The Institute of Chartered Accountants in Australia

11 September 2009

Mr Dick Warburton
Chair
The Board of Taxation
The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Dear Dick

Review of the Application of GST to Cross-Border Transactions

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to comment on the Board of Taxation "Discussion Paper on the Application of GST to Cross-Border Transactions" (the discussion paper).

The Institute is the leading tax and accounting professional body in Australia. Our reach extends to more than 62,000 of today's and tomorrow's business leaders, representing over 50,000 Chartered Accountants and 12,000 of Australia's best accounting graduates, who are currently enrolled in our world class Chartered Accountants postgraduate program.

Our executive summary below provides an overview of our key submission points and recommendations, while the attached appendices contain our detailed submissions.

In this submission, we have:

- examined the policy that underlies the assertion of jurisdiction to impose Australian GST;
- considered the ways in which that policy is given effect in the GST law;
- reiterated our view, previously expressed to the Board during its "Review of the Administration of GST", that there are deficiencies in the current rules;
- addressed the issues raised and the options proposed by the Board in its discussion paper; and
- made recommendations for appropriate changes to the law.

The changes we have recommended relate primarily to the desired outcome. In some cases we have noted possible ways in which that outcome could be achieved but we have not provided specific drafting recommendations.

Appendix A contains our detailed submission, including a summary of our key recommendations. It also outlines our views of the most appropriate way to apply (or not apply) Australian GST to the examples given in the discussion paper, which provides an opportunity for us to explain the operation of some of the changes we have recommended. Appendix B contains a more detailed discussion of the policy intent underlying the GST treatment of cross-border transactions, based on the destination principle, and the mechanics of the Australian GST law which seeks to implement that policy.

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Executive summary

In the Institute's view, the application of GST to cross-border supplies involves such fundamental issues that the relevant provisions cannot be considered in isolation or reformed in a piecemeal manner. Given the interdependence of the cross-border rules, reforms must be considered holistically and implemented by way of an integrated approach. Such an approach is essential to minimise the risks of unintended outcomes which could lead to revenue leakage or compromise Australia's global competitiveness.

We note that the Board is considering five main issues in relation to the reform of the cross-border provisions namely:

(i) Scope of the connected with Australia rules and the compulsory reverse charge rule
(ii) Introduction of a direct refund scheme
(iii) Scope of the GST-free rules, in particular the ss38-190(3) proviso
(iv) Expansion of the GST tax base to cover consumption not currently captured
(v) Registration procedures for non-residents and the resident agent rules.

We have primarily confined our submission comments to responses on the particular issues, options and scenarios raised by the Board. However, to ensure that the review is comprehensive and considers all possible alternatives so as to achieve the optimum outcomes, we would suggest that further discussions with the Board take place during the course of this review.

In summary, the Institute considers that the Australian GST law, as it currently applies to cross-border transactions, requires non-resident entities to become involved in the Australian GST system in a manner that affects the efficiency of the administration of the GST, and the international transactions themselves. In the almost ten years since the introduction of the GST, it has become increasingly apparent that the rules applying to supplies made by, and to, non-residents, and their interpretation by the Commissioner of Taxation (the Commissioner), are leading to uncertainty, increased compliance and administration costs, and risk to the revenue.

By international standards, the Australian GST law is in our view overly inclusive of non-residents, particularly in respect of supplies of "things other than goods or real property" (i.e. supplies of 'services'). This results in higher compliance costs for non-residents and higher GST costs for Australian firms and consumers than arise under the GST regimes of our international counterparts, such as New Zealand and Canada.

To address this, the Institute believes that there is significant scope and opportunity to shift the balance between the different mechanisms by which GST is applied to consumption in Australia to streamline current compliance, while maintaining the broad underlying policy of imposing GST on consumption in Australia (domestic consumption) but not on consumption outside Australia (foreign consumption).

Accordingly, the Institute supports amendments to the existing law to improve the efficiency of the administration and collection of GST, with the primary objective of decreasing the unnecessary involvement of non-residents in Australia's GST system. In particular, the Institute believes that the following key reform outcomes ought to be achieved:

- For supplies of services, in order to remove non-residents from the GST system:
    - the connected with Australia rules should be narrowed where unregistered non-residents are dealing with registered businesses or other unregistered non-residents (provided the latter creates no unintended risks to the revenue); and
    - the GST-free rules should be broadened where there is no final private consumption in Australia;

    These changes will automatically shift the Australian GST obligations to registered businesses in Australia, if there is any net GST to be collected from them.

- The Institute recognises the difficulties in applying GST to e-commerce and recommends that Division 85 be expanded to cover electronically delivered supplies. The Commissioner will, as he has with telecommunications services, then be able to collect tax when it is administratively feasible to do so.
- For supplies of goods with installation services in Australia, the Board should consider narrowing the rules to mirror the amendments suggested in relation to services, such that the supply by an unregistered non-resident of services to install goods in Australia does not make the supply of the goods by the non-resident connected with Australia, where the recipient of the services is registered (or possibly is another non-resident business that does not have an establishment in Australia and is not registered).
- For supplies of goods brought to Australia, consideration should be given to whether "imported" goods sold under DDP Incoterms to fully creditable Australian business customers can be excluded without risk to the revenue. If so, a significant number of non-residents could be removed from the GST net. In conjunction with this, the definition of creditable importation should also be reviewed and broadened to ensure that the fully creditable Australian business customer is able to claim the input tax credit where they enter the goods for home consumption (so as to remove the blackhole GST problem that can arise).
- For supplies of goods wholly within Australia, consideration should be given to adopting approaches similar to the Canadian 'drop-shipment' rules, which effectively remove non-resident suppliers from the GST regime when goods (and services closely related to goods) are supplied to a non-resident but the goods are directly delivered in Canada. If feasible, a similar effect should be achieved for leases of such goods.
- Where non-residents have Australian GST liabilities but do not carry on an enterprise in Australia, they should be allowed or even required to appoint a fiscal representative to handle all of their GST liabilities, entitlements, and obligations.
- The collective amendments above should reduce or eliminate the need for the resident agent provisions and the voluntary reverse charge mechanism. In addition, if the imposition of GST is effectively streamlined under the options proposed, the extent to which non-resident refunds are required should be reduced considerably.

In response to certain questions posed in the discussion paper:

- The Institute does not favour the application of a compulsory reverse charge to consumers, with or without a threshold, nor the various options proposed for making subsidiaries and other entities liable for the GST payable by non-resident;
- The introduction of a stand alone direct refund mechanism should not be necessary, however if the present refund system suffers from a lack of mutual recognition with other VAT jurisdictions, eg Germany, then it should be altered in such a way as to obtain that mutual recognition. We believe this could be achieved with minimal changes to the existing system.

We commend the efforts of the Government and the Board in seeking to review this fundamental area of Australia's GST system so as to improve its efficiency and international competitiveness. The Institute looks forward to continuing to work collaboratively with the Board to provide our views on how best to improve the existing cross-border GST regime for the future benefit of Australia's economic prosperity.

If you require any further information in relation to any aspect of this submission, please contact Donna Bagnall on 02 9290 5761.

