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Private and confidential

Mr Paul McCullough
The Secretary
GST Distribution Review
The Treasury
Langton Crescent
PARKES ACT 2600

30 July 2012

Dear Mr McCullough

Submission on interim reports of GST Distribution Review

I am writing in relation to the invitation for submissions on the interim reports of March and June 2012 of the GST Distribution Review.

I greatly appreciate the opportunity to make a submission to the Review Panel in relation to matters discussed in the two reports.

This submission addresses two issues for the Panel's consideration:

- The manner in which consumption taxation of employer provided fringe benefits is shared between the Commonwealth and States and Territories. Reform of this area of the taxation law would increase the GST revenues available for distribution to the States and Territories by up to \$300 million; and
- The possibility of increasing the GST revenue available for distribution to the States and Territories through the more efficient taxation of household consumption of financial services. This reform was supported by the *Australia's Future Tax System, Report to the Treasurer*, of December 2009 (AFTS) to increase GST revenues by more than \$3 billion.

In making this submission, I note that the second interim report observed that:

The Commonwealth Treasurer has said that the GST rate and base will not change. Therefore, the Panel has not considered options that would require a change in the GST rate or base to generate additional funds to facilitate State tax reform

Nevertheless, in the first interim report, the Panel observed that:

[T]he current weakness in GST revenue may have implications for achieving reform— simply put, reform would be easier in a strongly revenue positive environment.

Further:

- the reform to the taxation of fringe benefits is not, strictly, a change to the tax base. In addition to increasing the GST revenues of the States and Territories, the change outlined in this submission represents a more transparent, efficient and simpler method of taxation of household consumption by way of employer provided fringe benefits;
- the abandonment of the current input taxation of financial services in favour of full taxation of household consumption of financial services would reduce the inefficiency and complexity and compliance and administrative costs and risk associated with the current system.

Reference to the most recent Tax Expenditures Statement¹ and Taxation Statistics² indicate that the GST revenue could be increased by more than \$3.75 billion (in FY 2010/11 terms) by reform of the GST system to include household consumption of fringe benefits and financial services in the tax base.

Submissions

1. The FBT and GST law should be reformed to ensure that employers are liable for GST on the FBT taxable value of fringe benefits supplied to employees and that the current complex system of collection of FBT, as a proxy for GST on the household consumption of fringe benefits, cease.
2. The GST law should be adjusted, in accordance with the findings of the AFTS Report, to make inputs to financial services eligible for full input tax relief and to levy standard rate GST on the supply of financial services to households whether charged for by way of margin or explicit fee.

While this second matter may be deferred until there is a more stable environment in which the financial sector might implement the change, the consideration of policy and the design should be undertaken in preparation for a change to full taxation.

Background

One particular issue of weakness in the GST revenue under the current system on which the Panel focused in its first interim report was the omission from the GST base of household consumption of certain imported goods and services. The Panel commented that:

Any effective policy or compliance action to capture some of this revenue would bolster the GST revenue outlook.

¹ *Tax Expenditures Statement 2011*, The Australian Government the Treasury, January 2012.

² *Taxation statistics 2009-10*, Australian Taxation Office, Canberra. April 2012.

In this respect, the Panel commissioned my report on options for the GST taxation of imported goods and services. My report to the Panel³ examined whether the GST revenues available for distribution to the States and Territories might be increased by collecting GST currently forgone on the importation of goods below the “low value threshold” (LVT) of \$1,000 and services.

While I was not asked to explore other ways in which the GST revenues available for distribution might be increased, I observed that:

[T]he International Monetary Fund (IMF) have examined the narrowness of Australia's (and other countries') GST base. In their analysis the IMF concluded that Australian GST revenue could be increased by approximately 2.5% of GDP through the removal of existing concessions.

In addition, the Henry review observed the negative impact on GST revenue and efficiency arising from Australia's exemption of financial services which results in the under-taxation of consumption by \$3.9 billion (in 2011 terms). (Footnotes omitted)

The International Monetary Fund⁴ (IMF) decomposed the efficiency of value-added taxes into “policy” and “compliance” to measure of the degree to which a country's VAT system departs from a “pure” VAT with full compliance.

A policy gap of zero indicates a VAT with a single rate and no exemptions, while a compliance gap of zero indicates full compliance with the prevailing VAT system.

The Treasury Tax Expenditures Statement provides a guide to the amount of GST revenue that is **excluded** from the tax base through “policy gap”.

The Tax Expenditures Statement adopts the benchmark of the GST tax base as comprising the value of the final supply of all goods and services privately consumed and investment in residential housing in Australia. The extent to which the GST law departs from the tax base is regarded as a “tax expenditure” and hence a measure of the “policy gap”.

