not to be used predominantly for residential accommodation. In particular, the following types of commercial-flavoured transactions are to be treated as taxable supplies, and not input taxed:

- ***the leasing of strata titled units to hotel or similar operators;***
- ***the leasing of display homes to property developers; and***
- ***the sale of second-hand residential buildings as development sites.***

For a more detailed discussion of this issue, please refer to our submissions, dated 10 April 2007 and 19 September 2007 to the Department of Treasury.

6.2. Margin Scheme

At the time of writing, the Institute has participated in a confidential consultation on the Government's announced integrity measures for GST and sale of real property and the substantial amendments that have been proposed for Division 75. The policy intent behind Division 75, in the Institute's opinion, is an attempt to allow the vendor of real property to restrict the GST payable on the taxable supplies of real property to the value added since 1 July 2000 in the course of a GST registered enterprise.

While the Institute supports this policy, we submit that Division 75 in its current form has serious flaws and fails to achieve the basic rationale behind a margin scheme, as follows:

6.2.1. Application of GST to value added since 1 July 2000 that was not in the course or furtherance of a GST-registered enterprise

GST can apply to private gains on property purchased after 1 July 2000 – consider the following example:

A person buys his/her principal place of residence on a two hectare block for \$400,000 in September 2000. In September 2008, they decide to subdivide the block into two one hectare lots, construct a house on the vacant lot and sell it. Assume that the value of the total block is \$1.2 million at that time.

Assume also that a valuer would conclude that the value of that one hectare portion of the original title at the time it was acquired was \$100,000 and its value at the time that the person decided to undertake the development was \$500,000. After construction of the new residence, the subdivided block was sold for \$750,000 (GST inclusive) and the person continued to live in their principal place of residence. Under the margin scheme, as it is currently drafted and interpreted, the person would have a GST liability of 1/11th of \$650,000, which is \$59,000. The outcome is that the person has borne GST of \$36,364 (being 1/11th of \$400,000) in respect of the value added to his/her property before his/her enterprise commenced. Had the person purchased the property at anytime prior to 1 July 2000, their GST liability upon development and resale in the same circumstances would have been \$22,727 (1/11th of \$250,000) instead of \$59,091.

6.2.2. Application of GST to gains made before an entity is registered for GST.

The example in 6.2.1 could equally apply to a non GST registered entity which purchases vacant or other land on or after 1 July 2000 for investment purposes. Assume at some later stage it chose to develop the land in the course of an enterprise for which it then obtained GST registration. When the land is sold, the developer must pay GST under the margin scheme on the total value added since it acquired the property. Thus, the value added prior to the developer being registered is subject to GST. Again, Division 75 is deficient and fails to achieve its intended purpose because it does not have an equivalent provision to subsection 75-10(3) Item 2, whereby the enterprise can use as the "acquisition price" for property acquired after 1 July 2000, the value at the date of effect of its registration if that was after the date of acquisition.

6.2.3. Application of GST to value added prior to 1 July 2000

In many circumstances property vendors are unable to use the margin scheme because a previous vendor refused to use it. There is no policy reason why a purchaser should be prevented from using the margin scheme in those circumstances.

6.2.4. Cascading GST in respect of integrated residential and commercial developments

Consider the development of a single block comprising four retail units and 20 apartments for sale. If the original freehold is acquired under a taxable supply, a fundamental principle of GST is violated. The developer has to pay GST under the basic rules for the entire freehold but cannot use the margin scheme on the sales of the residential units. Alternatively, he must acquire the original freehold under

the margin scheme and cannot claim an input tax credit on the relevant portion of that land that relates to the retail units. Either excessive GST is borne by the developer on the residential and retail units or it is passed on in the price of the retail units to (and unable to be recovered by) the GST registered purchaser. It is unlikely that the current legislation allows vendors to sell a single title partially under the margin scheme and partially under the basic rules.

The Institute submits that the current margin scheme is overly complex and flawed in its operation. While we support the policy behind the margin scheme and agree with the principle that there should be relief so as to tax the value added to land, we consider that an alternate mechanism is required to effectively achieve this objective.

The Institute recommends two alternative solutions for consideration:

- 1. regard land as a wealth-building vehicle that is not consumed and exclude the land component from the value. This is in line with the original New Zealand proposal; or***
- 2. implement an input tax relief mechanism to prevent all forms of cascading by allowing an input tax credit, similar to the Division 66 second-hand goods credit (this is the current New Zealand approach)***

7. FINANCIAL SERVICES – INPUT TAX RELIEF AND APPORTIONMENT

The Institute considers that, since its inception, there have been many shortcomings with the design, interpretation and administration of the Australian GST law particularly in relation to financial services. Furthermore, whilst other jurisdictions have substantially improved the legislative scheme and policy to reflect the modern international capital market, Australia has failed to make significant improvements in this regard.

Australian business labours under a complex, more costly, less certain, inefficient, inequitable, anomalous, non-neutral and uncompetitive financial services regime compared to any other country operating a VAT. Many of these negative features arise, not out of the policy of exemption of financial services but from the cumbersome drafting of the law that fails clearly to state the principles concerned and thus allow a purposive construction to give effect to the policy, purpose and objects of the exemption scheme.

The anomalies, inefficiencies and uncertainties arise in two main areas:

- The definition of financial supplies in the GST Regulations and the manner in which it is drafted; and
- The manner in which input tax relief (and adjustments) for acquisitions related to the making of financial supplies is calculated.

The Institute seeks amendments to the GST law to ensure that the Australian treatment of financial transactions and costs incurred in carrying them out is clear, simple, efficient, neutral, internationally competitive, effective and capable of ready compliance. However, the opportunity to make this submission and the time frame involved is not sufficient to fully explore the numerous deficiencies in the present legislative scheme and its interpretation.

