



**Australian Government**

# **Implementation of the recommendations of Treasury's review of the GST financial supply provisions**

Discussion paper  
June 2010

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## CONSULTATION PROCESS

### Request for feedback and comments

The Government is seeking your feedback and comments on the design of the measures in this paper. Submissions may address all of the measures set out in this paper or one or more of these. Submissions should also identify any other issues, including interaction issues with other parts of the tax law, which may be relevant to the design of the measures. Specific focus questions have also been included in Chapter 2 for each measure for which feedback is sought. While submissions may be lodged electronically, by post or by facsimile, electronic lodgment is preferred.

All information (**including name and address details**) contained in submissions will be made available to the public on the Treasury website unless respondents indicate that they would like all or part of their submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information **marked** as such in a separate attachment. A request made under the *Freedom of Information Act 1982* to make available a submission marked 'confidential' will be determined in accordance with that Act.

### Closing date for submissions: 30 August 2010

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## FOREWORD



I am pleased to release this discussion paper on the design of the amendments to various aspects of the financial supply provisions in the GST law.

In the 2010-11 Budget, the Rudd Government announced that the GST law would be amended to implement the recommendations from Treasury's review of the GST financial supply provisions.

These reforms will result in fewer small businesses having to interact with the complexities of the financial supplies regime, they will also clarify and simplify the operation of some provisions, and tighten eligibility in some others to protect the integrity of the GST revenue base.

We look forward to receiving the community's views on the design of these changes to the financial supply provisions in the GST law.

SIGNED

**Assistant Treasurer**  
Senator Nick Sherry

## SUMMARY

On 11 May 2010, the Assistant Treasurer, Senator the Hon Nick Sherry, announced that the Government will introduce a package of reforms to the financial supply provisions of the GST.

Specifically, the Government will legislate to:

- increase the financial acquisitions threshold to \$150,000;
- make hire purchase fully taxable;
- allow full input tax credits upfront for small businesses accounting on a cash basis when they enter into hire purchase;
- expand the range of expenses qualifying for a reduced input tax credit (RITC) to include superannuation funds providing life insurance products, transactional fraud monitoring and clarify that lenders mortgage re-insurance qualifies for a RITC;
- exclude bank deposit accounts from the current special rules for borrowings;
- reduce opportunities for businesses to inappropriately take advantage of the reduced input tax credit (RITC) concessions by bundling services; and
- clarify the language and relationship between the concepts of guarantees and indemnities.

The media release is available on the Assistant Treasurer's website.

# 1. INTRODUCTION AND OVERVIEW

## 1.1 INTRODUCTION

On 12 May 2009, the Government announced that Treasury would undertake a review of the financial supply provisions of the GST to explore opportunities to simplify the operation of the legislation and reduce compliance and administrative costs whilst retaining the existing policy intent. This followed a recommendation from the Board of Taxation's Review of the Legal Framework for the Administration of the Goods and Services Tax.

The Treasury consultation paper that was released on 12 May 2009 provided background on the existing policy treatment of financial supplies under Australia's GST regime, along with options for achieving this policy outcome more efficiently and with reduced compliance costs.

The Government announced in the 2010-11 Budget that it will maintain the current architecture of the financial supply provisions but will make a number of changes, which will clarify the operation of the legislation and reduce compliance and administrative costs, particularly for many small businesses.

## 1.2 PURPOSE OF THIS PAPER

The purpose of this paper is to provide additional information on how the announced Government measures might operate and to seek feedback on their design and implementation.

Conducting consultation on announced Government measures is in line with the Government's in-principle agreement in 2008 to implement the recommendations of the Tax Design Review Panel, including that it should consult publicly on the design of announced policy, to ensure stakeholders have the opportunity to contribute to the process.

## 1.3 CONSULTATION PROCESS

The paper provides information at a level of detail similar to drafting instructions Treasury provides to the Office of Parliamentary Counsel, setting out the principles to be included in the law and areas in which further feedback is sought on approaches to implementation.

## 1.4 PRINCIPLES-BASED LAW DESIGN

The changes to the GST law will be drafted using the principles-based approach where possible.

Under principles-based law design, the operative legislative provisions that implement the policy are expressed as principles. They will prescribe the legislative outcome rather than the mechanism that

produces it, and typically avoid the detail that appears in more traditional legislative design approaches.

