

The Senate

Economics
Legislation Committee

Tax and Superannuation Laws Amendment
(2016 Measures No. 1) Bill 2016 [Provisions]

March 2016

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Chapter 1

Introduction and background to the bill

Referral and conduct of the inquiry

1.1 On 25 February 2016, the Senate referred the provisions of the Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016 (the bill) to the Senate Economics Legislation Committee for inquiry and report by 10 March 2016.¹ The bill was introduced into the House of Representatives on 10 February 2016 by the Treasurer, the Hon Scott Morrison MP.

1.2 The committee advertised the inquiry on its website and received six submissions. A list of the submissions received is at Appendix 1.

1.3 The committee received several pieces of correspondence from stakeholders noting that the short amount of time between the bill's referral and the committee's reporting date meant that they were unable to prepare written submissions.

Structure of report

1.4 This report comprises three chapters. The remaining part of this chapter provides an overview of the bill. The second chapter discusses the proposed changes in Schedule 1 of the bill. The third and final chapter considers the proposed changes contained in Schedules 2 and 3 of the bill. The committee's overall conclusion is at the end of chapter 3.

Explanatory memorandum

1.5 Many of the changes proposed by the bill are highly technical in nature. While this goes some way to explaining the length and density of the explanatory memorandum (EM), the committee encourages the Departments involved in the production of these documents to remember their purpose—namely, to clarify for members, Senators and the general public the purpose and the operation of the proposed amendments in the bill. Given the provisions of this bill affect domestic and international businesses, as well as small and medium agriculture business, the EM could have been clearer and more informative.

The Senate Standing Committee for the Scrutiny of Bills

1.6 The Senate Standing Committee for the Scrutiny of Bills assesses legislative proposals against a set of accountability standards that focus on the effect of proposed legislation on individual rights, liberties and obligations, and on parliamentary propriety. The Scrutiny of Bills Committee considered the bill, but had no comment to make.²

1 *Journals of the Senate* No. 141, 25 February 2016, p. 3816.

2 Senate Standing Committee for the Scrutiny of Bills, *Alert Digest No. 2 of 2016*, 24 February 2016, p. 82.

Purpose of bill

1.7 The bill has three schedules, and 10 parts in total. Schedule 1 of the bill extends the Goods and Services Tax (GST) to digital products and other services imported by consumers. GST will be collected by international businesses with Australian revenue greater than \$75,000 and remitted to the Australian Tax Office. This measure will go some way to ensuring that Australian companies are competing without a tax disadvantage, and that Australia's GST revenue base does not erode with the growth of the availability of digital content.

1.8 Schedule 2 amends the GST treatment of cross-border transactions between businesses to minimise the number of non-resident businesses required to register for GST purposes. This measure reduces regulatory burdens on non-resident businesses wishing to do business in Australia on a non-permanent basis.

1.9 Schedule 3 amends the administration of Farm Management Deposits (FMD) to raise the deposit cap and makes allowances for early withdrawal in times of severe drought. The changes will also facilitate the use of funds in FMDs to offset the interest on loans related to a primary production business.

Financial implications

1.10 The bill has a net financial impact of \$340 million over the forward estimates. This figure includes the collection of \$350 million through expanding the scope of GST collections to digital goods and services, and additional costs of \$10 million caused by raising the FMD deposit cap.³

Regulation Impact Statement

1.11 Extending the GST to digital products and other imported services is reported to have 'some transitional and ongoing compliance costs', whereas the changes in Schedules 2 and 3 are reported to only have minor transitional compliance costs.⁴

Human rights

1.12 According to the Explanatory Memorandum, the bill is compatible with human rights as 'it does not raise any human rights issues'.⁵

Acknowledgements

1.13 The committee thanks all those who contributed to the inquiry.

3 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, pp. 4, 7.

4 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, pp. 4, 6-7.

5 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, paragraphs 1.198, 2.242, and 3.73.

Chapter 2

Extending GST to digital products and other services imported by consumers

2.1 The Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016 (the bill) intends to increase the scope of the Goods and Services Tax (GST) to capture cross-border supplies of digital goods and services to Australian consumers.

Background

The Goods and Services Tax in Australia

2.2 A *New Tax System (Goods and Services Tax) Act 1999* (GST Act) was passed in 1999 to establish a GST, a broad-based tax of 10 per cent on most goods, services and other items sold or consumed in Australia.

