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The Australian GST regime and financial services: How did we get here and where are we going?

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1. INTRODUCTION

This paper seeks to critically appraise the financial supply provisions as set out in the *A New Tax System (Goods and Services Tax) Act 1999* (Act). The first part of this critique considers the policy intention underlying the taxing treatment of financial supplies and whether it has been properly interpreted and applied by the Courts. Where the policy intention has not been properly interpreted, this paper considers the reasons why this has occurred.

The second part of this critique considers how these issues may be rectified, what options are available for taxing financial services and whether the policy intention adopted by the Australian Commonwealth Government is still the most appropriate policy for the taxing of financial services.

In summary, it is the author's view that the precise drafting of the financial supply provisions has resulted in a literal interpretation of them by the Courts which works against the policy intention. Some observers argue that the legislative provisions can be interpreted in a manner which ensures that the policy intention is achieved. However, to do so arguably requires the Courts to undertake an analysis of context outside the words of the legislation itself. Placing reliance on the judiciary that they will always interpret the provisions appropriately when such a wide contextual analysis is required is fraught with danger. In the author's view, the drafting should therefore be amended to properly deal with this deficiency and put the matter beyond doubt.

Whilst unlikely at this stage and under this government, it is important to review policy intention on an ad-hoc basis to ensure that it is still appropriate. It is the author's view that the current policy intention to input tax financial supplies needs to be critically appraised and alternatives considered which will minimise tax cascading and achieve a more appropriate tax outcome for financial services.

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2. PART ONE: CRITICALLY APPRAISING THE FINANCIAL SUPPLY PROVISIONS – "HOW DID WE GET HERE?"

Before specifically considering the Australian provisions, it is important to place them in their context. Set out below is a brief summary of the problems inherent in taxing financial services under the Act. This provides an appropriate backdrop for understanding why the Australian Commonwealth Government adopted the policy decisions that it did at the time of implementing the Act.

2.1 Problems inherent in taxing financial services under a GST regime

Taxing financial services under a GST regime is inherently difficult and those difficulties are not easily resolved. Australia, like the majority of GST jurisdictions, has chosen to treat financial services as either "input taxed" or "exempt". However, this approach to taxing financial services h

Example:

Bank provides loan of $100,000 to customer A at 8% p.a.

Bank provides a term deposit facility of $100,000 to customer B at 6% p.a.

The Bank's interest rate spread is 2% p.a. However, this would need to be apportioned to customer A and customer B in order to determine the value attributable for the purposes of taxing the transactions as taxable supplies. What portion of the margin should be attributed to each customer?

In practice, this scenario is much more complex as this spread must be apportioned across a large customer base.

There is another issue. Even if it were possible to apportion margins between transactors, this valuation process would result in a transparency of the margins under which financial institutions operate not only to the revenue authorities but also to the public at large. This commercial information is highly sensitive and financial institutions have historically been (and still are) very reluctant to perform this difficult

This is an important concept to understand. If savings are taxed both at the time of undertaking the savings transaction and then again when those savings are used for the purposes of purchasing goods and services, double taxation will arise.[5]

However, there is a distinction to be drawn between the transaction dealing with the savings (whether it be by way of monetary deposit, loan, exchange of currency, margin lending etc) and the services that facilitate that transaction. Whilst the former should not be taxed under a GST, the latter should be taxed on the basis that they are services consumed by the customer similar to any other services provided.[6]

This paper therefore proceeds on the basis that it is preferable to tax financial services under a consumption tax on the basis that the tax should be imposed on the services that facilitate the financial transaction and not the underlying financial transaction itself.

2.2 Australia's approach to taxing financial services under a GST regime

The majority of jurisdictions choose to tax financial services by way of "exemption", or "input taxation". Input taxation means that the "supplier" of the financial service is not required to pay GST on the provision of the service, but is unable to claim input tax credits for acquisitions associated with making that supply. Hence the term "input taxation" refers to the taxation of the "inputs" rather than the "outputs" (as is thTD.0009 Tco8.5

There are a number of mechanisms to be aware of when considering the Australian financial supply provisions. A summary of these mechanisms is set out below:

a. the de-minimis threshold - this threshold excludes input taxed treatment where the acquisitions involved in making the financial supplies are less than the specified threshold.

