16 September 2008

Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

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

The Australian Financial Markets Association (AFMA) appreciates the opportunity to respond to the Board of Taxation's Issues Paper on the Legal Framework for the Administration of the Goods and Services Tax (GST). AFMA represents the interests of participants in the Australian wholesale banking and financial markets on regulatory issues that affect their business. Our members are industry leaders and comprise both Australian and foreign owned institutions, including investment banks, securities companies and traders in specialised financial markets.

The Board of Taxation's review into the legal and administrative framework of the GST is a timely stock-take of aspects of the law that can work more efficiently. AFMA supports the objective of the review to identify ways to reduce compliance costs, streamline and improve the operation of the GST and remove any anomalies. The reduction of unnecessary compliance costs will result in greater ease in conducting financial services business in Australia, and accords with the Government's objective of promoting Australia as a regional financial hub.

While the increasingly global nature of financial markets presents a challenge for the administration of the GST as well as other taxes, it is important that international capital flows are not discouraged by burdensome tax administration. It is also of vital importance that the GST provides neutral outcomes for different taxpayers and financial products. Our submission addresses these key concerns, with reference to the following specific issues:

1) Cross border global contracts between corporations;
2) Definition of "when an enterprise is carried on in Australia"; and
3) GST treatment of underwriting.

Should you have any queries about this submission, please do not hesitate to contact me. We look forward to further consultation on the review.

Yours sincerely

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1. Cross Border Global Contracts Between Corporations

All statutory references in this document are to the *A New Tax System (Goods and Services Tax) Act* 1999 (Cth) unless otherwise specified.

1.1 Issue

The GST treatment of cross border contracts commonly used by global corporate groups gives rise to complexity, administration costs and double taxation or tax cascading.

1.2 Background

Increasingly, an entity in a multinational group may enter into general services arrangements with clients, under which the related services may be provided by associated entities within the group located anywhere in the world (rather than by the main contracting party).

In this context, an Australian entity that is part of a multinational conglomerate group may offer a specific component of the group's global services. For example, the Australian entity may offer execution services in respect of ASX listed share transactions. The Australian entity is likely to have a general service level agreement to provide this particular service to its non-resident associates, so they can meet their obligations to their clients (eg to execute trades in Australian shares). These agreements are not conditional on the location of the ultimate client, so the consumer of the service could potentially be in Australia. In other circumstances, arrangements between the Australian entity and its non-resident associates may be informal because for instance, only an Australian registered member of the ASX can trade in a particular security, so the trade is given to the Australian entity to transact.

Currently, if a customer of a non-resident associate is located in Australia and, for whatever reason, the Australian entity provides services contractually to the non-resident associate (as a sub-contractor) but the service ultimately benefits the Australian customer, then under subsection 38-190(3) the Australian entity would be required to charge GST to the non-resident associate (on the basis the service is "provided" to an entity in Australia).

The GST would then be passed on by the non-resident associate to the Australian customer as a reimbursement of a cost (incurred by the non-resident). It is unlikely the non-resident associate will go through the administrative bother of registering for Australian GST, recovering the GST charged to it by the sub-contractor and then charging a separate GST amount to the Australian corporate customer for the component that is "connected with Australia". Furthermore, it is also likely that, to the extent the service received from the non-resident associate relates to an Australian corporate customer making input taxed supplies, the Australian corporate customer will reverse charge the service (including the GST passed on as a cost) on the basis that the non-resident's core service is not "connected" with Australia. What results is GST cascading, being GST assessed on GST already paid, to the detriment of Australian business.

While AFMA acknowledges that currently non-resident global service providers can register for GST in Australia in order to avoid the GST cascading problem, in practice multinational corporations with entities located in many countries around the world do not favour this type of solution as they would have to register hundreds of entities. Instead, they would prefer the matter to be addressed through the reverse charge rules.

1.3 Discussion

The Organisation for Economic Cooperation and Development (OECD) is currently revising its guidelines for cross border supplies of services and intangibles because of the increasing globalisation of international business models and the need to maintain efficient and consistent global standards.

In respect of global agreements where the supplier and customer are essentially in the same country there is little dispute the service should be taxed in that country. However, the transaction should not result in double taxation and should not result in complex administration for the non-resident entity.

