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21 January 2011

Ms Brenda Berkeley
General Manager
Indirect Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: marginscheme@treasury.gov.au

Dear Ms Berkeley,

The Taxation Institute of Australia (**Taxation Institute**) welcomes the opportunity to comment on Treasury's Discussion Paper entitled "Implementation of the recommendations of Treasury's review of the GST margin scheme" released on 10 December 2010 (the **'Discussion Paper'**). We set out our comments on this Discussion Paper below.

We take this opportunity to express our thanks to Treasury for taking on board the Taxation Institute's suggestions for reform in this area, particularly insofar as such reforms are intended to reduce confusion in this area and minimise compliance costs.

1 Overview

In our submission dated 6 August 2009 to Treasury in response to Treasury's Consultation Paper entitled "Review of the margin scheme" (the **'Consultation Paper'**), we recommended the Government make six technical corrections to the margin scheme provisions to overcome deficiencies. We also recommended including specific provisions dealing with the margin scheme and partnerships, and the margin scheme and partitions of property, to overcome the complexity in the ATO's public rulings. This submission is attached at Appendix A to this submission for your reference.

We note that following from that Consultation Paper, the Government's response (as set out in the Discussion Paper) has been to agree to implement only one minor technical amendment. The Discussion Paper notes that this policy, involving no further amendments, "contains a number of trade-offs where what might appear to be the desirable policy outcome in relation to the amount of tax collected is foregone in favour of simplicity and integrity considerations".

We therefore have not proposed any corrections to the provisions in this submission. However, we hope to be involved in any further consultation that is undertaken if the Government's policy

changes so that amendments to the margin scheme provisions are considered (e.g. due to Court cases).

2 Restructure proposal

The proposed restructure of Division 75 into three Subdivisions – Core Rules; Particular Circumstances; Adjustments, is a welcome initiative. However, we do not believe that the proposed form of restructure put forward by Treasury addresses the core concerns raised by the Taxation Institute in its submission of 6 August 2009.

In particular, the key concept underpinning the simplification proposed by the Taxation Institute was to give prominence to the core rules which apply to approximately 95% of all transactions involving the margin scheme. These core rules (described below in non-statutory language) are:

1. The margin scheme cannot apply if the property being supplied was acquired as a fully taxable supply.

2. The margin scheme only applies if there is an agreement in writing between the parties.

3. The GST liability is ordinarily 1/11th of the difference between the consideration for the supply of the property and the consideration for the acquisition of the property.

4. No input tax credits can be claimed for any GST payable on acquisition of the property under the margin scheme.

Importantly, the purpose of this proposed change is to bring together the core provisions which apply to a very high proportion of all supplies made under the margin scheme. As we have previously indicated, the margin scheme provisions are somewhat different from many other provisions of the GST Act in that they are applied on a regular basis by a broad range of stakeholders – conveyancers, property developers, property lawyers, real estate agents, as well as tax agents, accountants and other tax professionals.

We recognise that the core provisions will need to be subject to the special rules which cater for the full range of exceptional and unusual circumstances now contained in the law. However, by grouping the core provisions in this way, the risk of inadvertent error, misapplication or misunderstanding of the law is seriously diminished.

Treasury would no doubt be aware that there has been a plethora of cases before the Courts and Tribunals dealing with the margin scheme concerning the imposition of penalties where the taxpayer (or their adviser) had clearly not understood the law correctly, as well as professional negligence cases where conveyancers and lawyers had not made appropriate provision in contracts for the application of the margin scheme. The restructure of the provisions in this way is intended to address the underlying issue that these cases highlight.

The difference between the approach suggested by Treasury and that suggested by the Taxation Institute is that:

- Treasury's approach will still require taxpayers (and their advisers) to wade through a detailed set of core rules to find the rule which is applicable to their circumstances. So, for example, the restructured form of section 75-10 would still occupy around 3 pages of legislation and, likewise, the restructured ineligibility rules would contain a table that deals with many circumstances that would only ever apply very rarely in practise.

