

The Review of the Legal Framework for the Administration of the GST
Board of Taxation
C/- The Treasury
Langton Crescent
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Via Email: taxboard@treasury.gov.au

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Dear Board of Taxation

The Insurance Council of Australia (Insurance Council) ¹ welcomes the opportunity to participate in the consultation process being undertaken by the Board of Taxation (Board) in relation to its Review of GST Administration. In this regard, the Insurance Council makes this submission and in particular brings two principal issues to the attention of the Board:

- The GST anomaly concerning settlement of insurance claims relating to business customers
- Challenges associated with complying with the current requirement to 'know' the input tax credit entitlement of the insured (Section 78-10) in order to calculate an insurer's decreasing adjustment.

Each issue is explained in more detail below together with an outline of the relevant legislative references. We also outline possible solutions to the issues raised by the Insurance Council in order to assist the Board with its consideration of these matters. All legislative references are in respect of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act).

GST anomaly concerning the settlement of insurance claims involving business customers

In the course of settling general insurance claims insurers generally have two options:

- to provide monetary compensation to the insured or third party for their loss (ie a cash settlement), or alternatively to;
- undertake restitution activities that return the effected party to the position they were in prior to the relevant event occurring (ie provide goods and services to satisfy the obligations under the insurance contract). While business models can vary between insurers, a very common approach to claims settlements is to undertake restitution activities by providing relevant goods and services.

The latter approach is beneficial to the insurer as it enables greater ability to manage the cost of claims through preferred supplier arrangements etc. However, this approach is often demanded by customers given that many customers see the role of insurers being to 'pay all bills directly' irrespective of whether the insurer's preferred supplier or an alternative supplier has been engaged by the insured or third party.

¹ The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. 2008 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross premium revenue of \$30.8 billion per annum and has assets of \$90.6 billion. The industry employs approx 60,000 people and on average pays out about \$83 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

As a result of these customer demands, a large segment of the general insurance industry (and supporting suppliers and service providers) have developed entrenched business practices that involve suppliers invoicing insurance companies directly for work authorised by another party (usually the insured).

While industry practice has enabled significant efficiencies to be gained in terms of invoicing and payment processes, given that the insurer may not have authorised the work but was still required to (or at least expected to) pay suppliers' invoices, significant complexities have arisen for insurers with the introduction of GST due to the requirements of Section 11 of the GST Act.

For example, Section 11 sets out the rules relating to the entitlement to input tax credits of the GST Act. Under these rules, in order to be entitled to an input tax credit in relation to a payment made, requirements under Section 11-5 (as well as Section 11-15) must be met. Amongst other things, Section 11-5 requires that:

- A taxpayer is the recipient of the supply; and
- The taxpayer is able to provide or is liable to provide consideration for any said supply.

Where a transaction involves three parties - a supplier, a recipient of the supply and a payer (ie the provider of the consideration to the supplier) the above requirements of Section 11-5 become restrictive to the extent that only the recipient of the supply (who also is generally liable to provide consideration for the supply) meets the Section 11-5 criteria and thus only that entity is entitled to claim input tax credits under the GST Act. The payer has no entitlement to claim input tax credits.

In isolation, such an outcome may appear appropriate in order to ensure that an entity's entitlement to input tax credits correctly aligns with the contractual liability to provide consideration for the particular supply. However, this requirement creates significant ramifications in business to business transactions where the actual recipient of the supply has entered into arrangements with a third party for that third party to make payments to the supplier - the third party being known as "the payer".