For the 2011 fiscal year, the Tax Expenditures Statement measures the GST revenue forgone on the input taxation of financial services as \$3,450 million.

Two GST revenue matters for consideration

This submission seeks the Panel's consideration of:

- Firstly, the manner in which household consumption of employer provided fringe benefits is treated under the current system. The current system operates so that the consumption tax in respect of goods and services consumed as fringe benefits is paid to the Commonwealth Government as FBT.

³http://www.gstdistributionreview.gov.au/content/submissions/backgroundpapers/GST_on_internet_sales_report_Michael_Evans_January_2012.pdf

⁴ Fiscal Monitor of November 2010

The Taxation Statistics published by the Australian Taxation Office for the 2010-11 FBT year indicates that the GST revenue if the fringe benefit were subject to GST would be increased by at least \$230 million.

- Secondly, the under taxation of financial services – in large part because reform of the taxation of consumption financial services will remove significant distortions, inefficiencies, complexity and compliance costs and risk.

The Tax Expenditure Statement (consistent with the AFTS report) provides an indication of significant under taxation of household expenditure on financial services amounting of \$3.45bn.

Consumption taxation of fringe benefits

The existing taxation system collects FBT as a proxy for the GST properly payable on fringe benefits; with the consequence that GST revenues are less and FBT revenues are more. In addition, because the States and Territories are large FBT payers, the State and Territory governments contribute to the taxation of consumption by way of fringe benefits. The contribution is, however, to Commonwealth FBT revenue rather than GST revenue.

In essence, the model Australia uses for the consumption taxation of fringe benefits increases State and Territory outlays and decreases State and Territory revenues. The beneficiary of the State and Territory outlays is the Commonwealth budget.

Australia's taxation of fringe benefits

The fringe benefit tax system was introduced as a part of the 1985 Reform of the Australian Tax System (RATS). Prior to 1 April 1986, the value to an employee of non-cash benefits given in respect of the employment of the employee was included in assessable income under the then paragraph 26(e) of the *Income Tax assessment Act 1936*.

The RATS Draft White Paper opined that the practical difficulties of determining *the value to the taxpayer* “lead to the almost universal non-inclusion by employees of fringe benefits received in kind”. Nonetheless, the RATS White paper contended that “in kind fringe benefits” were a proper part of the personal income tax base.

The consequential reform of the tax system involved “the imposition of a tax on employers in respect of non-cash fringe benefits while exempting such benefits from tax in the hands of employees”⁵.

The current system of taxation of fringe benefits seeks to collect tax on the supply of fringe benefits as a proxy for both:

- Personal income tax that is otherwise avoided by the employee; and
- GST that would otherwise have been paid on the purchase of the fringe benefit.

⁵ RATS page 88.

Operation of the fringe benefits tax law

The *Fringe Benefits Tax Assessment Act 1986* (FBTAA) makes employers liable for a tax (called Fringe Benefits Tax) imposed⁶ at a rate equivalent to the top marginal income tax rate of individuals. The FBTAA contains a comprehensive set of rules to determine:

- Fringe benefits of an employee of an employer;
- The taxable value of each type of fringe benefit;
- Reductions in value of fringe benefits;
- Exemptions for certain types of fringe benefits;
- Rebates of tax for some not-for profit employers.

The taxable value of fringe benefits is, generally, the arm's length value of the benefit.

Prior to 1 July 2000

Prior to the introduction of GST, the taxable value of a fringe benefit was “grossed up” so that the amount⁷ to which the 46.5% rate⁸ is applied is the pre-tax salary that would need to be earned to purchase the fringe benefit (after payment of income tax at the top marginal rate). For the 2011 FBT year, the gross up factor was 1.8692.

For example, a fringe benefit with an arm's length value of \$100 would be grossed up to an amount of \$186.92 upon which FBT of 46.5% is payable = \$86.92. This is the amount of income tax that would have been payable by the employee on \$186.92 salary and would leave \$100 to buy the fringe benefit.

Accordingly, prior to the introduction of GST in July 2000, FBT can be seen to be a proxy for the personal income tax the employee would have paid, had the employee received sufficient cash salary to purchase the benefit in an arm's length transaction.

From 1 July 2000

The introduction of the GST resulted in changes to the FBT rules. Essentially:

- The taxable value of a benefit is calculated by reference to its GST-inclusive value; and
- The “employer's fringe benefits taxable amount” to which the 46.5% rate is applied depends upon whether the employer was entitled to an input tax credit for the acquisition of the thing that is provided as a fringe benefit:
 - Where the employer is not entitled to an input tax credit for the thing supplied as a fringe benefit, the taxable value is grossed up by the **1.8692 factor**;

⁶ Under the *Fringe Benefits Tax Act 1986*

⁷ Referred to as the “employer's fringe benefits taxable amount”.