2.3 At the time of the introduction of the GST, cross-border supplies of services or other intangibles were relatively unusual for consumers. Intangible goods have a value but do not have a physical presence. A hardcover copy of a book would be a tangible asset, whereas an e-book can be considered an intangible asset. As the supply of intangible goods by non-resident entities was rare when the GST was established, it was not considered necessary to make provisions in the GST Act for the collection of GST on these transactions. At the time, there was only a very limited range of services available to consumers that were not performed in Australia or through an enterprise carried on in Australia.¹ University of Sydney Professor of Law, Rebecca Millar, has pointed to a second consideration in deciding not to tax these goods when the GST was introduced:

The problem was that in 1998 it was unclear whether GST on services imported by consumers could effectively be collected. Collecting GST from suppliers with no presence in Australia would be difficult. Asking consumers to pay GST on their own purchases was impractical and unlikely to meet with high levels of compliance.²

2.4 Whereas physical goods can be stopped at the border and have the relevant customs and duties levied, the nature of digital importation means they are unable to be captured by the model historically used for imported goods, as they cannot be physically held at the border.

2.5 Presently, for the purposes of calculating GST, supplies of digital services are only subject to GST if they are made through an enterprise operating in Australia. Over time, growth in the digital goods and services sector has brought to light the

1 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 11.

2 Professor Millar, 'The "Netflix tax" — coming to a country near you', *The Conversation*, 22 April 2015.

significant tax integrity risks associated with the digital economy. As a matter of tax principle, cross-border supplies of digital goods and services should be captured by the GST in the same way they would be if provided by an Australian business. Due to the current wording of the legislation, transactions on the same goods and services are taxed differently depending on whether the provider is or is not in Australia.³

2.6 The growth and adoption of e-commerce platforms within the Australian community means that it is now just as easy for a consumer to order many types of services and items of intangible property from a foreign supplier as from a local supplier. Because GST does not apply to these purchases, local suppliers are at a tax disadvantage and the GST-revenue base is progressively eroded.

International efforts to address the challenges of the digital economy

2.7 In an increasingly interconnected world, national tax laws have not maintained pace with advances in technology and corporate strategy. New technologies and consumer tastes that are not being adequately captured by current taxation regimes have the potential to erode national tax bases and distort markets. Many consumers now purchase the majority of their entertainment in digital formats which, depending on whether the seller has a physical presence in Australia, may be GST-free.

2.8 Many countries have already acted to tax offshore supplies to their consumers, including Norway, Japan, Switzerland, Iceland, South Korea, South Africa and the member states of the European Union (EU).⁴ Non-EU businesses have been required to collect Value-Added Tax (VAT) on supplies of electronic services to EU consumers since 2003, and since 1 January 2015 all cross-border supplies of electronic service to EU consumers must be taxed in the Member State of residence, even when supplied from other EU countries.⁵

2.9 Reflecting the shift in global awareness of the erosion of national tax bases by emerging technologies and management techniques, the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) project has been working to bring together the international community to address global taxation challenges. In July 2013, the Group of Twenty (G20) identified 15 key areas to be considered, including *Addressing the Tax Challenges of the Digital Economy*.⁶ The principle at the heart of the BEPS project is to 'ensure that profits are

3 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 48.

4 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 11.

5 Professor Millar, 'The "Netflix tax" — coming to a country near you', *The Conversation*, 22 April 2015.

6 Organisation for Economic Co-operation and Development, *About Base Erosion and Profit Shifting*, <http://www.oecd.org/ctp/beps-about.htm> (accessed: 1 March 2016).

taxed where economic activities generating the profits are performed and where value is created'.⁷

2.10 In October 2015 the OECD's report, *Addressing the Tax Challenges of the Digital Economy—Action 1—2015 Final Report*, was released. The report highlighted the impacts of the evolution of technology. It noted that technology has dramatically increased the ability of private consumers to shop online and the ability of businesses to sell to consumers around the world, without the need to be present physically or otherwise in the consumers' country.⁸ In particular, the report noted:

The digital economy also creates challenges for value added tax collection, particularly where goods, services and intangibles are acquired by private consumers from suppliers abroad.⁹

2.11 Using the work of the BEPS Project, the OECD has published guidelines (GST Guidelines) for the taxation of cross-border supplies of services and intangibles. The GST Guidelines concerning the place of taxation rules and collection mechanisms for business-to-consumer supplies were endorsed by the OECD Council on 1 October 2015, delivered to G20 Finance Ministers on 8 October 2015 and endorsed by the third meeting of the OECD Global Forum on VAT on 6 November 2015. The OECD Global Forum posited that:

These Guidelines recommend that foreign sellers register and remit tax on sales of e-books, apps, music, videos and other digital goods in the jurisdiction where the final consumer is located. The Guidelines also include a recommended mechanism to ensure the effective collection of VAT by tax authorities from foreign sellers, thus helping governments to protect VAT revenues and levelling the playing field between domestic and foreign suppliers.¹⁰

2.12 The work of the OECD BEPS Project and the release of the GST Guidelines point towards a growing international appetite to prevent further erosion of national tax bases caused by emerging technologies. The Australian Government has expressed an intention to implement 'the balance' of the OECD recommendations, including addressing the tax challenges of the digital economy.¹¹

7 Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digital Economy*, OECD Publishing, Paris, 2014, p. 3.

8 Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD Publishing, Paris, 2015, p. 13.

9 Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD Publishing, Paris, 2015, p. 13.

10 OECD Global Forum on VAT, *OECD delivers international standard for collection of VAT on cross-border sales*, media release, 6 November 2015.

11 The Hon Scott Morrison MP, Treasurer, 'OECD report supports Australian Government action on multinational tax avoidance', media release, 6 October 2015.

2015/16 Budget measures

2.13 In the 2015/16 budget the Australian Government announced measures to address this gap in the current legislation, stating:

The Government will also apply the GST to cross-border supplies of digital products and services imported by consumers from 1 July 2017. This will help correct an anomaly in the current system and level the playing field between domestic and international businesses.¹²

2.14 The budget papers referred to this as 'closing the digital tax loophole', and referred to the purchase by consumers of cross-border digital products and services. These include: consultancy, accountancy and legal services; financial and insurance services; telecommunication and broadcasting services; online supplies of software and software maintenance; online supplies of digital content (movies, TV shows, music, e-books, apps and games), digital data storage; and online gaming.¹³

2.15 The government's proposed changes are supported by the OECD's GST Guidelines, which argue:

For supplies of services and intangibles whose consumption bears no necessary relationship to the location in which the supply is performed and in which the person performing the supply is located, a rule based on the customer's usual residence is the most appropriate approach for determining the place of taxation in a business-to-consumer context.¹⁴

2.16 Generally, there is support for extending the GST to cover digital goods and services. Professor Millar, writing in *The Conversation* observed that:

...we should be taxing the consumption of digital products by Australian consumers, regardless of origin. It is part of Australia's consumption tax base and for the most part it is not one of the 'social goods' that routinely give rise to exemptions from consumption taxes.¹⁵

2.17 On 12 May 2015, Treasury released an exposure draft of the bill and explanatory memorandum and conducted eight weeks of consultation ending on 7 June 2015. A further exposure draft and accompanying explanatory material was released on 7 October 2015 for a two week consultation period. Treasury reports that 26 formal submissions were received across both rounds of consultation with submissions received from resident and non-resident businesses, accounting firms,

12 Australian Government, Budget Paper No. 1 2015-16, p. 1-14.

13 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 49; Australian Government, *Closing the digital tax loophole*, <http://www.budget.gov.au/2015-16/content/glossy/tax/html/tax-03.htm> (accessed: 10 March 2016).

14 Organisation for Economic Co-operation and Development, *International VAT/GST Guidelines*, 2015, p. 46.

15 Professor Millar, 'The "Netflix tax" – coming to a country near you', *The Conversation*, 22 April 2015.

academics and peak bodies associated with accounting and business.¹⁶ Treasury has yet to release the details of these consultations, but has indicated that both consultation rounds resulted in changes to the proposed legislation.¹⁷

Key provisions

2.18 Schedule 1 of the bill makes proposed amendments to the GST Act to ensure that digital products and other imported services supplied to Australian consumers by foreign entities are subject to GST.

2.19 A non-exhaustive list of digital products and other intangible property includes the streaming or downloading of movies, music, apps, games and e-books as well as other services such as consultancy and professional services.¹⁸

Registration requirements on non-resident entities

2.20 The collection of GST on digital products and services will use a vendor registration model. Overseas online vendors will be required to collect GST from the Australian consumer at the point of sale. The overseas vendor will then remit the collected GST to the Australian Taxation Office (ATO) on a periodic basis.

