



Australian Government
The Treasury

8 October 2008
File:

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Sir

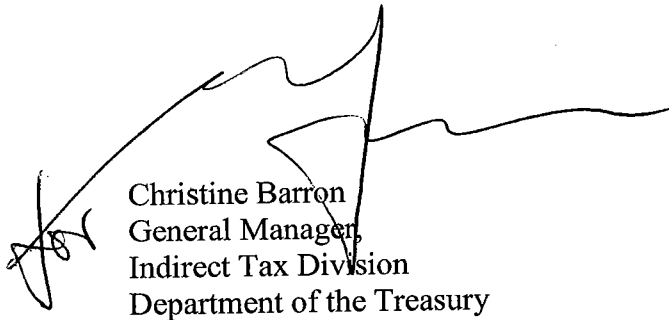
TAX LAWS AMENDMENT (2008 MEASURES NO. 5) BILL 2008

Thank you for the opportunity to provide a submission to the Senate Economics Committee Inquiry into the Tax Laws Amendment (2008 Measures No. 5) Bill 2008.

Please find attached our submission in respect of Schedule 1 of the Bill – Goods and services tax and real property.

Please contact Mr Michael Harms (6263 3308) if you require any further information.

Yours faithfully

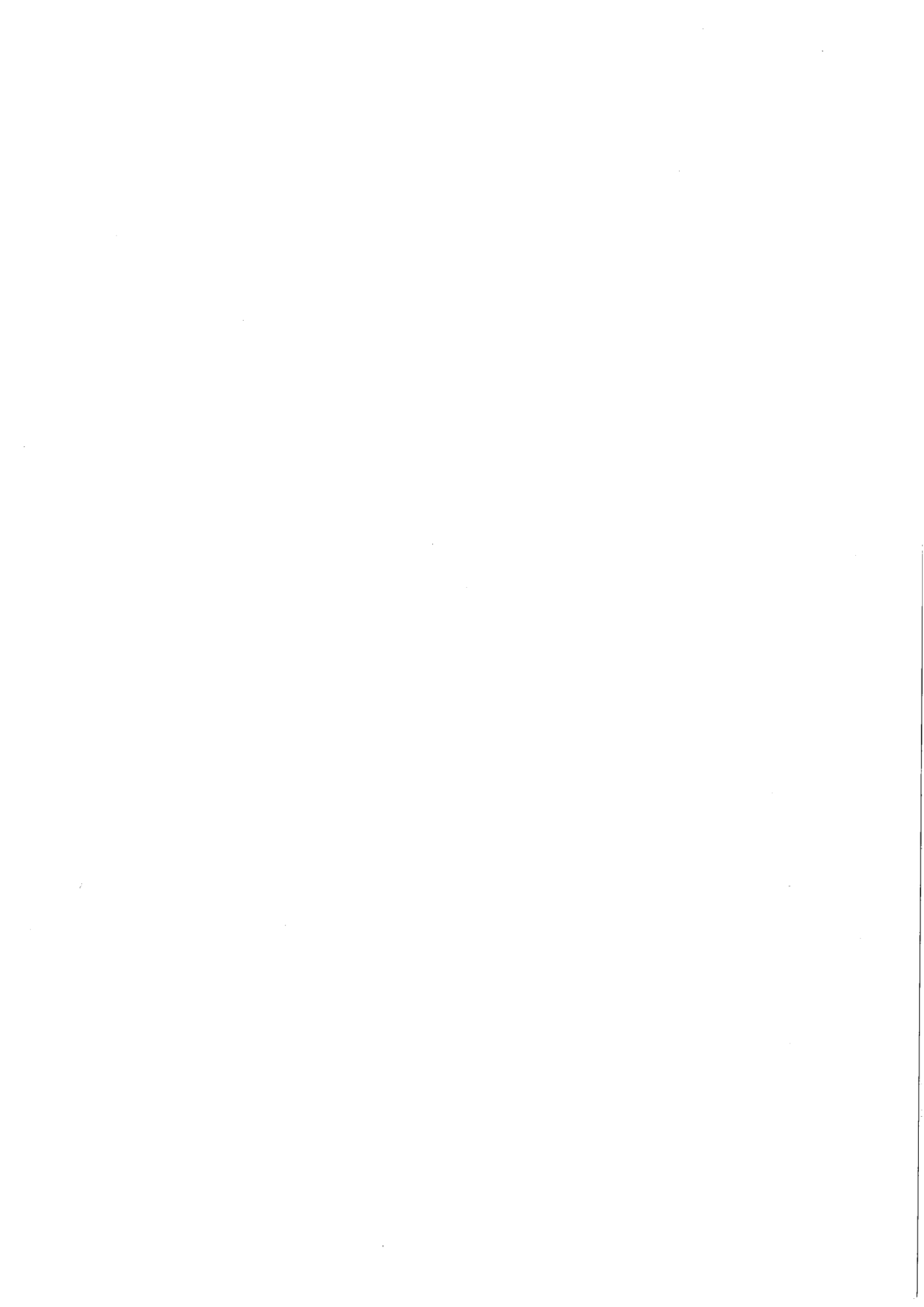


Christine Barron
General Manager,
Indirect Tax Division
Department of the Treasury

