

eJournal of Tax Research

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EDITORS' NOTE

The *eJournal of Tax Research* is a refereed journal that publishes original, scholarly works on all aspects of taxation. It aims to promote timely dissemination of research and public discussion of tax-related issues, from both theoretical and practical perspectives. It provides a channel for academics, researchers, practitioners, administrators, judges and policy makers to enhance their understanding and knowledge of taxation. The journal emphasises the interdisciplinary nature of taxation.

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Editorial

It is a privilege to have been invited back by the *eJTR* to pen this editorial for its December 2011 issue. This might be described as an “indirect tax” issue of the *eJTR* because all the articles are about aspects of indirect tax.

The first article, by Vincent Mangioni, is about land tax and the challenge of maintaining transparency in the context of land valuation. Mangioni attempts to measure the transparency aspects of the land valuation process in NSW. He concludes with a summary of improvements in transparency that he has identified as well as recommendations for refinements in, and development of, further transparency measures. The second article looks further afield, Pakistan in fact, and is the jointly authored work of Saira Ahmed, Vaqar Ahmed and Cathal O’ Donoghue. The article assesses contentious taxation reforms being considered in Pakistan in order to widen the tax base and rationalize the rate structure of different taxes. It singles out VAT and some direct agricultural taxes as more attractive for various reasons including ease of collection and revenue adequacy. The article makes a powerful argument for an increase in revenue collection which, in the authors’ simulation, increases public sector spending. Bearing in mind (as *eJTR* readers know) that the art of taxation is the plucking of feathers with limited hissing¹, the authors advocate an incremental approach to tax reform with a gradual increase in the tax net.

The article on VAT in Pakistan brings this issue of the *eJTR* neatly to a series of invited articles drawn from the annual Atax Goods and Services Tax Conference held in 2011. The first of these is a policy orientated article by Kavita Benedict which examines the Australian approach to the taxation of financial services and compares the policy intent behind that approach with the outcomes that we have seen in judicial interpretation. The author concludes that an overly literal interpretation of the precise drafting that was adopted has led to interpretations that undermine the policy intent.

Staying with financial services under the Australian GST, the article by Ross Stitt is a deep and detailed critique of how the Australian reduced input tax system affects the practice of ‘bundling’ services and trustee services within the financial supplies context. It also looks at ‘unbundling’ and outsourcing providing deep technical insights into these activities and the Australian Tax Office’s view.

The final article is by Melanie Baker and it continues the practical theme established by Stitt and Mangioni with its detailed examination of the litigation aspects of GST. Baker’s article essentially photographs the litigation landscape just as we enter a GST self-assessment phase and it notes recent changes to the process of dispute resolution

¹ The quote “The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.” is attributed to the 17th Century French statesman (Minister of Finacne to Louis XIV) Jean Baptiste Colbert. But this writer has never been able to accurately track down its source.

caused by the introduction of the *Civil Dispute Resolution Act 2011 (Cth)* as well as changes to the Federal Court Rules.

Readers will find these excellent articles useful as a source of information and stimulus in your own research.

Professor Michael Walpole
School of Taxation and Business Law
University of New South Wales

December 2011

Transparency in the valuation of land for land tax purposes in New South Wales

Vince Mangioni*

Abstract

Transparency is an important taxation principle in maintaining integrity in the taxation of land. This paper is a review of improvements in transparency following recommendations for reforms to the valuation of land by the NSW Ombudsman in 2005. Data on objection rates to land values has been sourced from the NSW Department of Lands both pre and post the introduction of the 2005 reforms recommended by the NSW Ombudsman. This paper attempts to measure improvements in transparency via changes in objection rates to land values issued by the Valuer-General, resulting from the availability of sales information to land tax payers from 2005. In conclusion a summary of improvements in transparency are provided as well as recommendations for refinements in the development of further transparency measures which may be adopted.

1. INTRODUCTION

Land taxes in Australia are imposed by state government as well as local government in the form of council rates. The focus of this paper is on state land tax, although the underlying principles are common to council rating, to a lesser degree. Land value taxation, better known as land tax comprises four key components, the unit or taxpaying entity, the base on which the tax is assessed, namely land value, the rate in the dollar applied to the base and a threshold above which the aggregate land value of an entities assessment is taxed. The specific focus of this paper is the improvement in transparency of the valuation process through the provision of sales information to tax payers used to value land.

Unlike other taxes where the base is readily definable (income, consumption, capital gains, turnover or payroll), land tax has an additional layer of complexity in that the base is required to be determined by valuation as the first step in the assessment process. This is further compounded by the fact that unlike other taxes, in which the tax payer has a perceived level of control or input through the lodgment of an income tax, GST or other form of return, no such taxpayer input exists in the taxation of land. Once ownership of land is declared, land taxes are solely assessed by government without any reference to, or input from the taxpayer.

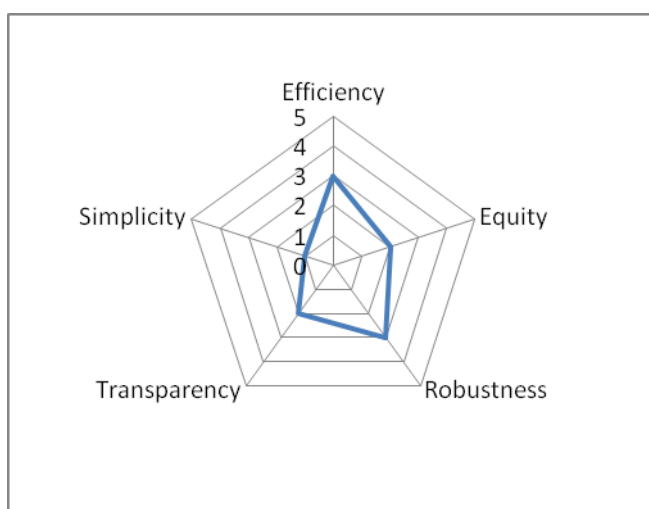
In the absence of tax payer input, perceived control, lack of predictability of assessments and potential for fluctuations in value from a number of causes, which bare little or no relevance to the ability to pay, heightens speculation about the validity of the valuation process. To this end, the objection process serves as an important

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taxpayer outlet and in some cases constitutes tax payer participation and input in the land tax assessment process. This is compounded by the fact that a lack of information relating not only to the process used to determine land value, but the evidence used, is an important part of the information to be provided to the tax payer.

A 2008 review of NSW state taxes highlighted the weaknesses in the taxation of land under the principles of transparency and simplicity of the tax, as shown in Figure 1.¹ Contributing to poor performance against the criteria of transparency and simplicity, is concern that taxpayers have poor information when a property exceeds the threshold and subsequently becomes liable for the land tax. Whilst the three year averaging of values² has added a further level of complexity to this tax, the key issue is making available to taxpayers³ the information used to value land in their land tax assessments. Here, the sales data and related information used when valuing land has been identified as key in providing greater transparency and understanding for taxpayers on how the tax is assessed.⁴

Figure 1: Principles of ‘good tax design’



Source: IPART NSW 2008

Some of this lack of simplicity and transparency arises from how land taxes are imposed. In some countries it is primarily a tax levied at the local government level in return for the provision of services. However, Australia is one of the few countries which imposes a recurrent property tax both at the local government level in the form of council rating and as a recurrent land tax by the state (or middle tier of) government. Most countries imposing a recurrent property tax apply it to improved

¹ IPART Independent Pricing and Regulatory Regime, *Review of State Taxation Report to the Treasurer* (2008).

² Ibid.

³ NSW Ombudsman, *Improving the quality of land valuations issued by the Valuer General* (2005).

⁴ Ibid; J. Walton, *Report of Inquiry Into Operation of Valuation of Land Act* (1999).

value (land & buildings) at the local government level and apply some form of limitation or cap on increases in revenue from this tax.⁵

2. EVOLUTION OF PROPERTY TAXATION AND CURRENT PROBLEM WITH LAND VALUE

Understanding why recurrent land tax has evolved into a tax which is imposed on quite different measures of the bases has its origins in the long history of this tax. This section will therefore provide a summary of the evolution of these bases, along with an overview of the problems currently experienced with transparency in determining land value from improved value in modern highly urbanized cities such as Sydney.

The taxation of land and property as a source of government revenue pre-dates the Roman Empire with traces of its existence dating back to Ancient Egypt 3,500 B.C., where taxes were imposed on the value of produce from land. This involved the tax assessor recording cattle, crops and produce and imposing a tax at 10 percent of actual production.⁶ This basis of assessing the tax had a level of transparency, as the taxpayer knew what their land produced or was capable of producing.

During the medieval period of particular notoriety for king, country and subject was the administration of land and asset taxes. In 1086 during the reign of William the Conqueror, the first national and orderly record of wealth and estate was established. The 'Doomsday Book' was a detailed and comprehensive audit of the assets owned in England at that time.⁷

Seeking some level of tangible measurement the Hearth tax was introduced in 1662. The negative impact of this tax, which taxed property based on the number of fireplaces in a property, was also known as the chimney tax. This tax was readily assessable from the exterior of the property by reference to the number of chimneys. The tax was unpopular and despite an increase in the threshold of the number of hearths of two per house, the tax was abolished by King William III in 1689 and replaced by a window tax.⁸

The window tax lasted almost two hundred years until it was repealed in 1851 and replaced by a House Duty. The window tax was seen as easily assessable and transparent and in effect taxed larger property higher which had more windows. Opposition to the tax was consistent, as it was seen as a tax on light and air.⁹

The Colonial period of 1600-1750 in the United States denoted a period of settlement, growth and the development of land. From the beginning of this period taxes on land, buildings and personal property were taxed but typically paid to the church. With the growth of local governments, this tax became the base for collecting their tax revenue. As the tax grew in importance, councils were directed at the request of their communities to publish lists of taxpayers, their assets and tax payable.

⁵ M. & Sexton Haveman, T.A., *Property Tax Assessment Limits - Lessons from Thirty Years of Experience* (2008). p3.

⁶ R.H. Carlson, 'A Brief History of Property Tax' (Paper presented at the IAAO Conference on Assessment Administration, Boston, Massachusetts, 1 Sept 2004).

⁷ C.A Daw, 'Land taxation: an ancient concept' (2002) 1(Feb 2002) *Australian Property Journal* 20-25.

⁸ J. Gibson, 'The Hearth Tax' (2008).

⁹ G. Timmins, *The History of Longparish* (2001).

This pressure grew from suspicions of inequitable assessments, abatements and residency fraud and the movement of assets between residences.¹⁰ In contrast to the transparency of the window tax, the taxing of buildings and personal property raised questions of transparency and challenged the notion of consistent and equitable assessment. Of particular concern was the inequity associated with the under-valuation of property, this being as low as one fifth of the market value in the United States during the 1800s.¹¹ An ideological divide between the north and south also saw property taxes move out of favour in the south where larger estates were held by the wealthy. With this move away from property based tax came a move to poll taxes.¹²

Once again as the necessity for property taxes grew, a residential frontage tax was introduced in New Orleans which was met with the development of the shotgun house, a long narrow house developed to avoid the tax. As the frontage tax moved to a 2nd storey tax, the camel back house was developed with the second storey set back to avoid the tax. The final attempt to establish consistency of the base of a property tax resulted in a room tax, which subsequently led to the bricking up of closets and pantries in attempts to minimize the impact of the tax on the house.¹³ Whilst these taxes were unpopular, general uniformity existed in their application.

Land value taxation has existed in Australia since 1884 with its origins in South Australia. This tax was first imposed in NSW in 1895. In 1906 the tax was abolished in NSW as part of the reform of Local Government and to avoid competition between state and local government for the same revenue source. The Commonwealth introduced a land tax in 1910 which stayed in force until 1952. NSW reintroduced a land tax in 1956 and the tax was imposed on the Unimproved Capital Value of land.¹⁴ With the reintroduction of the tax in 1956, land transactions were abundant as cities were urbanizing, which provided evidence and transparency as to how land value was determined.

In New South Wales, state land tax co-exists with local government council rating. The primary difference between the two is the exemption of the principle place of residence from state land tax. The difference between land tax and council rating addresses the concern raised that land tax is inherently regressive for poorer people as they spend a higher proportion of their income on their property,¹⁵ more explicitly their home.

In 1982, New South Wales moved from unimproved capital value to land value as the base for the assessment of land value taxation¹⁶. The primary difference between unimproved value and land value is set out in Figure 2, which provides a conceptual definition of possible alternate bases. The primary objective of moving to land value was to account for improvements to the land which primarily provided services to it and for its use which included clearing, excavation and its retention.

¹⁰ R.H. Carlson, 'A Brief History of Property Tax' (Paper presented at the IAAO Conference on Assessment Administration, Boston, Massachusetts, 1 Sept 2004).

¹¹ Ibid.

¹² Ibid.

¹³ G.W. Fisher, *The worst tax: A history of property taxes in the United States* (1996).

¹⁴ S. Smith, *Land Tax: An Update* (2005).

¹⁵ C. Coleman and M. McKerchar, 'The history of land tax in Australia' (2008) *Australian School of Taxation UNSW*.

¹⁶ V. Mangioni, *Land Tax in Australia* (2006).

The majority of land that is taxed and rated in urban locations is not unimproved land. In bringing land into production in urban locations, it has services such as water, power, gas and telecommunication connections, which may be termed as improvements to the land. Whilst refinements were being made to the basis of value on which the tax was assessed. Problems with transparency began to emerge with fewer land transactions.

Figure 2: Bases of value

Base Value	Conceptual Meaning
Unimproved Value	Land with or without services to land. Broadly no or minimal improvement to the land. Prarie or en globo value
Land Value	Land including any improvements to it, including water sewerage services drainage, excavation and its retention, clearing and removal of stones.
Improved Value	Land including water sewerage services drainage, excavation and its retention, clearing and removal of stones plus the added value of buildings erected on the land.

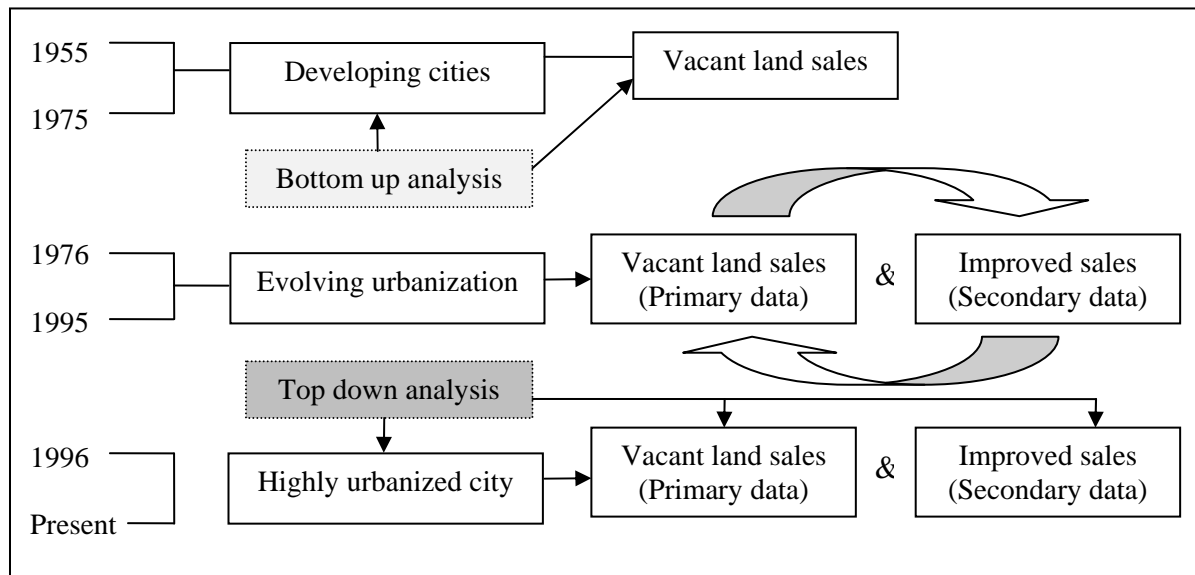
Historically land value has been measured based on the sale of vacant land. The absence of vacant land sales for rating and taxing purposes has resulted in concern over how land value is determined in practice.¹⁷ This question has been the subject of much scrutiny and has challenged the transparency of the assessment of land value around Australia. Scrutiny has largely been leveled at the perceived element of judgment in the analysis and accounting for the added value of improvements, as land value is now more commonly deduced from improved sales. This has been an evolving issue over the past 15 years as cities of Australia and particularly Sydney has become highly urbanized.

As can be seen in Figure 3, the difference in the determination of land value between 1955 and 1975 using the bottom up analysis by reference to vacant land sales, and the period of 1996 to the present, using the top down analysis using improved sales epitomizes the problem. At the time of reintroduction of state land tax in NSW in the 1950s, vacant land sales were abundant during the 1960s and 70s. The following twenty years marked a period of rapid growth in the urbanization of Sydney.¹⁸ During the period mid 1990s to the present, vacant land sales have become the exception, resulting in greater reliance on improved sales in the determination of land value, which has raised concerns over transparency.

¹⁷ NSW Ombudsman, *Improving the quality of land valuations issued by the Valuer General* (2005).

¹⁸ M.T. Daly, *Sydney Boom Sydney Bust* (1982).Pg 153 p.153

Figure 3: Evolutionary deduction of value in the Sydney Basin



At this point it may be suggested, that a move to improved value as a basis for assessing the property tax is warranted. Whilst improved value may be accepted for local government rating in a number of countries, where services are visible to the tax payer, a tax on land may be far less tolerable. This is due to the fact that land value is market determined and predominantly based on its location.¹⁹ In contrast, improvements such as buildings may be an underutilization of the land or physically obsolete which add little or no value to land, a factor reflected in improved value.

The use of land value over improved value has been defined as a far more neutral base on which to assess the highest and best use of land.²⁰ That is, land is assessed based on what it could be used for if the existing use of the land is not utilized to its maximum economic and developable potential. At present as highlighted in Figure 3, this requires a process for partitioning land from improvements in highly urbanized locations in the absence of vacant land sales.

What may be viewed as a simple process in determining the value of land, the Privy Council's 1925 simplistic account of land and the conceptual meaning of its value²¹ requires further refinement in the 21st Century. The explanation for what the prevailing legislation intended has resulted in a far more prescriptive and concise process needed in a top down analysis of improved sales in determining land value. The ability to provide transparency in the deduction of land value raised the question as to how improvements on land are to be notionally accounted for in determining their added value. The residual value of land resulting from analysis of improved property sales again challenged the principle of transparency.

¹⁹ T. Vickers, *Location Matters* (2007).

²⁰ W.E. Oates and R.M. Schwab, *The Impact of Urban Land Taxation: The Pittsburgh Experience* (1996).

²¹ *Toohey's Ltd v. Valuer General*, (1925).

“What the Act requires is really quite simple. Here is a plot of land: assume there is nothing on it in the way of improvements: what would it fetch on the market?”

As vacant land sales become the exception, in its most simplistic terms, the primary issue turns on how improved sales are interpreted and how the added value of improvements are accounted for in the extraction of land value. Initially the question emerges of how to partition the constituent components of property which contribute to its value. However, a more complex paradox precipitates this question, that is what constitutes the highest and best use of land in the first instance and how are improved sales construed within the context of this question. In simple terms, if the added value of improvements are deducted from land which is not utilized to its highest and best use, a value well below land value may result.

Whilst not the subject of this paper, this question warrants brief discussion, as it determines in the first instance, which property sales are best suited for the partitioning process. In the absence of vacant land sales, at what point do improvements on land constitute added value and how is the added value to be determined? The two most pressing issues raised in the deduction of land value from improved sales were identified as, the absence of a method by valuers for the adjustment of time between the sale date and date of valuation and secondly, the absence of a method by valuers for the adjustment of the added value of improvements on land.²²

In the assessment of the added value of improvements and in particular in countries where improved value is the basis of assessment, an additional dimension exists. That is, how does the tax payer perceive the added value of improvements of their property and more importantly, how do they perceive the improvements of their property against the improvements of property that has transacted. As set out in Figure 4, the potential risk of this judgment lends itself to over focus and concentration on the visible attributes of improvements and less on the underlying attributes of land.

In addressing the gap in taxpayer understanding of the conversion of improved value to land value in the assessment of this tax, a further challenge arose to its transparency. This required a more systematic approach to the information provided to the taxpayer, which is covered in the following section under reforms to transparency of the valuation of land and prevailing legislation.

Figure 4: Factors of value and perception

Basis of value	Factors of value	Assessment & perception
Land value	Size, shape, access, views & slope of land.	Valuer assessed where the added value of improvements are accounted for by the value in the sales analysis process
Improved value	Size, shape, access, views & slope of land plus	Valuer assessed where the added value of improvements are part of the value and the taxpayer notionally compares the added value of improvements of their property with the sales.
	Size, type, style, layout, No of bedrooms, aspect to the living area etc.	

²² NSW Ombudsman, *Improving the quality of land valuations issued by the Valuer General* (2005). p 21 & 24

3. INFORMATION TRANSPARENCY AND THE TAX PAYER

The principle of transparency and tax payer understanding of how the value of land is determined has been identified as paramount over the past 10-15 years.²³ Following two recent inquiries into the valuation of land²⁴ In NSW, the importance of the principle of transparency has been acknowledged and has led to a number of changes in improving transparency. The key improvement has been the availability of sales information to taxpayers supporting the assessment of land values in New South Wales.

In understanding the importance of sales information in the context of objection to land values, a summary of the grounds of objection are highlighted in Figure 5 against the information available to the tax payer prior to the 2006 changes implemented by the NSW Valuer General.

Figure 5: Grounds of Objection

s34 Valuation of Land Act 1916 NSW	Information Pre 2006
(a) that the <u>values</u> assigned are too high or too low	Not available
(a1) that the <u>area</u> , dimensions or description of the land are not correctly stated	Definable by survey or deposited plan
(b) that the interests held by various persons in the land have not been correctly apportioned	Better understood by the taxpayer
(c) that the apportionment of the valuations is not correct	Better understood by the taxpayer
(d) that lands which should be included in one valuation have been valued separately	As used by the taxpayer
(e) that lands which should be valued separately have been included in one valuation	As used by the taxpayer
f) that the person named in the notice is not the <u>lessee</u> or <u>owner</u> of the land	Better understood by the taxpayer

In each of the parts of section 34 as shown in Figure 5, with the exception of Part (a), the tax payer is able to determine the correctness of the facts relating to their assessment of land value by reference to an alternate source of information. As to the correctness of land area and ownership of land, title details, deposited plans and surveys and tax payers own knowledge of the land provides a basis for any objection to be lodged if this information is incorrect. It is Part (a) which addresses whether the land value is too high or too low that accounts for most objections to land values and has been the least supported and most scrutinized ground of objection.

²³ J. Walton, *Report of Inquiry Into Operation of Valuation of Land Act* (1999).

²⁴ NSW Ombudsman, *Improving the quality of land valuations issued by the Valuer General* (2005); J. Walton, *Report of Inquiry Into Operation of Valuation of Land Act* (1999).

3.1 Method

In gauging the impact and benefits yielded from the recommendations implemented by the NSW Valuer-General from the 2006 land tax year, with particular reference to making sales information available to land tax payers, a preliminary analysis of pre and post 2006 objections has been conducted.²⁵ This analysis has been conducted based on objection information provided by the NSW Department of Lands using objection numbers to land values from a sample of ten local government areas located within 15 kilometers of the Central Business District of Sydney. As at the date of this analysis there were forty two local government areas within the Sydney Metropolitan area, of which the sample of local government areas analysed, represents approximately 25 percent.

In qualifying the information and results of this preliminary analysis, a number of other factors which are not quantifiable, have been identified. These include the adoption of a three year averaging of land values and threshold, the revised formula for the annual adjustment of the threshold and the level of values at the commencement of the 2006 land tax year. Each of these factors would to some degree impact on land tax assessments and were among the thirty two recommendations made and subsequently phased in.²⁶

The objection numbers have been provided by the New South Wales Department of Lands for each local government area in the analysis. In analyzing the number of objections to land values, two factors were considered. The first consideration was the location in which objections were grouped by local government area. The second consideration was the base date of valuation. In New South Wales, each parcel of land is valued annually as at 1 July each year and is the basis of value for the following land tax year. This date is known as the base date of valuation. The analysis was undertaken between base dates 1-7-2000 and 1-7-2008.

Table 1 sets out the objections by local government area and base date, in which a grand total of objections has been tallied on each of these basis, to provide an overall trend by area and time. A detailed discussion on this data follows.

²⁵ NSW Parliament, *Parliamentary Debates*, NSW Valuation of Land Act 1916).

²⁶ NSW Ombudsman, *Improving the quality of land valuations issued by the Valuer General* (2005).

Table 1: Objection totals by location & date

Council	1/07/02	1/07/03	1/07/04	1/07/05	1/07/06	1/07/07	1/07/08	Grand Total
ASHFIELD	7	4	63	6	8	7	2	97
BOTANY BAY	3	8	14	15	3	17		60
BURWOOD	8	7	48	11	3	7		84
LEICHHARDT	217	30	38	67	16	10	59	437
MARRICKVILLE	51	146	27	17	42	7	17	307
MOSMAN	252	23	102	152	9	3	38	579
NORTH SYDNEY	61	43	462	71	26	44	12	719
RANDWICK	31	217	74	185	195	21	32	755
WAVERLEY	51	91	25	121	159	50	47	544
WOOLLAHRA	93	316	30	144	200	50	77	910
Grand Total	774	885	883	789	661	216	284	4,492

3.2 Analysis and discussion

In looking at the general trend of objections in Table 1, from 2004 to 2007 it may well be argued that the provision of sales information to land tax payers has increased transparency and resulted in a reduction of objections. This cannot be concluded at this point, as the number of objections increased from a low base in 2000 climbing to a peak in 2003/04 and then declined again until 2008, where a small increase is noted. This may also well be argued to be part of the larger cycle of ebbs and flows in objections to land values over longer periods and cycles.

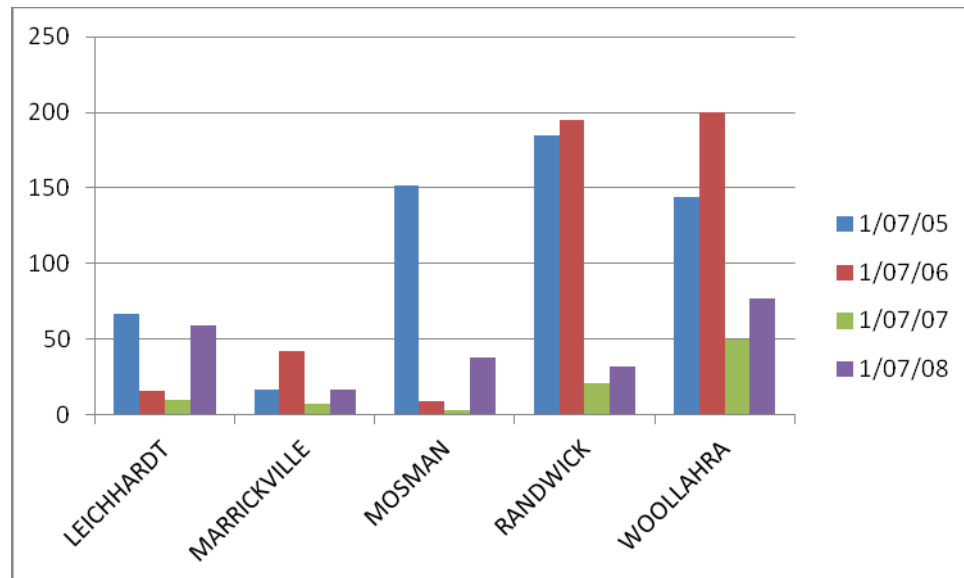
A more detailed account of this is highlighted in five of the ten local government areas as set out in Figure 6, in which an increase in objections is noted for base date 1-7-2008. From this information, it may be that these increases which are marginal increases, are at or below the 2005 level and further confirms that a review of objections for 2009 & 2010 will be necessary. This data is not yet available, as objections to 2009 and 2010 are still in either the objection phase or before the courts.

Still remaining a consideration for tax payers which is not readily observable, is whether land tax payers whilst still engaging in the objection process, have a better understanding of how their land value was derived and its relativity to the available sales information. This raises the question of whether land tax payers are more accepting of the value, but not of the tax itself. In summary, as tax payer understanding continues to evolve, do objections to land values solely constitute objections to values, or a broader dislike for land tax itself of which the land value is the outlet for expressing dislike for the tax.

As highlighted earlier, land values are assessed and land tax liabilities are determined by government and their valuation contractors with little or no input or reference to the taxpayer. In the absence of tax payer input, perceived control, predictability and potential for fluctuations in value from a number of causes, government must understand the importance of the objection process. In fact, the objection process serves as an important taxpayer outlet, and in some cases constitutes tax payer participation and input in the land tax assessment process.

The objection process is crucial in many cases as some land values will inevitably be incorrect, that is the primary function of the objection process to identify and correct. It may well be that the provision of sales information is an important first step in minimizing objections and this may still be proven to be correct over time.

Figure 6: Upward objection trends 2005 to 2008



4. RECOMMENDATIONS AND CONCLUSION

As highlighted in the evolution and history of recurrent property taxation, the base of this tax has taken many forms over the centuries including a chimney tax, window tax, room tax, to the present base of land value. This base is now beginning to show signs of movement as a number of states move council rating to improved value, based on the perception that improved value is better understood by the tax payer. This is further noted in some highly urbanized locations where land rarely transacts and the analyses of market transactions are moving from bottom up to top down.

In maintaining land value as a base of recurrent taxation, continual improvements in the analysis, determination and application of value are crucial. In continuing to address the expectations of tax payers and information about their land values, tax administrators will need to continue to allocate sufficient resourcing to both the provision of opportunities to obtain information and to make objections to land values when necessary. A lack of transparency leads to a tax being challenged and actively campaigned against. Both the Walton Inquiry 1999 and Ombudsman Report 2005 have greatly contributed to the improvement of taxpayer understanding through recommendations for information and transparency of the valuation of land process. The recommendations of these inquiries have been successfully implemented by the NSW Valuer-General since 2005.

The provision of sale information to tax payers in New South Wales is a significant step in building bridges and improving transparency as to how land values are determined. In continuing to improve transparency, the continual updating of sales information and its availability to taxpayers at intervals throughout the year would be useful. This is particularly important since the introduction of the three year averaging

of land values. To this end, a register of sales information used to assess land values could be made available to taxpayers in advance of the issuing of land tax assessments. It would also include sales information used for each of the three years relevant to the taxpayers assessment.

A lesson exists for tax administrators of other taxes in observing the assessment of land tax and the objection process. Where consideration is being given to minimizing taxpayer input in the assessment process of other taxes, information which underpins the transparency of the tax is paramount to its sustainability. A lack of transparency leads to a tax being disliked and actively campaigned against. This is particularly important where there is little or no opportunity or tax payer input in the pre-assessment stage, in which land tax is one of the best taxes to observe this. The opportunity to both obtain all relevant information pertaining to an assessment, as well as the opportunity of having an assessment reviewed in a transparent manner, is an important balance in managing the administrative efficiency of any tax.

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Reforming indirect taxation in Pakistan: A macro-micro analysis

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Abstract

This paper provides an *ex ante* economy-wide assessment of some contentious taxation reforms being considered in Pakistan, in order to widen the tax base and rationalise the rate structure of different taxes. Amongst the main proposals, those focusing on value added tax (VAT) and agricultural direct taxes seem relatively more attractive. The former has the highest share in indirect taxes and is also easier to collect, while the latter is intended to bring the presently exempted agricultural incomes into the tax net. Our results indicate the tough choices for policy makers in trying to improve the dismal tax to GDP ratio in Pakistan. All simulations result in a decrease in investment and consumption levels, and an increase in poverty. However government income increases sharply which in turn also increases spending by public sector and wages of skilled labour. A key benefit of such reforms is also to document the vast economic activity that currently lies out of the tax net. We thus recommend a gradual approach to tax reform that can make the adjustment process less painful.

