CPA Australia Ltd
ABN 64 008 392 452

CPA Centre
Level 28, 385 Bourke Street
Melbourne VIC 3000 Australia
GPO Box 2820
Melbourne VIC 3001 Australia

T +61 3 9606 9606
F +61 3 9670 8901
E vic@cpaaustralia.com.au
W www.cpaaustralia.com.au

15 September 2008

Review of the legal framework for the administration of the GST
Board of Taxation
c/- the Treasury
Langton Crescent
PARKES ACT 2600

Email: taxboard@treasury.gov.au

Dear Sir

Review of the Legal Framework for the Administration of the Goods and Services Tax

CPA Australia represents the diverse interests of more than 117,000 finance, accounting and business advisers both in Australia and around the world.

Please find enclosed our submission to the review. If you have any questions regarding this submission, please contact Mark Morris FCPA - Senior Tax Counsel on (03) 9606 9695 or via email at mark.morris@cpaaustralia.com.au.

Yours faithfully

Paul Drum FCPA
Director - Policy and Research

T: +61 3 9606 9701
F: +61 3 9642 0228
E: paul.drum@cpaaustralia.com.au

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CPA Australia

Review of the Legal Framework for the Administration of the Goods and Services Tax

Submission

15 September 2008

REVIEW OF THE LEGAL FRAMEWORK FOR THE ADMINISTRATION OF THE GOOD AND SERVICES TAX

Executive summary

CPA Australia represents the diverse interests of more than 117,000 finance, accounting and business advisers. Our organisation is committed to working with governments and their agencies to ensure current and future economic and social policies foster an environment that facilitates sustainable economic growth.

It is against this background that we have prepared this submission on the Board of Taxation's Review of the Legal Framework for the Administration of the Goods and Services Tax

We have not sought to address all the questions listed in the Board's 'Issues Paper' on the review which was released on 18 July 2008, but have instead focussed on the most crucial compliance issues which are of generic concern to a broad cross-section of our membership.

Against this background, the structure of this submission is to raise issues that relates to the administration of the Goods and Services Tax ("GST"), to discuss and contextualise each issue raised and to make a recommendation about how the issue might be resolved where possible.

Summary of recommendations

1. Principles based drafting

Recommendation

The GST law should be reviewed to determine the circumstances where more detailed legislation can be used to make the application of the GST law more certain without the need to have resort to volumes of administrative rulings.

This is especially the case in respect of those parts of the GST Act that vary the impact of GST from the standard one eleventh of the price such as the GST-free supply of a going concern.

2. Record keeping requirements on settlement discounts

Recommendation

The rules relating to the requirement to hold an adjustment note before a supplier can attribute a decreasing adjustment arising as a result of a settlement discount should be relaxed.

3. Limitations of Division 57

Recommendation

Division 57 of the GST Act should contain a definition of 'Australian resident agent' at least in relation to the importation of goods, to confirm that an Australian resident that makes a taxable importation of goods owned by a non-resident either as consignee or as agent, for the purposes of supplying a service to the non-resident to enable the non-resident to comply with Australian contractual obligations, is entitled to an input tax credit for the GST paid at the time that the goods are entered for home consumption on behalf of the non-resident.

4. *Financial acquisitions threshold*

Recommendation

Consideration should be given to removing the alternate '10 per cent' test relating to the application of the financial acquisitions threshold under section 189-5(1)(b) as the costs associated with complying with this test are often potentially disproportionate to the amount of input tax credits denied.

Alternatively, if the '10 per cent' test is retained it should be amended to include notional input tax credits that would have been available had acquisitions related to taxable supplies rather than GST-free supplies.

5. *GST registration of non-resident businesses*

Recommendation

It is recommended that section 38-190(3) of the GST Act should be amended to limit its operation to circumstances where the non-resident would not be entitled to a full input tax credit. A similar type of approach is taken in Division 84 where a reverse charge GST liability is payable by the recipient of certain supplies made from outside Australia where the recipient is not entitled to a full input tax credit. Such an application of the provision or an amendment to achieve this result should have no impact on the Revenue and would assist in avoiding the need for many non-residents to register for GST.

6. *Definition of 'entity'*

Recommendation

The provisions of the GST Act that deem a relationship to be an entity in circumstances where there is no legal entity create confusion about the identification of the entity that is required to be registered for and account for GST. This is particularly the case in circumstances where the persons who enter into the relationship do so as a joint venture. The definition of 'entity' should be reviewed to address the uncertainties that currently arise.

7. *Increase utility of GST grouping rules*

Recommendation

The GST grouping rules should be amended to expand the categories of commonly controlled entities that are eligible to form a GST group. These rules should also be amended to apportion the tax period in which a member becomes or ceases to be an eligible member into periods when the entity was a group member and a non-group member to reflect the 'real time' creation and cessation of GST group membership.

8. *Efficacy of the 'apply test' in Division 129*

Recommendation

Division 129 of the GST Act should be amended to provide that if a thing that was acquired has not been consumed by the time of the review, the basis of the review is the intended use at the time of that review compared with the intended use at the time that the thing was acquired.

