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26 March 2013

Dear Sir or Madam

Submission: Exposure Draft Legislation, Refunding Excess Goods and Services Tax (GST)

We are writing to your office on behalf of our client, the Australian Capital Territory Land Development Agency ("**LDA**")[1], to make a submission with respect to the Exposure Draft legislation released on 26 February 2013 that proposes to replace existing section 105-65 in Schedule 1 to the *Taxation Administration Act 1953* ("**the TAA**") with a new Division 142 in the *A New Tax System (Goods and Services Tax) Act 1999* ("the **GST Act**"). The Exposure Draft legislation is referred to hereinafter as "proposed Division 142".

We understand that the proposed Division 142 is a replacement for, and not in addition to, the proposed Division 36 which was contained in the first Exposure Draft legislation released on 17 August 2012. We acknowledge the following improvements made to the Exposure Draft legislation for refunding excess GST following the consultation process for the former proposed Division 36:

- proposed Division 142 enables taxpayers to self-assess their entitlement to GST refunds by clarifying in subsection 142-10(1) that the restriction on GST refunds does not apply to the extent that the extra GST has not been "passed on" to another entity; and

- subsection 142-10(3) provides the Commissioner with a discretion not to apply the restriction on GST refunds in certain circumstances.

The LDA acknowledges that Treasury may wish to amend the law dealing with refunds of GST in order to maintain the policy intent that taxpayers should not obtain windfall gains if they have not borne the cost of GST. We agree that there should be no automatic entitlement to a refund of overpaid GST, as this may entitle a supplier to a "windfall gain" in circumstances where the GST has been passed on and has not been borne by the supplier. However, for the reasons set out in this submission, we are of the view that the desired policy outcome of preventing windfall gains is not achieved by precluding GST refunds in all but very limited circumstances.

[1] The LDA is an ACT Government agency within the Economic Development Directorate. Its core business is developing and selling land on behalf of the ACT Government. The LDA facilitates the development of residential, commercial, industrial and community land.

In a real property context, the impact of proposed Division 142 is particularly harsh given certain presumptions (in both section 142-15 and the Explanatory Memorandum to Exposure Draft legislation for refunding excess GST ("**the EM**")) as to when GST is taken to be "passed on". Specifically, we do not agree with the presumption contained in the EM that GST is taken to be "passed on" due to the supplier calculating its "likely GST liability under the margin scheme" (refer to Example 1.14). We are of the view that proposed Division 142 may cause adverse and unintended outcomes for real property transactions where GST is commonly borne by the supplier, including supplies where GST is calculated under the margin scheme.

Summary of key submissions

Our key submissions regarding proposed Division 142 are as follows:

1. Amendments to the EM are required on the basis that the 'judicial observations' with respect to "passing on" in a sales tax context involving supplies of manufactured consumer goods are not applicable to supplies of real property under the GST regime. Prices of real property are generally set by reference to broader market conditions and are not necessarily set to cover foreseeable costs, including the potential cost of GST. Furthermore, the commentary in the EM regarding "passing on" in a margin scheme context should be amended to acknowledge that a refund of extra GST may be available where the parties agree on a GST inclusive contract price and the GST is calculated using the margin scheme;

2. Proposed Division 142 is inconsistent with the established policy of the Australian Taxation Office ("**ATO**") to accept that refunds of GST are payable for miscalculations of GST, including where the GST amount is worked out by applying an incorrect margin scheme valuation (e.g. Item 1 instead of Item 4 of the table in s75-10(3) of the GST Act; and

3. The discretion in proposed subsection 142-10(3) for the Commissioner to allow a refund of extra GST is overly restrictive and it appears that it may only be applicable in certain very limited situations. Furthermore, the general presumption that GST is "passed on" for supplies of real property may lead to a view that the cost of the extra GST has not been "effectively borne" by the supplier, and the Commissioner's discretion to refund extra GST to the supplier is unable to be applied in legitimate circumstances.

Our detailed submissions and recommendations are set out in Appendix A.

We thank you for the opportunity to make submissions with respect to the exposure draft legislation and we look forward to working with you to resolve the identified issues.

Please feel free to contact me on (08) 9238 3117 or Sophia Varelas on (03) 8603 3247 if you have any questions.

Yours sincerely,

Ross Thorpe

Appendix A

1. "Passing on" in a real property context

In determining whether an entitlement exists to a refund of overpaid GST, proposed Division 142 introduces into the GST Act the concept of whether or not GST has been "passed on" to any other entity. We acknowledge a change to the wording of the primary provision regarding refunds of extra GST (proposed section 142-10(1), formerly proposed section 36-5(2)) in that it only applies to so much of the GST that you have "passed on". That is, if the extra GST has not been "passed on", then proposed Division 142 does not apply and there are no restrictions on the GST refund. Instead, the taxpayer is able to self-assess the GST refund entitlement as extra GST is not taken to have always been payable if it was not "passed on". This is an improvement to the former proposed legislation.