1. INTRODUCTION

The taxation system in developing countries usually suffers from a narrow tax base, complex rate structure, and high compliance costs. Achieving goals related to progressivity and redistribution thus become more difficult due to the challenges related to the narrow structure of earning population. In a country like Pakistan where 68 percent of the population lives in rural areas and around 30 percent of households are below the poverty line, the scope of direct (income) taxes is not attractive. To meet the government's operational and development expenditure needs, indirect taxes account for a major chunk of overall revenue collections. However, tariffs, excise duties and surcharges are being gradually phased out due to their distortionary impacts. The general sales tax (GST) in VAT mode now contributes the most to national exchequer amongst the indirect taxes in Pakistan.

The economy has witnessed substantial capital inflows during the period 2002 to 2008, which in turn boosted domestic investment and consumption, ultimately keeping the GDP growth rate at an average of around six percent. However, this economic growth could not render higher tax revenues given the inelastic nature of taxes. It was under this milieu that a comprehensive tax reform agenda was put forward by the government which included first generation reforms (rationalizing tax brackets and

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rates) and second generation reforms (focusing on the administrative capacity of tax machinery in Pakistan).

By 2007-08, while these efforts were underway, the economy started to feel the financial crunch posed by the increasing fiscal and current account deficits largely due to: a) rising global oil and food prices (which lead to a higher import bill), b) the burden of subsidies allowed for electricity, oil, wheat, fertilizer and textile exports, and c) depreciating value of domestic currency.

To bridge the twin deficits the economy required external help through multilateral and bilateral arrangements⁴. Under both these avenues the donors demanded a more aggressive fiscal effort from the state in order to raise domestic mobilization levels. Put in numbers, they wanted to see Pakistan's tax to GDP ratio improved. In this context, several tax policy options have surfaced. For example, the International Monetary Fund (IMF) has been suggesting a transition from GST to a full VAT. However due to the politically unpopular reaction to this move the Government and IMF settled for a reformed-GST regime, where several options are open, such as: an increase in the GST rate and a widening of the tax base, as the GST currently does not cover various services sub-sectors. On the other hand, the World Bank (WB) has advised the initiation of direct taxation on the agricultural incomes, which remains tax exempt since the country's independence in 1947. The on-going reforms at Federal Board of Revenue (FBR) have focused on widening the tax bases through adjustments in threshold and withdrawal of exemptions⁵.

The rural areas, home to 70 percent of Pakistan's population, still lack financial infrastructure. There is little record of consumer transactions in rural regions. Therefore the government cannot fully benefit by taxing consumption where economic activity remains largely undocumented. There is also a grave issue of duplicity of taxes in the country. There are many taxes that are charged by the Federal Government and are also levied by the provincial or local governments using the same or a similar name. On the administrative side, the foremost issue is that of tax compliance. Only half the registered persons and businesses actually file periodic returns. The poor relationship between the tax payer and the tax administrator is the major cause of such an issue.

In our knowledge there is no quantitative research on *ex ante* economy-wide effects of contentions tax reforms which have been in the pipeline for many years now. There is some previous research on the evaluation of tax progressivity in Pakistan. See Ilyas (2004), Alauddin *et al.* (1981), Ahmed *et al.* (1986), Azfar (1972), Jeetun (1978), Malik *et al.* (1985, 1989). For decomposition analysis of tax system in Pakistan see Ahmed and O' Donoghue (2009).

In this paper we will use a Computable General Equilibrium (CGE)-microsimulation framework in order to obtain macro, meso and micro level results of our policy simulations. Section 2 gives an overview of tax reforms in the country. Section 3

⁴ The most recent episode is IMF Stand By Arrangement initiated in November 2008, which provides Pakistan \$7.6 billion, at an interest rate of 3.5 to 4.5 percent over 3.5 to 5 years.

⁵ In its annual review for the year 2003-04, the FBR has reported that out of a population of 151 million, only 1.3 million are tax payers. After clearing claims submitted for rebates, this number is further reduced to 0.9 million. However, even within this group there are inherent difficulties such as evasion and under-reporting of earned income and profits.

explains the specifications of the model and datasets used in this study. We also discuss here the considerations that went into the design of our simulations. In section 4 we interpret our results, where we initially study the general equilibrium impact of the present form of taxes. Estimates of revenue loss due to evasion are also given. We then focus on the macro-micro impact of tax reforms.

2. TAX REFORMS IN PAKISTAN

Pakistan has shown dismal performance in increasing its tax revenues as its tax system continues to suffer from complexity (difficult to administer and comply with), inelasticity (unresponsive to economic growth), inefficiency, and inequity (GoP 2003). As cited earlier, the tax to GDP ratio in Pakistan is among the lowest in the world. Table 1 gives a comparison in a cross-section of countries. Pakistan's 10.5 percent tax to GDP ratio is well below other Asian countries like Sri Lanka (16.5%), India (14.1%), and the Philippines (12.6%).

Table 1: Tax to GDP ratio in selected countries 2005

Country	Tax/GDP Ratio
India	14.1
Pakistan	10.1
Sri Lanka	16.5
Mexico	19.0
Egypt	14.1
Korea, Rep	24.6
Thailand	16.4
Malaysia	16.1
Philippines	12.6
Turkey	31.3
Sweden	50.4

The tax to GDP ratio for disaggregated taxes is given in Figure 1. Between 1992 and 2006, note that the highest decline was in revenue collected through tariffs (or customs duties). This has been compensated through increase in revenue from GST. The revenue from income taxes (as percent of GDP) shows a stagnant trend. The fiscal effort from the provinces has been minimal. There is negligible amount of tax collected from avenues classified under the provincial domain. These include agricultural incomes, capital gains on tangible assets, services, and urban property.

Figure 2 exhibits the indirect tax trend between 1991 to 2009. In the early 1990s customs duties contributed the highest amount (Rs. 62 billion in 1992) followed by excise duties (Rs. 31 billion) and sales taxes (Rs. 21 billion). However, with a view to remove distortions, subsequent governments gave increased importance to sales tax in VAT mode whose collection increased to Rs. 295 billion in 2006 followed by customs duties (Rs. 138 billion) and excise duties (Rs. 59 billion).

Figure 1: Tax to GDP ratio for disaggregated taxes

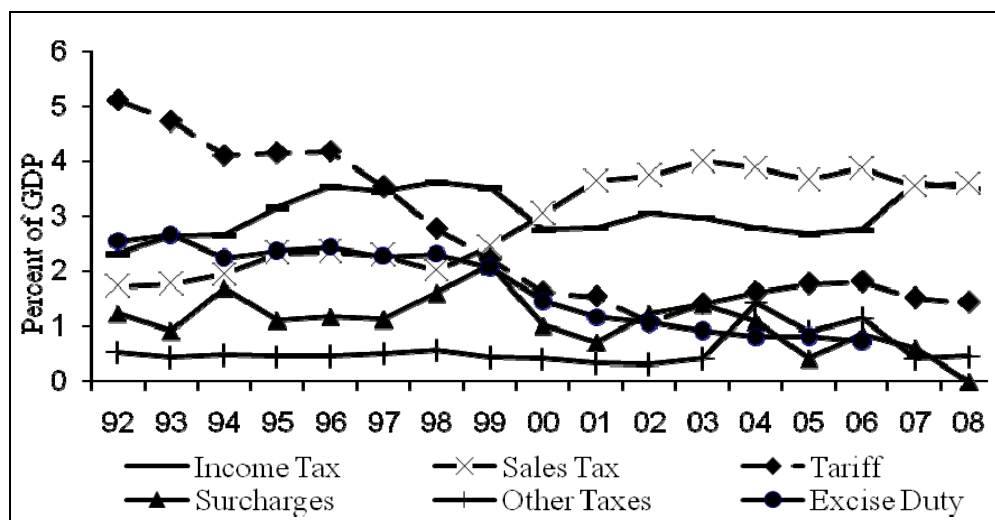
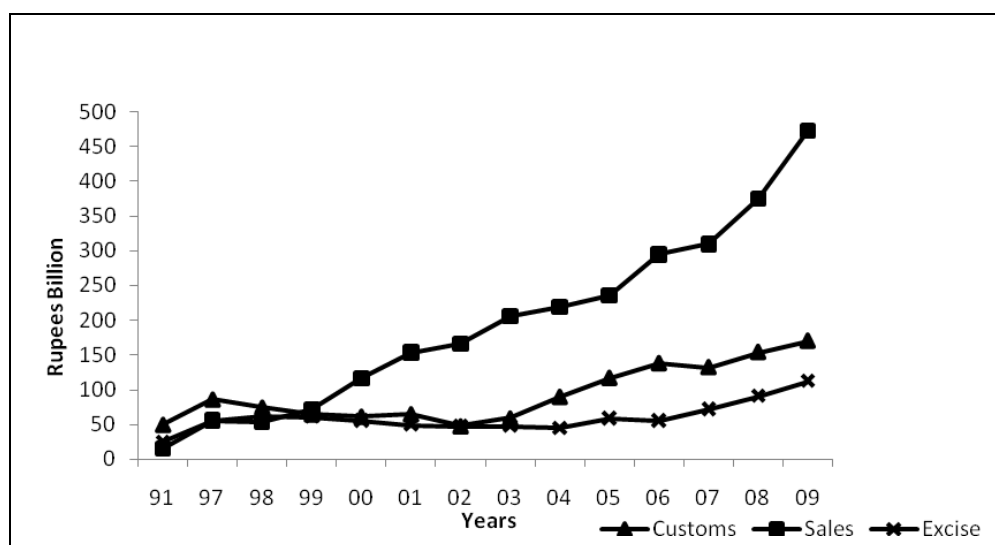


Figure 2: Structure of federal tax revenue



Recent tax policy reforms in Pakistan can be classified into first and second generation reforms. The first generation reforms focused on aligning the tax rates and structure with the country’s overall economic growth (see Yusuf 2007). Main measures included widening the tax base through adjustments in threshold, reforming GST along the lines of VAT, reducing reliance on excise duties, rationalizing customs duties, implementing a uniform rate structure for corporate taxation, and gradually reducing income tax rates. The second generation reforms focused on administrative changes. Collaborating with WB in 2001, Pakistan initiated the implementation of reforms in the area of tax administration and management. The objective of these reforms was to minimize tax avoidance and evasion through simplification of procedures, self-assessment schemes, a focus on the buoyancy of different types of taxes, and improved overall organizational management.

While the administrative capacity of the tax authorities still remains constrained, it is however important that as growth rate climbs up, the additional wages and rents

should be brought under the tax net. In the case of Pakistan, it may be noted that the incomplete reforms in the areas of income and sales taxes have not been able to fully compensate for the decline in tariffs and excise duties (Ahmed 2008). Therefore, in order to craft a medium-term plan for tax policy reforms it is essential that an agenda based on transparency, equality and simplicity be followed, which should address the existing caveats in the areas of documentation of informal economy, automation of business processes, and capacity building of human resources involved in tax administration. In this regard, FBR initiated its Tax Administration Reforms Project (TARP) in 2005 aimed at achieving greater efficiency and productivity in tax collection. In 2007, the WB provided assistance in helping the tax authorities to learn from best practices of other countries, and subsequently a Tax Policy Programme was initiated with technical assistance from the Andrew Young School of Policy Studies at Georgia State University.

The still pending compliance issues point towards the complexity of tax assessment which needs regular attention. Sometimes it is the pursuit of progressivity that makes the taxation process more complex. However Martinez-Vazquez (2006) explains that there seems to be low progressivity in Pakistan's overall tax structure. To some extent the low progressivity (or vertical equity) is primarily due to the already high burden of taxes on poor. See also Ahmed and O' Donoghue (2009).

3. DATA, MODEL AND SIMULATION DESIGN

3.1 Datasets

The Social Accounting Matrix (SAM) for our CGE model was derived from Dorosh, Niazi and Nazli (2004)⁶. This SAM is comprised of information from five different data sources namely; Input-Output table (updated for 2002), national accounts data for 2002, Pakistan Integrated Household Survey 2002, Pakistan Rural Household Survey 2002 and Pakistan Economic Survey 2002.

On the activities side this SAM includes payments and receipts for 12 agricultural sectors, 16 industrial sectors, and 6 services sectors. Similar sectoral details are observed in the commodity accounts. Factor accounts include labour, land and capital with labour disaggregated into 10 different categories. This categorical disaggregation is based on the criteria of farm size, agriculture/non-agriculture wage, and unskilled/skilled labour. Land is disaggregated according to farm size (in different provinces). Capital is categorised into livestock, other agriculture, and informal and formal capital. The household accounts are distributed into rural and urban with rural households being further classified into 17 categories based on farm size, and rural poor/rural non-poor. Urban households are classified into poor and non-poor. Other institutions in the SAM include enterprises, government, and the rest of the world. The details about household budgets are obtained from the Household Income and Expenditure Survey 2002 which is a nationally representative survey of 16400 households.

⁶ The details on SAM are drawn from Ahmed and O' Donoghue (2010).

3.2 CGE Model Specifications

The basic specifications of this model are from Cororaton and Orden (2007). This framework is based on the EXTER convention (see Decaluwe, Dumot, Robichaud, 2000). The model's production block combines the intermediate inputs and value added to give the final output, which is then either exported or domestically sold. The imported inputs are combined with the domestic goods to provide the composite goods. The export transformation has been specified using a constant elasticity of transformation (CET) function and the import to domestic good relation has been specified using a constant elasticity of substitution (CES) function. The value addition is derived from four different sources (specified using a CES function) namely; skilled labour, unskilled labour, capital, and land. Due to the considerations of Pakistan being a developing country with an agricultural sector contributing substantially to overall GDP, the unskilled labour is thus further sub-divided into farm labour and unskilled workers, represented using a CES function. Land, capital and unskilled labour are combined using a CES function to give the agricultural sector's value addition. In the case of the non-agricultural sector land is replaced by unskilled labour while other two factors of production remain the same.

The model specifies consumption using a linear expenditure system (LES), which is in line with the standard tradition used in many CGE models. The overall consumption at the household level is the difference between the disposable income and household savings. The demand for capital by destination is determined (amongst other factors) by the ratio of return to capital and user cost of capital. The summation of this demand for capital by destination then gives us the overall real investment which is then multiplied by the price of investment in order to obtain overall nominal investment. Finally we can calculate the investment demand by origin. This is done by multiplying the ratio of nominal total investment to composite price of the commodity with the investment shares given in the base data.

Output price is a weighted combination of export and local price. The latter is different from the domestic price due to indirect taxes. These taxes are also added along with the world price of import (multiplied by exchange rate) and tariff rate to give the domestic import price. The export price is determined by world the price of exports (multiplied by exchange rate) and export subsidies⁷.

In the agricultural sector capital and land are fixed, while in the non-agricultural sector only capital is fixed. Unskilled labour is allowed mobility across sectors, while skilled labour can only move between non-agricultural sectors. The supply of skilled labour, farmers, and workers is fixed. Supply of land is also fixed.

The supply in goods market is equated with the sum of intermediate demand, household and government consumption to give the goods market equilibrium. Total investment is equal to total savings which is, in turn, comprised of household, firm, foreign and government savings.

Real government consumption is fixed, allowing government income and savings to vary. Savings of firms are fixed; a rise in firm's income will therefore imply increased dividends to households but not an increase in retained earnings of firms. Most of

⁷ However, this is not in the present specification of this model.

these closure rules are similar to Cororaton and Orden (2007) allowing an extension of analysis to Pakistan's economy⁸.

The weighted value-added price is considered as a numeraire. The nominal exchange rate is kept flexible, which implies that foreign savings as measured by the domestic currency is also flexible. Thus the external account is cleared by the exchange rate given that foreign savings in terms of foreign currency is fixed.

3.3 Microsimulation Model

Following Alatas and Bourguignon (2000) we estimate the wage income as a function of personal characteristics of earning members of the households thus allowing for heterogeneity of earnings within the wage groups. We retain the same wage grouping as explained above in the CGE model. The heterogeneity may be due to differences in for example educational profile, area of residence and experience. For mathematical details see Ahmed *et al.* 2009.

The self employment income of the households is estimated as a function of household members associated with the business activity as well as the household characteristics such as region, type of experience, size of land ownership, and schooling of head of households. Using an accounting identity we sum the wage income of households members, earnings of members involved in self employment and the non-labour income of household which in Pakistan's case may include remittances, Zakat⁹, and miscellaneous. Any direct taxes paid by the household may be deducted. In order to obtain the real household income we deflate the amount with a household specific consumer price index. This index is calculated as the sum of all budget shares multiplied by the price of goods.

The occupational choice available with an individual is then determined in a discrete fashion (using a multi-logit model). The value for inactivity is set to zero and the values for wage or self employment are functions of household characteristics. The individual will choose for example self employment if the value associated with this choice is greater than other alternatives.

The total expenditure is obtained by subtracting household savings from total nominal income. This expenditure multiplied by the observed budget shares gives us the monetary value of commodity-wise consumption.

In this paper we use the top-down approach for linking the macro-micro models (see Bourguignon *et al.* 2003). For transmitting incomes from macro to micro model, we changed the wage intercept terms for labour in four different categories: skilled, unskilled – farm labour, unskilled – workers in industry, unskilled – workers in margin services, and self employed¹⁰.

⁸ Cororaton and Orden (2007) conducted simulations that include: a) impact of increase in foreign savings; b) increase in world prices of cotton lint; c) improvement in total factor productivity; and d) production subsidy.

⁹ An obligatory contribution which every wealthy Muslim is required to pay to the state, or to distribute amongst the poor.

¹⁰ The process of transmitting wages, prices and employment is done after ensuring data consistency between macro and micro data.

4. INTERPRETATION OF RESULTS

4.1 General Equilibrium Impact of Existing Taxes

In order to study the general equilibrium impact of existing taxes, we start by removing them one at a time and see their macroeconomic impact (Table 2). In the case where income taxes are not present real investment increases by 6.1 percent. Overall household consumption increased by 5 percent, within which households belonging to the farm sector are the highest gainers (7.3%) followed by urban non-poor households (3.6%) and rural workers (2.7%). However urban poor households faced a decline in consumption by 0.4 percent. This increase in consumption may partly be responsible for the hike in prices of food items (8.0%), and durable items (1.4%). Prices declined for services by almost 7.0 percent and this may have partially come about as a result of the decline in government revenue. The decline in revenues may also be to some extent responsible for the decline in wages of skilled labour by 15.7 percent. The wages for farm and unskilled labour increased by 12.6 and 2 percent respectively. While direct taxes declined by 100 percent there is an increase in tariff and indirect tax revenue by 2.9 and 3.7 percent, respectively. The increase in these taxes is through the channels of increased investment and household consumption.

In the second case where the GST rate is kept at zero the increase in most macroeconomic economic variables is greater than the previous simulation, a result of the greater income and substitution effects. Investment increased by 23.8 percent, household consumption increased by 9 percent where farmers and rural workers are the main gainers. The consumption of both urban non-poor and urban poor declines primarily due to the increase in consumer prices of durable items and services. The decline in government revenue partially impacts urban services. This reduction in public sector revenue may also explain the decrease in wages of skilled labour (29%); the wages of farmers and unskilled labour increase by 27 and 4.4 percent respectively. The direction of change in wages is similar to the case without income taxes. However, the magnitude of change is greater. The consumer prices of durable items fell by 6 percent and services sector consumer prices decreased by 16.3 percent. It seems that increases in wages and consumption of rural households pushed the food prices higher by 11 percent.

In the third case removal of tariff has a much lower impact on macroeconomic variables. This lower magnitude can be justified given that the share of trade taxes in tax revenues is 18 percent (according to 2005 figures). As a percentage of GDP tariff collection is almost 2 percent thus resulting in lesser income side linkages. It is interesting to note the pro-poor effects of tariff removal on household consumption. The household breakup indicates that farmers, rural workers, and the urban poor see increased consumption levels while for the urban non-poor households consumption declines by almost 2 percent. This also has inequality-reducing implications and can also be seen from the increase in wages, which improve for both unskilled and farm labour. Such a scenario goes in favour of trade liberalisation via reduction in price-based restrictions (such as tariffs).

Our estimates for evasion show that if statutory rates are applied instead of the effective rates, then; a) customs duty revenue increases by 6.4 percent, b) direct tax revenue increases by 20.2 percent and c) revenue from GST, excise and surcharges increases by almost 40 percent. The evasion in the case of indirect taxes may be even greater; however, this may depend on how correctly we estimate the size of the

informal and undocumented portion of the economy. For detailed analysis on tax evasion in Pakistan see Yasmin and Rauf (2004), Kemal (2003) and Aslam (1998).

Following the recent discussions between the Ministry of Finance and multilateral organizations, we focus on four main policy simulations (SIM) for tax policy changes. These are as follows:

- Sim-A: Increasing GST rate by 33 percent
- Sim-B: A 10 percent GST on presently tax exempt export-oriented sectors
- Sim-C: Increasing GST rate by 33 percent + bringing services into the tax net
- Sim-D: Increasing GST rate by 33 percent + bringing services into the tax net + levying a 5 percent flat tax on agricultural incomes

The impact of these experiments should be seen in terms of their socio-economic costs and benefits in 2002 prices. These are not necessarily comparable with each other. However, we retain the same closure rules for all simulations.

Table 2: Impact of present taxation structure (% change over base)*

	Ytax=0	GST=0	Tariff=0
Real Investment	6.1	23.8	3.1
Revenue			
Tariff revenue	2.9	2.7	-100.0
Direct tax revenue	-100.0	-9.6	-1.7
Indirect tax revenue	3.7	-100.0	0.8
Wages			
Farm labour	12.6	27.1	4.1
Rural worker	-1.3	-1.8	-0.2
Skilled labour	-15.7	-29.2	-5.5
Unskilled labour	1.71	4.37	0.71
Output			
Agriculture	1.03	1.92	0.50
Industry	1.76	5.11	0.58
Services	-7.87	-20.31	-3.11
Consumer Prices			
Food	8.0	10.9	8.1
Durables	1.4	-5.9	-0.7
Services	-6.8	-16.3	-2.5
Household Consumption	4.76	8.65	1.50
Farmer	7.29	14.78	2.35
Rural worker	2.68	5.17	1.09
Urban non-poor	3.64	-9.51	-1.65
Urban poor	-0.35	-0.52	0.17

*ytax=0 → removal of income tax, gst=0 → removal of GST, tariff=0 → removal of tariff.

4.2 Result-I: Increasing GST rate by 33 percent

This policy change leads to a decline in overall investment by 5.6 percent (Table 3). While government income increases by 15.4 percent, firm incomes decrease by 1.5 percent. The return to factors indicate a decline in the case of land (-7.1%) and capital (-1.5%), whereas labour returns show mixed results. The wages decrease for farm labour by 6.5 percent, increase for skilled labour by 8.9 percent, and change negligibly for unskilled labour.

Table 3: Impact of proposed tax reforms (% change over base)*

	Sim-A	Sim-B	Sim-C	Sim-D
Real Investment	-5.6	-10.3	-14.6	-15.8
Government Consumption	20.0	48.3	78.3	91.0
Government Income	15.4	39.4	65.3	77.6
Firm Income	-1.5	-4.1	-4.6	-5.4
Tax Revenue				
Tariff revenue	-0.6	-0.4	-1.0	-2.1
Direct tax revenue	2.8	7.7	9.0	46.0
Indirect tax revenue	30.6	77.6	129.7	130.9
Wage				
Farm labour	-6.5	-16.1	-18.4	-22.3
Skilled labour	8.9	23.8	28.8	34.9
Unskilled labour	0.1	0.1	-1.3	-1.6
Land return	-7.1	-18.2	-20.3	-24.5
Capital return	-1.5	-4.1	-4.6	-5.4

How does the increase in GST rate impact the consumer prices? This is exhibited in Table 4 where the prices decrease for agricultural goods yet increase in the case of industrial goods. The reason for this can be explained from the tax base selected for the imposition of GST. The majority of agricultural goods (particularly staple food items) are exempt from any form of indirect taxation. Therefore, the entire burden is borne by the industrial sector which includes large and small scale manufacturing, mining, electricity, gas, and construction. A similar explanation can be found in Refaqt (2003) in the context of social incidence of GST in Pakistan.

In the case of agriculture, the largest decrease in prices is seen for sugarcane (-9%), cotton (-6%), and rice (-4%). In the case of industry the highest increase in consumer prices is seen for food manufacturing (11.3%) and petroleum refining (9.3%). For the services sectors the prices for both private and public services increase by 2.3 and 7.1 percent, respectively. At this stage, the change in consumer prices can also be explained by the underlying changes in the factor prices.

In the agricultural sector the wages for farm labour have declined and so have the returns to land. The land returns decline in all agricultural sub-sectors. The return to capital decreases for some industrial sectors having backward linkages with the agricultural sector. These include livestock (-4.3%), food processing (-3.5%) and

fisheries (-2.4%). The activities showing an increase in their return to capital include leather (11.9%), housing (1.7%), rice (4.5%), and wheat milling (2.5%)¹¹.

Table 4: Percentage change in consumer prices for selected items (% change over base)*

	Sim-A	Sim-B	Sim-C	Sim-D
Wheat irrigated	-2.9	-7.3	-8.4	-10.9
Wheat non-irrigated	-3.2	1.8	-9.1	-11.8
Paddy IRRI	-3.5	-11.9	-11.5	-14.5
Paddy basmati	-4.0	-10.0	-13.0	-16.4
Cotton	-6.0	-12.5	-14.8	-17.7
Sugarcane	-9.0	-20.4	-24.0	-28.9
Other major crops	-4.1	-10.2	-11.3	-14.1
Fruits, vegetables	-2.1	-4.3	-5.7	-7.6
Livestock, cattle, dairy	-2.1	-0.6	-6.6	-9.8
Poultry	-0.8	2.9	-2.4	-3.6
Forestry	-1.4	6.9	-4.0	-5.3
Fishing Industry	0.6	9.7	1.1	0.9
Mining	5.1	3.4	7.2	7.2
Vegetable oil	1.4	3.0	3.5	2.9
Rice milling IRRI	0.2	10.7	0.7	0.0
Rice milling Basmati	-0.3	9.9	-0.7	-1.7
Sugar	1.3	0.7	2.1	0.9
Other food	11.3	4.2	14.5	14.5
Cotton lint, yarn	3.3	-1.8	3.5	2.9
Textiles	3.0	17.9	8.4	9.0
Leather	1.2	19.9	7.2	6.6
Wood products	0.5	3.4	2.9	3.2
Chemicals	1.8	3.2	3.8	3.6
Petroleum refining	9.3	4.9	13.2	13.3
Other manufacturing	2.1	2.8	3.9	3.7
Energy	5.0	7.3	11.0	12.5
Construction	0.4	0.0	0.5	0.7
Commerce	1.3	13.1	13.4	14.0
Transport	3.6	3.8	6.5	6.5
Housing	1.8	4.6	3.0	5.7
Private services	2.3	5.4	17.7	18.6
Public services	7.1	17.4	34.5	39.0

¹¹ The sectoral tables on return to land and capital not exhibited in the paper due to space constrain

What is the impact of changes in goods and factor prices on exports? We see this in Table 5 where key exporting sectors lose substantially as the indirect tax burden is increased. The textile sector exports, which account for more than a 60 percent share in Pakistan's overall exports, decline by 6.2 percent. Other sectors facing a decline include chemicals (-2.1%), manufacturing (-1.5%), transport (-2%) and cotton yarn (-1%). There is a general decline in imports as shown in Table 6. However, textile and private services show an increase of 1.8 and 2.3 percent, respectively.

Table 5: Percentage change in selected exports (% change over base)*

	Sim-A	Sim-B	Sim-C	Sim-D
Fruits, vegetables	4.2	11.3	12.7	15.5
Poultry	1.9	11.4	6.0	7.4
Fishing Industry	0.0	2.6	1.3	1.3
Mining	-1.9	-5.7	-7.5	-9.4
Vegetable oil	-3.0	-2.4	-5.8	-5.3
Rice milling Basmati	1.3	1.9	3.8	5.0
Other food	-2.4	-4.8	-6.4	-7.1
Cotton lint, yarn	-0.7	3.3	-1.2	-1.3
Textiles	-6.2	-13.5	-14.5	-16.4
Leather	1.9	-9.7	-1.9	0.0
Chemicals	-2.1	-3.2	-5.3	-5.3
Other manufacturing	-1.5	-2.9	-4.9	-5.9
Transport	-2.0	-1.4	-3.3	-3.9
Private services	-0.4	-0.1	-2.8	-3.2

Table 6: Percentage change in selected imports (% change over base)*

	Sim-A	Sim-B	Sim-C	Sim-D
Wheat irrigated	-3.2	-9.7	-12.9	-12.9
Fruits, vegetables	-2.2	-5.9	-6.7	-8.1
Livestock, cattle, dairy	-2.8	-12.5	-8.3	-11.1
Fishing Industry	-0.8	-5.0	-2.8	-2.9
Mining	-2.5	-3.6	-5.3	-6.0
Vegetable oil	0.0	-2.5	-1.7	-2.9
Wheat milling	-2.4	-7.1	-8.3	-10.7
Sugar	-3.6	-3.6	-7.1	-7.1
Other food	-1.8	-0.9	-1.8	-1.8
Cotton lint, yarn	-4.1	-13.7	-11.0	-12.3
Textiles	1.8	0.6	5.4	5.4
Chemicals	-0.6	-1.5	-1.9	-2.4
Petroleum refining	-0.3	0.3	0.0	-0.3
Other manufacturing	-2.7	-4.9	-6.4	-7.0
Private services	2.3	4.1	5.0	6.4

The changes in production and trade can impact the sectoral employment levels. The employment of unskilled labour declines in cotton, sugarcane, paddy, textile and other manufacturing¹². However, there is an increase in wheat and rice milling, leather and private services. The skilled labour declines in all sectors except public services where employment expands by 8.5 percent indicating government's capacity to employ more given the increase in tax revenues.

Most of the welfare indicators show some deterioration. The change in household consumption given in Table 7 indicates a decline for farmers, farm renters, rural workers, and the urban poor. The consumption of urban non-poor increases by 2.8 percent which indicates that in consumption terms such a policy change has been regressive. Our microsimulation results show an increase in poverty headcount by 2.1 percent (Table 8). There is also an increase in the poverty gap (2.4%) and poverty severity (2.6%). The highest increase in poverty is seen in Sindh province (4.9%) followed by NWFP (1.4%). The inequality also worsens (Table 9) as the Gini coefficient increases by 0.6 percent.

Table 7: Percentage change in household consumption (% change over base)*

	Sim-A	Sim-B	Sim-C	Sim-D
Large Farmers_Sindh	-5.2	-12.2	-14.0	-22.7
Large Farmers_Punjab	-4.2	-10.7	-12.0	-20.5
Large Farmers_Other Pakistan	-4.1	-9.3	-10.3	-19.6
Medium Farmers_Sindh	-4.2	-10.6	-12.0	-20.5
Medium Farmers_Punjab	-3.4	-8.7	-9.8	-18.0
Medium Farmers_Other Pakistan	-4.1	-10.9	-12.1	-20.7
Small Farmers_Sindh	-2.7	-7.1	-8.0	-16.1
Small Farmers_Punjab	-2.7	-6.9	-8.0	-15.9
Small Farmers_Other Pakistan	-2.2	-5.6	-6.6	-14.3
Small Farm Renters_landless_Sindh	-2.7	-6.5	-7.7	-9.2
Small Farm Renters_landless_Punjab	-2.5	-6.2	-7.3	-8.9
Small Farm Renters_landless_Other Pakistan	-2.1	-6.3	-7.0	-9.2
Rural agricultural workers_landless_Sindh	-0.5	-1.5	-2.5	-3.0
Rural agricultural workers_landless_Punjab	-0.6	-1.7	-2.6	-3.2
Rural agricultural workers_landless_Other Pakistan	-1.1	-2.2	-3.3	-4.4
Rural non_farm non_poor	-0.7	-1.8	-2.7	-3.3
Rural non_farm poor	-0.9	-2.4	-3.2	-3.8
Urban non_poor	2.8	7.7	9.1	11.0
Urban Poor	-0.2	-0.5	-1.7	-2.1

¹² Tables on sectoral employment not exhibited in the paper due to space constraint.