Copies to:

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Treasury submission to the Standing Committee on Economics Inquiry into Tax Laws Amendment (2008 Measures No.5) Bill 2008 Schedule 1 – GST and the sale of real property integrity measure

Overview

The Goods and Services Tax (GST) and the sale of real property measure was announced in the 2008-09 Budget and is important for the integrity of the GST system.

The interaction of a number of provisions in the GST law means that GST is not payable on the value added to real property in certain transactions. This gives rise to tax minimisation opportunities that would pose a substantial and growing risk to the revenue if they were allowed to continue. The amendments will address these deficiencies in the GST law.

The amendments have been drafted in close consultation with industry in order to avoid unintended consequences and to minimise compliance costs.

The proposed measure would not be expected to have a significant effect on house prices. The section of the housing market directly affected by the integrity measure is relatively small compared to the whole housing market. The amendments will ensure a level playing field for participants in the property industry.

The changes will only apply prospectively from the date of Royal Assent so as not to impact on existing contractual arrangements.

GST and the sale of real property integrity measure

Previous integrity measure

Legislative amendments to address similar integrity issues were withdrawn from the Tax Laws Amendment (2005 Measures No. 2) Bill in light of industry concerns such as over-taxation and retrospective application. The previous measure was intended to tax the increase in value from 1 July 2000 even though property may not have been in the GST system until after that time. The new integrity measure will only look back through one sale prior to the final sale under the margin scheme and not back to 1 July 2000.

The current integrity measure addresses most of the concerns raised about the previous measure and adopts a more pragmatic approach.

Current integrity measure

GST is intended to apply to the value added to real property (eg land) by registered entities after 1 July 2000. The 'margin scheme' was designed to ensure that GST is payable only on the incremental value added to land by each party in a series of transactions after 1 July 2000. However, the interaction between the margin scheme provisions and the going concern, farmland and associates provisions can result in GST not applying to the full margin of increases in property values from 1 July 2000.

Under the existing law where a property is sold as part of a GST-free going concern or farmland or sold to an associate for no consideration, and it is subsequently sold under the margin scheme, the value added by the supplier of the property as part of a going concern or farmland or the value added by an associate is not taxed.

This measure will ensure that where the margin scheme is used after a GST-free sale of a going concern or farmland, or after a supply between associates for no consideration, the value added by the registered entity which made that supply is included in determining the GST subsequently payable under the margin scheme.

However, it is important to note that the supply of property under the GST-free going concern or farmland provisions or between associates for no consideration is optional. The margin scheme can be used instead for such supplies and this would mean that each entity in a series of transactions would pay GST on the value it has added. In these circumstances, the entity that makes a final sale of new residential premises to a consumer would only be liable for GST on its own value added and would not be liable for GST in respect of value added by any previous entity.

If a supply as a GST-free going concern or a supply to an associate for no consideration is made prior to a subsequent sale under the margin scheme, then the integrity measure will require the entity making the sale under the margin scheme to account for the GST on its own value added as well as the previous entity's value added. However, as the measure is fully prospective these arrangements would be made in full knowledge of GST liabilities and the sale price would be negotiated taking this into account.

Under the existing law an entity that would otherwise be prevented from applying the margin scheme, on the basis that it acquired the property as a taxable supply under the basic rules, can reinstate eligibility for the margin scheme by interposing a GST free supply of a going concern or farmland or a supply to an associate for no consideration (a non-taxable supply) prior to selling the property under the margin scheme.

This measure will ensure that eligibility to use the margin scheme cannot be reinstated by interposing a GST-free or non-taxable supply.

The general anti-avoidance provisions in the GST law provide the Commissioner of Taxation with broad powers to cancel GST benefits that arise from contrived schemes. The measure amends the anti-avoidance provisions to confirm that the GST general anti-avoidance provisions apply to contrived arrangements entered into with the sole or dominant purpose of creating a circumstance or state of affairs that enable a choice, election, application or agreement to be made that gives rise to a GST benefit.

Attachment A provides additional explanation about GST and the sale of real property.

