GST – PRACTICAL IMPLICATIONS

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Due to the Government's desire to introduce a GST system that is more expansive than anywhere else in the world many practical issues have arisen that are unique to Australia.

Issues that are of interest include:

- GST causing divergence of equivalent product.
- The treatment of foreign brokerage paid by financial institutions.
- Transitional issues.
- Expense recovery issues for trustees and fund managers.
- Status of "bare trusts".
- Adjustment events and assets.
- The apportionment formula.
- FBT and GST.
- Contractors.

Divergence of GST treatment of equivalent product

Stiglitz suggested that the hallmarks of good tax laws were:

1. Simplicity;
2. Equity;
3. Efficiency; and
4. Neutrality.

This being the case "good GST laws" would adhere to the above principles. Unfortunately the Federal Treasury do not adhere to the above principles. Early on officers of the Treasury made it very clear that they would reject lobbying efforts seeking similar GST treatment for equivalent products. As far as they were concerned the tenets of the system were more important than concepts such as neutrality. One example of this is the GST treatment of Cash Management Trusts.

A Cash Management Trust ("CMT") is a unit trust arrangement with daily income entitlements. Daily income entitlements are necessary in order to ensure that unit prices can be maintained at one dollar. CMTs are an alternative product to high interest accounts offered by banks and other Authorised Deposit-taking Institutions ("ADIs"). In virtually all respects they operate identically. Both offer cheque books, ATM access, direct debit and EFTPOS facilities. Similarly the providers charge fees for identical reasons such as failure to keep a minimum monthly balance or writing cheques that exceed the available funds. In the case of fees charged by a bank the supply is an incidental financial supply (regulation 40-14) in connection with a financial supply (regulation 40-13(2), item 1) and is therefore input taxed.

However, fees charged by a CMT provider are within item 13 of regulation 40-16 and are therefore subject to GST. Admittedly the CMT is entitled to a reduced input tax credit of 75% (regulation 70-2(2), item 10) but nevertheless the fee charged to the CMT is subject to an effective net GST of 2.5% whereas the fee charged to a bank account is not subject to any GST.

It could be expected that most banks will be increasing their fees in order to recoup the cost of input taxation. The size of this increase may compensate for the 2.5% burden borne by CMTs. Indeed, it may be that the rise in bank charges will exceed the 2.5% net GST.

The key point is that equivalent products may attract very different GST treatments.

The treatment of foreign brokerage paid by financial institutions

Under Division 84 of the "A New Tax System (Goods and Services Tax) Act 1999" ("the GST Act") where services are obtained from overseas, a "reverse charge" applies. That reverse charge is imposed upon the recipient and is equal to 10% of the price of the supply. Where that acquisition is used for a *creditable purpose* then an input tax credit will be available that will offset that reverse charge obligation so that no tax will be payable.

eg:	Services cost	$1,000
	Prima facie reverse charge @ 10%	$ 100
	Input tax credit	$ (100)
	GST payable	***NIL***

For a financial institution the extent of creditable purpose will rarely be 100% and therefore a reverse charge liability will normally arise.

It is likely that acquisitions of things that are financial supplies (as defined in regulation 40-13) will not be subject to reverse charging. However, financial services that do not amount to financial supplies will attract reverse charging. One example of such acquisitions is brokerage charged by an overseas dealer.

In this instance there are two variables that produce four different scenarios:

	Buying Securities from non resident	**Selling Securities to non resident**
Domestic Securities	1	2
Overseas Securities	3	4

(In all instances where a domestic broker is used GST should be charged by that broker regardless of the type of security)

For an entity such as an Australian unit trust or superannuation fund which makes no taxable supplies there will be no creditable purpose. Accordingly reverse charging under Division 84 should apply to all overseas purchases. (Admittedly, the true cost of this is mitigated by the availability of a 75% reduced input tax credit, regulation 70-2(2), item 9.)

However, the ATO has recently written to IFSA outlining their views on the subject. The ATO believes:

- The sale of securities to a non-resident is a GST free supply and therefore any overseas brokerage is not subject to reverse charging. [1]

- Overseas brokerage services incurred by a resident, in respect of a purchase from a non-resident are subject to reverse charging. [2]

Hence it would appear that the ATO will apply different reverse charging principles depending upon whether the overseas brokerage relates to a purchase or to a sale.