The Institute recommends that the financial services, input tax relief and adjustments provisions of the GST law be recast such that:

- ***the definition of input taxed supplies is directed at “exempting” a supply that would otherwise be taxable from GST;***

- ***the creditable purpose test be directed at the denial of input tax credits for inputs to activities that are undertaken for the purpose of adding value through making financial supplies; and***
- ***an apportionment approach be available that is simple to undertake and certain in its outcome. Consideration ought be given to making available input tax relief based on a revenue based formula or arbitrary percentage as an alternative to the costly, ineffective and complicated process flowing from the requirement to satisfy the “the extent to which” test. This formulaic or arbitrary basis of apportionment might be only made available to financial institutions and could replace both the Division 11 apportionment requirement as well as the Division 129 adjustments.***

Specifically, we submit that the GST law should be amended as follows:

- Remove the tortuous, legalistic, narrow drafting style of the Regulations to enable a more purposive interpretation, thus avoiding non-neutral outcomes. Simplicity would be enhanced if regulations were repealed and the provisions were drafted in a manner similar to the repealed section 40-5. The narrowness of the legislative scheme and its consequential uncertainty is illustrated by the fact that an agreement to take up a security is not presently included as a financial supply.
- Remove all reference to the concept of “acquisition supply” or any other activity that is not of itself a supply unless it is thought necessary to exempt such a transaction that would otherwise be taxable.
- Clarify the definition of security which presently refers to the Corporations Law, an enactment that is no longer operative. If the Corporations Law is not the appropriate statute to which regard should be had, it appears that put options are no longer covered as financial supplies.
- Recast item 7 to ensure that its scope is clear and neutral as between like financial products – under the present item, for example, a guarantee of the physical performance of a building contract is treated as input taxed, whereas insuring a financial loss is taxable. GSTR 2006/1 illustrates the cumbersome nature of the existing item.
- Clarify the treatment of an interest in a management investment scheme where the supply acquired by contract is a taxable supply (e.g. a right to management of a portfolio managed under a managed investment scheme is “an interest in a managed investment scheme”). The regulations require that the “provision” of the relevant interest be “for consideration”. The uncertainty and inappropriate consequences of allowing the term “for” to be replaced by “in connection with” is already described under section 1 above. The financial supply definition suffers from similar limitations such that there is some doubt as to whether consideration “for” a particular contractual supply might give rise to rights that are classified as “a derivative” or “an interest in a managed investment scheme” notwithstanding that the consideration was not given “for” those rights.
- Clarify the meaning of “capital of a partnership or trust”. Is it intended that this item refers to the creation, provision or disposal of an interest in a trust or partnership?
- Recast the definitions of financial supply such that sub-regulations 40-5.09(2) and (4) are not necessary. These sub-regulations are testimony to the inadequate drafting of the financial supply regulations in general.
- Ensure that the treatment of capital raising costs, mergers and acquisitions costs and share capital related costs are consistent with the international treatment of such inputs to business (as discussed in detail above).

8. ADJUSTMENTS

The complexity, inflexibility and illogical operation of the current adjustment regime leads, in particular, to Division 129 & Division 132 being two of the most misunderstood and poorly complied with GST provisions.

In the light of the limited efficacy of this mechanism due to inability for taxpayers to comply, the fundamental question to protect the revenue base going forward is whether an alternative, more rudimentary mechanism, may be preferable to one which is theoretically more accurate but too complex to be complied with.

As indicated above, in the Institute's view, the policy behind Division 129 and other adjustment provisions needs to be re-examined with a view to deciding whether:

- we should maintain a mechanism which seeks to ensure that, over the lifetime of the asset, the full input tax relief that is possible under our consumption tax (with no cascading) applies; or
- this aspiration is too complicated for the current or any regime to achieve, such that it would be preferable to have a simpler arbitrary mechanism which avoids the need for future adjustments.

8.1. Arbitrary *simplistic* adjustment mechanism

If, after the policy is re-visited, it is decided that a more achievable and flexible adjustment mechanism is preferred, the Institute proposes the following alternative adjustment model:

- Allow taxpayers the option of locking into a fixed percentage-based formula to claim one-off input tax credits for all acquisitions (or use a different formula if they choose), with no adjustments.

For example, the Canadian VAT has a special apportionment regime for financial institutions. Similarly, Singapore has a fixed one-off apportionment percentage based on industry licensing, e.g. investment banking, retail banking and the like. This is similar to the Australian Reduced Input Tax Credit (RITC) regime, except it applies across the board to all acquisitions.

- Retain an adjustment regime for certain types of assets only, i.e. land, vehicles and computer hardware, where for example the capital value is divided over 5 years and the adjustment is done over that period (similar to a depreciation model).

This would involve a stepped adjustment process, whereby input tax credits are clawed-back on a gradual straight-line basis as the acquisition is progressively consumed by the business over the 'adjustment life' of the asset. An adjustment mechanism which reflects subsequent stepped application of an acquisition by an enterprise towards an input taxed or private purpose, arguably provides a fairer and more appropriate outcome since the consumption does not happen immediately, but rather uniformly over the life time of the asset.

A gradual 'consumption-based' adjustment mechanism appears consistent with the original policy of the GST law which requires an initial assessment of "creditable purpose" based on intended use, and then subsequent adjustments based on actual application or use. Both concepts involve identifying the particular purpose of the intended or actual use, i.e. whether it is for a creditable or non-creditable (input taxed or private) object. Once input tax credits are claimed initially based on intended use, however, input tax credits should only be reduced to the extent that there is actual use of an acquisition, i.e. consumption, for a non-creditable purpose.

8.2. Accurate complicated adjustment mechanism

If it is preferred that the existing policy for an accurate mechanism be retained, then the ultimate outcome should be to implement an adjustment regime that ensures net input tax credit recovery over the lifetime of the acquisition relative to the value consumed by the taxpayer or the value added by the taxpayer respectively.

The Institute submits that legislative amendments (and possibly altered administration) are necessary to achieve the following objectives which the current mechanism does not fulfil:

- To make the GST system easier to comply with and administer.
- To remove cascading within the GST system, hence making it more efficient and neutral.
- To enhance fairness between taxpayers.
- To ensure that the net input tax credit claimed by a taxpayer for an acquisition (after adjusting for any GST payable on the eventual supply of that acquisition) equates to one-eleventh of the value of the acquisition consumed by the taxpayer in making taxable or GST-free supplies (or non-supply outputs) in the course or furtherance of a GST-registered enterprise.
- To move to a position where the net amounts paid by taxpayers in their GST returns equate to one-eleventh of the value added by them in the course or furtherance of a GST-registered enterprise.