The European Council's sixth Value Added Tax (VAT) Directive was recast in 2006 to clearly address the "place of supply" for services in order to encourage administrative efficiency.[1] Article 56 of the Directive states, amongst other things, that the place of supply of specified services[2] to taxable persons established in the EU but not in the same country as the supplier, shall be the place where the customer has established his business or has a fixed establishment for which the service is supplied. In essence, the Directive requires a taxable customer to "self assess" VAT for an intermediary service provided to it from an entity in another country, so the supplier does not need to charge VAT. This is the approach AFMA recommends for Australia.

Consider the example of an Australian superfund who uses a global brokerage agreement with a non-resident multinational broker to trade its international share portfolio. The actual execution of orders is "done" by a network of country specific brokers located wherever the relevant exchange for the particular shares being traded is situated. This arrangement is made via a network of general service level agreements, or informal arrangements, between the non-resident multinational broker and various usually associated sub-brokers. The Australian sub-broker would therefore provide its service under a general service level agreement to the non-resident global broker for all its customers who trade Australian shares (the bulk of which would be non-residents). However, if the Australian superfund, for whatever reason, decided to trade some Australian shares using the global broker, then the actual trade would be executed by the Australian sub-broker along with all the other Australian share trades it does for all the non-resident customers of the non-resident global broker.

In practice, the non-resident global broker is not likely to register for GST in Australia. If the Australian sub-broker charges GST to the non-resident multinational broker because section 38-190(3) denies GST-free status (potentially the Tax Office's position) and the superfund reverse charges the proportion of the fee from the non-resident broker that relates to the Australian trade, then there is clearly GST cascading which is inefficient for the financial services industry in Australia and is completely unnecessary given the reverse charge rules could address this matter for those entities registered for GST.

Moreover, the Australian sub-broker may not always be aware that the underlying client is Australian. Therefore, the current treatment leads to inconsistencies where GST is charged in certain cases and not in others, depending on whether it is transparent to the Australian supplier that the end user is in Australia or not. Given the existence of the

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[1] Articles 44 and 56 of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (the 6th Directive). The place of supply of services to taxable persons established in the Community but not in the same country as the supplier, shall be the place where the customer has established his business or has a fixed establishment for which the service is supplied, or, in the absence of such a place, the place where he has his permanent address or usually resides.

[2] Including the supply of services by intermediaries, acting in the name and on behalf of other persons, where those intermediaries take part in the supply of the services of banking, financial and insurance transactions, amongst other things.

reverse charge rules, it is preferable for an Australian end user to self assess GST under the reverse charge provisions.

1.4 AFMA Suggested Treatment

Amend Section 38-190(3)(b) to read "the supply is provided, or the agreement requires it to be provided, to another entity in Australia who is not registered for GST". In this way, there will be no loss to revenue and an obligation to charge GST will still exist if the ultimate consumer is not registered for GST in Australia.

Note: No requirement should be placed on the supplier to actively inquire if the recipient of the supply is registered in Australia, as this would be an impractical obligation to comply with. In practice, the risk of GST avoidance under amended section 38-190(3) should be minimal, as any business not registered for GST is unlikely to have the critical mass or sophistication to avoid GST by routing their acquisition of supplies through a non-resident on a systematic basis.

2. Definition of "When an Enterprise is Carried On in Australia"

2.1 Issue

The GST law potentially captures a wide range of businesses offshore within the GST administrative net and imposes a high administrative compliance burden on non-residents.

2.2 Background

Subsection 9-25(6)(b) includes in the definition of "*When enterprises are carried on in Australia*" activities that would not ordinarily give rise to a permanent establishment (PE) in Australia for income tax purposes. This inconsistency with the income tax legislation causes administrative problems for non-resident businesses that may use people located in Australia to introduce corporate customers to them but who essentially provide the particular service to that corporation from offshore.

In these circumstances, Division 83 technically does not operate (even though the transaction is "done" outside Australia) because the customer was introduced or brokered by a person in Australia. Likewise, Division 84 does not come into play because the service is "connected with Australia". As such, the current technical approach is that the non-resident entity is required to register for GST in Australia and charge GST where applicable notwithstanding they do not have a PE in Australia for income tax purposes.

AFMA advises that this asymmetry is problematic for multinational financial service providers who may have PEs located in many countries around the world all of which are potentially capable of providing services to Australian corporations, which themselves are registered for GST and would be quite capable of reverse charging the service if necessary.

