Investment & Financial Services Association Ltd
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12 September 2008

Mr Eric Mayne
Chairman- Board of Tax Review Working Group
c/- the Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Dear Mr Mayne

The **Investment and Financial Services Association Limited** thanks the Board of Tax for the opportunity to take part in the *Review of the Legal Framework for the Administration of the Goods and Services Tax.*

IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 145 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

IFSA welcomes this Review as an important step toward the goal of an effective, efficient and modern broad-based taxation system which does not inherently disadvantage or advantage any group of tax payers. The GST was a major overhaul of the Australian taxation system and there has been limited opportunity to address the inconsistencies and inefficiencies since its introduction in July 2000. IFSA looks forward to assisting the Board of Tax in addressing these issues.

IFSA supports the Government's aim to reduce compliance costs, streamline and improve the operation of the GST and remove any anomalies. A key priority for IFSA is to support laws and regulations that put investors first and promote industry efficiency, and which are framed and enacted with workability as a priority.

The most significant issue facing IFSA members is the definition of an entity in Division 184. IFSA considers that this should be a high priority for reform. The issue is set out in more detail in section 2.1 'entities'.

This submission is limited to issues which affect the financial services industry as this is IFSA's area of expertise. Due to the nature of some of the issues identified, IFSA has not proposed a specific solution in all cases. For example, *Chapter 4: GST Administrative Environment*- Input tax credits (Q 4.11). IFSA suggests the rules relating to input tax credits do not minimise complexity and compliance costs. One reason for the complexity of input tax credits is uncertainty relating to matters such as entities. However, the issue of input tax credits as a whole is too involved for this submission. IFSA requests involvement in a broad industry consultation on the simplification of input tax credits which IFSA will be happy to help facilitate.

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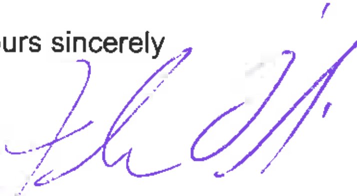
IFSA supports initiatives, such as those by the ATO, ASIC and APRA, to improve industry efficiency and reduce costs to consumers through the promotion of electronic communication and verification. While IFSA is not in a position to comment on behalf of small business or accountants to small business, IFSA welcomes the opportunity to participate in any industry forum to review the current BAS for financial service providers. IFSA suggests this may be a similar consultation process to the co-design of the IFSA/ATO Standard Distribution Statement. IFSA requests further consultation on the process of BAS submission and the potential for aggregation of data for multiple entities.

If you have any questions regarding this submission or would like to arrange a meeting with IFSA, please feel welcome to contact myself or Emma Hungerford Espino on 02 9299 3022.

Yours sincerely



John O'Shaughnessy
Deputy CEO

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Chapter 1: Basic Administrative Rules

1.1 Narrow Definition of agents

Issue: GST and agents

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

The GST law contains a number of provisions dealing with agents:

- Division 153-A, which deals with attribution of input tax credits and adjustments for transactions made through agents and GST documentation issued by agents.
- Division 153-B, under which principals and agents are able to agree to be treated as separate suppliers or acquirers.
- Division 57, which deals with resident agents acting for non-residents.
- Division 111, which deals with reimbursements of agents and others.

There are various administrative problems that arise under these provisions, as discussed below.

Discussion:

The purpose of Division 153 is to simplify the way agents and principals account for GST (refer to the EM to the *Indirect Tax Indirect Tax Legislation Amendment Bill 2000,* which introduced Division 153-B). In particular, Division 153 ensures that the GST arrangements for agents and principals are consistent with the way such arrangements operate commercially in practice.

Division 153 requires that the principal make the supply or acquisition through its agent. There is no definition of the term 'agent' in the GST law. The ATO interprets the agency concept in a narrow way. GST ruling GSTR 2000/37 states (paragraph 45):

> "When an agent is authorised to undertake a transaction on behalf of the principal, thereby binding the principal to the legal effects of the transaction, then the transaction is made by the principal through the agent."

Accordingly, in order to fall within Division 153, the agent must conclude the contract with third parties that govern the supplies or acquisitions.