- The Taxation Institute's proposed approach is to emphasise the set of rules which apply to the very significant majority of all transactions in which the margin scheme applies.

To be clear, the Taxation Institute is supportive of Treasury's general approach and efforts in seeking to reduce compliance costs. However, the Taxation Institute considers that its alternative approach will fulfil that goal more efficiently and effectively.

A possible means of bringing together Treasury's approach with what the Taxation Institute has suggested is as follows:

1. Insert a 'guide' to Division 75 of the GST Act which contains the 4 core rules referred to above as **operative** provisions. Those 4 core rules referred to above would, in effect, be extracts of the existing provisions and drafted in simple terms. The guide should indicate that these 4 core rules, in practice, apply to most transactions in which the margin scheme is applied. However, these core rules are to be read subject to the detailed provisions in Division 75.

2. The detailed provisions of Division 75 would then contain the structure of the substantive provisions proposed by Treasury in its Discussion Paper. Significantly, the detailed provisions would build on the 4 core rules so as to not overlap with them.

Another possible means of bringing together Treasury's approach with what the Taxation Institute has suggested is, as follows:

1. Insert a guide to Division 75 of the GST Act which contains the 4 core rules referred to above as **non-operative** provisions, so that the existing provisions could then be included in their current or similar form. This would allow the 4 core rules to be written in plain English in the form proposed in the Taxation Institute's submission. An advantage of this approach is that of simplifying the provisions albeit in non-operative form for the various stakeholders identified above, who don't necessarily have to (or want to) read the intricacies of the GST Act. The status of the guide would then be governed by the rules in Divisions 4 and 182 of the GST Act.

2. As with the first proposal above, the detailed provisions of Division 75 would then contain the structure of the substantive provisions by Treasury in its Discussion Paper.

As a final observation, if Treasury's approach as set out in the Discussion Paper is implemented, we suggest that section 75-14 (which reflects the Federal Court's approach in *Sterling Guardian* and is merely for the avoidance of doubt) should be in the second Subdivision rather than a core rule. Alternatively, this section can be deleted in its entirety on account of the *Sterling Guardian* case, in which event it would be appropriate to reference this in the Explanatory Memorandum to the Bill effecting these changes.

We further note that once the provisions are re-structured, the "effective dates" of the provisions may become a challenge for taxpayers and the various stakeholders to follow, particularly as it is not intended, as we understand it, to change the effective dates of the law although the law will be recast into new sections. Treasury would be aware that amendments have been made to various rules in Division 75 which have differing application dates, for example, certain supplies are ineligible for the margin scheme where they are a 'new supply'–see application provisions relevant to s. 75-5(3). We encourage specific consideration to be given to how the application of the various provisions may be simply addressed, including, if appropriate, the insertion of a table in the Explanatory Memorandum so as to provide some 'point in time' references for the legislation.

3 Amendment for subdivided land

The technical amendment proposed is to change section 75-15 to clarify that the relevant cost base for margin scheme purposes on the sale of sub-divided or strata-titled land, where the

valuation method is used, is a proportion of the valuation of the land that existed at the relevant valuation date.

We welcome this technical clarification to avoid any potential disputes.

We note however, and it should be made expressly clear in the Explanatory Memorandum for this amendment, that it is a clarification of the law and not a change in the law. Not only does the ATO already apply the law in this way, but the Federal Court in *Brady King* confirmed that this is the correct interpretation of the current law.

For completeness, we note that the reference in paragraph 46 of the Discussion Paper to how the current provision works in the absence of this amendment does not reflect the correct interpretation of the law.

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If you would like further information or assistance in respect of our submission, please contact me on (02) 8223 0011 or the Taxation Institute's Tax Counsel, Deepti Paton on (02) 8223 0044.