At times, a principle may be wider in its application than the policy intent; for example, it may encompass more situations than desired. Rather than modifying the principle in a way that results in a loss of coherence, carve-outs from the operation of the principle are used.

Alternatively, a principle may not cover a situation that needs to be treated in a similar way. An add-on to the principle is therefore identified, unless there is a coherent way of reforming the principle at a higher level.

## 1.5 OBJECTIVES OF REFORMS

The key objectives of the reforms are to assist small sized businesses by ensuring fewer are caught up in the financial supply regime, clarify the operation of some existing provisions, and tighten eligibility under others to protect the integrity of the GST revenue base.

## 1.6 TIMETABLE FOR REFORMS

The reforms will apply from 1 July 2012, and will apply prospectively.

## 2. IMPLEMENTATION INFORMATION

### 2.1 FINANCIAL ACQUISITIONS THRESHOLD

#### 2.1.1 Government decision

The indirect tax law will be amended to increase the financial acquisitions threshold from the current \$50,000 to \$150,000 of input tax credits.

#### 2.1.2 Background

##### Operation of existing law

1. Most financial supplies are input taxed. This means that entities making financial supplies generally cannot claim input tax credits for the GST paid on related financial acquisitions.
2. A financial acquisition is an acquisition that relates to a financial supply, other than a financial supply consisting of a borrowing. In order to determine the amount of input tax credits an entity can claim, the entity must identify the extent to which acquisitions relate to the making of their input taxed supplies. This results in increased compliance costs and complexities for businesses, especially small businesses that only make a small number of financial transactions.
3. The financial acquisitions threshold (FAT) was introduced to reduce the costs of compliance for small businesses that only make a small number of low value financial supplies. Businesses who do not exceed the FAT are able to claim input tax credits for acquisitions that relate to the making of financial supplies.
4. Whether a business has exceeded the FAT is determined by looking at:
  - financial acquisitions made in the current month plus the previous 11 months (current financial acquisitions); and
  - financial acquisitions made, or anticipated to be made, in the current month plus the following 11 months (future financial acquisitions).
5. Under Division 189 of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act), an entity will have exceeded the FAT (and therefore fall within the financial supply regime) if the input tax credits claimable for current or future financial acquisitions made by the entity exceed:
  - \$50,000 in the relevant period; or

- 10 per cent of the total amount of input tax credits the entity could claim for all its purchases (including financial acquisitions) during the relevant period.
6. Currently, businesses that are falling on the borderline need to monitor their compliance on a monthly basis, which results in increased compliance costs for these businesses.

### 2.1.3 Proposal — Financial acquisitions threshold

#### Principle — increase FAT from \$50,000 to \$150,000

7. An entity will exceed the FAT if the dollar value of input tax credits claimable for current or future financial acquisitions made by the entity exceed \$150,000 in the relevant period.

#### Commentary

8. The intention of this principle is to reduce compliance costs for businesses that only make a small number of low value financial supplies. The increase in dollar amount for the threshold will mean that fewer businesses will be prevented from claiming input tax credits on acquisitions that relate to making financial supplies.
9. The relevant periods in which financial acquisitions made, or anticipated to be made, by the entity will remain the same — that is, the current month plus the previous 11 months and the current month plus the following 11 months.
10. The 10 per cent threshold also remains unchanged. As the law currently stands, if the input tax credits that an entity can claim for its current or future financial acquisitions exceed 10 per cent of the total amount of input tax credits it could claim for all its purchases (including financial acquisitions) during the relevant period, then the FAT has been breached.
11. This will require replacing all occurrences of the FAT dollar amount in Division 189 with the new dollar threshold of \$150,000.
12. The change will be made in the legislation rather than in the regulations (as provided for in the current legislation). This will make compliance simpler and easier for businesses, as well as improve accessibility and eliminate confusion by removing the need to refer to the regulations.

## 2.2 HIRE PURCHASE

### 2.2.1 Government decision

The indirect tax law will be amended to:

- simplify the treatment of hire purchase by making it fully taxable; and
- allow full input tax credits upfront for small businesses accounting on a cash basis when they enter into hire purchase.