⁸ For the FBT year ended 31 March 2011.

- Where the employer **is** entitled to an input tax credit for the thing supplied as a fringe benefit, the GST inclusive taxable value is grossed up by a **factor of 2.0647**.

This gross up has the effect of collecting FBT of an amount equal to the sum of:

- The income tax that would have been paid by the employee on a salary sufficient to purchase the benefit at its GST include value (after paying personal income tax at the top marginal rate on the salary); and
- The GST that would have been payable on the purchase of the benefit.

For example, a fringe benefit with a GST inclusive arm's length value of \$100 would be grossed up to an employer's fringe benefits taxable amount of \$206.47 upon which FBT of 46.5% is payable = \$96. This is the sum of:

- The amount of \$86.91 income tax that would have been payable by the employee on \$186.91 salary and would leave \$100 to buy the fringe benefit; and
- The amount of \$9.09 GST that would have been paid on the expenditure of \$100 to purchase the benefit.

Revenue collections of tax on fringe benefits

After the introduction of GST in July 2000, FBT can be seen to be a proxy for **both**:

- the personal income tax the employee would have paid had the employee received sufficient cash salary to purchase the benefit in an arm's length transaction; and
- the GST that would be paid on purchase of the benefit.

The Taxation Statistics indicate the fringe benefits tax paid by all employers on account of the higher GST gross up factor was \$230 million in the 2010-11 FBT year, that is:

- GST revenue was less than it would otherwise have been because of the allowance of input tax credits to employers on the acquisition of things that are provided as fringe benefits; and
- Fringe Benefits Tax revenue is higher by \$230 million, being the amount of FBT employers pay as a proxy for GST on household consumption by way of fringe benefits.

Significantly, the loss to GST revenue is greater than this amount. The higher gross up rate is only applicable where the employer purchases the thing supplied as a fringe benefit. In those cases where the fringe benefit is "manufactured", or is a service provided, by the employer, input tax credits associated with the manufacture or service are available **but** the lower gross up rate is applied. That is, **no** GST revenue (or the FBT proxy for GST) is gathered in relation to the value of the fringe benefit consumed.

Lastly, but importantly, for fringe benefits provided by the States and Territories, the FBT proxy for GST is paid by the States and Territories to the Commonwealth – thus having the result of both a loss of GST revenue and an actual outlay of "tax equivalent" to the Commonwealth.

In addition, for Commonwealth employees, no GST is paid on goods and services consumed as employees. FBT is paid instead, but to the benefit of Commonwealth revenue.

An alternative basis of consumption taxation of fringe benefits

The New Zealand arrangements for FBT and GST, it is submitted, reflect the proper tax base as well as its appropriate allocation between the proxy of income tax and GST on employer provided fringe benefits.

The NZ GST regime requires the employer to pay GST of 15/115ths (the NZ rate is 15%) of the taxable value of fringe benefits as GST for the tax period in which the FBT payment is due. In this way, the FBT system is used merely to calculate the value of the consumption by way of fringe benefits - not to change the incidence of the tax itself.

For example, for a fringe benefit with a GST inclusive value of \$100 – using Australia's 2010/11 GST and FBT rates:

- FBT of \$86.91 would be payable; and
- GST of \$9.09 would be payable.

In addition, because GST is collected on the value of the fringe benefit in all cases, the full value of household consumption by way of fringe benefits is collected. As indicated above, the current Australian system **does not collect GST** unless the employer purchases the thing supplied as a fringe benefit.

Consumption taxation of financial services

The AFTS Report (the Report) of December 2009 contains consideration of Australia's GST system and the treatment of financial services in particular.⁹

The following extracts contain the principles and findings of the Report and the recommendation for the full taxation of household consumption of financial services.

Current treatment compared to consumption benchmark

... the value of domestic private consumption of financial services should be taxed, while financial services provided to non-residents or business should not be taxed.

However, estimates based on the existing GST system suggest that the current tax treatment of financial services under the GST over-taxes business by around \$760 million in 2010–11, while the failure to fully tax household consumption of financial services results in a \$3.9 billion shortfall from the consumption tax benchmark ...

Principle

The value added by the financial services sector to household consumption should be taxed in an equivalent way to consumption in other parts of the economy, while inputs to production should not be taxed. ...

⁹ Section D4 of Volume 1 of Part 2 of the Report.

