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

18 September 2009

Dear Sir or Madam

Submission to Board of Taxation – Application of GST to cross-border transactions

We are writing this submission in response to the Board of Taxation's invitation to stakeholders to comment on the recent discussion paper regarding the 'Review of the Application of GST to Cross-Border Transactions' ("the Discussion Paper"). In particular, through this letter we seek to provide feedback on the issue of the broad application of the '*connected with Australia*' provisions, the scope of the GST-free rules and the proposed options for change set out in the Discussion Paper.

This submission addresses the current and proposed GST treatment of various supplies made pursuant to four types of international services contracts typically entered into by our clients which are affected by the broad application of the '*connected with Australia*' provisions and the scope of the GST-free rules. We have also made certain recommendations to the Board of Taxation to further ensure compliance costs for business and administration costs for the Australian Taxation Office ("ATO") are minimised while enhancing the integrity of the Australian GST system.

Executive Summary

The current broadly drafted 'connected with Australia' rules in relation to supplies of services and intangibles create significant and unnecessary GST compliance issues for many non-resident entities. These rules are generally unenforceable and strike at the integrity of the tax. Furthermore, the narrowly drafted GST-free rules in relation to the supplies of services to non-residents results in many non-resident entities being charged GST. Consequently, many non-resident entities register for GST purposes for the sole purpose of recovering the GST so charged. This is clearly inefficient.

Broadly we support option 1 (modified to address supplies between non-resident entities) and option 3.1 of the Discussion Paper.

Liability limited by a scheme approved under Professional Standards Legislation

We submit that the efficiency and integrity of the Australian GST system can be enhanced by the adoption of the recommendations outlined in our submission.

Outline of Submission

In support of our submission, we set out the following:

(a) Four scenarios which are representative of the types of cross-border transactions our clients enter into, being:

- Scenario 1 – Global services contract between two non-residents pursuant to which certain services are provided to an entity(s) in Australia;
- Scenario 2 – Services supplied by a non-resident to an Australian registered entity where the provision of the services is made by an Australian subcontractor;
- Scenario 3 - Services provided by a non-resident to an Australian registered entity, in Australia; and
- Scenario 4 – Services supplied by an Australian registered entity to a non-resident where some services are provided to another entity in Australia.

Each of these scenarios is outlined diagrammatically below, with a brief explanation.

(b) The current ATO view of the GST treatment and implications for supplies made in each scenario;

(c) The proposed GST treatment set out in the Discussion Paper and our comments; and

(d) Our recommendations.

Submission

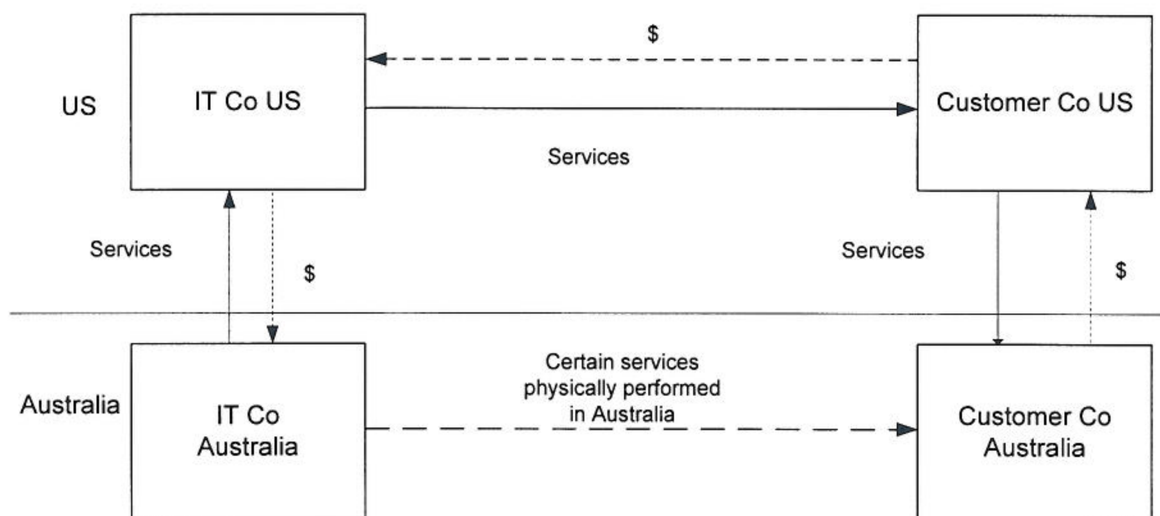
For the purposes of this submission:

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

- The relevant sections of the GST Act referred to in this submission are set out in Appendix A;
- A reference to "services" in the scenarios addressed in this submission includes consulting services and technology services such as outsourced data processing, maintenance and support services.

(a) Scenarios

1 – Global services contract

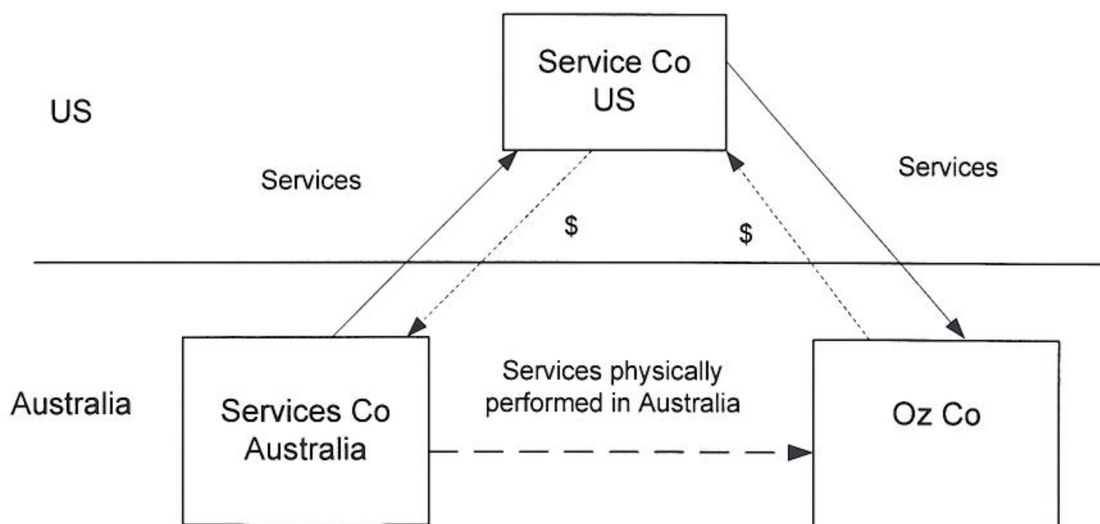


Under this scenario:

- IT Co US a US resident company with no permanent establishment in Australia enters into a global contract with a US resident company ("Customer Co US") to supply services to Customer Co US's and its worldwide affiliates.
- IT CO US will charge Customer Co US for the supply of global "services".

- IT Co US may be required to supply services that are physically performed in Australia (such as training and technical support services). IT Co US would generally enter into a sub-contract arrangement with its wholly owned subsidiary ("IT Co Australia") to provide these services.
- Customer Co US would generally charge Customer Co Australia for services acquired from Customer Co US.
- Under this scenario it is possible that Customer Co Australia could be a financial services provider (e.g. making input taxed financial supplies). It is also possible in this scenario that there is an additional non-resident entity that acts as a procurement company for Customer Co US.