The general insurance industry is particularly affected by the above provisions, given that in nearly all cases at least three parties are involved in an insurance claim when a claim is settled by way of restitution. The three parties involved are the supplier of goods or services, the insured (who has instructed the supplier and is the recipient of the supply) and the insurer (ie payer) who pays the supplier. Applying the appropriate provisions, the insurer pays the supplier for the goods/services provided to the insured, but in circumstances where the insurer itself did not engage the supplier, it cannot claim input tax credits in relation to the payment (even when holding a valid tax invoice for the supply). As a result, the GST component becomes a further cost to the insurer where the insurance claim relates to a business customer.²

That is, even in cases where the insured has a primary binding obligation to pay the supplier, the supplier generally agrees to invoice the insurance company direct provided an insurance claim number is provided. Once the invoicing process occurs in this way, the ability to ensure GST symmetry is achieved for business to business transactions becomes extremely difficult as the only party that has the legal entitlement to claim input tax credits is the entity that did not receive an invoice.

Consequently, difficulties arise as most taxpayers account for GST on actual transactions, supported by records, that have been processed by their accounting systems, rather than capturing 'notional' or theoretical transactions. Accordingly, in relation to arrangements involving three parties (such as insurance) the 'true' recipient of the supply (the insured) generally receives no records of the 'transaction' which it has been supplied with, but instead only the payer (the

² While Division 78 of the GST Act provides relief for insurers from these complexities in relation to insurance claims involving private (ie non-business) insureds, there is no similar relief in relation insurance claims involving GST registered business customers (where the customer operates a fully creditable business). During the introduction of the GST the given rationale for this position was that insurers who settled claims with business customers would only be required to pay the GST exclusive cost of the goods/services as the business customer themselves would be entitled to claim the relevant input tax credits.

insurer) is invoiced for the supply. As a result the recipient (the insured) has no source document upon which to calculate its input tax credit entitlement and therefore, no input tax credit claim is recognized in its accounting system. In contrast, the payer (the insurer) is in possession of all relevant source documents (including tax invoices), but it is unable to make any claim of input tax credits as it does not satisfy Section 11-5 given it is not the '*recipient of the supply*' or '*liable to provide consideration to the supplier*'.

Possible Policy Options

As outlined above, the current requirements of Section 11-5 create disparity in the GST system rather than obtaining the desired GST symmetry in many business to business transactions that involve a third party payer. This is especially the case in the general insurance industry.

A fundamental premise of the Australian GST regime is that the GST should not be a cost in business to business transactions. Regrettably, the current inflexibility of the GST law appears to result in a revenue distortion. To remedy the current situation, the Insurance Council proposes to the Board two possible policy pathways:

- easing the requirements of Section 11-5 to provide greater flexibility regarding the entity that may claim input tax credits.
- maintain the existing requirements of Section 11-5, but introduce additional specific rules that either:
 - enable the input tax credit entitlement of one entity to be “transferred” to another entity (similar to the GST Grouping provisions) provided appropriate integrity measures are satisfied (such as agreement with the other party, application to the Commissioner, introduction of a reverse charge mechanism to the extent that the 'true' recipient is not entitled to full input tax credits); or
 - “deem” a payer entity (ie the entity that provides the consideration for a supply) to be the recipient of the supply for the purposes of Section 11-5 (similar to the deemed relationships under Section 153B) provided appropriate integrity measures are satisfied (such as agreement with or notification to the 'true' recipient that this deeming provision has been applied).

Challenges associated with complying with the requirement to 'know' the input tax credit entitlement of the insured (Section 78-10) in order to calculate an insurer's decreasing adjustment.

As a result of general insurance being treated as a taxable supply, and consistent with the principles of a true value added tax regime, GST relief is provided in relation to an insurer's claims costs so that only the 'value added' by the insurer is subject to GST.

To achieve this outcome, a unique GST provision (Section 78-10) has been developed that entitles insurers to obtain GST relief in situations where the insured was a private customer (ie the insured was not entitled to claim input tax credits). A key provision in this Section is the requirement that an insurer is required to 'know' the entitlement of the insured in order to calculate the insurer's “decreasing adjustment” (that is, the mechanism which provides the intended GST relief).

