The Legal Framework for GST Apportionment by Financial Suppliers

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'Neither a borrower, nor a lender be'
(Hamlet, Act 1, Scene 3)

This paper discusses the legal framework for the apportionment of GST paid on acquisitions related in part to the making of financial supplies. It does not cover apportionment generally, or the interaction of apportionment methodologies with the reduced input tax credit regime.[1]

The legislative provisions

Within the basic rules in Chapter 2 of the GST Act, are the central provisions in Part 2-1. 'GST is payable on taxable supplies and taxable importations',[2] while 'entitlements to input tax credits arise on creditable acquisitions and creditable importations.'[3] 'Amounts of GST and amounts of input tax credits are set off against each other to produce a net amount for a tax period (which may be altered to take account of adjustments).'[4] 'Every entity that is registered, or required to be registered, has tax periods applying to it.'[5] 'The net amount for a tax period is the amount that the entity must pay to the Commonwealth, or the Commonwealth must refund to the entity, in respect of the period.'[6]

Part 2-2 of the GST Act is also within the basic rules and is headed 'Supplies and acquisitions'. This Part contains only Division 9, entitled 'Taxable supplies', and Division 11, entitled 'Creditable acquisitions'.[7]

You make a 'taxable supply' if:

> (a) you make the supply for consideration; and
> (b) the supply is made in the course or furtherance of an enterprise that you carry on; and
> (c) the supply is connected with Australia; and
> (d) you are registered, or required to be registered.
> However, the supply is not a taxable supply to the extent that it is GST-free or input taxed.[8]

A supply in turn 'is any form of supply whatsoever.'[9] The Explanatory Memorandum states that this definition 'is defined broadly and is intended to encompass supplies as widely as

[1] The reduced input tax credit regime is 'a unique Australian invention that certain kinds of activities, being, generally speaking, those which might be outsourced by entities making financial supplies and are in aid of making such supplies will, albeit that those activities might be defined as financial supplies, attract a reduced input tax credit of 75 per cent of the credit otherwise available': per Hill J in *HP Mercantile Pty Limited v Commissioner of Taxation* [2005] FCAFC 126 at [17]
[2] GST Act, s 7-1(1)
[3] GST Act, s 7-1(2)
[4] GST Act, s 7-5
[5] GST Act, s 7-10
[6] GST Act, s 7-15
[7] The headings to Parts and Divisions form part of the Act: GST Act, s 182-1(1)
[8] GST Act, s 9-5
[9] GST Act, s 9-10(1)

possible.'[10] The ordinary meaning of the term 'supply' is then expanded by the statute to include:

(a) a supply of goods;
(b) a supply of services;
(c) a provision of advice or information;
(d) a grant, assignment or surrender of real property;
(e) a creation, grant, transfer, assignment or surrender of any right;
(f) a financial supply;
(g) an entry into, or release from, an obligation;
  (i) to do anything; or
  (ii) to refrain from an act; or
  (iii) to tolerate an act or situation;
(h) any combination of any 2 or more of the matters referred to in paragraphs (a) to (g).[11]

A supply 'does not include a supply of money unless the money is provided as consideration for a supply that is a supply of money.'[12] This provision is designed to ensure that the payment of money as consideration for goods, services, rights or other things, is not itself a supply or acquisition unless, for example, it forms part of a foreign exchange transaction.

The expressions 'consideration' and 'enterprise' are defined in sections 9-15 and 9-20 of the GST Act respectively, while supplies 'connected with Australia' are defined in section 9-25.

A supply is GST-free if, relevantly, it is GST-free under Division 38 of the GST Act, or is a supply of a right to receive a supply that would be GST-free under Division 38,[13] while a supply is input taxed if, relevantly, it is input taxed under Division 40 of the GST Act, or is a supply of a right to receive a supply that would be input taxed under Division 40.[14] For financial institutions, the main type of supply that is GST-free is a supply for consumption outside of Australia, while the main type of supply that is input taxed is a financial supply.

In the event a supply is both GST-free and input taxed, such as with a financial supply for consumption outside of Australia then, subject to an immaterial exception, the supply will be treated as GST-free.[15]

The relevant entity must pay the GST payable on any taxable supply that it makes.[16] The amount of GST on a taxable supply is 10% of the 'value' of the taxable supply,[17] where the value of the taxable supply equals 10/11ths of the 'price'.[18] 'Price' in turn is the sum of (a) so far as the consideration for the supply is consideration expressed as an amount of money – the amount (without any discount for the amount of GST (if any) payable on the supply); and (b) so far as the consideration is not consideration expressed as an amount of money – the GST inclusive market value of that consideration.[19]

[10] Explanatory Memorandum to the A New Tax System (Goods and Services Tax) Bill 1998, paragraph 3.6
[11] GST Act, s 9-10(2)
[12] GST Act, s 9-10(4)
[13] GST Act, s 9-30(1)
[14] GST Act, s 9-30(2)
[15] GST Act, s 9-30(3)
[16] GST Act, s 9-40
[17] GST Act, s 9-70
[18] GST Act, s 9-75(1)
[19] GST Act, s 9-75(1)

Section 9-80(1) of the GST Act is an apportionment provision dealing with outputs. If a supply is partly a taxable supply, and partly a supply that is GST-free or input taxed, the value of the part of the supply that is a taxable supply is the proportion of the value of the supply that the taxable supply represents.[20] The value of the supply is:

$$\frac{\text{Price of the supply x 10}}{10 + \text{taxable proportion}}$$

The taxable proportion is the proportion of the supply that represents the value of the taxable supply (expressed as a number between 0 and 1).[21]

Turning then to inputs, or acquisitions, Division 11 of Part 2-2 of the GST Act is headed 'Creditable acquisitions'. You make a creditable acquisition if:

(a) you acquire anything solely or partly for a creditable purpose; and
(b) the supply of the thing to you is a taxable supply; and
(c) you provide, or are liable to provide, consideration for the supply; and
(d) you are registered, or required to be registered.[22]

An entity is entitled to an input tax credit for any creditable acquisition that it makes.[23] An acquisition is 'any form of acquisition whatsoever.'[24] The Explanatory Memorandum to the GST Act states that this definition 'is defined broadly and is intended to encompass acquisitions as widely as possible.'[25] The ordinary meaning of the term 'acquisition' is then expanded by the statute to include:

(a) an acquisition of goods;
(b) an acquisition of services;
(c) a receipt of advice or information;
(d) an acceptance of a grant, assignment or surrender of real property;
(e) an acceptance of a grant, transfer, assignment or surrender of any right;
(f) an acquisition of something the supply of which is a financial supply;
(g) an acquisition of a right to require another person:

  (i) to do anything; or
  (ii) to refrain from an act; or
  (iii) to tolerate an act or situation;

(h) any combination of any 2 or more of the matters referred to in paragraphs (a) to (g).[26]

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20 GST Act, s 9-80(1)
21 GST Act, s 9-80(2). For almost nine years now it has escaped everyone's attention that this statutory formula is incorrect. The example in the Explanatory Memorandum to the A New Tax System (Goods and Services Tax) Bill 1998, at paragraph 3.18, does not attempt to use the statutory formula. Whichever way you do the maths with the statutory formula you will not arrive at the GST amount given in the example. It is not a promising start to a discussion of apportionment when one of the basic sections in the Act dealing with the subject, albeit of outputs rather than inputs, is fundamentally flawed
22 GST Act, s 11-5
23 GST Act, s 11-20
24 GST Act, s 11-10(1)
25 Explanatory Memorandum to the A New Tax System (Goods and Services Tax) Bill 1998, paragraph 3.21
26 GST Act, s 11-10(2)

Conversely, 'an acquisition does not include an acquisition of money unless the money is provided as consideration for a supply that is a supply of money.'[27]

You acquire a thing for a creditable purpose 'to the extent that you acquire it in carrying on your enterprise.'[28] Lindgren J in *AXA Asia Pacific Holdings Ltd v Commissioner of Taxation*,[29] described this provision as 'very broad', and observed that 'it is not necessary that there be an actual "on-supply" by the acquirer.'[30] Of importance for financial suppliers is whether their acquisitions have been acquired solely or partly for a creditable purpose.[31] You do not acquire the thing for a creditable purpose 'to the extent that:

(a) the acquisition relates to making supplies that would be input taxed; or
(b) the acquisition is of a private or domestic nature.'[32]

The critical issue is in paragraph (a) – does the acquisition relate to making supplies that would be input taxed? Lindgren J rightly described this paragraph as a 'blocking provision'.[33]

An acquisition is not treated as relating to making supplies that would be input taxed to the extent that the supply is made through an enterprise, or a part of an enterprise, that is carried on outside Australia.[34] Further, an acquisition is not treated as relating to making supplies that would be input taxed 'to the extent that:

(a) the acquisition relates to making a financial supply consisting of a borrowing; and
(b) the borrowing relates to you making supplies that are not input taxed.'[35]

The amount of the input tax credit for a creditable acquisition is an amount equal to the GST payable on the supply of the thing acquired. However, the amount of the input tax credit is reduced if the acquisition is only partly creditable.[36] An acquisition is partly creditable if it is a creditable acquisition to which one or both the following apply:

(a) you make the acquisition only partly for a creditable purpose;
(b) you provide, or are liable to provide, only part of the consideration for the acquisition.[37]

Section 11-30(3) provides that the amount of the input tax credit on an acquisition that is partly creditable is to be calculated in accordance with the following formula:

Full input tax credit	x	Extent of creditable purpose	x	Extent of consideration

A 'full input tax credit' is what would have been the amount of the input tax credit for the acquisition if it had been made solely for a creditable purpose and the claimant had provided, or had been liable to provide, all of the consideration for the acquisition.

27 GST Act, s 11-10(3)
28 GST Act, s 11-15(1)
29 [2008] FCA 1834
30 [2008] FCA 1834 at [38]
31 GST Act, s 11-5(a)
32 GST Act, s 11-15(2)
33 [2008] FCA 1834 at [38]
34 GST Act, s 11-15(3)
35 GST Act, s 11-15(5)
36 GST Act, s 11-25
37 GST Act, s 11-30(1)

The 'extent of creditable purpose' is the extent to which the creditable acquisition is for a creditable purpose, expressed as a percentage of the total purpose of the acquisition. This is a fundamental concept for the apportionment of GST paid on acquisitions related in part to the making of financial supplies.

The 'extent of consideration' is the extent to which the claimant provides, or is liable to provide, the consideration for the acquisition, expressed as a percentage of the total consideration for the acquisition.

Interpretation principles

Having considered the relevant statutory provisions, it is worthwhile pausing to discuss two principles of statutory interpretation that have particular relevance to GST.

A practical business tax?