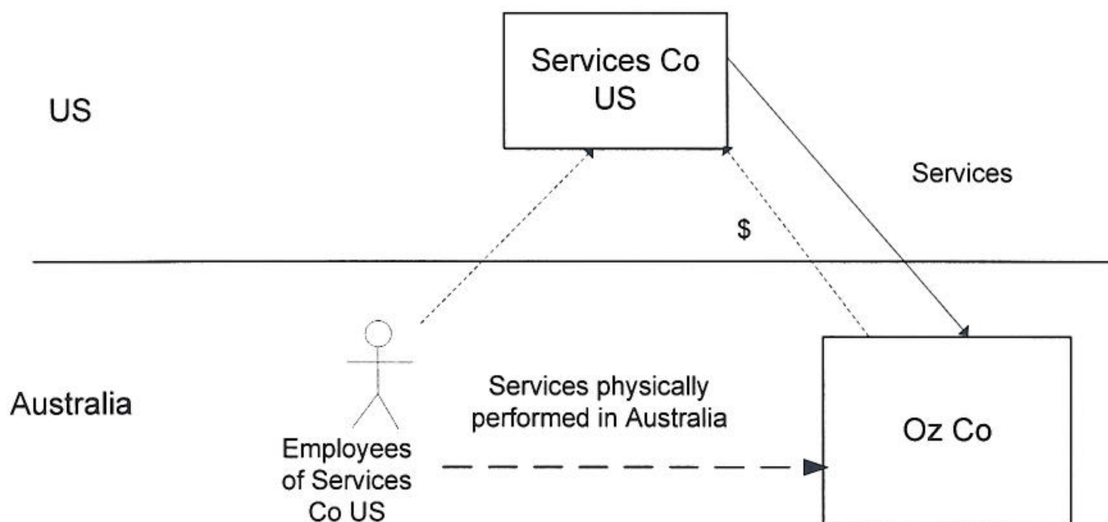
2 – Subcontracted service arrangement



Under this scenario:

- Services Co US (a US resident company with no permanent establishment in Australia) enters into a contract with Oz Co (an Australian resident company) to provide services (such as training services) to Oz Co's employees in Australia.
- Since Services Co US does not have any staff in Australia, to physically perform the services it engages Services Co Australia to physically provide the services to Oz Co in Australia.
- Services Co Australia would charge Services Co US for providing the relevant services in Australia.
- Services Co US charges Oz Co for the services provided under the relevant contract.

3 Services provided to an Australian registered entity by a non-resident, in Australia

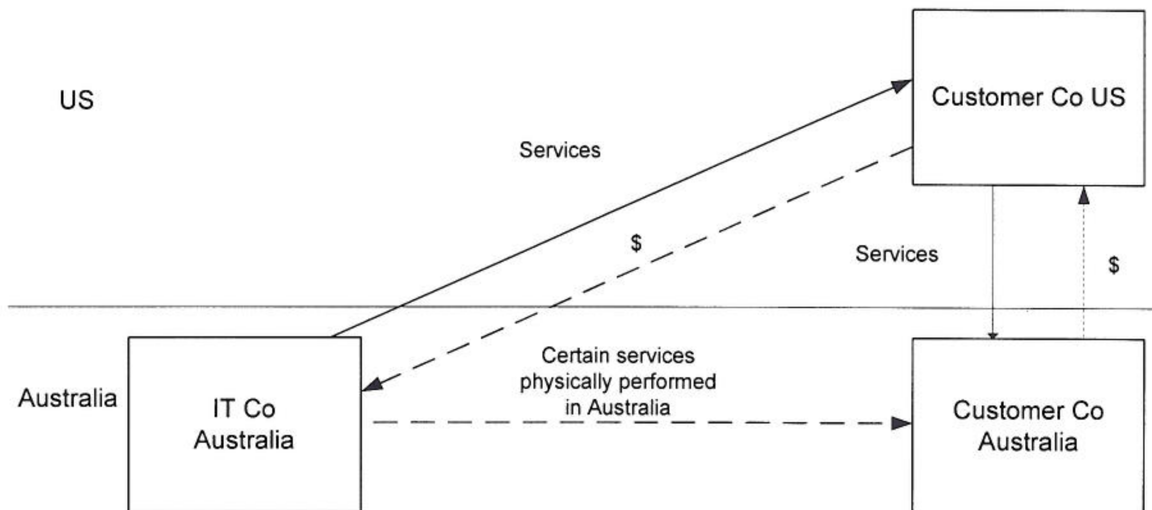


Under this scenario:

- Services Co US (a US resident company with no permanent establishment in Australia) enters into a contract with Oz Co (an Australian resident company) to provide services (such as training services) to Oz Co's employees in Australia.

