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TAXATION INSTITUTE *of* AUSTRALIA
IT'S ESSENTIAL

12 June 2009

The General Manager Indirect Tax Division
The Treasury
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PARKES ACT 2600

Email: GSTadministration@treasury.gov.au

Dear Sir

Discussion Paper: Implementation of the recommendations of the Board of Taxation's review of the legal framework for the administration of the GST

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide its comments in response to the Treasury Discussion Paper: *Implementation of the recommendations of the Board of Taxation's review of the legal framework for the administration of the GST* (**Discussion Paper**).

As a preliminary note, the Taxation Institute would like to thank Treasury for the opportunity to make the following submissions and to consult with Treasury in Canberra on 4 June 2009. The purpose of this letter is to reiterate and supplement some of the issues and concerns raised in the course of the consultation. Please note that the submissions below are not exhaustive, nor are they intended to substitute the comments previously made by Taxation Institute in respect of the Discussion Paper.

The Taxation Institute's comments relate to the following areas of GST reform:

1. Time to claim input tax credits;
2. Grouping and joint ventures; and
3. Reverse charge mechanism.

1. Time to claim input tax credits (Chapter 2.5) (Recommendation 20)

The Taxation Institute understands that the amendments outlined in chapter 2.5 are intended to remove what is referred to in the Discussion Paper as "the anomaly under which input tax credits can be claimed indefinitely". The amendments will have retrospective effect from the time of the public announcement (7.30pm AEST on 12 May 2009.)

It is the view of the Taxation Institute that these amendments will potentially lead to outcomes that will impede the recovery of input tax credits in circumstances that are outside the control of taxpayers (and which the Taxation Institute thinks will not have been intended by Treasury). This may occur in one of the following ways:

1. The Commissioner may amend an assessment for an earlier GST period under s. 105-25 of the *Taxation Administration Act* 1953 (**TAA**) on the cusp of the four year time limit on recovery outlined in s. 105-50. This may in turn give rise to a GST liability where, as a

practical matter, the taxpayer will not have sufficient time available to claim related input tax credits. For example, a supply of residential premises treated as input taxed by the taxpayer, whereas the Commissioner decides it is taxable – the taxpayer should be entitled to claim input tax credits, e.g. construction costs.

2. A recipient may enter an agreement that contains a GST "gross-up clause" contractually obliging that recipient to pay an amount of GST to a supplier in the event that there is a change in the GST treatment of the supply (whether this change is imposed by the Commissioner in the circumstances described at 1 or otherwise). In that event, the recipient may be required to pay an amount of GST to the supplier (depending on when it is notified of the liability by the supplier) and will not be in a position to recover the corresponding input tax credits if the GST was paid more than 4 years after it was entitled to claim the credit.

Relevantly, the Taxation Institute notes that in Press Release No 042, *Government Response to Board of Taxation Review of GST Administration*, the Government agreed to the following recommendation of the Board of Taxation (Recommendation 19):

> ***Period of Review***
>
> *The four year period of review for the GST, luxury car tax, wine equalisation tax and fuel tax credits should be refreshed in cases where the Commissioner or the taxpayer reduces (or increases) the amount of tax payable or increases (or reduces) a refund payable to a taxpayer based on the information provided by the taxpayer, but only in respect of the particular that led to the review.*

The Discussion Paper does not address how the 'Period of Review' amendments will apply, nor does it discuss how those amendments are likely to interact with the Chapter 2.5 amendments (Recommendation 20). The Taxation Institute assumes that this will be the subject of a later discussion paper.

The Taxation Institute considers that both reforms should be considered together in order to avoid or minimise inequitable outcomes, such as those discussed at 1 and 2 above. While there may be some justification in the four year limit amendments applying where there has been an oversight by a taxpayer in claiming an input tax credit (i.e. certainty for the Commissioner), it is not appropriate that they apply where there has been a change in circumstances outside the taxpayer's control, as that potentially leads to taxation in the form of denial of credits. On any policy view, it is not intended that businesses are disentitled from claiming input tax credits in these circumstances.

2. Grouping and Joint Ventures (Chapter 2.7) – Measures C and D (Recommendations 32 (d) and (e))

The Taxation Institute is in favour of amendments that will allow entities to revoke a GST group or GST joint venture at any time during a tax period (Chapter 2.7, Measure C – Recommendation 32(d)). The Taxation Institute also supports the initiative to provide entities with the opportunity to enter into clean exit agreements (**CEAs**), which will provide greater certainty in respect of GST liabilities upon exiting a GST group (Chapter 2.7, Measure D – Recommendation 32(e)).

It is the Taxation Institute's view, however, that Measure D does not go far enough, as it provides certainty only in respect of the tax period in which an entity leaves a GST group and does not address earlier tax periods.

In the context of merger and acquisition (**M&A**) transactions, it is commercially appropriate that entities are able to quarantine and manage joint and several exposures that arise from historic GST grouping. This is because, in most circumstances, it would be impossible for an acquiring entity to conduct due diligence to determine the potential GST exposures of *all members* of the

GST group to which the target entity belongs. Particularly in the current economic climate, acquiring entities are simply unable to obtain sufficient certainty in this regard and warranties and indemnities sought are of limited usefulness.