The value thresholds and the number of review periods in section 129-20 should also be reviewed to confirm that they are set at appropriate levels given the GST Act has now been operative for more than 8 years.

9. Correcting mistakes

Recommendation

The ATO concession on correcting prior period errors in a current BAS should be amended so that it is applied more consistently. Accordingly, the ability to make such corrections should apply for all entities where such changes do not exceed, say, the greater of 1% of an entity's annual turnover or a stated monetary limit. It should also apply to mistakes for the whole of the statutory period that is established by section 105-50 in Schedule 1 to the *Taxation Administration Act 1953*.

10. Implementation of proposed 'BAS easy' reporting

Recommendation

Further clarification on the BAS Easy method is required to clarify how the snapshot and business norms methods will apply in practice. Accordingly, we believe the following issues must be expressly addressed in any proposed legislation on the BAS Easy method:

- Clarification is required as to the circumstances in which the Commissioner will review the average ratio under the snapshot method
- Some indicative criteria is required to provide guidance on what constitutes a significant change in the nature of the business which will necessitate a recalculation of the average ratio determined under the snapshot method
- Benchmark ratios applied under the business norm method should only be determined by the Commissioner in consultation with professional industry associations and members of the professional accounting bodies to ensure that any average ratio reflects typical commercial practice in the relevant business category
- Entities electing to use BAS Easy should be alerted to the need to separately account for capital sales and purchases as any related input tax credits are expressly excluded from the BAS Easy method, and
- Entities should be reminded to retain all records (including tax invoices) especially as an average ratio under the snapshot method may be potentially subject to review by the ATO.

1. Principles based drafting

Issue

The principles based drafting style that was used in the GST law adds considerably to the costs incurred by entities complying with the GST system and the costs associated with the administration of the GST by the ATO.

Discussion

The drafting style that has been adopted in drafting the GST law, particularly the *A New Tax System (Goods and Services Tax) Act 1999* ('the GST Act') depends on defined principles without accompanying detail. This style tends not to promote certainty and requires the legislation to be interpreted.

It has therefore been necessary for the ATO to issue extensive GST rulings that set out the ATO's view on the detailed meaning of large parts of the GST Act, and the application of those views to specific fact situations. In addition, the ATO has also issued a burgeoning range of determinations, interpretative decisions, practice statements, bulletins, taxpayers alerts, GST industry specific publications and other written material to also address the lack of guidance in the GST legislation.

This lack of prescriptive guidance in the GST legislation has already led to the following two cases where the ATO's interpretation of a matter under the GST legislation differed from subsequent judicial interpretation of the same issue:

- The ATO expressed its views on the application of the GST Act to the supply of residential premises for residential accommodation in GST Ruling GSTR 2000/20. The Full Court of the Federal Court of Australia later expressed a contrary view in *Marana Holdings Pty Ltd v Commissioner of Taxation* [2004] FCAFC 307 which led to retrospective amendments to the GST Act to support the incorrect view of the law that had been earlier expressed by the ATO; and

- The ATO published GST Ruling GSTR 2006/2 that expressed the view that Division 99 of the GST Act created a taxable supply in circumstances where a deposit provided as security for the performance of an obligation was forfeited. Although the High Court of Australia ultimately confirmed an assessment of GST payable in the circumstances of a forfeited deposit in *Commissioner of Taxation v Reliance Carpet Co Pty Limited* [2008] HCA 22, it expressly denied the ground that the ATO had relied on in GST Ruling GSTR 2006/2 and found a liability in completely different circumstances.

Both taxpayers undertaking transactions, and the ATO itself, are required to go to considerable expense in order to determine how the GST Act might apply to the transactions, often with little certainty that the correct outcome has been determined. This is especially the case with those elements of the GST law which depart from the standard GST treatment where GST is one eleventh of the price.

In particular, there is considerable uncertainty where there is a sale of a business and the parties are seeking to determine whether the transaction or transactions qualify as GST-free supplies of a going concern under section 38-325 of the GST Act. That provision defines a 'supply of a going concern' but many of the concepts within that definition are not defined and require interpretation.

For example, section 38-325(2) refers to a supply under an arrangement that provides, inter alia, for the following:

- There is a requirement to transfer all of the things that are necessary for the continued operation of an enterprise. There is no guidance about what 'things' might be necessary in the provision although it is very extensively discussed in GST Ruling GSTR 2002/5. In

addition there is a reference to the 'operation' of an enterprise. The GST Act defines 'carrying on' an enterprise but there is no guidance in the provision about the distinction between the 'carrying on' an enterprise and the 'operation' of an enterprise

- There is a requirement that a supplier will carry on the enterprise until the day of the supply. The reference here is to 'carry on' rather than 'operate' and the GST Act has no provision that specifies when a supply takes place in these circumstances.

Entities that undertake sale of business transactions are therefore left with the need to enter into the written agreement required by section 38-325(1) but must also make specific provision for the recovery of GST in case the supply or supplies are not GST-free. In some circumstances the parties find it necessary to go to lengths of making provision in the sale agreement for the parties to jointly seek a private ruling from the ATO before the GST-free treatment is applied to the sale transaction.