An example of such a financial service would be the provision of best endeavours underwriting services for, say, the issuance of debt by an Australian company in Japan facilitated by a Japanese associated entity of a multinational investment bank located in Australia. If the Australian company was introduced to the Japanese entity by relationship bankers located in Australia, then even though the core (underwriting) service is provided from Japan, under a strict reading of s.9-25(6)(b) the Japanese entity could potentially be required to register for GST assuming it meets the GST registration turnover threshold. This is so notwithstanding the service relates, in its entirety, to GST-free supplies (of debt securities in Japan) being made by the Australian company.

2.3 Discussion

Although most countries have adopted similar principles for the operation of their value added systems, there remain differences in the way the systems are implemented, even between OECD member countries. These implementation issues create obstacles to business activity and distort competition, often as a result of double taxation and/or administrative inefficiency.

To date, the general approach to "place of supply" adopted by most countries fail to recognise the increasingly global markets that their own corporations now operate and compete in. For multinational businesses, differing "place of supply" laws generate undue administrative burdens and uncertainties, particularly where services are performed in specific jurisdictions for customers located anywhere around the world (ie Euro bond markets, Japanese debt markets, US equity/debt listings). Such services may be exempt from GST in some countries, while taxable in others depending on whether

"arranger" services are taxable, exempt or out of scope. Furthermore, countries use varying means to alleviate the various problems including refund schemes for foreign businesses or registration procedures to achieve the same effect. However, such disparate approaches are burdensome to multinationals especially where the services are provided to corporations registered in the "place of consumption" that could more easily "reverse charge" the particular service if it is taxable and relates to an input taxed supply.

In Australia, "arranger services" are taxable (if connected to Australia). Currently, the law suggests that non-resident entities of a multinational group must register for GST in Australia if the transaction is introduced to them by an agent/broker located in Australia, even where that agent/broker does not have the authority to negotiate or conclude contracts on behalf of the non-resident.[3] That is, there would be no PE for income tax purposes and yet the non-resident would need to get an Australian Business Number (ABN) and register for GST. The question then arises whether the non-resident is entitled to get an ABN and what the Australian corporation's obligations under the PAYG withholding provisions of the *Taxation Administration Act* 1953 (Cth) would be. Finally, for all this administration there is no gain to the revenue of Australia because the service is provided to a corporation registered for GST in Australia and the service either relates to GST-free supplies made by the recipient or, if it relates to an input taxed supply, would be captured by the reverse charge rules. There is only a very remote risk these types of services would be provided to an unregistered entity in Australia.

As an example, a major Australian company such as, say, BHP Billiton (BHP) is likely over time to engage the services of a multinational bank in many parts of the world to provide specific services whether it be corporate advice, underwriting, global banking services etc. A subsidiary of the multinational bank located in Australia will, therefore, have many associated entities potentially, over time, providing various different services from anywhere in the world to BHP. The multinational bank will be required to register all the non-resident entities for GST if the services supplied would be taxable in Australia and BHP was introduced to the non-resident entity by, say, a relationship manager in Australia or even a mere representative agent. In practice, to register every non-resident associated entity of a multinational financial services provider located in Australia for Australian GST is impractical.

Consider the complexity if the non-resident entities not only registered for Australian GST but were then grouped. There would be services between entities that would be excluded because of grouping while others would have to be reverse charged under Division 84 to the extent they related to input taxed supplies made by the non-resident, while other services would not be connected with Australia and also outside the reverse charge regime. It results in an administrative conundrum, the risk of which is virtually impossible to control without enormous amounts of resources dedicated to tracking all deals done throughout the world.

The current approach makes Australia a less desirable destination for non-resident entities to offer valuable financial services and hinders Australia's position as a major financial hub. To fix the problem would not result in any meaningful loss to revenue.

2.4 AFMA Suggested Treatment

Delete Subsection 9-25(6)(b) so that Section 9-25(6) reads "An enterprise is carried on in Australia if the enterprise is carried on through a permanent establishment (as defined in subsection 6(1) of the *Income Tax Assessment Act* 1936)".

[3] Definition of PE in subsection 6(1) (e) or (f) of the *Income Tax assessment Act* 1936.

3. GST Treatment of Underwriting

3.1 Issue

The lack of clarity in GST law as it applies to underwriting arrangements creates market uncertainty and unnecessary compliance costs for the financial services industry.

3.2 Background

Currently, Regulation 70-5.02(2) item 9(i) indicates that a part of an underwriting service is input taxed under Regulation 40-5.09. Unfortunately, the item does not clearly identify what the matter is that is input taxed, which has led to significant market uncertainty about the precise impact of the law in its application.