Finding

Financial services paid for through an interest margin, rather than explicit fees, cannot be taxed directly using an invoice-credit GST or a simple cash flow tax. The use of input taxation under GST potentially biases production and consumption decisions, resulting in large efficiency costs and additional complexity from special provisions designed to reduce the inefficiency. ...

To remove the adverse efficiency costs of input taxation on business and exports, financial services could be removed from the GST (effectively, made GST-free). However, this would have a large revenue cost and inappropriately exempt private consumption of financial services. The Australian government, in consultation with the financial sector, could further develop an alternative method of taxing domestic consumption of financial services to replace input taxation under the GST, or to complement a cash flow tax, to ensure that consumption of financial services is treated equivalently to other forms of consumption.

As indicated above, the Tax Expenditures Statement estimates the GST revenue cost of the input taxation of financial services at \$3.45 billion.

The inefficiencies and deadweight costs of the current complex system of partial exemption and reduced input tax credits referred to in AFTS have not been quantified. In fact, there is little empirical evidence of the inefficiencies and distortions that are thought to arise from the partial exemption of financial services adopted in international VAT models.

Nevertheless, in an attempt to overcome the perceived distortions or to increase VAT revenues generally, there has been a great deal written on the options for full taxation of financial services under the invoice-credit VAT model. The IMF¹⁰ commented in this regard:

Exemption of financial services usually rests on technical difficulties in identifying value added in financial intermediation. However, this concern appears less relevant now, as Huizinga (2002) and Poddar (2003) have suggested variations on a VAT system that would allow full taxation of financial intermediation.

In considering the extent of the distortions of partial exemption and the effect on household budgets of full taxation of financial services, it is necessary to recognise that the economic incidence of the VAT depends not only on the nature of the tax itself but prevailing market conditions at a particular point in time. Ebrill¹¹ writes that:

The effective incidence of a VAT, like that of any other tax is determined not by the formal nature of the tax but by market circumstances, including the elasticity of demand for consumption and the nature of competition between suppliers.

In other words, in a highly competitive financial services market, financial service providers will bear the burden of any embedded tax, as it will not be able to be passed on to final consumers.

¹⁰ Fiscal Monitor, November 2010

¹¹ Ebrill, L et al, *The Modern VAT*, Washington, IMF, 2001

The issues of incidence take on even greater importance in a globalized, integrated and highly competitive international financial services sector. With greater competition in financial services markets, the more likely it is that financial service providers will bear the burden of any embedded taxes, with less ability to pass these costs through to final consumers.

In any event, it would seem possible to design a tax on household expenditure on financial intermediation services that would increase GST revenues for the States and Territories with:

- little effect on the cost of financial services to households;
- less distortions, inefficiencies and complexity; and
- improved efficiency and less risk to the revenue,

when compared to the current regime.

At its simplest, GST at the standard rate could be applied to:

- explicit fees;
- the proportion of the margin or spread on financial intermediation provided to households;¹²

with inputs to financial services eligible for full input tax credits.

In this regard, in considering a system of imposing a GST charge on financial institutions, it must be recognised that:

- the partial exemption system currently adopted by all VAT jurisdictions is an arbitrary and approximate collection of tax on inputs to financial services;
- the costs borne by the financial institution is not “passed through” to the class of customer to whom the services are supplied;¹³
- financial institutions could be prevented from explicitly collecting or disclosing the GST charge to consumers.

The adoption of a regime to fully tax the value of household consumption of financial services could increase GST revenues for the States and overcome the negative factors associated with the current system.

It is submitted that the current system of partial exemption and reduced input tax credits is:

- unnecessarily generous;

¹² This might be the reverse of the formula adopted in NZ to ascertain the proportion of B2B financial services that are zero-rated.

¹³ Essentially, a financial institution does not operate on a “cost plus” model for each supply, or even supplies to classes of customers. Borrowing and lending rates are not able to be adjusted to reflect input tax costs on a supply by supply basis.

- inefficient, complex and high in compliance and administrative costs and risk;
- uncertain as to its incidence.

It is submitted that the Panel should give consideration to the amendment of the GST law, in accordance with the findings of the AFTS Report, to make inputs to financial services eligible for full input tax relief and to levy standard rate GST on the supply of financial services to households whether charged for by way of margin or explicit fee.

While this matter may be deferred until there is a more stable environment in which the financial sector might implement the change, the consideration of policy and the design should be undertaken in preparation for a change to full taxation.

Thank you for the opportunity to contribute to the Panel's consideration of the GST system and the distribution of GST revenues between the States and Territories.

Please do not hesitate to contact me if there is any matter upon which further comments or clarification is required.

Yours sincerely



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