## 2.2.2 Background

### Operation of existing law

13. Under a hire purchase agreement, goods can be purchased through instalment payments. It is possible to use the goods while paying for them, but ownership of the goods does not transfer until the final instalment is paid.
14. Hire purchase agreements commonly apply to goods such as vehicles, office equipment and machinery, and most hire purchase arrangements are transactions between businesses. In addition to hire purchase, other methods of financing include chattel mortgages.
15. Under the existing law, the GST treatment of the supply of credit in hire purchases depends on how the associated interest charge is set out:
  - where the interest charge is separately identified and disclosed by the supplier, no GST is payable on the supply of credit as it is treated as a financial supply and input taxed (GST Regulation 40-5.09 item 8); however
  - where the interest charge is not separately identified and disclosed by the supplier, the supply of credit is not a financial supply and GST is payable on the total amount under the contract.
16. As outlined above, hire purchase is only treated as a financial supply and thus input taxed where the interest charge is separately identified. This does not fit with the underlying policy where financial supplies are input taxed because consideration cannot be readily identified on a transaction by transaction basis.
17. In respect of the taxable component of a hire purchase agreement, the way in which the GST payable and any related input tax credits is attributed depends on the accounting basis of the taxpayer:
  - taxpayers accounting on a cash basis attribute any credits and liabilities when they make or receive each instalment payment; however
  - taxpayers accounting on a non-cash basis must, in respect of supplies, account for their GST liability in full upfront at the earlier of when the first payment is received or an invoice issued and conversely in respect of acquisitions, may claim the input tax credit in full upfront at the earlier of when they make their first payment, or when a tax invoice is obtained.
18. Under the existing law, two methods of accounting for GST are allowed — cash and non-cash. The default accounting method is non-cash. However, a concession exists which generally allows taxpayers with an annual GST turnover at or below \$2 million to account on a cash basis. Accounting on a cash basis generally requires less record keeping and is easier for small businesses. Certain other taxpayers may also be allowed to account on a cash basis.
19. While cash basis taxpayers are not able to obtain input tax credits upfront for hire purchase agreements, they are able to do so for broadly equivalent arrangements such as chattel mortgages.

20. A chattel mortgage is a security over movable articles of property (chattels) held by the lender that gives the lender recourse in the event of default by the borrower. Under a chattel mortgage, the purchaser takes title in the chattel from the time of purchase, and they finance the purchase by way of a loan obtained from a lender. The purchaser then applies the borrowed funds as payment in full to the supplier for the chattel.
21. This differs from a hire purchase agreement. A hire purchase agreement is a contract where the title in the goods remains with the financier and does not pass to the purchaser until either the option to purchase is exercised by the purchaser, or the final instalment is paid. For GST purposes a hire purchase agreement is recognised as a method by which the 'hirer' purchases goods on deferred payment terms.
22. Under a chattel mortgage, as all the consideration for the chattel has been provided, the cash basis taxpayer will be able to access full input tax credits upfront in respect of the acquisition of the chattel. In contrast, under a hire purchase agreement the taxpayer is only paying part of the consideration for the goods when the taxpayer makes each instalment payment, and as such is only entitled to claim input tax credits as each instalment is paid.
23. Chattel mortgages have higher costs and risks than hire purchase arrangements. The higher costs relate to additional administrative tasks required for chattel mortgages as well as additional fees and charges. These apply because the financier is taking security over the asset, whereas under lease and hire purchase arrangements the financier is the owner. This distinction is also the reason for the increased risks of a chattel mortgage.
24. The different GST treatment of hire purchase and chattel mortgages for taxpayers accounting on a cash basis means that arrangements such as chattel mortgages that enable purchasers to access full input tax credits upfront have been increasingly preferred over hire purchase arrangements. These decisions appear to be based on the earlier availability of input tax credits, rather than on commercial reasoning. Thus the tax treatment of hire purchase is creating an inefficiency that is driving taxpayers towards other finance products. Removing the distinction will restore the choice of financing methods for cash accounting businesses and remove the current market distortion.
25. The United Kingdom, New Zealand and South Africa have specific GST/VAT rules that apply when accounting for hire purchase.
26. The UK specifically excludes hire purchase from cash accounting (subregulation 58(2) of the Value Added Tax Regulations 1995).
27. New Zealand has a special time of supply rule that deems goods supplied under a hire purchase agreement to be supplied when the agreement is entered into. This enables taxpayers to claim the whole amount of the credit upfront (*Goods and Services Tax Act 1985* paragraph 9(3)(b)).
28. South Africa, like New Zealand, has special time of supply rules. They deem the supply to take place at the earlier of the time the goods are delivered or the time any payment of consideration is received (*Value Added Tax Act 1991* paragraph 9(3)(c)).

