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TAXATION INSTITUTE *of* AUSTRALIA
IT'S ESSENTIAL

6 August 2009

General Manager
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The Treasury
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Email: financialsupplies@treasury.gov.au

Dear Sir,

Review of the Financial Supply Provisions

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide the following submission prepared by our GST Subcommittee, in response to the consultation paper on the review of the financial supply provisions contained within the *A New Tax System (Goods and Services Tax) Act 1999* (**GST Act**) and the *A New Tax System (Goods and Services Tax) Regulations 1999* (**GST Regulations or Regulations**). The Taxation Institute thanks the Treasury for inviting the Taxation Institute to participate in the meeting held on 3 July 2009 in Canberra.

Pursuant to the meeting, the Taxation Institute understands that the review of the financial supply provisions will be an iterative process, in that there will be continuing dialogue throughout the review. As a consequence, the following submission focuses on the main issues raised, and the Taxation Institute is prepared to make further, more detailed submissions on one or more of the points if required by the Treasury.

Whilst many of the points were raised and undoubtedly captured in the meeting, the Taxation Institute would like to outline the points below for completeness.

Overall view of the financial supply provisions

Whilst there are some issues of concern regarding the complexity and/or uncertainty of the financial supply provisions, overall the Taxation Institute is of the opinion that the regime is not creating problems of a magnitude that would require a major change to the regime, or a complete change to the way in which the provisions are written.

Over the past decade, many taxpayers have incurred significant costs in the process of understanding the current provisions and implementing appropriate systems, and are generally of the view that the financial supply provisions are not so defective that extensive changes to the regime are justified.

If changes to the financial supply provisions did not give rise to such significant costs, the Taxation Institute may have supported a detailed consideration of alternatives to the current regime. In particular, consideration could have been given as to whether more supplies should be input taxed, and the reduced input tax credit (**RITC**) regime abolished. The current regime of taxing supplies which are not normally taxed under GST / VAT systems in other countries, and allowing RITCs, has arguably only shifted the burden of compliance from one set of taxpayers, being suppliers, to another set of taxpayers, being recipients. As a consequence, recipients, rather than suppliers, now bear the burden of resolving classification and apportionment issues.

In addition, consideration could be given to a margin type regime, as implemented by South Africa. However, the Taxation Institute notes that this type of regime has its own complexities and difficulties. Very significant consideration would need to be given as to whether this regime is better than the current regime.

Financial Institutions/Non-Financial Institutions

It should be noted that the financial supply provisions impact financial institutions and non-financial institutions differently.

As a general proposition, the major issue impacting financial institutions is input tax credit recovery, and in particular, apportionment. Accordingly, consideration needs to be given to the possible improvement of the financial supply regime by providing taxpayers with some safe-haven apportionment methodologies.

Financial institutions also have concerns in relation to specific issues, in particular, the GST treatment of hire purchase arrangements.

In contrast, the major issue confronting non-financial institutions in respect of the GST treatment of financial supplies, is the:

- applicability of the financial acquisition threshold and the disallowance of credits if that threshold is breached;
- the issue of shares;
- the return of share capital; and
- acquisition supplies.

Drafting of provisions

As indicated above, there are some areas of concern in respect to the operation of the financial supply provisions.

The Taxation Institute is of the view that some of the problems have arisen from the GST Act or GST Regulations inadequately conveying the policy intention of the provisions. In other cases, some of the problems appear to have arisen as a result of the drafting.

The Taxation Institute does not favour the rewriting of the provisions to give effect to a principle-based approach.

The Taxation Institute would, however, support the incorporation of the policy intention of the provisions into the provisions in order to assist in their interpretation.

The Taxation Institute supports the re-introduction of all the financial supply provisions within the GST Act, which was how the GST Act was originally drafted, prior to its amendment by Act No 177 of 1999. A variation of this approach would be to have the relevant listings of particular financial supplies incorporated in schedules of the GST Act. This is the approach currently taken with respect to the supply of food.

The Taxation Institute also notes that certainty could be improved, and unintended outcomes mitigated, by providing examples in Schedules 7 and 8 of the GST Regulations for all of the items noted in Regulations 40-5.09 and 40-5.12. Currently, Schedules 7 and 8 only list examples for specific items in the GST Regulations. Schedules 7 and 8 should also be regularly amended and updated by Parliament (i.e. by way of an Amendment Act) in order to provide more certainty and clarity for taxpayers, and facilitate reduced reliance on the Australian Taxation Office (**ATO**) Rulings system.

