WOOLWORTHS LIMITED

A.B.N. 88 000 014 675

The Chairman
Reviewing Committee
The Board of Taxation
C/- Treasury
Langton Crescent
Parkes ACT 2600

30 July 2008

Received
18 AUG 2008
Board of Taxation

Dear Chairman,

Review of the legal framework for the administration of the GST

Woolworths Limited

Woolworths provides this submission to assist the Board in its review of the legal framework for the administration of GST. Issues 1, 3, 4, 5 and 6 were raised with the previous government and although a meeting was convened with representatives of Treasury, a (negative) response was only ever received in relation to issue 6. Issues 2, 7 and 8 below are newly raised.

Whilst there are a number of GST matters that we consider require attention, those of the most concern are as follows:

1. Wash transactions
2. Financial acquisitions threshold
3. GST classification of goods
4. The inability to rely on classification rulings given by the ATO to suppliers
5. Administration of pricing adjustments
6. GST treatment of Woolworths' Essentials Cards (shopping cards for charities)
7. Grouping provisions
8. Administration of BAS amendments

1. Wash transactions

Wash transactions arguably provide the greatest challenge to the operation of GST today and add significantly to compliance costs for both business and the ATO.

In a normal taxable transaction between businesses a supplier charges the purchaser GST and remits the tax to the ATO. The purchaser pays the GST to the supplier and claims an input tax credit (ITC) from the ATO on its BAS.

A wash transaction is a transaction between two businesses in which a supplier fails to charge GST on a taxable supply to a purchaser. Given that the purchaser cannot claim an ITC, there is no loss to revenue. The potential for wash transactions is ever present and generally occurs in complicated contractual situations, errors in classification and dual supply situations.

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The current approach of the ATO to underpayments of GST in respect of wash transactions is to assess the supplier for the GST liability and impose interest (GIC) on the liability. In some cases, further penalties may be imposed. The financial impost of the interest over a period of up to 4 years can be significant. In circumstances such as those in which the ATO wishes to impose GST on the supplier, the supplier may have recourse to recover the GST from the purchaser, which the purchaser can immediately claim as an ITC. In these circumstances, the supplier's net loss is the GIC and, in some instances, an amount of penalty.

The issue has been ameliorated to some extent by the issue of Practice Statement PSLA 2008/9 and the acceptance by the Commissioner in the practice statement that general interest charges (GIC) can be either partially or fully remitted in certain situations. Business however, cannot necessarily rely on the Commissioner's ability to apply the benefit of a practice statement in all circumstances.

There still remain areas however, where business can be 'penalised' without public ruling protection. For example, the supplier must bear the full cost of the GST liability in circumstances where the purchaser is no longer in business or refuses to accept the additional charge for the GST. Clearly this is inequitable and outside the spirit of the GST legislation.

Further, another form of wash transaction that has not been given recognition by the Commissioner to date involves transactions that are subsequently determined not to be supplies at all, ie, neither taxable; input taxed nor GST-free. There are many instances where suppliers and purchasers can wrongly identify a payment or part of a payment as being consideration for a taxable supply in circumstances where no supply has occurred. This issue has been the subject of several overseas court decisions and recently came under notice in Australia (see *FC of T v RELIANCE CARPET CO PTY LTD 2008* ATC 20-028).

2. Financial acquisitions threshold (FAT)

The GST legislation contains provisions that disallow the entitlement to input tax credits for acquisitions that relate to making input taxed supplies (ss 11-15 (2)). To relieve business of the administrative burden however, the legislation contains a threshold under which the restriction on input tax credits does not apply.

The threshold does not apply to an entity if:

i. the input tax credits in respect of financial supplies exceeds $50,000; or
ii. the amount of the input tax credits mentioned above are more than 10% of the total annual input tax credits.

Many entities fail to satisfy test (i) above because they have a large one-off transaction for which financial supply related input tax credits exceed $50,000.