Specifically, we propose that a simplified adjustment mechanism should be adopted to achieve the above objective. In this regard, ***the Institute recommends that the following actions be taken:***

- ***Replace the plethora of single issue or narrowly targeted individual adjustment provisions within Division 129 to Division 141 of the GST Act with a single, broad adjustment regime operating on consistent rules and principles.*** An example of the current problem can be found in the omission from Division 132 of supplies of things that were used in making input taxed transactions (other than financial supplies) such as premises used to supply residential rental. Division 132 is possibly supposed to be complemented by an inadequate subsection 9-30(4) of the GST Act, which can cover only some residential property connected supplies. Unless Division 129 is applicable, there does not appear to be a decreasing adjustment regime for supplies of anything used partly in connection with input taxed supplies of residential rental.
- ***Decouple the current regime of basing Division 135 and Division 138 adjustments upon Division 129 provisions in a manner that is arguably both ineffective and unnecessarily complex.***
- ***Replace the complex structure and length of adjustment periods under subsection 129-20(1) with a more consistent, logical structure that complies with traditional accounting practices.***
- ***Reduce the number of adjustment periods and duration of possible adjustments required, particularly for smaller businesses. Under the current regime (as interpreted by the ATO), it is possible for the ATO to seek a BAS adjustment (in respect of a Division 129 matter) fifteen years after the original acquisition.***
- ***Simplify the adjustment period timing so that the first adjustment period is the tax period ending on 30 June of the financial year of acquisition.***
- ***Incorporate a regime to allow taxpayers to claim a decreasing adjustment for acquisitions, other than of goods, which were acquired before the taxpayer was registered for GST and which are subsequently used wholly or partly in the course or furtherance of a GST-registered enterprise.***
- ***Provide for net input tax credit recovery (after adjusting for any GST payable on the eventual supply of that acquisition) equal to one-eleventh of the value of the acquisition consumed by the taxpayer in making taxable or GST-free supplies (or non-supply outputs) in the course or furtherance of a GST-registered enterprise.***

- ***Allow full input tax credit recovery for taxpayers where an acquisition is supplied for a value greater than the acquisition value, so that the net GST returned on the acquisition equates to one-eleventh the value added by them in the course or furtherance of their GST-registered enterprise.***

As this type of 'accurate' adjustment mechanism is seeking to calculate creditable/non-creditable application with precision, it should be flexible and incorporate the ability for taxpayers to elect one of several methods. It is submitted that it should do this through methodology statements in the legislation to provide certainty on acceptable apportionment formulae. However, whatever formulae are used they should not generate adjustments which, at the time of accounting for them, it becomes clear that they will be reversed in future periods based on intended use.

9. ENTITIES AND GROUPS

9.1. GST Groups

It is the Institute's view that the rationale for GST grouping is that a series of entities should be allowed to be treated as one entity for GST purposes because of:

- the high degree of legal association between the entities (e.g. common control);
- the high degree of economic association between the enterprises they carry on (e.g. size and frequency of transactions between them and/or commonality in industries or supply chains);
- the accounting and reporting requirements and practices of the entities; and
- the scheme of GST being to fully credit most taxable supplies at a business to business level and to impose the burden of the tax on the end consumption.

9.1.1. GST Group membership

The Institute submits that there are a number of important principles that should govern the membership requirements for GST grouping. These principles are as follows:

9.1.1.1 GST groups that are currently in existence should be able to continue being GST groups after any change in membership requirements for a GST group

To be fair to the GST groups that have formed under the current provisions, existing GST groups should be able to continue being groups for GST even though the entities may no longer satisfy any new membership requirements for a GST group. It is only when an entity falls out of both the old membership requirements and the new membership requirements that it should be required to de-group.

9.1.1.2 Where an entity is part of a consolidated group for income tax that entity should be able to form a GST group with members of the same consolidated group

Where a group of entities are members of the same consolidated group for income tax purposes, an entity in the consolidated group should be able to form a GST group with any other member or members. This means that there can be any number of GST groups within an income tax consolidated group.

9.1.1.3 The Commissioner should have discretion to approve GST groups who do not fall within the membership requirements but should be able to form a GST group

The Commissioner should have discretion to approve GST groups where a group of entities do not satisfy the membership requirements but have a degree of control and economic association such

that it is appropriate under GST policy and economic reality to group the entities for GST purposes. In determining whether entities have sufficient association of businesses/enterprises, the Commissioner could consider a range of factors including:

- size and frequency of transactions between entities;
- nature and quality of accounting of systems employed by the entities; and
- in the context of the purposes and object of GST law, whether it is appropriate that the entities be treated as a single entity for GST.

In addition, the Commissioner's exercise of discretion should be a reviewable GST decision under section 62 of the *Taxation Administration Act 1953*.

9.1.1.4 The 90% ownership test

The current 90% ownership membership requirement should continue to be available as the degree of ownership is a clear and simple concept which can be applied by a broad cross section of taxpayers.

9.1.1.5 Holding companies should be able to be grouped even if not registered or required to be registered for GST

Where a holding company satisfies all of the membership requirements of a GST group of related entities other than GST registration, consideration should be given to allowing it to group with these related entities. This would be consistent with the underlying policy of input tax relief discussed above in the creditable purpose section.

9.1.2. Other Grouping issues

9.1.2.1. Choice as to when entities become part of a GST group

In view of the above, entities that can form a GST group should be able to choose what day they form a GST group. As a parallel, under section 703-50 of the ITAA 1997 (Choice to consolidate a consolidatable group), a head company can choose a day that a consolidatable group is taken to be consolidated. This means that an entity can be a subsidiary member of a consolidated group for only part of an income year – the entity does not need to wait till the first day of the next income year to become part of a consolidated group for income tax purposes.