The narrow interpretation of agent causes administrative problems where agency-type arrangements arise and the relationship does not technically meet the GST requirements to be an agent. Common examples are where one party acts as a paying or billing agent for another party and service providers that do not meet the technical interpretation of agents, but perform a similar function. While it would normally be useful to use the simplified agency arrangements in Division 153 for such arrangements (since this would make the GST and commercial arrangements consistent), the narrow interpretation of agents prevents this.

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As an example, where a billing agent is used, the entity making the supply must issue the tax invoice for the supply, even though it is normally only the billing agent that issues an invoice to third parties. That is, sections 153-15 and 153-20 do not apply and therefore the parties must satisfy the requirements of section 29-70 and section 29-75. IFSA note that the ATO has issued ATO ID 2006/110, which allows an entity to issue tax invoices on behalf of a supplier in certain circumstances, however, this option is limited in application and not appropriate for many arrangements.

While this is an issue for many industries, in the context of IFSA members, these issues arise for bare trustees and custodians.

The Commissioner has exercised his discretion to allow a bare trustee to effectively act as an agent for GST documentation purposes (refer paragraphs 75 to 79 of GST Ruling GSTR 2008/3, *Goods and services tax: dealings in real property by bare trusts)*. Nevertheless, on the face of it, this ruling does not apply to custodians and may be limited to bare trustees in real property transactions.

IFSA's recommendation:

IFSA suggests two possible solutions for the above problems:

- Broaden the scope of Division 153 so that it includes service providers that do not meet the technical definition of agents (but perform a similar function) and billing / paying agents.
- Implement an arrangement where one party can agree to issue and hold GST documentation for a transaction, similar to a Division 83 agreement, but for GST documentation, rather than supplies.

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1.2 Residents acting for non-residents that are not registered for GST

Issue: Residents acting for non-residents that are not registered for GST

Discussion:

Under section 57-10, the resident agent (and not the non-resident principal) is entitled to claim the input tax credit where the non-resident makes the creditable acquisition.

Accordingly, where the resident agent only acts as an agent for the purpose of acquisitions and not supplies, the resident agent will only be entitled to the input tax credit where the non-resident is registered or required to be registered for GST (since this is one of the requirements for a creditable acquisition). The non-resident therefore needs to register for GST and lodge nil GST returns only so the resident agent can claim the input tax credit.

A common example is where the resident agent acts as an agent for the purpose of importing goods for a non-resident. Since taxable importations are not included in an entity's registration threshold, the non-resident is not required to be registered for GST and therefore the resident agent is not entitled to claim back the GST on the importation unless the non-resident is registered for GST.

A further related concern is the onerous proof of identity requirements imposed on non-residents that seek to register for GST.

IFSA's recommendation:

IFSA suggests that section 57-10 be amended to allow the resident agent to claim the relevant input tax credit where the non-resident would make a creditable acquisition or creditable importation if it was registered for GST.

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1.3 Invoicing and invoicing in a group situation

Issue:

Generally, a taxpayer must hold a tax invoice at the time when it lodges its GST return for the tax period in which the claim for an input tax credit is made. This prerequisite, in its present form, places an unnecessary compliance burden on taxpayers.

All legislative references are to the *A New Tax System (Goods and Services Tax) Act 1999*, unless specified otherwise.

Discussion:

Pursuant to subsection 29-10(3), if a taxpayer does not hold a tax invoice for a creditable acquisition when that taxpayer gives to the Commissioner a GST return for the tax period to which the input tax credits on the acquisition would otherwise be attributable, the input tax credit will not be attributable to that tax period. The input tax credit will then be attributable to the first subsequent tax period in which a tax invoice for that acquisition is held.

There are similar rules with regard to adjustment notes as contained in subsection 29-20(3).

A tax invoice is a specific type of document that is mandatory only for GST purposes and is used to substantiate a taxpayer's entitlement to input tax credits on a creditable acquisition.

Sub-division 29-C sets out the information that must be contained in a tax invoice and this includes any other information as specified under Sub-division 29-C of the *A New Tax System (Goods and Services Tax) Regulations 1999.* To the extent that a document does not strictly contain all the required information, that document will not be a tax invoice unless the Commissioner exercises his discretion and treats it as a tax invoice under section 29-70(1).