Yours sincerely,

Yasser El-Ansary
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The Institute of Chartered Accountants in Australia

Appendix A

Detailed Submission

1. THE DESTINATION PRINCIPLE AND THE RULES TO IMPLEMENT IT IN THE AUSTRALIAN GST

The Australian GST, like all OECD countries, is based on the destination principle under which supplies consumed in Australia and imports into Australia are generally taxed, while exported goods and services are not subject to GST. The way in which this policy objective is best achieved is the subject of the Board's discussion paper and this submission.

In summary, four mechanisms are used to implement the destination principle in the Australian GST:

1. The connected with Australia rules: s9-25 and Division 85;
2. The GST rules for supplies consumed outside Australia: Subdivs.38-E, 38-K, and 38-Q;
3. The 'importation' rules:
   (a) For goods, the taxable importation rules: Division 13;
   (b) For things other than goods or real property, the compulsory reverse charge rules: Division 84, as it applies to supplies that are not connected with Australia;[1] and
4. The input tax credit (ITC) entitlement rules.

At Appendix B, we discuss in greater detail the mechanics and design features of the Australian GST which seek to implement the destination principle to achieve the underlying policy objective.

2. COMMENTS ON THE CURRENT LAW AND OPTIONS FOR CHANGE

Chapters 5 and 6 of the discussion paper consider a number of options for changing the GST law, grouping them into four main categories. The proposed changes fall into two broad groups, which correspond with our discussion of the legal design of the place of taxation rules:

- base definition; and
- liabilities and entitlements.

It is important to first consider together all issues relating to base definition, to ensure that changes to one of the four tools used to target GST at domestic consumption do not have unexpected interactions with the operation of any of the other tools. Therefore, Issue 1 (connected with Australia), Issue 3 (GST-free rules), and Issue 4 (expansion of the base) must logically be considered together. To the extent that the Division 84 compulsory reverse charge is used as part of the base definition, it should also be considered at the same time.

Issue 2 (refunds) and the other liability/entitlement and administrative issues covered in Chapter 5, 6, and elsewhere in the discussion paper would logically follow the establishment of the base, though it is important to design the scope of the base with the practicality of collecting the tax firmly in mind.

The Institute supports the continuation of the current approach under which there are separate place of taxation rules for tangible and intangible supplies. Consequently, the Institute does not favour extensive sub-categorisation of types of supply, with different rules applying for each type of supply.

The Institute's preferred approach is to retain the existing broad division into three categories (goods, real property, and everything else), with limited application of more narrowly targeted rules.

[1] Those referred to in section 84-5(1)(a).

The following comments address each broad category separately.

2.1. Base definition

2.1.1 Supplies of 'services'

The Institute considers that the combined interaction of the connected with Australia rules, the GST-free rules, and the compulsory reverse charge in Division 84 is over-inclusive of non-residents when it comes to supplies of 'services'.[2]

In our view, the difficulties created by the current rules can be reduced by combining a narrowed operation of the 'thing is done' proxy with a widening of the GST-free rules. This will have the flow-on effect of expanding the coverage of Division 84. It will also bring the Australian law more closely in line with the international practice, which relies on reverse charging for business to business (B2B) supplies of services, while retaining the approach of not actually reverse charging unless an input tax denial will result.

(i) Connected with Australia rules

The discussion paper proposes two options for narrowing the connected with Australia rules:

- Option 1: 'Supplies made by a non-resident that does not have a business presence in Australia would not be connected with Australia if that supply is made to an Australian business' (para 5.13)
- Modified option 1: In addition, 'limit the application of the connection rules for supplies that are made between non-resident businesses that do not have a business presence in Australia' (para 5.17).

While the discussion paper refers only to "supplies" generally in relation to the above options, we have assumed that these proposals are intended to relate to supplies of services only (not goods or real property). In such case, we note that no modifications to the reverse charge rules in Division 83 would be necessary to expand its operation and/or make it compulsory. This is because s84-5(1)(a) covers all supplies of services that are not connected with Australia, and so any narrowing of the connected with Australia rules for services automatically transfers the relevant supplies into the coverage of s84-15(1)(a).

The Institute also notes that Option 1 is insufficiently broad because it has no impact on supplies made between two non-residents in a global supply chain situation. Modified option 1 would ensure that the supply between the two non-residents in Examples 5 and 6 is not taxable. However, we note that the proposed rule for transactions between non-residents could result in non-taxation of consumption in Australia if it applies irrespective of whether the supply is made to a registered business or a consumer.

The Institute recommends a narrowing of the connected with Australia rules so that the 'thing is done' rule in section 9-25(5)(a) does not apply if the supply is made to a registered entity in Australia (or possibly to another non-resident business that does not have an establishment in Australia and is not registered). The latter additional exclusion will need to be considered further to determine how it interacts with s9-25(5)(c) and the reverse charge rules to ensure that no unintended revenue risks are created.

This will require the person providing the supply (which may be a non-resident supplier or a third party subcontractor) to know the registration status of the entity to which it is making the supply. It is already necessary for suppliers to be able to identify the residency, location, and requirement to register of their customers and it does not seem any more difficult to identify the registration status of the entity to which the supply is being made.

The Institute also recommends that the focus of the rules should be on whether the recipient is in fact registered. Where an entity is required to be registered but is not registered, the treatment of any supplies made to the entity should be determined by their actual registration status. This eliminates the need for suppliers to identify whether unregistered recipients are required to be registered.

The supplies excluded from the connected with Australia rules under the above changes would be captured, as necessary, by the Division 84 compulsory reverse charge.

[2] The term 'services' is used for convenience throughout this submission to refer generically to "things other than goods or real property".

The Institute supports the proposal in Option 1 and modified option 1 to limit the application of the 'thing is done' proxy in s9-25(5)(a), by defining the supply as not being connected with Australia if the non-resident supplier is not registered and either, the recipient is a registered entity, as opposed to just a business, (or possibly is another non-resident business that does not have an establishment in Australia and is not registered, provided no unintended risks to the revenue). This would have the flow-on effect that any tax to be collected would be collectible under Division 84, by a registered business.

(ii) GST-free rules

The scope of the GST-free rules is inextricably linked to the scope of the connected with Australia rules and the s84-5(1)(a) reverse charge rules. This link is not particularly apparent in the discussion paper, however it is clear that solving the problems of the non-residents in Examples 1, 2, 5, and 6 is only half complete if the rules are only changed to ensure that their supplies are not connected with Australia.

Unless the supply by the Australian business to the non-resident is GST-free, Australian GST will continue to impact on the non-residents. This issue arises irrespective of whether the supply is one of real property, goods, or services, however the comments here are confined to the rules for services, which are addressed in Issue 3.

Therefore, in conjunction with the narrowing of the connected with Australia rules, the Institute believes that the section 38-190(3) preclusion from GST-free treatment should only apply where the other entity in Australia is not registered.

The Institute notes, however, that a broad application of subsection 38-190(3) to cases where the "provision" and the "providee" are not evident from the contract of services itself create some difficulties for enforcement, audit and compliance, (see for example, in GSTR 2005/6, the conference example 25, the call centre example 35, and booklovers example 11). In addition, the difficulty in determining the identity of the "beneficiary" of the service is illustrated by the warranty chargeback determination GSTD 2006/2.

The difficulty for the ATO in identification and enforcement of the subsection (3) circumstances needs to be considered. Where the only documentation might be the engagement with the non-resident, the ATO might find it difficult to ascertain where (for example) advice is provided to another entity.