Note that, under section 703-50, the choice that a head company makes cannot be revoked and the day specified cannot be amended. As an integrity measure, a similar provision can be adopted for GST grouping.

The ATO's view of registration and attribution in respect of incapacitated entities and their representatives is a clear parallel that such a proposal is worthwhile for GST groups. The rules governing incapacitated entities provide a framework for determining the attribution of supplies between the subsidiary member and the group (see below).

In addition, an entity should be able to be part of one GST group for a period of time and be able to immediately join another GST group (provided it qualifies as a member) if it de-groups from one group to join another group during a period.

9.1.2.2. The ability to group for GST retrospectively

A group of entities should be able to form a GST group retrospectively if they satisfy the membership requirements for a GST group for the relevant periods. In this regard, we recommend that the Commissioner have a discretion to allow a group of entities to form a GST group retrospectively. As long as a group of entities satisfy the policy rationale behind GST grouping, the Commissioner should

be able to approve GST groups even where they do not fall within the strict letter of the membership requirements.

9.1.2.3. A GST group and a GST branch should be able to coexist

If a group of entities account for transactions such that some entities are grouped together but a division is carved out from one of the entities, we see no reason why a GST group cannot coexist with a GST branch. There should be a review of the legislation in this regard.

9.1.2.4. GST for non-profit organisations

Under Division 49 of the GST Act, registered religious entities, which are endorsed under Subdivision 50-B of the ITAA 1997, are able to form a GST religious group if they are members of the same religious organisation. The effect of forming a GST religious group means that the transactions between members of the group are not treated as taxable supplies/creditable acquisitions. However, each member is still treated as a single entity with respect to their transactions with external parties. Each member must account for GST payable and claim credits for their own transactions with external parties and lodge their own business activity statements. We submit that the GST treatment under Division 49 should be extended to the government and other non-profit organisations.

9.1.2.5. Effects on other GST provisions

Amendments should be made to other GST provisions, such as Divisions 129 -141, Divisions 153 and 156 to achieve the policy rationale that a series of entities should correctly be treated as a single entity for GST purposes.

Currently, the membership requirements of a GST group are contained in sections 48-10 and 48-15 of the GST Act and Division 48 of *A New Tax System (Goods and Services Tax) Regulations 1999* (the GST Regulations). An easy improvement to the membership requirements of a GST group would be to locate all the provisions in the one place. Given the GST grouping principles are intended to allow businesses to reduce their GST compliance costs, i.e. it is of an administrative nature, the Institute recommends that all requirements and processes for membership of a GST group are contained in the GST Regulations.

9.2. Partnerships

The Institute notes that real uncertainties exist as to when a particular relationship between two or more parties constitutes a general law partnership or a tax law partnership. Furthermore, under the ATO rulings concerning partnership, the GST consequences of these two types of partnership differ significantly.

As such, it is difficult for taxpayers to accurately determine the GST compliance obligations arising out of partnerships. The Institute submits that this creates undesirable and unacceptable levels of commercial uncertainty for taxpayers, particularly when GST is intended to be a practical business tax.

In GSTR 2003/13, at paragraphs 19 and 20, it is stated that a general law partnership is formed when “persons commence carrying on business together with a view of profit” and that “mutual assent and intention to act as partners is the essential element” for a general law partnership to exist. However, the ATO notes that a declaration of an intention not to be in partnership is not determinative. Furthermore, the ATO distinguishes a tax law partnership and takes the view that a tax law partnership is formed where two entities are in joint receipt of income by way of co-owned property (as discussed at paragraph 2.1.7 of the Issues Paper). However, the Institute notes that joint ownership and joint contracting capacity and obligations are a feature of the common law system as well.

As is evident from this, determining the nature and type of the partnership relationship for GST purposes is extremely complex and uncertain. This is highly problematic from a GST compliance perspective given that the GST treatment of transactions turns on whether the partnership is a tax law

partnership or a common law partnership. This problem is peculiar to GST since this distinction does not give rise to a different tax treatment for income tax purposes.

In addition to the complexities taxpayers face in determining their GST obligations depending on the type of partnership in existence, the Institute considers that the ATO rulings on partnerships create further compliance barriers as they contain some curious propositions. For example, it is incorrect to refer to capital accounts of partners as if they represent the partner's legal interest in the partnership. A partner's interest in a partnership is *sui generis*. It is an equitable interest which consists of a right to participate in profits and in the surplus on winding up. A partner has no interest in any particular asset, but has an equitable interest in all of the assets. As stated, however, this equitable interest is limited to a right to participate in profits and in the surplus on winding up.

The Institute submits that such ATO views have resulted in inappropriate and inconsistent outcomes. For example, the view that a capital account represents a partner's legal interest in a partnership leads to the incorrect conclusion that this amounts to consideration for a distribution of a partnership asset to a partner.

Given the different GST implications that will arise for partners depending upon whether it is a general law partnership or a tax law partnership under the ATO rulings and given the uncertainty that exists with respect to partnership relationships since *Everett*¹⁴, the Institute submits that a detailed examination is necessary to ensure that:

- the principles adopted in the various GST rulings concerning partnerships are materially correct and in line with the common law principles on partnerships; and
- the GST treatment adopted by the Commissioner is consistent with the tax treatment applicable in the context of other taxes, such as income tax and capital gains tax.

9.3. Joint Ventures

There does not seem to be any reason why only certain types of joint ventures can be GST registered e.g. mining joint ventures in the GST Act and a number of other industry specific joint ventures in the GST Regulations. Joint venture registration is simply a compliance measure not an industry based concession and should be available to all. If the Commissioner is concerned about risk, the legislation could include an eligibility test such as in s 162-5(d).

9.4. Entity issues

Many of the complications and compliance costs that arise under the GST system arise because of the specification of an "entity" with the consequences that:

- obligations are placed on the "entity" to pay tax on supplies, issue tax invoices and lodge BASs;
- entitlements to input tax relief arise only for acquisitions made by the entity; and
- taxable supplies are constructed by reference to the activities of the entity (often not having regard to economic benefit and control).