If a taxpayer made a claim for an input tax credit on a creditable acquisition in a tax period but subsequently found that the document it held was not a tax invoice (e.g. the document does not contain the recipient's ABN or address), the input tax credit will be denied for that tax period and the taxpayer will be liable to be penalised by an interest charge and penalty. Even though the taxpayer may be able to ask the supplier to re-issue the document as a valid tax invoice and make the claim of the input tax credit in a subsequent tax period, the interest charge and penalty will not necessarily be fully or partly remitted by the Commissioner.

IFSA recommends that the prerequisite of a tax invoice which is issued for the sole purpose of GST is artificial and does not perform an important integrity measure in the GST system. Instead, it places an unnecessary compliance burden on taxpayers.

In considering this submission, one should note that such extensive substantiation is not required for the purposes of income tax. Generally, normal commercial

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documents are considered as sufficient evidence for a taxpayer to substantiate the incurrence of a loss or outgoing and the associated income tax deduction.

Tax invoices in a group situation. Where two entities belong to the same corporate group, but not GST group, and use a common accounting system, the requirement that tax invoices be issued serves no commercial purpose. The requirement, in this circumstance, is merely an administrative burden. Tax invoices should not be required to support input tax claims in this circumstance.

IFSA's recommendation:

IFSA suggests that the requirements contained in Sub-division 29-C be removed or modified in such a way that an invoice (as presently defined under section 195-1) should be treated as a tax invoice to the extent that the invoice reasonably allows both the supplier and the recipient to work out the amount of GST payable on the supply or supplies. This can be achieved, for example, simply through the operation of paragraphs (4), (5) and (6) of the regulation 29-70.01 of the *A New Tax System (Goods and Services Tax) Regulations 1999*.

1.4 Division 129

Issue: Div. 129

Division 129 of the *A New Tax System (Goods and Services Tax) Act 1999* (the Division) places an unreasonable compliance burden on taxpayers and as a result there is a lack of integrity around the practical application of the Division.

Discussion:

The Division seeks to adjust a taxpayer's net amount where the creditable purpose of an acquisition or importation is changed.

Complexity arises due to:

- the low dollar value threshold to which the provisions apply
- the varying "adjustment periods" that apply depending on the dollar value thresholds
- the wide ambit of the Division

It is reasonable to argue that very few (if any) taxpayers are, aware of, or able to meet their full compliance obligations under the Division. Further, it has been the experience of taxpayers that tax administrators are unable or unwilling to enforce compliance given the complexity of the Division, putting the integrity of the Division at risk.

In the case of financial service (FS) providers the Division should work as an adjunct to the FS providers GST apportionment methodology.

IFSA's recommendation:

In view of the above the Division should be rewritten so that will specifically apply to:

- Goods and real property in excess of $500,000
- An adjustment period of 5 years from the time of acquisition or importation for goods and real property in excess of $500,000
- An adjustment period of 12 months for all other acquisitions

In the case of FS providers the Division can be made to work in conjunction with the addition to the FS provider's existing apportionment methodology. This would effectively allow for an "annual adjustment for all expenses with an extended period for high value acquisitions. This idea borrows features from United Kingdom VAT system's "capital goods scheme" and annual adjustment mechanisms, which has worked well in the UK to produce a fair result since 1990.

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1.5 Practical consequences of Division 57

Issue: Practical consequences of Division 57

Division 57 is seen as a revenue protection mechanism. The EM to the *A New Tax System (Goods and Services Tax) Bill 1998* states:

> "6.54 The reason for [Division 57] is that if a non-resident is acting through an agent there is someone in the Australian jurisdiction on which liability can be placed. Placing the liability on someone who is in jurisdiction decreases the compliance risk."

However, Division 57 is also used as a simplification and administrative tool to allow non-residents to remain outside the GST system where they would otherwise need to register for GST.

Discussion:

A number of problems arise in practice with the application of Division 57:

Non-residents object to appointing an agent in Australia, since it can increase the risk that the non-resident has a permanent establishment in Australia for income tax.