The position is often exacerbated by the fact that the failure to satisfy test (i) is often the direct result of purchasing or selling the shares in an entity rather than buying or selling the business. This is really a technical point that does not go to the substance of the

transaction. Further, consideration then has to be given as to whether the reduced input tax credit (RITC) provisions apply.

Accordingly, the existence of test (i) above leads to:

- The incurrence of unnecessary administrative costs in continually reviewing all acquisitions to determine if financial supplies have been made. It is not uncommon for businesses to satisfy test (i) one year; fail it the next, etc.
- The decision to purchase shares or assets potentially being influenced by the GST outcome.

The removal of test (i) would overcome the problems identified above, while at the same time ensuring that the integrity of the financial supply provisions is retained by ensuring that the provisions still apply to bona fide financial institutions. This would also place Australian businesses in much the same position as overseas counterparts that operate under their respective VAT systems.

3. GST classification of food

The GST legislation dealing with the classification of food has, with some exceptions, been largely reproduced from the sales tax legislation. The sales tax legislation evolved over a period of seventy years and was largely the result of an amalgamation of changes in government policy and consumer tastes; product development and marketing; and a series of court cases. In our view, the GST legislation dealing with the classification of food is disjointed and should be rewritten in a cohesive manner that properly reflects well considered government policy. This may mean that some products that are currently accepted by the ATO as being GST-free will become taxable (eg beef jerky, which competes with savoury snacks), while other products that are currently taxable will become GST-free (eg taxable "crispbreads", which are really akin to GST-free bread rather than taxable biscuits).

Given the number and variety of products sold by Woolworths, it is expected that issues will inevitably arise from time to time as to the correctness of individual interpretations made by the ATO. There are occasions however, where certain decisions of the ATO cause particular concern. A well known example for Woolworths is the "banana chip" issue in which the ATO determined that very small quantities of a taxable product could "taint" an otherwise GST-free product and make it taxable. Specifically, the ATO determined that the inclusion of a small number of banana chips (eg 1 or 2 grams) in a breakfast additive made the entire, otherwise GST-free product (500 grams) taxable.

Similarly, the ATO determined that the inclusion of a small number of taxable glace cherries in an otherwise GST-free packet of mixed fruit made the product taxable.

Conversely however, the ATO advised that the breakfast cereal *Kellogg's Just Right* with banana chips remains GST-free.

Woolworths recently approached the Commissioner on the problems with classification and the Commissioner agreed to establish a *GST Food Classification Partnership* to resolve food issues. The group, which consists of senior ATO officers and a small number of GST managers from large corporate taxpayers, has been most beneficial in

resolving individual classification issues. Notwithstanding the success of the group on a small number of difficult issues, the broader problem of the classification of food remains because of the inherent flaws within the GST legislation.

A full review of the classification system is required to simplify the process. Such a review could be undertaken by the Inspector General of Taxation. The proposals outlined in 4 below could assist in this regard.

4. Inability to rely on classification rulings given by the ATO to suppliers

The ATO contends that there is no mechanism within the GST legislation that allows retailers (or wholesalers) the right to rely on a private ruling given by the ATO to a supplier. The basis for the GST classification of goods sold by Woolworths and other retailers is the classification adopted by suppliers. Whilst Woolworths tax staff review individual products as far as practicable, we are inhibited by not being able to readily physically examine many of the 50,000 plus products that we sell throughout Australia. This situation is contrasted with that of our suppliers who generally only have a few products that require classification. In this regard, retailers are discriminated against by the ATO because it is physically impossible to obtain rulings on the full range of products that we sell. We are not in a position to submit samples for all products, nor can we provide the technical information on products that is only available to suppliers, eg formulation.

We contend that retailers and wholesalers should be able to rely on private rulings issued by the ATO to suppliers, given that suppliers generally develop, manufacture and market their own products and are in the best position to provide the detailed information necessary for proper classification by the ATO. Retailers are clearly disadvantaged by the sheer volume of products that they sell and simply cannot be expected to seek the broad range of rulings that good governance demands. Whilst in practice retailers do seek their own rulings on some products, reliance on supplier's rulings would mean a significantly reduced workload for ATO officers and retailers alike.

