



Tax Laws Amendment (Long-term Non-reviewable Contracts) Bill 2004

A New Tax System (Goods and Services Tax Imposition (Recipients)–General) Bill 2004

A New Tax System (Goods and Services Tax Imposition (Recipients)–Customs) Bill 2004

A New Tax System (Goods and Services Tax Imposition (Recipients)–Excise) Bill 2004

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Tax Laws Amendment (Long Term Non-Reviewable Contracts) Bill 2004

A New Tax System (Goods and Services Tax Imposition (Recipients) - General) Bill 2004

A New Tax System (Goods and Services Tax Imposition (Recipients) - Customs) Bill 2004

A New Tax System (Goods and Services Tax Imposition (Recipients) – Excise) Bill 2004

Date Introduced: 8 December 2004

House: House of Representatives

Portfolio: Treasury

Commencement: Royal Assent for the *Tax Laws Amendment (Long-term Non-reviewable Contracts) Bill 2004*. The three imposition Bills apply from 1 July 2005.

Purpose

The Long Term Non-reviewable Contracts Bill amends the *A New Tax System (Goods and Services Tax Transition) Act 1999* (GST Transition Act) so that:

- suppliers who are party to long term contracts entered into before the GST Transition Act received Royal Assent (8 July 1999)
- where the recipients supplied under those contracts who were not entitled to a full input tax credit for the supply and that agreement was made before 2 December 1998
- where those contracts for supply do not allow for a review before 1 July 2005;

have access to and arbitrator to enable negotiations with the recipient to take account of the GST's impact on those contracts after 1 July 2005.

If that mechanism fails to produce a satisfactory outcome to the supplier these amendments require a recipient to pay any GST obligation on these transactions.

Under the Imposition Bills the obligation to pay the GST falls on recipients under these contracts:

- they notify the supplier that they agree to pay the GST; or
- where the recipient has not accepted an arbitrated offer of a price change from a supplier.

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Where the recipient agrees to a change in consideration, or accepts an arbitrated offer for a change in consideration, or where no arbitrated offer has been made and no agreement reached, the supplier remains liable to pay the GST.

Background

The legislation implementing the GST recognised that there were numerous pre-existing contracts where supply was to be made after 1 July 2000. The prices set under these contracts were most likely negotiated without reference to the GST regime. If the GST has applied immediately to these contracts suppliers would have had to pay the GST but would not have had an opportunity to pass on these costs to the recipients. Further, recipients would have been able to claim the GST input credit, without paying a price for these goods that included the GST paid by the supplier.

Consequently, section 13 of the GST Transition Act allows supplies under a pre 8 July 1999 contract, or a pre 2 December 1998 contract where the recipient was not entitled to a full input tax credit, to remain GST free until either:

- the first opportunity for review of prices under that contract; or
- 1 July 2005;

whichever date arises first.

Supplies are also GST free beyond 30 June 2005 until a review opportunity arises (if any) only if all of the consideration for that supply was paid before 2 December 1998.

After 30 June 2005 this transition period finishes and under current legislation all goods and services supplied under pre 8 July 1999 contracts would become liable for the GST. As noted above, suppliers may face the situation where they are liable for the GST, but have no means by which to recover this cost from the recipients of those supplies.

The Government has been addressing this issue for some time:

- on 3 May 2000 the Treasurer issued a press release announcing that the Government would introduce measures to ensure that there was no disadvantage to either supplier or recipient after the transition period ended¹
- on 6 November 2000 a consultation document on the treatment of non-reviewable contracts was circulated to key stakeholders by Treasury
- on 21 November 2003 the then Minister for Revenue and Assistant Treasurer issued a press release noting that the Government intends to revise the way GST will be applied to long-term non-reviewable contracts after 30 June 2005.² Treasury released a new consultation paper on the same day to all interested parties. The new consultation

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paper was written as a result of the feed-back received on the paper circulated on 6 November 2000³ and

- on 29 October 2004 the Minister for Revenue and Assistant Treasurer announced that the draft legislation for the GST treatment of long-term non-reviewable contracts was released.⁴ A further consultation paper with the draft legislation attached was released by Treasury at the same time.⁵ The consultation period closed on 12 November 2004.

