
Review of the Legal Framework for the Administration of the GST

*Submission to the Board of Taxation
by the Federal Chamber of
Automotive Industries*



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Q3.6 DO THE ADJUSTMENT PROVISIONS COVER ALL TRANSACTIONS WHERE AN ADJUSTMENT SHOULD BE AVAILABLE? ARE THERE ANY OTHER ISSUES OR ANOMALIES WITH THE ADJUSTMENT PROVISIONS THAT NEED TO BE ADDRESSED? IF SO, WHAT CHANGES ARE NEEDED?

The Federal Chamber of Automotive Industries (**FCAI**) wishes to draw the attention of the Board of Taxation to the inadequacy of the adjustment provisions in Division 19 of the *A New Tax System (Goods and Services Tax) Act 1999 (GST Act)* in dealing with certain payments made to car dealers by car manufacturers and importers (together referred to as distributors in this submission). The particular focus of this submission is on the treatment of what are known in the industry as holdback payments.

The FCAI believes that the treatment of holdback payments since the inception of the GST regime provide a stark example of how the adjustment provisions do not properly reflect the commercial reality of the transactions.

Further, the FCAI believes that there are a number of other industry payments that likewise should be treated as adjustment events. Because of the somewhat unique nature of the industry, and the operation of the GST adjustment provisions, their classification for GST purposes remains unclear.

The essence of this view is the strong belief of the FCAI that where a payment by a distributor to a dealer is effectively, in a commercial sense, an adjustment to the price paid by the dealer for the car, this should be recognised by the GST adjustment regime as an adjustment event, giving rise to an increasing adjustment for the dealer and a decreasing adjustment for the distributor. As is explained below, the operation of the GST adjustment provisions, when coupled with the unique way in which the industry operates, does not allow for this outcome to be achieved.

BACKGROUND

Participants in the automotive industry

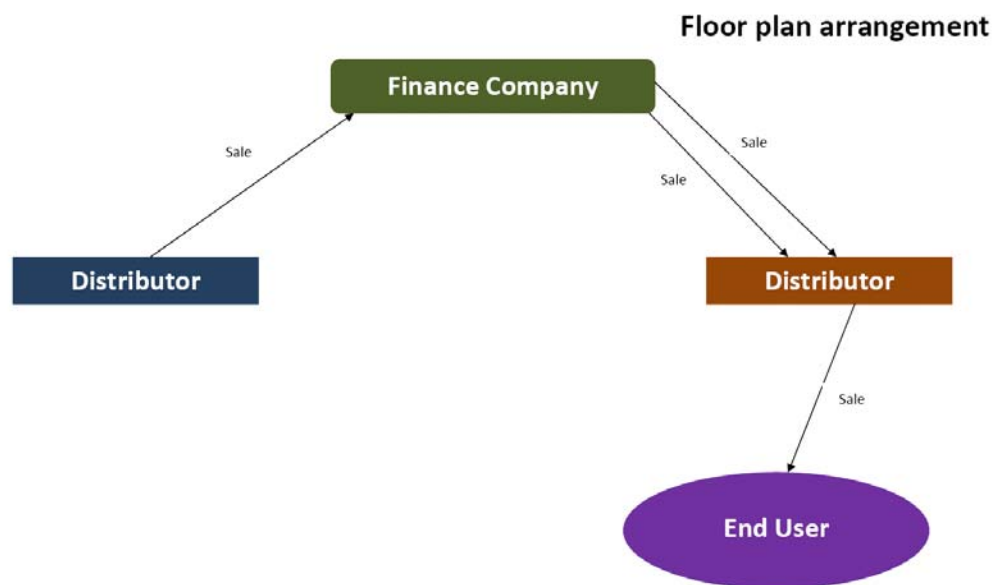
The sale of new vehicles in the Australian automotive industry typically involves the following parties:

- distributors, who import or manufacture cars for sale within Australia;
- dealers, who sell cars to end users; and
- finance companies, who finance the acquisition of the cars by the dealers from the distributors.