- Services Co US sends its employees to Australia to physically perform the training services in Australia. We note that this activity does not create a permanent establishment of Services Co US, in Australia

4 - Services supplied by an Australian registered entity to a non-resident



Under this scenario:

- IT Co Australia (an Australian resident entity) contracts with a US resident company, Customer Co US, to supply services to its Australian affiliate.
- IT Co US charges Customer Co US for services provided to Customer Co Australia.
- Customer Co US does not have a permanent establishment in Australia.

(b) The current ATO view and its implications

Supplies 'connected with Australia' – Scenarios 1, 2 and 3

The Australian Taxation Office's ("ATO") view in relation to the GST treatment of the various services provided by non-residents under scenarios 1, 2 and 3 described above is set out in GSTR 2005/6[1]. The ATO view is as follows:

> *"The supply by an overseas supplier is connected with Australia if the services are performed in Australia by the Australian supplier (paragraph 9.25(5)(a)). This is so even though the overseas supplier (that is the internal service provider or the non-resident supplier) does not physically perform that service in Australia. The service is physically performed in Australia by the Australian supplier"*[2]

According to the ATO, a non-resident that has a contracting obligation to supply services in Australia is making a supply that is 'connected with Australia' and is potentially liable for Australian GST. In relation to scenarios 1, 2 and 3 above, the ATO view is as follows:

- The supply of services physically performed outside Australia by a non-resident entity would not be '*connected with Australia*' as the supply is not 'done' in Australia or made through what is effectively a permanent establishment of the supplier in Australia.
- To the extent the supply relates to services 'provided' in Australia to an Australian entity (Customer Co Australia in scenario 1 and Oz Co in scenarios 2 and 3), the ATO would contend that this part of the supply by each of the non-resident entities is '*connected with Australia*' and is taxable.

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[1] GSTR 2005/6 - *Goods and services tax: the scope of subsection 38-190(3) and its application to supplies of things (other than goods or real property) made to non-residents that are GST-free under item 2 in the table in subsection 38-190(1) of the A New Tax System (Goods and Services Tax) Act 1999.*

[2] GSTR 2005/6 paragraph 165

Implications of the ATO view

Based on the ATO comments in GSTR 2005/6[3], the non-resident entities in scenarios 1, 2 and 3 may have a registration requirement and a GST liability in Australia in relation to the services provided in Australia to an Australian entity.

We contend that this is an inappropriate outcome for the following reasons:

- it is extremely difficult and costly for non-resident entities to extract relevant data and comply with the Australian GST law (if the ATO was to enforce it based on their view expressed in GSTR 2005/6) as their systems are not geared to charge foreign GST, VAT or similar transaction taxes, produce compliant tax invoices and lodge relevant returns (in the case of Australia, Business Activity Statements ("BAS")). Non-resident's systems and processes are geared to comply with local taxes, particularly transaction taxes;
- if registered, the non-resident entities would be entitled to recover any GST charged as an input tax credit;
- Determining the value of any taxable supply made under a global contract is often impossible due to the fee arrangements in place. For example, maintenance and support services are often charged by way of an agreed fee on a monthly (or quarterly) basis for a period of time. This fee will be payable irrespective of whether the service is used in that period or whether the services are provided locally or remotely. Therefore, accurately determining a GST liability is often impossible; and
- Non-resident entities do not have easy access to ATO information (notwithstanding they may have Australian subsidiaries or an Australian branch) in order to comply in a way expected by the ATO. In particular, it is unreasonable and naïve to expect any entity to know or have access to knowledge of the revenue streams of another, even a connected party. It is also

[3] GSTR 2005/6 - *Goods and services tax: the scope of subsection 38-190(3) and its application to supplies of things (other than goods or real property) made to non-residents that are GST-free under item 2 in the table in subsection 38-190(1) of the A New Tax System (Goods and Services Tax) Act 1999*

naïve and unreasonable to expect employees of the foreign companies have an understanding of the Australian GST law.

The Scope of GST-free supplies – scenario 4

In scenario 4, the supply of services by IT Co Australia to Customer Co US is clearly '*connected with Australia*. The issue at hand is whether those supplies (or part thereof) are GST-free pursuant to item 2 of subsection 38-190(1) of the GST Act and in particular, whether the supplies (or part therefore) are provided to another entity in Australia[4].