Financial implications

The integrity measure has two elements: the first involves sales of property under the margin scheme that was acquired as a GST-free going concern or farmland. The second involves sales of property under the margin scheme that was acquired from an associate for no consideration.

The revenue amount of \$523 million represents the additional GST that would have been payable on the value added to affected property sales had the transaction not been structured in a way to minimise the GST liability.

If the measure does not proceed the risk to revenue is likely to increase substantially as more property developments are structured to take advantage of the tax minimisation opportunities.

The revenue from the GST goes unconditionally to the States and Territories, providing them with a secure source of revenue to provide essential services such as health and education.

Issues

Treasury conducted extensive targeted, confidential consultation with key stakeholders to identify possible technical deficiencies in the draft bill and to ensure that the measure takes effect prospectively.

Most of the technical issues raised during the consultation process have been addressed in the draft bill. Some issues raised have not been addressed as they were beyond the scope of the measure or they would have added unreasonable complexity to the current provisions.

Apart from technical issues concerning the drafting of the bill, a number of concerns about the effect of the measure were raised during consultation. These are discussed below.

Housing affordability

Concerns were raised that the measure may have a negative impact on housing affordability. However, there is no reason to expect that the proposed measure would have a significant effect on house prices or the quantity of housing supplied. The section of the housing market directly affected by the integrity measure is relatively small compared to the whole housing market.

Further, only a small portion of the industry currently engages in this tax minimisation practice. Based on ABS data of building activity in Australia, Treasury estimates the total taxable value of new residential property in 2008/09 will be around \$30 billion rising to around \$35 billion in 2011-12. New residential property represents about 12 per cent of the total value of the market.¹ Treasury estimates that the value of property potentially affected in 2008/09 is around \$3.7 billion or about 1.5 per cent of all residential property sales. In a competitive industry, these companies are not likely to determine the market price. Tax minimisation would simply result in above-normal profits for these companies, and closing the loophole would have no impact on prices.

The supply of new housing is generally considered to be relatively inelastic in the short term. Any increase in tax paid by certain developers should therefore have limited effect on the quantity of housing supplied.

Furthermore, the measure will not apply to arrangements already entered into, so property developers will be able to take the new provisions into account when examining the feasibility of future development proposals.

Anti-avoidance amendment

Concerns were raised that the amendments to the GST anti-avoidance provisions will mean that the anti-avoidance provisions are too broad in scope and may capture innocent activities. However, the proposed amendments are aimed at *contrived* behaviour and are intended to clarify the operation of the GST anti-avoidance provisions. Further, the amendment introduces into the GST Act a concept that is already found in the income tax anti-avoidance provisions.

The amendment to the GST general anti-avoidance provisions confirms that they apply to contrived arrangements entered into with the sole or dominant purpose of creating a circumstance or state of affairs that enable a choice, election, application or agreement to be made that gives rise to a GST benefit.

¹ The value of the market is estimated to be about \$250 billion based on the value of housing loan commitments in 2007-08, excluding refinancing.

Review of margin scheme

A number of consultation participants submitted that the integrity measure should be postponed and a broader review be undertaken of the margin scheme and the treatment of real property under the GST law.

It is recognised that simplification of the margin scheme provisions may be desirable, but these amendments are intended to address integrity concerns that represent a significant and growing risk to revenue now.

The Board of Taxation is currently undertaking a review of the legal framework for the administration of the GST. The review is not considering the rate of GST or the base of the GST. Consultation participants were invited to make submissions to the Board on their broader concerns with the margin scheme. This approach will enable such concerns to be considered in the wider context of the Board's consideration of how to improve the operation of the GST system as a whole to reduce compliance costs.

Impact on the housing sector in the current economic climate

The housing industry is currently experiencing difficult conditions. Approvals for new dwelling construction have fallen by 8.6 per cent over the year to August, and 16.7 per cent since their peak last November. Nonetheless, the downturn has so far been relatively moderate by past standards. Approvals remain around 20 per cent above the troughs reached in previous housing downturns.

The downturn in the housing sector has been caused primarily by the impact of cumulative interest rate rises over recent years due to tighter monetary policy and the effects of the turmoil in global financial markets. As such, the key constraint on the industry at present is lack of demand, which is highly sensitive to interest rates. On the positive side, past experience indicates that housing activity recovers reasonably quickly once mortgage interest rates begin to fall.

The proposed integrity measure would have no effect on the cost or availability of finance, so it has no relevance to the problem of lack of demand. The measure could have an impact only to the extent that it contracts supply (independently of the contraction in demand). However, the supply of housing is highly inelastic in the short run. That is, supply does not change much in response to changes in the return to developers. Therefore, this measure is unlikely to impact on supply.

