

# CONSULTATION PAPER ON THE REVIEW OF THE FINANCIAL SUPPLY PROVISIONS

The Government announced on 12 May 2009 it will review the provisions in the GST Act that deal with the application of GST to financial supplies. The review flows from a Board of Taxation recommendation in its review of the Legal Framework for the Administration of the Goods and Services Tax (GST). The Board of Taxation recommended:

The Government should undertake a review of the financial supplies provisions with a view to reducing their complexity and introducing more principled rules, while maintaining the existing policy.<sup>1</sup>

This discussion paper provides background on the existing policy treatment of financial supplies under Australia's GST regime and aims to stimulate discussion on achieving this policy outcome more efficiently and with reduced compliance costs.

The Treasury invites public comment on how this can be achieved while maintaining the integrity of the existing GST.

This paper outlines the scope of the review, canvasses the treatment of financial supplies in countries with broadly comparable value added tax (VAT) systems, and considers options to achieve a more streamlined approach to taxing financial supplies.

## SCOPE OF THE REVIEW

This review looks at existing financial supply provisions under the GST law and related regulations to:

- reduce their complexity and inconsistencies;
- introduce more principled rules to ensure the law better reflects underlying policy; and
- improve the operation of the reduced credit acquisition system

in a manner consistent with maintaining the existing policy.

This review will not reconsider the key policy parameters, in particular the decision to input tax financial supplies and include supplies normally charged by way of a margin. In addition, the review will not consider the interaction of the financial supply rules with:

- Division 84, to reverse charge the GST on some supplies not connected with Australia;
- Division 129 relating to change in creditable purpose;
- the financial acquisitions threshold (FAT);

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<sup>1</sup> Board of Taxation, *Review of the Legal Framework for the Administration of the Goods and Services Tax*, December 2008, recommendation no. 23.

- fringe benefits tax (FBT); nor
- apportionment methods.

These issues are outside the scope of this review and to some extent were considered by the Board of Taxation in its earlier review. The Commissioner's administration of the existing law will also not be part of this review.

However, we note that the Australia's Future Tax System (AFTS) review consultation paper released on 10 December 2008 (pages 141 and 142) included issues raised during their initial round of consultation concerning technical problems under the 'invoice-credit' style GST. It sought further submissions on what changes, if any, to the tax system would improve the ability of Australian companies to operate internationally orientated businesses? Stakeholders were able to make submissions directly to that review on policy changes affecting financial supply providers.<sup>2</sup>

## Principles underlying the taxation of financial supplies

Financial supplies cover a wide range of transactions. While the definition of financial supplies varies between jurisdictions, it generally includes providing loans, taking deposits, trading in financial securities such as shares and units in trusts, life insurance, mortgages, and dealings in currency. In most jurisdictions, a wide range of entities engage in making financial supplies. These include financial institutions, such as banks and credit unions, but also entities supplying goods or services on credit (such as allowing late payment in return for interest) or issuing shares.

In Australia, both the entity making the financial supply and the entity acquiring the financial supply are generally treated as making financial supplies for GST purposes. (For example, the sale of shares by one business entity to another may involve both the vendor and purchaser making a financial supply.) Therefore, financial supplies are not exclusively an issue for financial institutions alone, and can affect almost all entities.

Generally, GST aims to tax final private consumption in Australia. Consistent with this principle, consumption of intermediation services<sup>3</sup> and other benefits provided in the making of financial supplies should be taxed. However, for various policy and/or administrative reasons, exceptions exist. The GST treatment of financial supplies is an exception and a general feature of VAT systems around the world.

The special treatment exists because the invoice-credit model has technical problems in taxing such supplies. (Australia's GST is consistent with general international practice.) Under such a model, entities pay tax on the consideration received from individual

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<sup>2</sup> Submissions to the AFTS review officially closed on 1 May 2009.

<sup>3</sup> Financial intermediation is a broad term encompassing the services provided in the intermediation of the plans of savers and investors so as to smooth consumption of both parties over time (Howell, *VAT treatment of financial services: a primer on conceptual issues and country practices*, INTERTAX, volume 34, issue 10, page 458). By way of example (refer Howell, page 460), assume a bank is paying 4% on its demand deposits at a time when the 'pure' rate (the rate solely representing the change in value over time) of interest is 7%. A depositor holding an average of 100 in demand deposits with the bank is thus forgoing 3% interest income. This presumably reflects the added value (such as the added convenience or provisions of services such as ATM access) of holding a checking account over government papers.

transactions ('supplies'), with registered recipients then generally entitled to a corresponding credit, so the tax burden falls only on final consumption.

For an invoice-credit model to operate, the consideration must be identifiable on a transaction-by-transaction basis. However in a large class of financial supplies, this generally is not possible. The consideration received for many financial services is not explicit, but implicit in a margin or investment return. For example, a bank may obtain consideration for the services it provides in arranging a loan through an implicit margin on various flows making up the transaction.<sup>4</sup> Determining the value of such implicit consideration for each individual supply, and for each party to the transaction, poses considerable challenges.

As a result of this complexity, no jurisdiction in the OECD seeks to tax financial services within the invoice-credit model. Instead, alternative approaches are either used or discussed theoretically in a consumption tax-type scheme. The approaches are:

- exemption (input tax)<sup>5</sup> – supply of financial services is not taxed and tax paid on acquisitions used in making these supplies has no GST refund;
- zero rating (GST free) – consumption of financial supplies is not taxed;
- addition method value added tax (VAT) – in its simplest form, the sum of wages and salaries and profits is taxed.; and
- subtraction method VAT – again, simply put, the difference between inputs and outputs is taxed.