## 2.2.3 Proposal — tax status of hire purchase

### Principle 1 — all hire purchase fully taxable

29. All hire purchase transactions should be treated as fully taxable supplies.

#### Commentary

30. The underlying policy is to input tax financial supplies in cases where the consideration cannot be readily identified on a transaction by transaction basis. Given this, it is not necessary that hire purchase transactions, where the interest charge is separately identified and disclosed by the supplier, be input taxed, and all hire purchase transactions should be fully taxable.
31. The intention of this principle is to simplify the GST treatment of all hire purchase transactions and reduce administration and compliance costs for taxpayers.
32. As a result of the changes, all hire purchase transactions will be treated consistently, regardless of whether the interest charge is separately identified and disclosed. In all cases, the supplies will be fully taxable (subject to the normal GST rules — for example, a hire purchase transaction that is an export would remain GST-free).
33. This will require removal of the existing item 8 in Regulation 40-5.09 from the list of supplies that are financial supplies.

## 2.2.4 Proposal — hire purchase attribution

### Principle 2 — all hire purchase accounted for on a non-cash basis

34. Input tax credits should be available upfront where GST has been paid upfront on a hire purchase agreement.

#### Commentary

35. This principle will ensure that hire purchase transactions are treated the same regardless of whether taxpayers account on a cash or non-cash basis.
36. The intention of this principle is to remove the distortion that exists between hire purchase and other forms of financing for cash based taxpayers. This distortion arises as a result of the interaction between the cash accounting rules and the GST treatment of hire purchase for taxpayers that account on a cash basis.
37. This principle could be given effect to by establishing an exception to the normal attribution rules requiring taxpayers that account on a cash basis to attribute hire purchase transactions as if they had accounted on a non-cash basis for that transaction only. For all other transactions, the taxpayer should continue to account on a cash basis.
38. This will require a special rule for accounting in the case of hire purchase transactions.

### Focus questions

- (i) Are hire purchase arrangements limited to transactions between businesses, or are there instances where hire purchase is used in consumer finance? Will consumers be affected by the change to make hire purchase fully taxable?
- (ii) Will the removal of the existing item 8 in Regulation 40-5.09 from the list of supplies that are financial supplies have any consequences beyond the direct imposition of GST?
- (iii) In addition to removing item 8 in Regulation 40-5.09 from the list of supplies that are financial supplies, is it necessary to also add an example in Regulation 40-5.12?

## 2.3 REDUCED INPUT TAX CREDITS

### 2.3.1 Government decision

The indirect tax law will be amended to expand the range of expenses qualifying for a reduced input tax credit (RITC) to include superannuation funds providing life insurance products, transactional fraud monitoring and clarify that lenders mortgage re-insurance qualifies for a RITC.

### 2.3.2 Background

#### Operation of existing law

39. In an effort to reduce incentives to self-supply certain services from arising due to the input taxation of financial supplies, Australia has a unique arrangement where some acquisitions related to the making of financial supplies nonetheless may give rise to RITCs of 75 per cent of the GST included in the price of the acquisition. This provides a degree of neutrality between large financial suppliers, who have the ability to insource the activity (and hence not bear GST on this activity when it is performed in house), and those that are required to outsource the same activity where GST would be charged. It also reduces the cascading of tax from embedded GST from unrecovered tax on financial institutions' business inputs.
40. If set at an appropriate rate, a RITC results in the same tax effect as would be the case if the service being provided was input taxed rather than taxed. As smaller financial supply providers outsource more of their activities this provides a greater benefit to them than the major banking institutions.
41. At the time of the GST's introduction, a list of the acquisitions eligible for RITCs was set out in the regulations. This followed extensive consultation with the financial sector. It had also been indicated in a consultation document issued in 1999 that this would be reviewed regularly, however, this current review has provided the first opportunity to do so.