One reason for this is that once the developer owns the land, there is a strong incentive to proceed with development because of the holding costs of capital locked up in the property. Selling the land for an alternative use is unlikely to be an option. The price of land zoned for housing on the urban fringe commands a substantial premium over the price of agricultural land, which is generally its only feasible alternative use. Of course, development will not proceed if there is not expected to be a buyer, but the level of demand is not affected by this proposal.

Conclusion

The current provisions in the GST law dealing with real property allow tax minimisation opportunities. These opportunities are inconsistent with the policy intent that the GST should apply to the value added to real property by registered entities from 1 July 2000.

If these unintended tax minimisation opportunities are not addressed, there will continue to be distortions in the GST treatment between entities that structure their activities to take advantage of the deficiencies in the law and those entities that do not structure their activities in this way.

Further, if not addressed, these opportunities would be expected to be increasingly taken up by entities in the property development sector which would represent a significant and growing risk to the revenue. The GST and the sale of real property integrity measure will ensure that the GST that was always intended to be collected is actually collected. It is not anticipated that the measure will have any significant effect on housing affordability.

Background - GST and sales of real property

For real property, special rules exist that allow taxpayers an alternative means of calculating GST. These rules are known as the margin scheme and are generally used for new residential property developments.

- The margin scheme was designed to ensure that GST is payable only on the incremental value added to land by each party in a series of transactions.
- Under the margin scheme GST is generally payable only on the value added to property after 1 July 2000 (the date of the commencement of the GST Act). It levies GST only on the 'margin' by which the value of the property increases each time it is sold after 1 July 2000.

Therefore, taxpayers selling real property have the choice of calculating GST under the:

- basic rules (GST is 1/11th of the GST-inclusive price) and may have an input tax credit (ITC); or
- under the margin scheme (GST is 1/11th of the margin) with no ITC – subject to certain conditions.

The margin scheme

Under the margin scheme, the margin, or value added that is subject to GST, is equal to the difference between the price the property is sold for and:

- if it was acquired *before* 1 July 2000 — the value of the property as at 1 July 2000 (the valuation method); or
- if it was acquired *after* 1 July 2000 — the price it was acquired for (the consideration method).

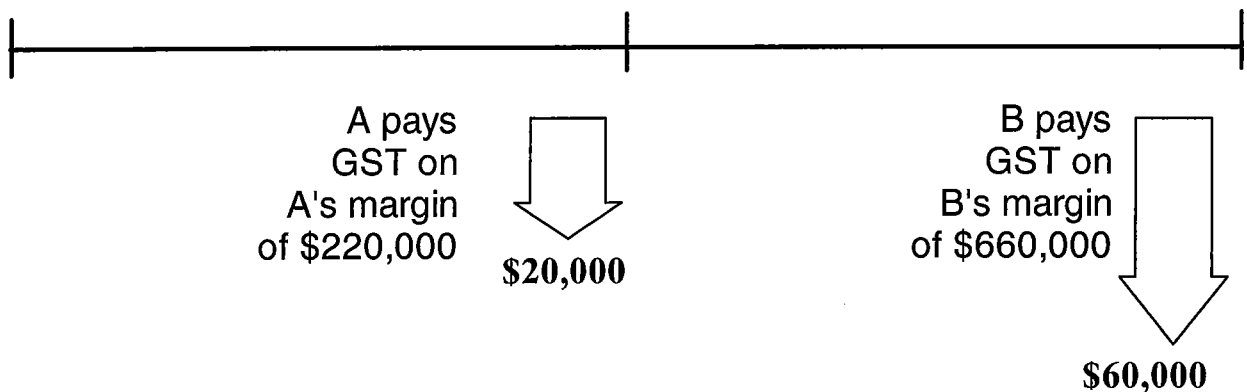
Purchasers of real property under the margin scheme cannot claim input tax credits for the acquisition. This is because an input tax credit would offset the GST payable so that GST would effectively not have been collected.

Example - Margin Scheme post 1 July 2000

**A holds land
at 1 July 2000
valued at
\$110,000**

**A sells to B
(\$330,000)**

**B sells to C
(\$990,000)**



Total GST Collected \$80,000

Registered property owner A sells property to developer B who in turn builds a new house on the property and sells it to consumer C.