Given that this seems to be in conflict with most interpretations of Division 84 further clarification is being sought from the ATO., particularly as the above comments were made prior to the May/June 2000 regulation changes.

Transitional issues

Until Goods and Services Tax Ruling GSTR 2000/9 was released there was considerable uncertainty over what did and did not qualify under the transitional provisions. One such area was the investment funds industry.

In order to qualify for transitional relief there are essentially three criteria:

1. A written agreement;

2. Entered into before the relevant date; and

3. Where a "review opportunity" has not arisen.

The first issue was whether a trust deed constituted a "written agreement'. An early view held by some industry participants was that an agreement required two distinct parties and that a trust deed could not satisfy this criteria. Fortunately the ATO has recognised the fundamental distinction between a trustee and beneficiaries to a trust and has expressly stated that a deed in existence prior to the relevant date (8 July 1999 or 2 December 1998 for input taxed recipients) can be a written agreement for

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1 "Where offshore brokerage services are acquired in relation to the supply, [of a security to a non-resident] there will be an importation of services. The application of Division 84 of the GST Act will need to be considered. As the sale of a security is to a non-resident is a GST-free supply pursuant to section 38-190, the acquisition of brokerage services will not be in relation to the making of input taxed supplies and therefore will be for a creditable purpose. Therefore, the supply of brokerage services will not be subject to the reverse charge rules contained within Division 84 of the GST Act."

2 The acquisition of brokerage services by the resident entity, will most likely be for the purposes of carrying on an enterprise in Australia. Where the brokerage services are not acquired solely for a creditable purpose it will be subject to the reverse charge rules.

the purposes of the transitional provisions; GSTR 2000/9 at paragraph 25. Further, it has also been accepted that amendments made to comply with the Managed Investments Act 1998 will not alter the position; paragraphs 80 to 82 of GSTR 2000/9.

The third issue also presents difficulties. What is a "review opportunity"?

Subsection 13(5) of the Transition Act provides:

> ***review opportunity***, *for an agreement to which this section applies, means an opportunity that arises under the agreement:*
>
> *(a) for the supplier under the agreement (acting either alone or with the agreement of one or more of the other parties to the agreement) to change the consideration directly or indirectly because of the imposition of GST; or*
>
> *(b) for the supplier under the agreement (acting either alone or with the agreement of one or more of the other parties to the agreement) to conduct, on or after 1 July 2000, a general review, renegotiation or alteration of the consideration; or*
>
> *(c) for the supplier under the agreement (acting either alone or with the agreement of one or more of the other parties to the agreement) to conduct, before 1 July 2000, a general review, renegotiation or alteration of the consideration that takes account of the imposition of the GST.*

These are typically two types of clause in a trust deed or constitution which might fall within this definition. Firstly there is the standard "other taxes clause". Typically such clauses read as follows:

> ***Outgoings:*** *All costs, charges, expenses and outgoings reasonably and properly incurred by the Responsible Entity in the proper performance of its duties in connection with the following matters or of the following nature in relation to any Trust are payable or reimbursable out of Trust Property of that Trust (and if referable to more than one Trust, apportioned in a manner determined by the Responsible Entity); … (f) all taxes.*
>
> ***Taxes:*** *means all taxes, including without limitation income, capital gains recoupment, debits, land, sales, payroll, fringe benefits, group, profit, interest, property, undistributed profits, withholding, and wealth taxes, stamp documentary, financial institutions, registration and other duties, municipal rates, and all other imposts, deductions and charges, related interest, penalties, charges, fees or other amounts assessed, charged, assessable or chargeable by or payable to any national, state or municipal taxation authority.*

It might be argued that such clauses allow managers to recover GST on their fees. However, the better view is that only GST in respect of outgoings (eg, the GST on valuation fees) is covered. The ATO shares this view, paragraphs 153 to 162 GSTR 2000/9.