The narrow scope of item 2 of subsection 38-190(1) of the GST Act requires IT Co Australia to determine whether any or all of the services supplied to Customer Co US is taxable on the basis that the services, or part thereof, are provided to another entity in Australia (Customer Co Australia).

Determining the extent to which the services are physically supplied by IT Co Australia to Customer Co Australia can be difficult to determine and should be unnecessary. Under the contract outlined in scenario 4, Customer Co Australia would be registered for GST purposes in Australia and, if it was charged for the relevant supply, it would be entitled to a full input tax credit. If Customer Co Australia was a financial institution, it would be liable for GST under Division 84 of the GST Act when it inevitably becomes liable to pay its offshore affiliate (Customer Co US) for procuring the relevant services.

In the circumstances outlined in scenario 4, GST should only apply if IT Co Australia where to charge Customer Co Australia directly for the services provided.

Taxing a supply by IT Co Australia to Customer Co US and, as a consequence, requiring Customer Co US to register on the basis that it will supply the same services to Customer Co Australia is inefficient for reasons expressed above. We note that Division 84 of the GST Act was designed to efficiently tax the relevant services supplied in these circumstances.

The options proposed in the Discussion Paper and our comments

Option 1 - Limit the application of the connected with Australia provisions

Option 1 of the Discussion Paper seeks to limit the scope of the *connected with Australia* rules for supplies (presumably of services and intangibles only) by non-residents to Australian businesses without impacting on the amount of GST that should be collected.

As the Board of Taxation states in paragraph 5.13 of the Discussion Paper:

> *"...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..."*

Under the solution proposed in option 1, it would only be the supplies made by the non-resident entity in scenarios 2 and 3 that would not be *connected with Australia* as its customer Oz Co is an Australian business.

Certain supplies made by IT Co US in scenario 1 would still be 'connected with Australia' and probably taxable as its customer (Customer Co US) is not an Australian business.

We submit that this is an inappropriate outcome and the Board of Taxation should consider a modified approach that excludes supplies of services between non-resident entities from the scope of the 'connected with Australia' rules of the GST Act. This is outlined in the "recommendation section" of this submission.

Option 1, modified to exclude supplies of services between non-resident entities from the scope of the 'connected with Australia' rules of the GST Act, would allow the existing compulsory reverse charge rules under Division 84 to operate, without further amendment. The current Division 84 rules are

[4] Refer subsection 38-190(3) of the GST Act

effective and efficient, applying only where a recipient is not entitled to a full input tax credit in relation to the acquisition.

Option 3.1 – Broaden the scope of the GST-free rules

This option must be considered with option 1. At option 3.1 the Board of Taxation suggests that supplies made to a non-resident but provided to a registered Australian business could be made GST-free. We have assumed this suggestion involves only supplies of services and intangibles and as a consequence, would be an amendment to subsection 38-190(3) of the GST Act. We assume the criteria in relation to item 2 of subsection 38-190(1) would remain.

We support the broadening of item 2 of subsection 38-190(1) in the manner suggested. Currently, subsection 38-190(3) has the effect that far too many supplies of services to non-residents are unnecessarily subject to GST. While the suggestion will raise some evidentiary issues for some suppliers, in many instances, it is self evident whether an entity that may be provided services in Australia is registered for GST purposes. Where there is doubt it will be the supplier's obligation to enquire as to the registration status of the entity that may receive the supply.

We note (in response to question 5.19) that services provided to an employee of a business (in his or her capacity as an employee) is a service provided to the business and not the employee.

Option 2.1 - Shift the GST liability of non-residents to resident businesses through a compulsory reverse charge

Option 2.1 considers leaving the '*connected with Australia* rules as they are and shifting the liability for GST to the recipient of the relevant supply by way of a compulsory reverse charge regime. Under this option, we assume Division 83 (a reverse charge rule that applies to supplies 'connected with Australia') would be modified to operate in a compulsory manner.

On the assumption that the Board of Taxation recommends option 1 (modified to deal with supplies between non-resident businesses) to the Government, we do not believe it is necessary for an additional compulsory reverse charge to be applied.