Further, the current situation can lead to a totally inequitable result. Retailers are not entitled to an input tax credit in circumstances in which the ATO has issued a GST-free ruling to a supplier. The Commissioner may alter his earlier GST-free view of the classification of a product and demand an adjustment of tax from a retailer who is not in possession of a ruling, but who erroneously sold the product GST-free on the basis of the earlier ruling by the Commissioner to the supplier. This exacerbates the problem because not only is the retailer unable to rely on the supplier's ruling, but it has to pay tax on the full value of the product sold. Ordinarily, retailers would only be liable to account for tax on the margin of the goods because of the available input tax credit.

It is accepted that retailers cannot rely on supplier's rulings in circumstances where the retailers own marketing affects the classification of goods. However, this will only apply to a limited number of goods that are the subject of a marketing test.

5. Administration of pricing adjustments

This issue concerns adjustments to the original purchase price of goods or services by way of a later adjustment to that price, usually by payment of a rebate.

Post invoice adjustments such as rebates are regarded as adjustments that require subsequent BAS adjustment and necessitate the raising of tax adjustment notes. The effect of these adjustments is revenue neutral because the payment of a rebate requires an increasing BAS adjustment to be made by the purchaser and a decreasing BAS adjustment to be made by the supplier.

This process has required significant software development by both suppliers and purchasers and poses a significant revenue risk where a purchaser does not make a consequent increasing adjustment to their BAS. The process is becoming increasingly complicated with the advent of e-invoice systems by which purchasers accept the responsibility of issuing adjustment notes for some adjustments, while suppliers are responsible for the issuance of other adjustment notes for the same supply.

The ATO recognises this risk and we understand devotes a significant proportion of its audit activity to verify that the correct accounting treatment has been made for adjustments. For instance, in the ATO's recent GST audit of Woolworths lasting in excess of 2 years, the ATO requested details of some 4 million accounts payable transactions for one year. The initial review (based on ATO audit software) indicated that Woolworths had a liability in excess of $16 million per annum over the 4 years, plus a potential unspecified liability. After an intensive review process and many months of administrative work by both the ATO and Woolworths, the liability was settled at $12,000 per annum for the four years of the audit as the administrative burden of further review could not be supported.

One of the main reasons for the disparity in the ATO's initial findings was that the ATO's analysis ignored the GST impact of adjustment events on the purchase price of a transaction.

Under the Canadian GST legislation, suppliers and purchasers can agree not to issue adjustment notes and simply base their GST liability on the original invoice. The administrative benefits to both business and the ATO would be significant if this process could be permitted under our legislation, while it would also significantly reduce one area of risk to the revenue.

6. *Essentials Card* – shopping card for the clients of charities

Woolworths produces and sells a shopping card largely for the benefit of charities and their clients. Approximately 98% of the cards are sold to various charities, including St. Vincent de Paul and the Salvation Army. The cards have an average value of less than $20 and can only be used to redeem 'essential' goods. They cannot be used to redeem alcohol, cigarettes and general merchandise.

Historically, the charities provided paper vouchers of their own manufacture to clients to redeem goods from supermarkets and other specified retail stores. Under these arrangements, the ATO accepted that the charities' clients were agents for the charities. The effect of the agency arrangement was that the charities were entitled to a refund of the GST paid on the goods redeemed by their clients. However, the administration created by this arrangement for both retailers and charities is substantial. Retailers must collect all receipts and forward them to a central processing area where individual tax invoices can be raised for each charity (sometimes as many as 200 branches for each charity). These invoices are then forwarded to the various branches where they need to be matched with the original voucher before payment is authorised.