However, in our view, uncertainty and questions of interpretation are likely to arise regarding whether GST has been "passed on" for a number of reasons, including the absence of a definition in the GST law for the term "passed on". We consider that such uncertainty will exist, particularly in a real property context, notwithstanding the additional guidance that has been inserted into the EM for proposed Division 142 as compared to the guidance that existed in the EM for formerly proposed Division 36. In particular, we make the following submissions:

(a) The principles in *Avon Products Pty Ltd v Commissioner of Taxation* [2006] HCA 29 (*Avon*) with respect to "passing on" are not applicable to supplies of real property;

(b) A 'pricing enquiry' with respect to the impact of GST on real property prices suggests that the starting point should not be that GST is "passed on" in the market price of real property;

(c) "Passing on" in a margin scheme context is inadequately dealt with in the EM ;

(d) Agreeing on a "GST-inclusive" price with reference to comparable sales within the surrounding areas is an indication that GST has not been "passed on"; and

(e) An additional example should be inserted into the EM to cover the more common situation of a supply of real property for a GST-inclusive price where the margin scheme is applied.

(a) The principles in Avon regarding "passing on" are not applicable to supplies of real property

We note that the EM now refers to the *Avon* case heard in the High Court of Australia as offering some guidance on the question of "passing on". This was a case that concerned the former sales tax regime and the eligibility for a refund of overpaid sales tax paid on supplies of manufactured consumer goods. The principle issue addressed was whether Avon passed the amount of overpaid tax on to its customers.

We consider that the 'judicial observations' that are considered in the EM to be 'readily adapted to a GST context' have no application to supplies of real property for the following reasons:

i. the former sales tax regime did not apply to supplies of real property or services;

ii. *Avon* did not involve supplies of real property or services, but instead was a case involving supplies of consumer goods;

iii. the 'principles' explained in the EM are specific to both the former sales tax regime and to sales of goods, and are taken out of context in the EM as general principles that apply to the overall GST regime;

iv. while it is acknowledged that the market for real property operates in an economy geared to making a profit, like the market for supplies of consumer goods, a general inference should not be made that GST is 'expected to be passed on' in the case of supplies of real property. Each market has unique characteristics that should be considered; and

v. selling prices for real property are generally set with reference to market forces and comparable sales and not to cover foreseeable costs as may be the case for manufactured consumer goods.

We therefore request that amendments be made to the EM to acknowledge that the 'judicial observations' from *Avon* may not necessarily apply to the supplies of real property.

(b) 'Pricing enquiry' with respect to the property market suggests GST is generally not "passed on"

We acknowledge and agree with the comments in paragraph 1.55 of the EM that whether a tax amount has been "passed on through the pricing process can be a relatively complex enquiry" because "prices may be set with reference to a wide range of factors". We consider that the unique characteristics of the market for real property must be taken into account in such pricing enquiry.

As currently drafted, we consider that the EM fails to take into account the very specific pricing policies and practices applicable to supplies of real property and the impact of these policies and practices on the "passing on" of GST. That is, property prices are dependent on the real estate market in the relevant area and surrounding areas, particularly in the case of sales by way of auction where the ultimate selling price is determined by the market.

In our view, a supplier of real property is unlikely to set the selling price from a starting point of cost recovery, as may be the case for supplies of manufactured consumer goods. Instead, a supplier of real property will set its prices based on an analysis of the likely price that will be achieved in the particular market in which the property is situated. That price will be dependent on various factors including demand for that type of property (eg. houses vs units) in that market, current vacancy rates in the area, the profile of likely purchasers in that market (eg. occupants vs investors), the economic and infrastructure profile of the particular area, etc.

While a supplier may have a belief that a supply is subject to GST and that the GST is a 'real cost of doing business' (refer to paragraph 1.56 of the EM), this belief does not itself indicate that GST is "passed on" in the supply of the real property. Suppliers of real property are generally unable to set property prices based solely on the costs incurred, including the cost of GST. Real property prices are heavily dependent on broader economic factors associated with the housing market and are not based

solely on cost recovery and profit making, as may be the case for other supplies such as manufactured consumer goods.

We also consider that the comments in paragraph 1.57 of the EM that "the GST, as calculated either under the general rules or under the margin scheme, is a foreseeable cost that would normally be taken into consideration in the costing and pricing structure of a business" are too general and are not necessarily an accurate reflection of the pricing for supplies of real property.