It is necessary to reflect on the design aspects of the difficulty posed by these examples. The Australian GST system asserts jurisdiction over services carried out within Australia or through an establishment here. GST-free status is granted, generally, on the locality of the recipient of the supply. The subsection 38-190(3) override applies where the "delivery" of the service is in Australia. As presently structured, the policy of ensuring full input tax relief for business inputs is achieved by allowing ITCs to the non-resident that suffers tax as a result of subsection 38-190(3) application.

An alternative approach could be to allow GST-free status for supplies to non-residents without an establishment in Australia where the non-resident is not registered. This, however, allows a gap in the tax base for services contractually supplied through a non-resident to a non-registered person.

Option 3.1 adopts the proxy approach of identifying whether the Australian use of the services would otherwise be creditable. Under option 3.1 is it proposed that the application of s38-190(3) would be limited to situations where the other entity in Australia is not registered for GST.

A corresponding change to s38-190(4), as proposed in option 3.2, is not considered to be necessary or appropriate. GST-free status should continue to apply where there is consumption outside Australia (i.e. the providee is outside Australia), regardless of whether or not the contractual recipient of the supply in Australia is registered. Bearing in mind that the GST-free rules are seeking to identify proxies for consumption outside Australia, they should operate so as to exempt such consumption accordingly.

We also consider that option 3.2 would complicate significantly existing compliance for taxpayers as the GST-free treatment would no longer be able to be determined by reference to the nature and location of the supply, but would depend upon the status of the recipient (which would create systems issues).

In our view, the scope of section 38-190(2A) should also be reviewed to determine whether it can be refined and narrowed to ensure that it does not inappropriately tax consumption outside Australia without a sufficient connection to real property in Australia.

The Institute supports the proposals in Option 3.1 under which the application of s38-190(3) would be limited to situations where the other entity in Australia is not registered for GST. However, we do not support Option 3.2, limiting the application of s38-190(4) to situations where the recipient in Australia is not registered, as this runs contrary to the policy that overseas consumption should not be taxed.

2.1.2 Supplies of real property

The Institute is of the view that the current 'place of taxation' rules for land are appropriate. In particular, the wide definition of real property, the use of the location of the land in s9-25(4), and the absence of GST-free rules for supplies of land to non-residents have the effect of treating the location of land as the proxy for the place of taxation of supplies of land and supplies closely connected with land. Such rules are simple for suppliers to understand and apply. The effective option to input tax supplies of commercial accommodation by non-residents prevents these rules adversely impacting on non-residents making supplies of commercial accommodation, but has no impact on other types of supply of real property.

The Institute does not support the use of reverse charging for B2B supplies of real property by non-residents to residents, which would likely be ineffective given that a non-resident that is in a position to be making supplies of real property to a resident is likely to have incurred input tax in Australia for which it will need to be registered to claim input tax credits.

In addition, where non-residents acquire supplies such as hotel accommodation in Australia, the only practical means for preventing cascading of Australian GST into foreign consumption and/or double taxation of domestic consumption is to refund the GST to the non-resident, whether through registration or through a separate refund mechanism. It is not practical to require hoteliers to treat some supplies as GST-free on the basis that the customer is a non-resident and such an approach is likely to pose an unacceptable revenue risk.

2.1.3 Supplies of goods

The Institute is in favour of retaining the use of the location to which goods are supplied as the appropriate proxy in the place of taxation rules for goods. It is presumed that the goods will be used in a B2B supply or consumed in a business to consumer (B2C) supply at the place where they are delivered. However, in a B2B context, this sometimes results in unnecessary inclusion of non-residents in Australian GST in a similar way as occurs for things other than goods or real property.

A non-resident may make taxable or GST-free supplies of goods and/or taxable acquisitions of goods in Australia without having any presence in Australia. In circumstances where there will be no net revenue collected (such as where the recipient is entitled to full ITCs), this does seem to place an unnecessary burden on non-resident suppliers.

Specifically, the design of the law and the interpretation by the Commissioner regarding when goods are "imported" into Australia causes the connected with Australia rules in relation to goods to operate in a way that can create:

- Unanticipated GST registration and compliance obligations for non-residents; and
- Mismatches between the person liable for GST on importations and the person who could claim the credit, with the result that no-one is entitled to the credit (blackhole GST).

For example, one problem area is the supply of goods on DDP ("Delivered Duty Paid") Incoterms. In this case, the ATO regards the non-resident supplier as the 'importer'. This is because under DDP terms, the supplier agrees to take responsibility for the Customs clearance procedures. This means that goods supplied on DDP terms will be connected with Australia, requiring registration if the value of such supplies exceeds $75,000 per year.

The mismatch arises because if another entity in Australia enters the goods as "owner", they are the one liable to pay the GST to Australian Customs, but the non-resident is the importer, which is the entity who would be entitled to claim the credit. However, to have a "creditable importation", you must satisfy three things – be the importer, be the one liable for the GST levied on importation, and be registered at the time of importation, so what happens is that no entity is entitled to claim the credit.

The Institute suggests that the Board should consider whether "imported" goods sold under DDP Incoterms to fully creditable Australian business customers can be excluded without risk to the revenue. If so, a significant number of non-residents could be removed from the GST net. In conjunction with this, the definition of creditable importation should also be reviewed and broadened to ensure that the fully creditable Australian business customer is able to claim the input tax credit where they enter the goods for home consumption (so as to remove the blackhole GST problem that can arise).

In addition, to achieve symmetry with solutions discussed above for the supply of services, we believe that the connected with Australia rules should also be reviewed and narrowed in relation to goods supplied with installation services in Australia by a non-resident.

The Institute considers that s9-25(3)(b) should be amended to mirror that of s9-25(5)(a), such that the supply by an unregistered non-resident of services to install goods in Australia does not make the supply of the goods by the non-resident connected with Australia, provided the recipient of the services is registered (or possibly is another non-resident business that does not have an establishment in Australia and is not registered).

Aside from the above, overall our observation is that the current rules for goods are relatively easy to apply compared with the rules for things other than goods or real property, and the locations from and to which goods are to be supplied are proxies that the supplier is able to control and determine. Furthermore, excessive zero-rating of transactions involving goods supplied wholly within Australia might provide unanticipated opportunities for missing trader fraud.

The Institute observes, however, that the place of taxation rules for goods assume that the supply involves a grant of possession in the goods. In this regard, 'delivery' or 'making available' goods that are sold is consistent with the character of the supply. However, where the supply of goods does not involve the giving of possession (e.g. a beneficial interest in the reversionary interest of leased goods) an alternative place of taxation rule focused on the location of the goods, similar to land, might be considered.

Where a non-resident's supply of goods is connected with Australia, while Division 83 provides a useful tool, in our view it is subject to unreasonable compliance costs because it relies on agreement between the parties and ongoing monitoring by the supplier to ensure that the conditions for the operation of Division 83 continue to be met. Furthermore, Division 83 does not adequately deal with the problem of transactions between two non-residents that involve supplies of goods that are connected with Australia. We consider that more efficient rules could also be

introduced to remove the need for non-residents to register in respect of the following transactions:

- Goods supplied between two non-residents may be wholly within Australia and therefore connected with Australia under s9-25(1) and not GST-free under s38-185 or s38-187 (subject to minor exceptions);
- Goods supplied between two non-residents may be GST-free exports, yet the supplier may be required to be registered for GST.