Table 8: Poverty impact of proposed tax reforms (% change over base)*

	Sim-A	Sim-B	Sim-C	Sim-D
Overall Pakistan				
FGT(0)*	2.1	4.7	5.6	14.2
FGT(1)	2.4	4.9	5.1	6.5
FGT(2)	2.6	5.4	5.7	7.1
Punjab Province				
FGT(0)	0.9	3.7	4.7	7.5
FGT(1)	0.3	0.8	0.8	1.0
FGT(2)	0.2	0.5	0.5	0.7
Sindh Province				
FGT(0)	4.9	4.9	4.9	8.2
FGT(1)	9.3	10.2	10.3	10.8
FGT(2)	10.5	11.1	11.1	11.4
N.W.F.P				
FGT(0)	1.4	1.4	1.4	5.8
FGT(1)	0.2	0.5	0.7	0.8
FGT(2)	0.2	0.4	0.4	0.5
Baluchistan Province				
FGT(0)	0.0	0.0	0.0	6.9
FGT(1)	0.4	0.8	0.8	1.1
FGT(2)	0.2	0.4	0.4	0.5

*Foster Greer Thorbecke measures where FGT(0) is poverty headcount ratio, FGT(1) is poverty gap and FGT(2) is poverty severity.

Table 9: Inequality impact of proposed tax reforms (% change in Gini Coefficient)*

	Sim-A	Sim-B	Sim-C	Sim-D
Overall Pakistan	0.6	1.0	1.3	1.5
Punjab Province	0.5	1.0	1.3	1.5
Sindh Province	1.0	1.7	1.9	2.3
N.W.F.P Province	0.5	1.0	1.5	1.8
Baluchistan Province	-0.2	-0.4	-0.3	-0.3

4.3 Result-II: 10 percent GST on presently tax exempt export-oriented sectors

Under the IMF stand-by arrangement Pakistan is now expected to start work on the implementation of a value-added tax which will replace the existing GST. In turn, this step will imply withdrawing the present tax exemption facility to key exporting industries (currently those industries that are contributing towards exports receipts receive tax exemptions and research and development subsidies, which are contrary to WTO conventions). These include textile, leather, sports, surgical equipment and carpets. The exemption facility has been in place since 2005-06. If such a policy change takes place, what precisely will be its economy-wide impacts? We discuss these in our second experiment by imposing a 10 percent GST (in VAT mode) on presently exempt goods.

The real and nominal investment is expected to decline by 10.3 and 8.5 percent, respectively (Table 3). The government income as a result of increased tax revenues

increases by 39.4 percent. Due to declining imports the revenue from customs duties declines by 0.4 percent; however the direct and indirect tax revenues increase by 7.7 and 77.6 percent, respectively. The enterprise sector bears the higher burden of taxes, which slash the overall firm incomes by 4.1 percent. The overall returns for factors of production decline except for skilled labour. The returns for capital decline by 4.1 percent and land by 18.2 percent. The wage for farm labour declines by -16.1 percent while there is a negligible increase for unskilled labour.

In Table 4 we see how the removal of the exemption facility impacts on consumer prices. The price level in key export-oriented sectors sees a sharp increase, decreasing the competitiveness of domestically produced goods vis-à-vis foreign exports as a consequence. The textile sector prices increase by 17.9 percent, leather by 19.9 percent, and rice by 10.7 percent. Some of the items that form a part of core inflation in Pakistan also increase. For example, the petroleum sector sees an increase in its price level by 4.9 percent while overall energy prices increase by 7.3 percent. As the prices in the industrial sectors rise, there are substantial reductions in the prices of agricultural activities. Apart from the fact that these activities are GST exempt, the decline in prices can also be explained through the changes in underlying factor prices. The land prices decline for major crops namely wheat (-18.2%), rice(-22%), cotton (-25%) and sugarcane (-33%). As industrial activities are relatively more capital-intensive, the increase in their prices is thus related to the price of capital. The capital returns increase for cotton yarn (6.7%), rice milling (5.8%), leather (3.6%), energy (6.3%) and petroleum refining (4.1%).

The textile sector exports (Table 5) decline by 13.5 percent. Given that Pakistan's economy is heavily reliant on imported raw material and machinery, it is important to note that a slowdown in export growth will in turn imply lesser availability of foreign exchange reserves. This will make affordability of imports difficult and can certainly have a detrimental impact on sustaining the country's overall macroeconomic stability. A prudent alternative may be the gradual removal of the zero rating facility (commodity by commodity) which will make the sectoral adjustment process less painful. In Table 6 we see that manufacturing sector exports decline by 4.9 percent. In agriculture, wheat sector imports decline by 7.1 percent, which may raise food security issues domestically.

The changes in employment indicate that unskilled labour employment is reduced in textile, manufacturing, and livestock, however it increases in cotton yarn, rice milling, and construction. Farm employment declines in paddy, cotton and sugarcane and increases in fruits/vegetables and forestry. The employment of skilled labour declines in all industrial activities except public services, where employment expands by 18.4 percent.

As seen in the first simulation, an increase in indirect taxes leads to a decline in household consumption for all segments of the population except urban non-poor (Table 7). The largest decrease is seen in the consumption levels of large and medium scale farmers in all provinces. In fact, this is a manifestation of the decline in wages of farmers as explained above, which translates to their lower consumption levels. The overall poverty headcount ratio increases by 4.7 percent (Table 8). As urban non-poor consumption increases one could expect a rise in inequality. In Table 9 the Gini coefficient increases by more than 1 percent in Punjab, Sindh and NWFP.

4.4 Result-III: Increasing GST rate by 33 percent and bringing services into the tax net

In Table 3 real investment declines by 14.6 percent. Government income increases by 65.3 percent but firm income decreases by 4.6 percent. The services sector contributes over 50 percent to overall GDP in Pakistan. Given the substantial scale of transactions in this sector the indirect tax revenue thus increases by 130 percent. The direct tax revenue increases by 9 percent and tariff revenue decreases by 1 percent. All factors of production see a decline in their returns; however, the wage for skilled labour increases by 28.8 percent.

After bringing the services sector into the tax net the consumer price of private services increases by 17.7 percent and public services by 34.5 percent (Table 4). Other services that see an increase in their price level are commerce (13.4%), transport (6.5%), and housing (3.0%). Given the increased rate the industrial sector prices also increase. The highest rise is seen in food processing followed by textile and leather, ultimately affecting competitiveness of key exports.

Factor prices are affected in the same manner as seen in the previous simulation, only this time the magnitude is higher. In the case of land prices the largest decrease is seen for sugarcane followed by cotton. It is interesting to note that two export-oriented sectors having a similar production structure behave differently; for the textile sector the capital returns decrease by 1.7 percent while for leather the returns increase by 26.2 percent.

The exports of most sectors face a decline (Table 5). Most notably, textile exports decrease by 14.5 percent, leather by 1.9 percent, and food processing by 6.4 percent. However, the rice sector exports expand by 3.8 percent. In the case of imports (Table 6), all sectors see a negative change except textile and private services whose imports increase by 5.4 and 5 percent, respectively. The rise in private sector imports can be explained in the context of the increased relative price of domestic services that in turn make foreign services more attractive.

Given the above macro-level impacts, the micro-level changes indicate an increase in consumption inequalities. While urban poor consumption decreases by 1.7 percent, urban non-poor consumption gains by 9.1 percent (Table 7). The consumption of households associated with the farm sector face a sharp decline, as both rural non-farm poor and rural non-farm non-poor see a 3.2 and 2.7 percent decline, respectively. The channels through which this simulation affects the welfare levels are two-pronged. First the price of services increased, which in turn raised the costs related to transport, storage, distribution, and wholesale and retail marketing. Second, the increased GST rate structure added to the existing burden of taxes and directly curbed consumer purchasing power.

The employment of skilled labour declines in all sectors, particularly private services (-24.7%). Given the increased revenue available with the government, employment in public services increases by 22.4 percent. Unskilled labour employment also increases in some sectors such as private services, energy, rice, cotton, and leather.

The poverty headcount ratio increases by 5.6 percent with both gap and severity increasing by 5.1 and 5.7 percent, respectively (Table 8). The Gini coefficient also increases by 1.3 percent, indicating an increase in overall inequality across households.

4.5 Result-IV: Increasing GST rate by 33 percent, bringing services into the tax net and levying a 5 percent flat tax on agricultural incomes

In our fourth experiment we combine the first and third simulations with an agricultural income tax. In response to such a change, government income increases by 77.6 percent (Table 3) as a result of an increase in indirect (131%) and direct taxes (46%). The increased burden of taxation depressed real investment by 15.8 percent. The income of firms also sees a decline of 5.4%. Farm labour loses the most in this simulation, and their wages decline by 22.3 percent. The return to land is also reduced by 24.5 percent.

The impact of these changes on consumer prices is very similar to the third experiment. The agricultural tax does not significantly add to the existing burden of price increases as this is a direct tax which at many occasions is easier to pass on to the consumers. Similarly, the direction of factor prices is very similar to the previous experiment. However, the magnitude of change is higher.

There is a decline in the export of textile and manufacturing by 16.4 and 5.9 percent, respectively (Table 5). Similarly due to decreased investment levels and a decline in firm income, the imports shown in Table 6 also reflect a decrease in sectors such as cotton yarn, manufacturing and chemicals.

In Table 7 we observe the scenario's impact on household consumption which declines sharply for the farming segment. The worst affected are large- and medium-scale farmers in Sindh whose consumption drops by 22.7 percent. The consumption for landless farm renters decreases by 9.2 percent and that of landless farm workers by 3.2 percent. The increased revenue which now becomes part of government consumption in fact boosts the welfare level of skilled labour in public services, which then leads to the consumption of urban non-poor increasing by 11 percent. This can be explained from the changes in employment where skilled labour working in public services increase by 25.6 percent. The employment of unskilled labour also increases in sectors such as private services, rice, cotton yarn, energy, and construction.

This policy change leads to an almost 14 percent increase in poverty (Table 8) that affects Sindh and Punjab provinces the worst, as their headcount ratio increases by 8.2 and 7.5 percent, respectively. In contrast to the previous experiments, here we observe that poverty also increases in Baluchistan province by 6.9 percent. Finally, the overall inequality level rises by 1.5 percent (Table 9).

5. CONCLUSION AND POLICY RECOMMENDATIONS

This paper provides an *ex ante* assessment of taxation reforms being considered in Pakistan in order to widen the tax base and rationalise the rate structure. Given the inelasticity of taxes in Pakistan, the options to increase government revenue through direct taxes are very limited. The increase in tax revenue in short term is bound to come from indirect taxes. The GST will be the preferred option given its less distortionary nature. A better move would be to convert the existing GST into a full VAT. Our experiments indicate that all options regarding increases in GST rate and the widening of its base will hurt investment and consumption. However, the policy conclusion should then be based on the question: *which option hurts less?*

The following policy conclusions may prove less painful for future tax policy:

Lesson from Sim-A: A differential GST rate may be more equitable. A structure encompassing further reduction in rates for pro-poor consumption items may make the existing GST relatively more progressive. In line with global best practices current regime of GST should be brought closer to VAT in order to lessen economy-wide distortions.

Lesson from Sim-B: Instead of full removal of the zero rating facility, a more prudent approach will be gradual removal that may take the form of: a) introduction of a reduced GST in the beginning, or b) introduction of GST commodity by commodity over a medium-term period. Gradually removing the exemption facility will make the sectoral adjustment in the export-oriented sectors less painful. In case of the exports it may be pointed out here that these sectors have remained protected for almost 3 decades. Such protection or any other form of support should not be without clear deadlines in order to ensure future competitiveness. There are several studies that suggest that keeping these export-oriented sectors protected has in fact led to inefficiencies in their production processes.¹³

Lesson from Sim-C: Public sector services having direct social incidence may be kept tax-exempt. This recommendation is particularly important under the current global economic milieu where rising commodity prices have made it impossible for developing countries to afford social sector and productive infrastructure through their own resources. Similar recommendations has recently been given in Pasha (2011) while discussing the reforms for public sector development program.

Lesson from Sim-D: A flat agriculture tax will be relatively regressive. A basic income threshold may be adopted in order to bring some progressivity in the system. Furthermore there is a need to discuss the structure of agricultural tax with all stakeholders in order to ensure fairness and equity. There is a large farmer community that believes that they are paying high indirect taxes on farm inputs including machinery and seeds. There are some provincial taxes on the movement of agricultural produce. Therefore a country-wide debate should try to bring forward proposals regarding the elimination of multiple taxes within the agriculture sector.

While we understand that all simulations result in a decrease in investment and consumption levels, and an increase in poverty, however government income increases sharply which in turn also increases spending by public sector and wages of skilled labour. It may also be reiterated that a key benefit of such reforms is also to document the vast economic activity that currently lies out of the tax net.

Finally efforts on the administrative front need to be stepped up. The promotion of a payer-friendly tax culture requires the automation of tax filing processes and minimizing the role of public officials. Educating the tax payers to use the on-line filing system can at least temper the perceptions of government revenue collection institutions being corrupt (in turn justifying evasive practices).

¹³ Planning Commission of Pakistan: *Framework for Economic Growth*, Government of Pakistan 2011.

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The Australian GST regime and financial services: How did we get here and where are we going?

Kavita Benedict¹

1. INTRODUCTION

This paper seeks to critically appraise the financial supply provisions as set out in the *A New Tax System (Goods and Services Tax) Act 1999* (Act). The first part of this critique considers the policy intention underlying the taxing treatment of financial supplies and whether it has been properly interpreted and applied by the Courts. Where the policy intention has not been properly interpreted, this paper considers the reasons why this has occurred.

The second part of this critique considers how these issues may be rectified, what options are available for taxing financial services and whether the policy intention adopted by the Australian Commonwealth Government is still the most appropriate policy for the taxing of financial services.

In summary, it is the author's view that the precise drafting of the financial supply provisions has resulted in a literal interpretation of them by the Courts which works against the policy intention. Some observers argue that the legislative provisions can be interpreted in a manner which ensures that the policy intention is achieved. However, to do so arguably requires the Courts to undertake an analysis of context outside the words of the legislation itself. Placing reliance on the judiciary that they will always interpret the provisions appropriately when such a wide contextual analysis is required is fraught with danger. In the author's view, the drafting should therefore be amended to properly deal with this deficiency and put the matter beyond doubt.

Whilst unlikely at this stage and under this government, it is important to review policy intention on an ad-hoc basis to ensure that it is still appropriate. It is the author's view that the current policy intention to input tax financial supplies needs to be critically appraised and alternatives considered which will minimise tax cascading and achieve a more appropriate tax outcome for financial services.

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2. PART ONE: CRITICALLY APPRAISING THE FINANCIAL SUPPLY PROVISIONS – “HOW DID WE GET HERE?”

Before specifically considering the Australian provisions, it is important to place them in their context. Set out below is a brief summary of the problems inherent in taxing financial services under the Act. This provides an appropriate backdrop for understanding why the Australian Commonwealth Government adopted the policy decisions that it did at the time of implementing the Act.

2.1 Problems inherent in taxing financial services under a GST regime

Taxing financial services under a GST regime is inherently difficult and those difficulties are not easily resolved. Australia, like the majority of GST jurisdictions, has chosen to treat financial services as either “input taxed” or “exempt”. However, this approach to taxing financial services has always been viewed as a compromise. It ensures that such transactions are taxed, albeit unsatisfactorily.

Taxing financial services under a GST regime is problematic for two reasons:

- *valuation issues* - how should a financial services transaction be valued for the purposes of determining the GST to be imposed?
- *theoretical concerns*- as a tax on final consumption expenditure, the question arises as to whether GST should be imposed on financial services where such services are inherently “savings” related? Some observers argue that it is more appropriate for financial transactions to be taken out of the GST net altogether and taxed under a separate tax regime specifically devised for financial transactions.

2.1.1 Valuation issues

Much has been written about the valuation issues associated with taxing financial services transactions in a GST system. This material is generally directed at services charged by way of a margin. That margin will typically be calculated by reference to an aggregate of transactions rather than “the transaction” which is the subject of the “financial supply”.

For example, the value added by a bank which provides a deposit facility for the safe storage of money and also lends money is usually calculated on the basis of the interest rate spread between the interest rate imposed on the borrowings less the interest provided for the deposits. This spread is payment for not only the services provided by the bank, but also represents compensation for risk and pure interest payments for the time value of money.² The example below illustrates this issue.

² See Kerrigan, Arthur, “The Elusiveness of Neutrality - Why Is It So Difficult To Apply VAT to Financial Services?”, *International VAT Monitor*, March/April 2010, 103 at 104.

Example:

Bank provides loan of \$100,000 to customer A at 8% p.a.

Bank provides a term deposit facility of \$100,000 to customer B at 6% p.a.

The Bank's interest rate spread is 2% p.a. However, this would need to be apportioned to customer A and customer B in order to determine the value attributable for the purposes of taxing the transactions as taxable supplies. What portion of the margin should be attributed to each customer?

In practice, this scenario is much more complex as this spread must be apportioned across a large customer base.

There is another issue. Even if it were possible to apportion margins between transactors, this valuation process would result in a transparency of the margins under which financial institutions operate not only to the revenue authorities but also to the public at large. This commercial information is highly sensitive and financial institutions have historically been (and still are) very reluctant to perform this difficult task solely for the benefit of the revenue authority. In any event, in a system which does not generally require suppliers to disclose their margins on transactions, it would be contentious to treat financial institutions differently.³

As a result of these valuation issues, many GST jurisdictions choose to exempt financial services charged by way of margin. In this way, these transactions are taxed on their inputs rather than their outputs. Australia is no different in its approach to these transactions. As set out in the Treasury's ("the Treasury") original consultation paper for financial services, the "key guiding principle" for determining what is a "financial supply" is identifying those services "that are normally charged for by way of a margin".⁴

2.1.2 Theoretical concerns

GST is a tax on private consumption expenditure. It is not a tax on savings as savings cannot be consumed at the time of saving, rather they are used for the purposes of consumption at a later stage (that is, savings involve deferred consumption rather than actual consumption). On one view, a significant proportion of financial services relate to savings-related transactions (whether they be by way of deposit savings, investment savings, etc). That is, financial services effectively involve the deferral of consumption rather than consumption of itself.

The problem with financial services is one of characterisation. If they are viewed as transactions associated with savings, and savings cannot be consumed, then they are transactions that cannot be consumed and should therefore be outside the GST net.

³ See Nathoem, Sandhya and Braakman, Ted, "Option for Taxation of Financial Services - it is an Option?", *International VAT Monitor*, March/April 2010, 113 at 115. Refer also Kerrigan, A, *Ibid*, at 105.

⁴ Costello P, *The Application of Goods and Services Tax to Financial Services*, Commonwealth Treasury, August 1999.

This is an important concept to understand. If savings are taxed both at the time of undertaking the savings transaction and then again when those savings are used for the purposes of purchasing goods and services, double taxation will arise.⁵

However, there is a distinction to be drawn between the transaction dealing with the savings (whether it be by way of monetary deposit, loan, exchange of currency, margin lending etc) and the services that facilitate that transaction. Whilst the former should not be taxed under a GST, the latter should be taxed on the basis that they are services consumed by the customer similar to any other services provided.⁶

This paper therefore proceeds on the basis that it is preferable to tax financial services under a consumption tax on the basis that the tax should be imposed on the services that facilitate the financial transaction and not the underlying financial transaction itself.

2.2 Australia's approach to taxing financial services under a GST regime

The majority of jurisdictions choose to tax financial services by way of "exemption", or "input taxation". Input taxation means that the "supplier" of the financial service is not required to pay GST on the provision of the service, but is unable to claim input tax credits for acquisitions associated with making that supply. Hence the term "input taxation" refers to the taxation of the "inputs" rather than the "outputs" (as is the normal position for taxable supplies). It is worth considering the Australian financial services provisions before undertaking a critical appraisal of those provisions.

The first point to note is that the financial supply provisions are not found in the body of the legislation. Instead, they are set out in the regulations, *A New Tax System (Goods and Services Tax) Regulations 1999* (Regulations). The reason for this is political more than anything else. At the time the legislation was introduced, a decision as to which financial services would be input taxed was yet to be made. As a result, the legislation was introduced with a reference to appropriate provisions being contained in the Regulations. This gave Treasury further time to seek industry consultation in composing the financial supply provisions.

Financial supplies are defined under the Regulations to include "incidental" supplies to those financial supplies. The main operative provision is regulation 40-5.09 which sets out the relevant criteria for a financial supply and lists the relevant "interests" which can give rise to a financial supply. Subregulation 40-5.09(1) states as follows:

“(1) The provision, acquisition or disposal of an interest mentioned in subregulation (3) or (4) is a financial supply if:

(a) the provision, acquisition or disposal is:

- (i) for consideration; and*
- (ii) in the course or furtherance of an enterprise; and*

⁵ See White, David and Pallot, Marie, "Improvements to the GST Treatment of Financial Services - The Proposed New Zealand Approach", *VAT Monitor*, November/December 2002, 481.

⁶ See Burns, Professor Lee, "Consumption Taxation of Supplies of Financial Services in the Asia-Pacific Region", *Asia-Pacific Tax Bulletin*, September/October 2008, 352.

- (iii) *connected with Australia; and*
- (b) *the supplier is:*
- (i) *registered or required to be registered; and*
- (ii) *a financial supply provider in relation to supply of the interest.”*

The Australian provisions are very precise in the way that they describe a financial supply. The Australian provisions require that there be a provision, acquisition or disposal of an “interest”. “Interest” is defined in regulation 40-5.02 as:

“anything that is recognised at law or in equity as property in any form.”

There must therefore be a provision, acquisition or disposal of a *proprietary* interest as set out in regulation 40-5.09(3) in order for a financial supply to be made.

Financial supplies can only be made by “financial supply providers” and hence the making of a financial supply is both attached to the characteristics or activities of a particular entity as well as the particular transaction itself. Introducing the term “financial supply provider” serves to narrow the scope of who can make financial supplies. A “financial supply provider” is defined in regulation 40-5.06 as follows:

“(1) An entity, in relation to the supply of an interest that was:

- (a) *immediately before the supply, the property of the entity; or*
- (b) *created by the entity in making the supply;*

is the financial supply provider of the interest....

(2) The entity that acquires that interest is also the financial supply provider of the interest”.

The Australian provisions also include the acquirer of an “interest” as a “financial supply provider” (as set out in subregulation 40-5.06(2)). The effect is to include the acquisition of an “interest” as a “financial supply”. Whilst this position is highly unusual, it is a consequence of the section 11-15 definition of “creditable purpose” which prescribes when entities are entitled to claim input tax credits.

Section 11-15 has a positive limb and a negative limb. An entity makes an acquisition for a “creditable purpose” where:

- it is acquired in carrying on the enterprise; and
- it does not relate to making supplies that would be input taxed and the acquisition is not of a private or domestic nature.

This differs from the European VAT jurisdictions where the equivalent creditable purpose test is linked to the making of “taxable supplies” and hence there would be no entitlement to an input tax credit unless it was acquired for making taxable supplies. Without the “acquisition-supply” concept, entities would be able to claim input tax credits for acquisitions associated with acquiring financial services. This would be contrary to the policy intention.

Finally, excluded from the term “financial supply providers” are those entities that arrange or facilitate financial transactions (such as brokers, merchant bankers etc). As a result, these arrangers and facilitators will always make taxable supplies to financial supply providers. Whilst this serves to narrow the class of supplies which may be defined as “financial supplies”, it perversely encourages tax cascading.

Subregulation 40-5.09(3) sets out the relevant proprietary interests which can be the subject of a financial supply. These can be summarised as follows:

- bank accounts made available by an Australian Authorised Deposit-taking Institution;
- debt or credit arrangements (eg loans);
- charges or mortgages over property;
- superannuation funds;
- annuities or allocated pensions;
- life insurance;
- guarantees (including indemnities);
- credit provided under a hire purchase arrangement;
- currency transactions;
- securities; and
- derivatives.

This list is fairly prescriptive rather than principle based. A principle based approach would focus on a series of over-arching principles with potential carve out provisions for certain supplies (eg. intermediaries). Whilst the prescriptive approach provides a level of accuracy, it can be disadvantageous in its precision as it becomes too difficult to include additional items without further amendment. The principle based approach, on the other hand, relies on an appropriate interpretation of the principles in order to apply the law. To the extent that there is a reliance on interpretation, this approach can provide less certainty and potentially less consistency. However, it does allow for flexibility in terms of the ability for items to be included or excluded as times and context changes. The present preference is for provisions to be drafted using a principle based approach, for example, the new Division 81 provisions.

In the financial services context, the prescriptive approach is supported by the lists of examples contained in the schedules to the Regulations. The list of financial supplies included is fairly standard and arguably narrower than other jurisdictions where services such as general insurance are also included. This narrow definition is in part possible due to the operation of the reduced input tax credit regime (which is discussed in further detail below).

There are a number of mechanisms to be aware of when considering the Australian financial supply provisions. A summary of these mechanisms is set out below:

- a. the de-minimis threshold - this threshold excludes input taxed treatment where the acquisitions involved in making the financial supplies are less than the specified threshold.

Referred to as the “Financial Acquisitions Threshold” (FAT), the threshold is designed to exclude those entities whose financial activities are incidental to the running of a non-financial services business (eg. IPOs, share acquisitions etc). However, in the author's view this purpose is not achieved because the current threshold limit is too low. Treasury proposes to rectify this failing by increasing the threshold.

- b. the exclusion of borrowing costs for those businesses otherwise involved in taxable activities - without this provision, entities could be subject to input taxation as a result of their borrowing activities. Excluding these borrowing activities where the entity makes otherwise taxable supplies is appropriate in order to ensure that input tax treatment is applied to a narrow class of supplies.
- c. the inclusion of a “reduced input tax regime” (RITC) to decrease the self-supply bias that would otherwise arise as a result of input taxation – “self supply bias” refers to the incentive that exists for financial supply providers to bring certain services “in house” rather than outsource those services due to the increased GST cost associated with outsourcing. Considering the effect of input taxation in isolation without taking into account other market factors, the increased cost of using external resources (as a result of the denial of input tax credits on inputs) can result in a bias towards hiring employees to provide such services internally. Whilst there are still costs in hiring staff, it is generally accepted that internal hiring would result in a saving when compared to using external resources where no input tax credit is available.

At the time of the introduction of the GST, credit unions and other small financial institutions viewed the input taxation of financial services as providing a further advantage to the larger financial institutions who had the size and the capacity to bring services in-house in order to reduce the GST cost. Credit unions and smaller financial institutions therefore considered that they would be disadvantaged with the introduction of the GST.

The RITC was introduced in order to put credit unions and smaller financial institutions on the same level playing field as the large financial service providers. The RITC regime operates by allowing financial supply providers to claim an RITC equal to 75% of the GST payable for certain listed services.

- d. the inclusion of a reverse charge mechanism to eliminate the competitive advantage that offshore providers of outsourced services would otherwise have - the reverse charge mechanism operates by self-imposing GST on the recipient of the outsourced service where that recipient would not have been entitled to claim a full input tax credit had the service been treated as “taxable”. Whilst GST is imposed, there is a separate RITC list for these offshore outsourced services so that the GST cost of acquiring these outsourced services is equal to the onshore treatment (ie. 25%).

The above paragraphs have provided a basic summary of the operation of the financial supply provisions. The discussion below considers whether these provisions have been interpreted in a manner which is consistent with the policy intention.

2.3 Have the Australian provisions achieved their stated policy intention?

The stated intention of the Australian financial supply provisions was fairly clear: tax a narrow group of financial *services* that were charged by way of margin through input taxation.⁷ Whilst the stated intention was clear, recent case law shows that the judiciary have been unable to agree as to the proper interpretation of the financial supply provisions.

In the author's view the reason for this disagreement lies in the drafting method adopted for the provisions which fail to properly identify what is in fact being taxed. As previously stated, it is not the intention of the provisions to tax the underlying financial transactions themselves, rather the aim is to tax the *services* which facilitate those transactions.

The plain meaning of the words of the current legislative provisions invite an interpretation that is so precise that it results in the taxing of the underlying transaction itself rather than the services that facilitate that transaction. In some scenarios, this interpretation will still achieve the desired result. However, in other circumstances (consider *Travellex* discussed below), the result is completely contrary to policy intention.

This leaves the taxpayer and the Commissioner of Taxation (Commissioner) vulnerable to the vagaries of interpretation by the judiciary who may or may not take an interest in the underlying theory of the tax. Where they don't and rely on the plain meaning of the words, there is the scope for the incorrect interpretation to be applied. To require the judiciary to undertake a detailed contextual analysis of the provisions and underlying theory of the tax is nonsense for it isn't their place and shouldn't be required. The plain meaning of the words should invite the appropriate interpretation.

Clearly, in a financial supply context, proprietary interests in financial assets are transferred. Accordingly, it is not wholly inappropriate for the definition to embrace the transfer (by the provision, acquisition or disposal) of such interests. However, where a literal interpretation of the wording is adopted, the current focus on this transfer is at the expense of the underlying purpose of a GST, namely to tax consumption expenditure: what is consumed in a financial services context is not the interests themselves but rather the services that facilitate their exchange.⁸ Prebble and Schalkwyk highlight this issue very succinctly in the following extract:

“There is no generally accepted definition of financial services for VAT purposes. The Concise Oxford (English) Dictionary definition is too wide to be useful. All jurisdictions have opted for a descriptive definition of financial services rather than a principle-based definition. There is an initial problem of language and syntax. One may speak, for instance, about taxing the exchange of currency, but that expression is not accurate. It is not the exchange of currency

⁷ Costello, P, *Ibid*.

⁸ Prebble, Professor John and Schalkwyk, Sybrand van, “Value Added Tax and Financial Services”, *Asia-Pacific Tax Bulletin*, September/October 2004, 363 at 364.

itself that is taxed but services that enable currency to be exchanged, usually on behalf of someone else. Similarly, the subject matter of these articles does not include “the exchange of cheques” but services that lead to, that promote, or that enable the exchange of cheques. There is no concise and elegant way of referring to this sort of service. These articles opt to solve this linguistic problem by referring to, for instance, “services that bring about the exchange of currency” or “services connected with the drawing of cheques” or “services bringing about debt”, and so on. While awkward, such expressions have the merit of accuracy.”

The Australian provisions do not refer to “services” in the financial supply definition but rather refer to the actual financial transaction itself. For example, “the provision, acquisition or disposal of an interest in or under Australian currency”. Whilst the understanding should be that the services which facilitate the exchange of currency are the subject matter for input taxation, the interpretation of these provisions in recent case law demonstrates that the Courts have not interpreted the provisions in this way (refer discussion below). The drafting of the provisions certainly invites this interpretation and hence it is no surprise that the Courts have taken this approach.

To illustrate this point, I examine below two recent cases that considered the financial supply provisions, *Travelex Ltd v Commissioner of Taxation*⁹ (*Travelex*) and *Commissioner of Taxation v American Express Wholesale Currency Services Pty Limited*¹⁰ (*Amex*). The analysis below is intended to highlight the clear divide in the interpretation of these provisions.

2.3.1 *Travelex*

Travelex involved a simple exchange of foreign currency at the international airport. The customer purchased 400 Fijian dollars and sold the equivalent in Australian dollars. *Travelex* charged a commission of \$8 for these services. The customer took the Fijian dollars overseas and spent these dollars whilst overseas.

It was accepted in the case that the supply made by *Travelex* to the customer was properly characterised as a financial supply. The question that arose was whether pursuant to s9-30(3) of the Act, the GST-free export provisions (known as “zero-rating” in other jurisdictions) over-rode that prima facie input tax treatment. The relevant GST-free provision was Item 4 of s38-190(1) of the Act which states that the following supplies are GST-free:

“a supply that is made in relation to rights if:

(a) the rights are for use outside Australia; or

(b) the supply is to an entity that is not an Australian resident and is outside Australia when the thing supplied is done.”

Travelex argued that the supply it made related to the rights attached to the Fijian dollars and those Fijian dollars were acquired for use overseas. Ipso facto, the supply made by *Travelex* was in relation to rights for use overseas.