In fact, the 'Housing Price Indexes' published by the Australian Bureau of Statistics (ABS) on a quarterly basis tend to suggest that GST is generally not "passed on" for supplies of real property. A review of the published indices in the two quarters immediately before and after the implementation of GST in Australia indicate that property prices **did not** increase in proportion to the rate of GST. That is, GST appears not to have been "passed on" in setting property prices following the introduction of GST.

The percentage change in the 'Housing Price Index' immediately before and after the introduction of GST is summarised as follows:

Quarter Ending	**Percentage Change from Previous Quarter**
March 2000	1.8%
June 2000	2.4%
September 2000	-0.1%
December 2000	2.4%

(c) Application of the margin scheme in a residential property context

We consider that the EM does not appropriately deal with situations where GST has not been "passed on" in a real property context. Where GST has been borne by the supplier, a restriction of refunds for overpaid GST results in a loss to the supplier and a "windfall" gain to the ATO equal to the overpaid GST remitted by the supplier. This outcome is obviously contrary to the policy intent.

For the reasons set out below, it is possible in a residential property context that GST has not been "passed on" to the recipient of a supply even where the contract of sale confirms an agreement for the margin scheme to apply (in accordance with the legislative requirement in section 75-5 of the GST Act):

- the price charged is generally not calculated with any reference to GST and instead is the most favourable price that can be obtained in the market. Accordingly, the supplier commonly "absorbs" the cost of GST on the taxable supply;

- as sales in the residential property market are predominately non-taxable supplies of existing premises, the supplier generally charges a market price without any increase for GST in order to compete in the market; and

- the recipient is generally unaware of the margin, has no knowledge of how much GST applies to the supply, and is unable to recover input tax credits. The amount of any GST cannot be factored into the pricing decision of a subsequent supply of the property.

In these circumstances, we consider that GST has not been "passed on" and that the supplier has actually borne the cost of GST.

Accordingly, there are many situations in a real property context where a refund entitlement should exist for GST overpaid by the supplier regardless of the fact that the margin scheme has been applied to calculate the GST on the supply. Allowing the supplier to claim a refund of overpaid GST in such circumstances would not result in a windfall gain to the supplier and would actually be consistent with the policy intent of allowing GST refunds for taxpayer's who have borne the cost of the GST.

(d) "GST-inclusive" as an indication that GST has not been "passed on"

In our view, a contract price that is stated to be GST-inclusive may be an indication that the supplier has borne the cost of GST and has not increased the contract price agreed with the purchaser on account of the imposition of GST (if applicable). We consider that this interpretation is consistent with paragraph 1.58 of the EM which suggests that it is appropriate to consider the contracts under which sales of real property are made in undertaking the pricing enquiry.

Agreeing on a GST-inclusive price is a common means of disclosing in the Contract of Sale the amount payable by the purchaser to the vendor for an acquisition of real property. This is particularly the case for supplies of real property where the GST is calculated using the margin scheme where the amount of GST is generally not separately disclosed.

The issue of whether GST applicable in relation to a residential contract for sale was the responsibility and/or risk of the vendor or purchaser was recently considered by Justice Dixon in the Victorian Supreme Court decision, *Duoedge Pty Ltd v Leong & Anor* [2013] VSC 36 *(Duoedge)*. Here, Justice Dixon held that in relation to a GST inclusive price, the risk that GST may need to be remitted to the ATO lies with the vendor, unless this risk is reversed to the purchaser by the insertion of the words 'plus GST' into the applicable section of the Contract of Sale. In our view, this analysis demonstrates that GST has **not** been "passed on" for supplies of real property where the price is stated to be "GST-inclusive" (ie. the words 'plus GST' have not been inserted into the contract). In such cases, the 'GST risk' (including any risk that GST that may be overpaid) lies with the vendor who bears the cost of GST as the parties have not reversed this risk to the purchaser.

We note that an additional example has been inserted into the EM (example 1.13) that considers agreeing on a GST-exclusive price and agreeing to apply the margin scheme is an indication that GST has been "passed on". Broadly, we agree with this position as the purchaser has agreed on a price exclusive of GST and is aware (by agreeing to apply the margin scheme) that an additional GST amount will apply (ie. GST will be "passed on"). This may be the case despite the purchaser not being aware at the time of contract of the exact amount of such GST as the margin scheme rather than the normal rules will be applied to calculate the GST.

Conversely, an inference may be drawn from example 1.13 that where the parties agree on a price inclusive of GST (as is the more common situation in real property transactions), GST has **not** been "passed on" regardless of whether or not there is an agreement to apply the margin scheme. In such cases there is no clear indication that the supplier is "passing on" the amount of GST (if any) to the purchaser.