   Referred to as the "Financial Acquisitions Threshold" (FAT), the threshold is designed to exclude those entities whose financial activities are incidental to the running of a non-financial services business (eg. IPOs, share acquisitions etc). However, in the author's view this purpose is not achieved because the current threshold limit is too low. Treasury proposes to rectify this failing by increasing the threshold.

b. the exclusion of borrowing costs for those businesses otherwise involved in taxable activities - without this provision, entities could be subject to input taxation as a result of their borrowing activities. Excluding these borrowing activities where the entity makes otherwise taxable supplies is appropriate in order to ensure that input tax treatment is applied to a narrow class of supplies.

c. the inclusion of a "reduced input tax regime" (RITC) to decrease the self-supply bias that would otherwise arise as a result of input taxation – "self supply bias" refers to the incentive that exists for financial supply providers to bring certain services "in house" rather than outsource those services due to the increased GST cost associated with outsourcing. Considering the effect of input taxation in isolation without taking into account other market factors, the increased cost of using external resources (as a result of the denial of input tax credits on inputs) can result in a bias towards hiring employees to provide such services internally. Whilst there are still costs in hiring staff, it is generally accepted that internal hiring would result in a saving when compared to using external resources where no input tax credit is available.

   At the time of the introduction of the GST, credit unions and other small financial institutions viewed the input taxation of financial services as providing a further advantage to the larger financial institutions who had the size and the capacity to bring services in-house in order to reduce the GST cost. Credit unions and smaller financial institutions therefore consideredre -im5h outso-16.9672 - TD3 TD.0009 Tc3(the inclusi

> *itself that is taxed but services that enable currency to be exchanged, usually on behalf of someone else. Similarly, the subject matter of these articles does not include "the exchange of cheques" but services that lead to, that promote, or that enable the exchange of cheques. There is no concise and elegant way of referring to this sort of service. These articles opt to solve this linguistic problem by referring to, for instance, "services that bring about the exchange of currency" or "services connected with the drawing of cheques" or "services bringing about debt", and so on. While awkward, such expressions have the merit of accuracy."*

The Australian provisions do not refer to "services" in the financial supply definition but rather refer to the actual financial transaction itself. For example, "the provision, acquisition or disposal of an interest in or under Australian currency". Whilst the understanding should be that the services which facilitate the exchange of currency are the subject matter for input taxation, the interpretation of these provisions in recent case law demonstrates that the Courts have not interpreted the provisions in this way (refer discussion below). The drafting of the provisions certainly invites this interpretation and hence it is no surprise that the Courts have taken this approach.

To illustrate this point, I examine below two recent cases that considered the financial supply provisions, *Travelex Ltd v Commissioner of Taxation*[9] (*Travelex)* and *Commissioner of Taxation v American Express Wholesale Currency Services Pty Limited*[10] *(Amex)*. The analysis below is intended to highlight the clear divide in the interpretation of these provisions.

2.3.1 Travelex

Travelex involved a simple exchange of foreign currency at the international airport. The customer purchased 400 Fijian dollars and sold the equivalent in Australian dollars. Travelex charged a commission of $8 for these services. The customer took the Fijian dollars overseas and spent these dollars whilst overseas.

It was accepted in the case that the supply made by Travelex to the customer was properly characterised as a financial supply. The question that arose was whether pursuant to s9-30(3) of the Act, the GST-free export provisions (known as "zero-rating" in other jurisdictions) over-rode that prima facie input tax treatment. The relevant GST-free provision was Item 4 of s38-190(1) of the Act which states that the following supplies are GST-free:

> *"a supply that is made in relation to rights if:*
>
> *(a) the rights are for use outside Australia; or*
>
> *(b) the supply is to an entity that is not an Australian resident and is outside Australia when the thing supplied is done."*

Travelex argued that the supply it made related to the rights attached to the Fijian dollars and those Fijian dollars were acquired for use overseas. Ipso facto, the supply made by Travelex was in relation to rights for use overseas.