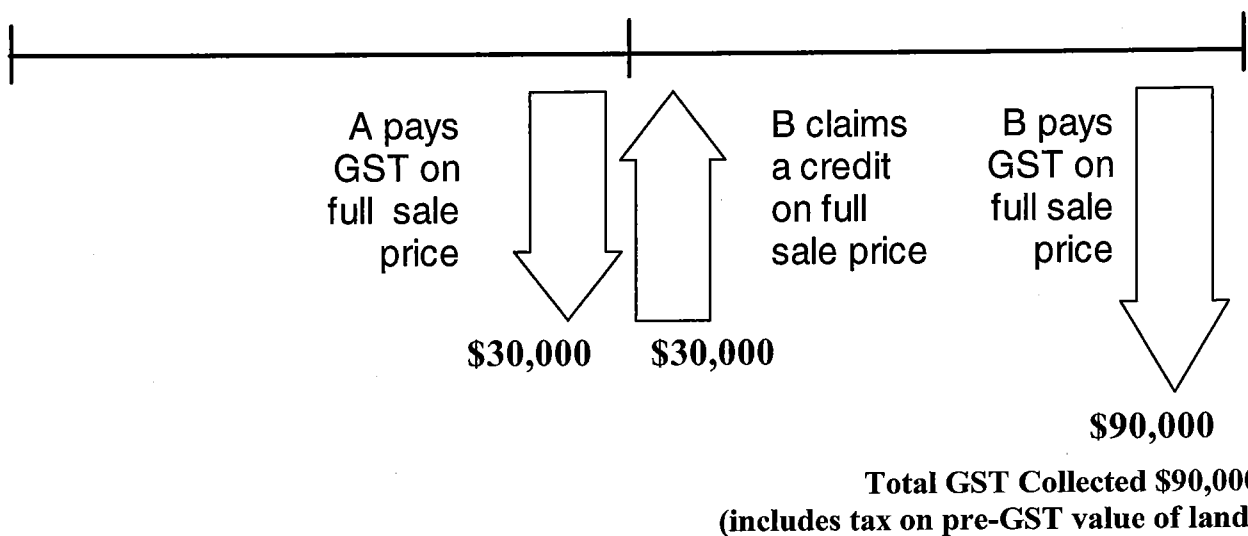
Under the margin scheme, GST is payable on the difference between A's purchase price (or value at 1 July 2000) and sale price to B (1/11th of the margin, or \$20,000). Under the margin scheme no input tax credits are available. When the property is sold to C under the margin scheme, GST is payable on the difference between B's purchase price and the sale price to C (1/11th of the margin - \$60,000). As a result, GST has been paid on the value added to the property in each transaction.

Example – Basic rules post 1 July 2000

**A holds land
at 1 July 2000
valued at
\$110,000**

**A sells to B
(\$330,000)**

**B sells to C
(\$990,000)**



Registered property owner A sells property to developer B who in turn builds a new house on the property and sells it to consumer C.

Under the basic rules the sale to B would be taxable supply so A remits GST (1/11th of the sale price) and B claims an input tax credit for the same amount. In effect there has been no net GST collected. When the property is sold to C, the supply is a taxable supply so B remits GST (1/11th of the sale price) and C cannot claim an input tax credit.

The above examples illustrate how the margin scheme can be used to exclude GST from the value of property prior to 1 July 2000. Where the basic rules are used the pre 1 July 2000 value of property is taxed as GST is applied to the sale price.

The margin scheme can only apply where:

- the property was not acquired as a taxable supply under the basic rules. This is because an input tax credit would have been claimed on the property's purchase and GST would therefore not have been collected on the marginal increase in value; and
- there is a written agreement between supplier and recipient that the supply will be under the margin scheme.

Going concern and farmland provisions

Generally, a supply of a going concern is GST free where the supplier provides to the recipient all of the things that are necessary for the continued operation of the enterprise.

The going concern provision is an optional concession that is designed to facilitate the sale and acquisition of enterprises that will be used to produce taxable supplies.

Farmland can be sold GST free, provided the seller has carried on a farming business on the land for at least 5 years previously and the buyer intends to carry on a farm business on the land.

The GST free going concern and farmland provisions recognise that sales of going concerns (broadly, operating enterprises) and farmland would generally be revenue neutral — that is, the supplier would be required to remit GST and the recipient would be entitled to a corresponding input tax credit. A GST free going concern cannot be sold to a final consumer – the recipient must be registered. In the case of a GST free sale of farmland the buyer must intend that a farming business be carried on, on the land.

Associate provisions

Special rules exist to ensure the appropriate amount of GST is collected on transactions between closely-related entities, such as associates, where the supply is made for no consideration, or for inadequate consideration. The amount of GST payable on a supply subject to GST because of the special rules is 10 per cent of the market value of the supply (exclusive of GST).

Interaction between margin scheme, going concern/farmland and associates provisions

The interaction between these provisions can enable some taxpayers to avoid paying GST on some or all of increases in value to property after 1 July 2000.