⁹ *Travelex Ltd v Commissioner of Taxation* [2010] HCA 33

¹⁰ *American Express Wholesale Currency Services Pty Limited* [2010] FCAFC 122

In considering the characterisation of the supply made by Travelex, French CJ and Hayne (who were in the majority) made the following comments:

“4. Although the determinative issue in the appeal depends upon the construction and application of Div 38 (and, in particular, s 38-190(1))[4], it is important to begin by examining why the sale of foreign currency constitutes a supply. That examination shows that there is a supply because there is a transfer of ownership, the subject of which is money. Both of those observations are important in deciding the central question in the appeal: whether there is a supply “in relation to” rights.

5. The chain of provisions engaged in this matter is very long. It is desirable, therefore, to identify important links in that chain. When Travelex sells foreign currency, there is a species of what the Act refers to as a “supply”. There is a “supply” because the sale of foreign currency is a “financial supply”. There is a “financial supply” because there is a disposal (by Travelex) of an interest in the currency of a foreign country..”¹¹

That is, there is a financial supply because there is a transfer of ownership in the currency not because there is the provision of services which facilitate the transfer of ownership of that currency. For the purposes of characterisation, their Honours focused on the transfer of ownership of the money. It is this transfer that their Honours viewed as the relevant “financial supply” under the Act. This follows from the definition of financial supply attaching to proprietary interests.

The problem here is that when such a characterisation of the supply is adopted, the “supply” which becomes the subject matter of the provisions is the transfer itself rather than the services that facilitate that transfer. Whilst it can follow that the services which facilitate the exchange may also be included within the definition (not the least by the result of the incidental financial supply provisions) this was not considered in *Travelex*. Even if it had been considered, the subject matter of the supply would still have been the transfer of ownership rather than the incidental services. Hence, the GST-free provisions would still have been available for application. The case demonstrates that the present drafting of the provisions invite an interpretation which over-emphasises the importance of “proprietary interests” at the expense of the underlying services that are intended to be taxed.¹²

Once this characterisation is accepted, it is only a small leap to also characterise the supply as a GST-free supply under Item 4 of s38-190(1). This follows from the fact that the proprietary interests being transferred can be characterised as “rights” (given

¹¹ *Travelex*, Ibid, at paragraphs 4 and 5.

¹² Heydon J’s judgement in *Travelex* (also part of the majority) echoes this approach (at paragraph 45): “45. When Mr Urquhart acquired the currency from Travelex, he acquired an interest in property (namely ownership of those statutory rights of action and negotiation). That interest in property was identical with, evidenced by, and not capable of disaggregation from, an “interest in or under ... the currency of a foreign country”: reg 40-5.09(3)[31]. To acquire an interest in the currency was to acquire an interest in the intangible rights connected with it, and vice versa. Hence what was acquired was an interest within the meaning of reg 40-5.09(3). The acquisition was therefore a “financial supply” within the meaning of reg 40-5.09(1) and ss 40-5(2) and 195-1 of the Act. It was thus a “supply” within the meaning of s 9-10(2)(f)[32] and the parties’ agreement in relation to the third question was correct.”

the wide and undefined concept of rights in the Act) and these rights were for use outside Australia. This was the conclusion reached by the majority in *Travellex*.

Yet, with respect, this conclusion is inconsistent with the core principles of a GST regime, including Australia's version. The exchange of foreign currency cannot be consumed of itself, and hence, that exchange remains outside the GST net. However, the services that facilitate that exchange are consumed by the customer and should be taxed.¹³ The following comments from Prebble and Schalkwyk succinctly put forward the argument:

“Services that bring about the exchange of currency require services that enable an exchange of currency to take place. The exchange of currency itself, on the other hand, refers only to the actual giving of one currency for another.

Exchanges of currency can be likened to transactions where goods are sold. The price of the good always represents the value of the good together with the services required to get the good in a saleable position. Where the exchange of currency is concerned, the phrase “exchange of currency” refers to the part of the transaction where one good is exchanged for another. It does not include any charges for services rendered that make the exchange possible. Confusion may arise if this distinction is not maintained.

... services that bring about the exchange of currency should be taxed under a broad based VAT. The actual exchange of currency itself cannot be taxed, because there is nothing to tax. No value has been added because the transaction is a mere exchange of one commodity for another. It follows that this exchange should remain outside the grasp of a VAT.”

In the case of *Travellex*, the services that facilitated the exchange were consumed by the customer in Australia at the international airport. They were not consumed whilst the customer was overseas. As a result, the consumption took place in Australia and the services should be taxed in Australia. The focus on proprietary interests invites an analysis of the transaction itself rather than the services that facilitate that transaction.

To illustrate the differences in interpretation, five of the nine Federal and High Court judges who considered the *Travellex* case concluded in favour of the taxpayer. The other four concluded in favour of the Commissioner. The High Court minority, in particular, arrived at their conclusion on the basis of a consideration of context in order to properly interpret the meaning of the words in the provisions. This begs the question as to what extent judges should be required to understand context in order to interpret taxing provisions where the plain meaning of the words invite an alternative interpretation.

Justice Tony Pagone of the Victorian Supreme Court recently delivered a paper in which he expressed a sanguine view on judicial interpretation of tax laws. The below extract from this paper is relevant to the present discussion:

“...there is a general approach to legislation that its terms should be understood by an ordinary reader and not one versed in a special field of

¹³ Sydrand van Schalkwyk and Professor John Prebble, “Imposing Value Added Tax on the Exchange of Currency”, *Asia-Pacific Tax Bulletin*, 469 at 470.

knowledge or discipline: the words used should carry their ordinary meaning unless there is a clear intention shown otherwise... The judge interpreting tax law finds refuge not in the underlying discipline which the legislation may seek to express but in the words themselves...

"The purposive construction of all legislation requires judges to give effect to the underlying objectives which legislation seeks to achieve. Legislation drafted to give effect to economic concepts is no exception. The problem is not a lack of legislative direction but that judges do not have the training, background or resources to implement legislation as an economist, accountant or person of commerce would require. There is also a fundamental concern about how judges should act upon economic concepts. Such concepts are traditionally treated as matters of evidence to be given by experts whose evidence is subject to testing through cross-examination. The idea that a judge should apply some personally held view of economics, accounting or commerce may be inconsistent with the judge's role as independent (non-partisan) interpreter of legal text enacted by parliament in ordinary language."¹⁴

We cannot, and should not, expect the judiciary to interpret taxing provisions according to the economic precepts underlying the legislation if the plain meaning of the words suggest an alternative construction for which an ordinary person would be entitled to conclude. Where there are problems in the drafting of the provisions, these should be corrected by parliament rather than relying on a purposive construction of the provisions to be applied by the Courts (which may not always be forthcoming).

2.3.2 Amex

This case involved the interpretation and application of the apportionment methodology used by Amex (specifically American Express Wholesale Currency Services Pty Limited) to claim input tax credits for expenditure associated with the provision of credit cards and charge cards.

The apportionment methodology adopted by Amex (and accepted by the Commissioner) was based on revenue using the following formula:

$$1 - \frac{[\text{revenue derived from input taxed supplies}]}{\text{total revenue}} \times 100$$

As a result, to the extent that Amex's revenue was not derived from input taxed supplies, the denominator would be increased, thereby increasing the apportionment percentage which could be used to claim input tax credits.

The question that arose was whether the revenue derived by Amex in the form of late payment fees on credit cards and charge cards was "revenue derived from input taxed supplies". Although the terminology used was "revenue" (a term not defined in the Act), the case initially proceeded on the basis of whether the late payment fees received by Amex for credit cards and charge cards were consideration for the making

¹⁴ Hon Justice Tony Pagone, "Some problems in legislating for economic concepts — a judicial perspective", paper delivered at Treasury on 2 December 2010 as part of the Revenue Group seminar series, 39 at 41 and 46.

of input taxed supplies. However, the case was ultimately decided by the majority on the basis of whether the late payment fees were “revenue derived from input taxed supplies” in accordance with the agreed apportionment methodology. For the purpose of this analysis, this paper has focused on the initial argument regarding the nexus between the consideration received by Amex and the making of input taxed supplies.

In examining regulation 40-5.09 and in particular the application of item 2 of subregulation 40-5.09(3), Dowsett J (in the minority) interpreted the provisions similarly to the majority in *Travellex*. That is, in terms of whether or not there had been a supply of a proprietary interest. However, Dowsett J went slightly further than the majority in *Travellex*. He considered in detail, what “property at law” should be understood to mean in a GST context. In this regard, Dowsett J made the following comments:

*“39. The terms upon which American Express issues cards are identified in the joint reasons and in the primary Judge’s reasons. American Express provides the cardholder with a card. The cardholder is thereafter, in effect, able to pledge American Express’s credit with suppliers. The suppliers look to American Express for payment, and American Express requires cardholders to pay to it the amounts incurred for purchases, such payments to be made at fixed times. These rights and obligations seem generally to be personal rather than proprietary. Certainly, nothing supplied to the cardholder is capable of being assigned, and the relevant arrangements are determinable at will. The American Express facilities are no doubt quite complex. To the extent that they are capable of being “owned”, the owner is, presumably, American Express. A cardholder acquires no interest in them, but rather a contractual right to utilize their services. As I have said, the right is determinable by American Express at will and cannot be assigned. Such circumstances led the High Court in *Toohy* to conclude that the grazing licence did not comprise property. Whilst a cardholder has access to the facility, he or she does not control access to it.*

*40. A cardholder acquires possession, but not ownership of a card. No doubt the cardholder is a bailee. A bailee is said to have “special property” in the property bailed. Academic writers have asserted that a bailee’s rights are of a proprietary nature. See George W Paton’s *Bailment in the Common Law* (1952, Stevens & Sons Ltd, London) at 30. However, at 17-18, the author notes the decision in *The Odessa* [1916] 1 AC 145 at 158-9, where Lord Mersey, in giving the advice of the Judicial Committee of the Privy Council, said:*

‘But when the nature of the right of a pledgee to sell is examined it will be seen that the so-called “special” property which it is said to create is in truth no property at all. This has been recognized by many Judges who have used the expression “special interest” as a substitute for “special property”’

Dowsett J concluded that the provision of the credit and charge cards by Amex did not give rise to the provision of a proprietary interest as required under regulation 40-5.02 and hence did not give rise to a financial supply. This view is on its face surprising

given that the provision of credit and charge card facilities was clearly within the ambit of the financial supplies definition as originally conceived.¹⁵

However, Dowsett J concluded otherwise based on the plain meaning of the wording of the provisions and, certainly, the wording of the provisions invite the interpretation favoured by his Honour. In reaching his conclusion, Dowsett J was under no illusion that his interpretation was contrary to the intention of the drafters. However, as he aptly stated, where the plain meaning of the words suggest one meaning, such an interpretation should not be overridden as a result of an apparent legislative intention to tax otherwise. His comments on this issue are included in full below as these are particularly relevant in the context of this paper:

“47. If there is no provision, acquisition or disposal of an interest (ie legal or equitable property) in or under any item in the Table in reg 40-5.09, then there can be no financial supply pursuant to that regulation. However the Commissioner submits that such an approach deprives Item 2 of the Table of any function and has a similar effect upon Items 2 and 3 of the Schedule. In my view s 15AD of the Acts Interpretation Act excludes the use of Sch 7 to expand the operation of Div 40. The section contemplates the possibility of a conflict between a substantive provision and examples of its operation. It directs that the substantive provision should prevail. The Commissioner seems to submit as follows:

- *Items 2 and 3 in the schedule are examples of a credit arrangement or right to credit for the purposes of reg 40-5.09;*
- *the American Express charge and credit card facilities are capable of being described in the terms used in those items;*
- *therefore the American Express charge and credit card systems are credit card arrangements or rights to credit; and*
- *therefore, they are financial supplies.*

48. This approach overlooks two aspects, namely:

- *the operation of s 15AD of the Acts Interpretation Act; and*
- *the requirement that a financial supply be of an interest, ie legal or equitable property in or under a debt, credit arrangement or right to credit.*

49. In looking to the examples for guidance as to whether there is a financial supply, the Commissioner fails to observe the requirement contained in s 15AD of the Acts Interpretation Act. That section requires that primacy be given to Div 40. Further, regs 40-5.02 and 40-5.09 require that there be a provision, acquisition or disposal of legal or equitable property. The American Express facility, however it may be named, does not satisfy that requirement. It is no answer to say that such an approach renders the examples otiose. That is the effect of s 15AD. In any event, there may be other credit card systems which

¹⁵ Costello P, *Ibid.*

involve the supply of interests in property. It seems that the regulation-maker contemplated such an arrangement. The proper question is whether the American Express facility falls within Item 2 in the Table. The question is not whether it is capable of being described in terms of Items 1 and 2 of the Schedule.”

Dowsett J's judgement supports the concerns highlighted in this paper regarding the present drafting of the provisions. His Honour also raises a further issue regarding the weight which can be attached to the examples included in the schedules to the Regulations.

Of course, Dowsett J was in the minority in *Amex*. Kenny and Middleton J (in the majority) interpreted the meaning of “property” in a broad manner based on the context of the Act and specifically the meaning of “real property” in the Act. Yet, the difference between the concept of “real property” as used in other sections of the Act and “property” as used in the financial supply provisions is that the latter specifically refers to “property at law or in equity” whereas the former defines property in an expansive manner without reference to its definition at law or in equity.

In any event, whilst the majority in *Amex* accepted that there was a proprietary interest capable of transfer in the charge and credit card circumstances, they essentially undertook the analysis of what is a financial supply by reference to whether or not it involved the provision of such a “proprietary interest”. In this way, the focus remained on the underlying transaction itself as opposed to the services that facilitated that transaction.

3. PART TWO: CONSIDERING THE CHANGES THAT CAN BE MADE AND SHOULD BE MADE – “WHERE ARE WE GOING?”

This part of the paper considers ways in which the provisions could be amended in order to ensure that the stated policy intention is applied. Further, this part of the paper also considers whether the current policy intention for the taxing of financial supplies remains appropriate.

Treasury released a consultation paper in 2009 regarding a proposed redraft of the financial supply provisions.¹⁶ Unfortunately this consultation paper did not progress and none of the proposals were in fact implemented. However, a review of Treasury's proposed reforms does provide an insight into the government's present reluctance to deal with the fundamental problem with these provisions.

The options proposed were as follows:

- *Replace existing legislative framework with a principle or set of principles* - there was a suggestion made that these principles could involve a carve out for financial supplies where an explicit fee was charged (similar to South Africa). Notably whilst proposed drafting options were provided, 2 of the 3 drafting options did not involve a move away from the proprietary interest concept. The third involved a link to the income tax regime concept of “financial arrangements”;

¹⁶ Commonwealth Treasury, “Consultation Paper on the Review of the Financial Supply Provisions”, May 2009.

- *Amend existing law* - this option simply involved the implementation of minor changes to deal with specific issues (raised by industry bodies, practitioners or court cases) rather than a complete redraft; and
- *Extent of eligible reduced credit acquisitions and rate of RITC* - this option was specific to the RITC regime and not relevant to the present discussion.

As already discussed, financial transactions are input taxed in order to deal with the valuation issues associated with services charged by way of margin. In fact, the original intention of the operation of the financial supply provisions in Australia was that they apply to only those services charged by way of margin.¹⁷

Treasury's proposal to treat as taxable those financial services for which the provider charges an explicit fee has merit in this context. The assumption to be made for these services is that the consideration received for the provision of these services is encapsulated in the explicit fee charged and hence can be valued appropriately for the purposes of taxable treatment.

Whilst this assumption may not always be true (for example, the consideration for a financial service could have both an explicit fee based component as well as a margin-based component), where there is an explicit fee charged, the assumption would need to be made that the consideration received for the service would be proximate to the explicit fee charged.

It may be appropriate to include provisions which ensure that the explicit fee is more than simply a nominal amount (such as \$1) and does fairly and reasonably reflect the consideration for the supply. However, this leads the discussion back to complex valuation issues as to what should be the consideration for the particular financial services. It should be noted that South Africa does set out any such valuation rules in its provisions.

One of the main criticisms of the explicit fee based approach is the potential for product substitution such that financial products are redesigned to provide for explicit based fees. Whilst this risk exists, it is difficult to determine the extent to which substitution would pose a risk to revenue as there has been little empirical research done in the area.¹⁸ Without empirical data, it is difficult to comment on the likelihood of substitution. Given the current market competitiveness in the industry as well as the intense media and government scrutiny, it would not be unreasonable to assume that substitution would be difficult unless other commercial factors existed to make it viable.

Other than the explicit fee proposal, it is the author's view that the options proposed by Treasury do not address the real problem. Perhaps this is because Treasury does not accept that the provisions themselves invite two different interpretations and that Treasury should not rely on the Courts being able to decipher which is the correct/intended interpretation. What is required is a clarification of the law by way of redrafting of the provisions to ensure that it is clear that it is the "services" that are being taxed not the underlying transaction.

¹⁷ Costello P, Ibid.

¹⁸ Refer Burns, Ibid.

Possible solutions could include that the words “services connected with” or “services that bring about” be included within the provisions to put the policy intention beyond doubt. For example, the provisions could read:

“services connected with the provision, acquisition or disposal of an interest..”

It would need to be ensured that such drafting does not have unintended consequences. For example, this could lead to an approach where a financial supply was interpreted as having two components: one the underlying transaction and the other the actual services facilitating the transaction. Whilst the latter would be input taxed, it may be the case that the former could still be open to the current literal interpretation (for example, the foreign currency exchange could still be treated as GST-free similar to the *Travellex* reasoning). The issue would then become one of valuation and apportionment. To what extent do the particular acquisitions relate to making the input taxed component and to what extent do the particular acquisitions relate to making the GST-free component?

The answer to this would be to move away from “interests” altogether, such that the drafting could read as follows:

“services connected with the provision or acquisition of the following activities”.

Moving to this approach would mean that the current precision in which financial supplies are defined would be compromised. However, the wording may lend itself to a literal interpretation that better accords with policy intention. That raises the question as to whether the current policy intention is still appropriate.

3.1 Is the policy intention still appropriate?

Some would say that input taxation achieves an appropriate taxing position for financial services: recipients do not pay an additional amount on account of GST for the financial services and any embedded GST is essentially charged at a lower statutory rate than would otherwise apply had the services been taxable. Yet is the cascading of embedded tax really satisfactory if there are other mechanisms which can be put in place to better deal with the taxing of financial services?

Tax cascading is an obvious consequence of input taxing financial services. Subject to market conditions, financial supply providers will generally pass on the GST cost from input tax treatment to other businesses and end consumers. Even where those businesses are registered for GST, they are unable to claim an input tax credit for the embedded GST passed on by the financial supply provider as they have not acquired a taxable supply.

Those registered businesses in turn typically increase their prices to their customers to take account of this increased cost. Their customers then essentially pay a double GST impost: the GST included on the actual supply (note this GST is calculated on the increased price as a result of the embedded GST on-cost) as well as the GST passed on from the financial supply provider.

The embedded GST essentially cascades through the supply chain until it is ultimately paid by the end consumer. Tax cascading is essentially “over-taxation” and results in an increased cost to the provision of financial services when compared to the supply of other goods and services.¹⁹ In fact recent studies in the European Union suggest that tax cascading through business to business (B2B) financial services transactions results in an increase in prices through the supply chain of up to 4%.²⁰

This should be compared to the situation with business to consumer (B2C) transactions where the input taxation of these transactions actually reduces the cost of financial services to end consumers. Any passing on of embedded tax would be less than the value added by the financial supply provider and hence the statutory rate of taxation of these supplies would be less than that applicable to taxable supplies.²¹ The result is a scenario where input taxation can work in a B2C context but causes real tax cascading in B2B transactions.

Tax cascading as a result of input taxation is not unique to the GST taxing regime. There are plenty of examples of tax cascading in the Australian tax system which typically arise due to the significant number of taxes imposed. For example, tax cascading occurs in the stamp duty context where stamp duty is levied on the GST-inclusive value of the transaction. Tax cascading also occurs indirectly in a pay-roll tax context where the additional cost of pay-roll tax will be factored into the pricing structure of the supplies made by the employer organisation in order to deal with this additional cost. However, whilst there are other instances of tax cascading that does not mean that tax cascading within the GST system should be accepted if there are viable means in which to eliminate that cascading.

In New Zealand, certain B2B financial supply transactions are zero-rated. The New Zealand B2B zero-rating rules are fairly complex and therefore are elective rather than mandatory. The relevant New Zealand provision (section 11A(1)) states as follows:

“ A supply of services that is chargeable with tax under section 8 must be charged at the rate of 0% in the following situations...

(q) the services are financial services that are supplied in respect of a taxable period, by a registered person who has made an election under section 20F, to a registered person who makes supplies of goods and services such that taxable supplies that are not charged with tax at the rate of 0% under this paragraph or under paragraph (r) make up not less than 75% of the total value of the supplies in respect of—

(i) a 12-month period that includes the taxable period; or

(ii) a period acceptable to the Commissioner; or

¹⁹ Burns, *Ibid*, at 353.

²⁰ Borselli, Fabrizio, “A Sensible Reform of the EU VAT Regime for Financial Services”, *International VAT Monitor*, September/October 2009 375 at 378 quoting a study undertaken by PricewaterhouseCoopers for the European Commission in November 2006.

²¹ Poddar, Satya, “Consumption Taxes: The role of the Value-Added Tax”, chapter 12 in *Taxation of Financial Intermediation: Theory and Practice for Emerging Economies*, Honohan, Patrick (ed), World Bank and Oxford University Press, 2003.

(r) the services are financial services that are supplied in respect of a taxable period, by a registered person who has made an election under section 20F, to a person who is a member of a group of companies for the purposes of section IA 6 of the Income Tax Act 2007 and—

(i) the members of the group make supplies of goods and services to persons who are not members of the group in respect of—

(A) a 12-month period that includes the taxable period; or

(B) a period acceptable to the Commissioner; and

(ii) not less than 75% of the total value of the supplies referred to in subparagraph (i) consists of taxable supplies that are not charged with tax at the rate of 0% under this paragraph or under paragraph (q).”²²

The provisions are relatively onerous on the financial supply provider. The service provider must determine not only the registration status of the customer but also the extent to which that customer makes taxable supplies in a twelve-month period. However, under section 20E the provider is allowed to rely on data provided by the customer to determine the percentage of taxable supplies made.

The provisions exclude zero-rating treatment for B2B transactions made between financial institutions. The rationale here was the fear that where there were no further B2B transactions in the supply chain, the transaction would essentially not be taxed. Obviously, it could also be argued that where there were further B2B transactions in the supply chain, tax cascading would continue to occur.

If the aim is to achieve a method of taxing financial services that is both fair and efficient, then zero-rating of B2B transactions should be considered. It effectively achieves what would otherwise occur if the financial transactions were treated as taxable, ie. output tax would equal input tax and hence the transaction would be revenue neutral. If no revenue would otherwise have been received by the government had taxable treatment been adopted, then that status quo needs to be maintained in a financial services context.

Of course, the impetus for such radical change is unlikely to come from government as the implementation of such provisions would result in a marked decrease in tax revenue. A country such as New Zealand has a history of being able to pragmatically and practically deal with tax issues. Australia does not have such a history. In fact, Australia's tax legislation is renowned for its complexity and technicality both in interpretation and application. Nevertheless, tax purists can only hope that radical change will be forced upon the government at some point in the future. At the very least, the zero-rating option should be entertained in order to determine whether the approach would be viable and efficient whilst achieving the rare qualities of fairness and simplicity.

²² Goods and Services Tax Act 1985 (NZ).

4. CONCLUSION

The underlying policy intention for the taxing of financial services under the Australian GST regime was to treat as input taxed those financial *services* which are charged by way of margin. Although the provisions have been drafted in a very precise manner, they invite an interpretation which leads to the incorrect taxing treatment.

Rather than rely on judicial interpretation that takes into account the appropriate context, the provisions should be redrafted in order to provide certainty and consistency. In that regard, it should be ensured that there is no doubt that what is being taxed is the “service” that facilitates the financial transaction rather than the underlying financial transaction itself.

Excluding explicit based fees is also consistent with this approach and the original policy intention. As a result, it is a proposal that needs to be seriously considered in undertaking any redraft. However, further consideration needs to be given to the option of zero-rating or treating as “GST-free” certain B2B financial supply transactions. Whilst this would, in the short term, lead to a decrease in revenue for the government, it may, in the long term provide for a more simpler, efficient and fairer imposition of tax on financial services.

Financial supplies: Bundling & unbundling

Ross Stitt¹

1. INTRODUCTION

The focus of this paper is on Australia's unique 'reduced input tax credit' system and, in particular, the implications of 'bundling' within that system. Bundling is not defined in the GST legislation. It is a term used to describe the situation where a single supply of services incorporates two or more different elements, each of which could be supplied separately. Bundling is perceived by the Australian Taxation Office (the *ATO*) as a potential mischief because of the way in which it can, in some circumstances, result in greater reduced input tax credits than would otherwise be the case.

The first section of this paper examines the history and purpose of the reduced input tax credit system. That is followed by an analysis of the implications of bundling for arranging services and trustee services. There is then a discussion about the proposals to limit the potential for bundling in relation to trustee services. The next section of the paper looks at the reduced input tax credit implications of a special purpose in-house 'arranger' of financial supplies and the *ATO's* Taxpayer Alert 2010/1 GST – Interposing an Associated 'Financial Supply Facilitator' to enhance claims for reduced input tax credits for expenses incurred in the course of a company takeover. The final section discusses bundling and outsourcing.

2. THE REDUCED INPUT TAX CREDIT SYSTEM

Section 11-20 of the *A New Tax System (Goods and Services Tax) Act 1999* (the *GST Act*) dictates that an entity is only entitled to an input tax credit for the GST component of the cost of an acquisition that it makes where that acquisition is a creditable acquisition. One of the requirements for a creditable acquisition set by section 11-5 is a creditable purpose. Section 11-15(2)(a) of the *GST Act* provides that an acquisition does not have a creditable purpose where it relates to making input taxed supplies. Therefore, where an acquisition relates to making such supplies, *prima facie* the acquirer has no input tax credit entitlement.

The Government was concerned in the development of the GST regime that restrictions on the ability of financial suppliers to claim input tax credits would create

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a self-supply bias such that financial suppliers would bring in-house many of the activities that they had previously acquired from third party service providers. This was perceived as being potentially damaging to those service providers.

This problem was exacerbated by the relatively narrow application of input taxed financial supply treatment which means that arranging and facilitation type services in the financial sector are taxable supplies. This can be compared with the position in many overseas VAT jurisdictions which exempt such services. The definition of financial supplies was originally contained in a table in section 40-5(2) of the GST Act rather than Regulation 40-5.09(1) of the *A New Tax System (Goods and Services Tax) Regulation 1999* (the *GST Regulations*). The original definition included 'agreeing to make, or arranging' supplies of various securities and other financial instruments and 'a supply of anything directly in connection with' such an agreeing or arranging supply. Pursuant to the original section 40-5(3) 'a supply of advice', including a supply of advice in relation to a financial supply, was expressly excluded from the ambit of financial supplies.

However, the Government preferred a narrower scope for the financial supply definition. Its object was to avoid the problems perceived to have arisen in overseas jurisdictions in interpreting the concept of arranging. The result was the current definition in the GST Regulations. Agreeing to make and arranging other financial supplies is not included in that definition.

Participants in the financial sector realised that the combination of taxable treatment for arranging and facilitation services and the denial of input tax credits for acquisitions associated with the making of financial supplies would make GST a significant cost for them. The threat to bring services in-house was part of their response.

In a Consultation Document² issued by the Treasurer in August 1999 the self-supply bias was identified as having an adverse impact on competitiveness in the financial services sector.

*A higher effective tax burden would be faced by smaller financial supply providers who outsource proportionately more of their business inputs. Larger market participants generally have a greater ability to insource services. For example, smaller financial service providers, such as credit unions or building societies, would have less scope to insource mortgage valuation services than would a large bank. Therefore, input taxing financial supplies has important implications for the relative competitiveness of different segments of the financial sector.*³

In many jurisdictions the self-supply bias problem is dealt with by extending the application of financial supply treatment upstream to arranging services. As noted above, the Government wanted a narrow concept of financial supply because of its concerns about the difficulty of determining the parameters of arranging. The solution that the Government came up with for the self-supply bias problem was the reduced input tax credit system. The objective of that system is to reduce the GST leakage that

² 'The Application of Goods and Services Tax to Financial Services'.

³ *Id.*, p. 18.

would otherwise arise on the acquisition of a wide range of supplies from third party service providers and thereby remove the incentive for financial suppliers to self-supply. The Consultation Document commented on the system as follows.

This approach can deliver a similar tax outcome to broader input taxation (ie. revenue neutral) but at a lower compliance cost for certain suppliers to financial institutions. The approach also reduces other potential self-supply biases as fewer suppliers are subject to input taxation.⁴

The self-supply problem and the Government's solution were summarised in the following terms at paragraphs 5.1 and 5.2 of the Senate Further Supplementary Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill 1998*.

Acquisitions that are made for the purpose of making financial supplies are generally input taxed. This means that generally input tax credits are not available for such acquisitions. This could create a bias towards in-sourcing in financial institutions because the effective tax burden is higher on the outsourced services than in-sourced services. ... This partial input tax credit effectively removes the bias towards in-sourcing of prescribed services.

The Explanatory Statement for the *A New Tax System (Goods and Services Tax) Regulation 1999* identified four benefits of the reduced input tax credit system at page 21 – 'reduced bias to insource, lower compliance costs for smaller entities, greater legislative certainty and a better competitive position for domestic service providers'. Greater legislative certainty was asserted on that basis that the Australian system would avoid the need to grapple with 'broad concepts such as arranging' that have caused difficulties overseas.

The reduced input tax credit system is set out in Division 70 of the GST Act and in Division 70 of the GST Regulations. It allows an entity a partial or reduced input tax credit for an acquisition where it would otherwise not be entitled to any input tax credit because of a relationship between the acquisition and the making of input taxed supplies. The level of reduced input tax credit is 75% of a full credit.

Reduced input tax credits are available for a range of acquisitions called 'reduced credit acquisitions'. These are specifically defined in Regulation 70-5.02. There is a list of 31 separate items many of which are refined further by numerous express inclusions and exclusions. The types of services encompassed by the list include transaction banking and cash management services, payment and fund transfer services, securities transaction services, loan services, debt collection services, insurance services, services remunerated by commission and franchise fees, funds management services and trustee and custodial services.

There is significant uncertainty about the scope of many of the items identified as reduced credit acquisitions. One well publicised example arose in the context of the securitisation industry. There was disagreement for many years between the ATO and participants in that industry as to the availability of reduced input tax credits to a securitisation vehicle for the acquisition of 'servicing' services. There were two

⁴ Id., p. 3.

separate points of dispute – whether the category of debt collection services in the definition of reduced credit acquisitions applies to the service of collecting all debts or only bad or delinquent debts, and whether the category of loan management services in the reduced credit acquisition definition is restricted to services acquired by actual lenders or could extend to subsequent assignees of the loans.

Another area of dispute was whether the acquisition of lenders mortgage insurance and title insurance extended to reinsurance.

Part of the problem in identifying reduced credit acquisitions is the mixed and diverse nature of the services listed in the GST Regulations and the specific terminology used to describe those services. The various items incorporate many terms that have particular meanings in the different specialist industries in which they are used and many terms that do not. The ATO has issued a comprehensive public ruling setting out its interpretation of the different categories of reduced credit acquisitions – GSTR 2004/1 Goods and Services Tax: reduced credit acquisitions. Given the binding nature of that ruling, this provides a high degree of certainty on many issues. Nevertheless there are numerous areas where there is disagreement between taxpayers and the ATO, and no doubt new issues will continue to appear.

One issue is currently emerging in the courts. Item 6 in Regulation 70-5.02 includes within the ambit of reduced credit acquisitions the acquisition of services supplied by the operator of a payment system to a participant in the system or to a third party in relation to access to the system. This item relates to item 4 in Regulation 40-5.12 which specifically excludes the supply of an interest in or under 'a payment system' from the financial supply concept. In the decision of the Full Federal Court in *Commissioner of Taxation v American Express Wholesale Currency Services Pty Limited*⁵, there was disagreement between the judges as to whether American Express provides an interest in or under a payment system to its cardholders. The majority, Kenny and Middleton JJ, held that American Express does not provide such an interest; Dowsett J, dissenting, held that it does.⁶ The High Court refused the taxpayer special leave to appeal on 5 May 2011.⁷ The Full Federal Court's conclusion on the GST implications of the nature of the relationship between American Express and its cardholders vis-à-vis the card payment system is therefore relevant to the application of item 6 in the list of reduced credit acquisitions.