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[9] *Travelex Ltd v Commissioner of Taxation* [2010] HCA 33
[10] *American Express Wholesale Currency Services Pty Limited* [2010] FCAFC 122

In considering the characterisation of the supply made by Travelex, French CJ and Hayne (who were in the majority) made the following comments:

> *"4. Although the determinative issue in the appeal depends upon the construction and application of Div 38 (and, in particular, s 38-190(1))[4], it is important to begin by examining why the sale of foreign currency constitutes a supply. That examination shows that there is a supply because there is a transfer of ownership, the subject of which is money. Both of those observations are important in deciding the central question in the appeal: whether there is a supply "in relation to" rights.*
>
> *5. The chain of provisions engaged in this matter is very long. It is desirable, therefore, to identify important links in that chain. When Travelex sells foreign currency, there is a species of what the Act refers to as a "supply". There is a "supply" because the sale of foreign currency is a "financial supply". There is a "financial supply" because there is a disposal (by Travelex) of an interest in the currency of a foreign country..".*[11]

That is, there is a financial supply because there is a transfer of ownership in the currency not because there is the provision of services which facilitate the transfer of ownership of that currency. For the purposes of characterisation, their Honours focused on the transfer of ownership of the money. It is this transfer that their Honours viewed as the relevant "financial supply" under the Act. This follows from the definition of financial supply attaching to proprietary interests.

The problem here is that when such a characterisation of the supply is adopted, the "supply" which becomes the subject matter of the provisions is the transfer itself rather than the services that facilitate that transfer. Whilst it can follow that the

the wide and undefined concept of rights in the Act) and these rights were for use outside Australia. This was the conclusion reached by the majority in *Travelex*.

Yet, with respect, this conclusion is inconsistent with the core principles of a GST regime, including Australia's version. The exchange of foreign currency cannot be consumed of itself, and hence, that exchange remains outside the GST net. However, the services that facilitate that exchange are consumed by the customer and should be taxed.[13] The following comments from Prebble and Schalkwyk succinctly put forward the argument:

> *"Services that bring about the exchange of currency require services that enable an exchange of currency to take place. The exchange of currency itself, on the other hand, refers only to the actual giving of one currency for another.*
>
> *Exchanges of currency can be likened to transactions where goods are sold. The price of the good always represents the value of the good together with the services required to get the good in a saleable position. Where the exchange of currency is concerned, the phrase "exchange of currency" refers to the part of the transaction where one good is exchanged for another. It does not include any charges for services rendered that make the exchange possible. Confusion may arise if this distinction is not maintained.*
>
> *... services that bring about the exchange of currency should be taxed under a broad based VAT. The actual exchange of currency itself cannot be taxed, because there is nothing to tax. tere is not be2(e.6066 -1.1ght6 .0003 Tc.0508 Tw[(*

given that the provision of credit and charge card facilities was clearly within the ambit of the financial supplies definition as originally conceived.[15]

However, Dowsett J concluded otherwise based on the plain meaning of the wording of the provisions and, certainly, the wording of the provisions invite the interpretation favoured by his Honour. In reaching his conclusion, Dowsett J was under no illusion that his interpretation was contrary to the intention of the drafters. However, as he aptly stated, where the plain meaning of the words suggest one meaning, such an interpretation should not be overridden as a result of an apparent legislative intention to tax otherwise. His comments on this issue are included in full below as these are particularly relevant in the context of this paper:

> *"47. If there is no provision, acquisition or disposal of an interest (ie legal or equitable property) in or under any item in the Table in reg 40-5.09, then there can be no financial supply pursuant to that regulation. However the Commissioner submits that such an approach deprives Item 2 of the Table of any function and has a similar effect upon Items 2 and 3 of the Schedule. In my view s 15AD of the Acts Interpretation Act excludes the use of Sch 7 to expand the operation of Div 40. The section contemplates the possibility of a conflict between a substantive provision and examples of its operation. It directs that the substantive provision should prevail. The Commissioner seems to submit as follows:*
>
> - *Items 2 and 3 in the schedule are examples of a credit arrangement or right to credit for the purposes of reg 40-5.09;*
> - *the American Express charge and credit card facilities are capable of being described in the terms used in those items;*
> - *therefore the American Express charge and credit card systems are credit card arrangements or rights to credit; and*
> - *therefore, they are financial supplies.*
>
> *48. This approach overlooks two aspects, namely:*
>
> - *the operation of s 15AD of the Acts Interpretation Act; and*
> - *the requirement that a financial supply be of an interest, ie legal or equitable property in or under a debt, credit arrangement or right to credit.*
>
> *49. In looking to the examples for guidance as to whether there is a financial supply, the Commissioner fails to observe the requirement contained in s 15AD of the Acts Interpretation Act. That section requires that primacy be given to Div 40. Further, regs 40-5.02 and 40-5.09 require that there be a provision, acquisition or disposal of legal or equitable property. The American Express facility, however it may be named, does not satisfy that requirement. It is no answer to say that such an approach renders the examples otiose. That is the effect of s 15AD. In any event, there may be other credit card systems which*

[15] Costello P, Ibid.

> *involve the supply of interests in property. It seems that the regulation-maker contemplated such an arrangement. The proper question is whether the American Express facility falls within Item 2 in the Table. The question is not whether it is capable of being described in terms of Items 1 and 2 of the Schedule."*

Dowsett J's judgement supports the concerns highlighted in this paper regarding the present drafting of the provisions. His Honour also raises a further issue regarding the weight which can be attached to the examples included in the schedules to the Regulations.

- *Amend existing law* - this option simply involved the implementation of minor changes to deal with specific issues (raised by industry bodies, practitioners or court cases) rather than a complete redraft; and

- *Extent of eligible reduced credit acquisitions and rate of RITC* - this option was specific to the RITC regime and not relevant to the present discussion.

As already discussed, financial transactions are input taxed in order to deal with the valuation issues associated with services charged by way of margin. In fact, the original intention of the operation of the financial supply provisions in Australia was that they apply to only those services charged by way of margin.[17]

Treasury's proposal to treat as taxable those financial services for which the provider charges an explicit fee has merit in this context. The assumption to be made for these services is that the consideration received for the provision of these services is encapsulated in the explicit fee charged and hence can be valued appropriately for the purposes of taxable treatment.

Whilst this assumption may not always be true (for example, the consideration for a financial service could have both an explicit fee based component as well as a margin-based component), where there is an explicit fee charged, the assumption would need to be made that the consideration received for the service would be proximate to the explicit fee charged.

It may be appropriate to include provisions which ensure that the explicit fee is more than simply a nominal amount (such as $1) and does fairly and reasonably reflect the consideration for the supply. However, this leads the discussion back to complex valuation issues as to what should be the consideration for the particular financial services. It should be noted that South Africa does set out any such valuation rules in its provisions.

One of the main criticisms of the explicit fee based approach is the potential for product substitution such that financial products are redesigned to provide for explicit based fees. Whilst this risk exists, it is difficult to determine the extent to which substitution would pose a risk to revenue as there has been little empirical research done in the area.[18]

Possible solutions could include that the words "services connected with" or "services that bring about" be included within the provisions to put the policy intention beyond doubt. For example, the provisions could read:

> "*services connected with the provision, acquisition or disposal of an interest..*"

It would need to be ensured that such drafting does not have unintended consequences. For example, this could lead to an approach where a financial supply was interpreted as having two components: one the underlying transaction and the other the actual services facilitating the transaction. Whilst the latter would be input taxed, it may be the case that the former could still be open to the current literal interpretation (for example, the foreign currency exchange could still be treated as GST-free similar to the *Travelex* reasoning). The issue would then become one of valuation and apportionment. To what extent do the particular acquisitions relate to making the input taxed component and to what extent do the particular acquisitions relate to making the GST-free component?

The answer to this would be to move away from "interests" altogether, such that the drafting could read as follows:

> "*services connected with the provision or acquisition of the following activities*".