2.21 Vendors with an Australian turnover greater than \$75,000 will be required to register. Vendors with a lower Australian turnover may register, but this is not compulsory.¹⁹ It is estimated in the Regulation Impact Statement that somewhere in the order of 100 non-resident entities will register for and remit GST as a result of this measure.²⁰ Vendor collection and remission models such as that proposed by the bill are in line with OECD recommendations that companies should collect revenue from end consumers.

2.22 Non-resident businesses will have two choices of GST registration: a limited registration which will facilitate the remission of payments to the ATO but will not enable the claiming of Input Tax Credits (ITCs) on supplies purchased in Australia; and a full registration that will be very similar to the current registration process undertaken by Australian businesses. The latter, full registration option will require a business to apply for an Australian Business Number (ABN) and will enable the business to claim ITCs.²¹

16 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 61.

17 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 12.

18 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 12.

19 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 52.

20 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 5.

21 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 54.

2.23 Registering for GST in Australia requires the provision of considerable amounts of information to verify the identity of the entity and its entitlement to be registered, which can pose particular challenges for non-residents. Many of these requirements stem from the necessity to ensure that there are no unauthorised ITC or GST refund claims. As non-resident suppliers only making inbound intangible consumer supplies have no need to claim a GST refund or ITCs, the bill includes a simplified registration process has been established to minimise compliance costs.²²

2.24 Many non-resident vendors are reported to already have the software systems in place to collect GST, as many larger online retailers operate in jurisdictions where the collection of GST is already a requirement.²³ In an effort to reduce compliance costs, the bill does not oblige providers to issue a tax invoice or adjustment note at the request of the consumer.²⁴

Electronic distribution platforms

2.25 Where a digital good or service is being provided through an electronic marketplace (electronic distribution platform), the operators of that marketplace will be responsible for any Australian GST on supplies to Australian consumers made through that platform. For example, the GST owing on a computer game purchased through an app store will be collected by the app store, not the game developer. Many Australian consumers would be familiar with these platforms from using Apple's iTunes store or Google Play to purchase digital goods.

2.26 The rationale for placing the burden of tax collection on electronic distribution platforms (EDPs) is that they will often be larger and better resourced than most of the individual vendors making supplies through the platform. These EDPs also have more information about the recipients of supplies to assist in determining if the consumer is an Australian resident for tax purposes.²⁵ Typically the operator of an EDP will also have significant influence over the terms of sales and payments made via the platform. Treasury is of the view that 'compliance and administration would be simplified if liability for GST rested on the platform operator rather than the vendor'.²⁶

22 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, pp. 41–44.

23 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, pp. 56, 62.

24 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 41.

25 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 30.

26 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 53.

2.27 For the purposes of the bill, advertisers, internet service providers, payment systems and processing services are not typically considered as EDPs as such services are not involved in making the supply available to a consumer.²⁷

Identifying Australian residents

2.28 Broadly, individuals are Australian residents if they usually reside in Australia. As identified by the OECD, for remote supplies of digital goods and services, it is often the place of usual residence of the consumer that is the best proxy for where the supply is consumed.

2.29 Determining the residency status of a consumer is not an easy undertaking, and the bill only requires that a non-resident supplier takes reasonable steps to obtain information concerning whether a recipient of supply is an Australian consumer. Having taken these steps, if the supplier reasonably believes that a recipient is not an Australian consumer they will not be required to collect GST.²⁸

2.30 As most online transactions will be completed automatically, without any human intervention, a consumer will be identified as an Australian resident based on the information collected by the company. Determination of a customer as an Australian resident will rely on appropriate systems and processes being put in place by suppliers. The EM provides an explanation of this policy decision:

The requirements placed on non-resident suppliers acknowledge the practical limits of what they can reasonably do in determining the residence of their consumers in other countries that may acquire services from them by largely automated processes.²⁹

2.31 Existing penalties for consumers that make false declarations of their place of residence to defeat the purpose of taxation law are only imposed for the most serious and deliberate breaches. To provide an alternative remedy to misrepresentation of residency status, the bill includes amendments to broaden the existing administrative penalties for making false and misleading statements. Australian consumers that make false or misleading statements in regard to their tax residency status are potentially liable to administrative penalties of up to:

- 60 penalty units (currently \$10,800) if the statement was false or misleading as a result of the intentional disregard of a taxation law;
- 40 penalty units (currently \$7,200) if the statement was false or misleading because of recklessness; and

27 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 32.

28 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 21.

29 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 25.