Justice Hill writing extra-judicially has stated:

> Unless the legislation otherwise requires, in interpreting the GST and characterising a transaction entered into for the purposes of the GST, that interpretation or that characterisation of the transaction will be adopted which produces a practical or commonsense business result that accords with business reality and is not unduly technical.[38]

In *Saga Holidays Ltd v FCT*,[39] Justice Stone, with whom Gyles and Young JJ agreed, stated:

> The Court has tended to adopt a purposive approach to the interpretation of the GST Act, rejecting strict grammatical analyses in favour of a consideration not only of the syntax but also of 'the policy and the surrounding legislative context' of the relevant provision; *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126; (2005) 143 FCR 553 at [66]. Consideration of these aspects of the GST Act has lead to the tax being described as 'a practical business tax'; *Sterling Guardian Pty Ltd v FCT* [2005] FCA 1166; (2005) 220 ALR 550 at [39].
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> The description is appropriate because it draws attention to two related aspects of the tax. The fact that liability to pay the tax is imposed at various stages of the supply chain means that it is a tax on business but, importantly, one that is designed, where practicable, to quarantine business from the ultimate burden of the tax. This and other aspects of the tax legitimately form part of the context in which the language of the Act is interpreted and explains, at least in part, why the description 'a practical business tax' seems to be appropriate. This does not mean, however, that there is some special canon of construction that should be applied when interpreting the GST Act. The purposive approach to interpretation, of its nature, takes account of the context of the Act and the phrase 'a practical business tax' is a reference to that context . . .[40]

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[38] D G Hill, *Some thoughts on the principles applicable to the interpretation of the GST*, (2003) 6 Journal of Australian Taxation 25

[39] [2006] FCAFC 191

[40] [2006] FCAFC 191 at [29]-[30]; see also R Olding, *'GST is a practical business tax' – 'spin and rhetoric' or an inconvenient truth?*, (2009) 9 AGSTJ 1

One aspect of the application of GST to financial supplies that can be drawn from the legislation itself is that such supplies are difficult to value. Apportionment methodologies which rely on valuing financial supplies need to be approached with that difficulty in mind. In that sense a methodology 'which produces a practical or commonsense business result that accords with business reality and is not unduly technical' is highly desirable.

The Act takes transactions as it finds them

In *Magna Alloys & Research Pty Ltd v FC of T* [41], Deane and Fisher JJ stated, in the context of the general deduction provision in section 51(1) of the *Income Tax Assessment Act* 1936:

> It is no part of the function of the Act or of those who administer it to dictate to taxpayers in what business they shall engage or how to run their business profitably or economically. 'The Act must operate upon the result of a taxpayer's activities as it finds them'(per Williams J. in *Tweddle v FC of T* (1942) 7 ATD 186 at 190; see also *Ronpibon Tin NL and Tongkah Compound NL v FC of T* 78 CLR at 56-7; *Cecil Bros Pty Ltd v FC of T* (1962-1964) 111 CLR 430 at 434, 441; *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* (No 1) [1971] AC 760 at 772; *FC of T v South Australian Battery Makers Pty Ltd* (1978) 140 CLR 645 at 653-4).[42]

The principle that the Act takes transactions as it finds them is of great importance in the application of the GST law, which most often taxes transactions in the guise of supplies.

What is GST and why are financial supplies treated differently?

The Explanatory Memorandum to the GST Act makes plain that, 'broadly speaking, the GST is a tax on private consumption in Australia,' and that 'the GST taxes the consumption of most goods, services and anything else in Australia, including things that are imported'.[43]

The taxing of private consumption in Australia is generally achieved by:

- imposing tax on supplies made by entities registered for GST; but
- allowing those entities to offset the GST they are liable to pay on supplies they make against input tax credits for the GST that was included in the price they paid for their business inputs.

In this way GST is effectively a tax on 'final' private consumption in Australia, and is imposed on a registered supplier in respect of a supply made to a recipient. The general scheme of the Australian GST has been described by Hill J in *ACP Publishing Pty Ltd v Commissioner of Taxation*:

> The GST is, in essence, the tax known in most countries as value added tax, a name which, perhaps, best describes the essence of the tax. The characteristics of a value added tax were aptly described by the European Court of Justice in *Dansk Denkavit ApS v Skatteministeriet* [1994] 2 CMLR 377 at 394-5 as being that it 'applies generally to transactions relating to goods or services; it is proportional to the price of those goods or services; it is charged at each stage of the production and distribution process; and

41 (1980) 80 ATC 4542
42 (1980) 80 ATC 4542 at 4557
43 Explanatory Memorandum to the A New Tax System (Goods and Services Tax) Bill 1998, Executive Summary, at 6

> finally it is imposed on the added value of goods and services, since the tax payable on a transaction is calculated after deducting the tax paid on the previous transaction.
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> These characteristics are displayed in the Australian legislation by the tax ('output tax') being levied, in effect, upon substantially all supplies (referred to in the GST Act as 'taxable supplies') being generally, although not exclusively, supplies of goods or services made by a registered person, or person required to be registered, for consideration . . . and the deduction referred to in *Dansk* (popularly known as an 'input tax credit') being given to a registered person, or person required to be registered, who makes a creditable acquisition, as that expression is defined.[44]

In *HP Mercantile Pty Limited v Commissioner of Taxation*[45], his Honour (with whom Stone J and Allsop J agreed) elaborated as follows:

> The genius of a system of value added taxation, of which the GST is an example, is that while tax is generally payable at each stage of commercial dealings ('supplies') with goods, services or other 'things', there is allowed to an entity which acquires those goods, services or other things as a result of a taxable supply made to it, a credit for the tax borne by that entity by reference to the output tax payable as a result of the taxable supply. That credit, known as an input tax credit, will be available, generally speaking, so long as the acquirer and the supply to it (assuming it was a 'taxable supply') satisfied certain conditions, the most important of which, for present purposes, is that the acquirer make the acquisition in the course of carrying on an enterprise and thus, not as a consumer. The system of input tax credits thus ensures that while GST is a multi-stage tax, there will ordinarily be no cascading of tax. It ensures also that the tax will be payable, by each supplier in a chain, only upon the value added by that supplier.[46]

But financial services do not easily fit the general scheme of the GST and are subject instead to an input taxing regime. The rationale for doing so was set out in the Explanatory Statement to the GST Regulations:

> The fundamental reason for input taxing financial services is that it is difficult to value most financial services as they are often charged by way of a margin. Where supplies are input taxed, it is not necessary to value the service . . .[47]

As we shall see later in this paper, an irony for the most common of apportionment methodologies, being the revenue method, is that it becomes necessary to value the very same financial supplies that are input taxed for the reason they are difficult to value.

Returning to *HP Mercantile Pty Limited v Commissioner of Taxation*[48], Hill J described how the scheme of GST applies to financial supplies:

> In terms of GST theory, it is generally accepted that there are certain kinds of activities where the basic system of output tax on supplies and input tax credits on acquisitions will not lead to taxation on the value added by each supplier in the chain. The most

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[44] [2005] FCAFC 57 at [2]-[3]
[45] [2005] FCAFC 126
[46] [2005] FCAFC 126 at [13]
[47] Explanatory Statement to the GST Regulations, Attachment E, at 2
[48] [2005] FCAFC 126

important example is said to be financial transactions of financial institutions such as, but not confined to, banks, because they constantly borrow and lend and turn over money in a way that amounts, such as interest charged, will not represent the real value added by the financial institutions. Indeed, as the explanatory memorandum distributed with the bill which, as amended, later became the GST Act says in Chapter 1 [5.140]: '…there is no readily agreed identifiable value for supplies consumed by customers of financial services'. In such a case, it is the margin or imputed margin that is the real economic subject of the supply. There are other examples where this may be the case, one of which is the leasing of, or other dealings with, residential property (not being new residential property).

> By way of what may be seen as a compromise for the difficulties of applying the normal system of value added taxation to financial supplies and other difficult cases, value added taxation design has created a form of supply which is referred to in Australia as an input taxed supply but which, in international value added tax parlance, is referred to as an 'exempt' supply. An input taxed or exempt supply (and financial supplies made by financial institutions will be the main example) will not, generally speaking, attract output tax, but the entity which makes financial supplies will, likewise, not obtain an input tax credit for the tax payable on acquisitions it makes in the course of its enterprise of making input taxed supplies.[49]

His Honour continued:

> If it be necessary here to state a general policy for the application of GST to enterprises making input taxed supplies, it would be that, to the extent that an entity carries on an enterprise that consists of making input taxed supplies, it will bear the GST on acquisitions without an input tax credit so that its pricing of outputs, if any are made, will take into account, commercially, all GST it will be required to bear on its inputs.[50]

Professor Burns from the University of Sydney explains in the following terms why it is too difficult to identify the value added by financial supplies in a particular transaction:

> The difficulty for lenders and borrowers is finding each other. This is the role of a financial institution, which provides intermediation services to lenders (i.e., those that have funds to lend who need to find borrowers) and borrowers (i.e., those who want to borrow funds who need to find lenders). Essentially, the intermediation service involves bringing borrowers and lenders together through deposit taking and lending. However, unlike with most agency services/intermediation services, the financial institution may not charge an explicit fee for the services provided. Instead, the fee may be embedded in the interest rate spread (i.e., the interest rate paid to depositors with the financial institution and the interest rate charged to lenders from the institution). This means that neither interest rate is the 'real' interest rate. The interest paid by borrowers is higher than the real interest rate and the interest paid to depositors is lower than the real interest rate.
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> There are two complications with taxing financial services under a credit-invoice VAT. First, it is difficult to identify the part of the interest rate spread that represents

[49] [2005] FCAFC 126 at [16]-[17]
[50] [2005] FCAFC 126 at [50]

> the collective fee charged for the intermediation services provided. Secondly, even if the collective fee for the intermediation services could be isolated, the services are being provided to two customers of the financial institution – depositors and borrowers – and, therefore, the fee must be allocated between those services.[51]

This difficulty has been recognised in international VAT jurisprudence. In *The Commissioners of Customs and Excise v First National Bank of Chicago*,[52] the European Court of Justice considered the meaning of Article 11A(1)(a) of the Sixth Directive (then in force) in relation to the deduction of input tax on certain foreign exchange transactions. Article 11A(1)(a) stated, relevantly, that 'the taxable amount shall be . . . everything which constitutes the consideration . . .'