The practical effect has been to require underwriters to separately assess each and every underwriting arrangement for GST purposes to determine what proportion of the underwriting supply is input taxed. This is a technically challenging exercise; for example, it has been necessary to determine, as part of negotiation processes with issuers, the amount of risk taken in accepting an underwriting engagement and how the GST legislation applies. Moreover, it imposes a tax overlay on underwriting that is at variance with the way that business is actually seen in practice (eg an underwriting fee, if it were not for GST, would generally be quoted as a single amount rather than splitting the fee into a taxable and input taxed component). Underwriting is an imprecise term and does not naturally fall into any one item of the GST regulations, as they are currently drafted. The effect of these uncertainties has been to impose a significant administrative burden on business that is unproductive from a policy perspective and adds little to the tax revenue base.

Setting the current uncertainty about the application of the law to one side, there is no policy reason for any part of the underwriting fee to be input taxed, as it is quite easily valued as a total business proposition. From a policy perspective, if Australia intends to tax all "Arranger Services", then really the only "matter" that needs to be input taxed in an underwriting arrangement is if the underwriter has to actually acquire shares or debt on its own account. That is, in theory, only the actual acquisition of the "shortfall shares" needs to be input taxed. Furthermore, if tax neutrality and minimising tax cascading are major objectives of the tax regime, then whether GST on equity financing should be treated differently from GST on debt financing should be reconsidered.

3.3 Discussion

Since the introduction of GST, the concept of trying to establish what matter is input taxed and how to value it has been problematic. This is because there are various types of underwriting and processes involved including institutional book building, retail bookbuilding, roadshows, advisory services, settlement support as well as the obligation to purchase any shortfall.

The term underwriting is not defined in the GST Act and is an imprecise term. The concept was considered by Finkelstein J in *Aberfoyle Ltd v Western Metals Ltd (1998) 28 ACSR 187* ("Aberfoyle"). There it was said:

> "In a broad sense there are three types of arrangements commonly referred to as underwriting: (compare L Loss & J Seligman, *Securities Regulation (3rd)* vol 1 ch 2 where five underwriting arrangements are described). The first is an arrangement by which before shares are offered to the public in the event that the public does not take up those shares the underwriter will take up the unsubscribed portion of the

issue: see *In Re Licensed Victuallers Mutual Trading Association; ex parte Audain* (1889) 42 Ch D 1, where a Court of Appeal, of which Lindley LJ was a member, found it necessary to bring in evidence to explain the meaning of the term; see also *Australian Investment Trust Ltd v Strand and Pitt St Properties Ltd* (1931) 31 SR(NSW) 266 on appeal [1932] AC 735. This type of underwriting is called in the United States 'strict' or 'old fashioned' or 'standby' underwriting: T L Hazen, *The Law of Securities Regulation* (2nd) vol 1 at 58.

In the United States the most common type of underwriting is firm commitment underwriting. Here the issuer sells the entire allotment usually to a group of underwriters represented by a lead underwriter or manager. The group in turn will contract other underwriters to act as wholesalers of the securities to be offered: see Hazen at 59, Loss & Seligman at 324 ff; *Palmer's Company Law (25th)* at para 5.216. However, this method of underwriting is not underwriting in the classic sense; that is, in the sense that the underwriter acts as an 'insuring house': see Loss & Seligman at 324. For examples of firm commitment underwriting agreements see L Israels & G Duff, *When Corporations Go Public* and [1971] *The Business Lawyer* at 648.

The third type of underwriting arrangement is referred to as 'best efforts' underwriting. Here the underwriter does not assume any risk if the issue is undersubscribed nor does the underwriter give a firm commitment to take securities. *With best efforts underwriting the underwriter undertakes to use its best endeavours to sell the securities for the issuer as an agent:* Hazen at 60; Loss & Seligman at 341-2. As Loss & Seligman say, *this is not really underwriting, it is simply merchandising*.

.... *An underwriting must involve some element of risk taking by the underwriter and best efforts underwriting does not put the underwriter at risk at all*"[4].

As can be seen there are, at least, three concepts of underwriting. This causes practical problems for industry, potentially resulting in variance in the GST treatment of underwriting. It is submitted that an effective solution, which would provide certainty and simplicity to taxpayers (both issuers and underwriters), is to treat all underwriting uniformly by making them all a taxable supply for GST purposes. In other words, the necessity for taxpayers to differentiate between different types of underwriting should be removed. This would relieve underwriters of the unnecessary administrative burden of having to analyse every underwriting contract to objectively determine the input taxed amount.