⁵ (2010) 187 FCR 398; [2010] FCAFC 122.

⁶ It followed as a consequence of the majority's conclusion that the supplies made by American Express to cardholders under the charge card and credit card facilities did not fall within the express exclusion from the definition of 'financial supply' in regulation 40-5.12, which provides that the supply of an interest in or under a 'payment system' is not a financial supply. Since the majority also concluded that the supplies made by American Express were supplies of an interest in or under a 'credit arrangement or right to credit', and therefore fell within a specified category of financial supply, it followed that the supplies were financial supplies. The consequence of Dowsett J's conclusion, conversely, was that the supplies made by American Express were automatically precluded from being financial supplies.

⁷ In refusing special leave, French CJ said: "The issues that arise in these applications arise from the proper construction of a formula agreed between the applicants and the Commissioner as a means for determining the relevant operation of [A New Tax System \(Goods and Services Tax\) Act 1999](#) (Cth). Having regard to the way in which the applicants chose to conduct their cases at trial this case, in our opinion, is not a suitable vehicle in which to explore questions about the proper construction and application of regulation 40-5.12 made under the Act."

Many of the services in the reduced credit acquisition list would be input taxed or exempt financial services in other jurisdictions. Accordingly, many of the difficulties that occur in those jurisdictions in interpreting the scope of financial services occur in Australia in the context of the reduced input tax credit system.

In the absence of a control, it is very difficult to know how effective the reduced input tax credit regime has been in Australia in terms of addressing the self-supply bias. However, many of the services identified in the reduced credit acquisition list are not readily substitutable or capable of being in-sourced. Perhaps the best example of this is investment banking services in relation to mergers and acquisitions. To the extent that such items are included in the list, the system is relatively concessionary. It allows an input tax credit even though in practice self-supply is often not a viable option for the acquirers of such services.

There are also many services that are readily substitutable and that can be in-sourced but that are not included in the list of reduced credit acquisitions. One of the best examples of this is some legal services. In relation to such services, the reduced input tax credit system does not alleviate the self-supply bias.

3. ARRANGING SERVICES AND BUNDLING

As noted above, the term bundling is used to refer to the situation where an entity acquires a single supply of services that incorporates two or more different elements, each of which could be acquired separately. There is a question whether bundling can create a potential mischief in the context of the reduced input tax credit system. This is best understood by analysing the application of one of the categories of reduced credit acquisition in two relatively simple examples.

Example 3.1

Predator Co made a successful takeover bid for Target Co. It engaged an investment bank to organise all aspects of the takeover on its behalf. It was known at the outset that a recent environmental disaster caused by Predator Co might have an adverse impact on the willingness of Target Co shareholders to accept its offer. Part of the investment bank's role in relation to the takeover included dealing with the public relations issues. It engaged a PR firm to assist it in dealing with these issues.

The investment bank charged an 'arranging' fee for its services. That fee comprised two components. The first component was based on a combination of time spent by the investment bank's employees and certain external costs incurred by the investment bank (including third party consultants). The second component was contingent on completion of the takeover and was based on the value of the deal.

The takeover involved Predator Co making only input taxed supplies.

Pursuant to section 11-15(2)(a) Predator Co is denied a full input tax credit for the acquisition of the investment bank's services because that acquisition relates to making input taxed supplies. There is therefore an issue as to Predator Co's entitlement to a reduced input tax credit for that acquisition. Item 9 in Regulation 70-5.02(2) defines a reduced credit acquisition to include the acquisition of the following.

Arrangement, by a financial supply facilitator, of the provision, acquisition or disposal of an interest in a security, including the following:

(e) arranging mergers and acquisitions;

(f) arranging takeover bids.

The term 'financial supply facilitator' is defined in Regulation 40-5.07 as 'an entity facilitating the supply of the interest for a financial supply provider'. At paragraph 31 of GSTR 2004/1 the ATO states that 'the facilitating of a supply refers to activities that help forward (assist) the supply, rather than those that simply assist the financial supply provider'.

Somewhat problematically the concepts of 'arrangement' and 'arranging' are not defined in the GST Regulations. The Macquarie Dictionary defines the term 'arrangement' as 'the act of arranging'. The only relevant definition of the verb 'to arrange' is 'to prepare or plan'. The Cambridge Dictionary defines 'to arrange' as including 'to organise'. The ordinary meaning of 'to arrange' in the context of mergers and acquisitions also incorporates the concept of to cause to occur.

At paragraph 287 of GSTR 2004/1 the ATO states that 'arrangement under this item includes activities relating to the preparation for the transaction, the planning of the transaction and the settlement of the details of the transaction'.

There has been no judicial consideration of item 9. In *Xenophou v Richani*⁸, the Supreme Court of South Australia analysed the meaning of the verb 'to arrange'. In that case the appellant agreed to transfer a residential unit to the respondent if the respondent could 'arrange' a loan for the appellant to fund a property development. The respondent introduced the appellant to a bank that was prepared to make a loan to the appellant. However, the appellant argued that to arrange a loan required more than a mere introduction.

The Court said at paragraph 73 that the meaning of the word arrange 'depends in each case on the surrounding circumstances'. It held at paragraph 79 that in this case 'the respondent clearly arranged the introduction of the appellant to the bank' and that it was that act that 'led to and caused the loan to be offered'. On that basis the respondent had arranged the loan.

The issue in *Customs & Excise Commissioners v Lloyds TSB Group Limited*⁹ (*Lloyds TSB*) was the meaning of 'the making of arrangements for' the granting of credit or the provision of instalment finance under item 5 of Group 5 of Schedule 9 to the *United Kingdom Value Added Tax Act 1994*. Lloyds assisted a finance subsidiary of the Volkswagen car manufacturer to enable it to provide finance to its customers. The functions performed by Lloyds for Volkswagen included (i) receiving hire purchase and leasing applications, (ii) obtaining credit references, (iii) accepting and rejecting applications, (iv) providing information and maintaining records, (v) making payments to dealers, (vi) calculating and paying dealers' commissions, (vii) transmitting and receiving funds, (viii) providing early settlement quotations, (vix)

⁸ [2004] SASC 30.

⁹ [1998] STC 528.

dealing with correspondence, (x) assessing recoverability of bad debts, and (xi) maintaining records.

Justice Keene of the Queen's Bench Division held that most of these services came within the category of the 'arranging' of new credit deals. Several were post-acceptance functions but he treated them as part of a package that qualified as a single supply of services.

*President's Choice Bank v The Queen*¹⁰ (*President's Choice Bank*) involved a retailer of groceries and other merchandise that entered into an arrangement with the Canadian Imperial Bank of Commerce whereby the bank provided financial products to the retailer's customers. The bank installed banking machines at the retailer's locations and the retailer installed and maintained kiosks for the sale of the bank's financial products. Both parties promoted the program. The bank paid fees to the retailer based on the products sold.

The issue before the Canadian Court was whether the service provided by the retailer to the bank was an exempt supply of 'arranging for' a financial service. The Court held that it was. It said at paragraph 39 that the retailer 'helped, assisted and was directly involved in the process of the provision of financial services'.

In example 3.1 above the activities of the investment bank, including its work on the PR issues, helped forward and assisted the acquisition by Predator Co of the shares in Target Co. Accordingly the investment bank was a financial supply facilitator of the transaction. In addition the investment bank's activities can be accurately described as involving the organisation, and the causing to occur, of the acquisition of Target Co by Predator Co. Accordingly the investment bank was an arranger of the transaction. Prima facie the requirements of item 9 are therefore satisfied and Predator Co's acquisition from the investment bank is a reduced credit acquisition in its entirety for which it is entitled to a reduced input tax credit.

Example 3.2

The facts in example 3.2 are the same as for example 3.1 with the exception that the investment bank's role did not incorporate dealing with the PR issues. Predator Co handled those issues itself. It directly engaged its own PR firm to assist it in that regard.

The analysis of Predator Co's acquisition from the investment bank is the same as in example 3.1. The investment bank was a financial supply facilitator and an arranger. Accordingly Predator Co's acquisition from it is a reduced credit acquisition.

Predator Co is not entitled to a full input tax credit for its acquisition from the PR firm because that acquisition relates to making input taxed supplies. Furthermore, it is not entitled to a reduced input tax credit for that acquisition because the acquisition does not come within the ambit of any of the categories of reduced credit acquisition in the table in Regulation 70-5.02(2). The acquisition does not meet the requirements of item 9 as it would not be correct to say that the PR firm 'arranged' the acquisition of Target Co for Predator Co.

¹⁰ 2009 TCC 170.

The essential difference between example 3.1 and example 3.2 is that in the former the 'bundling' of the PR services with the other services provided by the investment bank results in a greater reduced input tax credit entitlement for Predator Co. The PR services became arranging services by virtue of being incorporated into the services provided by the investment bank.

Is this the correct outcome? Is it consistent with the policy intent behind the reduced input tax credit regime? Is there a different analysis that gives a different result?

3.1 Policy considerations

As discussed above, the reduced input tax credit regime was designed partly to avoid input taxing a much wider range of services and partly to overcome the self-supply bias created by input taxation. The former does not provide any guidance as to the interpretation of the concept of 'arranging'. The original definition of financial supply in the GST Act encompassed the arranging of certain financial supplies. Under that definition those arranging services would themselves have been input taxed. The decision to treat those supplies as taxable but provide reduced input taxed credits for a wide range of acquisitions does not throw any light on how those acquisitions are to be interpreted. The scope of reduced credit acquisitions certainly goes well beyond the acquisition of supplies that would have been input taxed under the original definition of financial supplies.

It is interesting to note that the government adopted a narrower concept of financial supplies so as to avoid the perceived difficulties experienced in foreign jurisdictions over the interpretation of the concept of arranging. In some respects, those difficulties have simply been shifted from the financial supply definition to item 9 of the reduced credit acquisition definition.

The second key objective of the reduced input tax credit regime, namely to overcome the self-supply bias, is also of limited assistance in interpreting the various categories of reduced credit acquisition and item 9 in particular. The fact that a particular service is capable of being 'in-sourced' is clearly not determinative of its status as a reduced credit acquisition. While many of the categories of reduced credit acquisition are capable of in-sourcing, there are many more services that can be in-sourced but that cannot be acquired as reduced credit acquisitions.

An argument might be made that if the acquisition of a particular service is not specifically identified in the table in Regulation 70-5.02(2), then it should not receive 'indirect' reduced credit acquisition status by reason of being incorporated as a component of one of the other items in that table. However, this argument is circular. Either an acquisition qualifies as a reduced credit acquisition or it does not. The fact that it may incorporate components that would not qualify separately as reduced credit acquisitions should not be relevant.

The argument is further undermined by item 29 – 'trustee services'. As discussed in more detail below, it is clear that trustee services can incorporate many activities which if acquired separately would not qualify as reduced credit acquisitions. In other words, the category of trustee services is not read down by reference to other categories of reduced credit acquisition.

3.2 Identify the 'acquisition'

Regulation 70-5.02(2) simply states that 'the following acquisitions ... are reduced credit acquisitions' and then lists 31 different items. Confusingly, there is no consistency in the description of those items. Some items are specifically described in terms of acquisitions eg, item 3 – 'acquisition of transaction cards by account providers'. Some items identify different forms of insurance eg, item 12 – 'lenders mortgage and title insurance'. Most of the items contain descriptions of services rather than acquisitions. The clear implication is that an acquisition of one of these identified services constitutes a reduced credit acquisition.

The term 'acquisition' is defined in Regulation 40-5.05 of the GST Regulations but only in relation to the acquisition of interests for the purposes of Regulation 40-5.09. This is not relevant to Regulation 70-5.02. Section 70-5(1) of the GST Act states that 'acquisitions' as specified in the GST Regulations are 'reduced credit acquisitions'. Accordingly, the appropriate definition of acquisition for the purposes of Regulation 70-5.02 is the definition in section 11-10(1) of the GST Act. That provision defines an acquisition as 'any form of acquisition whatsoever'. Section 11(10)(2) specifically includes 'an acquisition of services' within the term 'acquisition'.

It follows that in order to determine the existence or otherwise of a reduced credit acquisition in a transaction, it is necessary to identify the actual acquisitions made. That may sound self evident but in some cases it can be difficult to identify the specific parameters of an acquisition. The same difficulty arises on the supply side given the mirror nature of the supply and acquisition definitions.

If a person goes to a car yard and buys five cars, is it a single acquisition of five cars or five acquisitions of one car each? If a person instructs a share broker to sell 100 shares in X Co and then use the sale proceeds to purchase 300 shares in B Co, does the person make an acquisition of a single broking service or does the person make two acquisitions, one of a selling service and one of a buying service? These are simple examples but they demonstrate some of the difficulties of determining the parameters of an acquisition. This can be highly relevant in identifying acquisitions involving services like those listed in the table in Regulation 70-5.02(2) including in particular arranging services.

3.3 Composite, mixed and multiple acquisitions

On the supply side of the analysis, the concepts of 'composite' supplies, 'mixed' supplies and 'multiple' supplies have been developed to assist in determining the nature of a transaction. Broadly speaking, a composite supply is a single supply with one dominant component. While it may involve other components, those components are ancillary or integral to the dominant one. A mixed supply is a single supply comprising several different components that are more than just ancillary to another component. Multiple supplies occur where a transaction involves two or more separate supplies. The distinction between a mixed supply and multiple supplies can be a subtle one and is not always recognised.

In GSTR 2004/1 the ATO applies the composite/mixed distinction to acquisitions in the context of the reduced input tax credit regime. Paragraph 28 of the ruling states as follows.

If something that is listed as a reduced credit acquisition is acquired together with something that is not listed as a reduced credit acquisition, those parts may need to be treated separately. This depends on whether the acquisition is a mixed acquisition or a composite acquisition. These terms are intended to be similar to the concepts of a mixed supply and a composite supply and to adopt similar principles. The difference is that these terms are used to describe an acquisition that consists of parts that are reduced credit acquisitions and parts that are not.

The ruling then cross references paragraphs 223 to 256 of GSTR 2002/2 Goods and Services Tax: GST treatment of financial supplies and related supplies and acquisitions. Those paragraphs explain the terms mixed acquisition and composite acquisition and provide guidance as to how to determine which is which. A mixed acquisition is described in paragraph 232 as an acquisition containing 'separately identifiable parts' where 'no part is dominant and each part has a separate identity'.

Paragraph 233 states that a composite acquisition 'is an acquisition of one dominant part and includes other parts that are not treated as having a separate identity as they are integral, ancillary or incidental to the dominant part of the acquisition'. A composite acquisition 'is essentially the acquisition of a single thing'.

Paragraph 236 of GSTR 2002/2 states that overseas case law illustrates that the relevant factor is 'what the acquirer in essence acquires' and 'what in substance and reality is acquired'. Citing the decision of the House of Lords in *Card Protection Claim v Customs and Excise Commissioners*¹¹, paragraph 237 states that 'you must have regard to the essential features of the transaction to see whether it has several distinct principal services or a single service'.

A number of cases since the issue of that ruling have adopted a similar approach in the context of determining the parameters of supplies. In *Beynon & Partners v Commissioners of Customs and Excise*¹² the House of Lords held that the identification of supplies should be based on 'social and economic reality'.

A similar issue was considered by the Full Federal Court in *Commissioner of Taxation v Luxottica Retail Australia Pty Limited*¹³. One of the issues in that case was whether the sale of spectacles comprising a frame with lenses fitted was a single supply or two supplies, being a supply of the frame and a supply of the lenses. Interestingly, the issue was not expressed as whether the sale of the spectacles was a composite supply or a mixed supply. The Full Federal Court reached the following conclusion.

We agree with the Tribunal that the sale of the spectacles was a single supply. While 'supply' is defined broadly, it nevertheless invites a commonsense, practical approach to characterisation. An automobile has many parts which are fitted together to make a single vehicle. Although, for instance, the motor, or indeed the tyres, might be purchased separately, there can be little doubt that the sale of the completed vehicle is a single supply. Like a motor vehicle, spectacles are customarily bought as a completed article and in such

¹¹ [2001] BVC 158.

¹² [2004] UKHL 53.

¹³ (2011) 191 FCR 561; [2011] FCAFC 20.

*circumstances are treated as such by the purchaser. The fact that either the frame or the lenses may be purchased separately is not to the point.*¹⁴

There are several financial services related examples from overseas jurisdictions where a supply that involves various activities and that is predominantly arranging in nature has been treated as a composite supply and therefore an arranging supply in its entirety – see *Lloyds TSB* and *President's Choice Bank*.

Under the approach adopted by the ATO in GSTR 2004/1 a distinction is drawn between composite acquisitions and mixed acquisitions for the purposes of determining reduced credit acquisition status. A composite acquisition either qualifies as a reduced credit acquisition in its entirety or it does not qualify at all. It is never a reduced credit acquisition in part. It qualifies as a reduced credit acquisition if its essential character comes within one of the items in the table in Regulation 70-5.02(2). By contrast the approach in GSTR 2004/1 dictates that each separate component of a mixed acquisition needs to be tested separately to determine whether it qualifies as a reduced credit acquisition. In this way different components of a single mixed acquisition can be treated differently.

Is the ATO's approach to a mixed acquisition allowed under the legislation? Is it possible to divide a single acquisition into constituent parts and then determine whether each part qualifies as a reduced credit acquisition? Regulation 70-5.02 does not use apportionment wording. However, some of the items in the table appear to contemplate apportionment. For example item 26(h) encompasses life insurance administration services provided to a life insurer to enable it to comply with industry regulatory requirements 'excluding taxation and auditing services'. This wording indicates that even when a life insurer acquires a single supply of administration services from an administrator, to the extent that the services include taxation and auditing services, the acquisition does not qualify as a reduced credit acquisition. This supports a mixed acquisition approach and different treatment for different components of a single acquisition.

Significantly, item 9 does not contain any specific exclusions. Furthermore, as noted above there is no definition of the terms 'arrangement' or 'arranging' used in item 9. In particular, there is no definition that specifically excludes items like PR services or that defines arrangement or arranging so narrowly as to exclude the possibility of the incorporation of activities like PR services in certain circumstances. In addition, neither term has an industry specific meaning that supports a narrow interpretation.

In the absence of any express exclusions from arranging services in item 9, any activity that is part of an arranging service will qualify as a reduced credit acquisition even though it would not qualify as such if it was acquired on a stand alone basis.

Nevertheless, there may be situations where a single acquisition consists of a number of components, some of which are part of an arranging service and some of which are not. However, this type of apportionment of a single mixed acquisition is not relevant to a scenario like the original example 3.1 where the PR services *are* an integral part of an arranging service that is a composite supply. Bundling can achieve creditable acquisition status for the acquisition of an activity that is part of a wider arranging

¹⁴ Id., para. 15.

service even if that activity would not qualify as a reduced credit acquisition on a stand alone basis. However, bundling cannot achieve reduced credit acquisition status for the acquisition of a component of a single acquisition if that component is not part of an arranging service.

3.4 The nature of arranging services

GSTR 2004/1 also contains some specific comments about the nature of arranging services for the purposes of item 9 in Regulation 70-5.02. Significantly, there is some commentary on bundling. Paragraph 289 states as follows.

Equally, due diligence activities, though part of the preparation for the float, are not arranging for the purposes of item 9 (d). This is because due diligence by itself, does not have sufficient connection to the 'arrangement' or preparing or planning a float. However, where an entity provides due diligence activities, as part of its services in planning or preparing a float, then it may come within item 9(d).

This paragraph is saying that a separate acquisition of due diligence services does not qualify as a reduced credit acquisition, however, where due diligence services are provided as part of a wider arranging service, the acquisition of those due diligence services may be part of a reduced credit acquisition. (This distinction is illustrated in examples 36 and 37 in the ruling.) It is implicit in this analysis that in the latter scenario the acquisition of the arranging service is a single composite acquisition incorporating the due diligence services. It does not involve a mixed acquisition or two separate acquisitions of arranging services and due diligence services. Applying the words in paragraph 233 of GSTR 2002/2, the due diligence services are 'integral, ancillary or incidental' to the arranging service. It 'is essentially the acquisition of a single thing'.

Paragraph 290 of GSTR 2004/1 describes services acquired by a financial supply facilitator in order to enable that party to make a supply of arranging services as 'inputs' into those arranging services. This is the essence of how bundling works. In example 36 in the ruling, the due diligence services acquired by the financial supply facilitator are an input into its supply of arranging services to the financial supplier and therefore are part of the acquisition of those services by the financial supplier.

The paragraphs in item 9 can apply to many different activities. Take paragraph (f), 'arranging takeover bids'. That term encompasses a very wide range of activities. That range is determined by factors such as the scale and complexity of the transaction and the requirements of the entity undertaking the transaction. For example, an entity might wish to take over a small private company with four shareholders. The entity might engage an investment bank to approach those four shareholders and arrange a sale at a non-negotiable price. The 'arranging' service provided by the investment bank would be relatively limited.

By contrast, an entity might be undertaking a contested takeover of a major public company. Necessarily, the scale and *nature* of the activities undertaken by an investment bank engaged by the entity would be very different to the activities undertaken by the investment bank in the previous paragraph. Nevertheless, both transactions involve the 'arranging' of the acquisition of securities by a financial supply facilitator.

The key point is that arranging is a relatively amorphous concept. It can take many different forms and will incorporate very different activities in different circumstances. In appropriate circumstances those activities could include broking services, advertising services, PR services, legal services, due diligence services, and accounting services. Whatever the circumstances in a given case, where the essence of the service is the organising and causing to occur of a financial supply by a financial supply facilitator, the activities that constitute that service will be part of an arranging service and the acquisition of all those activities will be a reduced credit acquisition. That will be the case even if the acquisition of one or more of those activities would not qualify as a reduced credit acquisition on a stand alone basis.

Returning to example 3.1 above there are two questions - (i) whether Predator Co makes a single composite acquisition from the investment bank including the investment bank's PR activities or makes either a mixed acquisition or two separate acquisitions, and (ii) if Predator Co makes a single composite acquisition, whether that is an acquisition of an arranging service.

The better view is that looking after the PR issues associated with the takeover bid is an integral part of the wider service that the investment bank provides in organising the transaction and causing it to occur. On that basis it is part of a single composite service acquired by Predator Co from the investment bank. Predator Co looks to the investment bank to organise all aspects of the takeover including the PR issues. In the words of paragraph 233 in GSTR 2004/1, it is 'essentially the acquisition of a single thing' by Predator Co from the investment bank.

It is clear that the investment bank can accurately be described as arranging the takeover by Predator Co of Target Co. It organises the takeover and causes it to happen. Accordingly, the composite acquisition acquired by Predator Co from the investment bank qualifies as an acquisition of an arranging service and is therefore a reduced credit acquisition.

3.5 In-house versus subcontracting

There is an issue as to whether the validity of bundling various activities into a single arranging service is influenced by whether the arranger performs those activities with its own resources or contracts out the provision of those services. Comparing the two variations may assist in interpreting the concept of an arranging service.

In example 3.1 the investment bank acquired PR services from an external PR firm in order to be able to provide its comprehensive arranging services to Predator Co. In a different scenario it might have been the case that the investment bank employed its own PR experts and was able to deal with the PR issues without consulting the PR firm. At a superficial level at least the PR services in that scenario seem to be more clearly integrated with the other parts of the service provided by the investment bank and therefore seem to be more clearly part of a single composite supply of arranging services.

However, there is no real substance to this distinction. When one party contracts to provide a service to a second party, the existence and nature of that service does not turn in any way on how the first party performs its contractual obligation ie. whether it uses its own employees, a subcontractor or a combination of the two. This can be demonstrated using a variation of example 3.1. Assume that the investment bank in

that example subcontracted with a second investment bank to perform the arranging services for Predator Co. That would not alter in any way the nature of the arranging service provided by the first investment bank to Predator Co. The acquisition of that service would still be a reduced credit acquisition to Predator Co irrespective of the subcontracting.

3.6 Pure pass through versus incorporation into arranging service

Subcontracting can take many forms. Consider two variations of example 3.1. In the first variation the investment bank simply instructs the PR firm to deal directly with Predator Co on all issues. This can be described as a pure 'pass through' of the PR services. In the second variation, the PR firm works solely with employees of the investment bank and has no contact with Predator Co. The services of the PR firm are incorporated into the work of the investment bank. In both cases the investment bank engages and pays the PR firm.

The second variation results in a more comprehensive bundling. The PR services are incorporated within the arranging service acquired by Predator Co from the investment bank. It would be very difficult to argue that there was not a single composite supply and acquisition.

In the first variation the PR services are still acquired contractually by Predator Co from the investment bank but they are not integrated with the other components of the investment bank's service. On the one hand it is still the case that the investment bank arranges all aspects of the takeover, including PR. On that basis the PR services are a component of the investment bank's single arranging service. On the other hand, the absence of any integration of the PR services with the other activities of the investment bank increases the risk that the transaction might be treated as giving rise to two separate supplies and acquisitions.

Broadly speaking, in situations like this the greater the degree to which a financial supply facilitator is a mere conduit for a service provided by a third party, the greater the risk that, in applying the reduced input tax credit regime, that service will be 'unbundled' from the other service provided by the financial supply facilitator.

The distinction between the pure passing through of a service and the incorporation of a service within a wider service is very relevant in the context of both 'in-house' arrangement services and trustee services. These are discussed in more detail below.

4. OTHER ACQUISITIONS INVOLVING BUNDLING

The analysis above focuses primarily on item 9 in the table in Regulation 70-5.02(2). Similar issues arise in relation to items 18 and 21 which refer to different forms of 'arrangement by a financial supply facilitator'. Item 11 includes 'arranging syndicated loans'.

These are not the only items in Regulation 70-5.02(2) that might be perceived as raising potential bundling issues. Item 16 refers to supplies between credit unions. Coverage by the item is determined by the nature of the supplier and the acquirer rather than the nature of the acquisition itself. The ATO accepts this in paragraphs 417-423 of GSTR 2004/1.

Item 27 covers 'supplies for which financial supply facilitators are paid commission by financial supply providers'. Once again status as a reduced credit acquisition is determined by the nature of the supplier and the acquirer, and the payment mechanism, and not by the nature of the acquisition. Provided that payment for the acquisition takes the form of a commission, bundling does not appear to be a concern. There is some discussion of the operation of item 27 in the ATO's GST Determination 2007/1.

There are specific inclusions in many of the other reduced credit acquisition items that are capable of widely differing interpretations. In some cases a broad interpretation of an inclusion can result in reduced credit acquisition treatment for a 'bundled acquisition' comprising some components that would not qualify as reduced credit acquisitions if acquired separately.

5. TRUSTEE SERVICES AND BUNDLING

Perhaps the most open ended categories of reduced credit acquisition in Regulation 70-5.02 are 'trustee services' in item 29 and 'single responsible entity services' in item 31. These are important items given the prevalence of trusts in many financial structures including in particular in securitisation and funds management. These items have been the cause of significant confusion since the GST regime was introduced. There are three primary reasons for this. First these terms are not defined in the GST Regulations or the GST Act. Second, while a trust is not a legal entity, section 184-1(1)(g) of the GST Act defines an entity as including 'a trust'. Furthermore, section 184-1(3) states as follows.

A legal person can have a number of different capacities in which the person does things. In each of those capacities, the person is taken to be a different entity.

This means that an entity that is a trustee of a trust has two different capacities – its personal capacity and its capacity as a trustee. It can act in relation to the trust of which it is trustee in both those capacities. It is these two different capacities that can create confusion in determining the parameters of 'trustee services' in relation to a trust. Similar issues arise for a single responsible entity.

The third cause for uncertainty and confusion in this area has been a wide variation of drafting in trust deeds and other documents to which trustees are party. In particular, the provisions within trust deeds pursuant to which trustees are paid, reimbursed or otherwise receive funds from a trust can create ambiguity in terms of determining whether they are consideration for trustee services. Other documents signed by an entity that is a trustee frequently do not clarify the entity's particular status as a party to the document.

Some of the uncertainty in this area was removed by paragraph 666 of GSTR 2004/1. That paragraph reads as follows.

Notwithstanding the focus on custodial functions, the reference to trustee services in item 29 is capable of applying widely to services acquired from a trustee. Where a trust has been established by a deed, the deed will normally set out the rights, duties and obligations of the relevant parties to the trust including the trustee. As such, the duties carried out by the trustee in

compliance with the terms of the deed are trustee services, the acquisition of which is a reduced credit acquisition under item 29.

This paragraph suggests that any services that a trustee is required to provide to a trust under the terms of the relevant trust deed are trustee services. Other services provided by the trustee are not trustee services. Furthermore services acquired by the trust directly from third parties (ie. by the trustee in its capacity as trustee) are not trustee services. The significant point here is that the characterisation of services as trustee services is not determined by reference to the *nature* of the services but rather by reference to the document giving rise to the obligation to provide those services. Trustee services might have been interpreted in a more limited way such as the holding of assets, the performing of certain administrative functions, the entering into of contractual arrangements on behalf of the trust etc. However, the ATO did not seek to go down that route in GSTR 2004/1 although to be fair it may not be available given the broad wording in item 29.

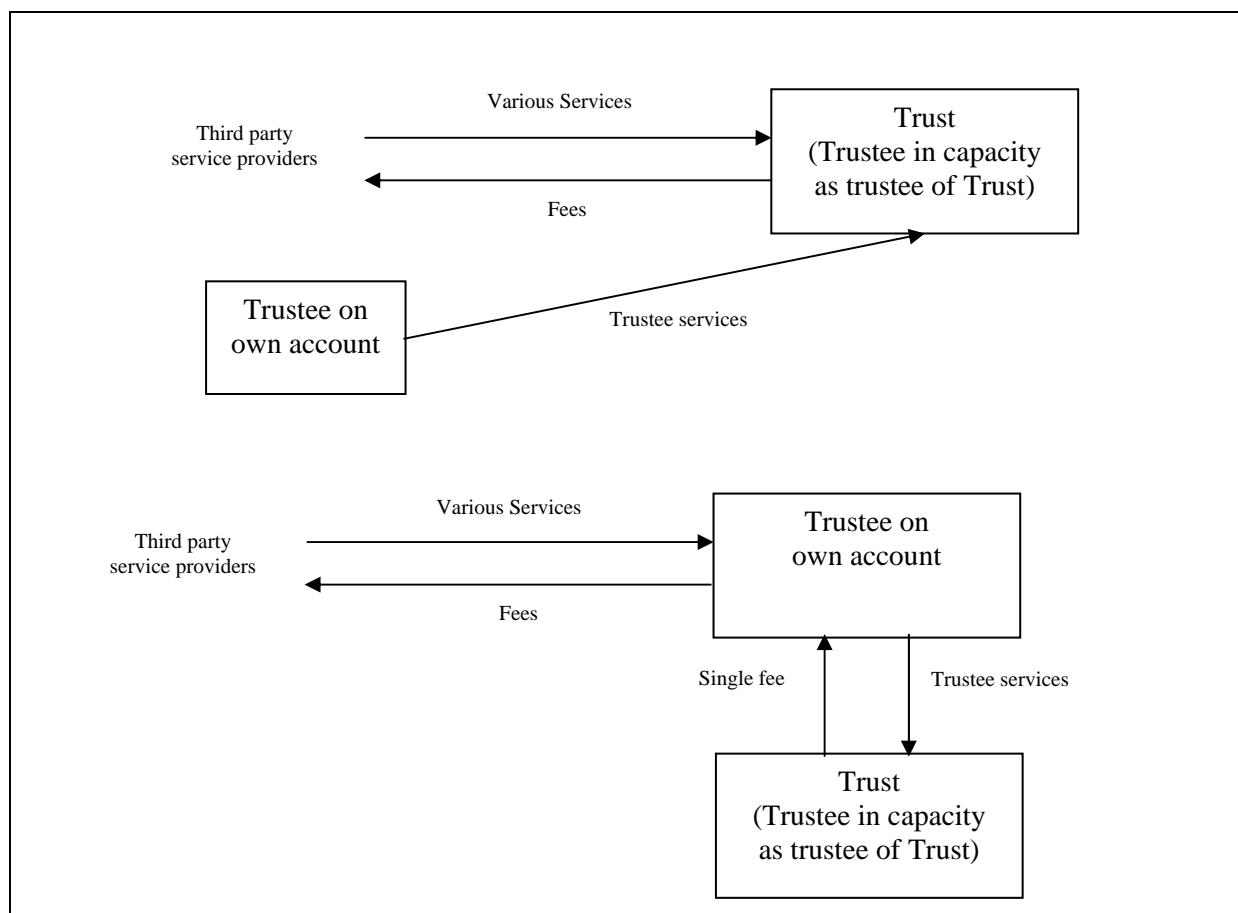
When GSTR 2004/1 was issued, there was tremendous variation in the services required to be provided by trustees and the services required to be arranged by trustees under different trust deeds. Some trust deeds operated on the basis that the trustee would provide a very wide range of services albeit, in the expectation that the trustee would sub-contract many of those services to third parties. Other trust deeds did not require the trustee itself to provide a wide range of services but rather required the trustee to arrange for other third parties to provide those services to the trust. In other words, the distinction was between the trustee acquiring third party services in its own right in order to provide comprehensive trustee services to the trust and the trustee acquiring services from third party service providers in its capacity as trustee of the trust. Under the latter scenario the trustee services acquired by the trust were much more limited.