There are problems with the interaction between Division 83 and Division 57. One of the requirements for a reverse charge agreement to be effective is that "the supplier does not make the supply through an *enterprise that the supplier *carries on in Australia" (section 83-5(1) (b)). This phrase is defined in section 9-25(6), which in turn references the definition of permanent establishment in section 6(1) of the *Income Tax Assessment Act 1936*, excluding paragraphs (e), (f) or (g). The exclusion of paragraphs (e) and (f) from the GST definition has the consequence that appointing an agent in Australia will usually constitute a PE for GST purposes, which will preclude the use of a reverse charge agreement.

IFSA's recommendation:

IFSA suggests that non-residents be given more options for staying outside the GST system. Options could include appointing a GST agent, broadening the scope of Division 83 or removing section 83-5(1)(b).

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Chapter 2: Other rules

2.1 Entities

Issue: Definition 184 definition of "entity".

Discussion:

A number of difficulties flow from the meaning given to "entity" in Division 184, in particular:

The term trust is undefined. A "trust" is at law a legal relationship, not an entity. The term trust as it appears in section 184-1(1)(g) is both undefined and unrestricted. Accordingly, the trust entity for GST purposes also includes bare trusts, custodians and nominees. This results in the GST consequences of transactions effected through a bare trust, custodian and nominee potentially needing to be accounted for by those GST entities, and not the beneficiary, even though these entities arguably do not carry on enterprise for GST purposes.

This problem leads to further complications in the operation of sections 184-1(2) and (3). These sections are poorly drafted, thereby creating uncertainty. In particular, it is unclear whether section 184-1(2) has the effect of a creating a third deemed entity ("the trustee of a trust", or "the trustee of a superannuation fund") in addition to the deemed entity of "a trust" (per section 184-1(1)(g)) and the deemed entity of a legal person in the capacity of trustee of a trust (per section 184-1(3)).

The term partnership includes taxation law partnerships (TLP). A TLP is an artificial concept. The inclusion of TLPs as an entity raises a number of conceptual difficulties with the application of GST to TLPs, the solutions to which are equally artificial. For example, for a TLP to be registered the deemed entity must be carrying on an enterprise, which by definition it in fact cannot do. Difficulties also arise with the application of the margin scheme and going concern provisions to TLPs. The term partnership should exclude TLPs.

IFSA's recommendation:

IFSA considers that the interaction of trust law, the scheme of the GST Act, in particular sections 184-1 and 195-1, and items 23 (c) and 29 of regulation 70-5.02 leads to the conclusion that all amounts paid to the trustee out of trust assets have the GST character of a fee for "trustee services". This is the same result which applies under items 23(d) and 31 where the trustee has the character of a responsible entity under the Corporations Act 2001. We recommend that Sections 184-1(2) and (3) should be redrafted to clearly reflect this outcome. IFSA requests further consultation with the Board of Tax on this issue.

IFSA suggests an alternative optional arrangement to replace TLP's should be considered, possibly through a revision of the joint venture provisions.

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2.2 Grouping

Issue: Division 48 grouping provisions.

Discussion:

The current operation of the grouping rules imposes additional administrative difficulties in two circumstances. First, it prevents an entity from joining, or leaving, a GST group at the actual time it joins, or ceases, to be a member of the GST group. This unnecessarily complicates the acquisition and disposal process and the drafting of the relevant documents. Second, there should be a single application process for a new entity to apply for an ABN and become a member of a GST group.

IFSA's recommendation:

Division 48 should be amended and that ATO's application process streamlined. Clarification is needed in regard to the definitions and application of Division 48 for different types of entities. IFSA suggests the legislation should be redrafted, with each type of entity treated separately so there in no overlap in definitions. The Commissioner should be given a specific discretion under Division 48 to approve a GST group in certain circumstances.

2.3 GST grouping – limitation on joint and several liability

Issue: Limitation on joint and several liability for securitisation trusts that are members of a GST group.

Discussion:

IFSA recommends clarification of the current GST grouping rules (vis-à-vis income tax consolidation) would facilitate GST grouping. There is a need to overcome current commercial practices that do not permit GST grouping (e.g. due to views expressed by rating agencies and/or investors) and align the GST rules with income tax, where joint and several liability is able to be restricted by the operation of a tax sharing agreement (i.e. a concept not available in the GST context). For example, trusts may be consolidated for income tax but are not able to group for GST purposes due to the lack of restrictions on joint and several liability. IFSA recommends addressing this will reduce compliance and administration costs such as multiple BAS, accounting for transactions between entities that could otherwise be members of the same GST group, adopting different compliance procedures for income tax and GST.