Secondly there is the ability of the manager to unilaterally increase fees within certain limits. For example:

> ***Responsible Entity's Fees:*** *Before and after Termination, the Responsible Entity is entitled to (but for any Trust or Holder may elect to receive less than):*
>
> *(a) an entry fee ("Entry Fee") of 6% (Existing Funds: 5%) of the Application Monies payable on application;*
>
> *(b) a management fee ("Management Fee") of 3% per annum of the total value of all Trust Property;*
>
> *(c) a custody fee ("Custody Fee") of 0.3.% (Existing Funds: 0.1%) per annum of the total value of all Trust Property; and to*
>
> *(d) an exit fee ("Exit Fee") of 6% (Existing Funds: zero) of the Redemption Price, each increased by an amount necessary for the Fee, to equal the rates specified above, calculated and payable on the last Days of each calendar month or calendar quarter or at such other times as the Responsible Entity in its discretion may determine out of Trust income, but if Trust income is insufficient then out of Trust capital.*
>
> *The Responsible Entity in its discretion* ***may from time to time elect to receive less than such fees in respect of all or any Units*** *(whether determined by reference to a minimum balance or on any other basis and whether for the life of a particular offer document or otherwise) and pay to any Holder, from its own resources, any amounts which it in its discretion so determines by way of offset or rebate of fees.*

The existence of such clauses means that, with one exception, the manager has a type (b) review opportunity. The one exception is where the manager is already charging the maximum amount permitted. Accordingly where a fund manager has a pre-July 1999 deed or constitution transitional relief will not be available in respect of a particular fee unless the current charge is already at the maximum charge.

It is also important to note that a written agreement may cover multiple supplies, eg, entry fees, exit fees, custody fees and management fees. It is possible for one such fee to qualify for transitional relief even though the others may not.

Expense recoveries

The existence of a list of expenses that qualify for a 75% reduced input tax credit implicitly means that there are some expenses that do not qualify. Examples of such non-qualifying expenses are:

1. Printing;
2. Audit services;
3. Legal services;
4. Tax services; and
5. IT services.

Where such expenses are borne by a trust or superannuation fund the introduction of GST will result in an increase of cost of 10% (assuming no sales tax savings). This is because trusts and superannuation funds will usually only make input taxed supplies and therefore will have no creditable purpose.

If it is possible for such expenses to be borne by the manager who then charges an increased fee this problem will be largely overcome. This is because the trust or superannuation fund will be entitled to a 75% ritc in respect of all of the manager's fee.

It should be noted that genuine commercial reasons will need to be found for moving to such a structure. This is because Division 165 will allow the Commissioner to deny the credits if he believes that a scheme was entered into with a purpose of seeking to obtain a GST benefit.

Status of bare trusts

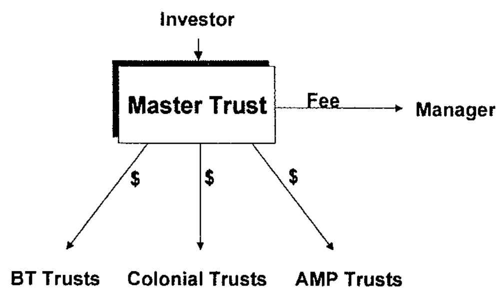
"Bare trusts" are a nebulous concept. Most practitioners take the expression as meaning a situation where the beneficiary has an absolute entitlement as against the trustee who is vested with legal title but has no other duties to perform. In the finance industry there are three common uses of a bare trust:

- custodians;
- mastertrusts; and
- wrap accounts.

The issue is whether such trusts have an identity for GST purposes.

Custodians perform a minor role in respect of the legal title of assets. Usually all assets will be registered in the custodian's name. A custodian will also have access to a client's bank account in order to fund acquisitions and deposit proceeds. The custodian has no beneficial interest in the assets held. The issue is that if the bare trust does have an identity for GST purposes then the custodians will need to lodge a monthly Business Activity Statement ("BAS") for each client relationship. Such BAS lodgements would be necessary because it would be expected that brokerage costs would be paid by the custodian and hence a ritc would be available; Regulation 70-2(2), item 9. Having to submit such statements would add a significant burden on custodians and impede the efficiency of their operations. Hence the providers of such services are seeking the adoption of a "look through approach" whereby all transactions they conduct are attributed to the end user.

Mastertrusts are a trust vehicle which offers investors the ability to invest in a range of other trusts. For example:



Formally such products are normally described as Investor Directed Portfolio Services.