Almost universally, jurisdictions choose to input tax financial supplies as a proxy for full taxation. The consideration of alternative approaches, such as making all financial supplies GST free or removing the input tax treatment from business-to-business transactions, is a policy matter and therefore outside the scope of this review.

However, this 'exemption' or 'input taxed' approach gives rise to concerns relating to efficiency, equity and simplicity. While these concerns are not unique to financial supplies, and can arise whenever exemptions or special treatments are applied to transactions, the nature of financial services makes this problematic. These distortions result in:

- cascading of tax – which arises when the entity making the financial supply cannot recover all the tax on its inputs, so it builds this tax into its own prices which, in turn, form part of the cost of production for other businesses and flow through into the price of their outputs;

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4 This complexity arises in part because many of these flows will typically not be taxable. Take, for example, a loan. A loan involves a transfer and return of capital. These movements are not consideration for a service, with the transfer itself being the service, and involve no consumption so should not be taxable. Likewise, there is a payment of pure interest. This is simply an adjustment to the capital value to reflect the different value of the capital over time and is also not consideration for any supply and relates to no consumption. Again this pure interest component should also not be taxed as it does not amount to consumption. However, implicit in these flows (typically in interest) will be the charge for the intermediation service. The loan may also incorporate a risk premium. The nature and appropriate treatment of this charge remains the subject of debate in the literature.

5 The language used in the Australian GST law has been adopted throughout this paper (for example references to 'exempt' supplies are referred to as 'input taxed' supplies).

- self-supply bias – financial service providers may consider it more cost effective to provide their key services in-house (such as brokerage, advisory, funds management) than acquire these from third parties where they are unable to recover the tax embedded in these supplies;
- apportionment complexities – entities using taxable inputs to make both input taxed and taxable or GST free supplies must apportion the GST on the inputs they are entitled to recover;
- consumption distortions – the input tax on financial supplies generally results in impacted financial transactions bearing less tax than if the normal tax rules are applied. This may bias consumption to more financial services than might otherwise occur; and
- impact on the financial sector’s international competitiveness – countries with a VAT/GST system that input taxes financial supplies will result in those entities providing their services internationally having a relatively higher cost structure than those supplying similar services from non-VAT/GST countries, due to the embedded tax. This would arise even though in many jurisdictions the supply of the financial services qualifies as being GST free as an export, entitling the supplier to recover input tax credits associated with those financial supplies made offshore.

## Policy and existing structure of the Australian regime

Reflecting the general international approach, the central rationale for the input taxed treatment of financial supplies in Australian GST is practical and administrative. Identifying the taxable value of individual transactions where part or all of the consideration is implicit in a margin or margins is difficult under an invoice-credit style GST.<sup>6</sup> Australia’s guiding principle is that only financial supplies which are normally charged by way of a margin ought to be input taxed<sup>7</sup>.

To define what supplies to input tax, two subordinate approaches were adopted to define a financial supply. First, a list of supplies was compiled that are ‘normally charged for by way of a margin’, and these were defined as input taxed financial supplies. This list included some supplies where consideration for individual products is provided by an explicit fee. Supplies that are incidental to the provision of a financial supply, which would normally be treated as taxable, are also input taxed (for example valuation fees charged to a borrower where this was a requirement of obtaining a loan which is a financial supply).

Second, the provisions extend this concept of ‘normally charged for by way of a margin’, to exclude types of supplies where consideration was not typically provided in this way. To be a financial supply, supplies generally need to be provided by a ‘financial supply provider’ and involve dealing with an ‘interest’.<sup>8</sup> This excludes services that merely assist in providing financial supplies, such as agency or arranging services (which are input taxed in many other jurisdictions), even where such a supply might otherwise be seen as belonging to the list of

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6 Australian Treasury, *The Application of Goods and Services Tax to Financial Services*, consultation document, August 1999, pages 1- 2.

7 Australian Treasury, *The Application of Goods and Services Tax to Financial Services*, consultation document, August 1999, page 2.

8 Regulation 40-5.09, *A New Tax System (Goods and Services Tax) Regulations 1999*.

financial supplies. Furthermore, a supply will be a financial supply only if it relates to the provision, acquisition or disposal of an interest listed in the Regulations.<sup>9</sup> Defining financial supplies in this way is unique to Australia.

Australia's approach means the 'acquisition' of an interest that is a financial supply is also itself treated as a financial supply. This achieves broadly equivalent outcomes to those in other jurisdictions applying an input taxed (or exemption) approach.

Another aspect of Australia's policy approach is to provide taxpayers with reduced input tax credits (RITCs) for certain acquisitions of financial services and impose a 'reverse charge'<sup>10</sup> on certain inputs acquired from overseas. These measures combat some distortions that arise from the input taxation of financial supplies. RITCs address the bias to in-source such services (and avoid any need for a wider definition of financial supply that other jurisdictions use to minimise this in-source bias). The reverse charge addresses the incentive for input taxed businesses to acquire overseas services which would not be subject to GST, by imposing the appropriate amount of GST on such services.