Allowing a limitation on joint and several liabilities for securitisation trusts would also resolve a number of consequential GST issues, such as the operation of the Division 72 "associate" rules.

IFSA's recommendation:

Such issues can be avoided by clarification of the GST grouping rules; and curtail unnecessary additional GST leakage that could otherwise be factored into pricing decisions. This is particularly important in the context of the current lending environment.

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2.4 Associates

Issue: GST Treatment of Trustees and the Associates Provisions

This paper sets out IFSA's position with regard to the application of GST associate provisions within Division 72 of the GST Act. Specifically, the definition of 'associates' in Division 72, which in the context of a trustee and a trust, is very broad and therefore Division 72 can have wider application for trusts than other entities.[1]

Discussion:

Division 72 of the GST Act sets out provisions designed to ensure that where a taxpayer makes supplies to an associate that are not wholly for a creditable purpose, and which are made for nil or inadequate consideration, there is a level of input taxation.

Generally speaking, the Division looks at the supplies made between associates and then imposes GST on those supplies. This is achieved by applying a GST liability to the supplier based on the market value of the supply and allowing an input tax credit to the associate to the extent of the creditable purpose.

In defining the term 'associate', the GST Act makes reference to section 318 of the *Income Tax Act Assessment Act 1936*, a lengthy and complex definition for income tax purposes. *Section 318 of the Income Tax Assessment Act 1936* was inserted with the entire Part X of that Act, which is titled "Attribution of income in respect of controlled foreign companies" (more broadly referred to as the "CFC Rules"). Section 318 details the relationships which will result in any entity being an associate of another entity for various sections contained in Part X.

The section was introduced in 1991 and was specifically designed for a complex area of the income tax legislation and was never designed to cater for GST and the complexities that arise when income tax definitions are used in a GST context.

In the GST context, and specifically in relation to trustees of a trust, section 318 states that an entity that benefits under a trust will be an associate. In looking at benefiting under the trust, section 318(6)(a) makes it clear that an entity will be taken to benefit under a trust if the entity actually benefits under the trust or is capable (whether by the exercise of a power of appointment or otherwise) of benefiting.

Therefore any potential beneficiary under a discretionary trust will be an associate for Division 72 purposes. Furthermore, where an entity owns one unit of a unit trust (unless that trust is a public unit trust), then that entity will be an associated for Division 72 purposes.

In relation to trustees of a public unit trust, referred to in section 318(5) as a 'public unit trust entity' and determining whether they are associates of another entity (which could include a trust), the trustee is to be treated as if it were a company. Public unit

[1] All section references in this paper are to A New Tax System (Goods and Services) Tax Act 1999 (GST Act) and the Income Tax Assessment Act 1936 (Income Tax Act) except where otherwise expressly stated.

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trusts are defined in section 102AAF(1) of the *Income Tax Assessment Act 1936* as trusts where any units were listed on a stock exchange, offered to the public or the units in the trust were held by at least 50 people.

The associate test in relation to a company relies on the concept of "sufficient influence" or "majority voting interest" which is also defined in section 318. This approach requires an entity to hold more than just a single share in a company to be an associate (where there are numerous shares on issue).

There are a number of instances where a Trustee of a Trust, such as corporate Trustee, may own units in a Trust, although not enough to influence or control. As these trustees could be considered to benefit under the trust they will be deemed to be associates and therefore Division 72 may have potential application. For example, IFSA is aware of a number of instances where the ATO has adopted an interpretation that where costs are incurred by the trustee and not passed on to the trust, Division 72 will apply to deem an on-supply to the trust.

Whilst a public unit trust entity would need to satisfy the tests mentioned above, which are more onerous, as stated above, trustees of other unit trusts that hold only one unit in the trust will be considered an associate for Division 72 purposes. For such a low threshold test to be considered, an associate of a trust results in significantly broader application of Division 72 to trusts than what may apply to other entities, such as companies. This can create additional GST costs and administration for trustees and trusts in this regard.

From a GST perspective it is unclear why companies (and public unit trusts) have a much more onerous test before being considered associates, i.e. requiring sufficient influence or a majority voting interest. It is submitted that in a GST context, both trusts and companies (and indeed all entities) should have the same influence and control requirements before being deemed associates for GST purposes.