Motor vehicles are high value goods. A dealer seeking to acquire trading stock of vehicles to display in a showroom is faced with a high capital cost. To effectively manage this cost to the dealers, it is common industry practice for a finance company to provide finance to dealers to assist them with the purchase of vehicles.

A finance company provides this financing solution by typically purchasing a vehicle from a distributor and placing it on bailment with a dealer. The finance company will complete the sale to the dealer at the point when an end user has agreed to buy the car from the dealer. Until that time, the dealer will hold the car on bailment under a floor plan arrangement. The transfer of ownership of the car by the finance company to the dealer, and the transfer of ownership of the same car by the dealer to the end user, occur virtually simultaneously.

The relationship between the parties is depicted in the following diagram.



In some instances, alternative financing solutions may be provided by a finance company. These are discussed later in this submission. In the vast majority of instances, the structure outlined above represents the typical financing solution within which the industry operates.

Holdback Payments/Rebates

Over time, a practice has developed in the industry whereby the wholesale price of a car is increased by an amount that would otherwise represent a portion of the dealer's margin. This adjusted price then forms the wholesale price when the vehicle is sold to the finance company and in turn by the finance company to the dealer.

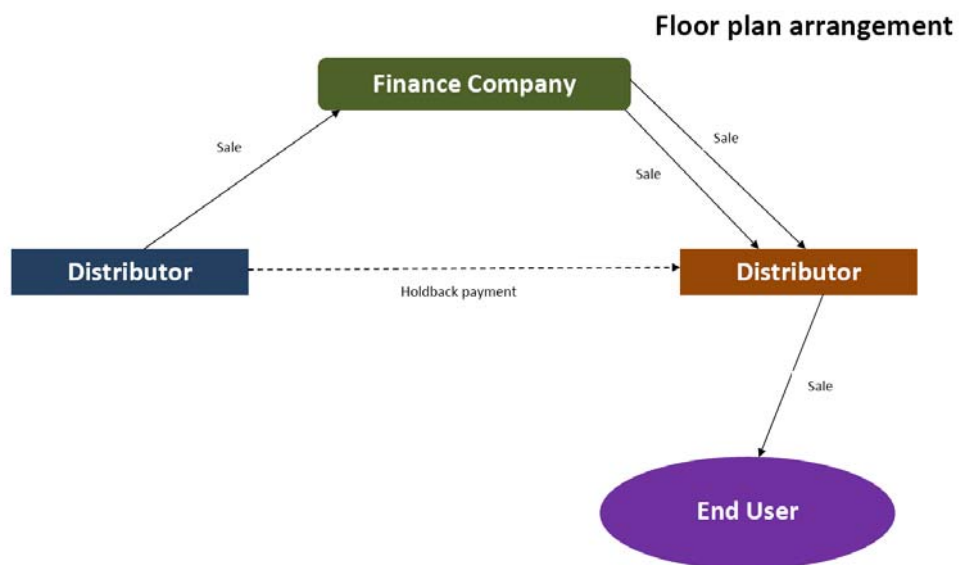
Either at the point when a finance company purchases a car from a distributor, or at the point when a dealer sells a car to an end user, an obligation is triggered for the distributor to make a holdback payment (essentially a form of price rebate) to the dealer. In essence, the adjusted portion of the wholesale price, representing a portion of the dealer's margin, is returned to the dealer.

The reason for the development of this practice as between distributors and dealers was to counter the tendency of retail sales staff to sell vehicles using the wholesale price as a

negotiating base. The Tax Office has been aware of this industry practice for some time and has addressed these payments in the context of other taxation issues. In 1991, the following observations about holdback payments were included in Taxation Ruling IT 2648:

“The reason for “holdback” arrangements is not completely clear. The main reason usually advanced is to conceal from salespersons a component of gross profit so that retail price is not lowered by negotiation to a level where the dealer earns a minimal gross profit on a sale.”¹

The holdback payment from the distributor to the dealer effectively returns the wholesale price of the car to a non-adjusted level. As shown in the following diagram, the holdback payment flows directly from the distributor to the dealer. Whilst the finance company participates in the original sale of the car, it plays no role in the making of the holdback payment.