Yours sincerely

Per Robert Jeremenko

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6 August 2009

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The Taxation Institute of Australia (**Taxation Institute**) refers to the consultation paper entitled "Review of the margin scheme" released by Treasury on 12 May 2009.

The Taxation Institute welcomes the opportunity to participate in this consultation process, and thanks you for allowing the Taxation Institute additional time within which to respond.

The submission that follows is consistent with the comments made by representatives of the Taxation Institute present at the consultation meeting held with Treasury on Friday 3 July 2009. Those representatives were Lachlan Wolfers, Gina Lazanas and Ian Jeffrey.

Retain existing margin scheme provisions

The Taxation Institute's preferred position is Option 3, which involves retaining the existing margin scheme provisions and addressing deficiencies in its operation. The Taxation Institute reaches this view for the following reasons:

1. The Taxation Institute fully acknowledges that the margin scheme provisions have proved to be too complex in practise. However, the Taxation Institute are concerned that further changes at this stage will only result in a new set of rules, which will undoubtedly give rise to a new set of issues and problems. Put simply, the cost and risk of moving to a new regime is greater than maintaining the existing regime and making appropriate changes to address deficiencies in its operation.
2. Many of the problems which have been identified with the margin scheme provisions are either transitional issues which are reducing over time, or are historical issues only which arose when the law (or administrative practice) was uncertain. For example:
   - Concerns with valuations arose primarily because of the ATO's early determinations being vague and uncertain. The use of valuations was far more prevalent in the early stages of GST, just after 1 July 2000. However, as time passes, this method of valuation is used less often. In particular, it is less common for developers to be selling properties which are held as at 1 July 2000. As such, valuation issues now arise less commonly.
   - In the early stages of GST, there were a number of disputes between vendors and the ATO, and between vendors and purchasers, concerning whether a choice had been made to apply the margin scheme. This has now been dealt with by s75-5(1A) of the *A New Tax System (Goods and Services Tax) Act 1999* (**GST Act**) and the need to have in place a written agreement to apply the margin scheme. In response to this legislative change, standard form contracts now include provisions for the parties to agree to apply the margin scheme.

- A number of legislative amendments have been made to close off perceived avoidance activity, or to overcome 'step-ups' in cost base through the use of the going concern or farmland concessions. Those amendments having been made only recently. It is unlikely that there will continue to be the same level of uncertainty or disputes with these provisions as a consequence of those changes.
- The ATO's approach to resolving valuation issues under the margin scheme was heavily criticised by the Inspector-General of Taxation in his report on the "Review of the Tax Office's administration of GST audits for large taxpayers" (22 January 2008). In response, the ATO is slowly progressing and resolving many of these audits.

3. Recent cases have settled a number of contentious issues arising under the margin scheme provisions, such as *Sterling Guardian* and *Brady King.* It is expected that the number of disputes likely to arise in the future will diminish. By contrast, if a new legislative regime is implemented, there is a real risk that new areas of uncertainty or disputes will arise.
4. The vast majority of land sales contracts occur under standard form contracts prepared by the Law Societies in each State and Territory and other similar bodies. The Taxation Institute is concerned that if changes are made to the margin scheme provisions then those standard form contracts will need to be rewritten. This often has a significant lead time.

In short, it is important for Treasury to be conscious of the fact that the margin scheme provisions need to be understood and applied by a very broad cross section of the community – including taxpayers, conveyancers, real estate agents, lawyers and accountants. Any significant changes are likely to have a lengthy lead time in terms of the education of those affected by these provisions.

The Taxation Institute is of the view that a number of the legislative changes which have been made were unnecessary, and many could have been avoided if the ATO had taken a more principled based approach to the interpretation of these provisions since 1 July 2000. However, having gone down that pathway, the Taxation Institute is of the view that further change would potentially only exacerbate the community's concerns about complexity in this area.