(e) Additional example of "passing on" in a real property context to be inserted in the EM

We acknowledge that improvements have been made in the EM regarding the specific examples of "passing on" for supplies of real property in the revised EM (examples 1.13 to 1.15). These examples in the EM now deal with situations where GST is "passed on", may have been "passed on" and may not have been "passed on" respectively. The example of where GST may not have been "passed on" (example 1.15) contemplates a situation where the price is inclusive of GST and the margin scheme has been applied, but the final selling price (ie. the reduced selling price) is determined based on reasons other than GST (ie. in order to effect a sale and move on to another development). We agree with the conclusion that GST may not be "passed on" in this case, despite the contract price stated to have been GST-inclusive and the margin scheme applied.

However, we consider that this sole example of where GST has not been "passed on" has limited application and is specific to a relatively unique situation of a price reduction. We consider that it would be appropriate to include a further example of where GST has not been "passed on" based on a more common factual scenario, such as an arrangement based on the following facts:

- the supplier may have estimated its GST liability prior to sale using the margin scheme, but this has not been factored into the price of the property;
- the property price is set by reference to comparable sales in the relevant market, and is not based on cost recovery (including the cost of any potential GST);
- the contract price is not expressed to be " plus GST" (ie. the price is GST-inclusive);
- there is an agreement in the Contract of Sale between the vendor and purchaser to apply the margin scheme;
- the amount of GST applicable to the sale is borne by the vendor and ultimately reduces the margin otherwise enjoyed by the vendor; and
- the amount of GST was either miscalculated or the GST treatment of the supply was mischaracterised, resulting in an overpayment of GST.

In our view, this is a relatively common factual situation in the context of supplies of real property and it would be particularly useful to consider the application of proposed Division 142 to such a situation in the EM.

2. Proposed Division 142 is inconsistent with the established ATO policy to accept that refunds of GST are payable for miscalculations of GST under the margin scheme

The EM provides that proposed Division 142 ensures that the restriction on GST refunds applies to overpayments of GST, irrespective of whether the overpayment arises as a result of a mischaracterisation of the supply or miscalculation of the GST payable (refer to paragraph 1.1). In particular, proposed Division 142 and the EM indicate that no refunds of overpaid GST will be allowed where the margin scheme has been applied to a transaction, and there has been a miscalculation of the GST or mischaracterisation of the supply. We consider that the restriction on refunds in these circumstances is contrary to case law and established ATO policy.

International All Sports v Commissioner of Taxation [2011] FCA 824 (Sportsbet)

The *Sportsbet* case considered, in part, whether the current restriction on GST refunds in section 105-65 of the TAA applied to both miscalculations of GST and mischaracterisations of the supply. Following the *Sportsbet* decision, the Commissioner accepted that the restriction on GST refunds does not apply where the supply is correctly treated but an overpayment arises as a result of a miscalculation of the GST payable. Furthermore, in the Decision Impact Statement for the *Sportsbet* case, the Commissioner specifically accepted the decision in *Sportsbet* to allow refunds of overpaid GST where a taxpayer miscalculates the amount of GST in applying or failing to apply the GST margin scheme.

We acknowledge that this interpretation was based on the wording of section 105-65 of the TAA, and in particular the phrase "a supply was treated as a taxable supply… to any extent". However, we understand that the policy intent of section 105-65 of the TAA and proposed Division 142 of the GST Act is the same, being the prevention of windfall gains to a supplier who has not borne the GST.

Given that the policy intent of proposed Division 142 appears to be the same as existing section 105-65 of the TAA, there appears to be no valid reason to depart from the Commissioner's current interpretation of the GST refund provisions with respect to allowing refunds of overpaid GST for miscalculations of GST in a margin scheme context. In our view, it is unreasonable to preclude all refunds of overpaid GST in all cases where the margin scheme has been applied to calculate the GST amount based on a presumption in the EM that GST is "passed on".

Commissioner's Interpretation

The Commissioner's interpretation regarding restrictions on GST refunds under the current law in section 105-65 of the TAA is found in Miscellaneous Tax Ruling MT 2010/1 "restrictions on GST refunds under section 105-65 of Schedule 1 to the *Taxation Administration Act 1953*".

MT 2010/1 was to be amended to reflect the views expressed by the ATO in its decision impact statement regarding *Sportsbet*. We understand that these amendments were to reflect the Commissioner's view that a refund will exist for overpaid GST resulting from a miscalculation where the supply has been correctly characterised and treated by the supplier. In a margin scheme context, this view would result in refunds of overpaid GST in the following situations:

- supplies are treated as taxable under the margin scheme and there was an error in the calculation of the margin; and

- GST on supplies of real property has been calculated under the ordinary provisions, when in fact the margin scheme applied.