A discretionary mastertrust is largely a bare trust. As the manager charges a taxable fee to that trust potentially a 75% ritc will be available, provided the Mastertrust can establish that it is carrying on an enterprise; s9-5 and s9-20. Such a result would be satisfactory to most Mastertrust providers.

Wrap accounts are administration services that operate under a trust structure but allow all gains and losses to be derived by the ultimate investor. The ATO allows a flow through for income tax purposes. The providers of such products face the problem that the fee charged must carry GST yet no input tax credit is claimable (except in the unlikely case that the investor is carrying on an enterprise). Wrap account providers have been lobbying for this type of bare trust to be allowed to register for GST so that a 75%ritc can be claimed. The ATO is not sympathetic to such an approach.

Preliminary indications from the ATO are that a pure custodian will attract look through. The position for the other two products remains somewhat unclear.

Adjustment events

Under Division 129 a change in the extent of creditable purpose can give rise to an adjustment in respect of any input tax credit claim. For example:

eg:	Asset cost	$100,000
	GST	$ 10,000
	Total	***$110,000***

Creditable purpose at acquisition time 20%
Input tax credit $3,000

In the first three months of use the actual creditable purpose is relatively 19, 21 and 18%. This requires an adjustment in respect of each of the three months (assuming a monthly remitter) pursuant to Division 129-40.

This is a very difficult practical problem as it requires regular monitoring and calculation of adjustments. The Government has recognised the practical difficulties associated with these rules by providing the following concessions if the entity made the acquisition wholly or partly for the purpose of making financial supplies.

- Assets with a GST exclusive value less than $10,000 are not subject to adjustment; s129-10(1).
- If the asset has a GST exclusive value between $10,000 and $50,000 then an adjustment event only happens in the first tax period; s129-20(2).
- If the asset has a GST exclusive value between $50,000 and $500,000 then adjustments will only be required in the first five tax periods; s129-20(2).
- If the asset has a GST exclusive value in excess of $500,000 then adjustments will only be required in the first ten tax periods, s129-20(2).

It may be that an organisation has a significant number of assets with a value in excess of $10,000. If this is the case the administrative burden of monitoring the creditable purpose levels and making adjustments may be excessive. One way of dealing with this could be to establish a fixed asset holding company. Such a company would own all fixed assets costing in excess of $10,000 that are acquired after 30 June 2000. The company would not be part of the GST group and would lease assets to the group.

Using this procedure the holding company would be able to claim a 100% input tax credit on the acquisition as it would be exclusively making taxable supplies being the leasing of assets to another entity. The lease payments by the group to the holding company would bear GST but each payment would only fall in a particular tax period and therefore only one creditable use percentage would be applicable.

Admittedly such a lease would have to include an interest charge but this should merely compensate for any advantage gained in receiving a 100% up front input tax credit. It is stressed that this proposal is not intended to avoid or reduce a business' GST liability but rather to reduce the cost of GST <u>administration</u>.

The apportionment formula

The ATO has published a draft GST ruling, GSTR1999/D14, dealing with how financial supplies should apportion input tax credits. Essentially the Commissioner recognises two methods of apportionment:

- the direct attribution method; and
- the general formula.

[GSTR 1999/D14]

He is likely to insist that a business use the direct attribution method to the maximum extent possible and revert to the general formula for the balance.

The general formula is essentially:

$$\text{Input Tax Recovery Rate} = \frac{\text{Net revenue from taxable and GST free supplies}}{\text{Net revenue from total supplies}}$$

One problem with this formula is that some activities which are out of scope for GST purposes will be included in the denominator and this will reduce the recovery ratio. An example of such supplies is dividend income.

This problem has been put to the ATO and it is hoped that the final version of the ruling will make appropriate corrections.

FBT and GST

The Government has enacted the A New Tax System (Fringe Benefits) Act 2000 ("Fringe Benefits Act") to deal with various FBT issues. This Act attempts to address the distortion that currently exists when benefits subject to GST are packaged.

The method chosen to do this is to have two gross up formulas. The first formula is to deal with those benefits that are subject to GST and where the employer is entitled to an input tax credit. The second deals with benefits, which are not subject to GST and situations where the benefit is subject to GST but the employer is not entitled to any input tax credits.