Basis of policy commitment

The former Minister for Revenue and Assistant Treasurer's press release C109/03 of 21 November 2003 noted that the policy was to allow all suppliers with pre (GST) long term contracts that have not had a review opportunity before 1 July 2000 to recover the net impact of the goods and services from the recipient.

Position of significant interest groups/press commentary

A legal professional has expressed the following concerns:

- entities that receive supply under these contracts that are not registered for the GST or entities that are not entitled to full input tax credits such as financial institutions will be worse off under these changes
- for suppliers, arbitration will potentially be a complicated, long winded costly and uncertain process
- the legislation is silent on who should bear the cost of the arbitration process.⁶

Pros and cons

The above arguments should be further examined. Under the GST regime the end user, or the consumer, ultimately pays the cost of the GST, as they do not have the opportunity to claim an input tax credit. In these circumstances the price charged by the supplier would in part reflect the GST paid by the supplier. Where the entities mentioned above are the end users of the good or service, and do not have the opportunity to claim an input tax credit, it is normal for such entities to pay a price that includes the GST on the goods or services purchased from a supplier. The potential rise in prices, due to the supplier having to pay GST from 1 July 2005 puts such contracts on the same tax footing as any other contract concluded on or after the introduction of the GST regime.

Suppliers have every incentive to ensure that any arbitration process is completed as quickly as possible, as they are liable to pay the GST under the proposed amendments. Recipients have set time limits in which to respond to a final arbitrated offer (e.g. 28 days), lest they become liable for the GST arising under the contract.⁷ So, recipients also have an incentive to complete the arbitration process as quickly as possible.

Paying for the cost of arbitration is part of normal commercial negotiations. Under the proposed amendments, if a recipient does not agree to an arbitrated settlement they are

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liable for the GST on the goods supplied; the cost of which may be far higher than the cost of arbitration. This is a strong incentive for a recipient to enter into negotiations with their supplier and if necessary help pay for the cost of arbitration.

The regulations will specify who can be an arbitrator. There is no inherent incentive for the arbitrator and assessor to act with the same speed as the supplier or recipient. Further, these points apply only where the relative levels of GST to be paid, and the costs of the arbitration process, make it worthwhile for the arbitration process to be undertaken. As such, arbitration is likely to apply to larger business operating under high dollar value contracts.

Small Business

The Real Estate Institute of Australia (REIA) has estimated that the number of long term non-reviewable contracts that predate the introduction of the GST may be in the order of hundreds of thousands. It notes that the majority of real estate entities are small businesses administering low dollar value contracts. Against that background the REIA notes that:

- recipients will be resistant to accepting a revised contract price that reflects GST even if, as in the case of commercial leases, this may be counterbalanced by the claiming of input tax credits
- if the real estate entity is the supplier of the property or service, as a small business it has limited capacity to absorb the GST cost related to these contracts
- entering into an arbitrated outcome is unrealistic for small business with low value contracts, given the time and costs likely to be associated with this process. These costs are likely to exceed the GST liability on each individual contract. Entering into arbitration may also damage the agent/client business relationship
- the 1 July 2005 deadline is unrealistic, given that the draft legislation was not released until 29 October 2004 and further changes may be made as the legislation goes through Parliament
- the renegotiation of commercial property leases is likely to be very costly. There is potential for recipients to seek to achieve better margins in the renegotiation process, with arbitration not likely to be beneficial to long-term business relationships.

The REIA considers that the recipient should bear the liability to pay the GST in all cases.⁸ Normally the GST is paid by the supplier.

Pros and Cons

In brief, the REIA argues that if the recipient does not accept an increase in the consideration paid, and for low dollar value contracts it is unrealistic for the supplier to enter into an uncertain and potentially costly arbitration process the suppliers must absorb the costs themselves. If the supplier is a small business, as most real estate agencies are,

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they have limited capacity to absorb such costs. This indeed may be the case for low dollar value contracts where the GST liability may be \$8 - \$10 a month.