There are a large number of statements in the GST Regulations which should be redrafted to simplify the language used and enhance interpretation. For example, phrases such as "If a supply is both a financial supply and not a financial supply, then it is a financial supply" should be eliminated.

Financial Supplies - Issues of particular concern

Indemnities/Guarantees

The Taxation Institute queries whether Item 7 of Regulation 40-5.09 (3) (**Item 7**) achieves the policy objective. Presently, guarantees are treated as input taxed only if they adhere to the strict legal interpretation of a guarantee, whereas, arrangements described as guarantees in accordance with normal commercial terminology, which do not adhere to the strict legal interpretation of a guarantee, are not input taxed.

These GST Regulations operate independently of whether the underlying transaction is a financial supply or not. That is, input tax leakage potentially arises where there is a guarantee being made with respect to a taxable property transaction. The Taxation Institute notes that Item 3 of former subsection 40-5(2) (being the original list of financial supplies when contained in the GST Act) specifically excluded from the list of financial supplies dealings with a security for a debt where the security was a lease, licence or other similar arrangement in respect of real property.

The Taxation Institute suggests that Item 7 be amended to link the guarantees and indemnities to financial supplies to remove complexities.

Underwriting

The GST treatment of fees charged by underwriters often creates difficulties because of the distinction between "hard" underwriting and "soft" underwriting. In addition, it is not uncommon for underwriters to provide a mixed supply for one fee, which creates difficulties in determining the quantum of the taxable amount. Whilst an industry practice has been established, it has not been formally endorsed by the ATO and there is an inherent risk that the ATO could challenge it.

Treating part of the fee as input taxed and part of the fee as taxable also causes input tax credit apportionment issues for both the underwriters and their clients. The Taxation Institute is of the view that it would be preferable if all underwriting fees were treated as being input taxed. Again, the manner in which underwriting was treated under the former subsection 40-5(2) Item 8 provides relevant background as to how underwriting should be treated.

Hire Purchase Arrangements

Major difficulties arise from deeming part of the supply as input taxed while the balance remains taxable. The apportionment issues are very complex, as it is difficult to determine the extent of the creditable purpose of an acquisition in relation to a hire purchase arrangement which is deemed to be a supply that is partly input taxed, and partly taxable. The ATO and the financial services industry have been debating this issue since the introduction of GST.

The Taxation Institute notes that in many cases the difference between a lease and a hire-purchase arrangement is minimal. In some cases the only difference is that the hire-purchase arrangement provides an explicit option for the hiree to acquire the property, whereas a lease may only imply an agreement for the lessee to acquire the property.

The ATO effectively treats a hire-purchase arrangement as an installment sale, which gives rise to difficulties when an actual sale occurs. As a consequence, cashflow issues arise where the hire-purchase arrangement is entered in to by a taxpayer who accounts for GST on a cash basis.

The Taxation Institute understands that the GST treatment of hire-purchase arrangements has also influenced the way in which equipment is financed. The Taxation Institute is of the view that the GST laws should not be distorting the manner in which goods are financed.

The Taxation Institute suggests that the GST law be amended to allow the hirer and hiree to agree that the arrangements be treated as being fully taxable as this should reduce the impact of many of the current problems. The Taxation Institute recommends that this approach be optional, as financiers may still prefer to treat hire-purchase arrangements entered into with unregistered entities as partly input taxed.

Managed investment schemes

The current GST treatment of managed investment schemes is uncertain, particularly as Item 10 of Regulation 40-5.09 refers to securities including:

> *"(c) a scheme described in paragraph (e), (i) or (m) of the definition of managed investment scheme in Section 9 of the Corporations Law."*

Managed investment schemes cover a range of arrangements, including contractual arrangements. It is unclear how item 10 applies in respect of such schemes. The Taxation Institute recommends the GST law be amended to clarify this position.

Capital interests in partnership and trusts

Similar uncertainty is created by the reference in Item 10 of Regulation 40-5.09 to securities, including:

> *"(d) the capital of a partnership or trust."*

The Taxation Institute is of the view that the Regulation should be amended to clarify what, by way of "capital", this Regulation is intended to capture.

Put options

Whilst the supply of a call option over a security is clearly a financial supply, and logic would dictate that the supply of a put option over a security would also be a financial supply, the financial supply regulations, as currently drafted, do not give effect to this logical outcome.

The Taxation Institute suggests that the Regulations be amended to remove this uncertainty.

Issue of Shares

In Australia, input tax credits cannot be claimed in relation to the issue of shares, whereas input tax credits in relation to borrowings (which are not used for input taxed activities) can be claimed. This creates a bias towards debt funding.