Formula 1

$$\frac{\textit{FBT rate} + \textit{GST rate}}{(1 - \textit{FBT rate})\ (1 + \textit{GST rate})\ \textit{FBT rate}}$$

This currently produces a gross up of 2.1292

Formula 2

$$\frac{1}{(1 - \text{FBT rate})}$$

This produces a gross up of 1.9417 and is the same as the formula that applies for the 1999/2000 FBT year.

These formulas deal adequately with those users where the benefit is not subject to GST, the employer is entitled to zero input tax credits or the employer is entitled to 100% input tax credits. However, the more likely situation where a member is entitled to partial credits is not dealt with effectively. Indeed, for this situation a distortion is created which makes packaging inefficient.

The following examples illustrate these comments:

	Benefit not subject to GST *	**Benefit subject to GST**	
		100% GST	**50% GST**
Benefit	1,100.00	1,100.00	1,100.00
GST Refund	-	(100.00)	(50.00)
FBT	1,035.90	1,135.92	1,135.92
Tax Deduction @ 0.34	(726.20)	(726.21)	(743.21)
After Tax Cost	1,409.70	1,409.71	1,442.71
Before Tax Value to Employee	1,100.00	1,100.00	1,100.00

* *This is the same as a benefit subject to GST where the employer has a zero recovery rate*

The difference in after tax cost in situations where there is not 100% recovery is such that an employer would realign the salary sacrificed to reduce after tax costs to $1,409.71. This would reduce the value of the benefit to the employee to a level where the effective tax rate was higher than that applying for salary. An employee would not rationally package this type of benefit in the absence of other advantages.

The way to address this error is to modify formula 1 by allowing for the partial recovery. This can be done by reducing the FBT by:

(FBT under existing formula 1 – FBT under formula 2) (1 – GST recovery rate)

In the above example, this would produce the following after tax cost:

	50% Recovery	70% Recovery
Benefit	1,100.00	1,100.00
GST Refund	(50.00)	(70.00)
FBT	1,085.92	1,105.92
Tax deduction @ 0.34	(726.21)	(726.21)
After Tax Cost	1,409.71	1,409.71
Before Tax Value to Employee	1,100.00	1,100.00

In short, the correction will produce exact neutrality.

The GST recovery rate could be based upon the previous year, the last month's BAS statement or whatever reasonable basis was suggested.

It is recommended that the Act be amended by:

1. retaining formula 1 for the employers who have a 100% recovery,
2. retaining formula 2 for benefits not subject to GST or where the employer has a zero recovery rate, and
3. introducing a new formula 3 for those employers who do not have a zero or 100% recovery rate.

It should also be noted that the choice of whether to use formula 1 or 2 depends upon the recovery rate for EACH employee. This will add immensely to FBT compliance costs unless a business-wide approach is adopted.

Contractors

In the last decade there has been a tendency for many businesses to outsource functions. This has usually been driven by efficiencies of scale and a desire to "focus on what we do best". However, the introduction of GST provides an incentive not to outsource.

This is because all payments to contractors will be subject to GST so it would be expected that contractor prices will rise. Given the low input tax recovery percentages typically borne by banks this rise would largely be a non-recoverable increase. (The exception is of course those items that qualify for a ritc.) Consequently, GST will significantly affect decisions to outsource functions that are heavily dependent upon labour or equipment that is already owned. Such functions include IT, legal services, human resources and training.

GST Practical Implications

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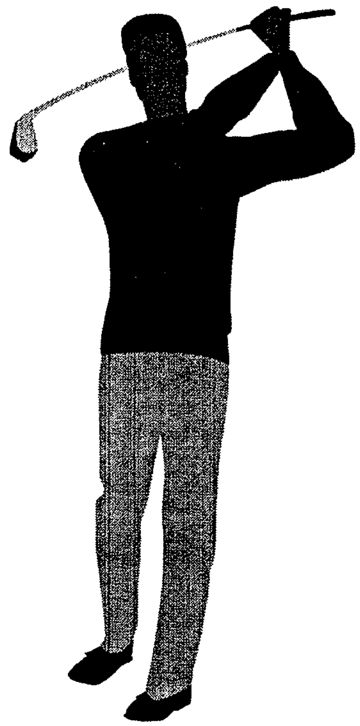
GST - Practical Implications