The first situation can arise in scenarios analogous to Example 6 but with the direct delivery of goods in Australia rather than the provision of services to another entity in Australia.

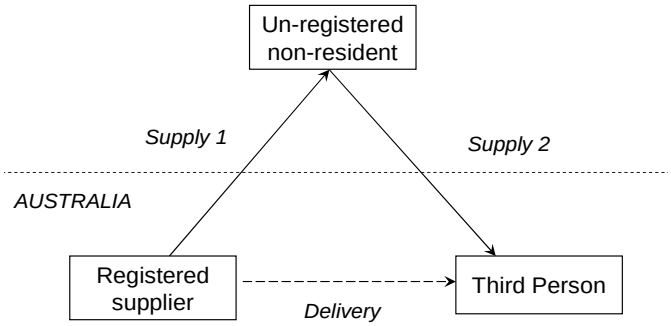
The Institute does not support the extension of Option 1 and modified option 1 to supplies of goods. Such an approach would be ineffective in any case because if one turns Examples 5 and 6 into situations involving goods wholly within Australia, preventing the supplies by the non-residents from being connected with Australia will have no effect because at least one of the non-residents will have been charged GST when acquiring the goods.

An alternative approach is used in the Canadian GST to deal with these situations, which the Canadians refer to as 'drop-shipments'. The Institute recommends that the Board investigate the operation of the Canadian special rules for drop-shipments of goods with a view to determining whether they could provide a useful guide for the Australian GST.

The Canadian Revenue Authority (CRA) describes the transactions to which the rules apply as follows:[3]

> 4. Unregistered non-resident suppliers may make supplies of [goods] that originate in Canada. In such cases, the non-resident will typically make arrangements with a person in Canada (such as a registrant who sold the goods to the non-resident or supplied a service in respect of the goods), to have the goods "drop-shipped" in Canada to another person on behalf of the non-resident. Generally, for GST/HST purposes, a drop shipment of goods occurs where a registrant makes a supply to an unregistered non-resident of either goods by way of sale in Canada or a commercial service in respect of goods and then transfers physical possession of the goods in Canada either to another person on behalf of the non-resident or to the non-resident.
>
> 5. Subject to the exceptions mentioned in the following paragraph, the drop-shipment rules are mainly intended to ensure that tax applies to the fair market value of goods that are drop-shipped in Canada and supplied by unregistered non-residents for final consumption in Canada in the same way that tax would apply to goods acquired from the non-resident outside Canada and imported for that purpose. As a general rule, the drop-shipment rules address this issue by deeming the registrant in a drop-shipment situation to have made a supply of the goods to the non-resident recipient for consideration equal to their fair market value when the registrant transfers physical possession of the goods in Canada to another person on behalf of the non-resident or to the non-resident.

Example:



In their simplest operation, the rules operate in the above scenario to classify Supply 1 as taxable and Supply 2 as out-of-scope. However, when the third person is registered for GST, a further rule enables Supply 1 to be treated as GST-free and Supply 2 as out-of-scope for the non-resident and effectively reverse charged to the third person, but only if the third person provides a drop-shipment certificate to the Australian supplier. Supplies of services that become incorporated into the value of the goods (services performed on the goods, storage, transport etc) are also covered by the rules. It would also be necessary to ensure that the non-resident could not claim an ITC or refund for the GST charged where the VAT is charged on the fair market value.

Clearly, such rules have their basis in aspects of the Canadian GST / HST regime that differ quite significantly from the Australian GST, including different place of supply rules, different input tax credit entitlement rules, and different zero-rating rules for exports. Nonetheless, it is likely that the effect of the Canadian rules could be incorporated into the Australian GST in a way that removes the need for the non-resident to be involved in any way. Such rules are effectively an alternative to the ad hoc Division 83 reverse charge mechanism, with the 'reverse charge' arrangement made between the two local suppliers. However, rather than, as is currently the case, placing the primary liability on the non-resident, with an option to reverse charge if both parties agree, the Canadian rules effectively remove the non-resident from the equation by classifying such transactions as effectively equivalent to imports. This is achieved by:

- placing the primary liability on a local supplier;

[3] CCRA *GST/HST Memorandum 3.3.1* (June 2008), at p 2, available online at http://www.cra-arc.gc.ca/E/pub/gm/3-3-1/3-3-1-e.pdf.

- basing the GST charge on what is effectively the value of a taxable import (rather than of Supply 1, which would exclude the mark-up of the non-resident, or Supply 2, the value of which might not be known the local registered supplier); and
- giving the option to reverse charge to the person receiving the goods in Australia.

Consistent with the Canadian regime, the drop-shipment rules could also be designed to cover the common commercial transaction of goods supplied by way of lease by a non-resident to a registered Australian business.

The drop-shipment rules could also be extended to cover sale and lease-back transactions involving non-residents, as is the case in Canada. A special rule is necessary to achieve this as the normal drop-shipment rules would not otherwise apply since the resident entity does not transfer possession of the leased goods to a registered consignee, but rather retains possession of the goods throughout the entire transaction.

The Institute recommends that the Board investigate incorporating the Canadian drop-shipment rules into the place of taxation rules for supplies of goods.

2.1.4 Narrowing the tax base

The Institute supports the maintenance of the existing position under which the Division 84 compulsory reverse charge applies to registered recipients, and is counted in determining whether unregistered recipients are required to be registered.

The Institute is not in favour of narrowing the operation of Division 84 so that it can only apply to registered businesses – it should potentially apply to all enterprises. However, the Institute supports the existing application of Division 84 such that it only applies in circumstances where the recipient would not be entitled to full input tax credits.

Currently, the compulsory reverse charge does not apply to acquisitions by private consumers (because a precondition to the operation of s84-5 is that the recipient acquires the thing supplied solely or partly for the purpose of an enterprise it carries on in Australia). However, s84-5(2) specifically includes the value of reverse-chargeable supplies in the recipient's GST turnover, which means that an unregistered recipient can become required to registered as a result of an obligation to reverse charge.

While it is true that if the value of such supplies still does not bring the entity over the registration threshold, then no reverse charge will apply, this is consistent with the approach of excluding small businesses from the obligation to register. While this does in theory provide very small businesses with an incentive to acquire services offshore, with the exception of electronically delivered services (on which we have made a separate recommendation), the smaller the business, the less likely it would be that this would be a viable option.

2.1.5 Expanding the tax base

The Institute is of the view that the $1,000 low-value imports threshold is reasonable and that a connection between the low value threshold and the customs duty rules is desirable.

The Institute does not favour the application of a compulsory reverse charge to consumers, with or without a threshold, unless 'enforceability' issues can be addressed. It is an important that the law be able to be applied with reasonable certainty and administered with consistency and efficiency. The issue of enforceability is discussed further below. At present, we consider that such a 'tax on honesty' would be difficult to administer and enforce and may necessarily be applied only on an ad hoc basis.

The Institute does not support the various options proposed for making subsidiaries and other entities liable for the GST payable by non-residents. We consider that the proposal in Example 7 to capture GST on on-line supplies by non-residents, i.e. broadening the connected with Australia rules and transferring the liability to an Australian subsidiary is not the preferred approach, and it only addresses associated arrangements, but fails to capture much of the perceived 'mischief'.

Consistent with the theme of our submission, the Institute prefers solutions which reduce the extent to which non-residents are required to be involved in the Australian GST regime by limiting the connection with Australia rules, widening the GST-free rules, and consequently widening the reverse charge provisions.