¹ Paragraph 14 of IT 2648: Income Tax: Motor Vehicle Manufacturers, Distributors and Dealers: Demonstration Stock Valuation; Holdback Amounts and Warranty Obligations.

THE COMMERCIAL REALITY OF HOLDBACK PAYMENTS

In a purely commercial sense, the arrangements as described above reflect a conscious decision by the parties, that is, distributor and dealer, for a new vehicle to initially be sold at an adjusted price and for that price to then be reduced through the holdback payment. Were it not for the incidence of the finance company in the sales chain, it is our view that the holdback payment would clearly reflect an adjustment to the wholesale selling price of the car. The intended effect of a holdback payment, and its actual effect, is to reduce the consideration for the dealer's acquisition of the car from the distributor via the finance company intermediary.

In industries where there is no finance company sales intermediary, such payments would clearly be classed as price adjustments and the GST consequences would flow accordingly. Specifically, Division 19 would apply to the transactions.

In the automotive industry however, because of the predominant incidence of the finance company in the supply chain, there is a significant disjunct between the treatment of holdback payments under the legislation and their real commercial impact.

THE LEGISLATIVE REGIME

Under Division 19 of the GST Act, an adjustment event is "any event which has the effect of:

- a) cancelling a supply or acquisition; or
- b) changing the consideration for a supply or acquisition; or
- c) causing a supply or acquisition to become, or stop being, a taxable supply or creditable acquisition."²

Further, subsection 19-10(2)(b) of the Act provides, as far as is relevant to this issue, that *a change to the previously agreed consideration for a supply or acquisition, whether due to the offer of a discount or otherwise, is an adjustment event.*

An adjustment event will give rise to an adjustment *for a supply* where the GST on that supply was attributable to an earlier tax period and as a result of the adjustment event, the previously attributed GST amount is no longer a correct reflection of the GST on the supply.³

An adjustment event will give rise to an adjustment for an acquisition where the input tax credit for that acquisition was attributable to an earlier tax period and as a result of the

² Section 19-10(b)

³ Section 19-40

adjustment event, the previously attributed input tax credit amount is no longer a correct reflection of the input tax credit for the acquisition.⁴

Therefore, adjustment events and adjustments do not arise under the legislation unless they are related to a supply or an acquisition. For this reason, where a vehicle is sold to a finance company, holdback payments are not technically recognised as adjustment events because they do not, strictly, affect a supply or acquisition. Although there is a supply flowing between the distributor and the finance company, and a supply flowing between the finance company and the dealer, the holdback payment does not impact the consideration for either of these supplies. Accordingly, while at a commercial level the holdback payment relates to the sale price of car as between the distributor and dealer, there is, in a technical sense, no direct supply from the distributor to the dealer to which the holdback payment relates.

THE TAX OFFICE'S TREATMENT OF HOLDBACK PAYMENTS IN THE GST REGIME

In the public ruling Goods and Services Tax Ruling GSTR 2000/19, as originally drafted, the Commissioner indicated in paragraphs 40 to 42 that he was prepared to treat a payment of a similar kind to a holdback payment as giving rise to an adjustment event. This was despite the fact that there had been no earlier supply between the party making the payment and the party receiving it. The original paragraphs 40 to 42 of GSTR 2000/19 are extracted below:

"Payments to third parties

40. A supplier (such as a manufacturer) may make a payment to an end user who acquires a thing from a retailer. Often in cases like this, the manufacturer will make the payment directly to the end user independently of the retailer. Effectively, this payment changes the consideration the manufacturer receives for the supply of the thing and price that the end user pays for the acquisition of the thing.

41. Where this type of payment has the effect of changing the consideration received by the manufacturer and paid by the end user, the payment will be an adjustment event that affects only the manufacturer and the end user.

Example

42. Car Manufacturer Pty Ltd offers \$1,100 payment to end users who purchase its vehicles. The supply chain it uses for marketing its vehicles is:

Car Manufacturer => Retailer => End User.