While the Taxation Institute does not support a move to principles based drafting of these provisions, the Taxation Institute does recommend that the margin scheme provisions should be reordered. The reordering should be done so as to ensure that the following principles are given prominence:

- You cannot apply the margin scheme to the sale of a property if you acquired it as a fully taxable supply.
- If you acquire the property under the margin scheme, you cannot claim an input tax credit for the acquisition.
- Normally, your liability when property is supplied under the margin scheme will be based on $1/11^{th}$ of the difference between the consideration for the supply and the consideration for the acquisition of the property.

The Taxation Institute anticipates that these principles would be expected to be invoked in over 95% of all sales of new residential property. Unfortunately, the numerous legislative amendments which have been made to the margin scheme provisions since 1 July 2000 have meant that these core principles have become lost or hidden in the detail of the legislation.

Technical changes

The Taxation Institute is concerned about the overly-complex approach to interpretation of the margin scheme provisions which is being taken by the ATO in its public rulings. For example, the rulings concerning partnerships and the margin scheme, and partitions and the margin scheme are likely to be sources of considerable dispute in years to come. The reason being complex interpretations that, at times, can be counterintuitive or lead to GST liabilities applying when the vendor is not deriving real cash consideration for the sale. Recent history in other areas of taxation

suggests that when tax is imposed other than at the point of effective realisation of an asset, potential for inadvertent avoidance or non-compliance arise. For example, this is one factor which led to the introduction of the CGT scrip-for-scrip rollover provisions, and also underlies recent concerns with employee share schemes.

Put simply, the Taxation Institute strongly urges Treasury and the ATO to reconsider the recent rulings issued by the ATO in relation to partnerships and the margin scheme, and partitions and the margin scheme. These issues will undoubtedly be the cause of disputes in years to come. Despite the Taxation Institute's representatives expressing these concerns in meetings with the ATO, the ATO has issued their rulings.

The Taxation Institute further supports technical corrections in the following areas:

1 To remove the requirement in s75-5(1) of the GST Act for there to be a "sale" of the freehold interest or stratum unit in order to apply the margin scheme. There is no logical reason why the margin scheme should be limited to "sales".

2 To ensure that s75-15 of the GST Act applies not only where a taxpayer supplies only "part of" the land or premises which they acquired, but also where they supply "an interest in" the land or premises which they acquired. This is intended to cater for situations where a taxpayer acquires say a freehold interest in property and 'sells' the property by way of the grant of a long-term lease. In theory, the margin scheme provisions apply to such a transaction, but there are no valuation rules which adequately deal with this.

3 To introduce simple provisions dealing with the margin scheme and partnerships, and partitions of property to overcome the current complexity in public rulings.

4 To ensure that when a taxpayer acquires real property post 1 July 2000 which they venture into an enterprise, that they can utilise the market value of the property at the time it is so ventured. At present, item 2 of s75-10(3) of the GST Act only applies where the property is acquired before 1 July 2000. There is no obvious policy reason why the provision should be limited in this way.

5 To amend the discretion conferred on the Commissioner under s75-5(1A) of the GST Act to allow further time to apply the margin scheme. At present the Commissioner may only exercise his discretion where there is a written agreement to apply the margin scheme. In practise, there may be instances where there is no mischief in the vendor seeking to apply the margin scheme, but they are unable to due to the purchaser unreasonably refusing or being unable to enter into a written agreement. Examples include purchasers who have died since the property was acquired, or become insolvent, or who refuse so as to obtain some other commercial benefit in circumstances where the margin scheme is of no detriment to them (e.g. a private purchaser).

6 To amend s75-22 of the GST Act so as to allow a decreasing adjustment, not just an increasing adjustment.

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The Taxation Institute welcomes the opportunity to provide further clarification of any of the issues raised in this submission. Any queries concerning this submission should be directed to Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis on (02) 8223 0011 or Lachlan Wolfers, Partner, KPMG on 02 9355 7515 who, with contributions from other members, wrote this submission.

Yours faithfully

David Williams
Vice President