Our comments above surrounding:

- establishment of partnerships and their reconstitution; and
- accounting for supplies and acquisitions for changes in membership of groups,

are indicative of the problems that the system creates.

¹⁴ (1980) 143 CLR 440

The Institute submits that many of the compliance costs and complexities in the GST system arise through the need to identify the “proper taxpayer”. However, the GST system does not rely on the GST being imposed on a particular taxpayer for its efficiency. The efficiency is determined by ensuring that GST of 1/11th is part of the expenditure of the consumer – the person that is **not** part of the GST system. Which entity accounts for GST or claims the input tax credit is not critical to the system.

The Institute recommends that registered entities be permitted to nominate another entity or person to account for GST or claim input tax credits on their behalf where to do so enhances the simplicity and purpose of collection of the tax. Substitution of the “proper taxpayer” already exists in a number of situations, e.g.:

- ***groups***
- ***incapacitated entities***
- ***religious practitioners;***
- ***agents***
- ***joint ventures.***

10. VOUCHERS

The Institute has concerns with respect to vouchers sold at a discount from their stated monetary values (“discounted vouchers”), however, our concerns do not extend to discounted vouchers where the discount is given as consideration for services to be provided by anyone to, or for the benefit of, the supplier and the ultimate retail customer pays the face value of the voucher.

The Institute has a different view of the situation under Division 100 of the GST Act where vouchers (typically “gift vouchers” or gift cards) are supplied / sold at a discount from their face value. These discounted gift vouchers are sometimes sold by retailers or other organisations to:

- (a) corporate customers which -
 - (i) give them away to their own customers or others for promotional purposes or to their staff, or
 - (ii) use them to satisfy their obligations under credit card or other “reward schemes loyalty programs”; and
- (b) other customers given away at no charge in varying circumstances such as when given as honorariums or tokens of appreciation by professional bodies to speakers at their conferences or seminars.

The Institute’s concerns in relation to the application of Division 100 to discounted gift vouchers are summarised below:

- (a) contrary to the general principles of the GST law involving arm’s length supplies, the liability to GST on the face value will result in the suppliers of the discounted gift vouchers paying GST in excess of the statutory rate of 10% on the amounts received from their customers for these supplies;
- (b) while there may be another party (typically the ultimate consumer) who receives the discounted gift voucher from the supplier’s actual customer, there is no commercial distribution chain in place with value being added for reward at each stage as there is with phone cards;
- (c) the increasing adjustment where a discounted gift voucher is not redeemed also creates an obvious inequity in that, contrary to the general GST principles with arm’s length supplies, once again the supplier will be made liable for GST at a rate in excess of the statutory 10% rate;

- (d) the requirement for GST to be paid on the face value of discounted gift vouchers at the time of their redemption would be akin to making suppliers who sell their products at a discount liable for GST on their pre-discounted prices; and
- (e) the situation with suppliers of discounted gift vouchers, who redeem them from holders who are then supplied with goods or services with advertised or shelf prices equal to the face value of those vouchers, is no different from circumstances where a supplier chooses, for whatever commercial reason, to supply its particular goods or services at a discount to a customer paying by cash or against a credit card. The recipient may consider that he or she has acquired something “worth” the face value in such circumstances but this should have no relevance when GST principles are involved. All that is relevant is what the supplier’s customer pays and what money the supplier receives.

Finally, the Institute has some difficulty in recognising that the intended policy behind the introduction of Division 100 by the “Amendments Bill (No.2) 1999” was to ensure “that GST be remitted on the face value” of vouchers. Our understanding was that the intention was to overcome the problems, which arose where GST-taxed vouchers were redeemed in connection with supplies that were not wholly taxable.

In particular, it was stated in paragraph 1.92 of the Explanatory Memorandum to this Bill - “. . . subsection 9-15(3)(a) of the GST Act currently operates so that there is only GST on the first supply of the right, that is at the time the voucher is purchased. When the voucher is redeemed, consideration on the second supply is limited to the additional amount of consideration provided for the thing supplied. This treatment creates difficulties where the voucher is used to buy goods that are GST-free or input taxed.”

The Amendments Bill (No. 2) 1999 made reference to the face value of the voucher being taxed on redemption as the consideration for the supply then being made but this appears to be in the context of the vouchers having been supplied at their face value. In paragraph 1.95 of the Bill, it was stated that “the normal rules will apply”, meaning the amount in money terms received by the supplier or paid by the recipient “in connection with” or “for the inducement of” the subsequent supply of whatever thing was involved.

The Institute has difficulty in accepting that Parliament intended to create a situation whereby retailers, who sell vouchers at prices below their face value, would be liable for more GST than 1/11 of their actual revenue from these supplies. If such departure from the basic principles of GST law was intended, the Institute submits that this would have been specifically referred to in either the Second Reading Speech or the Explanatory Memorandum when Division 100 was being introduced.

The Institute recommends that the Division 100 in the GST Act be confined to phone cards or other vouchers supplied to consumers (i.e. those recipients which do not resell the vouchers) at their face value, irrespective of the means by which the vouchers are distributed to those consumers.

Alternatively, the Institute recommends that, either:

- ***Division 100 be repealed and replaced with a different “attribution” rule whereby GST on “prepayments” by way of “voucher” or other stored value mechanism are attributable to the tax period when they are used. It would be necessary to restrict this approach to vouchers that are redeemed by the issuer or a related entity and are not “distributed” through a chain of suppliers; or***
- ***A vouchers regime is typically only of substantial benefit where an entity supplies vouchers which are used to acquire a significant proportion of GST-free supplies. Under the current GST regime, it is submitted that few vouchers are used to acquire GST-free supplies. In fact many whole sectors make only taxable supplies via vouchers. It is recommended that the vouchers regime be restructured to allow suppliers to “opt-in” if they choose. Other suppliers would treat all voucher sales as taxable under the usual rules. If the vouchers were used to make GST-free acquisitions, the relevant suppliers***

would have a decreasing adjustment. This regime would cater for situations where a voucher supplier is a different entity from the one making the underlying supply of the thing acquired by the voucher purchaser. The application of GST to the supplies made between those parties would ensure that GST applies to the total value added generated on the transactions.