- 20 penalty units (currently \$3,600) if the false or misleading statement resulted from a failure to take reasonable care.³⁰

2.32 Australian residents that are also registered for GST, but misrepresent their status as Australian consumers in respect to a purchase made solely for personal purposes, may be liable for GST in relation to that purchase under an extension of the reverse charge rule.³¹

Enforcing compliance

2.33 The proposed changes will be administered and enforced by the ATO. The EM notes that '[i]nternational experience indicates that larger entities will voluntarily comply'.³²

2.34 The ATO will be provided with \$1.7 million over the forward estimates for administering the measures and marketing the above mentioned law changes to affected parties.

Commencement and ongoing review

2.35 In accordance with the announcements in the 2015–16 Budget, the new laws will come into effect on 1 July 2017. This will provide sufficient time for non-resident businesses to understand their obligations, register for GST and update their software systems where necessary.³³

2.36 Post-implementation, the ATO will monitor collections of digital supplies from non-resident suppliers, and inform the Australian Government in the event the legislation is not working as intended.³⁴

Issues

2.37 The committee did not receive any submissions relating specifically to this schedule of the bill.

Committee view

2.38 The proposed changes in the bill address one the emerging challenges raised by the growth of the digital economy. The changes proposed in the bill ensure that Australia's businesses are not at a tax disadvantage compared with their international competitors. The committee considers that it is prudent to put in place legislation to

30 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 26.

31 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 14.

32 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 54.

33 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 65.

34 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 65.

ensure the GST base does not progressively erode over time as more services become digitised.

Chapter 3

Schedules 2 and 3

3.1 The Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016 (the bill) makes changes to the treatment of cross-border transactions between businesses and amends rules relating to Farm Management Deposit accounts (FMD).

Schedule 2

3.2 The changes proposed in Schedule 2 are technical amendments to *A New Tax System (Goods and Services Tax) Act 1999* (GST Act). The bill proposes to amend the circumstances in which a non-resident entity is required to register for GST in Australia.

3.3 These changes enact recommendations of the May 2010 Board of Taxation (BOT) report—*Review of application of GST to cross-border transactions*—on the application of Australia's GST to cross-border transactions, and Australian Government Budget initiatives from 2010–11 and 2012–13 Budgets. The BOT report found that Australia's GST system is overly inclusive of non-residents which can place unnecessary compliance costs on non-residents.¹

3.4 The justification for the proposed changes in Schedule 2 can be found in the BOT's aforementioned 2010 report:

Non-resident businesses can be drawn into Australia's GST system because of the 'invoice-credit' mechanism which seeks to tax the valued added at each stage of the production chain on a transaction by transaction basis. To ensure that no GST is borne by businesses on their inputs, businesses are required to register for GST to claim a refund of the GST paid. In order for non-residents to claim a refund of the GST they have paid, they are required to register and so are drawn into Australia's GST regime.

This gives rise to administrative costs for non-residents and integrity concerns for the ATO, which has limited jurisdictional control over non-residents. In addition, if non-residents do not register and claim their input tax credits, there is the potential for GST to be 'embedded' in the price of the supply.²

3.5 Schedule 2 proposes changes to improve the balance between ensuring that Australia's GST system does not unnecessarily draw in non-residents while maintaining the existing GST base. The changes proposed in Schedule 2 do not alter

1 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 69.

2 The Board of Taxation, *Review of application of GST to cross-border transactions*, 2010, pp. 5-6.

the tax base. The changes are anticipated to result in decreased regulatory burden in complying with Australia's tax laws.³

3.6 The committee heard concerns from Lloyd's—an insurance market—that the proposed changes would create difficulties for some members of the insurance industry as it provides services to businesses and consumers whose tax affairs are treated differently. This may have the potential of increasing compliance costs for insurers and their clients.⁴ Lloyd's has also made these concerns known to Treasury and Australian Taxation Office.⁵

3.7 Lloyd's also expressed concerns that in the current climate of tax scrutiny, where many people believe large companies do not pay their fair share of taxation, these amendments have the potential to create a negative impression on non-resident entities appearing to be tax free.⁶

3.8 The committee received one submission relating to this schedule, discussed above.

Schedule 3

3.9 The bill proposes to change the administration of FMDs, which were introduced in 1999 to replace the Australian Government's Income Equalisation Deposit and Farm Management Bond Schemes.⁷ The proposed changes received general support from the submissions received by the committee.⁸

3.10 Farm Management Deposit accounts assist primary producers to manage risks from fluctuations in primary production income over multiple financial years. FMDs allow primary producers to carry over income from years of good cash flow for use in later years. This smooths income tax liabilities over seasonal fluctuations and economic events. Income deposited into an FMD is treated as an income deduction in the year of deposit, and is later assessed as income when the funds are withdrawn.⁹

3 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 67.

