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

Kavita Benedict¹

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 has always been viewed as a compromise. It ensures that such transactions are taxed, albeit unsatisfactorily.

Taxing financial services under a GST regime is problematic for two reasons:

- *valuation issues* - how should a financial services transaction be valued for the purposes of determining the GST to be imposed?
- *theoretical concerns*- as a tax on final consumption expenditure, the question arises as to whether GST should be imposed on financial services where such services are inherently “savings” related? Some observers argue that it is more appropriate for financial transactions to be taken out of the GST net altogether and taxed under a separate tax regime specifically devised for financial transactions.

2.1.1 Valuation issues

Much has been written about the valuation issues associated with taxing financial services transactions in a GST system. This material is generally directed at services charged by way of a margin. That margin will typically be calculated by reference to an aggregate of transactions rather than “the transaction” which is the subject of the “financial supply”.

For example, the value added by a bank which provides a deposit facility for the safe storage of money and also lends money is usually calculated on the basis of the interest rate spread between the interest rate imposed on the borrowings less the interest provided for the deposits. This spread is payment for not only the services provided by the bank, but also represents compensation for risk and pure interest payments for the time value of money.² The example below illustrates this issue.

² See Kerrigan, Arthur, “The Elusiveness of Neutrality - Why Is It So Difficult To Apply VAT to Financial Services?”, *International VAT Monitor*, March/April 2010, 103 at 104.

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 task solely for the benefit of the revenue authority. In any event, in a system which does not generally require suppliers to disclose their margins on transactions, it would be contentious to treat financial institutions differently.³

As a result of these valuation issues, many GST jurisdictions choose to exempt financial services charged by way of margin. In this way, these transactions are taxed on their inputs rather than their outputs. Australia is no different in its approach to these transactions. As set out in the Treasury's ("the Treasury") original consultation paper for financial services, the "key guiding principle" for determining what is a "financial supply" is identifying those services "that are normally charged for by way of a margin".⁴

2.1.2 Theoretical concerns

GST is a tax on private consumption expenditure. It is not a tax on savings as savings cannot be consumed at the time of saving, rather they are used for the purposes of consumption at a later stage (that is, savings involve deferred consumption rather than actual consumption). On one view, a significant proportion of financial services relate to savings-related transactions (whether they be by way of deposit savings, investment savings, etc). That is, financial services effectively involve the deferral of consumption rather than consumption of itself.

The problem with financial services is one of characterisation. If they are viewed as transactions associated with savings, and savings cannot be consumed, then they are transactions that cannot be consumed and should therefore be outside the GST net.

³ See Nathoem, Sandhya and Braakman, Ted, "Option for Taxation of Financial Services - it is an Option?", *International VAT Monitor*, March/April 2010, 113 at 115. Refer also Kerrigan, A, *Ibid*, at 105.

⁴ Costello P, *The Application of Goods and Services Tax to Financial Services*, Commonwealth Treasury, August 1999.

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 the normal position for taxable supplies). It is worth considering the Australian financial services provisions before undertaking a critical appraisal of those provisions.

The first point to note is that the financial supply provisions are not found in the body of the legislation. Instead, they are set out in the regulations, *A New Tax System (Goods and Services Tax) Regulations 1999* (Regulations). The reason for this is political more than anything else. At the time the legislation was introduced, a decision as to which financial services would be input taxed was yet to be made. As a result, the legislation was introduced with a reference to appropriate provisions being contained in the Regulations. This gave Treasury further time to seek industry consultation in composing the financial supply provisions.

Financial supplies are defined under the Regulations to include "incidental" supplies to those financial supplies. The main operative provision is regulation 40-5.09 which sets out the relevant criteria for a financial supply and lists the relevant "interests" which can give rise to a financial supply. Subregulation 40-5.09(1) states as follows:

"(1) The provision, acquisition or disposal of an interest mentioned in subregulation (3) or (4) is a financial supply if:

(a) the provision, acquisition or disposal is:

(i) for consideration; and

(ii) in the course or furtherance of an enterprise; and

⁵ See White, David and Pallot, Marie, "Improvements to the GST Treatment of Financial Services - The Proposed New Zealand Approach", *VAT Monitor*, November/December 2002, 481.