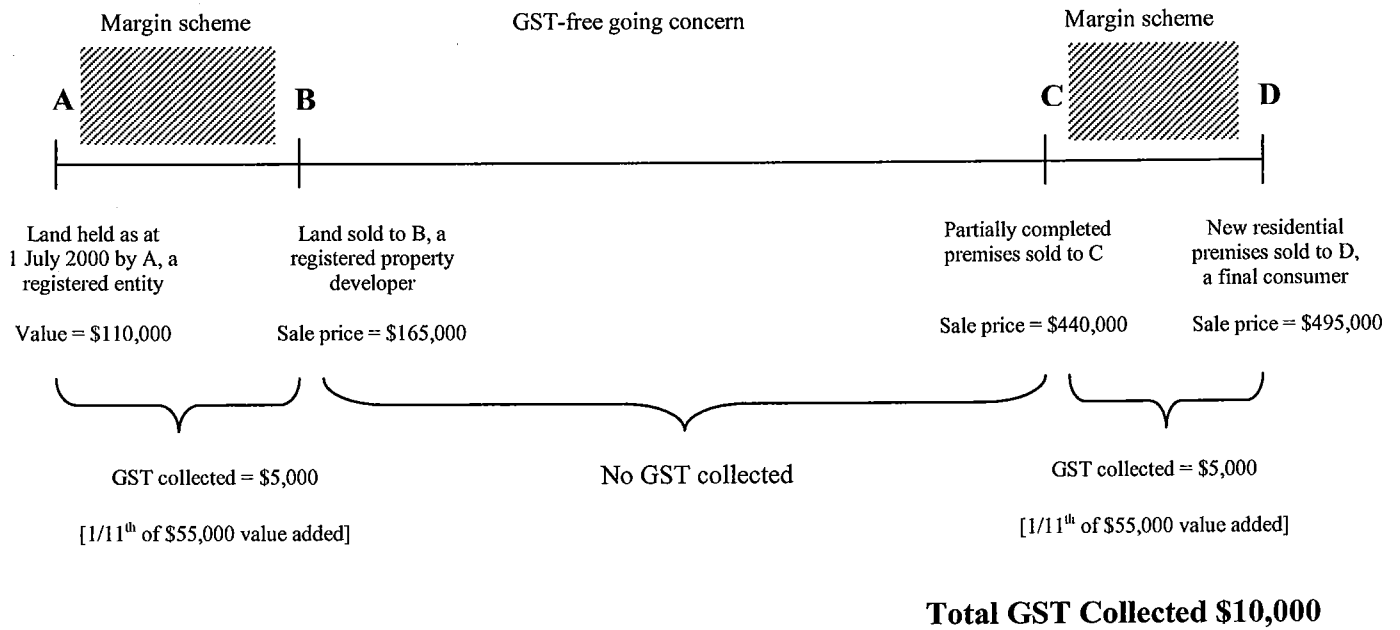
Where a property is sold as part of a GST free going concern or farmland or sold to an associate for no consideration, and it is subsequently sold under the margin scheme, the value added by the supplier of the property as part of a going concern or farmland or the value added by an associate is not taxed. (See illustrations 1 and 2 below.)

An entity that would otherwise be prevented from applying the margin scheme to the sale of a property on the basis that it acquired the property as a taxable supply under the basic rules, could be eligible for the margin scheme following the property being supplied as part of a going concern. This can also result in value added by previous suppliers not being taxed. (See illustration 3 below.)