Car Manufacturer sells a vehicle to Retailer Pty Ltd for \$22,000. Retailer sells this vehicle to End User for \$33,000. As a result of the purchase, End User receives a \$1,100 payment from

⁴ Section 19-70

Car Manufacturer. The consideration for the supply from Car Manufacturer to Retailer is still \$22,000 and the consideration for the supply from Retailer to End User is still \$33,000.

The payment made by Car Manufacturer to End User effectively reduces the consideration it received for the sale of the vehicle. Therefore, Car Manufacturer will have a decreasing adjustment of 1/11 of the \$1,100.

The payment received by End User from Car Manufacturer effectively reduces the price it paid for the vehicle. Therefore, End User, if registered or required to be registered, will have an increasing adjustment of 1/11 of the \$1,100.”

It is noted that the example set out in the original paragraph 42 of GSTR 2000/19 was not quite the same scenario as that described in this submission as it addressed a payment between a manufacturer and *an end user* rather than a manufacturer and the dealer who sells to the end users. However, the example was otherwise comparable⁵ and for a time the Tax Office treated holdback payments as giving rise to adjustments for the dealer and the distributor in accordance with the view expressed in the paragraphs extracted above. In essence this was in recognition of the underlying commercial reality of the transactions.

In a private ruling issued to the FCAI dated 17 July 2001, the Commissioner confirmed his view (at the time) that in some cases a payment made by a distributor to a dealer caused a change to the consideration for an earlier supply (not between those parties) and constituted an adjustment event. It was also stated in that private ruling that the Commissioner would treat a document issued to the dealer by the distributor in this circumstance as an adjustment note, allowing the distributor to claim a decreasing adjustment and the dealer to make an increasing adjustment.⁶

On 17 December 2003, GSTR 2000/19 was amended and significantly, signalled a different approach on the part of the Commissioner to this issue. In revised paragraphs 40 and 41, the Commissioner expressed the view that a payment by a manufacturer to an end user would *not* give rise to an adjustment even though he left open whether it may instead amount to consideration for a new supply to the manufacturer by the end user.

In new paragraph 42B, the Commissioner discussed payments to third parties other than end users (such as holdback payments to dealers) and made the following statement:

“Provided such a payment is made directly by the manufacturer to that third party entity and does not involve any other entity, it does not give rise to an adjustment event. Whether the payment is consideration for a separate supply made by the third party entity to the manufacturer will depend on the surrounding facts and circumstances of the case.”

Paragraph 42C introduced the example of a manufacturer selling a car to a financier, which is then bailed to a dealer who markets it to the public. This example is extracted below:

⁵ In a meeting of the Motor Vehicle Consultative Committee on 30 May 2001, Tax Office representatives confirmed that the term “end user” “was not intended to preclude dealers from the scope of the principle outlined in these original paragraphs.

⁶ This was also stated by Tax Office representatives at the meeting of the Motor Vehicle Consultative Committee on 30 May 2001.

“42C. Manufacturer Pty Ltd (M) manufactures motor vehicles that are sold to customers by dealers. Due to the high value of the motor vehicles, the trading stock of a dealer is financed under a bailment arrangement. Under the finance arrangement the financier has title in the vehicles and allows the dealer to display and sell the vehicles for a fee.

The supply chain for the vehicle is:

Manufacturer => Financier => Dealer => Customer.

Dealer Pty Ltd (D) acquires its stock of vehicles as follows:

D orders a vehicle from M on behalf of Financier Pty Ltd (F). M sells the vehicle to F for \$22,000. F bails the vehicle to D. When D finds a retail customer, F supplies the vehicle to D, also for \$22,000. D subsequently sells the vehicle to a customer for \$25,000.

After the retail sale, pursuant to a separate agreement between M and D, M makes a payment to D of \$1,100. The agreement provides an incentive to D to take part in a special promotion and marketing of M's vehicles for the purpose of boosting M's market share. D does not have to enter into this agreement, but in doing so, is entering into a binding obligation.