42. The present list does not allow non-life insurers, including superannuation funds, to obtain a RITC for the assessment on claims relating to life insurance policies. The list also contains an item relating to lenders mortgage insurance that has given rise to some concern from industry about whether lenders mortgage re-insurance is covered. Finally, the list does not specifically include transactional fraud monitoring services. The requirement to monitor and report certain financial transactions is a relatively new requirement imposed on financial institutions. The Government believes such services should be eligible for a RITC.

### 2.3.3 Proposal — extending the availability of RITCs

#### **Principle 1 — equivalent treatment of all providers of life insurance**

43. Non-life insurers providing life insurance products should be able to access RITCs for the same acquisitions that give rise to RITCs for life insurers providing equivalent products.

##### **Commentary**

44. The intention of this principle is to address an anomaly in the GST law that prevents certain entities providing life insurance from obtaining RITCs.
45. This will be achieved by amending the relevant items so they apply to entities providing life insurance rather than for life insurers.

#### **Principle 2 — specifically include lenders mortgage re-insurance**

46. Lenders mortgage re-insurance should be specifically listed as a reduced credit acquisition.

##### **Commentary**

47. The intention of the present law and the view of the Commissioner of Taxation is that lenders mortgage re-insurance falls within the scope of the present item covering lenders mortgage insurance.
48. However, submissions to the Treasury Review of the Application of GST to Financial Services expressed concern that the present treatment of lenders mortgage re-insurance was ambiguous.
49. This amendment will ensure the treatment of lenders mortgage re-insurance is clear by including specific mention of it in the regulations.

#### **Principle 3 — include transactional fraud monitoring services**

50. Transactional fraud monitoring services should be added to the list of reduced credit acquisitions.

##### **Commentary**

51. Since the introduction of the GST, there have been a number of developments in the regulation of the financial sector. One new area of regulation has been substantial increases in the obligations on financial institutions to undertake measures to monitor transactions to prevent fraud.

52. These services are inherently linked to financial services and are capable of being insured. Given this, they meet the criteria to be included on the list of reduced credit acquisitions.

#### **Focus question**

- (iv) What specific examples of services should be included in the ambit of transactional fraud monitoring services?

## **2.4 SPECIAL RULE FOR BORROWINGS**

### **2.4.1 Government decision**

The indirect tax law will be amended to exclude bank deposit accounts from the current special rules for borrowings.

### **2.4.2 Background**

#### **Operation of existing law**

53. As most financial supplies are input taxed, entities that make financial supplies are generally not entitled to claim input tax credits for related acquisitions.
54. A number of exemptions to this general rule have been included in the GST law. They aim to reduce compliance costs for small businesses and businesses that only make limited financial supplies. These concessions include:
- the financial acquisitions threshold (FAT) which enables businesses (that do not make financial acquisitions in excess of a de minimis threshold) to access input tax credits (Division 189 of the GST Act);
  - the borrowing concession, which takes borrowings out of the financial acquisitions de minimis threshold (section 189-15 of the GST Act); and
  - allowing input tax credits for acquisitions that relate to making a financial supply consisting of a borrowing to the extent that the borrowing relates to the making of supplies that are not input taxed supplies (section 11-15(5) of the GST Act).
55. The borrowing concession complements the FAT in ensuring that small businesses borrowing funds for use in their business activities do not find themselves breaching the FAT and then coming within the financial supply regime.
56. As almost all businesses would be making some input taxed financial supplies, in the absence of these concessions, most businesses would be required to identify the extent to which acquisitions relate to the making of their input taxed supplies.

57. The objective of the borrowing concession, as expressed in the Revised Explanatory Memorandum (Indirect Tax Legislation Amendment Bill 2000), is to provide input tax credits for expenses related to borrowings except where the borrowing is undertaken by a financial institution or where the borrowing is undertaken by the corporate treasury of a large business for the purposes of making other input taxed supplies.
58. The current view is that accounts with authorised deposit-taking institutions (ADIs) represent amounts borrowed by the ADI from the account holder, and the ADI makes a financial supply consisting of a borrowing in relation to each such account. Thus the existing law does not achieve the policy intent, and financial institutions are able to recover input tax credits on their inputs related to their deposit taking to the extent that these do not relate to making input taxed supplies.