The anomaly arises in the use of the income tax definition of associates for GST purposes, where, whilst under CFC Rules it is common for a trustee to be an associate of a trust, the association does not, in isolation, bring about any adverse implications in accordance with the CFC legislation. However, the same association for GST purposes can, and particularly in terms of how the ATO is applying this provision, bring about an additional GST liability for the trustee and additional non-recovery of part of that GST for the trust.

IFSA's recommendation:

IFSA considers that the definition of "associate" used within Division 72 of the GST Act should not refer to section 318 of the *Income Tax Act Assessment Act 1936*. A definition of "associate" should be included within the GST Act with specific reference for GST and draw upon the core concept of control and influence.

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2.5 Financial Acquisitions Threshold

Issue: FAT in Div. 189

The financial acquisitions threshold in Division 189 of the GST Act does not operate effectively as the threshold is too easily breached and captures certain supplies that, ideally, should not be captured.

Discussion:

Entities are generally not entitled to claim input tax credits (**ITCs**) where their Acquisitions relate to the making of financial supplies. However, the GST Act contains a *de minimis* test which seeks to ensure that the majority of entities are not denied ITCs where they make financial supplies, which do not form part of their main business activities. The threshold test is known as the financial acquisitions threshold (**FAT**) and is contained in Division 189 of the GST Act.

Division 189 contains a threshold test which allows full credits for an entity if its acquisitions do not exceed certain value and percentage thresholds. If the threshold is exceeded for either current or future acquisitions, the entity will not be entitled to ITCs on acquisitions to the extent that they relate to the making of input taxed financial supplies[2].

To determine whether an entity exceeds the FAT for a particular month based on the 'current acquisitions' test, the entity is required to assume that all the financial acquisitions[3] that it makes or is likely to make in a particular month are made solely for a creditable purpose. The entity will exceed the FAT during a particular month if either of the following would apply:

- the amount of all the ITCs to which the entity would be entitled for its financial acquisitions would exceed $50,000 or such other amount specified in the GST regulations[4] (**first limb**); or

- the amount of the ITCs to which the entity would be entitled for its financial acquisitions would be more than 10% of the total amount of ITCs to which it would be entitled for all its acquisitions and importations (including the financial acquisitions) during that 12 months (**second limb**).

It is submitted that both the first and second limbs of the threshold are too low and therefore are breached too easily. This undermines their use and effectiveness. In particular, the 'greater than 10%' test under the second limb would almost always be breached by smaller financial services businesses.

For example, assume that a property trust makes $22,000 worth of financial acquisitions out of a total of $88,000 of acquisitions. Although the fund would not breach the first limb (as the input tax credits for its financial acquisitions are only $2,000), it would breach the second limb of the threshold as the ITCs for its financial

[2] Unless the acquisition is a "reduced credit acquisition" or another exception applies (eg. the borrowing exemption)

[3] Defined in section 189-15 as an acquisition that relates to the making of a financial supply (other than a financial supply consisting of a borrowing)

[4] No other amount is currently specified

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acquisitions as a proportion of the ITCs for its total acquisitions would exceed 10% - in this case it would be 25% ($2,000/$8,000). In this case, given the fund has only incurred a small amount of GST in relation to its financial acquisitions (i.e. $2,000), it is submitted that the fund should not be required to consider complex apportionment compliance issues.

As such, it is suggested that the FAT test be changed so that entities are required to satisfy both the first limb and the second limb. This would make the FAT a more truly effective threshold and allow businesses that only make a small amount of financial acquisitions to claim input tax credits in full as was the original intention of the provisions.

In any event, IFSA recommends that the amount of the thresholds should be increased given that it is almost 10 years since the thresholds were first introduced. IFSA note that since the introduction of the GST, there have been increases to other thresholds in the GST Act in line with increases in CPI and business activity etc (e.g. registration turnover threshold, cash basis accounting threshold and tax invoice requirement thresholds).