The Bank submitted that the consideration was everything which was received in the course of foreign exchange transactions, that is to say the turnover representing the total value of the currencies supplied in the course of foreign exchange transactions. This submission was rejected by the Court, which made the following observation:

> Determining the consideration therefore comes down to determining what the Bank receives for foreign exchange transactions, that is to say *the remuneration* on foreign exchange transactions *which it can actually take for itself* . . .[53] (emphasis added)

The Court went on to say:

> . . . The Bank carries out a large number of transactions relating to different amounts and involving different currencies, the rates of which are in constant fluctuation. A trader cannot normally foresee, when concluding one particular transaction, at what moment and at what price he may subsequently effect one of more transactions enabling him to eliminate or fix, at a specific amount, the risk of a change in rate to which he is exposed following the first transaction.
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> So, the consideration, that is to say the amount which the Bank can actually apply to its own use, must be regarded as consisting of the net result of its transactions over a given period of time.[54]

In *MBNA Europe Bank Ltd v The Commissioners of HM Revenue and Customs*,[55] it was common ground between the parties, and accepted by Briggs J, that when a bank lends money to a customer, the bank makes a supply of credit (that is, the use of the money lent) rather than a supply of the money itself. The consideration is therefore the interest (and any relevant charges) payable by the borrower, rather than the aggregate of the interest, the charges and the value of the promise to repay the principal.

Apportionment – the Australian Cases

A critical concept for financial suppliers under section 11-15(2) of the GST Act is that they do not acquire a thing for a creditable purpose, relevantly, '*to the extent that* . . . the acquisition

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[51] Lee Burns, *Consumption Taxation of Supplies of Financial Services in the Asia Pacific Region*, Fifth Annual Asia Tax Forum, New Delhi, May 11-13, 2008, at 31-32
[52] [1998] EUECJ C-172/96
[53] [1998] EUECJ C-172/96 at [44]
[54] [1998] EUECJ C-172/96 at [46]-[47]
[55] [2006] EWHC 2326 (Ch)

relates to making supplies that would be input taxed'. (emphasis added) The phrase 'to the extent that' is suggestive of an apportionment and is a direct descendant of the phrase 'to the extent to which' found in former section 51(1) of the *Income Tax Assessment Act 1936 (Cth),* which was the general deduction provision. The decision of the High Court in *Ronpibon Tin NL & Tongkah Compound NL v Federal Commissioner of Taxation*[56] is undoubtedly the leading authority on apportionment in a taxation context and, in particular, in relation to section 51(1).

Ronpibon Tin

Ronpibon Tin owned and worked a tin mine in Siam (now Myanmar) under leases from the Siamese Government. Tongkah Compound owned and worked a tin mine in Malaya and held shares in other companies which owned and worked tin mines at the same place. Each company had derived substantial revenues from tin mining but the revenues formed no part of their assessable income as it was exempt from income tax.

After the Japanese obtained control of Siam and Malaya the companies were cut off from all access to their workings. The mining manager and assistant mining manager of Ronpibon Tin were interned, but the wife of one and the wife and children of the other had been sent to Australia where the company continued to pay for their support.

The last year of income in which each company received income from tin mining was the year ended 30 June 1942 for Ronpibon Tin and the year ended 30 September 1942 for Tongkah Compound. In assessing the respective companies to income tax upon the income derived during successive income years up to that time, the Commissioner had necessarily to deal with the question to what extent the outgoings incurred by the companies in Australia were referable to the mining operations in Siam or Malaya and to what extent they were referable to the derivation of income from other sources. The other sources of income consisted only in interest on money invested in either Treasury Bonds or upon fixed deposit. The dividends Tongkah Compound received from the shares of other tin mining companies were also treated as exempt income.

Each company incurred expenditure in the central administration of the affairs of the companies. There were directors' fees, management expenses, the cost of cables, postages, stationery, audit fees and some minor incidental expenditure.

Each company followed a practice common among mining companies of employing a legal manager at an overall annual fee in return for which he allowed the company to use his premises as its registered office and did, or caused to be done by his staff, the clerical and other work of management, charging other out-of-pocket expenses to the company.

It was evident that the principal work both of the legal manager and of the directors was concerned with mining and not investment. For example, for the year ended 30 June 1941 the receipts of Ronpibon Tin from the proceeds of tin was almost £100,000, while the interest from money invested was almost £1,000.

In dealing with the question what amount of the expenses incurred should be considered referable to the income from investments and allowed accordingly as a deduction the

[56] (1949) 78 CLR 47; [1949] HCA 15

Commissioner took a short cut. He allowed as a deduction an amount equal to 2.5% of the income from investments. This followed a method which apparently he found convenient to employ in cases where it was necessary to apportion to income from investments part of the general expenses incurred by a company which had some other main purpose.

Neither of the appellant companies objected to this method of distributing their expenses between their exempt income and their assessable income. But in the accounting periods following those on foot at the time of the entry of Japan into the war, the Commissioner applied the same method of ascertaining how much of the expenditure incurred in administering the affairs of the companies was referable to the assessable income. He did this notwithstanding that in these accounting periods the companies were conducting no mining operations in Malaya and Siam.

The Commissioner considered that, for whatever purpose the administrative structure of each company was maintained, no greater part of the expenditure it entailed could be treated as incurred in the course of holding and superintending the investments and receiving the interest income. It could not matter whether the administrative structure established for the main purpose of winning tin in Malaya or Siam was maintained for that purpose, as it was in prior accounting periods, or for the purpose of awaiting in a state of preparedness the ultimate restoration of the companies' undertakings and in the meantime dealing with questions growing out of the past or present situation or for any other purpose. It would still remain true, so the Commissioner appeared to have considered, that only a small part of the total expenditure could be referable to the gaining of assessable income from investments.

The companies challenged the Commissioner's view and claimed that the whole of the office expenses should be allowed as a deduction from the assessable income from investments.

In the year ended 30 June 1944, Ronpibon Tin derived £1,374 as interest from government loans and £459 as interest from fixed deposits, making in all £1,833. It had no other income.

On the expenditure side, the company paid £450 as the fee or salary for management. It paid £200 in directors' fees, while the expenditure on cables, postages, stationery, audit fees and travelling and general expenses amounted to £136.

The expenditure on cables related to matters arising out of the production of tin in Siam. About 1938 the International Tin Committee formed a pool of tin stocks as a cushion or buffer to control the effects of an under or over supply of tin. The pool was called the 'Buffer Stock Scheme,' and it was this scheme and the disposal of tin in the pool which occasioned the cables. The expenditure in travelling arose from the fact that one of the directors journeyed to meetings from another State. The last item on the expenditure side consisted in allotments to the dependants of the mine manager and assistant mine manager who had been interned in Siam. This amount was £420. The total of these items of expenditure was £1,206, which formed the deduction claimed by Ronpibon Tin.

The work done in the management of the company covered the registration of transfers of shares, in which there was some movement, and the interviewing of the many shareholders about the prospects of the company, particularly with reference to its Siamese assets. The directors had caused some investigation to be made of possible mining enterprises in Australia. During the accounting period in question, however, only one such prospective venture was looked into and that was done by or through one of the directors who had formerly been the company's consulting engineer. He acted in his capacity of director.

The case of Tongkah Compound was of the same nature but there were differences in the precise facts. In that company there was no attempt to look for other ventures. The expenditure included no items for allotments or sustenance of the mining staff or any of their dependants. On the other hand the receipts of the company for the year ended 30 September 1943 included a sum of ₤4,999 paid from 'The Buffer Stock Scheme' as the company's share of the proceeds of realising the stock held. The interest of the company in the Pool had stood in the balance sheet at ₤1,081 and the difference was taken into the profit and loss account at ₤3,913 (sic). In assessing the company the Commissioner appeared to have treated this income as exempt income. The company derived ₤2,809 from government loans and fixed deposits. It expended ₤300 in directors' fees and ₤590 in meeting the manager's salary, audit fees, postages, printing, stationery and advertising. It sought to deduct from the assessable income consisting of the interest the total of these two amounts, namely ₤890.

The Chief Justice submitted for the opinion of the Full Court (comprising Latham CJ, Rich, Dixon, McTiernan and Webb JJ) the question, in each case, whether in point of law he was at liberty to find that in assessing the taxpayer to income tax in respect of income derived during the accounting period the Commissioner acted rightly in disallowing in whole or in any and what part the deduction claimed.

The answer to the question depended primarily on the construction of section 51(1) of the *Income Tax Assessment Act* 1936, which was the general provision dealing with allowable deductions from assessable income: 'All losses and outgoings *to the extent to which* they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business, for the purpose of gaining or producing such income, shall be allowable deductions except *to the extent to which* they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.' (emphasis added)

In the end, the order made by the Full Court stated, in part: '. . . the learned judge should decide as a matter of fact what part or proportion of the . . . expenses was fairly and properly attributable to gaining the assessable income.'

The reasoning in the High Court sheds some light on the principles to be applied.

The High Court first undertook the task of properly characterising the receipts (or outputs) as either assessable income or exempt income, and outlays (or inputs) as either an allowable deduction, or in the nature of capital, or private or domestic.[57] According to the High Court, nearly all the activities of the companies were a concern of capital. Communications and business transacted with reference to the Buffer Stock Scheme could be put aside as a matter concerning exempt income. The only assessable income was interest upon investments.[58]

The Court then went on to examine two kinds of items of expenditure that required apportionment. One kind consisted in undivided items of expenditure in respect of things or

[57] This is similar to the approach taken by Briggs J in *MBNA Europe Bank Ltd v The Commissioners of HM Revenue and Customs* [2006] EWHC 2326 (Ch) at [5], and by Lindgren J in *AXA Asia Pacific Holdings Ltd v Commissioner of Taxation* [2008] FCA 1834

[58] [1949] HCA 15 at [15]-[16]

services of which distinct and severable parts were devoted to gaining or producing assessable income and distinct and severable parts to some other cause. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services.[59] For example, the payments to the dependants of staff were clearly not allowable, nor were costs incurred in cables and other expenses relating to the buffer stock scheme.[60]

The other kind of expenditure requiring apportionment is a single outlay or charge which serves two objects indifferently, of which Directors' fees is an example. In this case 'there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or rateable division because it is common to both objects.'[61] Elsewhere in the judgment, it is said that the apportionment must be 'just'[62], while the order made by the Court used the language of 'fairly and properly attributable'.

According to the Court, the question of what expenditure is incurred in gaining or producing assessable income is a question of fact and in the case of outlays which serve two objects indifferently, the result must depend in an even greater degree upon a finding by the tribunal of fact.[63]

HP Mercantile

In *HP Mercantile Pty Limited v Commissioner of Taxation*[64], Hill J (with whom Stone J and Allsop J agreed) made the following observations relevant to apportioning the GST paid on acquisitions related in part to the making of financial supplies:

> It is, perhaps, not unremarkable that s 11-15 of the GST Act bears, in its structure, some similarity to the general business deduction provisions of the Australian income tax law, ie s 51(1) of the *Income Tax Assessment Act* 1936 (Cth) and s 8-1 of the *Income Tax Assessment Act* 1997 (Cth). In both the GST provision and the income tax provisions, there is a need to pass first through a positive test. In the case of GST, the positive test is the requirement that the acquisition has been in whole or in part acquired in carrying on an enterprise. In the income tax context, there is the need to find that the loss or outgoing be incurred in gaining or producing assessable income, or in carrying on a business. In both cases apportionment arises where the positive test is only partly satisfied. Next, both require consideration of negative tests which exclude the allowance of a credit in the GST context or the allowance of a deduction in the income tax context. In the GST context the negative tests are those set out in s 11-15(2) of acquisitions relating to supplies that would be input taxed or acquisitions of a private or domestic nature. In the income tax context, the negative tests also involve the case where the loss or outgoing is of a private and domestic nature as well as where it is capital or of a capital nature. In both cases, a question of apportionment arises where the negative tests only partly apply.