## Details of Australia's approach

Australia's approach to dealing with financial supplies under GST is a modified version of the 'exemption' systems widely used in European VAT systems. These modifications seek to reduce some of the equity and efficiency distortions from input taxation. As discussed above, two modifications are:

- an RITC equal to 75 per cent of the full input tax credit for a defined range of acquisitions that would otherwise be input taxed. This is a unique feature of Australia's GST regime; and
- adopting a narrower definition of financial supply for GST purposes<sup>11</sup> than many other international jurisdictions do.

There are also a number of other features that seek to reduce these distortions. These included:

- introducing a de minimus threshold (known as the financial acquisitions threshold or FAT);<sup>12</sup>

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<sup>9</sup> With some exceptions, one being the recent provisions dealing with supplies of certain ATM services, Regulation 40-5.09(4A).

<sup>10</sup> Division 84 of the GST Act requires the recipient of an intangible supply from offshore to treat the supply as taxable and to account for the GST on the supply where the supply to the recipient would not be fully creditable.

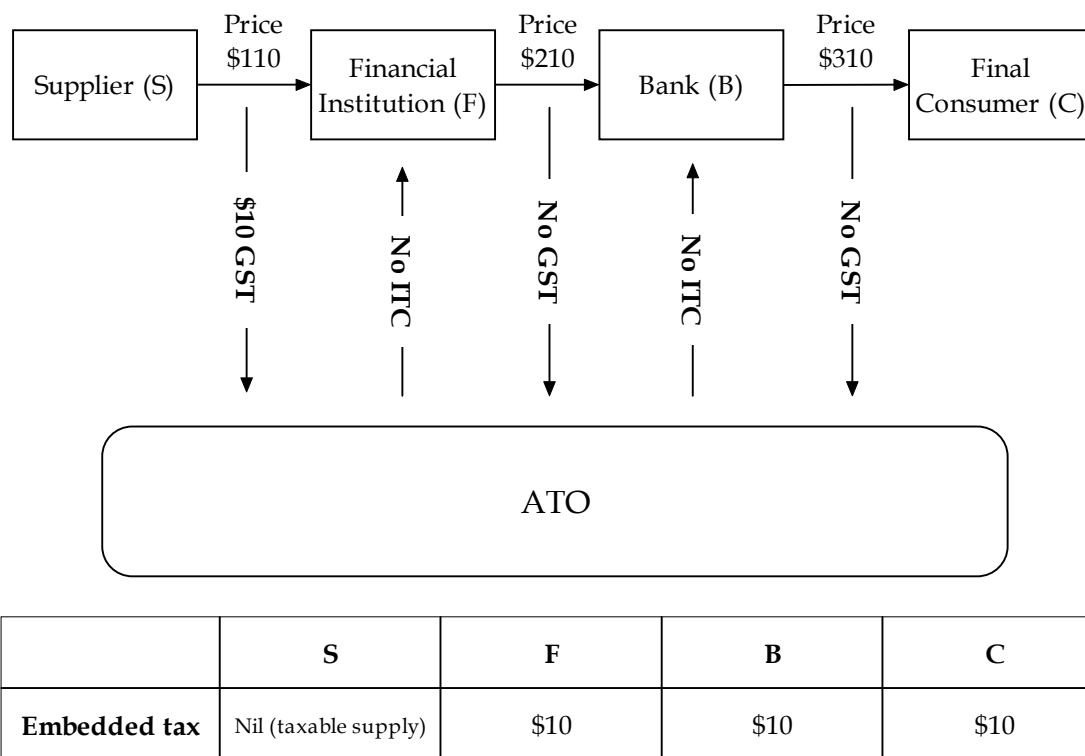
<sup>11</sup> In *Consumption Taxes: The role of the Value Added-Tax*, chapter 12 by Satya Poddar, it is suggested that countries which have introduced VAT systems more recently, like Australia, Canada and New Zealand, have taxed more financial supplies due to the reduction in substitution between fees and margins as a result of recent market developments.

<sup>12</sup> Notwithstanding that entities may be making financial supplies, where they do not exceed the FAT, they are not denied entitlement to full input tax credits for acquisitions used in making those financial supplies.

- including a special exemption for certain borrowing costs where the funds are used in making supplies that are not input taxed;
- avoiding incentives for input taxed entities to acquire their inputs from overseas by requiring them to make equivalent GST payments (reverse charging); and
- excluding insurance (other than life insurance) from the definition of financial supplies.

An additional feature of Australia’s approach to financial supplies arises from its adoption of the input tax mechanism which, unlike other jurisdictions, does not provide for a credit of input tax on acquisitions based on a link between an acquisition and a taxable (or zero-rated or GST free) supply. Under Australian GST law, input tax relief is available on all acquisitions made in carrying on an enterprise, but is denied to the extent that the acquisition relates to making input taxed supplies. Thus *acquisitions* as well as *supplies* of financial interests are treated as ‘financial supplies’ to appropriately deny input tax credits.

This diagram illustrates how the input tax treatment works.



In this series of transactions, the embedded GST of \$10 is passed on through the supply chain. This leaves the final consumer \$20 better off than if the supply had been a taxable supply (assuming a constant \$100 profit margin), but business consumers who cannot recover the tax are \$10 worse off.