⁶ See Burns, Professor Lee, "Consumption Taxation of Supplies of Financial Services in the Asia-Pacific Region", *Asia-Pacific Tax Bulletin*, September/October 2008, 352.

- (iii) *connected with Australia; and*
- (b) *the supplier is:*
 - (i) *registered or required to be registered; and*
 - (ii) *a financial supply provider in relation to supply of the interest.”*

The Australian provisions are very precise in the way that they describe a financial supply. The Australian provisions require that there be a provision, acquisition or disposal of an “interest”. “Interest” is defined in regulation 40-5.02 as:

“anything that is recognised at law or in equity as property in any form.”

There must therefore be a provision, acquisition or disposal of a *proprietary* interest as set out in regulation 40-5.09(3) in order for a financial supply to be made.

Financial supplies can only be made by “financial supply providers” and hence the making of a financial supply is both attached to the characteristics or activities of a particular entity as well as the particular transaction itself. Introducing the term “financial supply provider” serves to narrow the scope of who can make financial supplies. A “financial supply provider” is defined in regulation 40-5.06 as follows:

“(1) An entity, in relation to the supply of an interest that was:

(a) immediately before the supply, the property of the entity; or

(b) created by the entity in making the supply;

is the financial supply provider of the interest....

(2) The entity that acquires that interest is also the financial supply provider of the interest”.

The Australian provisions also include the acquirer of an “interest” as a “financial supply provider” (as set out in subregulation 40-5.06(2)). The effect is to include the acquisition of an “interest” as a “financial supply”. Whilst this position is highly unusual, it is a consequence of the section 11-15 definition of “creditable purpose” which prescribes when entities are entitled to claim input tax credits.

Section 11-15 has a positive limb and a negative limb. An entity makes an acquisition for a “creditable purpose” where:

- it is acquired in carrying on the enterprise; and
- it does not relate to making supplies that would be input taxed and the acquisition is not of a private or domestic nature.

This differs from the European VAT jurisdictions where the equivalent creditable purpose test is linked to the making of “taxable supplies” and hence there would be no entitlement to an input tax credit unless it was acquired for making taxable supplies. Without the “acquisition-supply” concept, entities would be able to claim input tax credits for acquisitions associated with acquiring financial services. This would be contrary to the policy intention.

Finally, excluded from the term “financial supply providers” are those entities that arrange or facilitate financial transactions (such as brokers, merchant bankers etc). As a result, these arrangers and facilitators will always make taxable supplies to financial supply providers. Whilst this serves to narrow the class of supplies which may be defined as “financial supplies”, it perversely encourages tax cascading.

Subregulation 40-5.09(3) sets out the relevant proprietary interests which can be the subject of a financial supply. These can be summarised as follows:

- bank accounts made available by an Australian Authorised Deposit-taking Institution;
- debt or credit arrangements (eg loans);
- charges or mortgages over property;
- superannuation funds;
- annuities or allocated pensions;
- life insurance;
- guarantees (including indemnities);
- credit provided under a hire purchase arrangement;
- currency transactions;
- securities; and
- derivatives.

This list is fairly prescriptive rather than principle based. A principle based approach would focus on a series of over-arching principles with potential carve out provisions for certain supplies (eg. intermediaries). Whilst the prescriptive approach provides a level of accuracy, it can be disadvantageous in its precision as it becomes too difficult to include additional items without further amendment. The principle based approach, on the other hand, relies on an appropriate interpretation of the principles in order to apply the law. To the extent that there is a reliance on interpretation, this approach can provide less certainty and potentially less consistency. However, it does allow for flexibility in terms of the ability for items to be included or excluded as times and context changes. The present preference is for provisions to be drafted using a principle based approach, for example, the new Division 81 provisions.

In the financial services context, the prescriptive approach is supported by the lists of examples contained in the schedules to the Regulations. The list of financial supplies included is fairly standard and arguably narrower than other jurisdictions where services such as general insurance are also included. This narrow definition is in part possible due to the operation of the reduced input tax credit regime (which is discussed in further detail below).

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 considered that they would be disadvantaged with the introduction of the GST.

The RITC was introduced in order to put credit unions and smaller financial institutions on the same level playing field as the large financial service providers. The RITC regime operates by allowing financial supply providers to claim an RITC equal to 75% of the GST payable for certain listed services.