The lack of certainty in the application of the GST law adds considerably to the costs of entities that are required to lodge a Business Activity Statement (BAS) that correctly identify their GST liabilities and input tax credit entitlements in the BAS period.

Recommendation

The GST law should be reviewed to determine the circumstances where more detailed legislation can be used to make the application of the GST law more certain without the need to have resort to volumes of administrative rulings.

This is especially the case in respect of those parts of the GST Act that vary the impact of GST from the standard one eleventh of the price such as the GST-free supply of a going concern.

2. Record keeping requirements on settlement discounts

Issue

The record keeping requirements that apply where a supplier allows a customer to take a settlement discount impose an obligation that exceeds commercial standards.

Discussion

A requirement to keep business records that are utilised for a number of purposes is a common sense approach. Generally speaking the record keeping requirements imposed by the GST law are consistent with the record retention requirements imposed under other legislation.

An exception to this rule arises where a supplier is required to hold an adjustment note before being able to attribute a decreasing adjustment to a tax period that arises because of an adjustment event. That exception relates to a decreasing adjustment that arises as a result of a recipient taking advantage of a settlement discount that is offered by the supplier for early payment of an account.

Anything that results in the price of a supply being decreased is an adjustment event that gives rise to an adjustment where it arises in a different tax period from that to which the original GST liability was attributable. Where a recipient takes advantage of an offer of a settlement discount, that is an adjustment event and the supplier has an entitlement to claim a decreasing adjustment. However, it is not standard business practice to issue credit notes or adjustment notes in circumstances where a customer takes advantage of a settlement discount.

Nevertheless, where the amount of the decreasing adjustment exceeds $50, the supplier is unable to attribute the decreasing adjustment until an adjustment note is held.

In the case of a settlement discount, that adjustment note would be issued by the supplier because the supplier would in normal circumstances have issued the tax invoice for the supply. In our view the requirement imposed on the supplier to issue an adjustment note adds nothing to the integrity of the GST regime as the entity that requires the adjustment note to attribute the decreasing adjustment is the entity that will itself issue that document.

Recommendation

The rules relating to the requirement to hold an adjustment note before a supplier can attribute a decreasing adjustment arising as a result of a settlement discount should be relaxed.

3. Limitations of Division 57

Issue

The current structure of Division 57 of the GST Act limits the circumstances where a non-resident can make a taxable importation and a creditable importation through an Australia resident business that imports goods 'on behalf of' the non-resident.

Discussion

As explained at paragraph 1.1.19 of the Issues Paper, Division 57 of the GST Act is one of the provisions that is designed to reduce the compliance costs for foreign residents that have dealings with Australia.

Broadly, Division 57 provides for the following:

- Where a non-resident makes a taxable supply or a taxable importation through an Australian resident agent, the GST payable on the supply or importation is payable by the Australian resident agent, not the non-resident; and

- Where a non-resident makes a creditable acquisition or a creditable importation through an Australian resident agent, it is the Australian resident agent, not the non-resident, that has an input tax credit entitlement.

A key difficulty in applying Division 57 in practice is that it does not contain a definition of the term 'Australian resident agent'.

In the absence of any specific statutory definition the term 'agent' might be taken to mean someone with the authority to bind the principal on the legal consequences of actions taken by the agent which the agent is authorised to make on the principal's behalf.

However, there are practical difficulties in applying this general agency principle in the context of taxable importations and creditable importations under Division 57.

GST is imposed on goods that are imported. The entity that has the obligation to pay GST is the entity that enters the goods for home consumption. This is determined under the *Customs Act 1901* which provides that goods can be entered for home consumption by '....any person....being or holding himself out to be the owner, importer, consignee, agent, person possessed of, or beneficially interested in, or having any control of, or power of disposition over goods'.

An input tax credit is available to a person who makes a creditable importation. That person must be the importer of the goods and the person who paid GST on a taxable importation. For this purpose the ATO defines the importer as the person who causes goods to be brought to Australia for their own purposes.

Many non-residents operate through Australian businesses. The non-resident, for example, enters into a contract to lease equipment to an Australian customer. A requirement under the lease is that the goods are to be delivered to and installed at the Australian premises of the customer before the lease commences. If the non-resident does not have a permanent establishment in Australia it will engage a local Australian business to fulfil the local obligations that are imposed on the non-resident under the lease, (being the delivery of the equipment to, and the installation of the equipment at, the premises of the Australian customer). The non-resident will dispatch the equipment from its off-shore base and will retain ownership of the equipment throughout the period of shipment and the further period of the lease to the Australian customer. The equipment will be consigned to the Australian business that has contracted to carry out the delivery and installation on behalf of the non-resident.

The Australian business will enter the goods for home consumption (either personally or through a customs agent or a forwarding agent). It will then deliver the equipment to the Australian customer and install the goods at the premises of that customer. The arrangements under which the Australian business contracts to supply the non-resident with the services that are required to fulfil the contractual obligations of the non-resident might not make any specific reference to the Australian business being an 'agent' of the non-resident in connection with the performance of its contractual services.