*Here, the services supplier (S), a registered entity, sells services at \$110, including GST, to the financial institution (F). As this is a taxable supply, the services supplier must remit 1/11th of this amount, \$10, as GST. The financial institution (F) is registered and has purchased the service for their business. However, the service is used to provide an input taxed financial supply and therefore cannot claim an ITC.*

*The financial institution (F) provides this financial supply at \$210, excluding GST, to the bank (B). As this is an input taxed supply, no GST need be remitted. The bank (B) is a registered entity, but cannot claim a credit, both as the supply is to be used in making an input taxed financial supply and the supply itself was input taxed and hence bore no direct tax.*

*Finally, the bank (B) provides a financial supply to the final consumer (C) at \$310, excluding GST. As this is an input taxed supply, the bank need not remit GST.*

*If the final consumer is not a registered entity, it benefits from input taxation as the \$10 of embedded tax (namely the \$10 that was charged by S and not recoverable by F) in the price is less than the \$30 of GST they would bear if the supply had been taxable (\$310 less the embedded tax of \$10 plus GST of \$30, or \$330). Hence they pay \$310 rather than \$330. If the final consumer is a business, it is worse off as while the \$10 of embedded tax is less than the \$30 of GST, it cannot claim an ITC for the embedded tax. Hence, it must effectively pay \$310 if the supply is input taxed rather than \$300 if the supply is taxable (\$330 less \$30 ITC).*

*The outcome for unregistered entities is effectively the same as if all their activities were input taxed. They need remit no tax on any supplies as they are not registered. However, they can also claim no credit on their acquisitions.*

### **The legislative regime for taxing financial supplies in Australia**

The detail underlying the tax treatment of financial supplies is not found in the principal Act but lies in the Regulations.<sup>13</sup> The diagram below illustrates the current legislative structure for Division 40 which contains the key provisions.

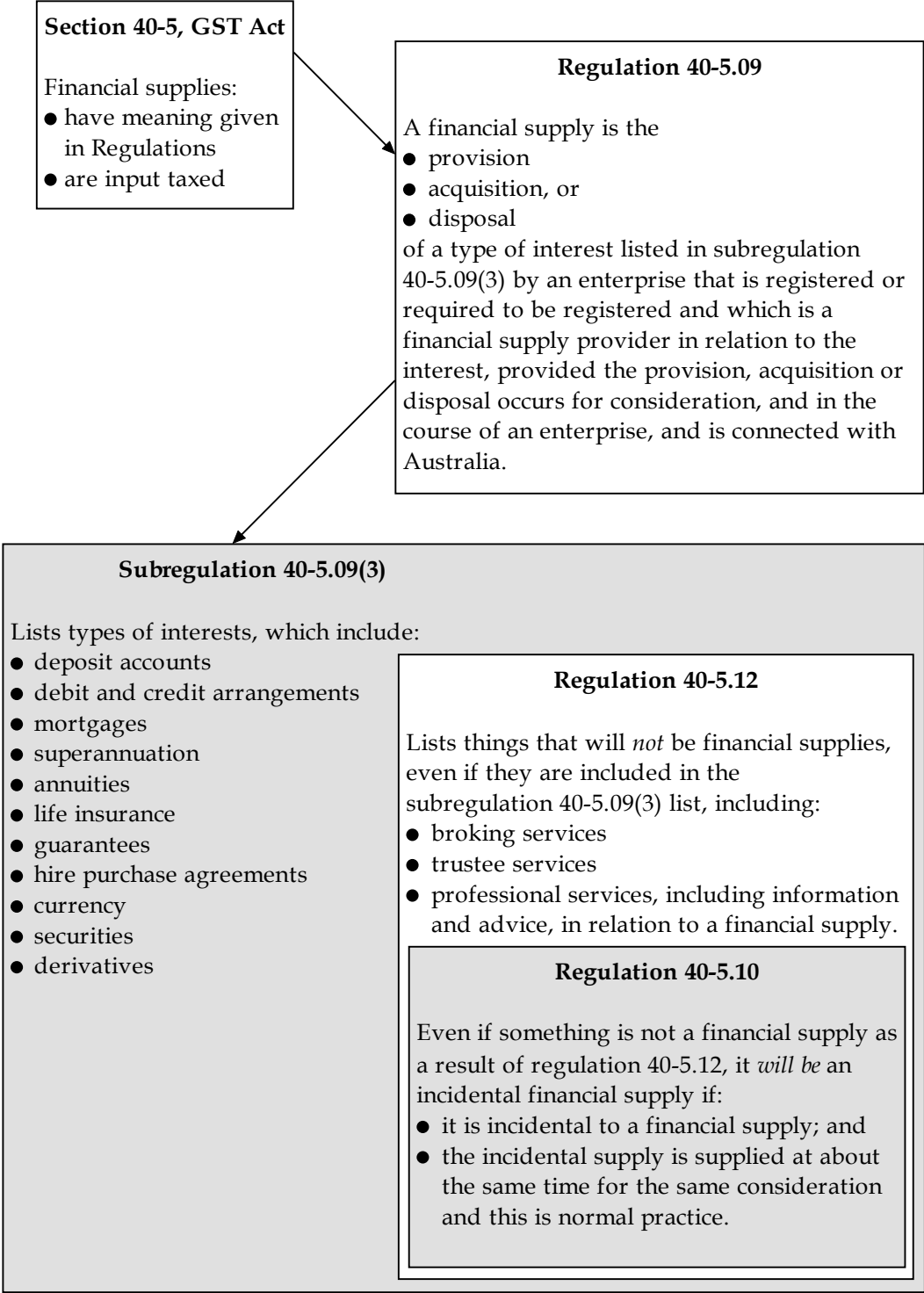
Division 70 defines reduced credit acquisitions and the entitlement to a RITC. Various schedules to the Regulations provide examples of financial supplies. (See also 'Eligible RCAs' later in this paper.)