- d. the inclusion of a reverse charge mechanism to eliminate the competitive advantage that offshore providers of outsourced services would otherwise have - the reverse charge mechanism operates by self-imposing GST on the recipient of the outsourced service where that recipient would not have been entitled to claim a full input tax credit had the service been treated as “taxable”. Whilst GST is imposed, there is a separate RITC list for these offshore outsourced services so that the GST cost of acquiring these outsourced services is equal to the onshore treatment (ie. 25%).

The above paragraphs have provided a basic summary of the operation of the financial supply provisions. The discussion below considers whether these provisions have been interpreted in a manner which is consistent with the policy intention.

2.3 Have the Australian provisions achieved their stated policy intention?

The stated intention of the Australian financial supply provisions was fairly clear: tax a narrow group of financial *services* that were charged by way of margin through input taxation.⁷ Whilst the stated intention was clear, recent case law shows that the judiciary have been unable to agree as to the proper interpretation of the financial supply provisions.

In the author's view the reason for this disagreement lies in the drafting method adopted for the provisions which fail to properly identify what is in fact being taxed. As previously stated, it is not the intention of the provisions to tax the underlying financial transactions themselves, rather the aim is to tax the *services* which facilitate those transactions.

The plain meaning of the words of the current legislative provisions invite an interpretation that is so precise that it results in the taxing of the underlying transaction itself rather than the services that facilitate that transaction. In some scenarios, this interpretation will still achieve the desired result. However, in other circumstances (consider *Travelex* discussed below), the result is completely contrary to policy intention.

This leaves the taxpayer and the Commissioner of Taxation (Commissioner) vulnerable to the vagaries of interpretation by the judiciary who may or may not take an interest in the underlying theory of the tax. Where they don't and rely on the plain meaning of the words, there is the scope for the incorrect interpretation to be applied. To require the judiciary to undertake a detailed contextual analysis of the provisions and underlying theory of the tax is nonsense for it isn't their place and shouldn't be required. The plain meaning of the words should invite the appropriate interpretation.

Clearly, in a financial supply context, proprietary interests in financial assets are transferred. Accordingly, it is not wholly inappropriate for the definition to embrace the transfer (by the provision, acquisition or disposal) of such interests. However, where a literal interpretation of the wording is adopted, the current focus on this transfer is at the expense of the underlying purpose of a GST, namely to tax consumption expenditure: what is consumed in a financial services context is not the interests themselves but rather the services that facilitate their exchange.⁸ Prebble and Schalkwyk highlight this issue very succinctly in the following extract:

"There is no generally accepted definition of financial services for VAT purposes. The Concise Oxford (English) Dictionary definition is too wide to be useful. All jurisdictions have opted for a descriptive definition of financial services rather than a principle-based definition. There is an initial problem of language and syntax. One may speak, for instance, about taxing the exchange of currency, but that expression is not accurate. It is not the exchange of currency

⁷ Costello, P, Ibid.

⁸ Prebble, Professor John and Schalkwyk, Sybrand van, "Value Added Tax and Financial Services", *Asia-Pacific Tax Bulletin*, September/October 2004, 363 at 364.

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.

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 services which facilitate the exchange may also be included within the definition (not the least by the result of the incidental financial supply provisions) this was not considered in *Travelex*. Even if it had been considered, the subject matter of the supply would still have been the transfer of ownership rather than the incidental services. Hence, the GST-free provisions would still have been available for application. The case demonstrates that the present drafting of the provisions invite an interpretation which over-emphasises the importance of “proprietary interests” at the expense of the underlying services that are intended to be taxed.¹²

Once this characterisation is accepted, it is only a small leap to also characterise the supply as a GST-free supply under Item 4 of s38-190(1). This follows from the fact that the proprietary interests being transferred can be characterised as “rights” (given

¹¹ *Travelex*, Ibid, at paragraphs 4 and 5.