Coy

↓ Sponsorship

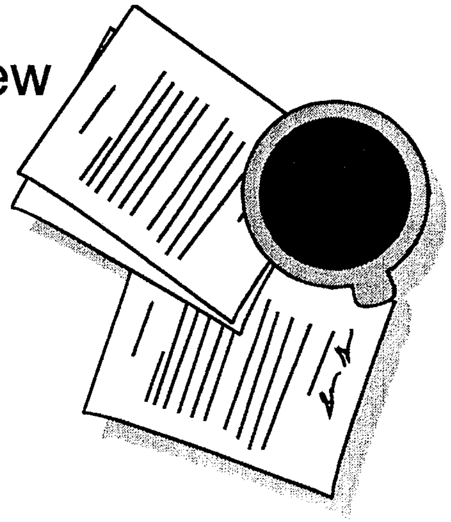
Sporting Team

- Sponsorship is usually in return for marketing and advertising
- Result is that the team gets to keep only 10/11ths of amount received

GST - Practical Implications

Transitional issues

- GST free status if pre 8 July 2000 written agreement
- AND no review opportunity
- Is a trust deed a written agreement
- Do "other taxes" clauses contribute a review opportunity



GST - Practical Implications

- Divergence of equivalent product
- Cost Management Trusts vs Bank deposit accounts

BANK

↓ **Fee - Input taxed**

A/C

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GST - Practical Implications

FUND MANAGER

↓ Fee - Subject to GST

Cash Management Trust

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GST - Practical Implications