Before accepting this argument it is important to consider exactly what is being discussed. It appears that the REIA's concerns are for contracts between real estate agents (suppliers of management services) and landlords (recipients of these services). If this is the case it is also important to consider what type of property is being managed and the likely duration of these contracts. Most, if not all, contracts to manage residential property last for one year, in keeping with the common term for leases between the landlord and tenant. It is unlikely that arrangements to manage residential property that were concluded before the start of the GST are still in force.

This may not be the case where commercial property is involved. It may be the case that contracts to occupy commercial premises were concluded before the start of the GST, and that these contracts are still in force. It follows that the contract to manage these properties is also still in force. It is likely that these contracts are not low dollar value contracts and may well be of sufficient value to justify resort to the arbitration process. At what point it becomes commercially viable for a small business to enter into an arbitration process, which if unsuccessful allows the GST to be imposed on the recipient, will depend on the costs of that process.

The balance of negotiating advantage during any commercial transaction depends on many factors such as the alternative supply available and the commercial position of the supplier. While these bills may provide the occasion for the renegotiation of a commercial lease they are unlikely, of themselves, to provide a negotiating advantage for the recipient. Further, it would be a rare negotiation indeed where one party did not try and seek to better their margins.

It may be the case that entering into an arbitration process damages a commercial relationship. However, under the provisions of these bills such a process can only be entered into after an initial offer has been made by the supplier to change the price. The rejection of such offers, leading to the arbitration process (should that occur) may damage such relationships before the arbitration process started.

ALP/Australian Democrat/Greens policy position/commitments

These bills passed the House of Representatives on 8 December 2004. During the Second reading speeches the ALP supported the proposed amendments; subject to the further review of these amendments in the Senate.⁹

Any consequences of failure to pass

Failure to pass the legislation potentially exposes suppliers, operating under a pre 8 July 1999 contract, with either no review provisions, or whose provision only allow for a

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review after 30 June 2005, to a GST liability that they cannot recover from their customer by way of higher prices.

Failure to quickly pass this legislation in 2005 may leave business with insufficient time to undertake any necessary negotiations.¹⁰

Main Provisions

The major provisions for this measure are in the *Tax Laws Amendment (Long-term Non-reviewable Contracts) Bill 2004* (the Bill).

Item 13 of Schedule 1 of the Bill amends section 13 of the GST Transition Act so that:

- if supplier and recipient agree to change the consideration paid under a contract for supplies received before 1 July 2005 after the commencement of this particular subsection (new subsection 4B) GST is to apply to those supplies, but only from the date the agreement was made where that date is before 1 July 2005; but
- commencing the arbitration process (items 15J to 15M Schedule 1) or changing the consideration paid for supplies made on or after 1 July 2005 by agreement between supplier and recipient does not result in supplies made before 1 July 2005 becoming subject to the GST (new section 4C).

Item 14 adds **new section 15A** GST Transition Act, which contains a diagram outlining possible outcomes for payment of the outstanding GST after 1 July 2005.

Item 14 also adds **new section 15C** that requires the recipient to pay the GST where supply is specifically identified by an agreement mentioned in subsection 13(1) (i.e. a contract made before the GST Transition Act received Royal Assent 8 July 1999): and

- that agreement does not have provisions that require the consideration to remain unaffected by the imposition of a GST or similar value added tax
- had the supply been made immediately before 1 July 2005 it would have been GST free
- either the recipient notifies the supplier in writing that the recipient elects to pay the GST on the supply or the recipient fails to accept an arbitrated offer by the supplier to change the consideration paid for supplies received on or after 1 July 2005.

New subparagraphs 15C(2) to (5), in combination with the arbitration provisions (see below), set time limits on a recipient in responding to an arbitrated offer by the supplier. If the recipient does not respond to such an offer within these time limits they are liable to pay the GST.