In addition, this GST treatment is inconsistent with the value added tax treatment adopted in overseas jurisdictions, and does not achieve an equitable policy outcome, as the GST treatment of the two forms of funding differs.

Return of capital

Currently, the GST treatment of the return of capital depends upon how the return of capital is implemented.

If there is a return of capital by way of a return of the paid up capital of the company, no supply occurs for GST purposes. Hence the costs may be enterprise costs, and depending on the recovery rate of enterprise costs, the associated GST could be fully creditable. In contrast, if the return of capital is implemented by way of a share buyback, there may be a denial of input tax credits as the share buyback involves the acquisition of the shares prior to their immediate disposal.

It is difficult to understand the policy objective of the different treatment, which is also distortive. The Taxation Institute believes the GST law should be amended to allow input tax credits to be claimed based on the recovery rate of the entity making the acquisition of the shares in both scenarios.

Acquisition supply

The definition of financial supply currently includes an “acquisition supply”, which is unique to the Australian GST regime. This results in denial of input tax credits for the recipient of an input taxed financial supply. For example, the purchaser of shares may suffer input tax credit blockage in relation to the acquisition of shares.

A further illustration of this outcome is where, for example, an entity acquires another entity which owns assets (including a business), and the acquiring entity and the acquired entity then group for GST purposes and/or the assets are subsequently transferred to the acquiring entity. In this situation, the entity acquiring the shares is denied input tax credits due to the fact that the ATO treats the acquisition of shares as the first supply under the “acquisition supply” concept. This result is inconsistent with the position in other jurisdictions.

Furthermore, the concept of an “acquisition supply” currently gives rise to the anomalous outcome of an entity acquiring shares from a non-resident being required to register for GST where the value of these acquisitions exceeds the GST registration threshold and can cause the financial acquisitions threshold (**FAT**) to be breached, even though the acquisition of these shares is a GST-free supply.

It is not clear what the policy rationale is for the treatment of all acquisitions of financial supplies to be treated as supplies. The Taxation Institute suggests that the concept of acquisition supply be reconsidered. Where the concept is intended to capture certain types of transactions that would not otherwise fall within the meaning of supply, then consideration should be given to limiting the acquisition supply concept to these transactions.

Financial Acquisition Threshold

The FAT has caused significant problems for non-financial institutions, such as:

- To determine whether you satisfy the FAT, you will commonly need to undertake complex calculations to arrive at a fair and reasonable apportionment methodology. The FAT is meant to remove the need to undertake these exercises.
- One large acquisition or sale commonly breaches the FAT and, therefore, entities are required to undertake calculations to determine the extent of which overhead costs relate to day to day financial supplies, such as hedging contracts.

The Taxation Institute notes that the recommendations in relation to the reduction of the time required to perform the FAT calculations only goes part of the way to reducing compliance costs and the complexity of the apportionment methodology calculation. The Taxation Institute strongly supports the increase in the threshold which has remained the same since the start of GST.

Reduced credit acquisitions

Current rate

The Taxation Institute is not in a position to make a submission in relation to what the appropriate rate with respect to reduced credit acquisitions (**RCAs**) should be. However, the Taxation Institute notes that as the current rate is an average rate, it is likely that it is too high with respect to some acquisitions, but too low with respect to other acquisitions.

The Taxation Institute would not support a reduction of the average rate which is intended to align the rate to a rate that is appropriate for those acquisitions which may deserve a lower rate.

Multiple rates

With an average rate of 75% the Taxation Institute understands that most taxpayers are content with only having one average rate. The use of one average rate avoids the difficulty of determining which items in the Regulations apply to the acquisition. It also avoids taxpayers structuring acquisitions so as to have one item, rather than another less favourable item, apply to the acquisition.

However, if the average rate was to change significantly, some taxpayers and/or sub-sectors of the financial services industry may prefer to have more than one rate. This would avoid these sub-sectors being disadvantaged by the average rate being reduced significantly by another sub-sector. If a reduction of the current rate were considered, further consideration could be given to implementing multiple rates based upon groups of acquisitions or sub-sectors. For example, there may be one particular rate for acquisitions which are commonly acquired in the funds management or superannuation industry.

Amendments to the RCA provisions

The Taxation Institute notes that some of the items in Regulation 70-5.02 are phrased expansively, as they contain the word “include”, whilst other items are phrased exclusively, as they contain the words “The following”.

For example, Item 29, which is phrased expansively, states:

“Trustee and custodial services (except safe custody of money, documents and other things) including:.”