The GST Act operates to impose a GST liability on the non-resident in connection with the lease of the equipment to the Australian customer. We understand the ATO interpretation is that the Australian business is not an 'Australian resident agent 'for the non-resident in connection with the importation of that equipment for Division 57 purposes unless there is specific reference to it being an 'agent' in the contractual arrangements between the parties.

We also understand that the Australian business is required to pay the GST on the importation of the equipment because it was the entity that entered the goods for home consumption. However, it is not entitled to claim an input tax credit because it did not cause the goods to be brought to Australia for its own purposes.

Furthermore, even if the non-resident reimburses the Australian business for the GST paid at the time of importation it is not entitled to an input tax credit because it is not the entity that entered the goods for home consumption and incurred the legal liability to pay GST on the taxable importation.

Recommendation

Division 57 of the GST Act should contain a definition of 'Australian resident agent' at least in relation to the importation of goods, to confirm that an Australian resident that makes a taxable importation of goods owned by a non-resident either as consignee or as agent, for the purposes of supplying a service to the non-resident to enable the non-resident to comply with Australian contractual obligations, is entitled to an input tax credit for the GST paid at the time that the goods are entered for home consumption on behalf of the non-resident.

4. Financial acquisitions threshold

Issue

The costs that are associated with administration of the financial acquisitions threshold by entities that undertake some minor financial supplies is disproportionate to the input tax credit entitlements that may be denied on its application.

The current structure of the threshold also creates anomalies in circumstances where an entity acquires things that would be a GST-free supply to that entity.

Discussion

Broadly, the financial acquisition threshold applies to deny input tax credits on financial acquisitions relating to the making of financial supplies if one of the two alternate tests in section 189-5(1) of the GST Act is satisfied.

The first test in section 189-5(1)(a) will apply to deny input tax credits where the credits on financial acquisitions would exceed $50,000 in either the current or future year.

Alternatively, the second test in section 189-5(1)(b) applies where the total amount of input tax credits on financial acquisitions exceeds 10 per cent of the input tax credits of all an entity's acquisitions and importations during the current or future year.

Compliance with the threshold is in practice time consuming as entities need to take into account financial acquisitions on a monthly basis in determining whether either test is breached on both a retrospective or prospective annualised basis.

Moreover, the threshold will be triggered if the total amount of credits on the financial acquisitions exceeds the lesser of the above two tests requiring entities to monitor compliance with both tests on an on-going basis.

The application of this de minimis rule can lead to inequitable outcomes where the cost of complying with the test exceeds the amount of any input tax credits disallowed. Such an anomaly is best illustrated by the following example.

A private discretionary trust may be established to hold shares in blue chip Australian companies for long term investment, to invest in fixed interest securities, to hold small industrial properties for rent and to provide management services to related entities. Shares in companies are only brought and sold by the trust if an existing investment is non-performing.

For illustrative purposes the trust's annual income is, say, $70,000 and consists of the following:

- Dividends of $10,000
- Interest of $20,000
- Rent of $20,000; and
- Management fees of $20,000

The major cost of the discretionary trust is accounting fees that total $9,900 (including GST) per annum.

The accounting services are regarded as an overhead cost that relates to the whole of the trust's activities and because those activities relate partly to input taxed supplies (the supplies that generate the interest income) it is necessary to apportion the expense across all supplies to determine the trust's input tax credit entitlements.

Based on the ATO methodology set out in GST Ruling GSTR 2006/3, the costs would be allocated 1/3rd to each of the activities related to the interest, the commercial rental activities and the management service activities.

There would accordingly be input tax credits of $600 relating to the rental and management service activities. It is then necessary to determine whether the trust is entitled to claim an input tax credit for that part of the costs allocated to the activities associated with the interest earning activities.

While the trust will not breach the first test in section 189-5(1)(a), it will exceed the 10 per cent threshold test in section 189-5(1)(b) because the input tax credit relating to financial acquisitions is $300 being 33.3% of the total annual input tax credit entitlements of $900.

Hence, in these circumstances the potential administrative costs incurred in satisfying section 189-5(1) may often be disproportionate to the value of the input tax credits ultimately denied.

This compliance burden is exacerbated in that the application of the '10 per cent' test in section 189-5(1)(b) requires, amongst other things, for entities to have regard to all its input tax credits including those relating to the making of GST-free supplies. This can lead to anomalous outcomes which discriminates against entities making GST-free supplies.

For example, a managed investment fund may seek to raise $20 million for the purpose of purchasing a commercial building to establish an investment portfolio. The costs that are associated with raising the funds are $440,000 (including GST). The fund acquires a new (untenanted) commercial premises by way of a creditable acquisition for $22 million and claims an input tax credit of $2 million in connection with the acquisition.

In these circumstances neither test in section 189-5(1) is breached. Firstly, section 189-5(1)(a) will not apply as the input tax credits relating to the financial acquisitions only total $40,000 which is below the $50,000 threshold. Secondly, the 10 per cent test in section 189-5(1)(b) will not apply as the input tax credits relating to financial acquisitions total only $40,000 out of an aggregate input tax credit entitlement or $2,040,000, being s 1.96% of the fund's total input tax credit entitlements. The managed investment fund is therefore entitled to claim an input tax credit in connection with the costs associated with its fund raising activities.