59 [1949] HCA 15 at [18]
60 [1949] HCA 15 at [17]
61 [1949] HCA 15 at [18]
62 [1949] HCA 15 at [21]
63 [1949] HCA 15 at [18]-[19]
64 [2005] FCAFC 126

> [The indirect nature of the relationship between the acquisition and the making of the supplies] follows, perhaps more clearly, as well from the requirement of apportionment to be found in the words 'to the extent that' which indicate that an acquisition may relate to the making of supplies that are input taxed as well as supplies that are taxable, as would be the case with undifferentiated general overhead outgoings of an entity making both input taxed and taxable supplies (cf *Ronpibon Tin NL v Federal Commissioner of Taxation*).[65]

It is therefore clear that the principles of apportionment espoused in *Ronpibon Tin* have direct application to apportionment of inputs under the GST law, a proposition with which the Commissioner readily agrees.[66]

AXA Asia Pacific Holdings Ltd

In *AXA Asia Pacific Holdings Ltd v Commissioner of Taxation*,[67] the applicant, AXA, was the representative member of a GST group of entities that had been approved by the Commissioner. The proceedings were concerned with a member of that group, The National Mutual Life Association of Australasia Ltd (NMLA), which carried on business as an insurer with retail activities comprising both life insurance and non-life insurance business.

The issue was whether NMLA acquired certain things for a creditable purpose[68] and was therefore entitled to input tax credits in respect of those things.[69] This question, in turn, raised the question whether NMLA was denied input tax credits by reason of the fact that the acquisitions related to the making of supplies that would be input taxed.[70]

The things acquired by NMLA had been variously described as 'general management expenses' (GME), 'general administrative expenses' and 'overheads'. Lindgren J considered these to be loose descriptions on the basis that an expense or overhead is not a thing acquired, but for convenience conformed to the parties' usage of GME.[71] AXA claimed that its GME was incapable of being allocated to distinct identifiable supplies, although no evidence was specifically directed to showing this. The particular question posed, therefore, concerned the extent to which the GME of NMLA related to the making of supplies that would be input taxed.

In the course of its business activities, NMLA incurred expenses in acquiring things, some of which bore GST (such as commissions) and some of which did not (such as wages and salaries paid to NMLA's employees). Some of the expenses were identifiable as relating directly to input taxed supplies; taxable supplies; GST-free supplies; and supplies outside the scope of GST. An example of directly attributable expenses was commissions paid to independent sales agents in connection with the promotion and sale of NMLA's products. Such expenses were not in issue in the proceedings.

According to the evidence, the GME included staff salaries, staff on-costs, travel and accommodation, training and recruitment, rent, other occupancy costs, telephone, postage,

65 [2005] FCAFC 126 at [21]-[22]
66 GSTR 2006/3, paragraph 15
67 [2008] FCA 1834
68 GST Act, s 11-5
69 GST Act, s 11-20
70 GST Act, s 11-15
71 [2008] FCA 1834 at [16]

advertising and audit fees, and could not be directly attributed to particular activities of NMLA.

The Commissioner contended that none of the apportionment methodologies submitted by AXA were appropriate, and that it would be necessary for the parties to approach the question of an appropriate apportionment methodology *de novo* in the light of the Court's reasons on the various questions of law addressed by it.

Lindgren J thought it appropriate to indicate that in a case of apportionment of GME under s 11-30, 'ideally the evidence would specify the nature and use made of the things acquired in some detail, the attempts made to relate them directly to supplies, and the reason why the particular methodology and proxies proposed are most likely to approximate the relatedness between acquisition of the things and the use made of them.'[72]

NMLA was required to prepare its financial statements in accordance with the relevant actuarial and accounting standards. A valuation standard required that NMLA apportion its expenses into defined categories of acquisition expenses, maintenance expenses and investment management expenses. The valuation standard stated that for those expenses that could not be directly allocated to particular expense categories, processes of apportionment may be called for. A note to NMLA's financial statements related to operating expenses and included data on administration expenses.

The Commissioner argued that NMLA recorded only the amount of $33 million under investment management expenses, and that all other administrative expenses were attributed to categories related to input taxed supplies. AXA claimed that its GME relating to supplies that were not input taxed included many expenses not comprised within the $33 million.

In Lindgren J's view, 'the question of AXA's entitlement to input tax credits for the purposes of the Act is not necessarily limited by NMLA's published financial statements, although they are evidence of an admission by NMLA. Whether particular GME are "related to" particular input taxed supplies must be determined not by one piece of evidence or evidence of one particular kind but by reference to all of the evidence before the Court.'[73]

His Honour was also of the view that in determining the extent that acquisitions related, directly or indirectly, to the making of any input taxed supplies, neither the subjective intention of the claimant, nor the activities of the trustees of the unit trusts, was determinative.[74]

The apportionment issue was not addressed further as the matter was listed for further directions in the light of the Court's reasons on the various rulings of law made by it.[75]

Apportionment – the UK cases

Some care must be taken when examining foreign authorities as a means of shedding light on an Australian statute.[76] While acknowledging the differences between the UK and Australian

72 [2008] FCA 1834 at [75]
73 [2008] FCA 1834 at [81]
74 [2008] FCA 1834 at [127]
75 No directions had been made as at the date of publication of this paper
76 See generally, Edmonds, *Recourse to foreign authority in deciding Australian tax cases* (2007) 36 AT Rev 5

taxing regimes, such as with the European concept of 'direct and immediate link',[77] the justification for considering the UK cases is the touchstone of 'fair and reasonable' apportionment. As we shall see, the UK legislation provides for the making of regulations to secure a fair and reasonable attribution of input tax, so that comments on what is a fair and reasonable apportionment are of some relevance in an Australian context.

Lincoln Assurance Limited

In *Lincoln Assurance Limited v HMRC*,[78] the appellant appealed against a decision of Customs that, for the accounting period ending on 31 March 1999, the values of certain securities should not be included in the fraction used under the appellant's partial exemption method to determine the creditable portion of residual input tax.

Section 26(3) of the *Value Added Tax Act 1994 (UK)* provides, relevantly, that 'the Commissioners shall make regulations for securing a fair and reasonable attribution of input tax to [taxable and certain other defined] supplies . . .'

Regulation 101 of the *Value Added Tax Regulations 1995 (UK)* deals with the attribution of input tax between exempt (input taxed) supplies and taxable supplies. The amount of input tax which a taxable person is entitled to deduct is calculated by attributing to taxable supplies the whole of the input tax used exclusively in making taxable supplies; by providing that no part of the input tax used exclusively in making exempt supplies is attributable to taxable supplies; and by providing that, where supplies are used to make both taxable and exempt supplies, the amount of input tax attributable to taxable supplies is that proportion of the input tax used to make both taxable and exempt supplies which the value of the taxable supplies bears to the value of total supplies. This is called the 'standard method'.

It is plain from the Regulations that, in order to secure a fair and reasonable attribution, there should first be direct attribution before any apportionment, and that secondly a revenue method is prima facie fair and reasonable.

Regulation 102 provides that Customs may approve or direct the use of a method other than that specified in regulation 101. This is called a 'special method'.

The appellant had used the standard method since 1 January 1996.

Regulation 103 deals with the attribution of input tax to foreign and certain specified supplies. The House of Lords had earlier decided that this regulation was a separate regime for such supplies.[79] The issue before the VAT Tribunal concerned only input tax used in part to make specified supplies and in part to make other supplies (both taxable and exempt) in the United Kingdom and other member states. It was not disputed that the calculation under regulation 103 had to be based on use. What was in dispute was how use was to be determined.

The appellant argued that the value of the specified supplies as a proportion of total supplies represented a fair and reasonable measure of the use to which the supplies made to the appellant were put. Customs argued that a values-based method did not adequately reflect the

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[77] Compare GST Act, s 11-15
[78] (2008) VAT Decision No 20619
[79] *Customs and Excise Commissioners v Liverpool Institute for Performing Arts* [2001] STC 891

use of the supplies made to the appellant because few, if any, of those supplies were consumed directly in making specified supplies.

The Tribunal adopted a statement by Briggs J in *MBNA Europe Bank Ltd v Revenue and Customs Commissioners*:[80]

> 'But regulation 103 . . . merely requires the taxpayer to use any fair and reasonable way of attributing his residual inputs to specified out of country supplies that corresponds with his use of those inputs. He may choose any rationally fair method; there is no mandatory formula.'[81]

The Tribunal was assisted by an earlier decision of the Tribunal in *Merchant Navy Officer's Pension Fund Trustees Limited v The Commissioners of Customs and Excise,*[82] which was referred to with approval by Etherton J in *Banbury Visionplus Ltd v Revenue and Customs Commissioners.*[83]

In *Merchant Navy Officers* the issue before the Tribunal was whether a special method had achieved a fair and reasonable result and whether the standard method would achieve a fair and reasonable result. According to the VAT Tribunal in *Lincoln Assurance*:

> From [the decision in *Merchant Navy Officers*] we derive the principles that the attribution of inputs to different types of supply on the basis of actual use can, in some circumstances, be impossible or impractical in which case any other method will only approximate to actual use and has to be estimated or assumed. The method used must be fair and reasonable; should have the merit of simplicity; must be reasonable for the trader to operate; must not involve disproportionate or unreasonable resources; and should be capable of being checked by Customs and Excise without unreasonable effort.[84]

These principles would have application to an apportionment of inputs under the Australian GST law. That the method is 'fair and reasonable', 'be reasonable for the trader to operate', and 'capable of being checked . . . without unreasonable effort' seems entirely consistent with *Ronpibon Tin*. That the method 'should have the merit of simplicity', and 'not involve disproportionate or unreasonable resources' seems entirely consistent with a methodology 'which produces a practical or commonsense business result that accords with business reality'.[85]

Royal Bank of Scotland

In *The Commissioners for Her Majesty's Revenue and Customs v The Royal Bank of Scotland plc*,[86] (Lord President, Lords Kingarth and Penrose) the Commissioners had refused to approve a special method for the Royal Bank of Scotland plc (RBS) for allocating input tax on overhead expenditure incurred by companies within the RBS VAT Group.