Further consultation should be carried out to identify a method by which the GST exposures of an exiting entity can be, at the very least, quarantined from the balance of the GST group. This may involve some accounting to be undertaken independently by the relevant entity, although it may be that going so far as to require a separate BAS for each member of the GST group would impose a compliance burden that would detract from the benefits of GST grouping, as recognised in the Discussion Paper (see Chapter 2.7 Focus questions at page 52).

Perhaps some guidance can be taken from the income tax regime, which provides that joint and several liability does not apply where the group liability is regulated in accordance with a valid tax sharing agreement (**TSA**). Specifically, the ATO accepts that TSAs may be used to limit a leaving entity's exposure to an increased liability of the consolidated group, where that increased liability both is attributable to a period when the entity was a contributing member to the group and became due and payable on a date before the entity exited the group, to that part of the liability that is attributable to the entity's own activities (see the Consolidation Reference Manual C9-7-110 at page 7). The Taxation Institute also notes that, for income tax purposes, TSAs are optional. If the CEA rules took the same approach, they could be adopted by those taxpayers who are willing and able to adopt the compliance burden for the purpose of overcoming some of the difficulties in respect of joint and several liability. This is in contrast to the 'Alternative to Principles 1 and 2' discussed at paragraph 2.7.102 of the Discussion Paper which involves a similar approach to that taken for GST religious groups, which would be universally adopted and undesirable for members of GST groups where movement from the group is unlikely.

3. Reverse charge mechanism (Chapter 2.8) (Recommendations 33 and 34)

The Taxation Institute is in favour of removing the GST free concessions for the supply of going concerns and farmland supplied for farming, substituting those concessions with a reverse charge mechanism. It is our view that this will lead to significant improvements for taxpayer compliance and certainty.

However, as discussed in the course of the consultation, our concern is that the amendments may lead to unintended outcomes in respect of stamp duty, in the event that a recipient may be seen by state revenue authorities to be assuming a liability of the supplier.

Relevantly, in the NSW context, The Office of State Revenue (NSW) has published *Revenue Ruling No. DUT 33 Consideration for Duties Transactions* which states the following at paragraphs 20 and 21:

> *<u>Encumbrances and Liabilities</u>*
>
> *Section 22(1) states that the consideration for the transfer of dutiable property is taken to include the amount or value of all encumbrances, whether certain or contingent, subject to which the dutiable property is transferred...*
>
> *Consideration can also include an assumption by the purchaser of liabilities of the vendor. For example, in an agreement for sale where the purchaser agrees to take over debts or assume liabilities of the vendor, the amount or value of the debts or liabilities assumed is added to and forms part of the consideration on which duty is calculated.*

The Taxation Institute notes Treasury's comments at the meeting of 4 June that these amendments are not intended to give rise to any stamp duty liability and the Taxation Institute's preliminary view is that there should be no such corollary effect, at least in respect of NSW. According to the proposal (see paragraphs 2.8.7-2.8.12) and subject to the drafting and particulars of the amending clause, it is the Taxation Institute's view that in the event that the parties agree to reverse charge the supply of a going concern, the statutory liability to remit GST will lie with the recipient and not the supplier of the going concern, i.e. the Commissioner would, in those circumstances, have the right to recover GST from the recipient. Therefore, such a liability is not capable of being *assumed* by a recipient from a supplier for stamp duty purposes.

However, the Taxation Institute considers it appropriate that, in the course of obtaining unanimous agreement of the States and Territories in respect of the proposed amendments, Treasury also obtain definitive assurances from the States and Territories that the amendments with respect to the reverse charge mechanism will have no adverse impact for stamp duty purposes. In this regard, the Taxation Institute notes that Treasury undertook to make further investigations from the State and Territory revenue offices. The Taxation Institute thinks that this is entirely appropriate as the intention is not to have unintended nor anomalous outcomes from the Budget GST measures.

Interaction of proposed reverse charge mechanism with the margin scheme provisions

Focus question Q.8F asks whether the proposed reverse charge mechanism will interact effectively with the margin scheme provisions. The Taxation Institute believes that the ability to use the margin scheme should be retained in circumstances where the land has been acquired pursuant to a taxable supply of a going concern or a taxable supply of farm land and the parties have agreed to reverse charge the GST liability.

At the time land is acquired by a developer, it is not uncommon for the developer to be uncertain as to the exact form the future development of the land will ultimately take. For example, land may be acquired with a warehouse on it that is zoned industrial at the time of the acquisition. The developer may want to develop residential units on the land or part of the land, but any such development may be conditional upon the land being re-zoned for residential use. In these circumstances, if the warehouse is leased to a tenant, the most appropriate GST treatment of the acquisition by the developer is likely to be a supply of a going concern. As the law currently stands, subject to the immediately preceding supply of the land not being a taxable supply where the margin scheme was not used, the developer then has the option to use the margin scheme in relation to the future development of the land. The Taxation Institute considers that the developer should continue to have this option if the supply of a going concern becomes a taxable supply and the parties agree to reverse charge the GST liability.