Subjecting all underwriting fees to GST would potentially increase the "sticky" GST on business in Australia, but would reduce tax compliance costs and uncertainty within the banking industry. As a policy consideration, therefore, Parliament should also consider aligning the GST treatment of debt and equity issuance to minimise "sticky" GST which results in GST cascading throughout Australian business. That is, an underwriting service is a business-to-business transaction and there is no basis from a policy perspective for fully taxable businesses to suffer "sticky" GST when raising debt or equity. Rather, from a pure policy perspective, a predominantly taxable business should be able to raise either debt or equity without suffering "sticky" GST. Only an input taxed business raising debt or equity should suffer "sticky" GST and only to the extent the business is not entitled to a reduced input tax credit (RITC) for the GST on acquisitions

[4] *Aberfoyle* (1998) 28 ACSR 187 at 204-205 (emphasis added).

relating to the raising of debt or equity. Such a policy alignment, together with the policy of making all underwriting taxable would be a consistent and reasoned policy approach for underwriting based on fundamental principles.

For completeness, it is noted that the GST law was purposely amended to ensure that where an entity borrows money (which includes issuing debt instruments) and uses it in making taxable or GST-free supplies, then it will be entitled to input tax credits for its borrowing related expenses.[5] The law was changed in this manner to avoid a negative impact on business from GST cascading and to contain compliance costs for businesses. The problem is that there is now a clear tax distortion directed towards borrowing and against equity funding. Generally, the principles of good taxation require that tax should not favour one product over another (which income tax law seeks to do through dividend imputation). This is especially so given the current financial situation.

If there is a policy desire for taxation neutrality across funding instruments, and a desire to minimise "sticky" GST for business-to-business transactions, then it is submitted that the service of underwriting should have the same GST impact whether a company is raising debt or equity and, in order to minimise tax cascading, acquisitions relating to raising equity funding should be afforded the same treatment that debt receives under the current Subsection 11-15(5).

3.4 AFMA Suggested Treatment

The proposed legislative amendment would strictly have to be prospective, as there is necessarily variation in the current GST treatment of 'underwriting' within the terms of the current (complex) law given the character of the associated supplies.

1. To minimise GST cascading, insert Subsection 11-15(6) to Section 11-15 to read:

   "An acquisition is not treated, for the purposes of paragraph (2)(a), as relating to making supplies that would be input taxed to the extent that:

   (a) the acquisition relates to making a financial supply consisting of the issuing of shares; and

   (b) the capital raised from issuing of shares is used for making supplies that are not input taxed.

2. To bring all underwriting services under a taxable item, amend Regulation 40-5.12 item 11 to read "Broking services including underwriting services but not the physical purchase of any shortfall debt or equity".

3. To allow a RITC where underwriting services are provided to an entity that makes input taxed supplies, amend Regulation 70-5.02(2) item 9 (i) to read "underwriting services".

The suggested amendments should take effect either from date of Royal Assent or from public announcement of the proposed amendment, and should not be applied retrospectively to ensure the outcome is both fair and efficient.

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[5] Indirect Tax Legislation Amendment Bill 2000.

ANNEX – EU Council Directive 2006/112/EC

Extract – The Common System of Value Added Tax, 28 November 2006, Article 56

1. The place of supply of the following services to customers established outside the Community, **or to taxable persons established in the Community but not in the same country as the supplier**, shall be the place where the customer has established his business or has a fixed establishment for which the service is supplied, or, in the absence of such a place, the place where he has his permanent address or usually resides:

(a) transfers and assignments of copyrights, patents, licences, trade marks and similar rights;

(b) advertising services;

(c) **the services of consultants, engineers, consultancy bureaux, lawyers, accountants and other similar services, as well as data processing and the provision of information;**

(d) obligations to refrain from pursuing or exercising, in whole or in part, a business activity or a right referred to in this paragraph;

(e) **banking, financial and insurance transactions, including reinsurance, with the exception of the hire of safes;**

(f) the supply of staff;

(g) the hiring out of movable tangible property, with the exception of all means of transport;

(h) the provision of access to, and of transport or transmission through, natural gas and electricity distribution systems and the provision of other services directly linked thereto;

(i) telecommunications services;

(j) radio and television broadcasting services;

(k) electronically supplied services, such as those referred to in Annex II;

(l) **the supply of services by intermediaries, acting in the name and on behalf of other persons, where those intermediaries take part in the supply of the services referred to in this paragraph.**