D is making a supply to M, being the entry into the binding obligation. The payment from M is consideration for this supply.”

This example does not specify that the payment under discussion is a holdback payment and is to be differentiated as it is in respect of special promotion and marketing services provided by the dealer – a factor which does not exist in the case of holdback payments.

The key thrust of the Commissioner's changes was that an adjustment event could only directly impact the consideration as between a supplier and recipient of a supply. Any payments that by-passed the supplier and direct recipient of a supply were to be considered on their merits.

It suffices to say that the example had enough suggestive force to bring about the general treatment of holdback payments as, potentially, consideration for new supplies, although significant confusion remained.

This continued until the issue of GST Determination GSTD 2005/4 in which the Commissioner clarified his position specifically in relation to holdback payments, stating that they neither gave rise to adjustment events, nor were consideration for a new supply by the dealer to the distributor. This remains the Commissioner's view.

When examined from the perspective of the commercial reality of the transaction, and the technical operation of the adjustment event provisions, the FCAI believes that the Commissioner's view as expressed in GSTD 2005/4 is the only conclusion that was available to the Commissioner. Specifically:

- the commercial reality of the transaction is that of an adjustment to the sale price of a vehicle;

- the adjustment event provisions only impact the supplies between distributor, finance company and dealer;
- there is no supply directly between the distributor and dealer to which the holdback payments relate.

The resulting conclusion can only be that the payments fall outside the operational scope of the GST regime. As is noted below, this has had significant ramifications for the industry.

RAMIFICATIONS

Following the issue of GSTD 2005/4, dealers have been concerned to obtain refunds from the Tax Office in respect of:

- GST remitted where the holdback payments had been treated as payment for a taxable supply; and
- increasing adjustments where the holdback payment had been treated as giving rise to an adjustment event.

This has increased the administrative workload of taxpayers and the Tax Office alike. It has also led to disputes culminating in the case of *Kap Motors Pty Ltd v Commissioner of Taxation [2008] FCA 159*. The *Kap Motors* case dealt with the operation of the refund provisions as contained in the *Taxation Administration Act 1953*. The underlying transactions that resulted in the refund claims were holdback payments that were received by the dealers from distributors. The Court in that case was not required to adjudicate on the basis of the holdback transactions as these were presented to the Court as an agreed set of facts by the parties.

In the Federal Budget of 2008, the government made provision of \$500 million to meet expected GST refund claims arising out of the *KAP Motors* case.

The fact that holdback payments are now regarded as falling outside of the GST regime has created an ongoing administrative burden for industry because payments of this sort must be separately and correctly identified in the accounting systems of distributors and dealers.

While the Commissioner has, for the time being at least, reached a settled position on the GST treatment of holdbacks, there are a number of other payments made to dealers, such as model run-out discounts and fleet discounts, that the FCAI believes are similar to holdbacks. That is,

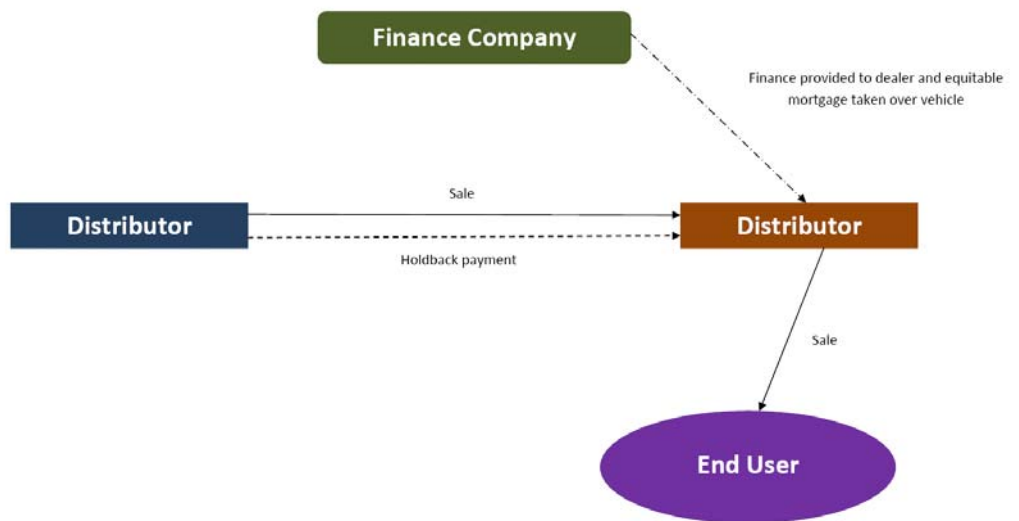
- they are paid directly to dealers by distributors;
- the transactions with the finance company are not impacted; and
- the commercial reality is that the transactions reflect a change to the original selling price of a vehicle.