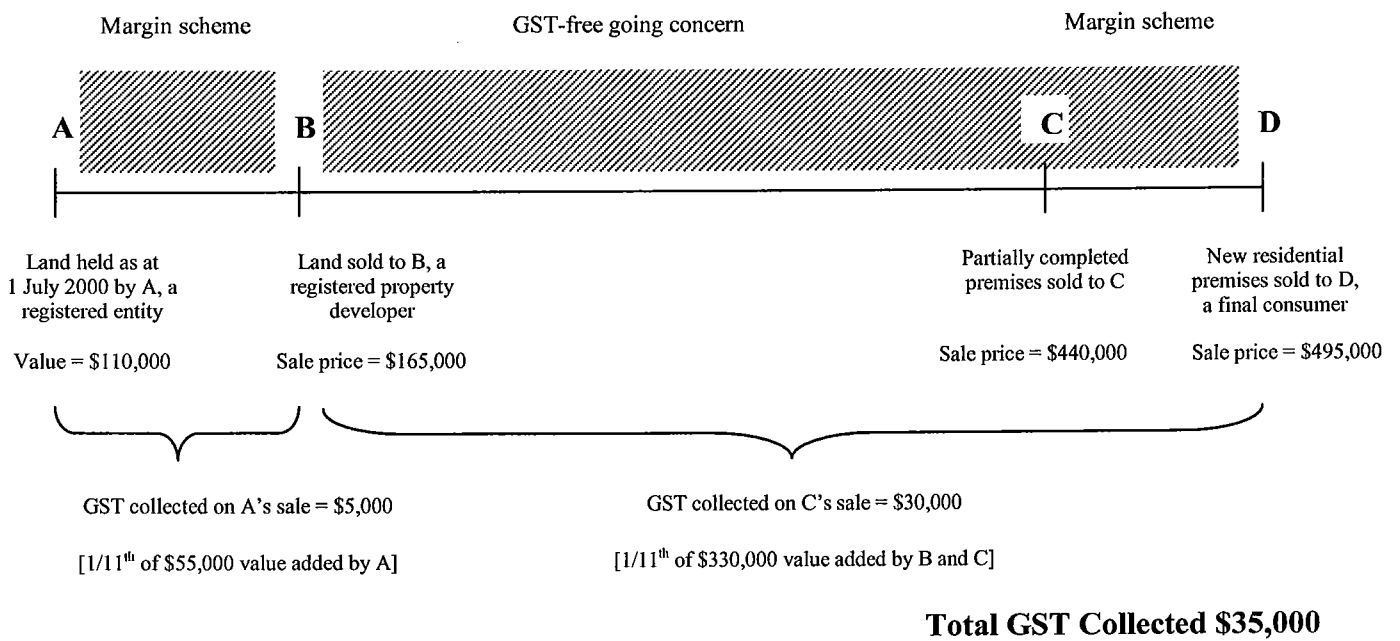
ILLUSTRATION 1 - reduced GST liabilities from the interaction of the margin scheme and the GST free going concern and farm land provisions

A, a GST-registered entity, holds land on 1 July 2000 valued at \$110,000
 A sells land under the margin scheme to B, a GST-registered property developer, for \$165,000
 B partially constructs new residential premises on the land, sells to C as a GST-free going concern for \$440,000
 C completes construction and sells to a final consumer under the margin scheme for \$495,000.

Outcome under current law



Outcome under measure



Summary table

	Current law	Proposed Outcome	Difference
GST payable by Entity A	\$5,000	\$5,000	-
GST payable by Entity B	\$0	\$0	-
GST payable by Entity C	\$5,000	\$30,000	\$25,000
Total GST collected	\$10,000	\$35,000	\$25,000

GST is collected on the entire value added (\$385,000) by A, B and C

Due to the fact that C is required to pay GST on B's value added

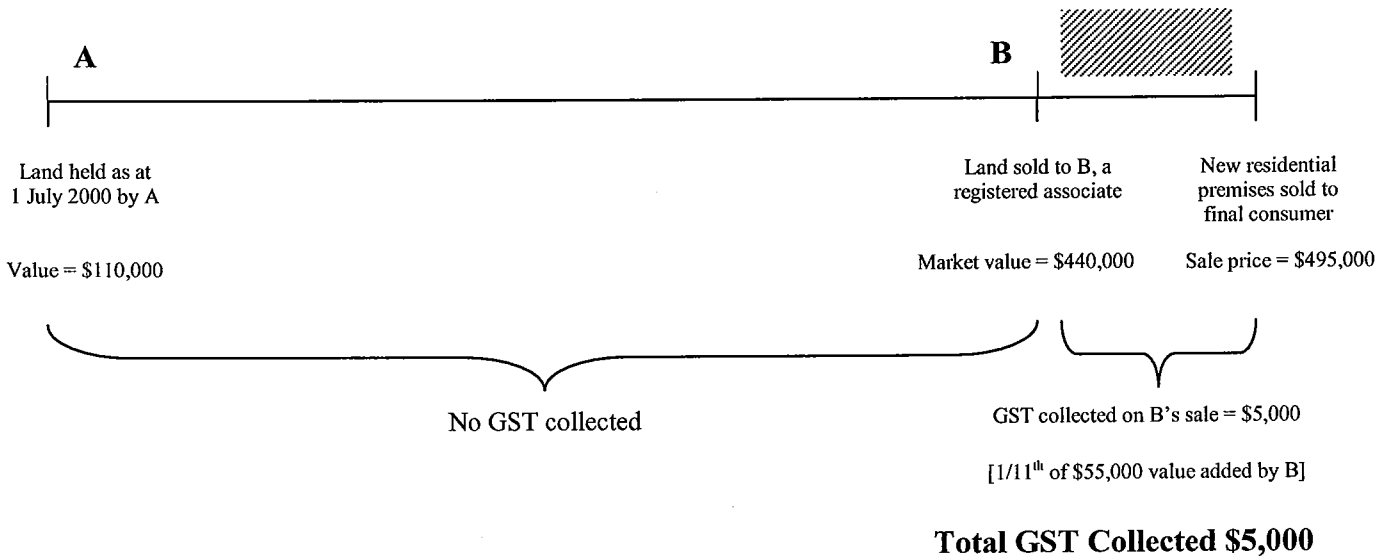
ILLUSTRATION 2 - reduced GST liabilities from the interaction of the margin scheme and provisions relating to supplies involving associates

A, a GST-registered entity, constructs new residential premises on land it held on 1 July 2000. The value of the land as at 1 July 2000 was \$110,000.