Finally, IFSA recommends that the definition of 'financial acquisition' should exclude acquisitions which relate to 'GST-free supplies'. 'Financial acquisition' is defined in section 189-15 as "an acquisition that relates to the making of a financial supply (other than a financial supply consisting of a borrowing)". A GST-free financial supply (e.g. the issue of shares to a non-resident) is, strictly speaking, still a "financial supply" despite section 9-30(3) which states that the GST-free treatment overrides the input taxed treatment. As such, acquisitions that relate to the making of GST-free supplies are included in the FAT calculations despite relating to offshore activity and giving rise to full ITCs. IFSA recommends that this is an "anomaly" with the FAT and acts as a potential disincentive for the export of goods and services from Australia.

IFSA's recommendation:

Amend the FAT threshold so that both limbs of the threshold (i.e. greater than $50,000 or greater than 10% of total ITCs) need to be satisfied before the FAT is breached. Both limbs of the FAT threshold should be increased (e.g. $100,000 and 20%). Additionally the FAT threshold should exclude acquisitions that relate to GST-free financial supplies.

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2.6 Borrowing exemption- section 11-15(5) - Methods for working out extent of creditable purpose of creditable acquisition

Issue:

The "borrowing exemption" under section 11-15(5) of the GST Act is too narrow and discriminates between different forms of capital raising activities, namely debt and equity.

Discussion:

Under section 11-15(5), an acquisition is not treated as relating to making supplies that would be input taxed to the extent that:

- The acquisition relates to making a financial supply consisting of a borrowing; and
- The borrowing relates to making supplies that are not input taxed.

This provision (often referred to as the "borrowing exemption") allows entities to claim input tax credits for acquisitions that relate to borrowings which are used to finance taxable or GST-free activities.

The term "borrowing" takes its meaning from section 995-1 of the *Income Tax Assessment Act 1997*, being "any form of borrowing, whether secured or unsecured, and includes the raising of funds by the issue of a bond, debenture, discounted security or other document evidencing indebtedness."

As such, the borrowing exemption is currently confined to a particular form of finance - essentially debt finance. IFSA recommends that the exemption should be broadened to include other forms of capital raising activities, and, in particular equity financing options such as the issue of shares. In our view, it should not matter whether debt or equity is used to finance the non input taxed activities of a business – the same GST outcome should arise.

IFSA suggests such a change is supported by the EU VAT treatment of capital raisings. In particular, IFSA note that in *Kretztechnik AG v. Finanzamt Linz*[5], the European Court of Justice held that the issue of shares was not a supply for the VAT purposes, thereby allowing full recovery of input tax credits. Although, IFSA do not recommend that the issue of shares is not a supply for GST purposes, IFSA recommends that the principle from *Kretztechnik* supports the availability of input tax credits for acquisitions connected to the issue of shares to fund taxable or GST-free activities.

This would also make Australia's financial system more competitive by allowing funding decisions to be unaffected by "anomalies" in the GST law. This would support the Australian Government's commitment to make Australia "a financial hub in the Asia-Pacific region"[6].

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[5] Case C-465/03 [2005] STC 1118

[6] Refer Media Release dated 23 July 2008 by The Hon Chris Bowen MP Assistant Treasurer

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IFSA's recommendation is entirely appropriate given the current state of the financial markets with the US sub-prime mortgage crisis resulting in a dramatic downturn in debt as a viable means of finance for Australian businesses. Accordingly, businesses are relying more on equity finance to fund their business activities.

The anomalous distinction for the exemption in section 11-15(5) in excluding equity financing is illustrated in ATO ID 2004/902. In that Interpretive Decision, the issue was whether an entity made a 'financial supply consisting of a borrowing' when it issued convertible notes to raise capital in the course of its enterprise. Under the terms of that issue, note holders had the right to redeem the note for cash or convert it into ordinary shares at a fixed price at a specified date. In that case, the Commissioner held that the entity did make a 'financial supply consisting of a borrowing' when it issued convertible notes to raise capital in the course of its enterprise. As such, the entity would have been entitled to claim input tax credits for acquisitions which related to the issue of the convertible note under section 11-15(5) notwithstanding the fact that the entity may have ended up with shares on issue rather than notes.

The broadening of the exemption in section 11-15(5) would "result in reductions in compliance costs" and "improve the operation of the GST"[7].