By contrast a totally different scenario will apply if the same investment fund entered into the same transactions albeit that it acquired the (tenanted) commercial premises as a GST-free supply of a going concern for $20 million rather than as a taxable supply where the GST inclusive price of the building is $22 million.

Where this scenario arises the fund will continue to incur costs associated with the raising of the funds to purchase the commercial building being $440,000 (including GST). However, the input tax credits of $40,000 associated with those financial acquisitions will breach section 189-5(1)(b) as the 10 per cent test will be triggered as such credits comprise 100 per cent of its total input tax credit entitlements. Thus, the managed investment fund will trigger the financial acquisitions threshold and be denied its $40,000 of input tax credits solely because it acquired the above building under a GST-free supply rather than a taxable supply.

Accordingly, if the dual tests in section 189-5(1) are to be retained the section should be amended to remove the discrimination that currently exists which includes acquisitions relating to an entity's GST-free supplies in its total acquisitions under section 189-5(1)(b). This can best be achieved by including any notional input tax credits that would have been available if a supply had been a taxable supply rather than a GST-free supply.

Recommendation

Consideration should be given to removing the alternate '10 per cent' test relating to the application of the financial acquisitions threshold under section 189-5(1)(b) as the costs associated with complying with this test are often potentially disproportionate to the amount of input tax credits denied.

Alternatively, if the '10 per cent' test is retained it should be amended to include notional input tax credits that would have been available had acquisitions related to taxable supplies rather than GST-free supplies.

5. Registration of non-residents

Issue

The processes that are associated with registering a non-resident business for GST purposes exceed the requirements for good administration and tend to result in Australian GST becoming an embedded cost for the non-resident business.

Discussion

The proof of identity requirements that are imposed by the ATO when a non-resident applies for GST registration have the result that registration cannot be finalised in less than 4 to 6 weeks. While the ATO generally advises a general registration standard of 28 days the practice is that the registration of an Australian resident entity is generally achieved within 48 hours.

It is recognised that there needs to be a balance between registering a bona fide non-resident business and guarding against granting GST registration to a non-resident seeking registration for fraudulent purposes. However, the current practices add considerably to the administrative costs associated with registering a non-resident, particularly in circumstances where the non-resident is required to be registered.

Of particular concern is the application of the full proof of identity requirements to limited partnerships where the general partner is a resident of Australia, (for example an Australian company), with only the limited partners being non-residents.

The GST Act and its interpretation by the ATO currently provide incentives for non-residents to seek to register for GST. Section 38-190(3) in its current form has the effect that there are broad circumstances in which an Australian entity will make a taxable supply to a non-resident entity and the non-resident is effectively required to become registered in order to avoid Australian GST becoming an embedded cost in the business operations of the non-resident.

Section 38-190 generally provides that the supply of services to a non-resident will be a GST-free supply where the cost of a service is borne outside of Australia. However, section 38-190(3) provides that a supply made to a non-resident is not GST-free if that supply is provided to another entity in Australia.

By way of example taken from the discussion about Division 57 above, an Australian Business may contract with a non-resident to supply services to that non-resident to enable the non-resident to fulfil delivery and installation obligations that arise under a lease of equipment. The ATO has expressed the view that even though the supply is made to the non-resident the things that are supplied (delivery and installation) are provided to the Australian customer of the non-resident. Therefore, the supply made to the non-resident is not a GST-free supply under section 38-190 but is a taxable supply because of the operation of section 38-190(3). The only way that the non-resident can avoid the GST charged by the Australian business from becoming an embedded cost in these circumstances is to register for GST and claim an input tax credit.

While the view that is taken by the ATO is arguable from the words of section 38-190(3) it is not clear that this was the intention of the provision. The example that was used in the Explanatory Memorandum to explain the purpose of the provision dealt with a supply made to a non-resident for the private purposes of that non-resident, being the education of his children in Australia.

Recommendation

It is recommended that section 38-190(3) of the GST Act should be amended to limit its operation to circumstances where the non-resident would not be entitled to a full input tax credit. A similar type of approach is taken in Division 84 where a reverse charge GST liability is payable by the recipient of certain supplies made from outside Australia where the recipient is not entitled to a full input tax credit. Such an application of the provision or an amendment to achieve this result should have no impact on the Revenue and would assist in avoiding the need for many non-residents to register for GST.

6. Definition of 'entity'

Issue

The identification of the relevant entity that carries on an enterprise is difficult especially in the area of 'joint ventures' and circumstances that might result in a 'tax law partnership' relationship.

Discussion

Difficulties arise in determining the relevant 'entity' that is required to be registered for GST where there is no legal entity carrying on an enterprise. The most common difficulty is determining the distinction between a common law partnership, a tax law partnership and a joint venture involved in property development.