11. BARTER TRANSACTIONS

Barter or 'contra' transactions commonly occur in a business to business context between independent businesses, e.g. 'partnering' alliances where the 'partners' exchange reciprocal benefits often in furtherance of their broader commercial relationship. Services or goods may be exchanged for other goods or services of commercially equal value. While these transactions may be informally recognised by way of 'contras' in business accounts, the occurrence and value of these transactions is difficult to identify and capture in the GST accounting system.

As a simplicity measure, we submit that registered businesses which undertake barter transactions of the type described above should be relieved from the obligations to issue tax invoices and take the transactions into account when compiling their BAS where the contra supplies are taxable supplies and give rise to a full input tax credit for both parties. This would not amount to a narrowing of the tax base as it is proposed only to apply to the tax invoice and reporting requirements.

The proposed rule would ensure that for revenue neutral barter transactions, i.e. supplies for non-monetary consideration, the obligation of a party to issue a tax invoice for their supply is only triggered if either party is not entitled to a full input tax credit in respect of their acquisition under the barter.

There are precedents in the GST law for a rule which requires one party to inform itself as to the input tax credit entitlement of another unrelated party, for example, the Division 78 insurance provisions and the section 13 transitional rules for contracts spanning 1 July 2000.

There are also precedents in the GST Act for rules which relieve the obligation to issue a tax invoice for a taxable supply and allow an input tax credit entitlement despite no tax invoice being held, for example section 83-35, sub-sections (1) and (2) respectively.

In addition, the GST Act does not require certain revenue neutral transactions to be reported where the parties are entitled to a full input tax credit, e.g. paragraph 84-5(1) which applies to imported services and Division 108 which applies to taxable supplies of good in bond. Both of these provisions take a sensible, business-friendly approach where the transactions are, or would be, revenue neutral.

We note also that Division 72, which ensures that dealings between associates for inadequate consideration are brought into the GST system, does not operate where the purchaser would be entitled to a full input tax credit.

There appears to be no mischief created by allowing this simplification to the reporting and tax invoicing obligations for fully taxable barterers, provided both parties are fully creditable. The Institute considers that if the ATO is unable to adopt this interpretation under the existing law, including the various discretions available under the GST Act and the general powers of administration of indirect tax laws under section 356-5 of Schedule 1 to the *Taxation Administration Act 1953*, the law should be amended. A suitable amendment will significantly reduce the compliance cost for many businesses.

12. INCAPACITY

The GST system currently has and needs to have a regime for ensuring compliance in respect of supplies and acquisitions before, during and after insolvency/incapacity. That regime needs to reflect that the insolvency stage is rarely, if ever, a final private consumption of the relevant supplies and acquisitions. The GST system needs to continue and maintain compliance processes during the insolvency stage as efficiently and effectively as if the incapacitated entity had continued to trade solvently.

The current regime for application of GST to insolvency is beset by significant legal uncertainties and compliance problems. These are frustrating for insolvency practitioners as GST can become their personal liability embedded at a business stage rather than passed on or be taxed as a final private consumption. Alternatively, the incidence of GST can reduce the pool of funds available to creditors other than the Commissioner. Even more insidiously, the costs of GST compliance can be significant, thereby reducing the pool of funds available to all creditors including the Commissioner.

It is suggested that the GST regime for insolvency be completely redesigned to achieve some or all of the following outcomes:

- Eliminate any personal liability of insolvency practitioners which cannot be recovered from the assets of the incapacitated entity.
- Clarify the transition or transfer of GST liabilities during the stages prior to the entity's incapacity and during and after the representative's appointment particularly if the entity trades through or after the period of appointment.
- Provide more clarity and more flexible compliance arrangements for representatives in respect of registration, liability, GST groups and returns.

The major compliance issues facing representatives relate to adjustments, with the two main ones being:

- Post appointment increasing adjustments relating to general pre-appointment supplies and acquisitions made by the incapacitated entity; and
- Input tax credit and bad debt adjustments when a dividend is paid to creditors.

The representative is required to identify and calculate adjustments often in the absence of adequate records kept by the incapacitated entity. The calculations made when a distribution is to be made are extremely complicated and time consuming. The requirement to notify the ATO of the increasing adjustments is onerous and the reporting guidelines are vague.

The Institute recommends that the GST incapacity regime be redesigned. A completely new model for the adjustment process is needed whereby the calculations are simpler, the notification obligations upon the representative are less onerous and the representative is not liable for any increasing adjustment. It is suggested that a compliance penalty is more appropriate if the representative is required to report the adjustments and fails to do so.

13. ADMINISTRATIVE ENVIRONMENT

13.1. General Interest Charge (“GIC”)

The Institute recommends that the application of GIC be limited in operation and amount to where:

- ***there has been a “loan benefit” to the taxpayer – the shortfall interest charge; or***
- ***there is an unpaid GST liability other than as a result of a shortfall – the full rate GIC, subject, of course to the normal discretion to remit.***

The Review of Aspects of Income Tax Self Assessment (ROSA) recommendations¹⁵ refer to the “loan benefit” that is obtained by underpaying the proper tax liability. In many circumstances in an indirect tax context, no “loan benefit” is obtained.

The Institute submits that there are two fundamental concepts of a VAT that makes it different from a direct tax:

- the intended incidence is the consumer’s expenditure. “Loan” benefits are only obtained if the incidence of the tax has been passed on to the consumer and has been received in cash as a benefit. Where this is not the case, any benefit is to the consumer and not the vendor; and
- the timing of the payment of an indirect tax is **not** critical to establish the Commonwealth’s entitlement to money. The timing of GST payments to the Government is not as critical as the direct tax base. Timing of GST accounting is more about consistency and simplicity with the accounting basis adopted by the vendor. The efficiency and integrity of the system is advanced, not detracted, by allowing taxpayers to account for the tax at the time that is consistent with their individual commercial accounting basis. Essentially, there is no moral right for the ATO to GST that might be payable according to technical operation of the law. The “loan” benefit argument is one that is only applicable for a direct tax system where the incidence of the tax is intended to be on the taxpayer who has “derived” income – i.e., something has “come home” that is subject to tax.