### 2.4.3 Proposal — special rules for borrowing

#### **Principle — exclude bank deposit accounts from the borrowing concession**

59. ADI accounts should be excluded from the current special rules for borrowings.

#### **Commentary**

60. A financial acquisition is defined in the GST Act as any acquisition that relates to the making of a financial supply (other than a financial supply consisting of a borrowing).
61. Borrowing is defined in the GST Act as any form of borrowing, whether secured or unsecured, and includes the raising of funds by the issue of a bond, debenture, discounted security or other document evidencing indebtedness.
62. The intention of this principle is to better target the borrowing exemption to reflect the policy intent and no longer provide input tax credits for expenses related to borrowing where the borrowing is in the form of an ADI deposit account.
63. The intention is that only bank deposit accounts with ADIs will be excluded from the current special rules for borrowings.
64. The change should not impact on non-financial institutions that undertake borrowing for the purposes of making taxable or GST-free supplies.

## 2.5 LIMITING REDUCED INPUT TAX CREDITS FOR BUNDLED TRUSTEE SERVICES

### 2.5.1 Government decision

The indirect tax law will be amended to reduce opportunities for businesses to inappropriately take advantage of the reduced input tax credit (RITC) concessions by bundling services.

### 2.5.2 Background

#### Operation of existing law

65. The GST law treats a trust as a separate entity to the trustee. However, as the trust is not a legal entity it cannot generally make acquisitions or supplies on its own behalf. Instead, supplies and acquisitions by the trustee on behalf of the trust are treated as the acquisitions of the trust. This means that a trustee may make supplies and acquisitions in multiple capacities (that is on its own behalf or on behalf of a trust that it operates).
66. In an effort to reduce incentives to self-supply certain services arising due to the input taxation of financial supplies, Australia has a unique arrangement where some acquisitions related to the making of financial supplies nonetheless may be eligible for a reduced input tax credit of 75 per cent of the GST included in the acquisition price. This provides a degree of neutrality between large financial suppliers, who have the ability to insource the activity (and hence not bear GST on this activity when it is performed in house) and those that are required to outsource the same activity where GST would be charged. It also reduces the cascading of tax.
67. Trusts are often used in financial sector structures such as managed investment schemes and superannuation funds. Trustee services can be provided for these trusts by the trustee or by appointing an external service provider.
68. RITCs are available for the following acquisitions:
  - acting as a trustee of a trust or superannuation fund;
  - acting as a single responsible entity;
  - trustee and custodial services; and
  - single responsible entity services.
69. It is possible for a single entity to be a trustee or responsible entity for a number of different trusts. Typically, a trustee or responsible entity is required to arrange for a number of activities to be undertaken for the trust to operate. The trust deed generally provides for the reimbursement of the trustee for any expense that it incurs in connection with the trust.
70. 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 their 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.

71. 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.

### 2.5.3 Proposal— no RITC for acquisitions bundled with trustee services

#### **Option 1 — made and provided**

72. 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.

#### **Carve out — items otherwise eligible for a reduced input tax credit**

73. RITCs and 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.

#### **Option 2 — substance and character**

74. 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.

#### **Carve out — items otherwise eligible for a reduced input tax credit**

75. RITCs and 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.

#### **Option 3 — define trustee services**

76. 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.

#### **Carve out — items otherwise eligible for a reduced input tax credit**

77. RITCs and 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.

#### **Commentary**

78. The intention underlying each of the three options outlined is to ensure neutrality in the RITC provisions by eliminating advantages associated with bundling various acquisitions into a single

acquisition of trustee services. (The term 'trustee services' includes responsible entity services.)