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80 [2006] STC 2089 at [141]
81 (2008) VAT Decision No 20619 at [72]
82 (1996) VAT Decision No 14262
83 [2006] EWHC 1024 (Ch) at [49]
84 (2008) VAT Decision No 20619 at [79]
85 To paraphrase, in a slightly different context, D G Hill, *Some thoughts on the principles applicable to the interpretation of the GST*, (2003) 6 Journal of Australian Taxation 25
86 [2008] CSIH 49; see also *Nordania Finans A/S, BG Factoring A/S v Skatteministeriet* (2008) Case C-98/07 (ECJ)

The relevant part of the business provided asset finance, which was a form of hire purchase finance. It was agreed between the parties that, for the purposes of VAT, each transaction at the outset involved the purchase and hire of property, and the provision of instalment credit finance. The purchase and hire of the asset and other transactions relating to its disposal were taxable, while the provision of instalment credit finance was exempt.

The issue before the Tribunal was whether the method of apportionment of input tax incurred on overhead expenditure proposed by the bank was appropriate.

Prior to the dispute, the proportion of any unattributable input tax recoverable was computed in accordance with a method of calculation agreed between the Finance Houses Association and the predecessor of HMRC. The first step in the calculation required the allocation of the bank's total unattributable input tax as between instalment credit business and total receipts.

A fixed percentage of the resulting sum, 15%, was allowed to be recovered against the taxable supplies. The 15% was a compromise, reached following negotiations, for general application across the industry.

The method proposed by the bank was that the unattributed input tax should be allocated 50% to taxable supplies. It was argued that there were two main transactions involved in a hire purchase agreement, one taxable and one exempt, and that the input tax incurred was mainly attributable to the collection of the instalments. The instalments related to the repayment of the principal sum and the payment of interest.

Neither party relied on the value of the supplies. The Tribunal had noted that a method based on value would produce a high attribution to the taxable supply because 'the goods will almost invariably cost substantially more than the credit facility.' According to the Court, however, that appeared to 'confuse the cost of the input supplies with the value of the output supplies which had to be the relevant basis':

> The credit supplied by [the bank] may exceed or be less than the purchase price of the goods. [The bank obtains] discounts from suppliers of assets that are not necessarily passed on to its customers. In many cases customers are required to pay deposits. The relative values of the goods and of the finance provided are likely to be affected by the casual features of individual transactions that might be difficult to accommodate in a simple generally applicable formula. It is unnecessary to form any view on the applicability of value-based methods, however.[87]

The Court went on to say:

> It is apparent that there are methods of allocating the input tax incurred by [the bank]. Mr Tyre produced an analysis based on examination of 'processes' which differed in its result from that produced by Mr Melville. An analysis of activities might have been a better way of expressing the exercise. 'Process' accounting might best be left to manufacturing industry. But there is nothing unreal or artificial in posing the question whether particular input tax arises in respect of an activity that has a connection with the administration of the asset hired or with the administration of

[87] [2008] CSIH 49 at [25]

> credit. If such an approach is to be rejected it must be for reasons particular to the case that require to be explained so that they can be tested. As an alternative, value might have been considered as a possible basis for a result approximating to that sought by [the bank]. This is not a case in which one is driven to a wholly artificial result on the simple premise that the exercise is founded on a wholly artificial construct required for VAT purposes. The scheme of the statue requires one to make an allocation. The fairness and reasonableness of the method adopted must depend on facts found on the basis of the evidence.[88]

In the circumstances the Court quashed the Tribunal's decision as there were no relevant findings of fact sufficient to support the decision.

Summary of propositions

It is convenient to summarise here the propositions which emerge from the above discussion before proceeding to evaluate the position adopted by the Commissioner in apportioning inputs.

1. The fundamental reason for input taxing financial services is that it is difficult to value most financial services as they are often charged by way of a margin, which is the real economic subject of the supply: *HP Mercantile Pty Limited v Commissioner of Taxation*; Explanatory Statement to the GST Regulations; Explanatory Memorandum to the GST Act.

2. In a revenue-based formula for apportioning GST paid on acquisitions, the revenue for financial services charged by way of a margin should generally be the margin itself, which is the remuneration the supplier can actually take for itself: *The Commissioners of Customs and Excise v First National Bank of Chicago; MBNA Europe Bank Ltd v The Commissioners of HM Revenue and Customs.*

3. In the case of foreign exchange transactions, the revenue is the net result of foreign exchange transactions over a given period of time: *The Commissioners of Customs and Excise v First National Bank of Chicago.*

4. In the case of a supply of credit, the revenue is the interest and any relevant charges payable by the borrower, rather than the aggregate of the interest, the charges and the value of the promise to repay the principal: *MBNA Europe Bank Ltd v The Commissioners of HM Revenue and Customs.*

5. There are two kinds of items of expenditure that require apportionment. One kind consists in undivided items of expenditure that can be directly attributed to specific purposes. In such cases it may be possible to divide the expenditure in accordance with those purposes: *Ronpibon Tin NL & Tongkah Compound NL v Federal Commissioner of Taxation*.

6. The other kind of expenditure requiring apportionment is a single outlay or charge which serves two objects indifferently. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or rateable division because it is common to both objects. The apportionment must be fair, reasonable, proper and just: *Ronpibon Tin NL & Tongkah Compound NL v Federal Commissioner of Taxation; HP Mercantile Pty Limited v Commissioner of Taxation.*

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[88] [2008] CSIH 49 at [37]

7. The question of what expenditure is incurred in relation to a particular object is a question of fact and in the case of outlays which serve two objects indifferently, the result must depend in an even greater degree upon a finding by the tribunal of fact: *Ronpibon Tin NL & Tongkah Compound NL v Federal Commissioner of Taxation.*

8. An apportionment between two objects can be made even where there is no revenue stream from one of those objects: *Ronpibon Tin NL & Tongkah Compound NL v Federal Commissioner of Taxation.*

9. The attribution of inputs to different types of supply on the basis of actual use can, in some circumstances, be impossible or impractical in which case any other method will only approximate to actual use and has to be estimated or assumed. The method used must be fair and reasonable; should have the merit of simplicity; must be reasonable for the trader to operate; must not involve disproportionate or unreasonable resources; and should be capable of being checked by the ATO without unreasonable effort: *Lincoln Assurance Limited v HMRC; Merchant Navy Officer's Pension Fund Trustees Limited v The Commissioners of Customs and Excise; Banbury Visionplus Ltd v Revenue and Customs Commissioners.*

10. A taxpayer may choose any rationally fair method of apportionment; there is no mandatory formula: *MBNA Europe Bank Ltd v Revenue and Customs Commissioners.*

11. It cannot be concluded that you are driven to a wholly artificial result on the simple premise that the exercise is founded on a wholly artificial construct required for GST purposes. The scheme of the statute requires one to make an allocation. The fairness and reasonableness of the method adopted must depend on facts found on the basis of the evidence: *The Commissioners for Her Majesty's Revenue and Customs v The Royal Bank of Scotland plc.*

12. In a case of apportionment of general overhead expenses, the evidence should ideally specify the nature and use made of the things acquired in some detail, the attempts made to relate them directly to supplies, and the reason why the particular methodology and proxies proposed are most likely to approximate the relatedness between acquisition of the things and the use made of them: *AXA Asia Pacific Holdings Ltd v Commissioner of Taxation.*

13. A taxpayer's published financial statements are evidence of an admission by the taxpayer, but whether particular overhead expenses are related to particular input taxed supplies must be determined not by one piece of evidence or evidence of one particular kind but by reference to all of the evidence before the Court: *AXA Asia Pacific Holdings Ltd v Commissioner of Taxation.*

14. In determining the extent that acquisitions relate, directly or indirectly, to the making of any input taxed supplies, the subjective intention of the taxpayer is not determinative: *AXA Asia Pacific Holdings Ltd v Commissioner of Taxation.*

15. The GST is 'a practical business tax' reflecting the fact that it is a tax on business but, importantly, one that is designed, where practicable, to quarantine business from the ultimate burden of the tax. This does not mean, however, that there is some special canon of construction that should be applied when interpreting the GST Act.: *Saga Holidays Ltd v FCT*; *Sterling Guardian Pty Ltd v FCT*.

16. It is no part of the function of the Act or of those who administer it to dictate to taxpayers in what business they shall engage or how to run their business profitably or economically. The Act must operate upon the result of a taxpayer's activities as it finds them: *Tweddle v FC of T*; *Ronpibon Tin NL and Tongkah Compound NL v FC of T*; *Cecil Bros Pty Ltd v FC of T*; *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd*; *FC of T v South Australian Battery Makers Pty Ltd*; *Magna Alloys & Research Pty Ltd v FC of T.*

GSTR 2006/3

GSTR 2006/3, 'Goods and services tax: determining the extent of creditable purpose for providers of financial supplies', is the leading public ruling on the apportionment of GST paid on acquisitions related in part to the making of financial supplies. The ruling needs to be evaluated against the propositions which have emerged from the decided cases, as well as against the practical guidance it gives taxpayers and ATO officers alike.

The ruling makes clear 'that any method . . . utilised in calculating input tax credits . . . must be fair and reasonable in the circumstances of the conduct of your enterprise.'[89] This reflects the approach taken in *MBNA Europe Bank* that a taxpayer may choose any rationally fair method of apportionment.

The Commissioner initially proceeds on the basis that acquisitions that can be directly attributed to a particular purpose should be so attributed. If the acquisition is allocated solely for a creditable purpose, no apportionment is necessary.[90] If the acquisition is allocated not at all for a creditable purpose, you are not entitled to any input tax credits.[91] If the acquisition is partly creditable, you need to apportion the total purpose between that part which on your estimate is creditable and that which is not.[92]

Importantly, 'the Commissioner recognises that, from a practical point of view, it may be difficult to fully attribute individual costs via existing direct estimation systems in many organisations. If financial supply providers are unable to match individual acquisitions with individual revenue streams, other apportionment methods (including combinations of direct and indirect methods) may need to be used.'[93] This would appear to adopt the *Lincoln Assurance* principle that the method used should have the merit of simplicity, and be reasonable for the trader to operate.

The examples in the ruling are more illuminating than the text of the ruling itself:

> Example 2 – establishing the extent of creditable purpose – combined use of direct and indirect methods
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> 82. FinanceCo has two business units, one of which makes taxable leasing supplies only, while the other makes input taxed supplies of chattel mortgages. These business units are physically separate and utilise different accounting systems. As part of a major IT upgrade, FinanceCo acquires 1000 desktop computers. 600 of these are intended to be used immediately in the leasing area, 300 in the chattel mortgage area

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89 GSTR 2006/3, paragraph 4
90 GSTR 2006/3, paragraph 28
91 GSTR 2006/3, paragraph 29
92 GSTR 2006/3, paragraph 30
93 GSTR 2006/3, paragraph 101

and 100 will be held in stock in anticipation of an imminent upturn in the financing industry.