In a VAT, cash flow advantages and costs are shared between taxpayers according to the tax period, basis of accounting and credit terms. Cash flow costs are an inherent inefficiency of the system and our law seeks to address them by flexibility in accounting rules and tax periods.

In theory, there ought to be no cost to the taxpaying community (in a cash flow context) of the operation of GST, however, the shortness of the time period in which GST is to be handed over after a sale is made (in Australia the 21 days after month end is one of the shortest in the world) means that accounting for GST can represent a real cost to business. If there is a countervailing benefit in the community though the allowance of a credit in advance of payment, this does not represent a “loan benefit” to either side.

The theory of VAT is that the market will adjust its terms to reflect the benefits and costs within the business community. The ATO’s part in this market is as a participant in the market for cash flows. It should not be assumed that by legislating timing rules, the revenue has established a need for revenue collection in accordance with those rules.

13.2. Refunds

The *Tax Laws Amendment (2008 Measure No. 3) Bill 2008* was introduced onto the House of Representative on 29 May 2008 and it contains 2 schedules. One of the schedules relates to restriction on GST refunds and time limits for recovery and refund of indirect tax. The Senate referred the provisions of the bill to the Economics Committee for report and the committee invited written submissions from the public.

¹⁵ Recommendations as contained in the report on aspects of Income tax self assessment (August 2004)

The Institute made a submission on the 7 July 2008 to the Economics Committee. The Senate did not accept the Institute's submissions. The Institute refers the Board to that submission.

The Institute submits that the *Taxation Administration Act 1953* (the "TAA") is inadequate, uncertain and complex in respect of the way it deals with:

- the ability of taxpayers and the Commissioner to alter liabilities and entitlement to refunds four years after the liability or entitlement has arisen;
- the mixture of terminology in the TAA between references to "net amounts" and GST payable and entitlement to input tax credits; and
- the interaction of the running balance account ("RBA") provisions with other liability and refund provisions on account of indirect tax.

The time frame the Board has set for submissions is, unfortunately, too short to enable a detailed commentary of the many inadequacies of the TAA.

The Institute recommends that the provisions be recast to:

- ***ensure that the TAA contains an exclusive code under which refunds can be claimed without reference to the RBA provisions. Refunds of net amounts should, in the Institute's view, not be available where a refund results in windfall gains or unjust enrichment to the supplier or recipient.***
- ***the limitations on the Commissioner and the taxpayer should be consistent in applying the 4 year finality rule. We agree with the Treasurer's statement of the policy intent of these amendments to "ensure a consistent four-year time limit applies to refunds and tax liabilities for indirect taxes."***
 - ***the taxpayer should be required to specify the amount of the overpayment, the tax period and the particularity of the overpayment within the 4 year period.***
 - ***As with the income tax law, nothing in section 105-50 or 105-55 should limit the making of a refund to give effect to a decision on objection, appeal or review of the net amount (and refund of same) are final after the four year period. However, where a taxpayer amends its BAS, a further four years is available to the Commissioner to the extent of the variation;***

13.3. Application of ROSA to Indirect taxes

The Institute observes that the time frame in which the Board has called submissions is insufficient for a detailed response to the way in which the GST regime that might be determined out of the ROSA recommendations.

The Institute has, therefore, recorded for the benefit of the Board some observations and matters of principle in this particular aspect of the Board's review.

1. The Institute observes that the legislative scheme for ROSA taxes invariably involves an annual assessment on which many of the concepts in the regime are based. In the absence of a formal assessment for GST, the objections, four year limitation and rulings systems for GST would have to be designed in a different way.
2. The Institute recommends that the Board consider whether an annual assessment of net amounts for the year would facilitate a more certain operation of the various matters falling under ROSA. If so, the Institute recommends that the monthly or quarterly BAS lodgments might be recast as "instalments" for the annual assessment in the same way as PAYG instalments operate for

income tax purposes. By having a similar payment and assessment regimes the changes necessary for the operation of ROSA in a legislative sense might be more readily achievable.

3. The Institute supports a right of objection and appeal against private binding rulings for GST (and other indirect taxes).
4. The Institute considers that a broader range of taxpayers ought to be able to rely on rulings under the indirect tax system and, as such, supports a broader concept of binding ruling – perhaps similar to class or product rulings.

14. BASIC ADMINISTRATIVE RULES

14.1. Correcting GST mistakes

The Commissioner has issued a Fact Sheet entitled *Correcting GST mistakes* which explains when businesses can use later BAS to correct mistakes made on an earlier BAS. As discussed at paragraph 3.2.7 of the Issues Paper, the ability to correct an error in a later BAS depends upon the entity's turnover, the amount of the error and how long ago the error was made.

The Institute accepts that this administrative arrangement is outside the scope of this review.

Nonetheless, the process of correcting mistakes in BAS is cumbersome, costly and unnecessarily complex.

The Institute recommends that errors in BAS be corrected by the submission of a supplementary BAS containing all errors for previous tax periods. The law should provide for appropriate penalties and GIC according to the nature of the omission (if applicable), bearing in mind that in the nature of a VAT, much of the tax paid is not a tax base issue because it might have been credited in any event.

14.2. Tax Invoices

The Institute submits that the tax invoice requirements, and in particular the Recipient Created Tax Invoice (RCTI) validity criteria, are too prescriptive and are inconsistent with the policy that GST is intended to be practical business tax.

If the rigorous rules introduced by regulation and determination are enforced, it imposes actual costs on business by way of risk, compliance costs, GIC and penalties, whereas the inherent aim of the GST system is that it should not impose a tax on business. If the way in which the system is regulated brings about actual tax-related costs, the design defeats the economic aim.