The remuneration arrangements in trust deeds reflected these two alternatives. Broadly speaking, where a trustee acquired third party services in its own right, it was entitled to be paid a single fee for its trustee services. The single fee could take one of two forms – (i) a fixed percentage of trust funds/fixed amount or (ii) a component for 'pure' trustee services plus a second component based on the cost of third party services acquired by the trustee entity in its own right. Where a trustee acquired third party services in its capacity as trustee of the trust, it was entitled to be paid a fee for its trustee services and to be reimbursed out of trust funds for the services acquired from third parties in its capacity as trustee of the trust.

These two alternatives can have very different GST implications. For example, where a trustee acquires accounting services in its own right in order to then provide accounting services itself to the trust under the terms of the trust, the accounting services are effectively bundled into the trustee services and the trust is entitled to a reduced input tax credit for the acquisition of the accounting services component of the trustee services. By contrast, where the trustee acquires the accounting services in its capacity as trustee of the trust, the result is that the trust itself acquires the accounting services. That acquisition is not a reduced credit acquisition and therefore the trust is not entitled to a reduced input tax credit.

The two alternative structures can be shown diagrammatically in figure 1 as follows.

Figure 1: Alternative structuring of trustee services



It can be seen from these examples that a trust can effectively obtain a reduced input tax credit for the acquisition of any service where that service is acquired from the trustee as trustee services pursuant to the terms of the trust deed. In other words, applying the approach in paragraph 666 in GSTR 2004/1, it seems that any service can be bundled into a trustee service seemingly without some of the uncertainties associated with bundling in relation to other categories of reduced credit acquisition such as arranging services.

Over the years there has been a perception that the very wide scope of trustee services has resulted in the availability of reduced input tax credits beyond that originally intended. In the Budget of May 2010 the Government announced measures for 'reducing opportunities for businesses to inappropriately take advantage of the reduced input tax credit concessions by bundling services'. The use of the word 'inappropriately' seems a little unfair in this context. It has often been the case that arrangements for the services and payment of trustees were in place before the reduced input tax credit regime was introduced. The Government's concern led to section 2.5 in the Government's Discussion Paper of June 2010¹⁵. The problem with

¹⁵ 'Implementation of the recommendations of Treasury's review of the GST financial supply provisions'.

trustee services was described in the following terms in paragraphs 70 and 71 of that Discussion Paper.

Different structures can be adopted in relation to the compensation of the trustee for expenses incurred in fulfilling trust obligations. The trustee may seek specific reimbursement for expenses. Alternatively, the trustee may charge a single fee which covers both the reimbursement and the remuneration for trustee services. Such a fee may take a variety of forms, such as a flat fee or a percentage of funds under management. In all cases, both the reimbursement or fee and any separate remuneration are met from trust assets.

There are many valid commercial reasons for having single fee trustee arrangements. However, the present GST treatment of such arrangements advantages them over all other entities engaged in equivalent activities, including trusts adopting different payment arrangements. There is no policy rationale for this distinction.

The Discussion Paper puts forward three possible options to remove what it identifies as a fee based problem. Those options are as follows.

Option 1 – made and provided

The consideration for a supply of trustee services should be reduced by the consideration for acquisitions the trustee has made that have been provided to the trust, except where a separate payment has been made by the trust to the trustee for it.

Option 2 – substance and character

RITCs should not be available for an acquisition of trustee services to the extent that the acquisition is the on-supply by the trustee to the trust of things the trustee has acquired without any alteration to the substance or character of the thing acquired.

Option 3 – define trustee services

RITCs should only be available for an acquisition of trustee services to the extent that the trustee service does not relate to advertising, auditing, taxation or valuation services.

There are various 'carve outs' for each of these options. The key objective of those carve outs is to ensure that input tax credits and reduced input tax credits 'should remain available to the trust to the extent that the acquisition is one for which the trust could have obtained a RITC or an input tax credit if the acquisition had been made directly by the trust from a third party'.

Paragraph 78 of the Discussion Paper describes the intention of these three options as 'to ensure neutrality in the RITC provisions by eliminating advantages associated with bundling various acquisitions into a single acquisition of trustee services'. The intention is reasonably clear. However, each of the three options put forward for achieving that intention has its problems.

It is easy to foresee interpretative difficulties arising in relation to each option. In terms of option 1, there would be many scenarios where it would be difficult to determine whether a particular service was 'provided' to the trustee or to the trust. (The made/provided distinction is often far from straightforward in the context of tripartite arrangements.) The Discussion Paper gives the example of the acquisition of investment advice from a third party and states that this advice is 'provided' to the trust because 'the benefit and substance of the advice' goes to the trust. However, if the trustee is a recognised funds manager in its own right, the terms of the trust deed require the trustee as part of its trustee function to manage the investments of the trust, and the trustee acquires the investment advice from the third party in order to assist it to perform that function, it seems difficult to argue that the investment advice is provided to the trust.

A similar issue arises in relation to option 2. The application of that option would turn on whether there was an 'on-supply' by the trustee to the trust of things acquired from third parties 'without any alteration to the substance or character' of those things acquired. The determination of whether something was on-supplied without alteration to its substance or character could well lead to disagreement. Paragraph 93 of the Discussion Paper gives an example of valuation services acquired by a trustee. It states that even though the valuation 'informs the trustee's decisions on the investment strategy for the trust', the 'substance' of the acquisition is passed on to the trust 'leaving the character of the acquisition unchanged'. Once again, if the trustee was a funds manager, it might not be correct to view the trustee as a pure conduit.

Both option 1 and option 2 would create ambiguity and complexity. In some circumstances this would lead to onerous compliance obligations on trusts. Option 3 has the potential for greater precision. The definition in item 29 already contains a specific exclusion (for certain safe custody services). Additional exclusions might assist the Government's objective. However, potentially there would still be problems in terms of determining the scope of the relationship to exclude services and in determining the activities of the trustee in dealing with the providers of those services that should qualify as true trustee services.

There could also be valuation problems. Take the situation where a trustee is paid a single fee based on a percentage of the value of trust funds and the fee is not broken down into its various components. Some kind of apportionment would be required and that often creates difficulties.

The distinction between services that a trustee entity performs with its own internal resources and services that are trustee subcontracts to a third party is also potentially relevant to the analysis in this area. The reasoning behind options 1 and 2 in the Discussion Paper assumes that most services are acquired by trustees from third parties and simply 'passed through' the trustee; ie. the trustee is a mere conduit for the services. Examples are accounting services and asset management services. However, some trustee entities have in-house resources that enable them to supply such services without subcontracting to an external party. Should the supply of accounting services by a trustee to a trust depend on whether the services are performed in-house or subcontracted? Policy considerations suggest that the determinative factor should be the nature of the services not how they arise.

The Government received submissions on the Discussion Paper. Many of those submissions were highly critical of options 1 and 2. It seems unlikely that either will eventuate. Option 3 was also identified as having problems. It remains to be seen what the eventual outcome will be. However, it is clear that there is no easy solution to overcome what the Government perceives as inappropriate bundling in the trustee context.

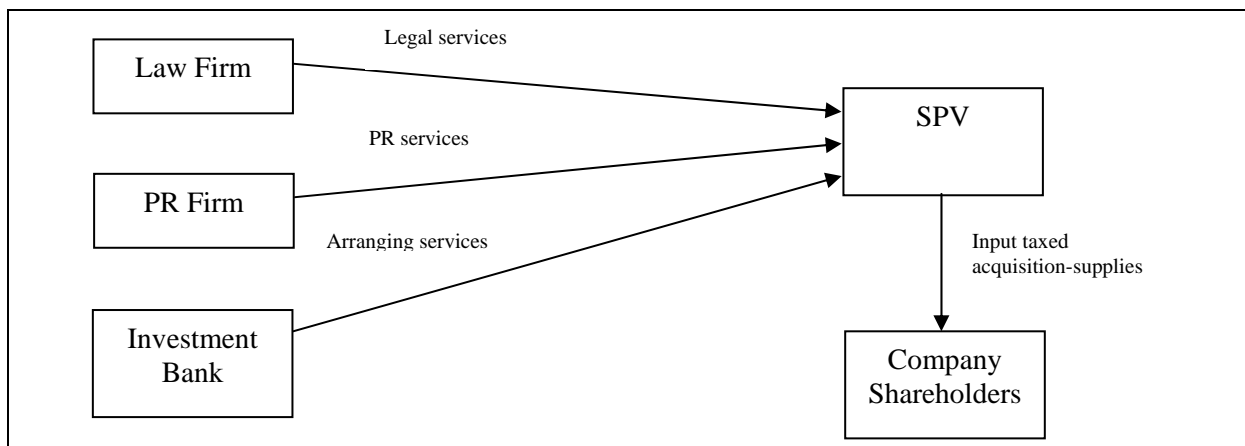
6. SPECIAL PURPOSE IN-HOUSE ARRANGER

Last year the ATO issued Taxpayer Alert TA 2010/1: GST – interposing an associated 'financial supply facilitator' to enhance claims for reduced input tax credits for expenses incurred in the course of a company takeover. That publication is directed at what the ATO perceives as a form of 'bundling' based mischief. It suggests that the activity described may have technical problems and/or fall foul of the anti-avoidance provisions in the GST Act.

To analyse TA 2010/1 it is useful to look at three different examples.

Example 6.1

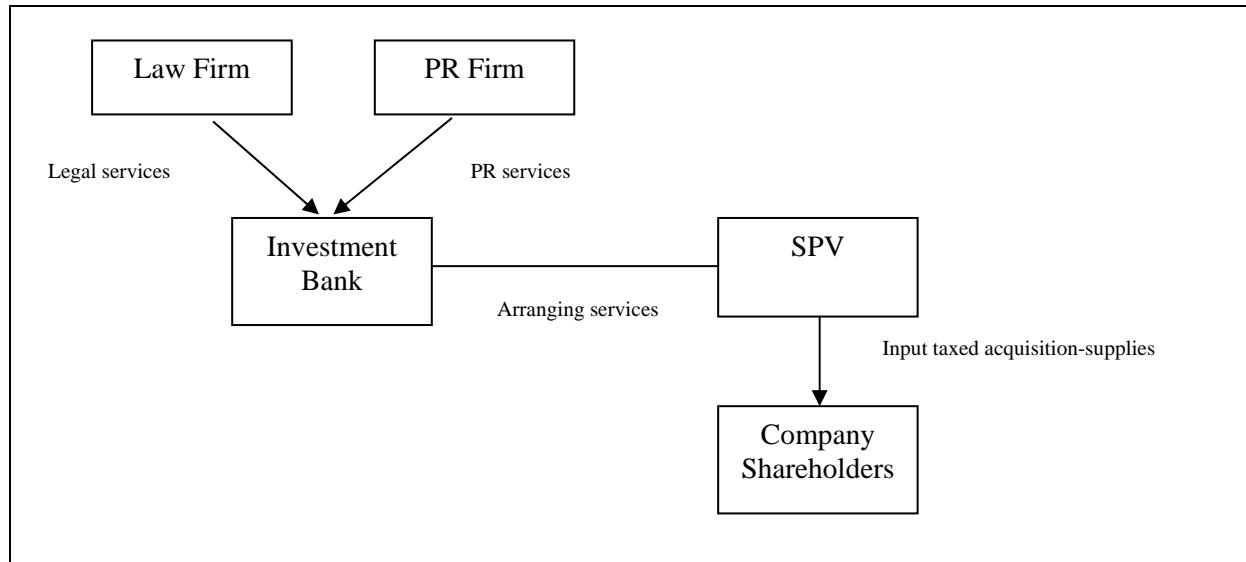
A special purpose vehicle (SPV) is established to acquire shares in a company pursuant to a takeover. It acquires a range of services from various unrelated third party service providers.



SPV cannot claim full input tax credits for any of its acquisitions because they relate to making input taxed supplies. It can claim a reduced input tax credit for the acquisition of the arranging services from the investment bank but it cannot claim a reduced input tax credit for the acquisition of either the legal services or the PR services.

Example 6.2

SPV enters into a 'package' arrangement with the investment bank whereby the investment bank agrees to arrange all aspects of SPV's takeover, including the legal and PR aspects.

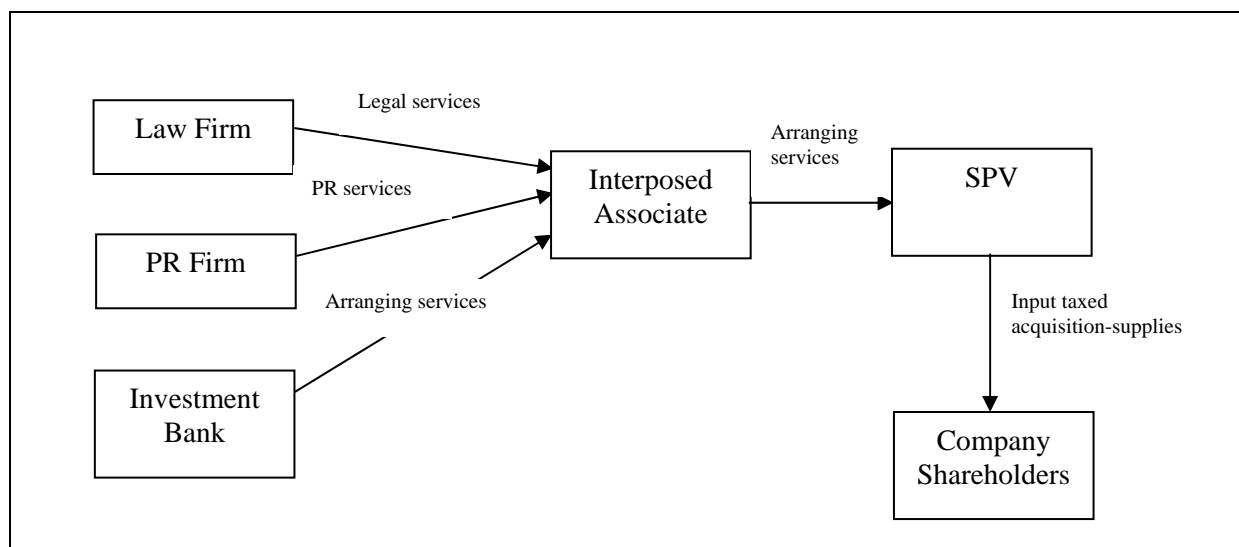


This example raises the same issues discussed earlier in relation to item 9 in Regulation 70-5.02(2) and the scope of arranging services. The key question is whether the legal services and the PR services are truly integrated into the other activities of the investment bank so that they become part of a single arranging service acquired by SPV from the investment bank.

The potential benefit of this type of structure was identified soon after the introduction of the GST regime. However, in practice, at least in relation to legal services, it has not been widely utilised. It has never been usual commercial practice for transacting entities to acquire comprehensive legal services from investment banks. Such entities prefer to acquire legal services from law firms and to have direct relationships with those law firms.

Example 6.3

SPV enters into an arrangement with an associate. The essence of the arrangement is that the associate acquires and pays for legal, PR and investment banking services supplied by third parties and then in turn supplies arranging services to SPV. SPV and its associate are not members of the same GST group.



The desired GST outcome from the perspective of SPV and its associate can be summarised as follows. The associate obtains full input tax credits for its acquisitions from the law firm, the PR firm and the investment bank. It accounts for GST in full on its supply of arranging services to SPV. SPV claims a reduced input tax credit for the entire acquisition of arranging services from the associate. The difference between example 6.1 and example 6.3 is that reduced input tax credits are effectively obtained by SPV for the acquisition of the legal services and the PR services in example 6.3 because of the way in which those services are bundled into the arranging services provided by the associate to SPV.

This structure raises the same issues discussed earlier in this paper about the nature and scope of arranging services and the efficacy of bundling. In any given situation it will depend upon the precise facts. If the associate utilises the legal services, the PR services and the arranging services in order to arrange for the SPV's acquisition of shares from the company shareholders, then SPV's acquisition from the associate may be a reduced credit acquisition in its entirety.

The example in TA 2010/1 has some additional facts that are crucial to the analysis. Point 3 in the description of the arrangement states that 'there is insufficient commercial rationale for the associate's involvement in the supply of the services'. The clear implication of these words is that the interposition of the associate serves no purpose other than to achieve a GST benefit, namely greater reduced input tax credits than would otherwise be the case.

TA 2010/1 identifies three particular concerns with this structure. First, it questions 'to what extent the services provided by the associate to the SPV' are covered by item 9. No further detail is provided however the implication is that either SPV makes separate acquisitions of each of the three different services from the associate rather than a single acquisition of arranging services, or that SPV makes a single acquisition of arranging services but that that acquisition can somehow be split into one part that constitutes a reduced credit acquisition and two parts that do not.

The second concern raised is that 'the anti-avoidance provisions of Division 165 of the GST Act may apply to the arrangement or any part of it'. Broadly speaking, Division 165 would apply if the arrangement gave rise to a GST benefit not simply attributable

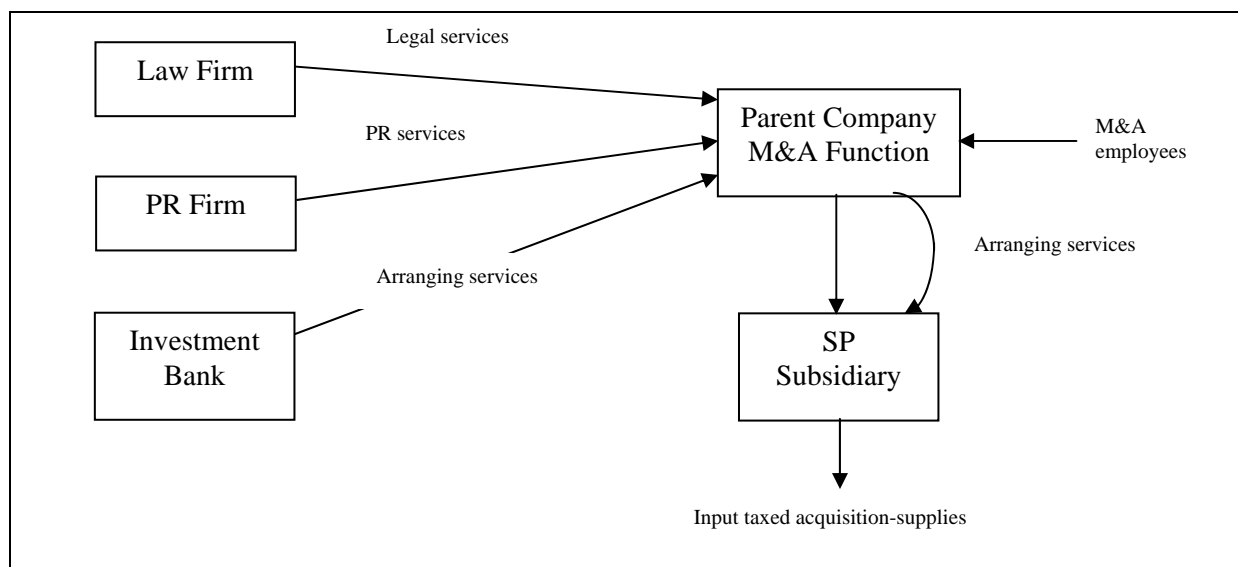
to the making of a choice, election, application or agreement expressly provided by the GST legislation and the GST benefit was either the principal effect of the scheme or the sole or dominant purpose of a party to the scheme. In the example in TA 2010/1, the key factual assumption that there was 'insufficient commercial rationale' for the associate's involvement tends to provide an automatic answer to the anti-avoidance question.

The third concern identified in TA 2010/1 is the possibility that an entity involved in the arrangement 'may be a promoter of a tax exploitation scheme for the purposes of Division 290 of Schedule 1 to the *Taxation Administration Act 1953*'.

Earlier this year the ATO followed up TA 2010/1 with the release of GSTD 2011/D2, a draft GST determination that addresses the arrangement described in TA 2010/1. It provides more detail of the ATO's approach in this area. The essence of GSTD 2011/D2 is that third party services acquired by a financial supply facilitator do not become part of arranging services provided by that party if they are 'merely passed on' and are not 'integrated' into the arranging services.

In practice there are some bundling arrangements that are both more complicated and more commercial than the simple examples in TA 2010/1 and GSTR 2011/D2. Some large corporate groups have their own in-house M&A functions that are responsible for all group M&A activities. Part of that function is to acquire, co-ordinate and pay for all services provided by external parties. The other relevant factor is that many corporate groups use a special purpose subsidiary to undertake each new acquisition. This can result in the following example.

Example 6.4



It is clear in this example that there is a 'commercial rationale' for the bundling of the services of external parties within the overall arranging service provided by the parent company to its subsidiary. In particular, the parent company is more than just a pure conduit. It does not simply pass through to its subsidiary the services provided by the external parties. It has its own employees with relevant expertise who are charged with managing all aspects of the transaction, including dealing with third parties.

Significantly, the acquisition of services from the third parties assists the parent company in providing its arranging services to the subsidiary ie. the acquired services are 'integrated' into the arranging services. It is not merely a case of the subsidiary acquiring the third party services via the parent company ie. the parent company providing the third party services 'in conjunction with' the arranging services. .

In many cases like this the subsidiary is a shelf company with no employees of its own. Often the subsidiary is not formed until close to the date of the actual transaction and after the time at which the third party service providers are engaged. This demonstrates that the parent company acquires the services of those third parties on its own account and that the arrangement does not involve a pure pass through of those services to the subsidiary.

If the parent company and its subsidiary in this example were members of the same GST group, those two companies would be treated pursuant to Division 48 as a notional single entity for the purposes of determining the entitlement to input tax credits and reduced input tax credits. Under that scenario the GST group would make three separate acquisitions from the external service providers. Similar to the position in example 6.1, it would be entitled to a reduced input tax credit for the acquisition of the arranging services from the investment bank but it would not be entitled to a reduced input tax credit for the acquisition of either the legal services or the PR services. Accordingly, any GST benefit arising from the bundling of the external services into the single arranging service provided by the parent company to its subsidiary would only be available if the two were not in the same GST group.

That raises the question as to whether Division 165 could apply merely because the parent company and its subsidiary did not elect to form a GST group or, if the parent company was already in a GST group, the parties did not elect to have the subsidiary join that group. It is difficult to see how Division 165 could be applied to require entities to form or join a GST group. In this case, failure of the subsidiary to become a member of a GST group with the parent company should not be interpreted as a scheme having the principal effect of, or the sole or dominant purpose of, obtaining a GST benefit.

Section 165-5(1)(b) states that Division 165 does not apply if a GST benefit is attributable to the making of a choice that is expressly provided for by the GST law. Division 48 provides choices as to the formation of a GST group or the adding of a new member to a GST group. Choosing not to form a GST group or not to add a new member is therefore arguably a choice expressly provided for by the GST legislation.

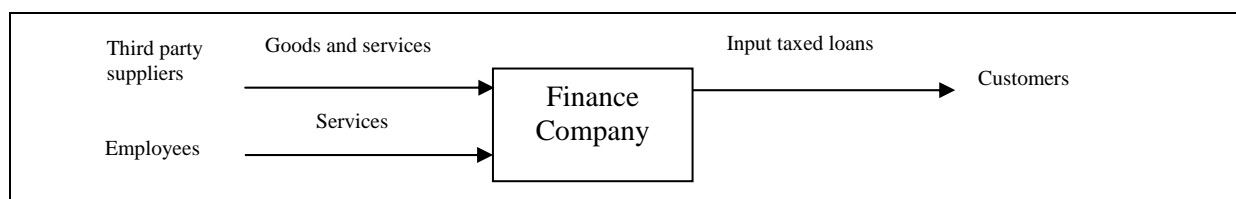
It is important to recognise that in example 6.4, any GST benefit from greater reduced input tax credits is offset by two elements of GST 'leakage'. Division 72 of the GST Act effectively requires the charging of market value consideration for supplies to an associate that is not entitled to full input tax credits. Accordingly, the parent company in this example must charge 'market value' to its subsidiary for the supply of the arranging services. That market value will reflect the salary and wages of the employees of the parent company involved in the transaction. In this way an additional GST liability will arise for the parent company. That liability will only be recoverable as to 75% by the subsidiary. The additional 25% will constitute GST leakage.

The requirement for a market value charge for the parent company's arranging services may also necessitate a mark-up on the cost to the parent company of the services acquired from third parties and its employees. That mark-up will be subject to GST and only 75% of that GST will be recoverable as a reduced input tax credit by the subsidiary. Accordingly, there will be 25% GST leakage on the mark-up.

7. OTHER FORMS OF BUNDLING

Bundling can arise in a wide range of circumstances for a wide range of reasons. Compare the following two examples.

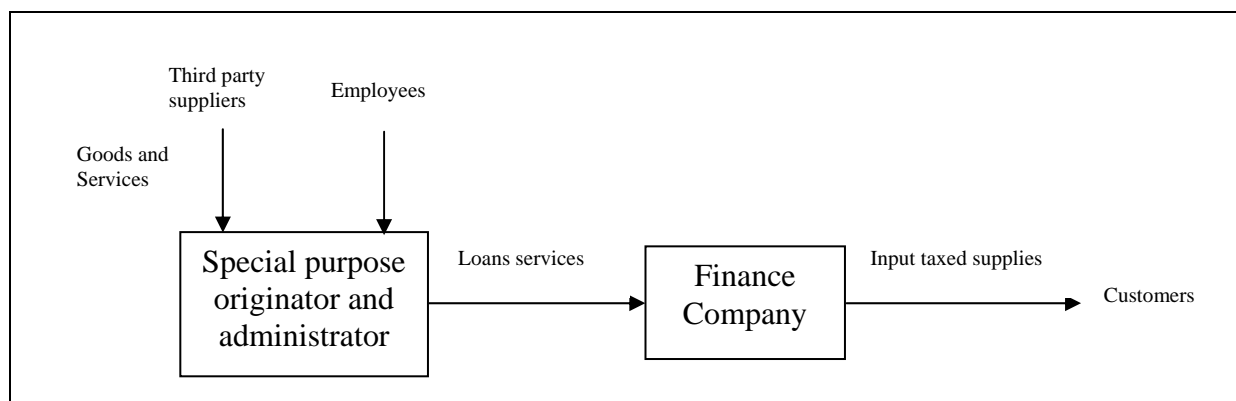
Example 7.1



The finance company makes input taxed loans to its customers. It acquires a wide range of goods and services from third party suppliers in order to carry on its loan making business. It also has employees.

The goods and services acquired from third party suppliers include items like the lease of premises, the purchase of computing equipment, and the acquisition of computing support services. None of these acquisitions qualifies as a reduced credit acquisition. Accordingly, the finance company is not entitled to any input tax credits.

Example 7.2



In this example, a special purpose originator and administrator is established. It makes many of the acquisitions previously made by the finance company. It leases premises, purchases computing equipment, acquires computer support services etc. It also has employees. The special purpose entity is able to provide a range of 'loans services' to the finance company including 'introducing and broking' and 'loan application, management and processing services'. Those services all come within item 11 or item 14 in the table in Regulation 70-5.02(2).

The special purpose entity is entitled to full input tax credits for the acquisition of goods and services from the third party suppliers and is liable for GST on its supply of

loans services to the finance company. The finance company is entitled to a reduced input tax credit for its acquisition from the special purpose entity.

The GST benefit in example 2 is that the finance company is effectively entitled to reduced input tax credits in relation to indirect acquisitions from third party suppliers for which it previously received no input tax credits or reduced input tax credits. However, that GST benefit is offset by GST leakage on the cost of the employees built into the fees for the loans services and on the mark-up charged by the special purpose entity to the finance company. Any net benefit is obviously driven by the cost of the employees relative to the cost of third party acquisitions and the size of the mark-up.

The special purpose entity in example 2 might or might not be an associate of the finance company. It could be an unrelated service provider. That would occur for example if the finance company in example 1 decided to outsource its loan origination and loan administration activities. GST might or might not be a relevant factor in that decision. The GST implications of bundling arise whenever an entity making input taxed supplies outsources part of its activities. Issues such as the status of particular acquisitions as reduced credit acquisitions and the potential application of Division 165 will depend on the precise facts of any given arrangement.

Managing GST legislation

Melanie Baker¹

1. INTRODUCTION

It has taken just over ten years since the introduction of the goods and services tax (GST), but we are finally beginning to see a critical mass of GST cases work their way through the legal system. To date, many discussions around managing GST litigation have centred on the merits of declaratory relief versus taxation review and appeal proceedings brought under Part IVC of the Taxation Administration Act 1953 (Cth) (TAA). However, just as we have become familiar with that aspect of GST litigation, the Government is threatening to change the landscape yet again with the introduction of self assessment.

At the same time, Federal Court litigation more broadly is changing. Not only has the Civil Dispute Resolution Act 2011 (Cth) commenced, but the Federal Court Rules have recently been rewritten.²

In the context of the changing landscape for litigation, this article seeks to examine both what is unique in GST when it comes to managing GST litigation, as well as considering some issues that are common to all tax litigation (and, indeed, commercial litigation more generally). The paper begins by examining why GST practitioners have embraced declaratory relief and considers whether the introduction of self assessment will mean that more GST litigation is likely to be brought under Part IVC of the TAA. The paper then moves on to describe some of the matters that GST practitioners should be aware of when managing taxation review and appeal proceedings brought under Part IVC of the TAA. The matters range from simple questions such as choosing the right applicant and selecting whether to pursue the proceedings in the Administrative Appeals Tribunal (AAT) or Federal Court, to considering how the processes established by the AAT and the Federal Court should influence how proceedings are run.

Although there are a number of cases involving private parties that raise interesting issues, such as rectification of documents to deal with defective GST clauses, they are beyond the scope of this article. Rather, this article focuses on GST litigation to which the Commissioner of Taxation (Commissioner) is a party.

¹ Victorian Bar

² Both the *Federal Court Rules 2011* and the former Federal Court Rules are referred to in this paper, where relevant.

2. DECLARATORY RELIEF

2.1 Discretionary power to grant declaratory relief

Superior Courts, including the Federal Court, have an inherent power to grant declaratory relief. The power to grant declaratory relief is a discretionary power, in respect of which it has been said that it is ‘neither possible nor desirable to fetter... by laying down rules as to the manner of its exercise’.³ However, it is clear that declaratory relief: ‘must be directed to the determination of legal controversies and not to answering abstract or hypothetical questions’, in that:⁴

‘The person seeking relief must have “a real interest” and relief will not be granted if the question “is purely hypothetical”, if relief is “claimed in relation to circumstances that [have] not occurred and might never happen” or if “the Court’s declaration will produce no foreseeable consequences for the parties”.’