Division 84 of the GST Act applies a compulsory 'reverse charge' of GST to imported services by a registered entity where a full input tax credit cannot be claimed on that supply.

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13 A New Tax System (Goods and Services Tax) Regulations 1999.

**Legislative structure for financial supplies**



**Criticisms previously raised with this legislative structure**

The inherent difficulties in taxing financial supplies under the GST have led to a level of criticism, largely concerned with uncertainties surrounding its application. It has been argued that:

- this unique structure relies heavily on regulations and results in additional complexity and uncertainties;<sup>14</sup>
- the examples in the regulations cannot be relied upon where they are inconsistent with the relevant provision;<sup>15</sup>
- the RITC goes some way to tackling the problem of self-supply bias but introduces a further layer of complexity. For example, in addition to requiring an apportionment of acquisitions between those used in making financial supplies and those used for making taxable/GST free supplies, those used in making financial supplies also need to be apportioned into those that qualify as reduced credit acquisitions and those which do not.

Other concerns raised in submissions to the Board of Taxation include:

- operation of the FAT. (As previously mentioned, the Government has responded to the Board of Taxation's recommendations on this matter and therefore it is not for further consideration as part of this review);
- the denial of ITCs for capital raising compared with certain borrowings. (This is outside the scope of this review as it would involve a significant policy change);
- non-compliance with the reverse charge requirements; and
- restricted range of reduced credit acquisitions. (For example, legal and accounting generally are excluded from the list of eligible acquisitions.)

## Options

The paper canvasses several approaches to reform to:

1. adopt a set of clear principles that are clear and consistent;
2. restructure the law (particularly relating to definitions) to remove inefficiencies and unnecessary complexity while maintaining the existing policy approach; and
3. review the eligibility and operation of the reduced credit acquisition (RCA) system and existing rate for a RITC (currently a single rate of 75 per cent).

These options are not mutually exclusive, and elements of each approach could be implemented together.

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14 'GST and Financial Supplies: A Comparative Analysis of Legislative Structure' by Peter Edmundson, *Australian Tax Review* Vol 30, 2001 and again in a similar article 'GST, Financial Supplies and Reduced input Tax Credits', *The Tax Specialist*, Vol 6 No. 3, February 2003.

15 Although to the extent that the examples are repeated in a Tax Office public ruling, this ruling provides administrative protection for any reliance.

## Option 1: Replace existing legislative framework with a principle or set of principles

### General discussion

It has been argued that part of the complexity with the existing policy approach lies in the prescriptive definition of what is and what is not a financial supply.<sup>16</sup> This option would, to the extent possible, replace the current 'list based' approach with a set of principles which describe the fundamental characteristics of supplies that should be financial supplies and the nature of a reduced credit acquisition according to the underlying policy.

In its submission to the Board of Taxation, the Institute of Chartered Accountants in Australia<sup>17</sup> commented that:

The Institute considers that, since its inception, there have been many shortcomings with the design, interpretation and administration of the Australian GST law particularly in relation to financial services.... Many of these negative features arise, not out of the policy of exemption of financial services but from the cumbersome drafting of the law that fails clearly to state the principles concerned and thus allow a purposive construction to give effect to the policy, purpose and objects of the exemption scheme.

Replacing the existing law with a set of clear principles would ensure the classification of financial supply is sufficiently flexible to cater for the introduction of new innovative financial products and services not specifically dealt with by the present list-based approach.<sup>18</sup>

A clear set of principles that gives effect to the desired policy outcome should provide greater clarity to the scope of input taxation or reduced credit acquisitions. Unlike a black-letter law list, an approach that incorporates underlying principles into the law can achieve the proper policy outcome without identifying all of the specific types of supplies where the law may apply and assigning appropriate treatment.

The absence of lists may mean that some taxpayers may, at least initially, face greater uncertainty. Addressing this uncertainty may, amongst other things, require use of the private rulings process until taxpayers become familiar with the changed law. It is not clear that this would result in a net increase in private ruling requests. There are already significant numbers of private rulings issued in this area. Further, where supplies are not clearly within a listed item, the need for a ruling should be reduced, not increased by the change. It should also be noted that the large body of case law and ATO materials dealing with the existing law would be expected to have continued relevance under this alternate approach.

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<sup>16</sup> Regulations 40-5.09 and 40-5.12.

<sup>17</sup> The Institute of Chartered Accountants in Australia, submission in response to the Board of Taxation's *Review of the legal framework for the Administration of the Goods and Services Tax* – September 2008, page 19.

<sup>18</sup> Although many of the existing items are framed quite widely, for example Item 2 of sub-regulation 40-5.09(3), 'A debit, credit arrangement or right to credit, including a letter of credit' is capable of capturing a very wide range of transactions.

A statement of principles would endorse the existing policy intention. Whatever set of principles is designed would need to ensure, as much as possible, that financial supplies involving a margin are input taxed and that any bias to self-supply is reduced as far as possible.