Rather than selling directly to a consumer, A instead transfers the property to B, a GST-registered associate, for no payment. The GST-inclusive market value of the property at the time of transfer is \$440,000.

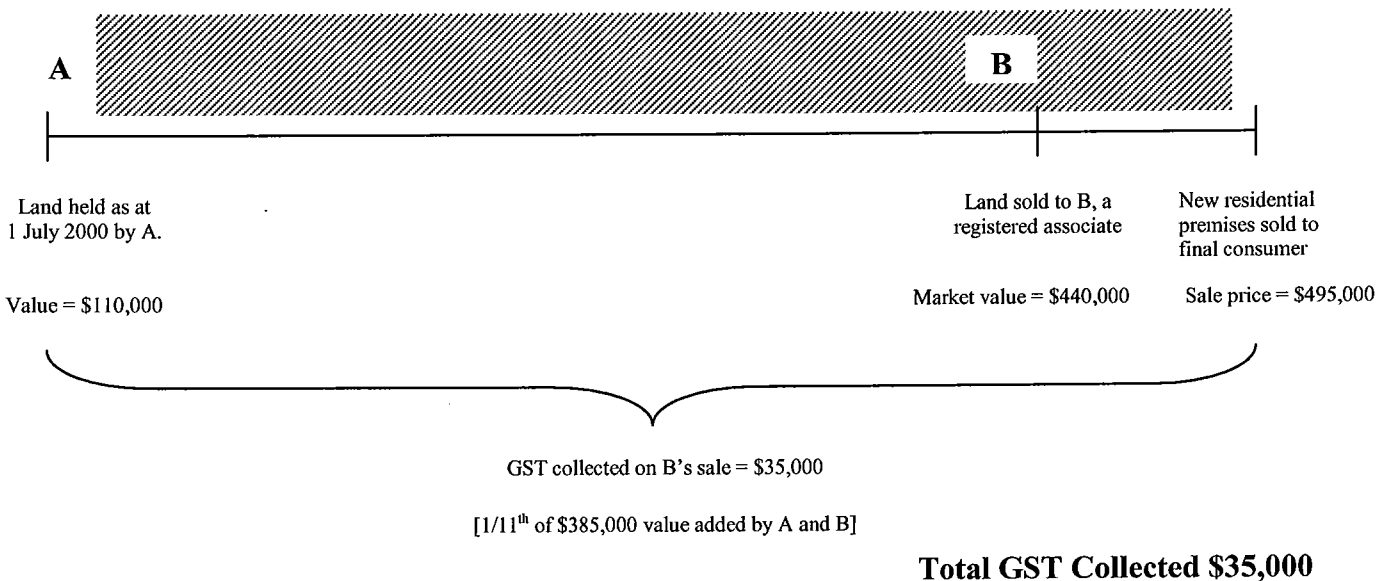
B sells the premises to a final consumer for \$495,000 under the margin scheme

Outcome under current law



If A had itself completed construction of the premises and sold them directly to the final consumer, it would have been liable to pay \$35,000 GST (1/11th * (\$495,000 - \$110,000)). Therefore, through the “scheme”, the associates have avoided paying \$30,000 GST.

Outcome under measure



Summary table

	Current law	Proposed Outcome	Difference
GST payable by Entity A	\$0	\$0	-
GST payable by Entity B	\$5,000	\$35,000	\$30,000
Total GST collected	\$5,000	\$35,000	\$30,000

GST is collected on the entire value added (\$385,000) by A and B

Due to the fact B is required to pay GST on A's value added

ILLUSTRATION 3 - ability to 'refresh' eligibility for the margin scheme using GST free going concern and farm land provisions

The recommended approach will also limit eligibility to the margin scheme if it was not eligible for use by the previous supplier. In the example below, if B was not eligible to use the margin scheme, because for instance B purchased the property under the normal rules, then C would not be able to make supplies of new residential premises under the margin scheme. This approach prevents entities from 'refreshing' the margin scheme by interposing a GST free sale under the going concern provisions.