A typical arrangement under which parties will agree to undertake a project would have the following features:

- The parties are likely to identify their relationship as a joint venture, a co-venture or by some other similar title.
- One party might own land while the other might have some specific expertise.
- Alternatively, the commencement of the arrangement might be the acquisition of land for the purposes of the project.
- The agreement might provide for the parties to carry out a project such as land development and could provide that one party is entitled to be reimbursed for what they have brought to the project such as land and that after all other expenses are met, the parties will share the net proceeds in agreed proportions.
- The agreement will contain a term that confirms the intention of the parties not to create a partnership for any purpose.
- A company will most likely be appointed to act as a nominee or a bare trustee for the parties.

These features probably result in the creation of a partnership although whether it is a common law partnership or a tax law partnership is far from clear. From a GST perspective that distinction is vital because of the ATO views about the different GST implications that arise out of the creation and dissolution of each type of partnership.

Recommendation

The provisions of the GST Act that deem a relationship to be an entity in circumstances where there is no legal entity create confusion about the identification of the entity that is required to be registered for and account for GST. This is particularly the case in circumstances where the persons who enter into the relationship do so as a joint venture. The definition of 'entity' should be reviewed to address the uncertainties that currently arise.

7. Increase utility of GST grouping rules

Issue

The GST grouping provisions are meant to be an administrative convenience for entities that associate themselves in carrying out business operations. Generally speaking there is no impact on the Revenue where entities register a GST group and each member of the GST group is jointly and severally liable for any net amount payable calculated on a group basis.

The current GST grouping rules do not apply in all circumstances where entities could achieve such administrative convenience, and the rules to determine the timing of the creation and cessation of membership of a GST group have some unintended consequences.

Discussion

There are at least two deficiencies in the current GST grouping rules:

- The category of entities that can form a GST group are too narrow; and
- The entry and exit rules that require GST group membership to change from the beginning of a tax period are overly restrictive.

The current GST grouping rules only allow two companies to be a member of a GST group if those companies are in, or are part of, a holding company and a subsidiary company relationship.

The grouping rules should be changed to allow commonly controlled companies to form a GST group. That control should either be direct control or indirect control as set out in the following examples:

Example 1 – Direct control

The sole shareholder of Company A is Mr A. Mr A is also the sole shareholder of Company B. Companies A & B should be permitted to form a GST group. GST grouping should also be allowed if Mr A & Mr B were the shareholders of both Company A and Company B.

Example 2 – Indirect control

The sole shareholder of Company X is the A Discretionary Trust that has been established for the family of Mr A. The B Discretionary Trust has also been established for the family of Mr A and it is the sole shareholder of Company Y. Company X and Company Y should be permitted to form a GST group because they are both indirectly controlled by the family of Mr A.

A member can also only be added to a GST group with effect from the beginning of a tax period.

The rule that if a member of a GST group leaves the group during a tax period that exit is taken to have effect from the beginning of that tax period creates an administrative cost and potentially an unexpected GST liability for entities. This rule applies whether the member departs the GST group voluntarily or whether the departing member no longer satisfies the requirements to be a member of the GST group.

While the entity was a member of the GST group all the members of that group would have entered into transactions with the departing member on the basis that supplies made to that member were not taxable supplies and acquisitions made from that member were not creditable acquisitions. The prices of the supplies and acquisitions would not therefore have had a GST component and tax invoices would not have been issued or received.

One effect of deeming the effective change in the GST group to be the commencement of the tax period during which that member departs the group is that the GST status of these transactions changes to become taxable supplies and creditable acquisitions. There is a need for the consideration applicable to the supplies and acquisitions to be changed to take account of GST and there is a requirement to issue and hold tax invoices. This requirement is imposed at a time when the other members of the GST group have lost effective control over the administration of the departing member.

The GST grouping rules should allow for tax periods that are only part of the normal tax periods (a month or a quarter) in these circumstances. One tax period would apply up to the date of departure and the GST grouping rules (including the application of the rules to transactions involving the departing member) would apply for this tax period. The balance of the tax period would be a discrete tax period that would apply to the GST group without the departing member (or the other entities individually if those entities were no longer capable of forming or did not wish to form a GST group).

Similarly, the GST grouping rules should apportion the tax period in which an entity becomes a member of a GST group to likewise provide more flexibility as to when an entity joins a GST group.

Recommendation

The GST grouping rules should be amended to expand the categories of commonly controlled entities that are eligible to form a GST group. These rules should also be amended to apportion the tax period in which a member becomes or ceases to be an eligible member into periods when the entity was a group member and then a non-group member to reflect the 'real time' creation and cessation of GST group membership.

8. Efficacy of the 'apply' test in Division 129

Issue

While it is recognised that there is a need to consider whether a thing that is acquired for a creditable purpose is actually used for a creditable purpose the existing rules under Division 129 of the GST Act do not operate appropriately in relation to the acquisition of an asset that has not been applied by the time that the review is undertaken.

Discussion

The GST Act gives an entitlement to an input tax credit based on the intended use of a thing acquired for a creditable purpose. It is considered appropriate that intention be the basis of on which an input tax credit is claimed.

There is a requirement that acquisitions be reviewed to ensure that they have been used for their intended purpose and if their actual use was not for a creditable purpose there is a requirement to make an adjustment to the previous input tax credit claim under Division 129 of the GST Act.