¹² Heydon J’s judgement in *Travelex* (also part of the majority) echoes this approach (at paragraph 45): “45. When Mr Urquhart acquired the currency from Travelex, he acquired an interest in property (namely ownership of those statutory rights of action and negotiation). That interest in property was identical with, evidenced by, and not capable of disaggregation from, an “interest in or under ... the currency of a foreign country”: reg 40-5.09(3)[31]. To acquire an interest in the currency was to acquire an interest in the intangible rights connected with it, and vice versa. Hence what was acquired was an interest within the meaning of reg 40-5.09(3). The acquisition was therefore a “financial supply” within the meaning of reg 40-5.09(1) and ss 40-5(2) and 195-1 of the Act. It was thus a “supply” within the meaning of s 9-10(2)(f)[32] and the parties’ agreement in relation to the third question was correct.”

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 *Travellex*.

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. No value has been added because the transaction is a mere exchange of one commodity for another. It follows that this exchange should remain outside the grasp of a VAT."

In the case of *Travellex*, the services that facilitated the exchange were consumed by the customer in Australia at the international airport. They were not consumed whilst the customer was overseas. As a result, the consumption took place in Australia and the services should be taxed in Australia. The focus on proprietary interests invites an analysis of the transaction itself rather than the services that facilitate that transaction.

To illustrate the differences in interpretation, five of the nine Federal and High Court judges who considered the *Travellex* case concluded in favour of the taxpayer. The other four concluded in favour of the Commissioner. The High Court minority, in particular, arrived at their conclusion on the basis of a consideration of context in order to properly interpret the meaning of the words in the provisions. This begs the question as to what extent judges should be required to understand context in order to interpret taxing provisions where the plain meaning of the words invite an alternative interpretation.

Justice Tony Pagone of the Victorian Supreme Court recently delivered a paper in which he expressed a sanguine view on judicial interpretation of tax laws. The below extract from this paper is relevant to the present discussion:

"...there is a general approach to legislation that its terms should be understood by an ordinary reader and not one versed in a special field of

¹³ Sydrand van Schalkwyk and Professor John Prebble, "Imposing Value Added Tax on the Exchange of Currency", *Asia-Pacific Tax Bulletin*, 469 at 470.

knowledge or discipline: the words used should carry their ordinary meaning unless there is a clear intention shown otherwise... The judge interpreting tax law finds refuge not in the underlying discipline which the legislation may seek to express but in the words themselves...

*"The purposive construction of all legislation requires judges to give effect to the underlying objectives which legislation seeks to achieve. Legislation drafted to give effect to economic concepts is no exception. The problem is not a lack of legislative direction but that judges do not have the training, background or resources to implement legislation as an economist, accountant or person of commerce would require. There is also a fundamental concern about how judges should act upon economic concepts. Such concepts are traditionally treated as matters of evidence to be given by experts whose evidence is subject to testing through cross-examination. The idea that a judge should apply some personally held view of economics, accounting or commerce may be inconsistent with the judge's role as independent (non-partisan) interpreter of legal text enacted by parliament in ordinary language."*¹⁴

We cannot, and should not, expect the judiciary to interpret taxing provisions according to the economic precepts underlying the legislation if the plain meaning of the words suggest an alternative construction for which an ordinary person would be entitled to conclude. Where there are problems in the drafting of the provisions, these should be corrected by parliament rather than relying on a purposive construction of the provisions to be applied by the Courts (which may not always be forthcoming).

2.3.2 Amex

This case involved the interpretation and application of the apportionment methodology used by Amex (specifically American Express Wholesale Currency Services Pty Limited) to claim input tax credits for expenditure associated with the provision of credit cards and charge cards.

The apportionment methodology adopted by Amex (and accepted by the Commissioner) was based on revenue using the following formula:

$$1 - \frac{[\text{revenue derived from input taxed supplies}]}{\text{total revenue}} \times 100$$

As a result, to the extent that Amex's revenue was not derived from input taxed supplies, the denominator would be increased, thereby increasing the apportionment percentage which could be used to claim input tax credits.

The question that arose was whether the revenue derived by Amex in the form of late payment fees on credit cards and charge cards was "revenue derived from input taxed supplies". Although the terminology used was "revenue" (a term not defined in the Act), the case initially proceeded on the basis of whether the late payment fees received by Amex for credit cards and charge cards were consideration for the making

¹⁴ Hon Justice Tony Pagone, "Some problems in legislating for economic concepts — a judicial perspective", paper delivered at Treasury on 2 December 2010 as part of the Revenue Group seminar series, 39 at 41 and 46.

of input taxed supplies. However, the case was ultimately decided by the majority on the basis of whether the late payment fees were “revenue derived from input taxed supplies” in accordance with the agreed apportionment methodology. For the purpose of this analysis, this paper has focused on the initial argument regarding the nexus between the consideration received by Amex and the making of input taxed supplies.