Our preferred approach to capture on-line supplies would be to include e-commerce in Division 85 now and leave it to the Commissioner to determine if and when the power is applied, and to what extent. While such a tax would itself also be a 'tax on honesty', it is the Institute's view that a tax on the honesty of large multi-national e-commerce suppliers is likely to be more fairly and effectively administered than a reverse charge on consumers. It would also be in keeping with the OECD Ottawa Framework recommendations and the EC VAT Directive. However, it is noted that the ATO has effectively abandoned any serious attempt to apply Division 85 to telecommunications and it might be that it does so also for e-commerce.

The Institute does not support the suggested rules set out in Example 7 requiring Oz Marketing to remit tax payable by Aussie Pics.

The Institute recommends that the Board should monitor the extent of such e-commerce activities and should consider the inclusion of electronically delivered products and services in the Division 85 'effective use or enjoyment' rules.

The Institute also recommends that the Board clarify what is meant by 'effective use or enjoyment' in item 3 of s38-190(1) and in Division 85. If necessary, these rules could be modified to refer to an appropriate proxy, such as the location of the person to whom the thing supplied is provided.

2.1.6 Enforceability

In conjunction with jurisdictional issues, the question of the enforceability of GST liabilities and obligations must be considered in the cross-border context, where we are dealing with non-residents that often have no establishment in Australia.

In a recent paper delivered at the TIA GST symposium in Melbourne, Marie Pallot[4] stated:

> In a paper delivered at a conference in Vienna earlier this year, American Professor Walter Hellerstein[5] notes:
>
> > Despite the fact that jurisdiction to impose a tax and jurisdiction to enforce a tax are different issues, analysis of jurisdiction-to-tax questions often fails to distinguish between these two discrete aspects of jurisdiction to tax. The consequence is not only a lack of theoretical clarity in analysing jurisdiction-to-tax questions. There are practical consequences as well. In our increasingly globalized and digitized economy, the "disconnect" between jurisdiction to impose a tax and jurisdiction to enforce it is a problem of growing significance with regard to both income and consumption taxes.[6]
>
> This highlights an important question in developing GST policy for cross border services in particular. For example, if a person uses their cell phone overseas which jurisdiction has the right to tax the telecommunication service and if enforcement is problematic in either case is it appropriate that either jurisdiction have the right to tax the supply? If an individual obtains services via the internet should the jurisdiction in which the individual is located have the right to tax the supply even though taxing would be very difficult to enforce?
>
> The recent Australian Board of Taxation paper[7] poses just this question:
>
> > The application of a reverse charge to private consumers may impose significant compliance costs on private consumers and would be very difficult to administer. Other jurisdictions generally do not try to do this. New Zealand, however, reverse charges private consumers who import a large amount of services in a calendar year.
> >
> > While we understand that the level of voluntary registration in New Zealand is high they acknowledge that it is not practically possible for authorities to identify all small- scale acquisitions of imported services by unregistered persons.

[4] Policy Manager Inland Revenue Department, New Zealand
[5] *Jurisdiction to Impose and Enforce Income and Consumption Taxes: Towards a Unified Conception of Tax Nexus?*
[6] The paper goes on to consider the adoption of a common approach to the problem for both income and consumption taxes.
[7] *Review of the Application of GST to cross-border transactions*, July 2009, paragraphs 38 and 39.

> The rationale for New Zealand's treatment is the desirability for neutrality of treatment between domestic and offshore suppliers. In this light it can be argued that there is a case for legislating what could be taxed in an ideal world with steps towards enforcement being undertaken progressively. The alternative response suggested in the Australian paper is that legislation should be introduced only if it is enforceable. It is undoubtedly true that from the taxpayer's perspective this is a better outcome in terms of both tax and compliance savings."

Marie Pallot's concluding comment about enforceability concerns was that "decisions about what should and should not be included as representing consumption within a jurisdiction's tax base should rely not just on what is conceptually sound. They should also rely on the ability of the taxpayer to reasonably demonstrate, and the government to reasonably determine, that the consumption will be offshore rather than domestic."

Viewed from this perspective, the Institute raises the possibility of including a liability for domestic consumption of offshore acquisitions within the law, accompanied by a Division 85-type let out on the basis of administrative difficulties in enforcement. Such an approach demonstrates the policy basis for non-inclusion and allows ready adoption of administration to new capabilities and modernisation of taxation systems.

The Institute does not favour the application of a reverse charge on consumers, unless it is accompanied by a Division 85-type carve out for lack of enforceability.

2.2. Liabilities and entitlements

2.2.1 Fiscal Representatives, Agency, Voluntary Reverse Charge

After the connected with Australia rules are narrowed, where non-residents are nonetheless still regarded as making taxable supplies, the Institute favours an expansion or shift in emphasis of Division 57 so that non-residents who are not carrying on an enterprise in Australia can be allowed, or possibly required, to appoint a fiscal representative.

The collective amendments proposed in this submission should reduce or eliminate the need for the resident agent provisions (Division 57) and the voluntary reverse charge (Division 83) mechanism.

Division 57 should not apply to non-residents that have appointed a representative, nor where non-residents are carrying on an enterprise in Australia but the particular supplies are not made through that enterprise.

2.2.2 Direct Refund Scheme, Registration, and Requirement to register

A stand-alone direct refund scheme should not be necessary, however if the present system suffers from a lack of mutual recognition with other VAT jurisdictions, eg Germany, then the existing refund system should be altered in such a way as to achieve that mutual recognition. We consider that this could be achieved with minimal changes to the existing system. For example, the existing registration system could be modified to introduce a limited class of registration status, such as "refund only" registration.

As suggested in the discussion paper, if the imposition of GST is effectively streamlined under the options proposed, we would expect the extent to which non-resident refunds need to be given will be reduced considerably.

In the Institute's view, if a non-resident's supplies are not out of scope under the connected with Australia rules but are GST-free, such supplies should be excluded from the non-resident's registration threshold for all purposes such that those supplies, alone or together with other supplies connected with Australia, should not cause a non-resident to be required to register.

As stated above, we consider that the best method of removing the non-resident's requirement to register without undermining the taxable or creditable status of the supply or acquisition made by the non-resident is to allow (or require) non-residents that are not carrying on an enterprise in Australia to appoint a fiscal representative to account for GST entitlements and liabilities on their behalf, in conjunction with a modified registration system to allow non-resident refunds.

3. DETAILED COMMENTS ON EXAMPLES

Example 1 – Repair services subcontracted – all registered businesses

It is the Institute's view that the requirement for World Cranes to be involved in the Australian GST regime should be removed by not taxing Supply 2 (the supply of repair services to World Cranes) if World Cranes is not registered for GST and transferring any GST liability that needs to be imposed on Supply 1 (the on-supply of the subcontracted services) to Crane Owner.

The exact mechanism for achieving this is less important than the outcome. However, any solution adopted must work not only for this transaction, but for other cross-border B2B transactions, for global supply contracts.

The features of the existing rules that prevent the desired outcome from being achieved are:

- section 9-25(5)(a), which makes Supply 1 connected with Australia because of the performance of the services in Australia by the subcontractor; and
- section 38-190(3), which prevents Supply 2 being GST-free because of the provision of the services to Crane Owner in Australia.

