LEAVING A GST GROUP – IS A CLEAN EXIT POSSIBLE?

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Treasury has announced some good news for taxpayers grappling with rules around exiting a GST group. Proposed amendments will remove the long-standing anomaly whereby entities are unable to leave a GST group on any day but the first day of a tax period, regardless of when ownership in the entity is transferred. A plan has also been put forward to limit the joint and several liability of entities in departing a GST group, providing what is referred to as a "clean exit". However, as discussed below, the proposed amendments are unlikely to achieve their stated objective of allowing entities to depart GST groups clear of any GST consequences. The more significant issue for Treasury and taxpayers is whether a clean exit for GST is possible.

The following analysis relates to *Treasury Discussion Paper: Implementation of the recommendations of the Board of Taxation's review of the legal framework for the administration of the GST*, with specific reference to Chap 2.7 and the proposed amendments in respect of entities departing a GST group.

References to the TAA are to the *Taxation Administration Act 1953*.

GST group v consolidated group – joint and several liability

Under the current law, the rules in respect of joint and several liability for a member of a GST group are broad and difficult to moderate. Relevantly, s 444-90(1) of the TAA states:

"*The *members of a *GST group are jointly and severally liable to pay any amount that is payable under an *indirect tax law by the *representative member for the group*."

This is analogous to s 721-5 of the ITAA 1997, which provides that a member of a consolidated group is jointly and severally liable to pay a group liability, where the head entity fails to meet its tax liabilities at the time that they become due and payable.

The significant difference between the GST and income tax regimes in this respect is that the ITAA 1997 allows for members of a tax consolidated group to enter into a Tax Sharing Agreement (TSA), for the purposes of regulating a "reasonable allocation of the total amount of the group liability among the head company and the TSA contributing members" (s 721-25(1)(c)).

Provided a TSA complies with the requirements of Div 721, the Commissioner is not empowered to recover any more from a contributing entity than the relevant "contribution amount", as stipulated by the TSA, notwithstanding the general joint and several liability provision at s 721-15(1).

It follows that when a party to a TSA leaves a tax consolidated group, any exposure of the leaving entity to the historical liabilities of the group (eg in the event of an amended assessment) can be mitigated, and to some extent quantified, with reference to the party's rights and obligations under the TSA.

Specific "clean exit" rules also apply upon a member's departure from a consolidated group, allowing the leaving entity to finalise its income tax obligations to the consolidated group by paying an amount equal to its contribution amount or, if this cannot be precisely calculated, a reasonable estimate of its contribution amount.

The clean exit and TSA rules are useful to any potential acquirer wishing to conduct comprehensive due diligence in respect of a target entity that is part of a consolidated group.

Historically, the GST regime has not provided grouped members the opportunity to enter into an equivalent to the TSA, nor has the GST Act contained comparable clean exit provisions. However, in the recent 2009 Federal Budget, Treasury signalled its intention to enact legislative amendments that include clean exit rules for entities departing GST groups – see 2009 WTB 20 [900]-[901].

Leaving a GST group – current rules

The continuing joint and several liability of an entity leaving a GST group is a concern for any potential acquirer seeking to conduct due diligence on a target entity, as it makes it impossible to quarantine the historical exposures of that entity from the remaining members of its original GST group. A potential acquirer will not usually have access to the information necessary to investigate the legacy issues of the remaining members. While tax indemnities and warranties play a role in these scenarios, their usefulness may be limited.

To further complicate matters, under the current rules, a revocation of an entity's GST group membership and the addition of a member to an existing GST group must take place ***on the first day*** of a tax period. The practical consequence of this is that an entity being sold must depart the original GST group on the first day of the tax period in which it is to be sold. If it is to be added to a new GST group, this will occur on the first day of the following tax period.

This creates a period of "limbo" for a departing entity, in which it is not eligible to be a member of the original GST group and must account for GST separately until it is eligible to join a new GST group. This has the potential to create a significant compliance burden in circumstances where the entity is not equipped with the requisite systems or accounting function to account for GST independently from the rest of the group. It may also give rise to GST consequences relating to transactions with "former" and "future" group members that would have been disregarded had the entity been in a position to remain grouped until the date it was effectively sold and to re-group from that date onwards.

By way of example, if an entity is sold out of a group (where the group has a monthly tax period) on 15 June, the entity's membership of the GST group will be revoked from 1 June. From that date, all transactions between the departing entity and the other group members must account for GST and the departing entity must separately furnish its own Business Activity Statement. It will not be eligible to join the GST group of the acquirer until 1 July.

Of course, one way of avoiding these complications is to ensure that the entity departs the group on the first day of a tax period. However, not surprisingly, GST is often not the determining commercial factor when selecting the date of a disposal or acquisition of an entity.

Proposed changes – Budget 2009

1. Date of effect of revocation

The proposed Budget measures will effectively alleviate the compliance burden on entities that leave and/or join a GST group on a date that is not the first day of a tax period. Treasury states at Chap 2.7 of the Discussion Paper that the GST law and TAA will be amended to ensure that:

"*entities will be able to self-assess their eligibility to form, alter and revoke a GST group or GST joint venture, and to form, alter and revoke a GST group or GST joint venture* ***at any time during a tax period***" (Measure C) – [Emphasis added].

The implementation of Measure C will allow an entity to join a new GST group (where it is eligible to do so) immediately after leaving its original GST group, on any day in a tax period. The entity will avoid the obligation to account for GST in its own right for an intervening period that arises under the current law. Under the amended law, the representative members of each of the former GST group and the new GST group will be required to recognise the periods before and after the change in group membership as separate tax periods and account for them accordingly, to avoid errors such as the double counting of input tax credit entitlements and GST payable (although lodgment of an additional BAS will not be required).