4 Lloyd's, *Submission 2*, p. 5.

5 Lloyd's, *Submission 2*, p. 2.

6 Lloyd's, *Submission 2*, p. 6.

7 Department of Agriculture and Water Resources, *Information for New Farm Management Deposit Holders*, <http://www.agriculture.gov.au/ag-farm-food/drought/assistance/fmd/info> (accessed: 10 March 2016).

8 Tasmanian Farmers and Graziers Association, *Submission 6*, p. [1]; Australian Honey Bee Industry Council Inc., *Submission 5*, p. 1; National Farmers' Federation, *Submission 1*, p. [6].

9 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 120.

3.11 Around 35,000 primary producers own around 45,000 FMDs holding approximately \$4 billion in assets. Approximately 10 per cent of primary producers in Australia currently hold an FMD.¹⁰

Reviews of Farm Management Deposit accounts

3.12 Reviews of the FMD scheme were conducted in 2002 and 2006 by the then Department of Agriculture, Fisheries and Forestry and in 2012 by the National Rural Advisory Council.¹¹

3.13 The 2002 review recommended that the scheme continue in its present form for at least another three years, with no other notable recommendations.¹²

3.14 The 2006 review found that the scheme was contributing to the financial resilience of primary producers by giving them an effective risk management tool:

By providing a tax based instrument that increases farmers commercial options through income smoothing and liquidity management, the FMD Scheme has been used for risk management purposes. Used in this way, FMDs promote better and timelier resource allocation decisions. For instance fertiliser is more likely to be applied when best needed rather than simply in the year high income is earned. Better farm management decisions are entirely consistent with better risk management decisions. Timely investments make the farm more financially viable and sustainable to cope with downturns due to climate variations or market fluctuations when they occur. Simply put, there is less risk that a farm will fail financially if poorly timed expenditure can be avoided. Without FMDs, poorly timed expenditure may be forced on farmers as they hurriedly seek to obtain off-setting tax deductions before the end of a high-income financial year. Poorly timed expenditure leads to sub-optimal productivity and leaves farmers more financially vulnerable than they need be.¹³

3.15 In response to one of the 2006 review's recommendations, the Australian Government increased the deposit cap from \$300,000 to \$400,000.¹⁴

3.16 In 2012, the National Rural Advisory Council conducted a review (NRAC Review), finding that '[t]here is no doubt that the scheme is an important tool for farmers across Australia'.¹⁵

10 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 140.

11 Department of Agriculture and Water Resources, *Reviews of the Farm Management Deposit Scheme*, <http://www.agriculture.gov.au/ag-farm-food/drought/assistance/fmd/review> (accessed: 10 March 2016).

12 National Rural Advisory Council, *Report on the effectiveness of the Farm Management Deposits Scheme*, 2012, p. 7.

13 Department of Agriculture, Forestry and Fisheries, *Farm Management Deposits*, 2006, p. 4.

14 National Rural Advisory Council, *Report on the effectiveness of the Farm Management Deposits Scheme*, 2012, p. 7.

3.17 The NRAC Review recommended in 2012 that the FMD cap on deposits be retained at \$400,000, 'as it is not considered to be a barrier to farmers participating in the scheme in the current operating environment'.¹⁶ The review recommended that the cap be reviewed every three years, noting that changes to input costs, farming practice, and the likelihood of increasing climatic variability:

...would inevitably put more pressure on the cap and, in turn, may reduce the scheme's capacity to help farmers have cash available to ride out or recover from downturns, such as drought.¹⁷

3.18 The current cap of \$400,000 for FMDs has not been updated since 2006–07 and has not been indexed since that time. The EM argued that doubling the cap 'would better meet the objective of encouraging primary producers to improve their resilience by building up additional cash reserves'.¹⁸ The Regulatory Impact Statement (RIS) noted, however, that 'the effectiveness of the increase in the cap will be constrained by the number of primary producers that have the financial capacity to put aside amounts over \$400,000'.¹⁹

3.19 Increasing the deposit limit to \$800,000 is expected to have a cost to revenue of \$20 million over the forward estimates period.²⁰

3.20 The NRAC Review recommended that the Australian Government 'consider including an exemption mechanism in developing and implementing its package of drought-related programs'.²¹ The proposed changes to the early access provision (discussed in greater detail below) appear to enact this 2012 recommendation.