Thus, possible solutions include:

- For Supply 1:

  Preferred option: defining the supply as not being connected with Australia because the recipient is a registered entity, with the flow-on effect that any tax to be collected would be collectible under Division 84;[8] or

- For Supply 2:

  Preferred option: treating the supply as GST-free by restricting the operation of s38-190(3) to situations where the other entity in Australia is an unregistered entity. This would be consistent with the New Zealand provisions and would have the advantage of not relinquishing taxing power over domestic private consumption. On the other hand, this does add to the compliance burden of the local sub-contractor, who will be required to determine the registration status of both its customer and the local providee.

Example 2 – training services subcontracted – unregistered providee

In the Institute's view, where Samuel is an Australian resident acquiring the training for private purposes the current law applies appropriately to Supply 2 and that this supply should be taxed (see the discussion of our Preferred option for Supply 2 in Example 1).

In addition, it is technically correct to classify Supply 1 as taxable, though it is difficult to see how the tax can be collected unless World Training chooses to register or is otherwise required to be registered. However, to treat Supply 1 as not being connected with Australia would risk the non-taxation of the full value of this transaction, since an ITC entitlement would be available to World Training. Reverse charging by Samuel is unlikely to be administratively feasible. However, to avoid the possibility that World Training would be subject to penalties and back taxes for such supplies were it at some stage to register, supplies such as Supply 1 should not be included in World Training's GST turnover for the purposes of determining whether it is required to be registered. However, if World Training registers to claim ITCs, the supplies would be subject to GST.

[8] Though in the specific example, it is unlikely that Crane Owner would be required to reverse charge since it is likely to entitled to full ITCs.

By contrast, where Samuel is an employee of World Training, who is being provided with the training, for example, as a fringe benefit, the application of Australian GST to Supply 2 seems inappropriate, since the cost of the education will be a business expense of World Training, which will be factored into the price of its foreign supplies. Under the current law, World Training would generally be entitled to an ITC in such circumstances if registered (unless the employee's services relate to making input taxed supplies). It could be argued that the compliance burden of requiring Oz Training to identify what Samuel's purposes are, and whether the training is part of World Training's business activities, may make any approach other than the current approach impractical. On the other hand, it is noted that Singapore zero-rates the supply of training services to employees of a foreign company and it is arguable that Australia should do so, both to avoid inappropriate application of Australian GST on foreign consumption and to ensure Australia's competitiveness as a regional education service provider.

In relation to this example, the Institute's recommendations are:

- ***Apply the preferred options for Example 1, Supplies 1 and 2;***
- ***Exclude Supply 1 from the registration threshold for World Training; and***
- ***Include an additional item in s38-190(1) zero-rating the supply of education services to the employees, officers, or directors of an entity that meets the same criteria currently included in item 2(b), and ensure that it operates notwithstanding sub-section (3).***

The result is that the non-resident will not be required to register, however if they do register, for example to claim input tax credits, then there will be a liability for GST on the supply.

Examples 3 & 7 – On-line supplies currently out of scope

The Institute does not support the suggested rules set out in Example 7 requiring Oz Marketing to remit tax payable by Aussie Pics. If the supplies are made through Oz Marketing, as agent for Aussie Pics, it is our view that the law should appropriately cover this.

The Institute takes the view that the current classification of Supplies 1 and 3 is correct and should not be changed. Any alternative approach would be unmanageable, both from a compliance and administration viewpoint. It is acknowledged that the effect is to result in non-taxation of the domestic consumption by Clementine and the Institute acknowledges that as the internet economy expands, this will create an increasing inefficiency in the Australian GST coverage of domestic consumption.

The Institute does not support the application of a reverse charge on consumers. Such a 'tax on honesty' would be difficult to administer and enforce and would necessarily be applied only on an ad hoc basis.

The Institute recommends that the Board should monitor the extent of such e-commerce activities and should consider the inclusion of electronically delivered products and services in the Division 85 effective use or enjoyment rules. While it is noted that the ATO has not to date made attempts to apply Division 85 to telecommunications and it might be that it does so also for e-commerce, one option is to include e-commerce in Division 85 now and leave it to the Commissioner to determine if and when the power is applied, and to what extent. While such a tax would itself also be a 'tax on honesty', it is the Institute's view that a tax on the honesty of large multi-national e-commerce suppliers is likely to be more fairly and effectively administered than a reverse charge on consumers. It would also be in keeping with the OECD Ottawa Framework recommendations and the EC VAT Directive.

Example 4 – Foreign tour operator's supplies and acquisitions

This is already covered by existing legislation. The Institute notes that the comments in *Saga Holidays*[9] call into question whether the 2005 changes do in fact effectively cover tourism services other than accommodation, since under the approach taken in *Saga* such supplies would be connected with Australia under section 9-25(5)(a) and therefore not under section 9-25(c), which would mean that they are not excluded from the registration turnover threshold calculations (unless the recommendation in Example 2 was adopted).

Examples 5 and 6 - Subcontracting arrangements, non-residents registered v. unregistered

The Institute's view is that where the non-residents are not registered for GST, Supplies 3 and 2 (the subcontracting and on-supply of the domestically performed audit services) should not be taxed and that any GST payable on Supply 1 should be payable by Oz Co Services. This result would be in keeping with the consensus emerging from the *Second Consultation Document* of the OECD.[10]

The OECD did not address the situation where the non-residents were either present in, carrying on an enterprise in, or registered for GST in countries other than their country of residence. If the non-residents are registered, there is no reason to treat the supplies differently from other supplies made between residents.

This leaves open the question of how to prevent cascading if only one of the non-residents is not registered. The Institute is of the view that the correct result can still be achieved if both the connected with Australia and GST-free rules take account both of the location of the entity to which the services are provided and the registration status of that entity.

The Institute believes that the following changes to the Australian GST could achieve the preferred outcome:

- if an unregistered supplier makes a supply of services through an enterprise carried on outside Australia, the performance of the supply in Australia should not invoke the 'thing is done' rule in s9-25(5)(a) if the recipient of the supply is either a registered entity or is a non-resident who does not have a presence in Australia and is unregistered (provided the latter creates no unintended risks to the revenue);[11] and
- in keeping with our preferred option for Example 1, Supply 2, the operation of s38-190(3) should be restricted to situations where the other entity in Australia is an unregistered entity, (other than employees of a registered entity receiving education/training services).

In combination, these rules would work as follows:

- If, as in Example 5, all the suppliers are registered:
  - Supply 1 will be connected with Australia (the proposed change will not apply because the supplier is registered) and will not be GST-free: Multi Co will therefore charge GST and Oz Co will not be required to reverse charge under Division 84;
  - Supply 2 will be connected with Australia but will be GST-free because s38-190(3) will not apply;
  - Supply 3 will be connected with Australia but will be GST-free, again because s38-190(3) will not apply.
- If, as in Example 6, neither of the non-resident suppliers is registered:
  - Supply 1 will not be connected with Australia because Oz Co is a registered entity. As a result, Oz Co will be required to reverse charge under Division 84 (unless it has a full ITC entitlement);
  - Supply 2 will not be connected with Australia because Multi-Co is a non-resident who is not registered for GST;

[9] *Saga Holidays Limited v Commissioner of Taxation* [2006] FCAFC 191
[10] Committee on Fiscal Affairs, Working Party No9 on Consumption Taxes, Centre for Tax Policy and Administration, *Applying VAT/GST to Cross-Border Trade in Services and Intangibles: Emerging Concepts for Defining Place of Taxation - Second Consultation Document – Invitation for Comments*, (OECD, Paris, June 2008)
[11] See, for example, the suggestions of Rebecca Millar in Millar, R "Taxing the Bull By the Horns: Reforming Australia's GST Rules" (2009) 24 *Australian Tax Forum* 281 (forthcoming)

  - Supply 3 will be connected with Australia but will be GST-free because s38-190(3) will not apply.