By limiting the scope of the '*connected with Australia*' rules, the supplies by non-residents to resident entities in each scenario outlined above would potentially fall for consideration under Division 84 of the GST Act. Therefore, an Australian resident entity would be liable for GST in each scenario if it was not entitled to full input tax credits in relation to the relevant acquisition. Importantly, a non-resident entity with no physical presence (whether permanent or temporal) in Australia would not be liable for Australian GST.

We note that if a non-resident made a supply to a fully taxable business in Australia, Division 84 would not apply as the law effectively and appropriately recognises that GST would otherwise "wash through". However, there would be no GST leakage, since any GST that would otherwise be reverse charged would be fully recoverable in the same tax period.

We submit that a compulsory reverse charge on supplies that are '*connected with Australia*' unnecessarily adds another layer of complexity to the Australian GST law. Currently, Division 83 is not aligned to Division 84. Notable differences include the following:

- Division 83 requires the recipient to reverse charge whether or not they are entitled to full input tax credits in relation to the acquisition. This is not the case with Division 84; and
- Division 83 applies to "a taxable supply" (of goods, real property, services or intangibles) whereas Division 84 applies only to a supply of services (and intangibles).

In our view, an optional reverse charge rule for supplies of goods and real property in the circumstances covered by Division 83 is desirable. A compulsory reverse charge rule reduces choice for taxpayers and increases the recipient's risk of non-compliance, particularly in relation to the supply of goods by a non-resident to an Australian recipient.

Most supplies of goods by non-residents to Australian entities are not 'connected with Australia' and are taxable upon importation. A compulsory reverse charge rule in relation to supplies of goods will require Australian recipients to determine whether or not a supply of goods is 'connected with Australia'. This would be a difficult exercise in many instances.

Furthermore, non-residents making taxable supplies of goods or real property in Australia also incur GST on some of their input costs. Consequently, these entities may be registered and recovering GST in any case. Currently, these entities have a choice as to whether they account for GST on their supplies or enter into a Division 83 agreement with their customer.

Division 84 applies to supplies of services and intangibles that are not 'connected with Australia'. It would be inappropriate to apply Division 84 to supplies of goods that are not 'connected with Australia' as these supplies are generally taxed upon importation.

Division 84, in its current form, keeps compliance costs to a necessary minimum by requiring only businesses not entitled to full input tax credits (in relation to the particular acquisition) to reverse charge.

In our view, making Division 83 a compulsory reverse charge provision would potentially increase compliance costs and provide an unnecessary layer of complexity to the GST system.

Option 2.2 - Transfer GST liability to an Australian subsidiary

Option 2.2 in the Discussion Paper considers transferring the GST liability to a registered Australian business that is not the recipient of the supply.

In scenario 1 this would mean that IT Co Australia would be liable for the GST on taxable supplies made by IT Co US.

We submit that it is commercially naïve to expect any entity to know or have access to knowledge of the revenue streams of another entity, even an associate. It is also unrealistic to expect employees of a foreign entity that does not operate in Australia to understand the Australian GST system sufficiently in order to comply or advise its Australian affiliate of any Australian GST liability it may have.

Moreover, we submit that applying Division 84 to the charge by a non-resident (Customer Co US in scenario 1) to a local registered business (Customer Co Australia in scenario 1) is the transaction that should be subject to Australian GST. We do not consider it appropriate to seek to impose GST on a supply by a non-resident (with no physical presence in Australia) where the recipient is another non-resident business (with no physical presence in Australia) or a GST registered business in Australia.

Therefore, we do not support the adoption of this proposal and believe our suggested solution (or at the least option 1 proposed by the Board of Taxation, modified to address supplies between non-residents) is a better approach.

Recommendation

We submit that the Board of Taxation should consider the following as an alternative to option 1:

- Paragraphs 9-25(5)(a) of the GST Act should only apply where services are physically provided by the supplier in Australia. Paragraphs 9-25(5)(b) and (c) should remain in its current form.
- If an entity does not make a supply in any of these circumstances, the relevant supply should not be '*connected with Australia*' and Division 84 should potentially apply to ensure there is no revenue leakage in relation to business-to-business transactions.
- If the Government is concerned about possible revenue leakage in relation to business-to-consumer transactions,
  - Division 85 could be expanded to address specific transactions (such as e-commerce transactions); and

- Subsection 38-190(3) could apply where the relevant services or intangibles are supplied by an Australian entity to a non-resident but provided to a third party in Australia that is not registered for GST purposes (this is effectively suggested in option 3.1).