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These provisions are an exception to the general rule in the GST Act because normally the GST is payable by the supplier. The Explanatory Memorandum contains additional information on **new sections 15D to 15J** dealing with the application of the new provisions in different circumstances.¹¹

Item 14 also inserts **new sections 15J to 15M** into the GST Transition Act dealing with making arbitrated offers to change the consideration paid for supplies made under long term non-reviewable contracts. Under these sections there are three steps to making an arbitrated offer:

- the supplier makes an initial offer, which must remain open for at least 28 days. If that is not accepted, only then
- the supplier applies for an arbitrator to appoint an assessor who determines an appropriate price change, and
- the supplier makes a final offer using the assessor's determination of an appropriate price change. This final offer must remain open for at least 21 days.

All offers and determinations must be in writing. The assessor must, in the opinion of the arbitrator, be suitably qualified to determine the appropriate change and be independent of both supplier and recipient. In making their assessment they must take only take into account the goods and services tax's impact on the supplier's costs and expenses.

Concluding Comments

There are still many questions surrounding the arbitration provisions, such as who will fill the roles of arbitrator and assessor. The time limits and costs of the arbitration process are not specified in the Bill. However, there is nothing in the Bill that prevents a supplier and a recipient abandoning the arbitration process at any point and coming to an agreement on who should pay the GST arising from these contracts.

In its final consultation paper of 29 October 2004 Treasury sought expressions of interest from organisations or bodies that wish to be included in the regulations as potential arbitrators.¹² **New section 15B** of the GST Transition Act allows for the specification of a person, or class of persons, as an arbitrator in forthcoming regulations. There is some suggestion that private sector bodies, such as large accountancy firms, may fill this role.

The Bill seeks to end a transitional process that began in 2000 and place all suppliers and recipients on an equal footing. The payment of GST on supplies that were previously not subject to this tax will increase the Government's revenue. However, the Explanatory Memorandum notes that any gain will be negligible and will, in any case, flow to the States and Territories under the usual GST arrangements. As such this measure promotes equity in tax treatment and also raises additional tax revenue.¹³

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Endnotes

- 1 The Hon. Peter Costello, MP, Treasurer, Press Release 3 May 2000 (No 36/2000), 'Long Term Non-Reviewable Contracts'.
- 2 Senator the Hon. Helen Coonan, Minister for Revenue and Assistant Treasurer, Press Release 21 November 2003 (C109/03), 'GST and Long-Term Non-Reviewable Contracts'.
- 3 Treasury – Discussion Paper, 'Proposed Amendment for the Goods and Services Tax (GST) Treatment of Long-Term Non-reviewable Contracts', 21 November 2003.
- 4 The Hon. Mal Brough, MP, Minister for Revenue and Assistant Treasurer, Press Release 29 October 2004 (No.009), 'Draft Legislation on Long-Term Contracts Released for Consultation'.
- 5 Treasury – Consultation Paper, 'Proposed Amendments for the Goods and Services Tax (GST) Treatment of Long-Term Non-Reviewable Contracts', 29 October 2004.
- 6 Sean Massingham, 'GST and long-term reviewable contracts: legislation at last', FOCUS Tax, Allens Arthur Robinson, November 2004
- 7 *Tax Laws Amendment (Long-term Non-reviewable Contracts) Bill 2004*, Item 14 – proposed new sections 15J to 15M of the *A New Tax Systems (Goods and Services Tax Transition) Act 1999*.
- 8 Real Estate Institute of Australia, REIA Submission on Proposed Amendments for the GST Treatment on Long-Term Non Reviewable Contracts, 12 November 2004.
- 9 Joel Fitzgibbon MP, Second reading speech, Tax Laws Amendment (Long-term Non-reviewable Contracts) Bill 2004, House of Representatives, *Debates*, 8 December 2004, p. 73.
- 10 Allesandro Fabro, 'Time running out for GST dispute bill', Australian Financial Review, 13 December 2004, p. 6.
- 11 Explanatory Memorandum to the Bill; Detailed explanation of new law, pp 12 to 18.
- 12 Treasury – Consultation Paper, 'Proposed Amendments for the Goods and Services Tax (GST) Treatment of Long-Term Non-Reviewable Contracts', 29 October 2004, p. 2.
- 13 Explanatory Memorandum to the Bill; General outline and financial impact, p. 3.

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