The fact that declaratory proceedings are not an appropriate method of testing the law where the question is hypothetical or advisory was at the heart of the Commissioner of Taxation’s response to judicial criticism of the ATO in *FCT v Indoороopilly Children Services (Qld) Pty Ltd* [2007] FCAFC 16. In his speech, ‘The Rule of Law: A Corporate Value’, given to the Law Council of Australia Rule of Law conference in Brisbane on 1 September 2007, Michael D’Ascenzo stated:

‘The Solicitor-General and counsel have advised that it would not usually be appropriate for the Commissioner to seek to use declaratory proceedings to resolve taxation disputes. In many cases, a declaration from the court would not be available to test an interpretation of the law because the question would be hypothetical or advisory. The advice confirms that the usual objection and appeal processes involving assessments and private rulings should be used to resolve issues between a taxpayer and the ATO.’

2.2 Declaratory proceedings v Part IVC of the Taxation Administration Act 1953 (Cth)

The conclusion that Part IVC proceedings should be preferred over declaratory proceedings is, of course, consistent with the views expressed by the High Court in *FCT v Futuris Corporation Limited* (2008) 237 CLR 146, by Gummow, Hayne, Heydon and Crennan JJ at 153 [10] where their Honours stated: ‘...as matter of discretion, relief under ss 75(v) and 39B [the original jurisdictions of the High Court and Federal Court, respectively] may be (and often will be) withheld where there is another remedy provided by Pt IVC’. Their Honours went further at 162 [48] where they stated that: ‘it should be emphasised that the pendency of a proceeding by Futuris under Pt IVC should have led the Full Court to refuse declaratory relief in any event.’⁵

As the existence of an assessment, and correspondingly, access to the objection, review and appeal procedures under Part IVC of the TAA, are matters that ‘should’

³ *Ainsworth v Criminal Justice Commission* (1992) 175 CLR 564, 581-582.

⁴ *Ibid* at 582. See also *Oil Basins Ltd v Commonwealth of Australia* (1993) 178 CLR 643, 649, in which the Commissioner was found to be a ‘contradictor’ notwithstanding professing his neutrality as to the outcome.

⁵ See also *DFCT v PM Developments Pty Ltd* (2008) 173 FCR 247, 252. *Platypus Leasing Inc v FCT (No 3)* (2005) 59 ATR 84, 96 [76]-[78] is also often identified as a GST case that illustrates the way in which the issue of an assessment could preclude the grant of declaratory relief.

lead the Court to refuse to grant declaratory relief, the introduction of self assessment for indirect taxes is likely to impact on the use of declaratory relief in GST (see further the discussion below under heading 2.4).

2.3 GST and declaratory proceedings: pre-self assessment

Of course, at present, a taxpayer's liability to pay GST does not depend on the making of an assessment,⁶ with the result that assessments are not an automatic part of the GST system.⁷ In the absence of an assessment, the taxpayer does not have recourse to Part IVC of the TAA to challenge the Commissioner's interpretation, which has clearly made the Courts more likely to exercise their discretionary power to make declarations. For that reason, GST practitioners seem to have embraced declaratory relief as a way of resolving disputes, with the vast majority of significant GST cases involving requests for declaratory relief.⁸

Even in the pre-self assessment world, GST practitioners have acknowledged that there is a risk that declaratory proceedings may be precluded if an assessment subsequently issues. *Platypus Leasing Inc v FCT (No 3) (2005) 59 ATR 84, 96 [76]-[78]* is often referred to as illustrating the point that the issue of assessments could be used to frustrate declaratory relief.⁹

The popularity of declaratory proceedings in GST disputes might be thought to suggest that many practitioners are confident that the Court will necessarily exercise its discretion to make a declaration if the taxpayer's interpretation of the law is preferred. This confidence may well be misplaced. Even in the absence of an assessment, there has never been any guarantee that the Court would exercise its discretion to make a declaration. Indeed, the types of circumstances that would militate in favour of the exercise of the discretion were outlined in *DFCT v PM Developments Pty Ltd (2008) 173 FCR 247, 253 [24]*:

'24. In this case, exceptionally, it seems to me appropriate, as a matter of discretion, not to withhold the granting of declaratory relief. I do so for these reasons. The declaratory relief has been sought in this Court, which unlike these days a State or Territory Supreme Court, is the usual forum for the resolution of Commonwealth revenue law liability controversies. The point raised is novel, controversial not only between the parties but evidently also in academic literature (see "Anderson and Morrison, GST and Insolvency Practitioner Liability: Who are you? (2001) 11 Revenue LJ 23") and one of pervasive significance to corporate insolvency administration. The latter factor was recognised by the Deputy Commissioner in submissions and evidenced by

⁶ Section 105-15 of Schedule 1 to the TAA.

⁷ At present, assessments will ordinarily only be made if requested by the taxpayer under section 105-10 of Schedule 1 to the TAA or as a result of audit action: see paragraph 45 of Annexure D to PS LA 2009/9.

⁸ See, for instance, *Travellex Ltd v FCT* [2010] HCA 33 (29 September 2010, French CJ, Hayne, Heydon, Crennan and Bell JJ); *DFCT v PM Developments Pty Ltd* (2008) 173 FCR 247; *Marana Holdings Pty Ltd v FCT* (2004) 141 FCR 299; *TAB Ltd v FCT* (2005) 223 ALR 309; *FCT v Gloxinia Investments Ltd* (2010) 183 FCR 420; *TT-Line Company Pty Ltd v FCT* (2009) 181 FCR 400; *South Steyne Hotel Pty Ltd v FCT* (2009) 180 FCR 409; *Saga Holidays Pty Ltd v FCT* (2006) 156 FCR 256.

⁹ However, note that the plaintiffs in that case gave an undertaking not to take the point that the Commissioner would act in contempt of Court if he issued the assessment in the first place: *Platypus Leasing v FCT* [2004] NSWSC 376 (19 November 2004, Gzell J) at [10].

his disposition, exceptionally, to pay the liquidator's taxed party and party costs of and incidental to the application in any event and, equally exceptionally, by his obviously considered decision not to make and tender an assessment, which would be the usual course for the Commissioner to adopt in a proceeding such as this in either this Court or, a fortiori, in a State or Territory Supreme Court: see, eg Platypus Leasing Inc v Federal Commissioner of Taxation (2005) 61 ATR 239 (NSW Court of Appeal). There is no evidentiary controversy. Further, and as was also conceded on behalf of the Deputy Commissioner in submissions, the point is one always destined for this Court even in the event of assessment with the raising of the same and determination of an objection and attendant delays and related expenses only serving, in the circumstances, further to diminish such funds as may be available for distribution to creditors (principally, the Commissioner on behalf of the Commonwealth).' [Emphasis added.]

Of course, the absence of an assessment as an automatic part of the GST system is not the only reason why declaratory proceedings are so popular in GST disputes. If it was, one would have expected more taxpayers to avoid the risk that the Courts would refuse to exercise their discretion to grant declarations by simply requesting an assessment under section 105-10 of Schedule 1 to the TAA to invoke the Part IVC review and appeal processes in GST matters.

The reality is that declaratory proceedings are easier to frame in terms of narrow issues and can be simple to run where the facts are not in dispute. Take for example the approach taken in *TT-Line Company Pty Ltd v FCT* (2009) 181 FCR 400, where the broader question of whether the liability to pay GST on transport services provided by TT-Line was determined by reference to the amount paid by its fare-paying customers, or whether it was to be determined by reference to that amount plus the amount paid by the Commonwealth under the Bass Strait Passenger Vehicle Equalisation Scheme, was dealt with in the context of a simple fact pattern involving services provided to 'Mr J Egan of Hoopers Crossing' and his companion on 6 May 2008. Other examples include the provision of accommodation to 'Ms Young' as a guest in the Sebel Hotel, which was formed the basis for one of the issues considered in *South Steyne Hotel Pty Ltd v FCT* (2009) 180 FCR 409, and the sale of Fijian currency on the departures side of the Customs barrier to Mr Urquhart in *Travelex Ltd v FCT* (2010) 76 ATR 329.

2.4 GST and declaratory proceedings: post-self assessment

If PM Developments suggests that the standard for satisfying the Court to exercise its discretionary power to grant declaratory relief is quite high, then the proposed introduction of self assessment may make it significantly harder to obtain declaratory relief.¹⁰

Under the original Exposure Draft legislation dealing with self assessment of indirect taxes,¹¹ the Commissioner was to be treated as having made an assessment of a taxpayer's net amount (including a nil amount) for a tax period when the taxpayer

¹⁰ Since this paper was presented, the Government has announced that the proposed 1 July 2011 starting date for self assessment of indirect taxes has been deferred.

¹¹ A revised Exposure Draft was published on 22 August 2011.

lodged their GST return for the relevant tax period.¹² Taxpayers were to be entitled to object, in the manner set out in Part IVC of the TAA, against the deemed assessment (or any subsequent amended assessment) if they were dissatisfied with it.

Based on the High Court's comments in *Futuris*, and Gzell J's approach in *Platypus Leasing*, it seems reasonably clear that the existence of an assessment in respect of a particular tax period will be a factor that will strongly militate against granting declaratory relief.¹³ However, there may still be some residual scope for taxpayers to seek declaratory relief in respect of other tax periods, including past tax periods in respect of which no assessment has been made and future tax periods before an assessment has been made. Certainly, Gzell J seemed to emphasise the fact that the assessments in *Platypus Leasing* had been made in respect of the same tax periods to which the declaratory proceedings related (*Platypus Leasing Inc v FCT (No 3) (2005) 59 ATR 84, 95 [74]*):

'74 In this case, on the other hand, the notices of assessment and declaration relate to the tax periods in question. They preclude this court calling in question the amount or particulars with respect to those tax periods.'

Although it might still be possible to seek declaratory relief in respect of past, pre-self assessment, tax periods, there is a risk in doing so as the declaration will not bind the Commissioner in respect of other tax periods. The circumstances in which estoppel operates against the Commissioner are rare, with the result that a declaration in respect of an earlier tax period may have very limited utility in respect of later tax periods.¹⁴

The Commissioner appears to have endorsed the use of declaratory proceedings in respect of future tax periods and transactions before an assessment has issued. Footnote 83 of the Statement on Tax Technical Litigation in the Federal Court at Annexure D of Law Administration Practice Statement PS LA 2009/9 states that declaratory proceedings need not always be used 'in substitution for' taxation appeal proceedings brought under Part IVC of the TAA:

'... Taxpayers may sometimes want a declaration from the Federal Court that an ongoing supply is GST-free. Due to the restrictions in section 105-65 of Schedule 1 to the TAA in getting refunds on overpaid GST on past sales, taxpayers are more concerned with using the declaration for future sales, whereas Part IVC of the TAA relates to past tax periods (although appeal decisions can have implications for the future).'

¹² See clause 155-17 of Schedule 1 to the original Exposure Draft setting out the inserts for Assessment of Indirect Taxes.

¹³ Given the statement in *Futuris* about the fact that the discretion to make declarations should not be exercised where Part IVC proceedings are pending, it seems unlikely that the Commissioner will follow his previous policy on declaratory proceedings in Sales Tax matters which was set out in Sales Tax Ruling ST 2454 (now withdrawn) at 12-13. That ruling, which also considered issues of jurisdiction and cross-vesting, suggested that the Commissioner might ordinarily have difficulty seeking a stay or dismissal, and that the preferred course might be to have declaratory proceedings and Part IVC proceedings heard together in the same Court.

¹⁴ Indeed, in the context of Part IVC proceedings dealing with income tax, the authorities suggest that revenue proceedings in respect of one year of income will not be determinative of any other year of income where there are findings of fact that may differ from year to year that are indispensable to the determination of the appeal; that is, issue estoppel does not arise in the later year (*Spassed v FCT (No 2) (2007) 165 FCR 484, 500-507*).

However, if the comments made by Dowsett J in *FCT v Gloxinia Investments Ltd* (2010) 183 FCR 420, 424 [13] are anything to go by, there might be some risk in pursuing declaratory relief in respect of future transactions where some aspect of the analysis requires an assessment of the facts and circumstances at the time of the transaction. His Honour's comments certainly suggest that declaratory relief may have been refused if the Commissioner had taken issue with the taxpayer seeking declaratory relief based on hypothetical facts (at 424 [13]):

'13. Subparagraph (a) [of the definition of 'long-term lease'] speaks of a reasonable expectation as to the duration of the lease, hire or licence, such expectation to be "at the time of the lease, hire or licence", presumably the date of grant. It seems that at least at the time of commencement of these proceedings, the Strata Lot Leases had not been granted. See the application and the primary Judge's reasons at [13] and [14]. If that is correct, then it is difficult to understand how it is possible to determine what, at the time of grant, "was" reasonably to be expected as to the likely duration of the lease. This suggests that, at least in theory, Gloxinia's application for declaratory relief is, or was, premature. The respondent (the "Commissioner") has not taken the point, either at first instance or on appeal. I propose to deal with the matter on the basis adopted by the parties. Nonetheless I observe that this, and some other aspects of the case, hint at the possibility that they are seeking little more than an advisory opinion.' [Emphasis added.]

Although there will likely still be some residual scope for taxpayers to seek declaratory relief once self assessment has been introduced for indirect taxes, the use and usefulness of declaratory proceedings in GST cases in the future will probably depend on the Commissioner's attitude to them. After all, it seems that the Commissioner will be able to make technical arguments to oppose the grant of declaratory relief in respect of future tax periods, or to ignore the results of declaratory relief in respect of past tax periods. As such, it might be necessary to gauge the Commissioner's view on whether declaratory proceedings are an appropriate way of resolving a particular dispute where Part IVC proceedings might otherwise be available, albeit in respect of a different tax period.

3. REVIEW AND APPEALS UNDER PART IVC OF THE TAA

The review and appeal processes set out in Part IVC of the TAA are doubtless familiar to most GST practitioners, so there is no need to outline them again here.¹⁵ It is sufficient to say that once an objection decision has been made disallowing the taxpayer's objection, wholly or in part, the taxpayer may wish to challenge the

¹⁵ Although it is worth noting that there are still plenty of examples where taxpayers have sought to invoke Part IVC where it clearly does not apply: see generally *Re Garrett v FCT* (2008) 73 ATR 564; [2008] AATA 749; *Re Kancroft Pty Ltd (Acting as Trustee for Robertson Family Trust) v FCT* (2004) 56 ATR 1086, 1088; [2004] AATA 591, at [16]-[17]; *Re Ivan Sop v FCT* [2007] AATA 1746; *Re Nyack Investments Pty Ltd v FCT* (2005) 59 ATR 1116; [2005] AATA 468; *Flack v FCT* 2005 ATC 2016. Therefore, it is necessary to note that Part IVC of the TAA only applies where a statutory provision confers a right to object. At present, the power to object against reviewable indirect tax decisions is found in section 105-40 of Schedule 1 to the TAA. As mentioned above, the Exposure Draft for self assessment contains a specific objection right in respect of indirect tax assessments at clause 155-75. Objections against assessments of penalties, the Commissioner's refusal to remit further any amount of penalty that exceeds 2 penalty units and objections against private rulings, amongst other things, are all subject to their own rights to object.

objection decision. This is the time to make decisions about whether it is worth the expense of 'fighting on', which may depend on the appetite your client has for risk and whether or not they can find the necessary evidence to discharge their onus of proof.

3.1 Who can seek review or appeal?

In order to apply for review of or appeal against an objection decision, the taxpayer must be a person 'dissatisfied with the Commissioner's objection decision'.¹⁶

The question of when a taxpayer is dissatisfied with an objection in the relevant sense has a few aspects. Beyond the question of what constitutes 'dissatisfaction', and how it interacts with the onus cast on taxpayers by sections 14ZZK and 14ZZO of the TAA in proceedings before the AAT and Federal Court respectively, there is also the question of who must be dissatisfied.

It is trite, but only the taxpayer (or the applicant for a ruling, in the case of objections against rulings¹⁷) can be dissatisfied in the relevant sense. Where the taxpayer is an individual or a body corporate, the question of who may bring review or appeal proceedings under Part IVC of the TAA will be obvious. Subject to the early error made by HP Mercantile Pty Ltd as trustee of the Recoveries Trust, it is also now apparent in whose name proceedings must be instituted where the taxpaying entity is a trust.¹⁸

Where the taxpayer is an entity for GST purposes which is exposed to joint and several liability, the issue is more difficult as *Russell v FCT* [2008] FCA 343 (14 March 2008, Logan J)¹⁹ demonstrates. In *Russell*, the question was whether the applicant, Mr Russell, could bring the Part IVC proceedings in his name alone despite the fact that the assessments being challenged related to a partnership in which he had been a partner with his former wife. In the case, the Commissioner contended that the proceedings should have been brought in the name of the partnership that lodged the relevant business activity statements, or alternatively that Mr Russell's former wife, who was the other partner in the partnership, should also be a party to the proceedings.

Justice Logan conceded that if the partner's liability for GST was only joint, rather than joint and several, 'the Commissioner's submission might have some attraction' (at [31]). However, Logan J emphasised the joint and several liability of partners in a partnership to conclude:

'41. ... The "person dissatisfied" with the Commissioner's objection decision in respect of a GST assessment might well, for just the reasons identified by the Court of Appeal in Sutherland v Gustar, be but one of a number of partners.'

¹⁶ Section 14ZZ of the TAA.

¹⁷ *Corporate Business Centres International Ltd v FCT* [2004] FCA 458 at [51].

¹⁸ See *HP Mercantile Pty Ltd v FCT* (2005) 143 FCR 553, per Hill J at 555 [2] commenting on the substitution of the trustee's name as the relevant party to the appeal against the *Recoveries Trust v FCT* (2004) 57 ATR 1038.

¹⁹ This issue was not revisited in the related proceedings *Russell v FCT* [2009] FCA 1224 (30 October 2009, Logan J) and its appeal proceedings *Russell v FCT* [2011] FCAFC 10 (4 February 2011, Dowsett, Edmonds and Gordon JJ).

44. *The word "person" in s 14ZZ of the TAA bears its ordinary meaning of referring to natural persons as well as bodies corporate and bodies politic: s 22 Acts Interpretation Act 1901 (Cth) and includes the singular as well as the plural: s 23 Acts Interpretation Act 1901 (Cth). As earlier noted, under the general law a partnership is not a separate legal entity. A partnership is not a "person". The liability in respect of GST being joint as well as several s 14ZZ of the TAA would certainly permit the members of a partnership jointly to institute an appeal against an objection decision in respect of a GST assessment if so disposed but the effect of that section is that it is not mandatory that each partner be a party to the institution of an appeal for that appeal to be competent.'*

Given that the GST law also affixes joint and several liability to GST joint ventures and GST groups, among other arrangements used for the purposes of GST, it will be interesting to see how broadly Russell may be applied in the future. Certainly, it seems possible that one entity might be dissatisfied in the relevant sense, without that entity's dissatisfaction representing the interests of the GST group as a whole.

Once a relevant person who is capable of being 'dissatisfied' has been identified, the next issue is whether they are dissatisfied in the relevant sense for the purposes of section 14ZZ of the TAA. What constitutes relevant 'dissatisfaction' was considered by Gummow J in *CTC Resources NL v FCT* (1994) 48 FCR 397 in the context of an objection against a private ruling (at 408):²⁰

'In my view, if regard is had to the context in which s 14ZZ appears, in its operation upon the jurisdiction of this Court, then the 'dissatisfaction' of the person initiating the proceeding is of the following nature. It is a dissatisfaction with the absence of a favourable decision upon the objection which would, if now rectified by the Court, place the party in the position for the administration of the taxation laws which should have applied if the ruling had been made by the Commissioner in the terms sought. A mere curiosity or interest in having a formal ruling by the Commissioner for some collateral commercial purpose of the applicant is not sufficient to amount to "dissatisfaction" in the relevant sense. That being the case, s 14ZZ clearly is valid. There is thus no occasion to consider what might have been the position if the provision were more widely construed.'

It appears that one may be dissatisfied when an taxation decision, such as an assessment, is too low.²¹ However, in those circumstances, their dissatisfaction will be based on the fact that the decision should have been made differently.²²

²⁰ In *CTC Resources*, the applicant could not be dissatisfied in the relevant sense because the income year to which the private ruling related had passed without the arrangement that was the subject of the ruling being implemented. As GST is now within the uniform rulings system, there is likely to be some scope for some of the same issues concerning whether the taxpayer is 'dissatisfied' in the relevant sense to arise in that context too. See also *Re Kenneth Hickey v FCT* [2009] AATA 347.

²¹ *Isaacs v FCT* (2006) 151 FCR 427 and TR 2010/D10 at 86-87. Subject, of course, to the restriction on objections against nil income tax assessments under subsection 175A of the ITAA 1936.

²² See, for instance, *Waverley Council v FCT* 2009 ATC 10-095, in relation to the burden of proof faced by the taxpayer under section 14ZZK of the TAA when they were alleging certain GST assessments were too low.

3.2 When must the application be made?

The taxpayer has 60 days from when they are served with the objection decision to seek review by the AAT²³ or to appeal to the Federal Court.²⁴ However, the AAT may extend the time period in which review can be sought.²⁵

3.3 Can one application be made in respect of multiple objection decisions?

In respect of appeals to the Federal Court, it has been accepted that a single appeal can be made in respect of multiple objection decisions. Further, it does not matter that those objection decisions deal with different subject matters, such as income tax and GST. As Logan J observed in *Russell v FCT* [2008] FCA 343 (14 March 2008, Logan J)

'9. In Krampel Newman Partners Pty Ltd v FCT [2001] FCA 976; (2001) 113 FCR 306 at 312, [15], Ryan J concluded that s 14ZZN of the TAA does not evince an intention contrary to the effect of s 23 of the Acts Interpretation Act 1901 (Cth), which is that the singular includes the plural. I respectfully agree. Thus, there is nothing in s 14ZZN of the TAA which forbids the inclusion in the form of initiating application which is lodged with this Court of appeals against more than one objection decision.

10. Krampel Newman concerned objection decisions each of which related to objections against income tax assessments. Does it make any difference here that one of the primary tax liabilities is in respect of income tax and the other is in respect of a net amount for the purposes of the GST Act? In my opinion it does not...'

Presumably the same reasoning would apply in respect of applications for review made to the AAT under section 29 of the Administrative Appeals Tribunal Act 1975 (Cth) (AAT Act), as modified by section 14ZZC of the TAA.²⁶

3.4 Subject matter of the review or appeal

3.4.1 Limited to grounds on objection

If a taxpayer seeks to challenge a decision made by the Commissioner on objection before the AAT or the Federal Court, then they will be limited to raising the grounds stated in the objection unless they seek leave to raise additional grounds.²⁷ The AAT and the Federal Court have a broad discretion to grant leave, but there is no automatic right to such an order.²⁸

The matters that will be considered by the AAT and the Federal Court when considering applications for leave to raise additional grounds are set out in Lighthouse

²³ In accordance with the AAT Act as modified by section 14ZZC of the TAA.

²⁴ Section 14ZZN of the TAA.

²⁵ Subsection 29(7) of the AAT Act confers on the AAT a discretion to extend the time for making an application. The Federal Court has no such jurisdiction: *Bayeh v FCT* (1999) 100 FCR 138.

²⁶ Certainly the AAT is prepared to hear applications for review against objection decisions dealing with different taxes together. See *Peerless Marine Pty Ltd v FCT* [2006] AATA 765; (2006) 63 ATR 1303.

²⁷ Paragraph 14ZZK(a) and 14ZZO(a) of the TAA.

²⁸ See generally *FCT v American Express Wholesale Currency Services Pty Ltd* (2010) 187 FCR 398, 447 per Kenny and Middleton JJ.

Philatelics Pty Ltd v FCT (1991) 32 FCR 148. These include matters such as expediency and whether permitting the additional grounds is in the interests of justice, or whether it would cause prejudice.

3.4.2 Court is seized with the entire objection decision

If you represent a taxpayer that is only dissatisfied with one aspect of the objection decision, it is worth keeping in mind that on appeal to the Federal Court (and possibly in seeking review to the AAT), the Court is seized with the entirety of the objection decision. In *FCT v Australia and New Zealand Savings Bank Limited* (1994) 181 CLR 466, the High Court stated (at 476):²⁹

'... An appeal relates to the objection decision made by the Commissioner albeit a taxpayer is dissatisfied only with part of that decision. A power to make such order as the Court thinks fit is clearly not unconstrained but there is nothing in s199 [the predecessor to section 14ZZP of the TAA] to suggest that the Federal Court may not make such order in relation to the objection decision as is appropriate in all the circumstances once the subject matter of the taxpayer's dissatisfaction has been resolved.'

3.4.3 Recovery and restriction on refund provisions as part of Part IVC proceedings?

One matter that is yet to be determined by a Court³⁰ that is unique to GST is the question of whether the Commissioner is correct in his view expressed in Miscellaneous Tax Ruling MT 2010/1 that provisions such as sections 105-55 and 105-65 of Schedule 1 to the TAA are relevant to the determination of a taxpayer's net amount and are, therefore, included in the ambit of Part IVC taxation review and appeal proceedings.

The Commissioner's view is set out in paragraphs [158] and [159] of MT 2010/1:³¹

'158. Determining the correct net amount is a two step process. The first step is to determine whether the entity is entitled to a refund because they overpaid GST as a result of incorrectly treating a supply as a taxable supply to some extent. If an overpayment did occur, then generally the net amount is reduced by the amount of the overpayment. However, before determining the correct net amount (that is the actual entitlement to a refund or obligation to pay) a second step is required. That step is to consider all the provisions that go to or may affect the entitlement to pay that refund. Section 105-65 operates to restrict that entitlement and if it operates to deny the refund then the entity has no

²⁹ Cited with approval by Logan J in *Russell v FCT* [2009] FCA 1224 (Federal Court of Australia, Logan J, 30 October 2009) at [165]. However, in that case, Logan J concluded that the powers exercisable by the Court did not include setting aside the decision on objection, making an order setting aside the assessment and making an order that Mr Russell's taxable income should have increased. Notably, Logan J left open the possibility that an increased assessment might be ordered where it is a consequential adjustment (at [177]-[178]).

³⁰ Certainly, the AAT has already considered provisions of this type in its review of Part IVC proceedings: *Re Australian Leisure Marine Pty Ltd and FCT* [2010] AATA 620 at [16] and [17]. This approach is also arguably implicit in other AAT decisions: see Miscellaneous Tax Ruling MT 2010/1 at [155].

³¹ See also the excerpt from the advice of J Daryl Davies QC, which can be found at Annexure 3 of the Draft GST minutes for September 2010 (although apparently in connection with the NTLG GST Sub-Committee meeting of 24 June 2010).

entitlement to the refund and the net amount must reflect this application of the law.

159. The view that the relevant TAA provisions impact upon the net amount, and hence also on assessments, means that taxpayers are provided with the ability to challenge decisions under Part IVC of the TAA and also may be able to obtain merits review in the Tribunal. In particular, on this view, taxpayers are able to obtain, as part of the review of an objection decision relating to an assessment of the taxpayer's net amount for a tax period, merits review of a decision made by the Commissioner not to exercise the section 105-65 discretion to pay a refund where its provisions otherwise apply.'

The view adopted by the Commissioner is undoubtedly favourable to taxpayers in that it will reduce the compliance costs associated with running separate proceedings. However, it may be susceptible to challenge (and may well be challenged by a taxpayer if there is any advantage in doing so in a particular case).

Even more unsatisfactorily, it is presently unclear how section 105-65 of Schedule 1 to the TAA, in particular, will interact with self assessment when it is introduced. The Exposure Draft legislation dealing with self assessment of indirect taxes did not deal with the issue at all. Hopefully this issue will be resolved through the consultative process that is currently ongoing in relation to self-assessment, as taxpayers will need to address the operation of section 105-65 of Schedule 1 to the TAA in drafting grounds of objection and preparing matters to litigate in the future.

3.5 The choice between the AAT and the Federal Court

In GST proceedings brought under Part IVC of the TAA, which deal with 'reviewable objection decisions'³², there is choice to be made between seeking review by the AAT and appealing to the Federal Court.

3.5.1 Difference in the roles and powers of the AAT and Federal Court

Where there is a choice between the AAT and Federal Court, it is necessary to be aware of the essential differences between the role and powers of the AAT and the Federal Court.

The AAT is an administrative body which undertakes reviews on the merits. That is, it makes administrative decisions afresh by effectively 'standing in the shoes of the Commissioner', which is particularly useful for the taxpayer where the matter involves the exercise of a discretion or power (take, for instance, remission of penalties). That is, section 43 of the AAT Act as modified by section 14ZZJ of the TAA applies in respect of the AAT's decision on review. Subsection 43(1) of the AAT Act relevantly states:

'(1) For the purpose of reviewing a decision, the Tribunal may exercise all the powers and discretions that are conferred by any relevant enactment on the person who made the decision and shall make a decision in writing:

³² 'Reviewable objection decision' is defined in section 14ZQ of the TAA to mean 'an objection decision that is not an ineligible income tax remission decision'. An 'ineligible income tax remission decision' is defined in section 14ZS of the TAA and broadly relates to certain penalties imposed under the former Part VII of the *Income Tax Assessment Act 1936* (Cth).

- (a) *affirming the decision under review;*
- (b) *varying the decision under review; or*
- (c) *setting aside the decision under review and:*
 - (i) *making a decision in substitution for the decision so set aside; or*
 - (ii) *remitting the matter for reconsideration in accordance with any directions or recommendations of the Tribunal.'*

Compare this to the power to make orders conferred on the Federal Court by section 14ZZP of the TAA, which is clearly confined to confirming or varying the decision, or setting it aside where it is wrong in law.

'Where the Federal Court hears an appeal against an objection decision under section 14ZZ, the Court may make such order in relation to the decision as it thinks fit, including an order confirming or varying the decision.'

The Federal Court therefore does not make new decisions. Rather, it undertakes judicial review of the Commissioner's decision. The Federal Court can only order the Commissioner to vary an assessment or set it aside where it is wrong in law. (Importantly, though taxation appeal proceedings under Part IVC are designated as 'appeals', they are actually brought in the original jurisdiction of the Court and are not 'appeals' in the strict sense.³³)

The distinction between the role and powers of the AAT and Federal Court is particularly important when it comes to cases where the Commissioner has exercised a discretion (for instance, remission of penalties). In those cases the AAT member may substitute his or her discretion if he or she reaches a different conclusion based on the evidence.

However, in other cases, it may nonetheless be preferable to appeal to the Federal Court where the issues in the taxation objection are extremely complex or technical.³⁴

3.5.2 Other differences between the AAT and Federal Court

Although the difference in the roles and powers of the AAT and Federal Court will lie at the heart of any choice between the two forums, there are a range of other matters that may also influence a taxpayer's choice. These may include likely cost (and the ability to recover costs if successful³⁵) and the mechanisms by which it is possible to preserve taxpayer anonymity in the AAT.³⁶

However, one of the most critical distinctions that may be relevant in factually intensive cases is the fact that the AAT is not bound by the rules of evidence, and it is

³³ Although an appeal to the Federal Court against the decision of the AAT on a tax matter is clearly an appeal in the strict sense.

³⁴ It is also arguable that the findings of the AAT cannot create an issue estoppel see *Blackman v FCT* (1993) 43 FCR 449, at 457 per Gray J, such that proceedings in the Federal Court may have other advantages (notwithstanding the difficulties in establishing that estoppel can operate against the Commissioner).

³⁵ In general, parties before the AAT bear their own costs.

³⁶ Sections 14ZZE and 14ZZJ of the TAA, and section 43(2)(c) of the AAT Act.

intended to operate with as little formality and technicality as possible.³⁷ Arguably, this feature of the AAT may explain why the AAT was chosen as the preferred venue for a number of income tax anti-avoidance cases, where establishing the objective facts was essential.³⁸

The fact that the AAT is not bound by the rules of evidence does not mean that ‘anything goes’ when it comes to adducing evidence. Rather, the AAT will often have regard to the rules of evidence in ‘informing itself’ as to the probative force of evidence and the weight to attach to it. This power to inform itself is set out in paragraph 33(1)(c) of the AAT Act, which states:

‘(1) *In a proceeding before the Tribunal –*

...