South Africa has adopted an approach that distinguishes between margin-based and explicit fees. It achieves this by defining 'financial services' in such a way that it excludes any services for which an explicit fee is charged.<sup>19</sup> This reflects the underlying policy rationale and minimises the ambit of input taxation. However, it does distinguish between transactions based purely on the method through which consideration is provided, which has the potential to give rise to distortions. Any distortions would need to be weighed against the potential compliance cost reductions that result from the reduced scope of input taxation.

In this context, it is worth noting that recent commentaries on the financial sector have indicated there are strong commercial pressures to move towards charging explicit fees, questioning the extent to which any distortions would emerge in practice.<sup>20</sup>

### Questions

1. Would replacing the existing legislative framework with a clear principle or set of principles giving effect to the underlying policy intention improve the law and reduce compliance costs?
2. What issues would need to be addressed in moving to such an approach?
3. Would adopting an approach similar to South Africa's, of only applying input tax treatment where there are margins, give rise to distortions?

### Specific methods of implementing a set of principles

It is unlikely that a set of principles could be developed that would mirror the existing law in full. This largely reflects the prescriptive structure of the existing law, which contains a series of lists with the rationale underpinning the inclusion/exclusion of some items not always clear. Consequently, any set of principles adopted is likely to result in some changes from existing outcomes.

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19 See section 2(1), Value-Added Tax Act, 1991 (Act 89 of 1991), 'Provided that the activities contemplated in paragraphs (a), (b), (c), (d) and (f) shall not be deemed to be financial services to the extent that the consideration payable in respect thereof is any fee, commission, merchant's discount or similar charge, excluding any discounting cost.'

20 See for example Poddar, Satya, 'Consumption taxes: the role of the value added tax' in Honohan, Peter *Taxation of Financial Intermediation: Theory and practices for emerging economies*, 2003, International Bank for Reconstruction and Development/Oxford University Press, Washington DC/New York pp.30-33 and McCann, Ewan, and Edgar, Tim 'VAT treatment of Interest and Financial Services with competitive banking and insurance sectors' *Tax Notes International* Vol.30 No. 3 pp.791-808 and Demirguac-Kunt, Asli and Huizinga, Harry, 'Determinants of bank interest margins and profit: some international evidence' 1999 *World Economic Review* Volume 13 No.(2) pp.379-308.

## Questions:

4. Given the policy outlined in the paper above, what areas of the existing structure do you see as giving rise to uncertainty, or to unintended GST outcomes? Do you see a principles-based approach fixing those uncertainties or unintended outcomes?

The existing policy is to input tax financial supplies as a proxy for taxing final private consumption of financial services. Thus, any principle must define the scope of supplies that are financial supplies.

There are a range of possible approaches to developing a set of principles, starting with an expression of a high-level principle supporting the desired policy outcome through to a set of principles of lower order (greater detail).

An example of a high-level approach is replacing the current list of financial supplies with a single statement of principle. This approach is the most concise and best ensures that input taxation only applies where required by the underlying policy. The trade-off, however, is its high level of generality which may result in more interpretation being required than if the particular cases were dealt with specifically in the law. It should be noted though, that not all situations can be explicitly addressed in black letter law, and where things are not addressed there will be greater complexity and a much higher likelihood of inappropriate outcomes.

Two examples of high level principles are set out below. Example 1 simply provides that the supply must relate to an interest in a 'financial asset' or 'financial activity', leaving the terms undefined. This allows the input tax treatment to apply broadly wherever consideration is paid by way of a margin. Example 2 instead refers to the concept of 'financial arrangement' from the Taxation of Financial Arrangements reforms. This allows the use of an existing concept and makes GST and income tax more consistent.

### Example 1

*The provision, acquisition or disposal of an interest in a financial asset or activity is a financial supply to the extent that:*

- *the consideration for the supply does not take the form of a fee, commission, discount or similar charge; and*
- *the provision acquisition or disposal would otherwise be a taxable supply.*

### Example 2

*The provision, acquisition or disposal of a financial arrangement is a financial supply to the extent that:*

- *the consideration for the supply does not take the form of a fee, commission, discount or similar charge; and*
- *the provision acquisition or disposal would otherwise be a taxable supply.*

An alternative approach is the supplementary principle approach, Example 3 below illustrates this. In this case the law would not comprise a single principle alone, but instead a principle would be introduced to supplement the existing law by excluding those supplies which it is feasible to tax. This approach would minimise the change to the existing law

while still reducing unnecessary input taxation. However, it would also do the least to remove complexity and embody policy directly in the law.

This approach would make use of the existing legislative framework but insert a new item into the list of supplies that are not financial supplies, excluding supplies to the extent that consideration is provided in a form that can be readily subject to GST. Alternatively, given the fundamental nature of the restriction, the aim could instead be achieved by inserting a provision into the part of the law defining what is a financial supply.<sup>21</sup>

### Example 3

*However, a supply will not be a financial supply to the extent that the consideration for the supply is in the form of a fee, commission, discount or similar charge.*

The final approach considered is the use of multiple principles. This would entail developing a series of principles that outline, in broad terms, the types of supply that should be financial supplies when consideration is provided by way of a margin. This approach provides greater specificity than the high-level principle approach while removing the problems associated with the present list.

The example below identifies four categories of activity that will be financial supplies, broadly encompassing underlying rationales for the items on the present list.