83. FinanceCo determines using a direct method that the 600 computers allocated to the leasing area are each acquired solely for a creditable purpose, and that the 300 allocated to the chattel mortgage area are each not acquired for a creditable purpose to any extent. In relation to the 100 units held in stock, as the anticipated upturn in activity is considered to equally affect both areas, FinanceCo uses an indirect method based on the specific allocation of the 900 computers. Therefore, as 600 of the 900 computers (two-thirds) specifically allocated were solely for a creditable purpose, the 100 units held in stock are each treated as being for a creditable purpose to the extent of two-thirds. This method of establishing extent of creditable purpose is fair and reasonable in FinanceCo's circumstances, subject to adjustments, if appropriate, under Division 129.

This example is not controversial (except perhaps for the imminent upturn in the financing industry), but its facts are relevant to the next example:

Example 3 – use of an overall indirect estimation method

86. Using the facts of Example 2, FinanceCo has determined using historical information that, as a whole, 55% of acquisitions relate to leasing, and 45% relate to chattel mortgages. This is based on an overall consideration of the intended use of all acquisitions in these business areas, including overheads, and the apportionment is reviewed by it periodically. The computer upgrade was budgeted for, and therefore taken into account when calculating the overall 55/45 recovery rate for the current year. FinanceCo has satisfied itself that the use of this method is fair and reasonable in its circumstances. It has a system in place to comply with Division 129, if the creditable use of acquisitions changes over time.

87. FinanceCo therefore calculates its input tax credit claim based on 55% of each of the 1000 computers acquired. FinanceCo considers that all the acquisitions made by its enterprise will result in an overall 55/45 use of total acquisitions across the two business units. Although FinanceCo had access to direct methods of calculating the extent of creditable purpose of the computers, its choice of an overall indirect method is fair and reasonable, subject to adjustments, if appropriate, under Division 129.

This example is clearly concessional. Although the taxpayer is able to directly attribute the acquisitions of computers as either creditable or non-creditable, the taxpayer is permitted to use an overall indirect method. There is no warrant in the legislation for this, or in the apportionment cases. It is also inconsistent with earlier statements of principle in the ruling that acquisitions that can be directly attributed to a particular purpose should be so attributed.[94]

The example is also a little circular. The overall indirect method is fair and reasonable if the calculation has already taken future acquisitions into account in determining the overall recovery rate, so that it would be mathematically equivalent to direct attribution in any event. It is perhaps unsurprising that we now have ATO auditors asking taxpayers in the financial

[94] GSTR 2006/3, paragraphs 28 and 29

services industry to justify their indirect methods my reference to what direct attribution would have given.

The Commissioner considers that if your accounts satisfy Australian Accounting Standards, or prudential requirements of equivalent rigor, they may provide an appropriate foundation for applying a direct estimation method, subject to that application being fair and reasonable in your individual circumstances.[95] Following the *AXA* decision, it might now be better expressed that a taxpayer's published financial statements are evidence of an admission by the taxpayer, but whether particular overhead expenses are related to particular input taxed supplies must be determined not by one piece of evidence or evidence of one particular kind but by reference to all of the evidence before the Court.

There is considerable discussion in the ruling of indirect estimation methods including, but not limited to: an overall, entity-based general formula, based on the proportion of input taxed and non-input taxed revenues of the entity as a whole; revenue-based formulas which are more narrowly targeted than the entity-based general formula; a combination of revenue-based formulas with direct methods; and non-revenue based indirect estimation methods.[96]

The basic revenue-based formula is expressed as follows:

$$\frac{\text{Revenue* (other than revenue from input taxed supplies)}}{\text{Total Revenue* (including revenue relating to input taxed supplies)}} \times 100$$

> *'Revenue' may be either net revenue or gross revenue depending on which provides the more appropriate reflection of the use of acquisitions in your circumstances. In any case, a consistent approach (gross or net) should be used for the same revenues occurring in both the numerator and denominator.[97]

This definition of 'revenue' marked a departure from the previous definition in the predecessor ruling GSTR 2000/22, and introduced an unnecessary degree of uncertainty. The previous definition stated that revenue 'is **net** revenue for financial supplies and **gross** revenue for non-financial supplies. Where a net **interest** figure gives a better reflex of the consideration for a financial supply, we accept that figure as the appropriate component. However, gross revenue can be used for non-financial supplies.'[98]

The earlier definition was endeavouring to capture the point discussed above that, in a revenue-based formula for apportioning GST paid on acquisitions, the revenue for financial services charged by way of a margin should generally be the margin itself, which is the remuneration the supplier can actually take for itself, and is the real economic subject of the supply. That is presumably why the definition specified net revenue for financial supplies and gross revenue otherwise. It is true that the earlier definition might have been better worded – not all input taxed financial supplies are charged by way of a margin (a supply of shares for example). But the earlier definition at least captured an important point missing from the later definition.

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[95] GSTR 2006/3, paragraph 100
[96] GSTR 2006/3, paragraph 104 and following
[97] GSTR 2006/3, paragraph 109
[98] GSTR 2000/22, paragraph 62

Example 11 in GSTR 2006/3 is the most comprehensive example on apportionment published by the ATO and is deserving of close attention. The example shows how a revenue-based method works in practice. The method is applied to certain acquisitions of a bank which cannot be allocated by available direct methods. The revenue-based formula is the same as that set out above. An identical factual example was used in GSTR 2000/22.

There are several components in the calculation. Components A to F are 'GST-free financial services revenues'. Components G and H are 'revenue from taxable supplies'. Components I to N are 'revenue in relation to total supplies'.

The example states that 'Components A and I in the table are net revenues'. Somewhat cryptically, the example then states that the 'treatment of other components will depend on the nature of the income', but there is no statement of principle to explain what this means. This departs from the identical example in GSTR 2000/22 which stated that 'all components in the general formula are net revenues except for components C, G and K. These components are gross amounts.'

Components A and I relate to revenue from forex and derivative 'trading' activities. In the notes explaining each component, Components A and I are confusingly joined with Component L, being 'other revenue from financial services', under the heading 'Actual margin'.

There seems to be an implicit assumption that revenue from financial services should be accounted for on a margin basis. In dealing with these components together, the ATO states:

> . . . The method used for calculating margins should be the revenue method used in your accounting records. Revenues from hedging derivatives, being typically accounted for against the underlying product being hedged on an accrual basis (by a business unit) will generally be included in the interest income/expense component of the formula.
>
> The use of an actual margin may contribute to volatility in the percentage calculated under the formula. For example, in some years, the actual margin from these activities may result in a negative value. This would suggest that it is not a representative figure. In these circumstances you should use an alternative option.[99]

It is interesting to observe that in relation to credit and card charge businesses, discussed below, the Commissioner does not accept that the 'method used for calculating margins should be the revenue method used in your accounting records.'

Determining foreign exchange revenue by reference to the margins involved seems entirely appropriate and consistent with the reasoning in *First National Bank of Chicago.* However, the suggestion that a negative margin might not be representative and, hence, cannot be used, is misconceived.

In the first place, if the margin is a good measure of revenue to begin with, why should it only be a good measure when it is positive? The Commissioner cannot have it both ways. Second, it offends the principle that the Act must operate upon the result of a taxpayer's activities as it

[99] GSTR 2006/3, paragraphs 172-173

finds them. It is not for the Commissioner to dictate to taxpayers how to run their business profitably or economically. If the margin is negative, so be it. Third, the ruling is inconsistent with overseas practice. For example, the Singaporean approach allows negative margins from forex dealings.[100]

Component B is ‘interest from non-residents’. According to the ATO:

> This amount should consist of interest income from non-residents less interest expense related to off-shore lending. Most businesses should already be identifying interest paid to non-residents for withholding tax purposes.[101]

The important point here is that interest income is being dealt with on a margin basis: interest income less interest expense. This is consistent with the comments in *MBNA Europe Bank* and *HP Mercantile.* It reflects the fact that the collective fee for the bank’s intermediation services are being provided to both depositors and borrowers. As we shall see below, it is surprising that the Commissioner has now departed from this approach.

Component C is ‘fees and commissions from non-residents’. These are dealt with on a gross receipts basis which seems appropriate for non-input taxed, non-margin supplies.

Component D is ‘other revenue from non-residents’. No indication is given as to the basis on which this should be brought to account, presumably being dependent upon the nature of the supplies made.

Components E, F and M relate to life insurance products. Components E and F are each GST-free supplies of life insurance. Component E relates to supplies to non-residents that qualify as exports, while Component F relates to supplies made under agreements that qualify for transitional relief. The ruling simply states: ‘You should include revenue from these supplies at Component E and F respectively’. Confusingly, however, the very next paragraph states:

> Other supplies of life insurance, included at Component M, may be calculated as follows:
>
> **Revenue =**
>
> $$\left(\begin{array}{c}\text{Shareholder}\\\text{Operating}\\\text{profit after}\\\text{tax}\end{array} + \begin{array}{c}\text{Acquisition}\\\text{Costs}\end{array} + \begin{array}{c}\text{Policy and}\\\text{maintenance}\\\text{costs}\end{array} + \begin{array}{c}\text{Investment}\\\text{management}\\\text{expenses}\end{array}\right) - \begin{array}{c}\text{Interest}\\\text{on}\\\text{retained}\\\text{earnings}\end{array}$$
>
> This calculation is based on Australian Accounting Standard AASB 1038.[102]

A number of comments may be made about this.

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[100] Inland Revenue Authority of Singapore, *GST: Partially Exempt Traders And Input Tax Recovery* (3rd ed, 1 January 2009)
[101] GSTR 2006/3, paragraph 174
[102] GSTR 2006/3, paragraph 174

First, if this revenue formula is relevant to supplies of life insurance, why is it only relevant to Component M and not Components E and F? The Ruling sheds no light on this but unless the formula is applied to all supplies of life insurance then the apportionment methodology will be comparing apples with oranges. Perhaps the ruling intends for all life insurance to be dealt with in the same way. If so, it fails to say so and is quite confusing.

Second, the formula is margin based, though there are different ways to calculate a margin and this margin is calculated quite differently from any other.

Third, the ruling is not clear about why this formula should be used. As we have already discussed, while a taxpayer's published financial statements are evidence of an admission, that is just one piece of evidence before the Court.

Fourth, if Australian Accounting Standards are to be used to determine one component of a revenue formula, why wouldn't consistency dictate that all components of the revenue formula are determined from accounting standards?

Component F relates to financial supplies that are GST-free pursuant to section 13 of the *A New Tax System (Goods and Services Tax Transition Act) 1999*. The notes shed no light on the basis on which these supplies should be valued.

Component G relates to fees and commissions, while Component N relates to 'other income' which, given the other components, necessarily excludes forex and derivatives, life insurance and financial services. The note to these components states:

> Commissions and fees from agency or other non-financial supplies should be included in this Component. Some examples are advisory trustee and custodian services, brokerage and merchant fees. The fees and commissions should be accounted for on a gross basis before deducting any related expenses.[103]

This treatment would seem to be correct if understood as relating to taxable supplies under the basic GST rules.