Charities are now moving to purchase Woolworths' plastic *Essentials Card*, which provides far greater flexibility and security, rather than using their own paper vouchers. Woolworths has recognised the administrative saving in using the cards and provides a 5% discount to the charities on the purchase of the cards. Despite legal advice provided to Woolworths to the contrary, the ATO contends that an agency relationship cannot exist between the charities and their clients where they use the *Essentials Card* for the purchase of goods. The effect of this is that the charities, while benefiting from the 5% administration bonus provided by Woolworths, are not entitled to claim GST refunds in respect of the tax payable on goods purchased with the *Essentials Card*. We are advised that Mr Stephen Howlin, an ATO Assistant Deputy Commissioner, attempted to have the agency principle accepted by the ATO, but the ATO's legal counsel refused to be persuaded by the legal advice provided to Woolworths in relation to this issue.

The approach of the ATO is at odds with the spirit of a speech made by The Hon Mal Brough, Minister for Families, Community Services and Indigenous Affairs, on 29 April 2007 titled "Social Innovations Dialogue". In that speech the then Minister suggested that certain welfare recipients have their payments directed specifically for the benefit of their children by ensuring that payments are only used to purchase essential goods and services. The Minister then went on to say that debit cards could be used to deliver targeted welfare. The above thinking has been adopted by the current government in ensuring that a proportion of welfare payments to some recipients are restricted to the necessities of life.

Illustrating the difficulties that the ATO's position poses for charities, we understand that the Anglican charities have now issued their own card where recipients act as agent for the charity so that the charity can access the input tax credits. This development now has established an anomaly between the various charities.

7. Grouping Provisions

The GST legislation provides that two or more entities may be grouped for GST if one is controlled by the other, or another common entity, to the extent of at least 90%. The effect of grouping is that transactions between group members do not come within the GST regime. Whilst this measure does not result in any loss to revenue, considerable administrative costs are avoided by the grouped members.

Woolworths has an associated company with significant business interests that is controlled to the extent of 75%. The grouping provisions cannot apply. The lack of the ability to group creates significant administrative difficulties and costs in attempting to run the businesses as one enterprise. The complications in attempting management control and a single purchasing function is continually complicated by having to make decisions on the application of GST to the numerous transactions and arrangements between the companies.

It is our view that this should be a high priority for the action unless there are real revenue risks associated with the reduction of the control level to, say, 51% control. There are many taxpayers in a similar position to Woolworths and there appears to be no logical impediment to a reduction in the control limit.

8. GST administration in relation to BAS amendments

It is generally accepted that the 'Running Balance Account' (RBA) mechanism used by the Commissioner to record debits and credits can involve significant administrative costs for both business and the Commissioner in determining a taxpayer's correct tax account balance.

This problem is compounded by the need to amend multiple BASs and reconcile the RBA to correct even minor mistakes. The GST legislation provides that every monthly BAS must be amended in circumstances where an error has occurred over a number of periods. This can involve the amendment of up to 48 monthly BASs for adjustments, be they large or small. The Commissioner recognised the problem and issued circular NAT 4700 07.2004, which allows adjustments to be made to a single (ie the current) BAS in very limited circumstances. The circular does not however apply to many situations, including adjustments resulting from ATO action.

The need to allow the Commissioner to process adjustments in one BAS should be self evident. However, even the Commissioner has publicly acknowledged the problem in PS LA 2002/12 at paragraph 17 where he states:

> 17. The ATO recognises that reversing transactions and revising every activity statement to correct errors of this particular type amounts to a paper 'round robin' among the registered recipient, the supplier, and the ATO. Significant compliance costs can be incurred with no change to the financial result.....Accordingly, the ATO has accepted an alternative solution that results in no detriment to GST revenue.

Although the above is in relation to certain wash transactions we believe that the sentiment of revising multiple BAS to correct errors made over a period is not good tax policy and should be altered.

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We hope that the above meets with your approval. If you require further detail on the above or any other issues relating to your report, please do not hesitate to contact us.

As you will no doubt appreciate, the above issues are significant to business in general and if actioned would greatly contribute to increasing efficiencies within the GST regime. In particular, the classification and adjustment issue would help reduce the administrative tax burden on less sophisticated businesses without any cost to the revenue.

I would welcome the opportunity of discussing the above with you in the hope that we may be able to advance the issues for the benefit of all business taxpayers.

Yours faithfully

Tom Pockett
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Woolworths Limited