2. Making a "clean exit" from a GST group

Treasury states the following at Chap 2.7 of the Discussion Paper:

"c*lean exit rules will be introduced to allow entities to* ***leave GST groups or GST joint ventures clear of any GST consequences***" (Measure D) – [Emphasis added].

However, the proposed changes with respect to Measure D reveal they are not nearly as ambitious as this statement suggests.

The proposed amendments will allow members to enter into a clean exit agreement (CEA) with the representative member of a GST group. Under the CEA, the departing entity will pay an amount that represents its share of the GST liabilities *for the tax period in which it leaves the group* (the final payment). Under the CEA, the member will not be jointly and severally liable in respect of "any GST liability that may become ***due and payable after it leaves the GST group*** but in respect of a tax period in which the member was a part of the GST group" [Emphasis added].

A critical issue is what legislative language will be used to define "GST liability" and "due and payable".

The CEA rules will overlap with the Measure C amendments. Those amendments require the tax period in which an entity departs a GST group to be divided into 2 parts, the first part relating to the period in which the departing entity was a member of the group and to which the final payment (calculated under the CEA) is referable. The departing entity will remain jointly and severally liable for the GST liabilities of the GST group for the first part of the tax period and all previous tax periods in which it was a member, but a valid CEA will ensure it is not jointly and severally liable for the remainder of the tax period following its departure.

In other words, the departing entity will not be jointly and severally liable for amounts that become due and payable after it exits the GST group, but notwithstanding the existence of a CEA, will remain jointly and severally liable for amounts that relate to the period of its membership. These may include:

- any unpaid GST liabilities payable by the representative member that arose while it was a member of the GST group; and
- any assessment or amended assessment issued by the Commissioner in respect of a tax period in which the entity was a member of the GST group.

The departing entity will also be liable for any increasing adjustments that arise after the entity has left the GST group in respect of ***supplies that it made*** while it was a member of the GST group. Presumably, the entity will also be entitled to the benefit of decreasing adjustments that arise in respect of ***acquisitions that it made*** during its membership.

Further, unlike a TSA, a CEA will not regulate or in any way moderate the obligations of the entity while it is a member of a GST group.

In light of these ongoing exposures, it is difficult to see how the changes will have the effect of allowing "entities to leave GST groups or GST joint ventures clear of any GST consequences", as suggested by Treasury. While it is true that a departing entity will have a framework for exiting a group during a tax period with a clear basis on which to calculate its final GST payment, there will remain a plethora of circumstances – amended assessments, included – in respect of which the departed entity will remain jointly and severally liable.

At their highest, the amendments may facilitate an "easy exit", but not necessarily a "clean exit".

The proposed alternative

An alternative proposal to the CEA amendments (and to joint and several liability for GST groups, generally) is outlined in the Discussion Paper. The alternative is analogous to the rules currently in place for GST religious groups. This would involve:

- ignoring the GST consequences of intra-group transactions; and
- separating each member's liability to remit GST and entitlement to input tax credits for supplies made outside the group and any consequent adjustments.

The options would then be to require:

- each member to submit a BAS separately (removing the requirement for all members of the same GST group to have the same tax period): or
- the representative member to continue to lodge one BAS on behalf of the group.

This approach would entirely remove joint and several liability for members of a GST group, as each member would retain its own GST liabilities and input tax credit entitlements. However, it would largely defeat the administrative advantages of grouping for GST. In large GST groups, the compliance burdens of this approach may outweigh the potential benefits.

Is a clean exit the right answer for GST?

The inconsistency between the stated intent of the proposed amendments in Chap 2.7 and their practical effect would suggest that Treasury has not achieved its objective of providing entities with a "clean exit" from a GST group. Indeed, the more significant issue is whether this can be achieved and at what cost.

Clearly, the interests of the Commissioner will be better served in circumstances where he can recover historical debts from a wider range of entities in the event that a representative member of a group defaults on a payment. Undoubtedly, this consideration has been taken into account in limiting the relief provided to entities departing a GST group under the proposed amendments.

On the other side of the coin, from a commercial point of view, it is appropriate that the historic GST exposures of an entity are capable of being quarantined, particularly in the context of M&A transactions. Potential acquirers will only rarely be in a position to conduct the necessary due diligence to determine the GST exposures of a target entity *and* all members of the GST group to which the target entity belongs. In these economic times, there would be obvious advantages in providing some certainty to entities entering into M&A transactions by mitigating (currently indeterminable) GST exposures.

This raises a further question: to what extent should the interests of a departing entity and its acquirer be placed above those of the remaining members of the GST group? Those members may consider it perfectly appropriate that an entity continue to be jointly and severally liable for GST liabilities that relate to periods in which the entity formed part of the GST group. To extinguish this ongoing liability would prejudice the interests of all members of the remaining group, who may find themselves shouldering the departed entity's share of a financial burden down the line. To some extent, this contingency could be addressed by negotiating tax indemnities and warranties. However, it would be more favourable for the remaining members of the GST group if a debt or part of a debt were directly recoverable from the departed entity by the Commissioner, particularly in circumstances where the departed entity carried out the activities that gave rise to the liability.

As in the income tax context, any solution will require the balancing of competing interests. While there are benefits to all parties under the current proposed amendments, the Commissioner's ability to recover amounts referable to an entity for any period in which it was a member of a GST group remains assured.

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