Moving to this approach would mean that the current precision in which financial supplies are defined would be compromised. However, the wording may lend itself to a literal interpretation that better accords with policy intention. That raises the question as to whether the current policy intention is still appropriate.

3.1 Is the policy intention still appropriate?

Some would say that input taxation achieves an appropriate taxing position for financial services: recipients do not pay an additional amount on account of GST for the financial services and any embedded GST is essentially charged at a lower statutory rate than would otherwise apply had the services been taxable. Yet is the cascading of embedded tax really satisfactory if there are other mechanisms which can be put in place to better deal with the taxing of financial services?

Tax cascading is an obvious consequence of input taxing financial services. Subject to market conditions, financial supply providers will generally pass on the GST cost from input tax treatment to other businesses and end consumers. Even where those businesses are registered for GST, they are unable to claim an input tax credit for the embedded GST passed on by the financial supply provider as they have not acquired a taxable supply.

Those registered businesses in turn typically increase their prices to their customers to take account of this increased cost. Their customers then essentially pay a double GST impost: the GST included on the actual

The embedded GST essentially cascades through the supply chain until it is ultimately paid by the end consumer. Tax cascading is essentially "over-taxation" and results in an increased cost to the provision of financial services when compared to the supply of other goods and services.[19] In fact recent studies in the European Union suggest that tax cascading through business to business (B2B) financial services transactions results in an increase in prices th

> *(r) the services are financial services that are supplied in respect of a taxable period, by a registered person who has made an election under section 20F, to a person who is a member of a group of companies for the purposes of section IA 6 of the Income Tax Act 2007 and—*
>
> *(i) the members of the group make supplies of goods and services to persons who are not members of the group in respect of—*
>
> *(A) a 12-month period that includes the taxable period; or*
>
> *(B) a period acceptable to the Commissioner; and*
>
> *(ii) not less than 75% of the total value of the supplies referred to in subparagraph (i) consists of taxable supplies that are not charged with tax at the rate of 0% under this paragraph or under paragraph (q).”* [22]

The provisions are relatively onerous on the financial supply provider. The service provider must determine not only the registration status of the customer but also the extent to which that customer makes taxable supplies in a twelve-month period. However, under section 20E the provider is allowed to rely on data provided by the customer to determine the percentage of taxable supplies made.

The provisions exclude zero-rating treatment for B2B transactions made between financial institutions. The rationale here was the fear that where there were no further B2B transactions in the supply chain, the transaction would essentially not be taxed. Obviously, it could also be argued that where there were further B2B transactions in the supply chain, tax cascading would continue to occur.

If the aim is to achieve a method of taxing financial services that is both fair and efficient, then zero-rating of B2B transactions should be considered. It effectively achieves what would otherwise occur if the financial transactions were treated as taxable, ie. output tax would equal input tax and hence the transaction would be revenue neutral. If no revenue would otherwise have been received by the government had taxable treatment been adopted, then that status quo needs to be maintained in a financial services context.

Of course, the impetus for such radical change is unlikely to come from government as the implementation of such provisions would result in a marked decrease in tax revenue. A country such as New Zealand has a history of being able to pragmatically and practically deal with tax issues. Australia does not have such a history. In fact, Australia’s tax legislation is renowned for its complexity and technicality both in interpretation and application. Nevertheless, tax purists can only hope that radical change will be forced upon the government at

4. CONCLUSION

The underlying policy intention for the taxing of financial services under the Australian GST regime was to treat as input taxed those financial *services* which are charged by way of margin. Although the provisions have been drafted in a very precise manner, they invite an interpretation which leads to the incorrect taxing treatment.

Rather than rely on judicial interpretation that takes into account the appropriate context, the provisions should be redrafted in order to provide certainty and consistency. In that regard, it should be ensured that there is no doubt that what is being taxed is the "service" that facilitates the financial transaction rather than the underlying(er,n18.6165 aione)-7.417H/creathatbas.1fe68 Ts1 Tc.2also c0 Tw6(.0009 Tthat fac98.2)-6(