3.21 The Australian Government released the *Agricultural Competitiveness White Paper* (the Paper) on 4 July 2015. The Paper contained a number of policies to strengthen the agricultural sector including improving the tax system for the agricultural sector and facilitating more effective risk management strategies for primary producers.²²

15 National Rural Advisory Council, *Report on the effectiveness of the Farm Management Deposits Scheme*, 2012, p. 2.

16 National Rural Advisory Council, *Report on the effectiveness of the Farm Management Deposits Scheme*, 2012, p. 21.

17 National Rural Advisory Council, *Report on the effectiveness of the Farm Management Deposits Scheme*, 2012, p. 21.

18 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 141.

19 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 142.

20 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 147.

21 National Rural Advisory Council, *Report on the effectiveness of the Farm Management Deposits Scheme*, 2012, p. 23.

22 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 119.

3.22 Citing unpublished figures from the Australian Bureau of Agricultural and Resource Economics and Science, the Paper reported that if all FMD holdings are used to offset loans, farmers could save primary producers \$150 million a year in interest costs.²³

Key Provisions of the bill

3.23 Schedule 3 makes amendments to the *Income Tax Assessment Act 1997* (ITAA Act) to amend the rules for FMDs.

Increased deposit limit

3.24 Currently FMDs may not have a balance of more than \$400,000 in total at any one time. The bill proposes to increase the maximum amount that can be held in FMDs by a primary producer up to \$800,000. The EM explains that:

This enhances the capacity of the FMD framework to assist primary producers to manage seasonal fluctuations in cash flow, including extended periods of positive or negative cash flow.²⁴

3.25 The National Farmers' Federation (NFF) supported this view, noting: 'An update of the deposit cap reflects the changes required to operate a modern farming business and allows farmers to better manage future risk.'²⁵ The NFF also called for regular reviews of the FMD criteria to ensure they maintain their real value.²⁶

Early withdrawal due to drought

3.26 The bill also makes provisions allowing primary producers experiencing severe drought conditions to withdraw money in an FMD within 12 months of its deposit, in the income year following deposit, without having to amend the preceding year's income tax treatment of the FMD. Under the current arrangements the FMD owner is required to amend their previous year's income tax assessment to remove the deduction claimed for the amount deposited.²⁷

3.27 The definition of severe drought is based on publicly available data from the Bureau of Meteorology. The qualifying primary production business must demonstrate that any part of the land of the business has experienced a rainfall deficiency for at least six consecutive months.²⁸ The rainfall deficiency is equivalent to a one in twenty year event; or less than 5 per cent of average rainfall for that

23 Australian Government, *Agricultural Competitiveness White Paper*, p. 24.

24 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 123.

25 National Farmers' Federation, *Submission 1*, p. [8].

26 National Farmers' Federation, *Submission 1*, p. [8].

27 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 121.

28 The rainfall deficiency test period can be prescribed by regulations. Until such a regulation is made the period is six consecutive months.

six month period.²⁹ The withdrawn money must have been in the FMD for the entire six month period covered by the drought event, and any future deposits in that financial year are not treated as FMDs.³⁰

3.28 The NFF suggested that the six month measure of drought conditions may be problematic, citing an example that shows that using a nine-month below-average drought window would enable more farmers to access the early withdrawal facility in some circumstances.³¹ Dr Lindsay Campbell argued the proposed definition of a drought might not be appropriate, and the use of a median and standard deviation measure may provide a more accurate representation of drought.³²

3.29 The early withdrawal provisions only apply to businesses likely to be adversely effected by drought. Commercial fishing, pearling, felling of trees and related industries are not included.³³

3.30 The Australian Honey Bee Industry Council Inc. noted that drought is not the only natural disruption that can negatively affect primary production. The recent bushfires in Tasmania for instance may place beekeepers in financial hardship for several years to come while the natural environment recovers.³⁴

Use of FMDs to offset other debts

3.31 Presently funds in FMDs are unable to be used to offset interest owing on debts associated with the operation of a primary production business. The bill proposes to allow amounts held in an FMD to offset a loan or other debt relating to the FMD owner's primary production business.