IFSA's recommendation:

Based on the above, IFSA recommends that the exemption in section 11-15(5), which currently only applies to "borrowings", should be broadened to include other forms of capital raising activities such as issuing shares.

[7] Refer page vii of the *Review of the Legal Framework for the Administration of the Goods and Services Tax Issues Paper July 2008*

Chapter 3: Subsequent events

3.1 Division 135

Issue: Division 135 increasing adjustments.

Discussion:

There are technical problems with the current drafting of Division 135. As a result of these deficiencies the scope of the provision is too wide and it interacts poorly with other provisions. For example, it is possible, for the amount of a Division 135 increasing adjustment to be greater than the aggregate GST liability which would have arisen if the assets of the enterprise had been discreetly sold as separate taxable supplies. This is because Division 135, in conjunction with section 38-325, operates by reference to the entire enterprise acquired (including the value of its input taxed activities eg receivables) rather than merely taxing the assets acquired.

IFSA notes that the issues paper makes reference to the article by M Timmers in the Australian GSTJournal, Vol. 4(8), 2004, page 213. IFSA supports the observations made in that article.

IFSA's recommendation:

Division 135 should be amended or completely redrafted.

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3.2 Error disclosures- including the GIC

Issue: Voluntary error disclosure.

Discussion:

The current administrative arrangements and remission guidelines which apply to voluntary error disclosures are complex, discretionary and do not take sufficient account of the complexities and the operation of ordinary business processes. Accordingly, their effect is to impose an excessive administrative burden on businesses who actively seek to be GST compliant.

Particular issues relate to determining when to disclose an error in the current period BAS, or to request an amended assessment for a prior period BAS. Resolution of this issue is practically determined in the ATO Fact Sheet "Correcting GST mistakes".

However, the Fact Sheet is issued under the Commissioner of Taxation's general power of administration in Division 356 of Schedule 1 to the *Taxation Administration Act 1953*. There is no specific legislative basis permitting a business to correct an error in a current BAS.

The time and correction limit rules contained in the Fact Sheet are too restrictive, given ordinary business processes. As a result a number of legitimate errors have to be reported by requesting an amended assessment to a prior period BAS, with a consequential increase in compliance costs. The time limit and correction limit rules should be revised.

IFSA's recommendation:

IFSA suggests the GST Law should contain a specific provision permitting errors to be amended in the current period BAS. IFSA recommends that the time limit is extended to a period of at least twelve months and the value limit increased to $1m for large businesses.

Inappropriate application of the general interest charge (**GIC**). The GIC should, given its punitive component to encourage compliance, only be applied in instances of persistent long term error. Due to the restrictive time and correction limit rules contained in the Fact Sheet this is not the case. Further, business as a matter of commercial practice needs to allocate GIC to the relevant cost centre. This is not possible given the way GIC is currently calculated and disclosed by the Australian Taxation Office (**ATO**)

Regarding the remission of penalties, the ATO in practice appears to presume, regardless of PS LA 2006/2, that any disclosed error is due to a failure to take reasonable care and imposes a penalty of 25% of the shortfall amount. The ATO policy is then to remit 80% of the base penalty amount for the unprompted voluntary disclosure. However, the fact of a voluntary disclosure prima facie demonstrates that suitable controls are in place and that reasonable care has been taken. There should be automatic remission of penalties for an unprompted voluntary disclosure of errors.

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Chapter 4: GST Administrative environment

4.1 Private rulings

Issue: *GST Private Rulings.*

Discussion:

There is no formal right of review to GST private rulings. This is an impediment to the GST private ruling system achieving its purpose. Because private rulings are not reviewable decisions businesses usually only seek private rulings when confident that the private ruling will confirm their view on the application of the GST Law to a transaction. Accordingly, the GST private ruling system does not, in practice, assist businesses to gain certainty as to the GST treatment of intended transactions which raise difficult GST issues.

IFSA's recommendation:

GST Private Rulings should be listed as a reviewable decision.

4.2 Public rulings

Issue: GST Public Rulings.

Discussion:

It is an unnecessary compliance burden to require a business for GST, but not income tax, purposes to demonstrate and retain evidence that it has relied on a public ruling (rather than merely showing that the public ruling applied to the business).

IFSA's recommendation:

GST Public Rulings should be given the same status as income tax Public Rulings.

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