79. Options 1 and 2 achieve this by reducing the value of the supply the trustee makes to the trust to the extent that this value represents acquisitions for which the trustee acts as a mere conduit. Option 3 attempts to achieve a similar outcome by specifically excluding certain acquisitions made by the trustee and provided to the trust from qualifying for a RITC where these form part of the trustee services fee.
80. Each option however, entails a different approach to giving effect to identifying these bundled acquisitions. While each seeks to give effect to the Government's decision there are important differences in process which could also have different impacts on compliance costs.
81. Option 1 (made and provided) identifies bundled acquisitions using the distinction between the recipient of the supply (the entity to which it is made) and the entity to which the supply is provided. Where acquisitions by the trustee are provided to the trust then the principle will ensure that the trust receives the same treatment as if it were made by the trust directly by denying the RITC on the payment for the associated services of the trustee.
82. The made and provided test is already well established in the context of the GST cross-border rules and the rules around entitlement to input tax credits. Its application in this context does not give rise to any new complexities that do not already arise in the cross-border context. Indeed, the close relationship between the trustee and trust eliminates much of the potential complexity around obtaining information that can arise in the cross-border context. In general any goods or services the trustee obtains on behalf of or to benefit the trust or trusts that it operates will be provided to the trust or trusts. In this respect, considering whether obligations may exist in the trust deed is not relevant.
83. Option 2 (substance and character) takes a different approach to preventing tax distortions associated with bundling. Rather than looking to which entity acquisitions are provided, it instead looks at whether the supply of services by the trustee includes the trustee acting as a conduit for acquisitions by the trust. Where the trustee has merely passed on unchanged acquisitions then the RITC available for the trustee services acquired by the trust will be reduced to reflect the value of the acquisitions that have been passed on. Not all changes to what is passed on will be sufficient to change the substance of what is acquired.
84. This principle works in a manner very similar to the rules around unabsorbed contributions in relation to acquisitions of off-shore services that have been subject to the compulsory reverse charge. In that case, the value of relevant reduced credit acquisitions (and therefore the amount of any RITC available) is reduced to the extent that the value reflects an unabsorbed contribution by the supplier.
85. While this principle also draws on a concept in the existing law, it currently applies only in the context of a quite limited range of transactions. As a result, the underlying concept has not been as extensively developed and there are likely to be more extensive administration and compliance costs were it to be adopted, as well as the potential for further interpretative guidance to be required from the Australian Taxation Office.
86. Option 3 (define trustee services) takes a very pragmatic approach by excluding from the definition of trustee services a range of acquisitions made by the trustee for which no RITC will be available to the extent that the trustee seeks to recover these costs as part of its fee for

trustee services. This approach effectively uses specific acquisitions to define the separation between the trustee acting in its own capacity and the trustee acting in its capacity as a trustee of a particular trust.

87. Those acquisitions identified in the principle have been included by way of example and arguably the benefit of these services flow to the trust rather than form part of the supply of trustee services.
88. Regulation 70-5.02 of the GST Act contains the list of acquisitions for which RITCs are available. Item 29 covers trustee and custodial services and it already excludes from eligibility for a RITC services related to the safe custody of money, documents and other things. This may be the appropriate place to add further exclusions from what can be claimed to be 'trustee services' for the purposes of obtaining a RITC.
89. While this approach lacks flexibility its application is likely to be simpler than the other options.
90. All three options are subject to a carve-out. The carve-out allows RITCs where the principle would otherwise deny them if the relevant acquisition is one for which a RITC would have been available had it been directly acquired by the trust. This ensures that these provisions do not unfairly disadvantage entities using single fee arrangements.

## Examples

### Principle 1 — made and provided

91. In general the vast majority of services the trustee obtains will be provided to the trust or trusts that they operate. This reflects the fact that trustees in general do very little in their personal or corporate capacity but almost exclusively act for the trust or trusts that they operate. This is the case regardless of whether the trustee may be obligated to make certain acquisitions by the trust deed, or whether certain acquisitions may be provided to a number of trusts.

*Trustee Co enters into a contract with Invest Co for the supply of investment advice for the purposes of assisting Trustee Co in investing the property of the various trusts it manages, as Trustee Co is obliged to do under the deeds of the trusts. This acquisition while **made** to Trustee Co is **provided**, in appropriate proportions to each of the trusts whose assets are under management. The benefit and substance of the advice goes to the trusts, whether or not it is acted upon.*

92. In cases where an acquisition is made by the trustee and provided to both the trust and the trustee, apportionment may be required. In this example, Trustee Co has agreed to provide trustee services to a trust for a single fee.

*Trustee Co enters into an arrangement with Legal Partners where it obtains legal advice on two matters involving an investment proposal for a flat fee. One of these matters relates to contracts connected to the proposal. Such services relate to the business of the trust and not the trustee and so are provided to the trust. The second matter pertains to certain related party elements of the transaction and the trustee's fiduciary duties. This advice is not provided to the trust — it goes to the scope of the trustee's duties not the performance of trust functions. Only that portion of the flat fee attributable to the advice in relation to the contracts falls within the principle.*

## Principle 2 — substance and character

93. Again, there will be few cases in which a trustee acquires something and changes its substance or essential character.