The current format of Division 129 is appropriate for a thing that has been fully consumed at the time that the review is undertaken but is not appropriate in respect of a thing, such as an asset, where the effective life extends beyond the review date.

Divisions 11 and 15 that create an entitlement to an input tax credit are based on the intended use of the thing acquired for a creditable purpose. However, Division 129 that creates an obligation to review how the thing that was acquired has been used requires a consideration of how the thing has been 'applied'. "Apply" is not exhaustively defined under section 129-55 but reads as follows:

> *Apply, in relation to a thing acquired or imported, includes:*
> *(a) supply the thing; and*
> *(b) consume, dispose of or destroy the thing; and*
> *(c) allow another entity to consume, dispose of or destroy the thing.*

In the case of a thing that has been supplied, consumed, disposed of or destroyed by the time of the review date, it does seem appropriate to consider whether there has been any difference between how the thing was intended to be applied and how the thing has been actually applied.

However, in the case of an asset that that has not been supplied or fully consumed or disposed of or destroyed by the time of the review date there is a threshold question whether Division 129 actually requires a review or whether that review needs to be postponed until one of those events occurs.

The ATO has taken the view that 'apply' effectively equates with 'use' and that the review required by Division 129 is a consideration of whether a thing has been used for a purpose that results in a different creditable purpose from the intended use of the thing at the time that thing was acquired. While the ATO approach means that Division 129 can operate in relation to assets (arguably on its terms the Division would have no practical application in the circumstances of the acquisition of an asset), it does create the anomalies that are noted in the Issues Paper where an entity can have an entitlement to input tax credits based on intention when a thing is acquired, have an obligation to make an increasing adjustment based on use up to the time of the review and subsequently have a decreasing adjustment at the time of a subsequent review.

Most of the anomalies would be removed if Division 129 provided for an adjustment (if applicable) based on any variations in the intended use of the thing that was acquired. In

other words, compare intention at the time of acquisition with intention at the time of the review.

The current and proposed application of Division 129 is best illustrated by an example involving property development.

A developer constructs residential premises with an intention that those premises will be sold as a taxable supply of new residential premises. Input tax credits are therefore claimed for the GST paid on the construction costs. Upon the premises being constructed the developer is unable to sell them and decides to rent the premises for a short period until the property market improves. It is expected that the premises will be sold within 5 years of the rental period commencing.

Under the current interpretation of Division 129 if the premises are being rented at the time of the first review, the input tax credits would be repayable as an increasing adjustment since the only 'use' of the premises to the time of the review date would be to make input taxed supplies of residential rental. If at some later time the premises were sold as a taxable supply there would be a subsequent entitlement to reclaim proportional input tax credits as a decreasing adjustment.

However if the Division 129 review was based on intention (consistent with that of Division 11) there would only be a proportional increasing adjustment at the time of the first review. There would be no need to make a decreasing adjustment if the premises were later sold as a taxable supply as intended.

Conversely, if the developer's intention changed, and the decision was made to hold the premises as a rental property rather than for sale, there would be an increasing adjustment at the time of the review period following that change of intention.

If the intention remained to sell the premises once conditions became favourable but premises continued to be rented for 5 years, the intention at the time of the next review would be an intention to sell the premises as an input taxed supply (as the premises would no longer be 'new residential premises'), and an increasing adjustment would be required at the time of that review.

The value thresholds and the number of review periods contained in section 129-20 of the GST Act should also be re-examined to consider whether those thresholds need to be adjusted from what was considered appropriate when the GST Act commenced in 2000. It is noted that any change in the value thresholds can only be made by amending the GST Act while the number of review periods for acquisitions that do not relate to business finance can be reduced by a Determination of the Commissioner in certain circumstances.

Recommendation

Division 129 of the GST Act should be amended to provide that if a thing that was acquired has not been consumed by the time of the review, the basis of the review is the intended use at the time of that review compared with the intended use at the time that the thing was acquired.

The value thresholds and the number of review periods in section 129-20 should be reviewed to confirm that they are at the appropriate levels given the GST Act has now been operative for more than 8 years.

9. Correcting mistakes

Issue

The Commissioner prescribes limited circumstances in its publication *Correcting GST mistakes (see NAT 4700-07.2004)* in which an entity may correct a BAS mistake in the current period rather than amend the BAS that was previously lodged for the tax period in which the error arose. The circumstances where this concession applies should be extended.

Discussion

The standard position is that if a mistake is made in the lodgement of a BAS, that mistake can only be corrected by amending the BAS. If an amendment increases a GST net amount, the correction will create a liability for general interest charge ('GIC') for late payment of the GST payable and potentially a liability for shortfall penalty.

The Commissioner has granted a concession that certain corrections can be made in a current BAS without the need to amend a previously lodged BAS. Where the concession applies, the correction can be made in the subsequent BAS without any liability for payment of GIC or shortfall penalty.

The concession only applies if the net effect of mistakes is within certain monetary thresholds and if the mistake occurred within certain time periods. Both the monetary and time thresholds vary depending on the annual turnover of the entity.