The Institute recommends that amendments need to be made to the tax invoice requirements so that they are not as prescriptive in terms of validity. The amended rules should provide greater flexibility to achieve the outcome that input tax credits should be claimable if a taxpayer can show sufficient evidence that a creditable acquisition has been made. This would reduce compliance and would be in line with the position for income tax purposes.

14.3. Recipient Created Tax Invoices (RCTI)

The requirement for whole industries refraining from using RCTI until the Commissioner issues an RCTI determination is cumbersome and unnecessary. It is recommended that RCTI arrangements should be available to all entities. It is also recommended that other measures be introduced to reduce risk to the revenue, including reverse charging the liability and introduce certain general compliance conditions based on which the Commissioner could exercise a discretion to disallow it for applicants with a poor compliance history.

14.4. Registration Thresholds

There seems to be little reason if any a different registration threshold for non-profit organisations, particularly given the number of voluntary registrants and the non-profit sub-branch regime. Either, the non-profit entity threshold should be reduced to \$75,000 (with appropriate grandfathering for existing entities) or the non-profit threshold should be held at \$150,000 until the for-profit threshold catches up with it.

14.5. Turnover thresholds generally

The legislative rules for determining turnover threshold are extremely complicated. Part of the problem is the different thresholds and rules for small business entities versus those carrying on an enterprise. Another source of the problem is the multitude of inclusions and exclusions for current GST turnover and projected GST turnover. For quarterly GST payers, those thresholds need to be determined for periods that cross tax periods.

We believe that it would be possible to draft a simpler model if the focus was to make the concessions widely available and the thresholds easy to calculate based on existing accounting records. The focus of the current complex turnover thresholds seems to be only on revenue protection. For any entity near a threshold, it is an extremely difficult and lengthy process to determine if the threshold is met or exceeded.

14.6. Small Business GST Concessions

The legislation includes two basic thresholds for six GST small business concessions, being:

- The registration turnover threshold for registration and annual GST reporting: and
- The \$2m threshold for cash accounting, quarterly instalments, annual private apportionments and simplified accounting measures.

Each of six different concessions is established through separate Divisions in the legislation. Each of the Divisions includes lengthy administrative rules for eligibility, making the relevant election, date of effect of the election, revocation, date of effect of revocation, timing, period of effect, Commissioner's powers and other compliance matters. Most of the rules are similar for each concession within the same threshold. Yet the threshold for each concession has a different label.

The Institute recommends that the various rules surrounding GST small business concessions be streamlined into one set of simple rules to the extent possible.

14.7. BASEasy and Simplified Accounting Methods

It is important for the GST system to have procedures enabling simpler and lower cost compliance for small businesses. In addition to the benefits to taxpayers it is suggested that such procedures reduce ATO administration.

The current simplified accounting methods within Div 123 are intended to achieve the simplicity and lower compliance cost objectives but have low incidence of actual use. The Institute believes that the low uptake of these methods is mostly explained by the complexity of the conditions which must be satisfied before they can be used. These conditions seem to have been formulated extensively for revenue protection purposes rather than for ease of access. The BASEasy proposals are likely to be a useful addition or improvement to the existing methods.

The Institute asserts that the primary objective for simplified accounting methods should be to reduce compliance costs for all small businesses rather than to protect the revenue. The Institute recommends that the eventual model contains, as far as possible, the following features:

- Availability - as far as possible, the methods should be available for all small business players who are in the relevant industries and which fall below the turnover thresholds.
- Turnover thresholds comparability – a single turnover threshold for all models and not a SAMS turnover threshold for some methods and a GST turnover threshold for other methods. It would be preferable if the turnover threshold test was the same as for other GST concessions for small business e.g. GST turnover of \$2 million.
- Point of sale equipment adequacy – the prohibition from using the methods because the entity has adequate point of sale equipment is counterproductive and should be removed. To prevent entities from using concessional methods because their systems are good seems to have no merit.
- Flexibility – tight prohibitions preventing small business players from shifting to a method they believe is better simply discourages use of any of the methods. It needs to be remembered that once an entity adopts a method, they typically are not able to recalculate their GST under the usual rules without great difficulty or cost. By preventing entities from shifting to a more favourable method entities are left with the concern that they may be stuck with an unfavourable method. Again, such rules discourage use of any of the methods.
- Duration – it is recommended that entities be entitled to use chosen methods for as long as possible and also to have the choice of ceasing the use of them at the end of any current or future tax period.
- Capital items – as far as possible, the methods should be applicable to capital items. Considerable complexity is added if entities must extract capital purchases and sales for the simplified accounting method calculations and report them separately. To that end, the existing simplified accounting methods are more cumbersome than the calculation of GST in the usual manner where typically the GST treatment on capital items only needs to be reported separately not calculated separately. Given the turnover thresholds, the vast bulk of revenue at stake could probably be protected if the only capital items excluded from the methods were say real property, businesses, vehicles, planes and boats.
- Business Norms – anecdotally, the actual business norms percentages seem far from generous. For example, the 35% GST-free sales percentage for fresh fish retailers who are not primarily take-away shops seems unrealistically low, hence discouraging their use. It is recommended that the actual percentages need to be recalculated every few years and re-issued.
- Non-food suppliers – as far as possible, simplified accounting methods should be made available for entities that are not food-retailers. It would be necessary for the Commissioner to identify which industry sectors are most; likely to benefit from the methods.
- Applying business norms ratios to turnover to account for all net amounts – this option should be explored further. The Institute can see considerable benefits if across industry ratios can be adopted by all entities in the relevant industry and not just new players. In practice, the Institute sees considerable difficulties in fine tuning the industry categories precisely enough to ensure ratios are realistic and/or attractive to adopt. Considerable resources may be required from the ATO to both fine tune the industry categories and calculate the business norms.

No matter what simplified accounting methods are available, the Institute perceives that their take up will be limited. Most entities have already implemented GST systems which enable them to accurately record and report sales and purchases. Such entities are unlikely to abandon accurate GST calculation for the uncertain GST result of simplified methods unless the methods can be clearly demonstrated to substantially reduce compliance costs.