3.32 The loan that is offset against an FMD must relate wholly to a primary production business carried on by the FMD owner either directly as a sole trader or through a partnership. The concession provided by these amendments does not extend to loans held by companies, trusts or a person who is not the FMD owner.³⁵ The NFF expressed concerns that access to this provision might be limited as loans are often held in the name of the business, not the individual or partnership.³⁶ According to the EM, financial institutions indicated that 'there would be significant complexities and

29 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 121.

30 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, pp. 126-7.

31 National Farmers' Federation, *Submission 1*, p. [8].

32 Dr Lindsay Campbell, *Submission 3*, p. 2.

33 The farming of aquatic animals is a qualifying class of primary production for the purposes of early withdrawal. Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 125.

34 Australian Honey Bee Industry Council Inc., *Submission 5*, p. 1.

35 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 129.

36 National Farmers' Federation, *Submission 1*, p. [9].

costs for them if they were to allow an FMD owner to offset a loan held by another entity'.³⁷

3.33 The EM highlighted stakeholder concerns regarding the difficulties of establishing offset arrangements for FMDs:

[F]inancial institutions were concerned with the policy and highlighted complexities and compliance costs that would be imposed on them from making the change. Financial institutions were not clear on whether they would offer FMDs as a loan offset.³⁸

3.34 The NFF also expressed concerns that the new arrangements might create prohibitive administrative burdens for producers, depending on how financial institutions implement these changes.³⁹ The EM notes:

Financial institutions will not need to offer FMDs as loan offset accounts and so the change allows financial institutions and primary producers to determine what arrangements are most suitable for them.⁴⁰

3.35 Only loans directly related to the primary production business can be offset using funds in an FMD. If the loan that is offset relates partly to a primary production business, and partly to other purposes, administrative penalties may apply in respect to the portion of the loan relating to the other purpose or activity. The EM outlines the penalties and justification:

The amount of the administrative penalty is equal to 200 per cent of the amount by which interest has been reduced on the portion of the loan used for non-qualifying purposes. The effect of the penalty is to remove any benefit from using an FMD loan offset for a non-qualifying purpose while also imposing an additional cost to act as a deterrent to taxpayers to enter into such arrangements and recovering the time-value of any benefit the taxpayer may have obtained through non-compliance.⁴¹

3.36 There is no restriction on the type of loan or other debt that an FMD can be offset against, provided the liability is solely related to the primary production business.⁴²

37 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 148.

38 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 148.

39 National Farmers' Federation, *Submission 1*, p. [8].

40 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 148.

41 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 131.

42 Explanatory Memorandum, *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Bill 2016*, p. 130.

Committee view

3.37 The committee supports the proposed changes to FMD accounts, which will give primary producers greater flexibility in managing risks to their business.

3.38 The early access provisions for drought conditions are an important amendment to ensure primary producers can use FMD accounts to address risks to their business caused by extreme weather events without undue compliance costs. The committee encourages the Australian Government to monitor the effectiveness of the early access provisions in the bill to ensure they are meeting their intended objectives.

3.39 The committee notes that drought is not the only extreme environmental event that threatens primary production businesses. The Australian Government may wish to consider increasing the scope for early access provisions for producers such as beekeepers whose income can be threatened from natural disasters such as bushfires.

Recommendation 1

3.40 The committee recommends that the Senate pass the bill.

Senator Sean Edwards

Chair

Additional Comments by Labor Senators

1.1 Labor Senators welcome the intent of the measures in Schedule 1, but would like to note that submissions to Treasury consultations during the exposure draft phase of the bill were not made public.

1.2 The Explanatory Memorandum of the Bill, and the Committee Report, acknowledge the difficulty in enforcement; both in ensuring Australian consumers do not misrepresent their location status (to avoid paying GST) and ensuring that foreign businesses collect GST revenue.

1.3 Labor Senators note that the Committee report makes reference to international experiences showing larger entities will voluntarily comply, but does not make reference to smaller and medium sized entities covered by the legislation.

1.4 Labor Senators note the Committee Report acknowledges the possibility of an Australian Taxation Office review of the laws being required in the event that they do not operate as intended.

1.5 On the understanding the Government has done its due diligence in designing the measure, the intent of which Labor Senators support, we nevertheless welcome the acknowledgement an ATO review may be required in the future to ensure this measure operates as intended.

Senator Chris Ketter

Deputy Chair

Appendix 1

Submissions

Submission Number	Submitter
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1	National Farmers Federation
2	Lloyd's
3	Dr Lindsay Campbell
4	WA Grains Group
5	Australian Honey Bee Industry Council Inc
6	Tasmanian Farmers & Graziers Association