Requiring an insurer to “know” the tax status of another entity places significant dependency and stress on existing business processes and relationships and creates unnecessary uncertainty and complexity. This is especially with the current drafting of Section 78-10(2) which provides no protection to insurers if they rely on information provided by the insured which subsequently is demonstrated to be incorrect.

As a result, to assist with this issue Section 78-50 was drafted to compliment Section 78-10(2) as it required all entities (including individuals) to inform their insurer of their actual entitlement to input tax credits for the premium it paid (if the entity wished to avoid being liable for GST on their insurance settlement). However, while Section 78-50 had an intended purpose of assisting insurers with the dilemma of Section 78-10(2), in practice this purpose has not been realised.

Difficulties arise for insurers with this provision because under Section 78-10(2), not only are insurers exposed if they are told the wrong information by insureds or are deemed to have not filled their obligation to 'know' (or substantiate that they know) the input tax credit entitlement of the insured, but in addition, under Section 78-50 an insured is liable to account for GST on an insurance settlement if they have provided incorrect information or no information to the insurer. Given that Section 78-50 applies irrespective of whether an entity is required to be registered for GST or not, this places a substantial burden on entities, including individuals that receive an insurance settlement in Australia.

Resulting from these requirements, insurers have developed significant business processes to obtain the relevant information from their customers (the insureds) to determine the input tax credit entitlement of insureds so as to determine the insurer's own decreasing adjustment entitlement. For example, as a result of these provisions many insurers have modified their claims notification and lodgment process to ensure they ask the claim lodger (ie insured) particular GST questions in an attempt to ascertain the insured's input tax credit entitlement. These include such questions as: do you have an ABN, are you registered for GST and/or what is the extent of your input tax credit entitlement? Although these questions can be quite confusing for private non-business customers, they are nevertheless a necessary feature of the system in order to satisfy the requirements of Section 78-10 insurers and to ensure entitlement to the applicable decreasing adjustment.

The Insurance Council submits that where a tax system requires the taxpayer to calculate their own tax position with reference to a third party's tax status (the customers), and that tax status is not easily determinable either by the taxpayer or the customer themselves, then such a system is in need of reform. In particular, such a system unnecessarily imposes significant compliance costs and risks to all parties particularly given the consequential impacts of any breakdown in the process.

Possible Policy Options

Due to the complexity of this issue, its wider ramifications and the significant systems impact any change would have upon the insurance industry, we recommend that the Board recommends that a review of Section 78-10 of the GST Act should occur in close consultation with the insurance industry.

We envisage that these discussions would include consideration of one or more of the following solutions:

- Work with existing legislation - greater alignment of Section 78-10 and Section 78-50 to provide certainty to insurers that if they rely on the information provided by insureds the insurer is not exposed under Section 78-10 (instead only the insured will be exposed under Section 78-50)
- Amend existing legislation – rather than the existing provisions of Section 78-10(2) which necessitate an ongoing dependency on information from insureds, insurers could be given an alternative method of determining their entitlement to decreasing adjustments under Section 78-10 such as:
 - Use of a 12 week register of claim payment information (similar to the FBT rules for meal entertainment expenses) whereby the average input tax credit entitlement of insureds surveyed (by portfolio type) can be used to determine decreasing adjustments.
 - Use of Government approved or ATO approved, average input tax credit information by portfolio type (similar to the model used in Division 79 for Compulsory Third Party Insurance) such that no GST related interaction with customers is required at the time of lodgement of an insurance claim.

The Insurance Council submits that such a review would allow decision makers to engage with the insurance industry to ascertain the relative costs and benefits of any changes.

Conclusion

The Insurance Council welcomes the opportunity of participating in the Board's Review into GST Administration and would like to work in concert with the Board on the issues raised in this submission and any other matter that the Board would like to engage the industry on.

For further information on this submission please contact Mr Alex Sanchez, Insurance Council's General Manager Policy, Economics and Taxation Directorate on (02) 9253 5130 or asanchez@insurancecouncil.com.au.

Yours sincerely



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