The purpose of the example below is to illustrate that there will be no impact on the revenue if a taxpayer continues to have the option to use the margin scheme in circumstances where the taxpayer has acquired the land pursuant to a taxable supply of a going concern or a taxable supply of farm land and the parties have agreed to reverse charge the GST liability.

Example

A owns a block of land with a warehouse on it. The land is currently zoned industrial/commercial and the warehouse is leased to a tenant. A acquired the land prior to 1 July 2000 and the market value of the land as at 1 July 2000 was $1,100,000.

A sells the land to B in July 2010 (after the implementation of the proposed reverse charge mechanism) for $5,500,000 (plus GST, if any). Subject to the land being re-zoned residential, B intends to develop the land into residential units and to sell those units for a total price of $22,000,000 (incl. GST). If B cannot achieve the re-zoning, it intends to develop the land into a business park.

Under the current proposal, B would be forced to make a decision in relation to the application of the margin scheme at the point it acquires the land. If A & B agree to apply the margin scheme to the sale of the land, A would have a GST liability of $440,000 (($5,500,000 - $1,100,000) x 10%) which it would recover from B. B would be unable to claim an input tax credit for that GST. If B were subsequently able to develop the land into residential units, B’s GST liability on the sale of the units would be $1,460,000 (1/11th x ($22,000,000 - $5,940,000)). The total GST revenue to the Government would therefore be $1,900,000 ($440,000 + $1,460,000).

If B were instead able to agree with A to treat the sale of the land subject to the lease as a taxable supply of a going concern, and to reverse charge the GST liability, B would have a reverse charge liability and corresponding input tax credit of $550,000 ($5,500,000 x 10%). If B were then able to develop the land into residential units, B's GST liability on the sale of those units would be $1,900,000 ($1/11^{th}$ x ($22,000,000 - $1,100,000)).

Accordingly, with appropriate amendments to Division 75 in relation to land acquired pursuant to a taxable supply of a going concern or a taxable supply of farm land, the total GST revenue received by the Government would be the same whether the margin scheme was used throughout the supply chain or whether the developer (B) had the option to acquire the land as a taxable supply of a going concern or a taxable supply of farm land where the GST liability is reverse charged. However, from the developer's (B's) perspective, the ability to acquire the land using the reverse charge mechanism is important because:

1. B retains the flexibility to develop the land into commercial premises without there being GST leakage of $440,000;

2. B's stamp duty cost remains the same as under the current law (it would increase if B were forced to use the margin scheme in relation to its acquisition of the land); and

3. B has access to the cash flow benefit offered by the reverse charge mechanism.

4. Tax invoices (Recommendation 9)

In paragraph 2.2.4 of Treasury's discussion paper, it is proposed to allow taxpayers to treat an otherwise invalid tax invoice as being valid despite the existence of "minor errors". The Taxation Institute notes that this exception is to be supplemented by the existing discretion conferred on the Commissioner under section 29-70 of the GST Act.

In the Taxation Institute's view, the proposed exception for "minor errors" is too narrow. The Taxation Institute submits that the proposed exception should be modelled on the substantiation requirements of the income tax law, under section 900-195 of the Income Tax Assessment Act 1997. Broadly, relief from substantiation is available where, having regard to the "nature and quality of the evidence" used to substantiate the claim, you can satisfy the Commissioner that the expense was incurred and was deductible.

The Taxation Institute supports this approach because it is consistent with the underlying principle that input tax credits should be available for creditable acquisitions, and tax invoices only serve the purpose of substantiating entitlement to input tax credits. This approach also serves to overcome artificial distinctions between "minor" and "major" errors.

5. Rulings and Self-Assessment (Recommendations 17, 18 and 21)

In paragraph 2.4.10 of Treasury's discussion paper, the view is expressed that GST private rulings should have a one year default end date, rather than the usual 4 year default end date which applies for income tax rulings. The Taxation Institute disagrees with this recommendation and asks Treasury to reconsider it for the following reasons:

1. Many transactions extend beyond one year, such as in relation to construction projects, mining projects, IT contracts etc;

2. Many private rulings are sought in relation to the general classification of goods (e.g. food products) and it would impose a significant compliance cost on business to have to renew those private rulings annually;

3. It is appropriate that the default period for relying upon private rulings should align with the 4 year period of assessment by the Commissioner, given that taxpayers typically seek

private rulings to obtain certainty so that a liability cannot be assessed by the Commissioner;

4. Many private rulings relate to the question of whether an entity is carrying on an "enterprise", and a determination of what is the entity for GST purposes (e.g. a partnership or otherwise). Those rulings may be referred to as entity 'status' rulings and the ability to rely upon them over a 4 year period is as important in a GST context as it is in an income tax context;

5. The ATO would be sufficiently protected in the event of issuing an erroneous ruling, by (amongst other things) being able to revise the earlier private ruling (s359-55 of Schedule 1 of the Taxation Administration Act).

If you require any further information or assistance in respect of our submission, please contact Joan Roberts on 03 9611 0178 or the Taxation Institute's Senior Tax counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours sincerely

Joan Roberts

Joan Roberts
President