It is expected that any amendments to MT 2010/1, as announced in the decision impact statement for *Sportsbet*, would reflect the Commissioner's interpretation of section 105-65 of the TAA in allowing refunds of GST in the above noted circumstances. In our view, proposed Division 142 represents a departure from the Commissioner's interpretation to allow refunds of overpaid GST in these circumstances. A departure from this view appears to be unreasonable given that proposed Division 142 and section 105-65 of the TAA both aim to achieve the policy that taxpayers should not receive a windfall gain (refer to paragraph 1.5 of the EM).

Recommendation

We consider that the EM and proposed Division 142 itself should have regard to the established position of the Commissioner to allow refunds of overpaid GST where the GST has been calculated by applying the margin scheme. We suggest that this could be achieved by acknowledging in the EM that situations exist where application of the margin scheme does not necessarily mean that GST has been "passed on" by the supplier.

3. The discretion in proposed subsection 142-10(3) for the Commissioner to allow a refund of extra GST is overly restrictive

We acknowledge that a 'discretion' has been inserted into proposed subsection 142-10(3) to allow a refund of GST in 'exceptional circumstances'. We consider that this discretion is consistent with the Board of Taxation Review of the Legal Framework for the Administration of the GST published in May 2009 ("the Review"), that "The law should be amended to clarify that the Commissioner has a discretion to refund the GST where appropriate".

However, we consider that the discretion is overly restrictive and it may only be applicable in certain very limited situations. In order for the discretion to apply, the Commissioner must be satisfied that the refund of GST:

(a) would flow to the entity that has effectively borne the cost of the extra GST; and

(b) would not give an entity a windfall gain.

We agree with the principle that a refund of GST should not result in a windfall gain and we consider it may be appropriate to include this condition to the Commissioner's discretion in the proposed amendments.

However, we consider that the discretion has no application because it only applies where the supplier has also "effectively borne" the cost of GST (ie. which would appear to be the inverse of the supplier **not** having "passed-on" GST). Where the supplier has not "passed on" GST, there is no restriction on GST refunds anyway because the restriction on GST refunds in proposed section 142-10(1) does not operate unless GST has been "passed on". In our view, the 'discretion' as currently drafted will never have any application.

Given the current views of "passing on" and "effectively bearing" the cost of GST as set out in the EM, refunds of GST will be unavailable for the following reasons despite the purported 'discretion':

a) where the extra GST has been "passed on" (based on the Commissioner's view and the commentary in the EM), it is taken under proposed section 142-10 (1) to have always been payable and on a taxable supply (assuming that the supplier will not reimburse the other entity as the price is a market price that was set without reference to GST); but

b) the discretion as currently worded cannot apply given that a refund of extra GST (if allowed) would flow to the supplier who, having "passed on" the GST (based on the Commissioner's view and the commentary in the EM) cannot be the entity who has "effectively born" the cost of the extra GST as required for the discretion to be exercised.

A general presumption that GST is "passed on" for supplies of real property may lead to a view that the cost of the extra GST has **not** been "effectively borne" by the supplier, This may mean that the Commissioner is unable to exercise its discretion to refund extra GST for supplies of real property where legitimate circumstances for a refund of overpaid GST may exist.

The only example contemplated in the EM of where the discretion can be exercised (refer to example 1.12) is a situation where the overpaid GST has incorrectly been reported by an entity other than the supplier. That is, the GST has been "passed on" by one entity but has "effectively been borne" by another entity, such that both the restriction in proposed section 142-10(1) and the pre-condition to the discretion in proposed section 142-10(3)(a) have been satisfied. This is obviously an extremely limited situation and one that is rarely considered to occur in practice.

In cases involving a single entity, we consider that it is not possible to satisfy the condition in section 142-10(3)(a) where GST is seen to have been "passed on". As currently draft, we consider the 'discretion' is overly restrictive as it cannot apply in a single-entity situation.

Recommendation

We consider that Division 142 should be amended to broaden the scope of the discretion by removing the condition that the Commissioner must be satisfied a refund of extra GST would flow to the entity that has effectively borne the cost of the extra GST. We further consider that the EM should be amended to contemplate that the discretion can be applied in a broader range of situations, including in a margin scheme context where the contract is not on a 'plus GST' basis and the recipient is unable to claim input tax credits (ie. the GST has not been "passed on" and the supplier is the entity who has "effectively borne" the cost of the extra GST.