- If, Audit International is registered but Multi Co is not:
  - Supply 1 will not be connected with Australia because Oz Co is a registered entity. As a result, Oz Co will be required to reverse charge under Division 84 (unless it has a full ITC entitlement);
  - Supply 2 will be connected with Australia but will be GST-free because s38-190(3) will not apply;
  - Supply 3 will be connected with Australia but will be GST-free because s38-190(3) will not apply.
- If, Multi Co is registered but Audit International is not:
  - Supply 1 will be connected with Australia (the proposed change will not apply because the supplier is registered) and will not be GST-free: Multi Co will therefore charge GST and Oz Co will not be required to reverse charge under Division 84;
  - Supply 2 will not be connected with Australia because Multi Co is a registered entity;
  - Supply 3 will be connected with Australia but will be GST-free because s38-190(3) will not apply.

The Institute acknowledges that the application of the recommended rules does not always result in the application of GST at each and every step of the transaction chain; however this is an inevitable consequence of the cross-border transactions. Precisely the same is true of supplies that originate overseas without having any prior Australian input. In such situations, the value added by all previous foreign suppliers is taxed to the first domestic supplier or, where the reverse charge is applied, to the local customer. The same is true in respect of imported goods and restaurant food made using GST-free inputs.

Summary of recommendations

- The Institute supports the use of the destination principle as the core jurisdictional rule in the Australian GST and the use of proxies to identify the place of consumption.
- The Board should consider inserting objects clauses into the key place of taxation rules.
- The Institute supports retention of the existing broad division of place of taxation rules into three categories (goods, real property, and everything else), with limited application of more narrowly targeted rules.
- The Institute is in favour of shifting the balance between the different tools by which GST is applied to consumption in Australia. This shift should have as its primary objective a decrease in the unnecessary involvement of non-residents in Australia's GST.
- For supplies of 'services', the connected with Australia rules should be narrowed where unregistered non-residents are dealing with registered businesses or other unregistered non-residents (provided the latter creates no risks to the revenue), and the GST-free rules should be broadened where there is no final private consumption in Australia, so as to remove non-residents from the GST system. This will result in an effective broadening of the compulsory reverse charge rules in Division 84 and a corresponding narrowing of the application of the voluntary reverse charge rules in Division 83, reducing the need for it to apply to things other than goods or real property.
- In particular:
  - the application of the 'thing is done' proxy in s9-25(5)(a) should be narrowed as suggested in this submission, without a corresponding expansion of the scope of s9-25(5)(c).
  - s38-190(3) should not prevent a supply being GST-free when the other entity in Australia is registered.
  - s38-190(4) should continue to apply whether or not the recipient in Australia is registered.
- The Board should consider whether s9-25(5)(c) has any effective operation and could consider removing it or achieving its objectives in other ways (for instance by clarifying what is meant by 'the thing is done' in a way that focuses on the performance of the subsequent supply that occurs when the right or option is exercised).
- The Institute recognises the difficulties in applying GST to e-commerce and recommends that Division 85 should be expanded to cover electronically delivered supplies. The Commissioner will, as he has with telecommunications services, then be able to collect tax when it is administratively feasible to do so.
- The Board should clarify what is meant by 'effective use or enjoyment' in Division 85 and in item 3 of s38-190(1) and should clarify the meaning of this expression by defining it in terms of an appropriate proxy for place of consumption.
- The Institute does not favour the application of a reverse charge to consumers, unless it is accompanied by a Division 85-type carve out for lack of enforceability.
- The scope of section 38-190(2A) should be reviewed, refined and potentially narrowed to ensure that it does not inappropriately tax consumption outside Australia, without a sufficient connection to real property in Australia.
- For supplies of goods with installation services in Australia, the Board should consider amending and narrowing s9-25(3)(b) to mirror the amendments to s9-25(5)(a), such that the supply by an unregistered non-resident of services to install goods in Australia does not make the supply of the goods by the non-resident connected with Australia, provided the recipient of the services is registered (or possibly is another non-resident business that does not have an establishment in Australia and is not registered).
- For supplies of goods brought to Australia, the Board should consider whether "imported" goods sold under DDP Incoterms to fully creditable Australian business customers can be excluded without risk to the revenue. If so, a significant number of non-residents could be removed from the GST net. In conjunction with this, the definition of creditable importation should also be reviewed and broadened to ensure that the fully creditable Australian business customer is able to claim the input tax credit where they enter the goods (so as to remove the blackhole GST problem that can arise).

- For supplies of goods (including leased goods) wholly within Australia, the Board should give consideration to adopting approaches similar to the Canadian 'drop-shipment' rules, which effectively remove non-resident suppliers from the GST regime when goods (and services closely related to goods) are supplied to a non-resident but the goods are directly delivered in Canada.
- Non-residents that make taxable supplies but do not carry on an enterprise in Australia should be allowed to appoint a fiscal representative to handle all of their GST liabilities, entitlements, and obligations.
- The liability of the fiscal representative should override and possibly replace any rules relating to resident agents (Division 57).
- The interaction of any new fiscal representative provisions with Division 83 should be carefully considered. If the Institute's recommendations are followed, the current scope of Division 83 would be covered by a broadened Division 84 (for things other than goods or real property), by the adoption of the Canadian drop-shipment rules (for goods), and by expansive fiscal representative provisions (which will cover supplies by non-residents, through an enterprise carried on outside Australia, supplies of real property, any supplies of goods not covered by the drop-shipment rules, and any supplies of other things not covered by Division 84 or 85)
- If the present refund system suffers from a lack of mutual recognition with other VAT jurisdictions, eg Germany, then it should be altered in such a way as to obtain that mutual recognition. We believe this could be achieved with minimal changes to the existing system.

Appendix B

Policy objectives underlying GST and cross-border transactions

1. THE DESTINATION PRINCIPLE

In keeping with the modern value added taxes in operation in most OECD countries, and in many other developed and emerging economies, Australia's GST asserts jurisdiction to tax consumption in Australia on the basis of the destination principle[12].

In theory, if the destination principle were properly and fully implemented both in Australia and in all other countries that contribute to the production of goods or services consumed in Australia, the following statements would hold true:

1. Expenditure on consumption in Australia (domestic consumption) would be taxed at the rate of GST applicable in Australia;
2. Any non-taxation or partial taxation of domestic consumption would be as a result of the application of Australian rules treating domestic consumption as GST-free (e.g. Division 38, other than Subdivisions 38-E, 38-K, and 38-Q), input taxed (e.g. Division 40), or taxable at a rate other than the standard rate (e.g. Division 87), or as a result of a choice not to exercise the jurisdiction to tax (e.g. the low-value thresholds for imports);
3. All of the tax revenue embedded in expenditure on domestic consumption would accrue to Australia; and
4. No Australian GST would be collected on goods or services consumed outside Australia (foreign consumption).