Component H is other income from taxable supplies, and is presumably included on a gross basis though this is not explicit in the ruling.

GSTR 2006/3 is a lengthy ruling relying on a mantra of that which is 'fair and reasonable'. While no exception can be taken to that mantra, it does little to assist taxpayers in any practical sense and, as we shall see below, can only lead to disputes between taxpayers and the Commissioner as each take diametrically opposing views on what is fair and reasonable. The mantra of 'fair and reasonable' is hardly a substitute for the certainty a ruling should endeavour to provide.

The ruling is distinctly unclear about major concepts underpinning apportionment methodologies. The statements on direct attribution are equivocal, with a circular example that an overall indirect method is fair and reasonable if the calculation has already taken direct attribution into account. The statements on the use of Australian Accounting Standards are piecemeal and, in the case of the major example given, confusing and inconsistent. For all of

[103] GSTR 2006/3, paragraph 180

the times that the mantra of 'fair and reasonable' is used in the ruling (over 60 times), there are no statements of principle that give further colour to this phrase. And on the fundamental issue of the use of gross receipts or net margin in a revenue formula, what principle there is must be gleaned from implicit assumptions used in an example.

Even worse, taxpayers who seek to rely upon this ruling may not obtain ruling protection at all. Section 105-60 of the *Taxation Administration Act 1953 (Cth)* applies to you if:

(a) the Commissioner alters a previous indirect tax ruling that applied to you; and
(b) relying on the previous ruling, you have underpaid a net amount or an amount of indirect tax, or the Commissioner has overpaid an amount under section 35-5 of the GST Act, in respect of certain supplies and acquisitions that happened before the alteration.

A previous ruling must have 'applied to you' if you are to obtain the protection afforded by the statute. It is therefore important that the facts on which the ruling was based be clearly identified.[104] As with the income tax rulings system, a distinction might well be drawn between the way in which the law applies to a particular set of facts, and 'the principles or reasoning' stated in the ruling.[105] As Merkel J commented in *Bellinz Pty Limited v FC of T*[106]:

> By making a ruling that states that it is binding 'to the extent it is capable of being a public ruling', or that a particular arrangement is 'likely to be regarded as a hire purchase arrangement', or that tax treatment of a particular arrangement is to be 'generally' as outlined the Commissioner is not providing the certainty that binding public rulings are intended to provide. Further, rulings in such terms obviously have a tendency to mislead which is antithetical to the system of certainty and fairness intended to be provided to taxpayers by the public rulings system.[107]

It would be a brave taxpayer who relies on the 'principles' in GSTR 2006/3 without the protection of a private GST ruling. Note also that you must have 'relied' upon a GST ruling to obtain protection,[108] which is quite different to the income tax rulings system.

Given the absence of fundamental statements of principle, the inconsistencies in statements, and the lack of certainty provided to taxpayers, GSTR 2006/3 should be rewritten in its entirety.

Singapore

The rules for apportionment of inputs for financial institutions in Singapore are simpler and clearer than in Australia. Singapore is relevant because it is an acknowledged centre for financial services in the Asia-Pacific region. In the Singaporean equivalent to GSTR 2006/3[109] the rules are set out as follows:

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[104] See *Bellinz Pty Limited v FC of T* (1998) 98 ATC 4399 at 4405; and (1998) 98 ATC 4634
[105] (1998) 98 ATC 4399 at 4413
[106] (1998) 98 ATC 4399
[107] (1998) 98 ATC 4399 at 4417
[108] See *Magna Stic Magnetic Signs Pty Ltd & Ors v FCT* (1989) ATC 5000
[109] Inland Revenue Authority of Singapore, *GST: Partially Exempt Traders And Input Tax Recovery* (3rd ed, 1 January 2009), paragraph 7.1

Where a partially exempt trader does not satisfy the de minimis Rule, he will have to claim his input tax as follows:

(i) input tax directly attributable to the making of taxable supplies will be claimable;

(ii) [not relevant to most major financial institutions]

(iii) input tax directly attributable to the making of . . . exempt supplies is not claimable;

(iv) residual input tax, i.e. input tax that is not directly attributable to the making of taxable or [input taxed] supplies, shall be apportioned in the following manner:-

(a) [not relevant to most major financial institutions]

(b) otherwise –

$$\text{Recoverable residual input tax} = \text{Total residual input tax} \times \frac{\text{Value of taxable supplies}}{\text{Value of total supplies}}$$

The Singaporean document contains much more than this but is nevertheless admirably succinct. It is also apparent from a worked example that the Singaporean Inland Revenue value taxable supplies on a gross basis, margin-based input taxed supplies on a margin basis ('foreign exchange gain/loss on sales'), and non margin-based input taxed supplies on a gross basis (sale of shares).[110]

A rewrite of GSTR 2006/3 should pay close attention to the Singaporean equivalent.

United Kingdom

The United Kingdom is also relevant because it is an acknowledged centre for financial services, and is a proxy for other European jurisdictions. The UK equivalent to GSTR 2006/3 sets out the applicable principles,[111] though it should be borne in mind that some of the attribution principles are prescribed by regulation.

First there is direct attribution: 'You can recover, in full, input tax on supplies of goods and services that are used, or to be used, exclusively in making taxable supplies or other supplies that carry the right to deduct', and 'in principle you cannot recover any of the input tax on supplies of goods and services used, or to be used, exclusively in making exempt supplies or other supplies in respect of which input tax is non-recoverable.'[112]

Residual input tax that cannot be directly attributed will be subject to either the standard partial exemption method (suitable for most small businesses) or a special method.[113] The standard method calculation[114] is:

[110] Inland Revenue Authority of Singapore, *GST: Partially Exempt Traders And Input Tax Recovery* (3rd ed, 1 January 2009), paragraph 12
[111] Notice 706, Partial Exemption, December 2006
[112] Notice 706, Partial Exemption, December 2006, paragraph 3.3
[113] Notice 706, Partial Exemption, December 2006, paragraph 3.9
[114] Notice 706, Partial Exemption, December 2006, paragraph 4.3

$$\frac{\text{Value of taxable supplies In the period (excluding VAT)}}{\text{Total value of supplies in the Period (excluding VAT)}} \times 100 = \text{Recoverable percentage of residual input tax}$$

Much of what is set out in the UK Notice is not prescribed by regulation. It provides that a number of supplies, whether taxable or exempt, are excluded from the calculation to prevent them from distorting the result, for example:

- supplies of capital goods used for the purposes of the business;
- incidental real-estate transactions;
- incidental financial transactions; and
- supplies of a going concern.[115]

It is also clear from an example given that the Inland Revenue also excludes any blocked input tax, for example, non-creditable entertainment expenditure.[116]

All special method calculations should:

- reflect all your business activities;
- provide for direct attribution of input tax to taxable supplies;
- provide for direct attribution of input tax to exempt supplies;
- identify residual input tax;
- calculate the element of residual input tax that relates to taxable supplies;
- calculate the element of residual input tax that relates to exempt supplies; and
- allow you to determine the total input tax that you can recover.[117]

Interestingly, and with effect from 1 April 2007, HMRC will only approve a special method if the business has declared it to be fair and reasonable. The declaration requires that a reasonable person has taken reasonable steps to ensure the proposed method is fair.[118]

A rewrite of GSTR 2006/3 would benefit from looking at its UK equivalent which, like Singapore, is a much simpler document.

Current Practical Problems

We now examine two current practical problems which amply demonstrate that the mantra of ‘fair and reasonable’ provides little or no assistance to financial suppliers charged with the responsibility of formulating apportionment methodologies. Even worse, the lack of a single, coherent statement of principle in a public ruling on the use of gross receipts or net margin in a revenue formula is leading to major disputes between the Commissioner and financial suppliers.

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[115] Notice 706, Partial Exemption, December 2006, paragraph 4.4
[116] Notice 706, Partial Exemption, December 2006, paragraph 4.8
[117] Notice 706, Partial Exemption, December 2006, paragraph 6.4
[118] Notice HM Revenue & Customs Brief 23/07, VAT: Partial Exemption special method approvals, 14 March 2007

Hire Purchase

One of the financial supplies mentioned in the GST Regulations is an interest in or under:

> Credit under a hire purchase agreement in relation to goods, if:
> (a) the credit for the goods is provided for a separate charge; and
> (b) the charge is disclosed to the recipient of the goods.[119]

There are complexities in this area of law. First, it must surely be an open question whether it is within the scope of the regulation making power for the regulations themselves to deem part of a taxable supply (a taxable hire agreement) to be something which it is not (a supply of credit).[120] Second, some have taken the view that because a 'charge' is disclosed within the meaning of paragraph (b) (for the purpose of complying with the uniform credit code, for example), paragraph (a) is necessarily satisfied. But that does not seem to follow. The Act takes transactions as it finds them and, in the case of a hire purchase agreement, there is simply a hire with an option to purchase. But let us assume for the purpose of this discussion that the regulation has been validly made and a disclosed hire purchase agreement is covered by the regulation.

In Practice Statement PS LA 2008/1 (GA),[121] the ATO states that two separate and distinct supplies are made under a disclosed hire-purchase agreement. These are the taxable (or GST-free) supply of the goods and the input taxed (financial) supply of an interest in or under a credit arrangement.[122] In 2002 the Commissioner set out his views on disclosed hire-purchase arrangements on the ATO website and stated, among other things:

> . . . the use of a general formula approach incorporating gross revenues for non-financial supplies (for example bailment and the supply of vehicles), and net revenues for financial supplies under hire-purchase agreements is not a fair and reasonable method of determining the extent of creditable purpose for overheads. This inconsistent treatment of financial supplies and taxable supplies in the general formula gives a weighting to taxable supplies which is out of proportion to the input taxed activities carried out . . .[123]

As we have discussed, in a revenue-based formula for apportioning GST paid on acquisitions, the revenue for financial services charged by way of a margin should generally be the margin itself. And we have seen that Example 11 in GSTR 2006/3 dealt with interest income on a margin basis, consistent with the comments in *MBNA Europe Bank* and *HP Mercantile.* The statement by the Commissioner on the website in 2002 is wrong in principle.