The significant benefit of our suggested '*connected with Australia*' rule is that the Australian GST law is enforceable against the supplier as it is physically in the country at the time the relevant supply is made. Furthermore, it is consistent with what a non-resident would expect in relation to a taxation system.

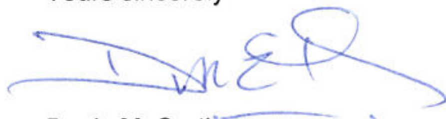
We submit that our recommendation is effective and efficient, ensuring GST is collected on the right amount, at the right time. Furthermore, it is enforceable thereby maintaining the integrity of the Australian GST system. In our view, there would be no further revenue leakage if this recommendation is adopted.

If the Board of Taxation does not adopt our suggested '*connected with Australia* rule', we would support option 1, provided it appropriately addresses supplies between non-resident businesses that do not have a business presence in Australia.

* * * *

We trust this submission is of assistance. Please feel free to contact me on 02 8266 5229 if you would like to discuss this submission further.

Yours sincerely



Denis McCarthy
Executive Director
Tax and Legal Services

Appendix A

We have provided the relevant excerpts from the legislation as follows:

Section 9-25

*(5) A supply of anything other than goods or *real property is* ***connected with Australia*** *if:*

(a) the thing is done in Australia; or

*(b) the supplier makes the supply through an *enterprise that the supplier *carries on in Australia; or*

(c) all of the following apply:

(i) neither paragraph (a) nor (b) applies in respect of the thing;

(ii) the thing is a right or option to acquire another thing;

(iii) the supply of the other thing would be connected with Australia.

Section 38-190(1) Item 2:

*Supply to a *non-resident outside Australia.*

*a supply that is made to a *non-resident who is not in Australia when the thing supplied is done, and:*

*(a) the supply is neither a supply of work physically performed on goods situated in Australia when the work is done nor a supply directly connected with *real property situated in Australia; or*

*(b) the *non-resident acquires the thing in *carrying on the non-resident's *enterprise , but is not *registered or *required to be registered.*

Section 38-190(1) Item 3:
Supplies used or enjoyed outside Australia.

> *a supply:*
>
> *(a) that is made to a *recipient who is not in Australia when the thing supplied is done; and*
>
> *(b) the effective use or enjoyment of which takes place outside Australia; other than a supply of work physically performed on goods situated in Australia when the thing supplied is done, or a supply directed connected with *real property situated in Australia.*

Section 38-190 (3)

Without limiting subsection (2) or (2A), a supply covered by item 2 in that table is not GST-free if:

> *a) it is a supply under an agreement entered into, whether directly or indirectly, with a *non-resident; and*
>
> *b) the supply is provided, or the agreement requires it to be provided, to another entity in Australia*

Section 84-5 Intangible supplies from offshore that are taxable supplies under this Division

(1) A supply of anything other than goods or * real property that is:

> a) a supply not *connected with Australia; or
> b) a supply connected with Australia because of paragraph 9-25(5)(c);
> is a ***taxable supply*** *if:*

*c) the *recipient of the supply acquires the thing supplied solely or partly for the purpose of an enterprise that the recipient *carries on in Australia, but not solely for a *creditable purpose; and*

*d) the supply is for *consideration; and*

*e) the recipient is *registered or *required to be registered.*

*However, the supply is not a *taxable supply to the extent that it is *GST-free or *input taxed.*

84-10 "Reverse charge" on offshore intangible supplies

*(1) The GST on a supply that is a *taxable supply because of section 84-5:*

*a) is payable by the *recipient of the supply: and*

b) is not payable by the supplier.

(2) This section has effect despite section 9-40 (which is about the liability for the GST).

(3) If a supply is a taxable supply under both sections 9-5 and 84-5, GST is only payable under this section (instead of section 9-40).

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