The Institute supports the use of the destination principle and considers it to be the appropriate basis on which to assert jurisdiction to apply GST to domestic consumption. In particular, the Institute agrees with the Board's implicit approval of the principles established by the Committee of Fiscal Affairs of the OECD, specifically the principle that:

The burden of value added taxes themselves should not lie on taxable business except where explicitly provided for in legislation.[13]

Two key issues arising from this principle form the basis of the Government's reference to the Board:

1. Which businesses should be treated as taxable businesses for the purposes of GST? and
2. When should the legislation explicitly provide for the burden of the tax to fall on a (taxable) business?

The answers given to these questions can have an impact on both the breadth of the tax base and the means by which tax on any given base is collected. For this reason, the terms of reference themselves create a tension between maintaining and/or expanding the tax base and reducing complexity.

While the Institute acknowledges that the terms of reference require the Board to have regard to the multi-stage feature of Australia's GST, such regard may nonetheless lead to a conclusion that a divergence to some extent is sometimes desirable in the interests of efficiency and global competitiveness.

[12] Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill 1998*, Chapter 1, Executive Summary
[13] Centre for Tax Policy and Administration, *International VAT/GST Guidelines*, (OECD, Paris, February 2006), at paragraph 9.

2. LEGAL DESIGN OF RULES TO IMPLEMENT THE DESTINATION PRINCIPLE

2.1 Tax base boundaries

In any destination-based consumption tax, there are a number of different mechanisms used to implement the destination principle. Each country combines these mechanisms in different ways and describes them using different words and/or concepts. Despite these differences, the key mechanisms are essentially the same the world over.

In Australia, four mechanisms are used to describe the boundaries of the tax base:

1. The connected with Australia rules: s9-25 and Div.85;
2. The GST rules for supplies consumed outside Australia: Subdivs.38-E, 38-K, and 38-Q;
3. The 'importation' rules:
   (c) For goods, the taxable importation rules: Div.13;
   (d) For things other than goods or real property, the compulsory reverse charge rules: Div.84, as it applies to supplies that are not connected with Australia;[14] and
4. The input tax credit (ITC) entitlement rules, including the absence of rules limiting ITCs to entities carrying on an enterprise in Australia, the absence of a required link to the making of taxable supplies, and ss11-15(3) and 15-10(3), which allow ITCs for acquisitions relating to supplies that would be input taxed but which are made through an enterprise carried on outside Australia.

The first three sets of rules make up what the OECD now refers to as 'place of taxation' rules.

Between them, the connected with Australia and compulsory reverse charge rules describe the outer boundaries of the domestic consumption that will be subject to Australian GST. A supply that is not captured by either of these sets of rules will not be taxed, even if it is consumed in Australia. For example, under the current law, anything other than goods or real property that is capable of being, and is in fact, acquired remotely (through a supply that is not connected with Australia) will not be taxed if the recipient is a consumer (i.e. does not make the acquisition in carrying on an enterprise).

At the same time, these rules also describe the boundaries of what will be considered to be foreign consumption. A supply is presumed to be consumed outside Australia if:

- it is not connected with Australia and not covered by the Division 84 reverse charge; or
- it is connected with Australia but is GST-free.

Conversely, a supply that is connected with Australia and not GST-free will generally be subject to GST.

In the business to business (B2B) context, Australia's GST allows an ITC when GST is charged to a foreign supplier, provided the input does not relate to making input taxed supplies through an enterprise carried on in Australia, but not when the customer cannot pass the administrative and practical hurdles of establishing its business credentials to the satisfaction of the Australian Taxation Office (ATO).

2.2 Proxies for place of consumption

The discussion paper notes that the international practice is to use proxies for place of consumption when determining the place of taxation, rather than trying to define consumption and identify the actual place where consumption occurs. Many jurisdictions, including Australia, do include some place of taxation rules that refer to the 'place of effective use or enjoyment'. This can be viewed as a direction to determine the place of taxation by reference to the actual place of consumption of a particular transaction.

[14] Those referred to in section 84-5(1)(a).

We note that such rules can create difficulties when different views are taken of what "effective use or enjoyment means", and when the focus is placed on different potential users. For example, the Commissioner has interpreted the effective use or enjoyment rule in item 3 of s38-190(3) as requiring a focus on the use or enjoyment by the entity to whom the relevant supply is provided, whether that be the recipient or a third party providee. This view has not been tested in the Courts and there are those who disagree with it, taking the view that the concept of effective use or enjoyment should be more widely interpreted.

The Institute supports the use of proxies in the Australian GST and takes the view that proxies are generally preferable to less well defined tests which seek to define consumption. We recommend that the use of the expression "effective use and enjoyment" be reviewed to determine whether it can be made more certain through legislative clarification.

2.3 Liability – who is the taxpayer?

Interacting with the rules that define the territorial boundaries of the domestic tax base are rules determining who will be the taxpayer. In the context of cross-border transactions, liability may be shifted from the supplier to the recipient, or to another entity. Reasons for shifting the liability include improving administrative efficiency, capacity to enforce the tax, and reducing compliance costs. Reducing non-resident involvement in Australia's GST can be justified on each of these grounds.

In Australia, the liability rules that can be of relevance to non-residents making taxable supplies otherwise than through an enterprise carried on in Australia include:

1. Section 9-40, under which a non-resident supplier might be required to remit the GST payable on a supply;
2. Division 83, under which a non-resident supplier can agree with a recipient that is registered or required to be registered that the GST will be reverse charged by the recipient (with flow-on effects for the non-resident's requirement to apply for registration);
3. Division 57, under which a resident agent is liable for the GST on supplies, and entitled to the ITCs on acquisitions, made by the resident as agent for a non-resident principal. Unlike Division 83, this does not have the benefit of a flow-on effect on the non-resident's requirement to apply for registration;
4. Division 48, under which a non-resident may be a member of (but not the representative member of) a GST group, in which case substantially all of the non-resident's GST liabilities, entitlements, and obligations will be met by the representative member;
5. Division 51, under which some of the GST responsibilities, entitlements, and obligations of a non-resident member of a joint venture may be transferred to the joint venture operator.

The broad scope of the connection with Australia rules, as interpreted and applied by the ATO, together with the limited mechanisms available in the GST law to exclude non-resident suppliers from liability, means that a large number of non-residents are brought into the Australian GST registration system for no net GST revenue collection.

The Institute supports a move away from imposing liability on non-resident suppliers.

2.4 Objects clauses

It follows from the Institute's support of the use of proxies in the 'place of taxation' rules that the Institute does not support a reliance on principles-based drafting, where that means the drafting of rules based only on the principles. Nonetheless, a clear statement of the underlying principle can be advantageous in ensuring that the proxies are interpreted in light of the objective to tax domestic consumption and not tax foreign consumption.

Given the fact that the four different elements/tools of the cross-border rules are found in disparate places in the GST law, it might be difficult to do this in a coherent way. Nonetheless, any changes that are enacted as a result of this consultation process should be accompanied by a clear Explanatory Memorandum outlining the objectives of the destination principle and explaining the role of proxies. At the same time, it might be useful to include specific objects clauses at the beginning or end of section 9-25, Subdivisions 38-E and 38-K, and Division 84.

The Institute recommends the inclusion of objects clauses into the place of taxation rules in the GST law.