In the more recent Practice Statement (which purports not to be a public ruling), the Commissioner states:

> A justifiable apportionment methodology in this context is one that takes into account the level of enterprise activities or business effort devoted to the taxable and input

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119 *A New Tax System (Goods and Services Tax) Regulations 1999*, regulation 40-5.09(3), Item 8
120 See generally K O'Rourke, *Are the GST Regulations dealing with Financial Supplies beyond power? Interpreting deeming provisions in the GST law*, ATAX Noosa, 13 April 2007
121 Practice Statement PS LA 2008/1 (GA), GST and input tax credits for acquisitions related to making supplies under a disclosed hire-purchase agreement
122 Practice Statement PS LA 2008/1 (GA), paragraph 13
123 Reproduced in Practice Statement PS LA 2008/1 (GA), paragraph 25

> taxed elements of a disclosed hire-purchase agreement. In this regard, the Commissioner considers that the main activity of such an enterprise predominantly involved the provision of credit and consequently the majority of expenditure would be related to the making of input taxed supplies.[124]

The statement by the Commissioner that the main activity in hire-purchase arrangements predominantly involves the provision of credit is contrary to his earlier view, in the context of the attribution rules, that the purchase is the 'paramount purpose'.[125] The earlier view facilitated the Commissioner bringing forward the time at which GST is attributed on the taxable component of hire-purchase arrangements.

The Practice Statement continues:

> . . . the Commissioner maintains the view that the use of a revenue based formula approach is not a fair and reasonable method of determining the creditable purpose of partly creditable acquisitions because it allocates a disproportionate amount of expenditure to the taxable activity which is contrary to the fundamental nature of the typical enterprise offering this type of credit arrangement.[126]

This is a very curious result. It might be thought that the Commissioner's main objection is that a revenue formula gives a result that permits a higher recovery of credits than he would like, rather than any objection based on principle. Of course, the same financier with a non-disclosed hire-purchase agreement (or with leasing agreements) would have a fully taxable supply, with the same amount of effort being directed to the provision of 'credit'. Yet with a deemed input taxed supply of an interest in or under a credit arrangement, the Commissioner takes the view that the main activity of the enterprise is the provision of credit. But as we have discussed, the Act takes transactions as it finds them and, in the case of a hire purchase agreement, there is simply a hire with an option to purchase. The main activity of the financier is actually a supply by way of hire.[127]

It will be recalled that in the *Royal Bank of Scotland* case,[128] the Tribunal had stated that a method based on value would produce a high attribution to the taxable supply because 'the goods will almost invariably cost substantially more than the credit facility.' But according to the Court, obiter dictum, the Tribunal's reasoning appeared to 'confuse the cost of the input supplies with the value of the output supplies which had to be the relevant basis'.[129] The Court also noted that: 'value might have been considered as a possible basis for a result approximating to that sought by [the bank]. This is not a case in which one is driven to a wholly artificial result on the simple premise that the exercise is founded on a wholly artificial construct required for VAT purposes. The scheme of the statue requires one to make an allocation. The fairness and reasonableness of the method adopted must depend on facts found on the basis of the evidence.'[130]

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124 Practice Statement PS LA 2008/1 (GA), paragraph 27
125 GSTR 2000/29, paragraphs 195-196
126 Practice Statement PS LA 2008/1 (GA), paragraph 29
127 See also *Freight Transport Leasing Ltd* (1990) VAT Tribunal Case 5578 at 4: 'In hire-purchase transactions, strictly speaking, it may be said that no element of credit is involved.'
128 [2008] CSIH 49
129 [2008] CSIH 49 at [25]
130 [2008] CSIH 49 at [37]

GSTR 2006/3 makes clear that any method may be used to calculate input tax credits provided it is fair and reasonable in the circumstances of the conduct of your enterprise. The Commissioner is effectively saying that a revenue-based method can never be an appropriate method for a hire purchase business on the dubious ground that a revenue formula gives a result that permits a higher recovery of credits than he would like (albeit thinly disguised by the statement that it is 'contrary to the fundamental nature of the typical enterprise offering this type of credit arrangement').

The Commissioner has stated that 'a taxpayer will be at a risk of audit in circumstances where they have applied a revenue based formula incorporating . . . gross revenues for non-financial supplies and net revenues for financial supplies. This is due to the ATO view on such practices being clearly outlined in GST public rulings.'[131] It is clear from a footnote that the public rulings comprise the statement on the website referred to above, and the definition of 'revenue' in the revenue-based formula in GSTR 2006/3. As we have seen, the statement on the website is wrong in principle, and GSTR 2006/3 is hardly a model of clarity on this issue. Example 11 in that ruling endorses a revenue based formula incorporating gross revenues for non-financial supplies and net revenues for financial supplies. The public ruling and the Practice Statement are simply inconsistent.

In the light of these observations, the Practice Statement must surely be withdrawn to make way for a clear statement of principle in a public ruling. The accompanying threat of audits is seriously misplaced and should be withdrawn with the Practice Statement.

Credit and Charge Card Businesses

Ignoring overseas transactions, a card issuer will typically make both input taxed financial supplies (a supply of credit) and taxable supplies (the provision of services). The consideration for the supply of credit will include interest, together with card and transaction fees. The consideration for the supply of services will include interchange and merchant service fees. Such a business was well described by Briggs J in *MBNA Europe Bank Ltd v Revenue and Customs Commissioners*:[132]

> The essential features of MBNA's credit card business are that pursuant to contracts with its card holding customers, MBNA is required to finance their purchases by making funds available through the credit card and banking systems, ultimately for the benefit of retailers and other suppliers to those customers, equivalent to the cost of the goods and services required by the customer, less a charge ultimately paid by the retailer known as 'interchange'. . . Customers using cards for the purchase of goods or services obtain interest free credit until the end of the month in which those purchases occurred. Thereafter, if they choose not to pay the full amount by the end of the month, they pay interest on any balance unpaid. If their month end payments fall short of a stipulated minimum, they may also be liable to pay penalties. . . The aggregate of interest, penalties and fees payable under the relevant credit card agreements are known as 'finance charges'.

In a paper circulated to industry members, the Commissioner has taken the view that a revenue based formula that calculates margin, or net income, must allocate interest expense

131 Practice Statement PS LA 2008/1 (GA), paragraph 35
132 [2006] STC 2089 at [43]

on a proportional basis to both input taxed and taxable revenue, rather than by allocating interest expense to interest revenue.

The apparent basis for this view is that many cardholders pay no interest on the supply of credit because they pay off their card debt within an interest free period. The Commissioner considers that the cost of funding the interest free period is factored into interchange fees and that an appropriate apportionment methodology should take into account the relationship between the cost of funding and the interchange supply.

There are several difficulties with the approach being taken by the Commissioner.

First, interest expense should generally be netted against the interest to which it relates. We discussed above how in a revenue-based formula for apportioning GST paid on acquisitions, the revenue for financial services charged by way of a margin should generally be the margin itself, and that in the case of a supply of credit, the revenue is the net interest. We have also seen that Example 11 in GSTR 2006/3 dealt with interest income on a margin basis. It is inappropriate to net interest expense against other unrelated income.

Second, the Commissioner seems to be concerned that there is a cross-subsidy within a card business as customers who pay interest, often at relatively high levels, subsidise those who do not. Interest expense is recovered through the interest charges passed on to customers. We have seen that the Act must operate upon the result of a taxpayer's activities as it finds them, and it is not for the Commissioner to allocate interest expense in a manner he would prefer to do in the absence of a cross subsidy.

Third, the netting of interest in card businesses is required under the relevant accounting standard, and is what financial suppliers do in practice.[133] In this respect, the Commissioner's approach is contrary to what is said in GSTR 2006/3.[134]

Fourth, a corollary of the Commissioner's reasoning is that he is comfortable including gross interest in a revenue-based formula for credit card operations. Quite apart from the lack of principle in that approach, recovery rates would fluctuate dramatically on the rise and fall of interest rates, such as in recent times when the official cash rate has halved.

Fifth, GSTR 2006/3 makes clear that any method may be used to calculate input tax credits provided it is fair and reasonable in the circumstances of the conduct of your enterprise. The Commissioner is effectively saying that the netting of interest expense in card businesses, while consistent with business operations, accounting standards and the netting of interest generally, can never be a rationally fair method of apportionment. That is quite an assertion.

The Commissioner has issued quite a number of private rulings to financial suppliers allowing them to net interest expense against interest revenue in card businesses. The Commissioner now proposes to withdraw those private rulings. Even worse, for those financial suppliers without private rulings, the Commissioner proposes to impose his view from the date of issue of GSTR 2006/3. Like his approach on the hire-purchase issue, the Commissioner now takes the view that the position on revenue-based calculations was clearly outlined in a public ruling.

[133] See Australian Accounting Standards AASB 118, *Revenue*, and AASB 139, *Financial Instruments: Recognition and Measurement*

[134] GSTR 2006/3, paragraphs 172-173

But we have seen above that GSTR 2006/3 does not contain a single statement of principle on the use of gross receipts or net margin in a revenue-based formula, let alone any discussion of hire-purchase or card businesses. The only statement or principle was contained in the predecessor to GSTR 2006/3, but this was omitted in the rewrite and not replaced with any further clarifying principle.

The discussion paper should be withdrawn, together with the accompanying threat of withdrawing private rulings and making retrospective adjustments.

Summary and Recommendations

This paper set out to discuss the legal framework for the apportionment of GST paid on acquisitions related in part to the making of financial supplies and, to that end, has summarised a number of propositions which have emerged from decided authorities.

We have seen that the fundamental reason for input taxing financial services is that they are difficult to value, especially when charged for by way of a margin. It is ironic that revenue-based formulae for apportioning GST paid on acquisitions require the valuation of the very financial supplies that are input taxed because they are difficult to value. But the courts have taken a reasonable view about this and, in the case of margin based supplies, have allowed the margin itself to be used in calculations as this is the remuneration the supplier can actually take for itself.

The propositions which have emerged from the decided authorities have not been fully expressed in the Commissioner's public rulings and pronouncements, but are most notably lacking in GSTR 2006/3. The definition of 'revenue' in that ruling marked a departure from the previous definition and introduced an unnecessary degree of uncertainty. We are left instead with a mantra of 'fair and reasonable' but not a single statement of principle on the use of gross receipts or net margin in a revenue-based formula. Even worse, taxpayers who seek to rely upon this ruling may not obtain ruling protection at all.

In the light of the discussion above it is recommended that:

1. GSTR 2006/3 should be rewritten in its entirety and, in so doing should:

    (a) Incorporate relevant propositions of law and relevant statements of principle.

    (b) Provide practical guidance to financial suppliers in accordance with those statements of law and principle.

    (c) Benefit from close attention to overseas equivalents, most notably in Singapore and the UK.

2. The Practice Statement on hire-purchase should be withdrawn, with relevant principles and guidance incorporated into a rewritten GSTR 2006/3.

3. The discussion paper on card businesses should be withdrawn, with relevant principles and guidance incorporated into a rewritten GSTR 2006/3.

4. The threat of audits on hire-purchase arrangements should be withdrawn pending a rewrite of GSTR 2006/3.

5. The threat of withdrawing private rulings on card businesses, and of making retrospective adjustments, should be withdrawn pending a re-write of GSTR 2006/3.