In examining regulation 40-5.09 and in particular the application of item 2 of subregulation 40-5.09(3), Dowsett J (in the minority) interpreted the provisions similarly to the majority in *Travellex*. That is, in terms of whether or not there had been a supply of a proprietary interest. However, Dowsett J went slightly further than the majority in *Travellex*. He considered in detail, what “property at law” should be understood to mean in a GST context. In this regard, Dowsett J made the following comments:

“39. The terms upon which American Express issues cards are identified in the joint reasons and in the primary Judge’s reasons. American Express provides the cardholder with a card. The cardholder is thereafter, in effect, able to pledge American Express’s credit with suppliers. The suppliers look to American Express for payment, and American Express requires cardholders to pay to it the amounts incurred for purchases, such payments to be made at fixed times. These rights and obligations seem generally to be personal rather than proprietary. Certainly, nothing supplied to the cardholder is capable of being assigned, and the relevant arrangements are determinable at will. The American Express facilities are no doubt quite complex. To the extent that they are capable of being “owned”, the owner is, presumably, American Express. A cardholder acquires no interest in them, but rather a contractual right to utilize their services. As I have said, the right is determinable by American Express at will and cannot be assigned. Such circumstances led the High Court in Toohey to conclude that the grazing licence did not comprise property. Whilst a cardholder has access to the facility, he or she does not control access to it.

*40. A cardholder acquires possession, but not ownership of a card. No doubt the cardholder is a bailee. A bailee is said to have “special property” in the property bailed. Academic writers have asserted that a bailee’s rights are of a proprietary nature. See George W Paton’s *Bailment in the Common Law* (1952, Stevens & Sons Ltd, London) at 30. However, at 17-18, the author notes the decision in *The Odessa* [1916] 1 AC 145 at 158-9, where Lord Mersey, in giving the advice of the Judicial Committee of the Privy Council, said:*

‘But when the nature of the right of a pledgee to sell is examined it will be seen that the so-called “special” property which it is said to create is in truth no property at all. This has been recognized by many Judges who have used the expression “special interest” as a substitute for “special property”’

Dowsett J concluded that the provision of the credit and charge cards by Amex did not give rise to the provision of a proprietary interest as required under regulation 40-5.02 and hence did not give rise to a financial supply. This view is on its face surprising

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.

Of course, Dowsett J was in the minority in *Amex*. Kenny and Middleton J (in the majority) interpreted the meaning of “property” in a broad manner based on the context of the Act and specifically the meaning of “real property” in the Act. Yet, the difference between the concept of “real property” as used in other sections of the Act and “property” as used in the financial supply provisions is that the latter specifically refers to “property at law or in equity” whereas the former defines property in an expansive manner without reference to its definition at law or in equity.

In any event, whilst the majority in *Amex* accepted that there was a proprietary interest capable of transfer in the charge and credit card circumstances, they essentially undertook the analysis of what is a financial supply by reference to whether or not it involved the provision of such a “proprietary interest”. In this way, the focus remained on the underlying transaction itself as opposed to the services that facilitated that transaction.

3. PART TWO: CONSIDERING THE CHANGES THAT CAN BE MADE AND SHOULD BE MADE – “WHERE ARE WE GOING?”

This part of the paper considers ways in which the provisions could be amended in order to ensure that the stated policy intention is applied. Further, this part of the paper also considers whether the current policy intention for the taxing of financial supplies remains appropriate.

Treasury released a consultation paper in 2009 regarding a proposed redraft of the financial supply provisions.¹⁶ Unfortunately this consultation paper did not progress and none of the proposals were in fact implemented. However, a review of Treasury's proposed reforms does provide an insight into the government's present reluctance to deal with the fundamental problem with these provisions.