*The trustee may acquire a valuation of some of the property of the trust. This valuation then informs the trustee's decisions on the investment strategy for the trust. It is arguable as to whether the trust receives exactly the same thing as the trustee obtained. However, this does not matter as, the **substance** of what has been acquired — the knowledge about trust assets — has been passed on, leaving the **character** of the acquisition unchanged.*

*As a result, RITCs will not be available for the trustee services to the extent this acquisition is included.*

94. Apportionment may be required either between various trusts or where an acquisition is partially but not wholly passed on.
95. We invite further comment and discussion on all three options.

### Focus questions

- (v) Are there any cases where applying one of the principles could create inappropriate outcomes?
- (vi) Could some trust arrangements be more or less disadvantaged under one of the options?
- (vii) If you favour Option 3 are there other categories of acquisitions that should be excluded from the definition of trustee services?

## 2.6 GUARANTEES AND INDEMNITIES

### 2.6.1 Government decision

The indirect tax law will be amended to undertake a technical amendment clarifying the language and relationship between the concepts of guarantees and indemnities.

### 2.6.2 Background

#### Operation of existing law

96. Legally, a guarantee is an agreement under which one entity (the guarantor) agrees to be liable for the obligations of the other if the other entity defaults. An indemnity, on the other hand, is an obligation to an entity (the creditor) assumed by another (the surety), under which the surety agrees to keep the creditor protected from risks arising from dealings with a third party.

97. Under subregulation 40-5.09(3) of the A New Tax System (Goods and Services Tax) Regulations 1999 (GST Regulations), the list of financial supplies includes at item 7 'A guarantee, including an indemnity (except a warranty for goods or a contract of insurance or re-insurance)'. This suggests that indemnities, warranties, insurance and re-insurance are all forms of guarantees, when they are all legally distinct arrangements.
98. The present wording gives rise to ambiguity and confusion, especially in identifying whether a particular arrangement is a financial supply or not. It is a basic tenet of legislative design that terms be clear and correct, and to the extent that terms are ambiguous or in error, they should be corrected.

### 2.6.3 Proposal — technical amendments

#### **Principle 1 — amend the list of supplies which are financial supplies**

99. A financial supply includes a guarantee or an indemnity.

##### **Commentary**

100. As guarantees and indemnities are legally distinct arrangements, they should not be listed as though one is a form of the other. The intention of this principle is to provide clarity to businesses trying to identify whether a particular arrangement falls within the definition of a guarantee or an indemnity.
101. It is intended that the existing GST treatment of guarantees and indemnities be retained.
102. This will require modifying item 7 of subregulation 40-5.09(3) of the GST Regulations to make the two arrangements distinct from one another. The exception relating to warranties should also be removed from this item.

#### **Principle 2 — amend the list of supplies which are not financial supplies**

103. The following are not financial supplies:

- a warranty for goods;
- a contract of insurance; and
- a contract of re-insurance.

##### **Carve-out — life insurance business**

104. Life insurance business is a financial supply.

##### **Commentary**

105. A warranty for goods is legally distinct from the concepts of guarantee and indemnity. As the existing regulation already lists various types of supplies that are not financial supplies, warranties for goods should be listed under this heading.

106. The intention of this principle is to remove confusion caused by the wording suggesting that warranties and contracts for insurance and re-insurance are forms of guarantee.
107. This will require inserting warranties (as described above) into the list in regulation 40-5.12. It is noted that 'insurance and re-insurance business' is already listed in item 10.
108. The exclusion for life insurance business from item 10 is to remain unchanged. Life insurance business to which subsection 9(1) of the *Life Insurance Act 1995*, or a declaration under subsection 12(2) or section 12A of that Act, applies, or related re-insurance business is currently listed in item 6 of subregulation 40-5.09(3) as a financial supply.
109. It is intended that Note 1 in regulation 40-5.12, which makes regulation 40-5.09 subject to regulation 40-5.12, remains unchanged.

#### **Focus question**

- (viii) Are there any other items in either subregulation 40-5.09(3) or regulation 40-5.12 that raise similar interpretational or definitional inconsistencies?