- Expense Recoveries

Manager

Fees taxable
but
ritc available

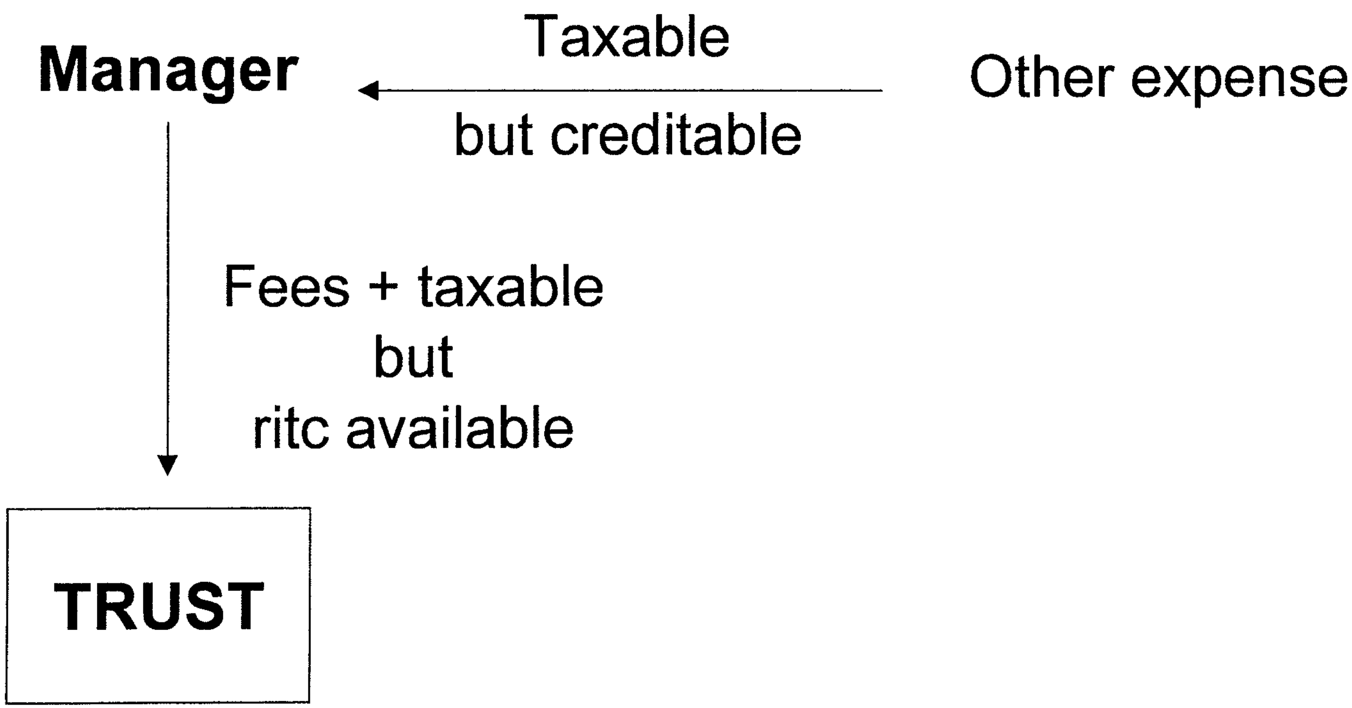
TRUST

Taxable
but no ritc

Other expense

GST - Practical Implications

- Expense Recoveries



- Subject to Division 165

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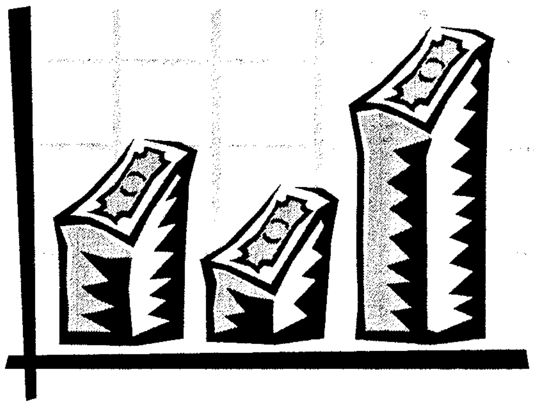
GST - Practical Implications

- Adjustment events - Division 129
- Affects assets with a GST exclusive value greater than $10,000
- Therefore change in use ⇒ adjustments
- Administratively nearly impossible
- Asset holding company outside group



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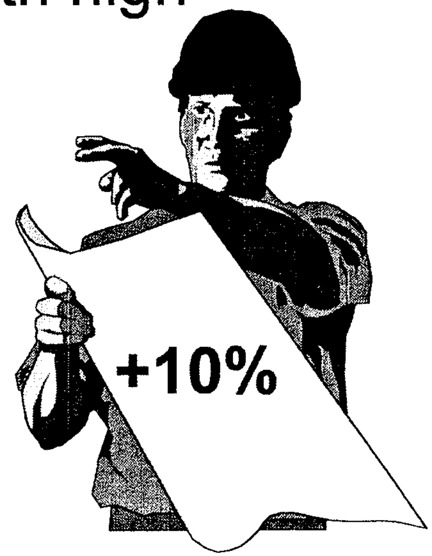
GST - Practical Implications

- Contractors now must charge 10% GST
- For an organisation that makes financial supplies, such as a bank contractors now more expensive
- Bias toward NOT out-sourcing services with high labour content



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GST - Practical Implications

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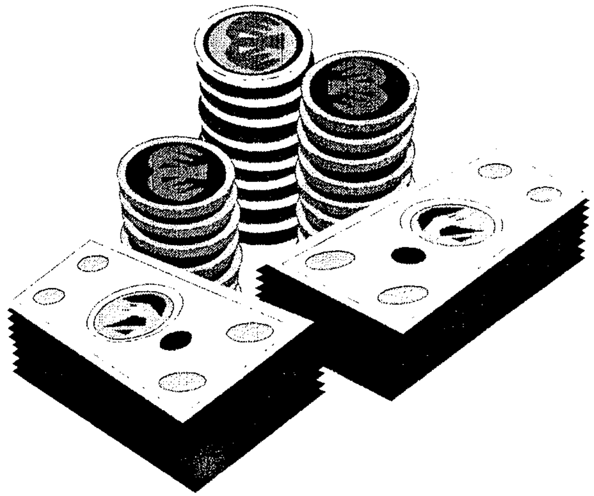
GST - Practical Implications

- Foreign Brokerage
- Reverse charging for financial supplies
- Purchases
- Sales



GST - Practical Implications

- Apportionment formula
- Fails to take into account transactions with no GST effect such as dividends
- Adjustment needed

GST - Practical Implications

- Definition of enterprise
- Bare Trusts - absolute beneficial entitlement
  - look through
- Custodians - look through
- Wrap Services - look through but no ritc

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