Conversely, Item 23, which is phrased exclusively, states:

“The following investment portfolio management functions (including those functions with superannuation schemes)”

The first issue to note is that inconsistent phrasing is used across the expansive items listed in Regulation 70-5.02, with the items variously ending with “including by using the following facilities”, “of the following kinds”, “including” and “including the following”. In this regard, the Taxation Institute recommends that one phrase be used consistently across all items.

The second issue to note is that the use of exclusive language, as in Item 23, causes ambiguity and uncertainty in relation to whether an acquisition is a RCA in situations where the service acquired is in the nature of the listed item, but is not explicitly listed as an example. The Taxation Institute recommends that expansive phrasing be used to eliminate this ambiguity.

Another area which causes concern is the definition of “Financial supply facilitator” in Regulation 40-5.07, as what constitutes a “facilitator” is unclear. In this regard, the Taxation Institute recommends that the Regulations be amended to provide a better definition.

Merger Costs

The costs associated with mergers and acquisitions are potentially covered by the RITC provisions (Item 9). However, in many cases when two companies commence merger discussions, it is unclear which company will ultimately acquire the shares of the other to give effect to the merger. Often, only the acquiring company will be able to obtain an RITC on the merger costs because the RCA only applies where an interest in a security is acquired or disposed of. That is, the company being acquired will generally not sell its shares to the acquiring company rather, the shareholders of the company being acquired will sell their shares to the acquiring company.

The Taxation Institute does not agree with the outcome of these RCA provisions and doubt that the drafters only intended that one party to a merger transaction would be entitled to claim RITCs. Also, the practical reality of merger transactions mean that it may not be known which of the two merging companies is actually entitled to claim the RITC.

The Taxation Institute recommends that the Regulations be amended to make it clear that both parties to a merger transaction are able to claim RITCs on their RCAs. This would appear to fit with the policy intention and, in allowing both parties to claim RITCs, resolves the temporal difficulties in deciding which party to the merger makes the RCA.

Legal and accounting expenses

Whilst it would be in the best interests of many of the Taxation Institute's members to have legal and accounting expenses treated as RCAs, and this may also avoid some transactions being structured in particular ways, the Taxation Institute does not support the adoption of this treatment as it does not appear to accord with the policy objective of obtaining a RITC.

In particular RITCs are being claimed for acquisitions which are taxable supplies in Australia, but are not taxable supplies in other jurisdictions. For example, legal and accounting fees are taxable supplies in other jurisdictions.

Unabsorbed contributions

The concept of unabsorbed contributions is contained in Regulation 70-5.02A. The Regulation is designed to eliminate the incentive a financial institution might have to have some of its internal activities undertaken offshore.

The Taxation Institute does not believe that it is appropriate to incorporate such a concept into Regulation 70-5.02A, as it would effectively unbundle acquisitions where there is an entitlement to a RCA. The Taxation Institute notes that the 75% RITC is based on the concept that no bundling occurs.   Furthermore, as Regulation 70-5.02A applies to related entities, it is possible to obtain the information necessary to undertake the calculations. In contrast, most of the acquisitions which fall within regulation 70.5-02A are acquisitions from unrelated entities. It would be difficult, and in some instances impossible, to obtain the information required to determine the input tax entitlement.

Addressing issues created by the RITC

The Taxation Institute notes that the consultative papers refer to some planning opportunities that arise because of the RITC regime. The Taxation Institute notes that this activity might arise because of the use of an average rate. In particular, as an average rate is being used in some circumstances, a higher input tax credit recovery can be obtained by outsourcing to create an acquisition which is a RCA (for example, where a lot of inputs are subject to GST). In other circumstances, a lower recovery would occur by outsourcing (where a lot of inputs are not subject to GST).

The Taxation Institute is of the view that the concerns expressed in relation to the GST leakage issue, are not sufficient to warrant the implementation of multiple RCA rates.

In addition, if some non-commercial arrangements are being entered into to maximise the input tax recovery rate, it is open to the ATO to use its powers under Division 165 to negate the benefits obtained. The Taxation Institute feels that this is the preferred approach, rather than making major changes to the RITC regime for the purpose of eliminating a disproportionately small number of arrangements.

Transitional measures

The Taxation Institute recommends that if any changes are made to the financial supply provisions, then an appropriate transitional period should be implemented to recognise the difficulties that this would cause for businesses with long-term contracts and agreements in place, and also to allow sufficient time for businesses to make the appropriate changes to their systems.

If Treasury would like to meet with the representatives of the Taxation Institute, or require any further information or assistance in respect of our submission, please contact the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis on (02) 8223 0011, or Ian Jeffrey, Partner, PricewaterhouseCoopers who, with contributions from a variety of members, wrote the submission.

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Yours faithfully,

DWilliams

David Williams
Vice President