### Example 4

*The provision acquisition or disposal of an interest in:*

- *a debt or credit arrangement;*
- *an equity arrangement;*
- *currency, including foreign currency*
- *derivative instruments of the above items, including options; and*
- *a life insurance policy, superannuation policy, annuity or managed investment scheme.*

*is a financial supply to the extent that:*

- *consideration for the supply is not in the form of a fee, commission, discount or similar charge; and*
- *the provision, acquisition or disposal would otherwise be a taxable supply.*

The above examples have been included to illustrate what a set of principles might look like. If this approach was supported, detailed consultation would be undertaken as to the final form any principles might take.

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21 Subregulation 40-5.09, *A New Tax System (Goods and Services Tax) Regulations 1999*.

### Questions:

5. Having regard to the examples above, do you think that the structure of the definition of financial supply could be replaced with a principle or set of principles? If so, what principle or set of principles provides the best policy outcome?
6. What transitional issues might arise if such an approach were adopted?
7. Would there be merit to applying such an approach to other areas of the financial supplies rules, such as reduced credit acquisitions? If so, what would be the best way of doing so and what issues would need to be addressed?

### Option 2: Amend existing law

There has been commentary to the effect that a number of the items in the Regulations are unclear, ambiguous or potentially variable. Issues raised included:

- when entities may be financial supply providers;
- exactly how various provisions apply to acquisition supplies;
- whether acquisition made after 1 July 2000 can relate to making input taxed supplies where they relate to say, a bank account opened prior to the introduction of GST;
- the treatment of guarantees (both whether an arrangement may constitute a guarantee and, more commonly, who the parties to a supply of a guarantee are); and
- the treatment of credit card surcharges.

Others have commented that while other provisions are clear, they do not seem fully consistent with the policy rationale or resulting somewhat arbitrary distinctions (for example. definitions of 'partnership' and 'hire purchase agreement' in the Regulations).

The present law has a list of things that are financial supplies (regulation 40-5.09), qualified by a list of things that are not financial supplies (regulation 40-5.12). What is not a financial supply is further qualified by the rules relating to incidental financial supplies (regulation 40-5.10) such that where something is both, it will be treated as being a financial supply. This legislative structure can result in complexities and administrative costs.

**Questions:**

8. Would you support continuing with the current legislative structure?
9. Would further specific amendments to deal with some of the issues identified above lead to greater simplicity, more certainty and a reduction in compliance costs or the reverse?
10. How would you see such an approach (continuing with ad hoc legislative amendments) dealing with new structures/arrangements which may result in outcomes contrary to the current policy intent?
11. What other amendments would you like to see and why?
12. Do we need a list of both what is and what is not a financial supply? If you favour a single list, should this be of what is, or is not, a financial supply?
13. Would a single list resolve any interpretive and administrative concerns that exist currently?

**Option 3: Extent of eligible reduced credit acquisitions (RCAs) and rate of reduced input tax credit (RITC)**

Since the initial list of eligible RCAs was prepared some 10 years ago there have been significant changes in the financial sector. These changes include new forms of financial products which has increased pressures to reduce costs. This raises questions about whether the current approach is achieving its intended purpose.

The Tax Institute of Australia in its submission to the Board of Taxation<sup>22</sup> commented that:

They were included in the Australian GST Act as an alternative way of dealing with certain design difficulties faced by all VAT systems. Eight years on, it would seem appropriate to consider if the RITC provisions are an efficient way of dealing with these difficulties and if they are operating as intended.

**Questions:**

14. How has the introduction of RCAs impacted on financial institutions use of outsourcing and subcontracting services?

It is worth noting that any changes to existing arrangements can be pursued in combination with either of the approaches identified as options 1 or 2 above.

**(i) Eligible RCAs**

One policy rationale for allowing an RITC for certain acquisitions used by financial supply providers is to counteract the bias to 'self-supply' where inputs are financial in nature and

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<sup>22</sup> Tax Institute of Australia, submission in response to the Board of Taxation's *Review of the Legal Framework for the Administration of the Goods and Services Tax* – September 2008, page 18.

may, in the absence of a Division 70 regime, have been included in the wider definition of financial supply.

**An example of how RITCs neutralise the self-bias incentive for an input taxed entity**

	Out-sourced (no RITC)	In house	Out-sourced (RITC available)
Material inputs (excluding GST)	\$500	\$500	\$500
Net GST (after any input tax credit entitlement)	na	\$50	na
Value added (wages and profit)	\$1,500	\$1,500	\$1,500
Total cost (excluding GST)	\$2,000	\$2,000	\$2,000
GST	\$200	na	\$200
RITC @ 75 per cent	na	na	\$150
Price/cost (incl. GST)	\$2,200	\$2,050	\$2,050

*In the example above, it can be seen that in the absence of an RITC the input taxed entity would face a cost of \$2,200 if it out sourced the supply of the service (column A) compared with a cost of only \$2,050 if it was able to source the service in house (column B). This demonstrates the clear incentive for self-supply. However, where the input taxed entity is entitled to a RITC for the acquisition from the out-sourced supplier (column C), the alternative cost would be the same to having self-supplied the service and the input taxed supplier would be neutral in whether to out- source the acquisition or acquire it in house.*

Concerns have been expressed that the current list of RCAs either does not go far enough or gives rise to uncertainty, tax planning opportunities and inequity. For example, certain inputs, such as legal and accounting services, are not eligible RCAs when acquired directly by an entity for use in making financial supplies. However, where such inputs are acquired via another entity as inputs into its supply of an eligible RCA, in some circumstances it may be possible for a RITC to be obtained.