As with holdback payments, these payments flowing between distributors and dealers are also effectively price adjustments though they may not be recognised as such. The classification of these specific payments, as well as a range of other payments, has been the

subject of ongoing discussion between the Australian Tax Office and industry representatives since the introduction of GST. A final position as to their treatment under the GST regime is yet to be reached.

ALTERNATIVE FINANCING SOLUTIONS — INCONSISTENCY OF TREATMENT

The discussions above have focussed on the typical financing solution utilised by dealers in the automotive industry. In a small minority of cases, alternative financing solutions may be utilised by a dealer. Most commonly, a finance company may carry out its financing role by taking an equitable mortgage over a motor vehicle in respect of which it has provided finance to the dealer. In these instances, the vehicle is sold by the distributor directly to the dealer. This arrangement is depicted in the following diagram.



In the circumstance shown above, a holdback payment made by the distributor to the dealer is treated as giving rise to an adjustment event relating to the supply of the vehicle by the distributor to the dealer. In these circumstances the GST treatment reflects the commercial reality that the holdback payment is an adjustment to the purchase price of the vehicle.

This treatment is exceptional. It does not arise because of a variation to the characteristics and purposes of the holdback payment. Rather, it arises because of different background circumstances relating to the manner in which the finance company provides a financing solution to the dealer.

The treatment of the holdback payment as an adjustment event also applies in the circumstance where no finance is obtained for the purchase of the vehicle by a dealer.

Again, while such instances are not common, the holdback payment is regarded as an adjustment event which relates to the supply of the vehicle by the distributor to the dealer.

It is clearly undesirable that some holdback payments should be treated differently to others under the GST regime when the purpose and effect of a holdback payment in all cases is to achieve the same end - to adjust the purchase price of the motor vehicle. Such inconsistency of treatment increases the administrative burden on taxpayers as it requires them to separately identify, and account for, the holdback payments that do fall within the GST regime contrary to those considered to be outside the scope of the provisions.

RECOMMENDATIONS

The shifting attitude of the Tax Office to holdback payments, the confusion that has ensued and the combined costs of correctly accounting for these payments both retrospectively and prospectively are all testament to the need to improve the adjustment provisions in the legislation.

The essence of our submission is that the provisions should reflect the commercial reality of a transaction, or specifically an adjustment.

In circumstances such as exist for holdback payments, where the payment does not relate to any new supply, it is submitted that the payment should be recognised as a price reduction for the dealer's acquisition of the car. The making of a holdback payment should be treated as an adjustment event giving rise to a decreasing adjustment for the distributor, and an increasing adjustment for the dealer.

This same approach should be adopted for similar payments that are made between parties where there may be an intermediary entity in the supply chain.

The cost to the revenue of such treatment would be neutral, but the benefits to all parties from a streamlined administrative perspective would be significant.

To this end, it is submitted that Division 19 of the GST Act should be amended to either:

- specify that an adjustment event may arise where a payment is made by one party to another which effectively reduces the consideration for a supply involving a third party; or
- give the Commissioner a legislative discretion to treat payments made by one party to another as adjustment events for supplies or acquisitions involving a third party if the economic result is that the consideration for such a supply or acquisition has been changed.

We would be pleased to further discuss any aspect of this submission if required.