The options proposed were as follows:

- *Replace existing legislative framework with a principle or set of principles* - there was a suggestion made that these principles could involve a carve out for financial supplies where an explicit fee was charged (similar to South Africa). Notably whilst proposed drafting options were provided, 2 of the 3 drafting options did not involve a move away from the proprietary interest concept. The third involved a link to the income tax regime concept of “financial arrangements”;

¹⁶ Commonwealth Treasury, “Consultation Paper on the Review of the Financial Supply Provisions”, May 2009.

- *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 Without empirical data, it is difficult to comment on the likelihood of substitution. Given the current market competitiveness in the industry as well as the intense media and government scrutiny, it would not be unreasonable to assume that substitution would be difficult unless other commercial factors existed to make it viable.

Other than the explicit fee proposal, it is the author's view that the options proposed by Treasury do not address the real problem. Perhaps this is because Treasury does not accept that the provisions themselves invite two different interpretations and that Treasury should not rely on the Courts being able to decipher which is the correct/intended interpretation. What is required is a clarification of the law by way of redrafting of the provisions to ensure that it is clear that it is the "services" that are being taxed not the underlying transaction.

¹⁷ Costello P, Ibid.

¹⁸ Refer Burns, Ibid.

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 *Travellex* 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 supply (note this GST is calculated on the increased price as a result of the embedded GST on-cost) as well as the GST passed on from the financial supply provider.

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 through the supply chain of up to 4%.²⁰

This should be compared to the situation with business to consumer (B2C) transactions where the input taxation of these transactions actually reduces the cost of financial services to end consumers. Any passing on of embedded tax would be less than the value added by the financial supply provider and hence the statutory rate of taxation of these supplies would be less than that applicable to taxable supplies.²¹ The result is a scenario where input taxation can work in a B2C context but causes real tax cascading in B2B transactions.

Tax cascading as a result of input taxation is not unique to the GST taxing regime. There are plenty of examples of tax cascading in the Australian tax system which typically arise due to the significant number of taxes imposed. For example, tax cascading occurs in the stamp duty context where stamp duty is levied on the GST-inclusive value of the transaction. Tax cascading also occurs indirectly in a pay-roll tax context where the additional cost of pay-roll tax will be factored into the pricing structure of the supplies made by the employer organisation in order to deal with this additional cost. However, whilst there are other instances of tax cascading that does not mean that tax cascading within the GST system should be accepted if there are viable means in which to eliminate that cascading.

In New Zealand, certain B2B financial supply transactions are zero-rated. The New Zealand B2B zero-rating rules are fairly complex and therefore are elective rather than mandatory. The relevant New Zealand provision (section 11A(1)) states as follows:

“ A supply of services that is chargeable with tax under section 8 must be charged at the rate of 0% in the following situations...

(q) 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 registered person who makes supplies of goods and services such that taxable supplies that are not charged with tax at the rate of 0% under this paragraph or under paragraph (r) make up not less than 75% of the total value of the supplies in respect of—

(i) a 12-month period that includes the taxable period; or

(ii) a period acceptable to the Commissioner; or

¹⁹ Burns, Ibid, at 353.

²⁰ Borselli, Fabrizio, “A Sensible Reform of the EU VAT Regime for Financial Services”, *International VAT Monitor*, September/October 2009 375 at 378 quoting a study undertaken by PricewaterhouseCoopers for the European Commission in November 2006.

²¹ Poddar, Satya, “Consumption Taxes: The role of the Value-Added Tax”, chapter 12 in *Taxation of Financial Intermediation: Theory and Practice for Emerging Economies*, Honohan, Patrick (ed), World Bank and Oxford University Press, 2003.

(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 1A 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 some point in the future. At the very least, the zero-rating option should be entertained in order to determine whether the approach would be viable and efficient whilst achieving the rare qualities of fairness and simplicity.

²² Goods and Services Tax Act 1985 (NZ).

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 financial transaction itself.

Excluding explicit based fees is also consistent with this approach and the original policy intention. As a result, it is a proposal that needs to be seriously considered in undertaking any redraft. However, further consideration needs to be given to the option of zero-rating or treating as “GST-free” certain B2B financial supply transactions. Whilst this would, in the short term, lead to a decrease in revenue for the government, it may, in the long term provide for a more simpler, efficient and fairer imposition of tax on financial services.