If the acquisition is one where there is a real bias to in-source and is ‘financial’ in nature, an RITC should, in principle, be available. However, consideration also needs to be given to the potential for bundling of services to:

- create significant additional compliance complexities;
- result in inequitable treatment of what are fundamentally similar acquisitions; and
- advantage those entities which are more likely to have the knowledge, funds and other necessary capacity, to create arrangements such as special purpose vehicles (SPVs) to maximise credit entitlements.

**Questions:**

15. Has the exclusion of certain out-sourced inputs resulted in distortions or tax planning opportunities, such as the establishment of a special purpose vehicle (SPV), to channel costs and recover an unintended higher level of RITCs?

## Range of RCAs

Consistent with the focus on outsourced activities, the range of acquisitions to which the RITC applies is limited to 31 listed RCA items contained in the GST Regulations.<sup>23</sup> Generally acquisitions in respect of which an RITC entitlement attaches include:

- outsourced account keeping activities such as operating, maintaining and performing transactions in respect of an account;
- processing services in relation to account information such as statement processing;
- providing credit reference and credit scoring assessments;
- services entailing the access to credit, debit and charge-card payment systems;
- processing, settling, clearing and switching transactions for credit and debit, cheque, EFT and light transactions;
- arranging for the supply of interests in securities such as mergers and acquisitions, flotations and settling trades;
- securities and unit registry services in relation to securities;
- mortgage broking, arranging syndicated loans and introducing and broking;
- lender's mortgage, title and loan protection insurance;
- loan application, management and processing services;
- debt collection services;
- arranging hire purchase financial supplies;
- arranging derivative and forward contract transactions;
- portfolio management services;
- administration functions for superannuation schemes and life insurance policies;
- trustee and custodial services.

The range of RCAs reflects both the underlying policy intent to reduce self-bias in services of a financial nature and consultations with industry at the time.

There is a further list (Regulation 70-5.02B) which, unlike the list above of essentially outsourcing activities, lists closely related activities which are generally 'in-house' in nature. This list is only relevant where these supplies are being made by an offshore branch of the same entity. The eligible activities fall under the following headings:

- senior executive management

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<sup>23</sup> Regulation 70-5.02, *A New Tax System (Goods and Services Tax) Regulations 1999*.

- human resources support
- corporate marketing and communications
- financial management
- supply procurement and management
- credit, operational and risk management
- relationship management
- in-house legal services
- technology systems
- business services.

Under these rules, a financial service provider is entitled to RITCs of 75 per cent of the reverse charged GST liability on the payments it makes to closely related enterprises offshore.

An interesting feature of these provisions is that relating to ‘unabsorbed contributions’ (see Regulation 70-5.02C) which essentially states that, in determining the reduced credit acquisition, the price of the service supplied by the off-shore entity is reduced by the amount passed on to the receiving entity of an ‘unabsorbed contribution’ from a third party.

An ‘unabsorbed contribution’ is defined as something that is supplied by a third party to the offshore entity and is passed on by the offshore entity to the receiving entity, where the character of that thing remains unchanged from when it was acquired by the offshore entity. An example given in the regulations of what is intended to be caught is an acquisition of legal advice by the offshore entity which is simply passed on to the receiving entity.

This mechanism is clearly aimed at reducing the scope for ‘bundling’ in this context.

#### Questions:

16. Does the current structure of the RCA provisions give rise to any ambiguities, and so give rise to compliance problems?
17. Do any of the RCAs listed require further clarification? If so, which and how?
18. Are there any changes that should be made to the existing list of RCAs?
19. Can these concerns be addressed by capturing the policy intent in a set of principles?

#### (ii) Rate of RITC

Currently there is a single rate of 75 per cent.<sup>24</sup> This rate was determined some 10 years ago after extensive consultation with the financial sector and, at that time, represented a

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<sup>24</sup> Regulation 70-5.03.

generous average rate for the types of acquisitions identified as being eligible for a reduced input tax credit.

The RITC was introduced to address the potential bias to in-source particular services. Ideally, the size of the RITC should be calculated by reference to the value added by the last supplier of a service into a financial service provider. The RITC reimburses the purchaser for the GST effectively applied to the wages and profits of the supplying firm. The availability of a RITC means that a financial institution will not face a tax incentive to in-source a service.

The rate for the RITC for a specific service should equal the percentage of value added at the final stage of the production process. The precise rate of credit required to achieve this result would, therefore, be expected to vary for different services. However, at the time of the introduction of GST the industry had expressed a preference for a single rate of RITC for all eligible services for the purposes of simplicity and this was supported by the government of the day.

#### Questions:

20. Does the current RITC rate of 75 per cent remain appropriate? If not, what should the rate be and why?
21. Should there be differing rates for different types of acquisition or sectors?
22. Would multiple rates lead to excessive administrative and compliance costs?

#### Comments

Treasury invites comments on the issues and options presented along with any other alternative approaches for simplifying the current treatment of financial supplies whilst maintaining the same policy outcome.

Submissions provided on this paper are intended to be made publicly available via the Treasury website. If you do not want your submission to be made publicly available, please indicate that clearly.

Email submissions to: [financialsupplies@treasury.gov.au](mailto:financialsupplies@treasury.gov.au)

Written submissions addressed to: General Manager  
Indirect Tax Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

For enquiries, please call Rob Dalla-Costa on (02) 6263 3328.

Submissions are due by: 31 July 2009.