(c) *the Tribunal is not bound by the rules of evidence but may inform itself on any matter in such manner as it thinks appropriate.’*

There are many AAT decisions which clearly illustrate that the AAT will often have regard to the rules of evidence as part of ‘informing itself’. For instance, *Re Ileris and Comcare* [1999] AATA 647 (Senior Member P Bayne) at [37] to [39] contains a lengthy analysis of the principles governing the acceptance of hearsay evidence by the AAT. Similarly, *Re Proctor and FCT* [2005] AATA 389, at [66]–[68] provides an illustration of when opinion evidence will be excluded by the AAT if it is directed to the ultimate issue that must be decided by the AAT.³⁹

In addition to the fact that the AAT may have regard to the rules of evidence in giving weight to evidence (or in refusing to accept it), it should also be noted that in practice the AAT’s use of its inquisitorial powers is often fairly limited.⁴⁰ Typically the AAT will generally rely on material produced by the parties.

Provided that the evidence produced in proceedings before the AAT is sufficiently probative, there are definite advantages associated with the AAT not being bound by the rules of evidence. For instance, in appropriate cases, it is arguable that the AAT may draw an inference in respect of one period when satisfied in respect of an earlier period. This obviously would assist where the taxation review proceedings deal with multiple tax periods. However, the AAT will only draw this inference if the evidence of the taxpayer is considered to be completely truthful or reliable.⁴¹

Despite the AAT not being bound by the rules of evidence, it is apparent that care must still be exercised in preparing evidence to discharge the onus of proof borne by taxpayers under section 14ZZK of the TAA before the AAT.

³⁷ Section 33 of the AAT Act.

³⁸ See, by way of example, *Re News Australia Holdings Pty Ltd and FCT* (2009) 75 ATR 971; [2009] AATA 750, which was appealed directly to the Full Court of the Federal Court of Australia in accordance with section 44(3) of the AAT Act (*FCT v News Australia Holdings Pty Ltd* [2010] FCAFC 78 (Stone, Jessup and Jagot JJ, 30 June 2010)).

³⁹ As to irrelevant material, see *Mt Gibson Manager Pty Ltd v DFCT* (1997) 81 FCR 335, 343 per French J, as his Honour then was.

⁴⁰ *Re Hobart Central Child Care Pty Ltd and FCT* (Cth) [2004] AATA 1222 at [18].

⁴¹ See *Re Goldfort Corporation, Brendan Smith and Julie Smith* [2010] AATA 883 at [55], referring to *Krew v FCT* (1971) 2 ATR 230 per Walsh J and *McCauley v FCT* (1988) 19 ATR 1443 per Lockhart J.

3.5.3 Discharging the onus of proof in the AAT

The onus of proof in GST cases, as in income tax, is on the taxpayer to demonstrate any facts necessary to show that the assessment is excessive and to show how the amount by which the assessments are incorrect. As Edmonds J stated in *Hua-Aus Pty Ltd v FCT* (2010) 184 FCR 430, 436-437 [23]:⁴²

'23. I agree with the Commissioner's submissions. It follows that if no evidence is adduced by Hua-Aus; if such evidence as is adduced is not a reasonable explanation of why the assessment is excessive and, in consequence, is not accepted as discharging the onus; or if such evidence is otherwise rejected, the Notice of Assessment of GST net amount issued to Hua-Aus must prevail: Gauci 135 CLR at 89 (Mason J).'

There are numerous examples of AAT decisions involving taxpayers who have failed to discharge their onus in GST cases.⁴³ One recent example, *Re Goldfort Corporation Pty Ltd, Brendan Smith and Julie Smith and FCT* [2010] AATA 883, illustrates that the fact that the AAT is not bound by the rules of evidence does not mean that the taxpayer is released from having to prove its case.

In *Re Goldfort*, the AAT began its decision by observing (ominously for the taxpayer) that 'in circumstances where the applicants seek to rely on memory and a lack of records, the Tribunal will rightly be reluctant to find that the applicants' onus has been discharged' (at [11]). Further, to the extent that the taxpayer was relying on the memory of individuals rather than business records, the AAT found its witnesses unimpressive.⁴⁴ Of one witness, Mr Mann, the AAT stated:

'30. In the opinion of the Tribunal his disclaimers as to knowledge of what was happening at the Vibe (see for instance his claim that he never went upstairs) are disingenuous, particularly given the parts of his evidence the applicants seek to rely on in their submissions. The truth about what he actually knew of the day to day operations of Vibe is obscured rather than illuminated by the inconsistencies between his asserted lack of knowledge on the one hand, his detailed knowledge on the other and the reliance on some of his evidence by the applicants.'

The AAT was similarly unimpressed by Mr Blake:

'33. Overall the Tribunal attaches little weight to Mr Blake's evidence, which is substantially adversely affected by his stated disinterest in the administrative aspects of the business [TS182.14-45], his poor memory [TS136.30 & 35; 139.22-25; 143.35-45; 150.3; 182.23; 192.5; 208.13], and his admitted heavy alcohol use [TS158.15-40].'

⁴² Although note that his Honour held that a taxpayer's evidence should not be discounted unless there is a positive reason the taxpayer should be disbelieved (citing at [46] *Ma v FCT* (1992) 37 FCR 225, 230).

⁴³ See, for example, *Re Martinazzo and FCT* [2009] AATA 62 and *Re QFP Professional Tomato Project 98 and FCT* [2010] AATA 864.

⁴⁴ Although the AAT declined to make any finding as to whether their conduct in giving away free drinks was in breach of liquor licensing guidelines (*Re Goldfort* at [64]).

The failure by one of the applicants (Ms Julie Smith) to give evidence also caused the AAT to draw the inference that her evidence would not have assisted the applicants (at [50]-[53]).

One of the matters that is unique to GST that should be considered when preparing evidence for GST litigation, is the impact of the multi-party nature of GST. It might be that calling third party witnesses will be necessary for corroboration of some matters, or to avoid any adverse inferences being drawn about their absence. It may also be prudent to investigate whether the other parties to the transaction took an inconsistent position, which may be exposed in the Commissioner's cross examination.

3.5.4 Legal professional privilege in the AAT

Common law legal professional privilege applies to confidential communications between a client and the client's legal adviser for the dominant purpose of giving or receiving legal advice ('legal advice privilege') or for use in existing or anticipated litigation ('litigation privilege').⁴⁵ The Evidence Act 1995 (Cth) applies to proceedings in a federal court, with sections 118 and 119 of that Act creating a statutory version of legal professional privilege.

A corollary of the fact that the AAT is not bound by the rules of evidence is that the Evidence Act 1995 (Cth), including sections 118 and 119 of that Act, has been held not to apply in matters before the AAT.⁴⁶ Although it has also been suggested that 'litigation privilege' (as distinct from 'legal advice privilege') does not apply to proceedings in the AAT⁴⁷, the AAT disagreed with that proposition in *Re Farnaby and Military Rehabilitation and Compensation Commission* [2007] AATA 1792 at [19]-[31] and held that common law privilege still applies in the AAT unless there is a clearly expressed abrogation of the privilege in the legislation governing the application.

However, just to complicate matters further, the AAT has also held that it may inform itself having regard to the provisions of the Evidence Act 1995 (Cth) in deciding matters of privilege (see *Re Seinor and Comcare* [2009] AATA 201).

What this means is that those involved in any tax litigation, whether before the AAT or Federal Court, will need to have a working knowledge of both common law principles that govern legal professional privilege and the Evidence Act 1995 (Cth). It is essential to be aware that there may be differences between how the two regimes for privilege apply to issues such as waiver of privilege and the operation of privilege with respect to in-house lawyers. Therefore, slightly different principles may apply depending on whether legal professional privilege is being claimed in proceedings before the AAT as compared to the Federal Court.⁴⁸

⁴⁵ *Esso Australia Resources Ltd v FCT* (1999) 168 ALR 123.

⁴⁶ *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2006) 67 NSWLR 91; [2006] NSWSC 530.

⁴⁷ *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2006) 67 NSWLR 91; [2006] NSWSC 530.

⁴⁸ Note that common law privilege also applies when making legal professional privilege claims when responding to requests for information made by the Commissioner, and also appears to apply in Freedom of Information proceedings when challenging the Commissioner's privilege claims.

3.6 Process for applying for review by the AAT

An application to the AAT for review of a decision must be made in writing and may be made in the approved form provided by the AAT,⁴⁹ which requires the taxpayer to provide reasons for their request for review. There is a fee that is fully refundable if the review is decided the taxpayer's favour. The fee may also be waived in some circumstances.

Twenty eight days after receiving notice of the application, the ATO will file material with the AAT pursuant to section 37 of the AAT Act. That material includes:

- a statement giving reasons for the decision;
- the notice of the taxation decision concerned;
- the taxation objection concerned; and
- every other document that is in the Commissioner's possession or under the Commissioner's control and is considered by the Commissioner to be necessary to the review of the objection decision concerned.

These documents are often referred to as the 'T-documents'.

Generally a conference by telephone will be arranged with a Registrar from the AAT. A pre-hearing timetable, including dates for the parties to file and serve Statements of Facts, Issues and Contentions, signed witness statements and any further relevant material will usually be set down. Often, alternative dispute resolution processes, such as a conciliation conference, will be included in the pre-hearing timetable.⁵⁰

3.7 Appeals to the Federal Court – The 'Tax List'

Appeals to the Federal Court require a written application which sets out brief details of the objection decision appealed against.⁵¹ It must be filed with the relevant Federal Court Registry. The application must also be accompanied by the prescribed filing fee. The application must be both filed with the Court and served on the Commissioner, as Respondent, at the Office of the Australian Government Solicitor in the state or territory in which the application was filed.

Within 28 days of serving a sealed copy of the application on the Commissioner, the ATO will provide the Court and taxpayer with:⁵²

- a copy of the notice of the objection decision concerned; and
- a copy of the taxation objection concerned; and

⁴⁹ Section 14ZZC of the TAA, which modifies section 29 of the AAT Act.

⁵⁰ See generally Practice Statement Law Administration PS LA 2007/23 generally concerning the ATO's approach to alternative dispute resolution, and in particular at [25]-[30] within the AAT.

⁵¹ See Order 52B rule 4 of the former Federal Court Rules, which prescribed that Form 55D must be used and Rule 33.02 of the *Federal Court Rules 2011*, which prescribes Form 73.

⁵² Order 52B rule 5 of the former Federal Court Rules and Rule 33.03 of the *Federal Court Rules 2011*. Note that the documents that the Commissioner must lodge are modified where the appeal relates to a private ruling: Order 52B rule 5A of the former Federal Court Rules and Rule 33.04 of the *Federal Court Rules 2011*.

- any return or other document in the Commissioner's possession or under the Commissioner's control to which the taxation objection relates that is relevant to the hearing of the matter; and
- an appeal statement or an appeal affidavit (which is an affidavit setting out the grounds for seeking an order to dispense with the appeal statement⁵³).

3.7.1 Appeal statements

The taxpayer's appeal statement must be filed and served upon the Commissioner within 40 days of the date on which the application was served on the Commissioner. Both parties must also complete, file and serve a copy of the pro forma questionnaire attached to the Practice Note reissued by the Chief Justice of the Federal Court on 1 August 2011, 'Tax 1 – Tax List' within 40 days of the date on which the application was served on the Commissioner.

Relevantly, the appeal statement is a statement that outlines succinctly the relevant party's contentions and the facts and issues in the appeal as that party perceives them. The Practice Note issued by the Chief Justice of the Federal Court on 25 September 2009, 'Tax 1 – Tax List', also requires that appeal statements must state in summary form:

- the basic elements of the party's case or defence;
- where applicable, the relief sought;
- the issues the party believes are likely to arise;
- the principal matters of fact upon which the party intends to rely; and
- the party's contentions (including the legal grounds for any relief claimed) and the leading authorities supporting those contentions.

The function of the appeal statement was considered by Stone J in *BAE Systems Australia (NSW) Pty Ltd v FCT* [2008] FCA 48 (Federal Court of Australia, 5 February 2008). Her Honour concluded that the appeal statement is not to be treated in the same way as pleadings even though it takes the place of pleadings, but rather:⁵⁴

'[18] The difference between pleadings and a statement of facts, issues and contentions or an appeal statement was recognised by Lindgren J in W R Carpenter Holdings Pty Ltd v FCT [2006] FCA 1252; *W R Carpenter Holdings Pty Ltd v FCT* [2007] ALMD 379; [2007] ALMD 572; [2007] ALMD 573; [2007] ALMD 592; [2007] ALMD 590; *W R Carpenter Holdings Pty Ltd v FCT* (2006) 2006 ATC 4652; 63 ATR 577; 234 ALR 451 where his Honour stated unequivocally (at ATR 585 [35]; ATC 4659 [35]; ALR 459 [35]), that a statement of facts, issues and contentions is not a pleading even within the extended definition of "pleading" in O 1, r 4 of the Federal Court Rules 1979 (Cth).

⁵³ See Order 52B sub-rules 5(2)(iv) and (3) of the former Federal Court Rules and Rule 33.03(a)(iv) of the *Federal Court Rules 2011*.

⁵⁴ See also *Pacific Exchange Corporation Pty Ltd v FCT* (2009) 180 FCR 300, 311 [53] per Logan J.

[19] Ultimately, however, what is clear from all of the authorities is that the issue is one of substance; the taxpayer, and the court, must be given a clear and succinct statement of the Commissioner's position without imposing any element of a burden of proof on the Commissioner. In substituting such a statement for pleadings the legislature has provided for a very practical approach to the unusual situation where the taxpayer bears the burden of proving that the Commissioner's assessment is excessive. In my view, such a statement should not be overly scrutinised in an attempt to find errors or inadequacies. The question is: does the statement give the taxpayer a practical understanding of the Commissioner's position?' [Emphasis added.]

Arguably, the 'practical understanding' threshold applied by her Honour to the Commissioner's appeal statement is a lower standard than that which previously applied to Statements of Facts, Issues and Contentions filed by the Commissioner.⁵⁵

3.7.2 Scheduling conference

After the parties have exchanged appeal statements, an initial directions hearing, called the 'Scheduling Conference', will be set down not less than 45 days from the date of the filing of the application.

The lawyers acting for each party are expected to attend the Scheduling Conference and they will be expected to address the following matters at the Scheduling Conference:

- In 'clear outline', narrow the issues and facts in dispute;
- Provide an initial witness list to form the basis of the 'Preliminary Witness List';
- Establish a pre-trial schedule;
- Deal with matters raised by the Pro Forma Questionnaire; and
- Fix a trial date.

In addition to dealing with the prescribed matters listed above, it appears that the parties must also have considered the following:

- The need for discovery, and whether discovery should be expanded beyond the limited categories outlined in paragraph 6.1 of the Practice Note, or whether discovery should be further limited; and
- Whether there are any exceptional circumstances that would justify a request for interrogatories (paragraph 7.1 of the Practice Note) or particulars (paragraph 7.2 of the Practice Note), having regard to the fact that it is expected that questions that would otherwise justify particulars should be discussed at the Scheduling Conference.

⁵⁵ See generally *Rio Tinto Ltd v FCT* (2004) 55 ATR 321 per Sundberg J at 342, where his Honour stated: that a 'statement of contentions "must propound all the necessary ingredients of the claim for which, as a matter of legal substance, that party contends"'.

Another issue that is increasingly addressed by the Tax List coordinating judge at the Scheduling Conference is the use of expert evidence. Commonly parties are now asked to exchange copies of curriculum vitae of proposed independent experts and to draft questions, which may need to be agreed.

One advantage of the parties being asked to consider their use of experts at an early stage is that it may prevent the inappropriate use of expert evidence, thereby avoiding some of the criticism levelled by Sundberg J at the parties in the ‘Mini Ciabatte’ case, *Lansell House Pty Ltd v FCT* [2010] FCA 329 (Federal Court of Australia, Sundberg J, 9 April 2010), when they sought to use expert evidence in GST characterisation cases dealing with ‘ordinary words’:

[60] It is not in my view the function of an expert to give evidence about the meaning of ordinary words such as bread, biscuit and cracker...

[64] On the other hand I do not need an expert to educate me about the appearance (size, shape, weight, thickness) of biscuits, crackers or bread. Nor do I need to be told how those food products are used – their mode of consumption. That is something I know from my own experience...

3.7.3 Purpose of the Federal Court’s Tax List

The Tax List process is intended to narrow the factual and legal issues in dispute and to enable proceedings to proceed as expeditiously as possible, thereby reducing costs and unnecessary delay. The Tax List has almost unquestionably ‘front-ended’ the evidence gathering processes undertaken by both taxpayers⁵⁶ and the Commissioner⁵⁷ before proceedings are instituted. However, the Tax List is also intended to steer litigants away from unnecessary recourse to Court processes, such as interrogatories, particulars and discovery, once proceedings have commenced.

Justice Edmonds described some of the matters that the Tax List process was intended to address as follows:⁵⁸

(1) The failure of the parties to identify the real issues in dispute (both factual and legal), at the earliest possible time and to hold the parties to those issues. Of course, there will be cases where the evidence will raise a new factual issue and that may need to be addressed by further evidence. But if all the known issues are identified at an early date, it should be possible, in the vast majority of cases, to make, at the outset, an informed and definitive assessment of the evidence that will be required to address those issues. ...

(2) Far too often the parties, but in particular the taxpayer, seek particulars of matters which are not the subject of a proper request; particulars of fact are one thing, particulars of argument are another.

⁵⁶ For instance by using Freedom of Information requests made pursuant to the *Freedom of Information Act 1982* (Cth).

⁵⁷ For instance, through use of his information gathering and access powers in sections 353-10 and 353-15 of Schedule 1 to the TAA.

⁵⁸ Justice Edmonds, ‘Recent tax litigation: A view from the Bench’ (2008) 37 *Australian Taxation Review* 79, at 94.

(3) A failure to properly rely on the curial processes of the court whether it amounts to a failure to utilise them or unnecessary recourse to them. Notices to admit facts fall into the first category; discovery into the second.'

One of the key points made by Justice Edmonds is that the introduction of the Tax List was intended to encourage litigants to utilise the curial processes of the Court. A 'Notice to Admit Facts', which his Honour referred to in the extract reproduced above, may be given pursuant to Part 22 of the Federal Court Rules 2011 (Order 18, rule 2 of the former Federal Court Rules). Where the notice is served by a party on another party in the required form, that other party is required to admit, for the purpose of the proceeding only, the facts or documents specified in the notice.

The Notice to Admit Facts is a method of proving facts in taxation proceedings. Another alternative to the use of affidavit evidence is the use of Statements of Agreed Fact. Although opinion is sometimes split on whether they are worth the effort given the difficulties that one can encounter in reaching agreement with the Commissioner, a recent GST going concern case (albeit a test case) provides an example of how a Statement of Agreed Facts can be used together with affidavit evidence to narrow factual disputes.⁵⁹

3.8 Methods of confining issues in tax proceedings

Although the quote from Justice Edmonds, which was reproduced above, focused on curial processes directed at establishing facts in Court proceedings, there are other processes that may assist litigants in GST disputes. For instance, a recent case that dealt with the Petroleum Resource Rent Tax Assessment Act 1987 (Cth) illustrated the way in which the Court may make orders to deal with the legal substance of a dispute before matters concerning quantification are determined.⁶⁰ The relevant power, which may also be useful in the context of GST litigation if declaratory relief is not available, is found in Rule 30.01(1) of the Federal Court Rules 2011 (Order 29 rule 2 of the former Federal Court Rules):

'(1) A party may apply to the Court for an order that a question arising in the proceeding be heard separately from any other questions.'

The power to make this order is discretionary and, in many instances, might well be opposed by the Commissioner given it presents the obvious difficulty that separating issues of quantum of GST for later determination may present with respect to taxpayers discharging the onus cast on them. (That is, taxpayers in taxation review and appeal proceedings are generally required to show, where the relevant taxation decision is an assessment, that the assessment is excessive or, where the taxation decision is not an assessment, that the decision should not have been made or should have been made differently.⁶¹) Nonetheless, it does demonstrate that there may be

⁵⁹ See *Aurora Developments Pty Ltd v FCT* [2011] FCA 232 (Federal Court of Australia, Greenwood J, 18 March 2011) at [5].

⁶⁰ *Esso Australia Resources Pty Ltd v FCT* [2011] FCA 360 (Federal Court of Australia, 13 April 2011, Middleton J).

⁶¹ Paragraphs 14ZZK(b) and 14ZZO(b) of the TAA in respect of the AAT and Federal Court, respectively.

some further scope for narrowing issues in dispute in Part IVC proceedings before the Federal Court,⁶² particularly where the parties agree to do so.

3.9 Offers made for the purposes of former Order 23 and indemnity costs orders

That some of the provisions of the Federal Court Rules are applicable to taxation appeal proceedings and can be utilised by taxpayer litigants in appropriate circumstances was recently highlighted in *Clark v FCT* [2010] FCA 415 (30 April 2010, Greenwood J).⁶³ *Clark* dealt with the question of whether an offer, in which the taxpayer applicant offered to settle the proceedings with the parties bearing their own costs if the Commissioner effectively ‘walked away’ (ie, allowed the objection decision and withdrew the notice of amended assessment), was covered by former Order 23 of the Federal Court Rules (the equivalent of which is now found in Rule 25.14 of the Federal Court Rules 2011).

Order 23 rule 2 of the former Federal Court Rules broadly provided that ‘in any proceeding’ a party may make an offer to compromise the proceeding on the terms set out in the notice of offer. Where the offer is made by the applicant in the required form, but is not accepted by the respondent, the offer may have cost consequences. The cost consequences were set out in Order 23 sub-rule 11(4) of the former Federal Court Rules as follows:

- (4) *If:*
- (a) *an offer is made by an applicant and not accepted by the respondent; and*
 - (b) *the applicant obtains judgment on the claim to which the offer relates not less favourable than the terms of the offer;*
- then, unless the Court otherwise orders, the applicant is entitled to an order against the respondent for costs incurred in respect of the claim:*
- (c) *up to and including the day the offer was made -- taxed on a party and party basis; and*
 - (d) *after that day -- taxed on an indemnity basis.*

In *Clark*, Greenwood J held that Order 23 of the former Federal Court Rules may apply to taxation appeal proceedings. His Honour concluded that the offer made by the applicant was a genuine offer, as the applicant absorbing its own costs, which were

⁶² In respect of the AAT, see generally *WAKN v Minister for Immigration & Multicultural & Indigenous Affairs* (2004) 138 FCR 579, 589 [41] per French J as his Honour then was. His Honour stated that although there is no specific power for the AAT to hear and determine preliminary questions, the AAT is empowered to give directions “as to the procedure to be followed at or in connection with the hearing of a proceeding before the Tribunal”. Although his Honour considered that these powers would be sufficient to support the hearing of particular issues separately from the main body of the hearing, it was a power to be ‘exercised with caution because, as the experience of the courts has shown, it can lead to fragmentation of what should be a relatively informal and expeditious process...’.

⁶³ *Clark* was listed as being subject to an appeal to the Full Court of the Federal Court. However, the matter is now recorded as having no future listing. In the meantime, the principles in *Clark* have again been applied in *International All Sports Ltd v FCT (No 2)* [2011] FCA 1027 (1 September 2011, Jessup J).

in the order of \$123,000 to \$184,000, had real value (at [92]) and were 'significant' (at [90]).

The applicant's offer was also found to be for a sum which was less than the applicant eventually achieved at trial. As such, a presumptive entitlement to indemnity costs arose under Order 23, sub-rule 11(4) of the former Federal Court Rules. The Commissioner failed to point to any 'compelling and exceptional circumstances' that would have justified Greenwood J making an order 'otherwise' than on the basis of indemnity costs (at [94]). In particular, the Commissioner's view that he had a real prospect of success was not sufficient, nor was the fact that the issue raised important matters of legal principle and was in the public interest (see generally [95-105]).

4. THE CIVIL DISPUTE RESOLUTION ACT 2011 (CTH)

Although this article has not sought to examine alternative dispute resolution processes in any detail, it is important to recall that alternative dispute resolution can play an important role in not just settling tax disputes, but also in narrowing issues in dispute. The trick is to engage in alternative dispute resolution processes at the right time, so there is a real prospect that facts and legal matters can be agreed, without simply adding another process that delays the resolution of the proceedings and increases costs.⁶⁴ Unfortunately, it is impossible to lay down any hard and fast rules about when to engage in alternative dispute resolution as each case is different.

Despite the fact that there are no hard and fast rules about when to engage in alternative dispute resolution, most potential litigants in the Federal Court and the Federal Magistrates' Court will soon be required to undertake at least some steps toward attempting to resolve their dispute before litigation commences.

4.1 Overview of the Civil Dispute Resolution Act 2011 (Cth)

The Civil Dispute Resolution Act 2011 (Cth) received Royal Assent on 12 April 2011. The operative provisions of the Act commenced on 1 August 2011, being the date fixed by proclamation. The object of the Civil Dispute Resolution Act 2011 (Cth) is to ensure that, as far as possible, people take genuine steps to resolve disputes before certain civil proceedings are instituted.⁶⁵ Importantly, lawyers are under a duty to advise their clients of their obligations under the Civil Dispute Resolution Act 2011 (Cth) and must assist them to comply.⁶⁶

The Civil Dispute Resolution Act 2011 (Cth) applies to most civil proceedings instituted in the Federal Court and Federal Magistrates Court of Australia. Certain types of proceedings are excluded proceedings, including civil penalty and criminal proceedings, appeals (for instance, an appeal against a decision of the AAT), and a range of judicial review proceedings.⁶⁷ Proceedings under particular statutes are also

⁶⁴ See also Practice Statement PS LA 2007/23 at [15]-[19].

⁶⁵ Section 3 of the *Civil Dispute Resolution Act 2011* (Cth).

⁶⁶ Section 9 of the *Civil Dispute Resolution Act 2011* (Cth). Failure to comply with the duty in section 9 may result in cost consequences for the lawyer, just as a party's failure to comply with the requirement to file a genuine steps statement may be taken into account in awarding costs: section 12 of the *Civil Dispute Resolution Act 2011* (Cth).

⁶⁷ Section 15 of Part 4 of the *Civil Dispute Resolution Act 2011* (Cth).

excluded⁶⁸ and there is scope for regulations to expand the categories of excluded proceedings.⁶⁹

Section 6 of the Civil Dispute Resolution Act 2011 (Cth) imposes an obligation on applicants who institute civil proceedings to file a ‘genuine steps statement’ at the time of filing the application instituting the proceedings. In the context of taxation appeal proceedings, presumably this will require the applicant to file the statement at the same time as filing its notice of appeal in accordance with Rule 33.02 of the Federal Court Rules 2011 (formerly an application under Order 52B rule 4 of the former Federal Court Rules).

The genuine steps statement filed by the applicant must specify:⁷⁰

- (a) *the steps that have been taken to try to resolve the issues in dispute between the applicant and the respondent in the proceedings; or*
- (b) *the reasons why no such steps were taken, which may relate to, but are not limited to the following:*
 - (i) *the urgency of the proceedings;*
 - (ii) *whether, and the extent to which, the safety or security of any person or property would have been compromised by taking such steps.*

Correspondingly, the respondent is required to file a genuine steps statement before the hearing date specified in the application.⁷¹ The respondent’s statement must set out whether the respondent agrees with the applicant’s statement, and any areas of disagreement.

Section 4 of the Civil Dispute Resolution Act 2011 (Cth) sets out what constitutes ‘genuine steps’ as follows:

4 Genuine steps to resolve a dispute

- (1A) *For the purposes of this Act, a person takes genuine steps to resolve a dispute if the steps taken by the person in relation to the dispute constitute a sincere and genuine attempt to resolve the dispute, having regard to the person’s circumstances and the nature and circumstances of the dispute.*
- (1) *Examples of steps that could be taken by a person as part of taking genuine steps to resolve a dispute with another person, include the following:*
 - (a) *notifying the other person of the issues that are, or may be, in dispute, and offering to discuss them, with a view to resolving the dispute;*
 - (b) *responding appropriately to any such notification;*

⁶⁸ Section 16 of Part 4 of the *Civil Dispute Resolution Act 2011* (Cth).

⁶⁹ Section 17 of Part 4 of the *Civil Dispute Resolution Act 2011* (Cth).

⁷⁰ Subsection 6(2) of the *Civil Dispute Resolution Act 2011* (Cth).

⁷¹ Section 7 of the *Civil Dispute Resolution Act 2011* (Cth).

- (c) *providing relevant information and documents to the other person to enable the other person to understand the issues involved and how the dispute might be resolved;*
 - (d) *considering whether the dispute could be resolved by a process facilitated by another person, including an alternative dispute resolution process;*
 - (e) *if such a process is agreed to:*
 - (i) *agreeing on a particular person to facilitate the process; and*
 - (ii) *attending the process;*
 - (f) *if such a process is conducted but does not result in resolution of the dispute—considering a different process;*
 - (g) *attempting to negotiate with the other person, with a view to resolving some or all the issues in dispute, or authorising a representative to do so.*
- (2) *Subsection (1) does not limit the steps that may constitute taking genuine steps to resolve a dispute.*

Although the parties are required to outline the genuine steps taken to resolve their dispute, section 17A of the Civil Dispute Resolution Act 2011 (Cth) expressly preserves the law in relation to the use and disclosure of information, the production of documents and the admissibility of evidence. This should permit the parties to continue to use ‘without prejudice’ communications as part of their settlement negotiations.

The Federal Court and Federal Magistrates’ Court may, in performing functions or exercising powers in matters before it, take into account whether the parties complied with their obligations under the Civil Dispute Resolution Act 2011 (Cth). In addition to influencing the award of costs, the explanatory memorandum suggests the Court may be empowered to refer the dispute to alternative dispute resolution and dismiss the proceedings in whole or in part, among other things.⁷² However, failure to file a genuine steps statement does not invalidate the proceedings.⁷³

4.2 Application of the Civil Dispute Resolution Act 2011 (Cth) to taxation appeal proceedings

At this stage, none of the categories of excluded proceedings would appear to exempt taxation appeal proceedings filed in the Federal Court under Part IVC of the TAA. This means that the Civil Dispute Resolution Act 2011 (Cth) is likely to apply in taxation disputes.

It is unclear at this stage precisely how the Civil Dispute Resolution Act 2011 (Cth) will apply to taxation appeal proceedings and quite what it will add to the established objection process that occurs before proceedings may be instituted. Arguably, one could argue that there are no ‘issues in dispute between the applicant and the

⁷² Paragraph 45 of the explanatory memorandum to the Civil Dispute Resolution Bill 2010 (Cth).

⁷³ Subsection 10(2) of the *Civil Dispute Resolution Act 2011* (Cth) and paragraph 39 of the explanatory memorandum to the Civil Dispute Resolution Bill 2010 (Cth).

respondent in the proceedings' until such time as the objection decision has been made by the Commissioner, at which time the applicant has only 60 days to file its appeal in the Federal Court and therefore may be prevented from taking further steps due to the limited time available. However, it is more likely that taxpayers will simply document all steps taken throughout the audit and subsequent objection stage, and provide that information in the genuine steps statement. After all, meetings and correspondence with the ATO, the provision of information in response to information requests, the exchange of position papers and appearances before the General Anti-Avoidance Panel, if applicable, would all seem to qualify as genuine steps. The question is, whether something more than documenting the status quo might be necessary to satisfy the Court that the parties have sought to comply with the Civil Dispute Resolution Act 2011 (Cth) in tax proceedings.

5. CONCLUSION

It is simply not possible to provide a definitive guide to managing GST litigation. Not only is the landscape of GST litigation undergoing some fundamental changes, particularly with the likely introduction of self-assessment, but managing litigation always involves matters of judgement. What is best in one proceeding will not necessarily work in the next.

To the extent it is possible to lay down any high level guidelines, they should be limited to these:

1. Do not forget that there are some considerations that are GST specific. These include identifying the relevant applicant, considering how provisions such as sections 105-50, 105-55 and 105-65 of Schedule 1 to the TAA should be approached, and considering the evidentiary implications of GST being a multi-party tax.
2. However, do not make the mistake of treating GST litigation as entirely unique. Advisers and parties to GST disputes should be aware of both civil procedure and taxation administration law more generally. The benefit of having a broader awareness of civil procedure is not just limited to complying with any applicable obligations. Rather, advisers and parties to GST disputes should be willing to make use of the Court's curial processes to their full advantage. Indeed, by doing so, they might well be able to reproduce some of the features of declaratory relief, such as narrowing the issues in dispute, in taxation appeal proceedings brought under Part IVC of the TAA.