The thresholds that have been determined by the Commissioner appear to be arbitrary and appear designed to maximise GIC liability. For example, while an entity with a turnover of less than $20 million can make a correction that increases its GST liability by $5,000 (potentially 0.0025% of its annual GST liability) within the last 18 months, an entity with a turnover of $1 billion can only make a correction that increases its GST liability by $300,000 (potentially a minimum of 0.003%) but only if the error occurred within the last 3 months.

Recommendation

The ATO concession on correcting prior period errors in a current BAS should be amended so that it is applied more consistently. Accordingly, the ability to make such corrections should apply for all entities where such changes do not exceed, say, the greater of 1% of an entity's annual turnover or a stated monetary limit. It should also apply to mistakes for the whole of the statutory period that is established by section 105-50 in Schedule 1 to the *Taxation Administration Act*.

10. Implementation of proposed 'BAS Easy' reporting

Issue

The proposed BAS Easy GST reporting method potentially extends the existing simplified accounting method (SAM) used by food retailers in preparing their BAS to any business which has a SAM turnover of $2 million or less per annum. However, there are a number of design features under the proposed regime as set out on pages 51 to 54 of the Issues Paper which require clarification. For example, it will be necessary to clarify the circumstances in which the Commissioner will require entities to recalculate their average ratio under the snapshot method, the criteria that will be applied in determining whether the nature of a business has significantly changed for an entity using the snapshot method, and details of how the Commissioner will determine the business norm ratio for each category of business.

Discussion

Under the BAS Easy proposal small businesses without GST-free transactions can elect to claim an agreed ratio of total input tax credits compared to its total taxable sales. Such a ratio will be determined under either the snapshot method or the business norms method as is the case for certain food retailers who can currently use such simplified accounting methods in preparing their BAS *(see ATO Publication NAT 3185).*

We acknowledge that the proposal will potentially significantly reduce the compliance burden of many micro businesses. The ATO recently noted that there were 2.5 million small businesses in this market segment with an annual turnover of less than $2 million on page 13 of its *2008/09 Compliance Program* issued on 13 August 2008.

Such entities which elect to use the proposed BAS easy method will not have to review all their tax invoices to precisely calculate their input tax credits which should slice the time spent in compiling their BAS.

Businesses electing to use the 'snapshot' method must calculate a ratio of input tax credits to sales for two periods of four weeks in a base year, and then take the average of those ratios which could be used prospectively in claiming input tax credits in their BAS for up to 3 years.

However, as noted at paragraph 2.3.21 of the Issues Paper the Commissioner could review the ratio and direct the business to recalculate its snapshot prospectively. Clarification is required as to the circumstances in which the Commissioner will review the ratio and any conditions that might apply to any recalculated ratio.

There is also commentary in this paragraph that there will be a need to recalculate the average ratio under the snapshot if the 'nature of the business changed significantly'. Likewise, some indicative criteria providing guidance on what constitutes a significant change in the nature of the business is required so that affected taxpayers have some indication as to when they will no longer be able to apply their average ratio under this method.

Alternatively, a small business may elect to use the business norm ratio where the business may use a ratio of input tax credits to gross sales for particular types of businesses as determined by ratios issued by the Commissioner. Once a business elects to use the business norm method the ATO will issue the relevant entity with details of its applicable business ratio which can also be used for a period of up to 3 years.

Paragraph 2.3.23 of the Issues Paper notes that the business norm ratio will be calculated by the Commissioner based on historical data available for each business category. Consideration should be given to ensuring that all such benchmark ratios are determined by the Commissioner in consultation with professional industry associations and members of the

professional accounting bodies who may be able to ensure that any average established under this norm best reflects commercial practice in the relevant business category.

Care will also need to be taken to ensure that any entity electing to participate in BAS Easy separately maintain records of any capital sales and purchases as any related input tax credits are expressly excluded from the BAS Easy method.

Further, participating entities will still be required to maintain all their GST records including their tax invoices as this requirement is not obviated by the election to use the simplified accounting methods under BAS Easy. Reference to such materials will be crucial especially if the ATO conducts a review of the taxpayer's activities and determines that the ratio calculated under the snapshot method has to be changed.

Recommendation

Further clarification on the BAS Easy method is required to clarify how the snapshot and business norms methods will apply in practice. Accordingly, we believe the following issues must be expressly addressed in any proposed legislation on the BAS Easy method:

- Clarification is required as to the circumstances in which the Commissioner will review the average ratio under the snapshot method
- Some indicative criteria is required to provide guidance on what constitutes a significant change in the nature of the business which will necessitate a recalculation of the average ratio determined under the snapshot method
- Benchmark ratios applied under the business norm method should only be determined by the Commissioner in consultation with professional industry associations and members of the professional accounting bodies to ensure that any average ratio reflects typical commercial practice in the relevant business category
- Entities electing to use BAS Easy should be alerted to the need to separately account for capital sales and purchases as any related input tax credits are expressly excluded from the BAS Easy method, and
- Entities should be reminded to retain all records (including tax invoices) especially as an average ratio under the snapshot method may be potentially subject to review by the ATO.