LUXOTTICA CASE: AN IMPORTANT WIN FOR TAXPAYERS

Robyn Thomas, Associate
Balazs Lazanas & Welch LLP

This article sets out the GST issues addressed by the decision in *AAT Case [2010] AATA 22, Re Luxottica Retail Australia Pty Limited and FCT* (reported at 2010 WTB 3 [139]) and the reasons why it signifies an important win for taxpayers.

The marketing strategy

The taxpayer, Luxottica Retail Australia Pty Limited, is the representative member of a group of retailers specialising in the retail sale of eyewear.

The matter before the AAT involved a series of promotions that were run by Luxottica between October 2002 and September 2008, whereby customers were offered a discount on spectacle frames (either in the form of a percentage discount or a set dollar amount) provided that both the frames (which are subject to GST) and lenses for prescription spectacles (which are GST-free) were purchased together in a single transaction.

In respect of every purchase made under the promotion, Luxottica applied the full amount of the discount to the frames and consequently reduced only the value of the taxable component of the supply and not the value of the GST-free component of the supply. This resulted in a reduction of its GST liability by a greater proportion than would have been the case had the discount been applied to reduce the value of both the frames and the lenses.

Broadly, Luxottica justified the decision to discount the frames and not the lenses on the basis that frames have become luxury fashion items that entice consumers to purchase new spectacles, even in circumstances where new lenses are not required. While the appeal of designer frames has increased in recent years, the medical benefits of prescription lenses are largely taken for granted.

The AAT accepted Luxottica's evidence that there were sound commercial reasons for discounting the frames and not the lenses. The AAT also considered there was "nothing contrived or artificial about the pricing methodology adopted by [Luxottica] in its promotional arrangements" (para 40).

As the evidence submitted by the taxpayer to this effect was not challenged by the Commissioner, presumably he, too, accepted that the reduction of the prices of the frames and not the lenses was not artificial or contrived. Consequently, his challenge to the GST treatment of the promotional activities was based on the statutory construction of ss 9-75 and 9-80 of the GST Act, rather than any suggestion of avoidance.

The Commissioner argued that it was not appropriate to apply the discount solely to the value of the frames on the basis that s 9-75 or s 9-80 (as applicable, see below) required the discount to be apportioned across both the taxable and GST-free components of the supply. According to the Commissioner, the mathematical relationship between the 2 components should be the same as it was when no promotional arrangements were in place (para 12).

Single supply or multiple supplies

The parties disagreed as to whether the supply of the frames and lenses constituted a single supply of spectacles (the Commissioner's view) or 2 separate supplies (the view of the taxpayer). This was relevant as s 9-75 applies in respect of a taxable supply, whereas s 9-80 applies to a supply made up of GST-free and taxable components. The AAT engaged in some discussion in

this regard, touching on the complex and often conflicting array of Australian and international case law relating to this issue.

The following conclusion was drawn at para 34:

"We are inclined to the view that the Applicant made one supply, which could perhaps be described as a pair of spectacles, comprising two components, the frame and the pair of lenses. That seems to us to be the more commonsense outcome, and one which sits more comfortably with the "practical business tax" approach to GST which has been favoured by the Federal Court... The alternative characterisation of the transaction as two supplies – a frame, on the one hand, and a pair of lenses, on the other – must necessarily require there to be a third supply (although one without consideration), being the service of fitting the lenses into the frame. Why a commonplace transaction such as this would need to be disaggregated in this way is not readily apparent."

The AAT did not elaborate as to why treating the lenses and frames as 2 supplies necessarily requires the act of fitting the frames and lenses together to be treated as a separate supply. There is no apparent reason why, in either case, this service could not be determined to be integral, ancillary or incidental to the supply of the prescription lenses or frames.

Arguably, the outcome is somewhat incongruous with the AAT's apparent recognition of the frames as having a distinct character as fashion accessories with their own specific strategic marketing focus. Further, the evidence indicated that in 20% of cases, frames and lenses were not purchased together in a single transaction. To then conclude that a sale of frames and a sale of lenses do not constitute supplies in their own right seems not entirely consistent with the evidence.

However, the AAT did not consider this issue to be determinative, and stated at para 35:

"It would be a surprising, and perhaps a capricious, outcome if the GST payable on a transaction were to turn on such an esoteric enquiry. And so, although we prefer the view that there is one supply, and that as a result s 9-80 is the relevant valuation provision, we agree with the parties that the same result would be reached on the alternative scenario involving two supplies, and valuation under s 9-75."

Under s 9-80, the single supply of "a pair of spectacles" is broken into taxable and non-taxable components. On the AAT's reading of the valuation mechanism in s 9-80, GST was calculated on each component in the same way that it would have been calculated under s 9-75 ie adopting, as the value of each component of the supply, the GST exclusive consideration agreed to by the parties (in the absence of tax avoidance and where the supply is not made between associates). The AAT therefore rejected the Commissioner's view that s 9-80 encapsulates a more complex apportionment methodology (see further below). On a different reading of s 9-80, the question of whether the lenses and frames constituted single or multiple supplies may have warranted a more detailed analysis.

Simple facts, convoluted law: the decryption of s 9-80

The creative drafting of s 9-80 of the GST Act was a source of contention in the proceedings.

In addition to several other relatively minor peculiarities in the drafting, the AAT recognised one significant flaw that undermines the section. Under s 9-80(2), the *value of the actual supply* must be calculated with reference to the *taxable proportion*. However, the *taxable proportion* is calculated using the *value of the actual supply*. In the words of the AAT, this mechanism is "almost impenetrably circular" (para 38).

Not surprisingly, the main point of contention between the parties was the proper construction of s 9-80, in particular, the interpretation of the "*value of the actual supply*" and the "*value of the taxable supply*".

The Commissioner argued that the GST-exclusive price of the frames, prior to any discount, was the appropriate value for the purposes of s 9-80 (even though that was not actually the price advertised under the promotion, or paid by the customer). This is a departure from the definition of 'value' in s 9-75, which bears a direct relationship to the actual price, and inherently suggests that 'value' for the purposes of s 9-80 is something other than the GST exclusive price agreed to by the parties.

In an Attachment to the Commissioner's outline of submissions, the Commissioner provided the following formula to illustrate his application of s 9-80(1):

value of taxable supply = value of actual supply x (value of taxable supply/value of actual supply)

On first glance, the formula is bafflingly truistic. However, on the Commissioner's approach, the equation cannot be broken down into a simple statement of "value of taxable supply = value of taxable supply", because the Commissioner attributes different meanings to each iteration of "*value of actual supply*" and "*value of taxable supply*".

In other words, the expression *value of taxable supply* does not simply refer to 10/11ths of the price referable to the taxable portion of the supply, but rather, refers to 2 different values (depending on the context of the words in the section) which are calculated with reference to the non-discounted price of the supply – which, notably, was not the price advertised to, or paid by, the consumer.

The Commissioner's view is a confused approach to what should be a simple calculation of GST payable on the taxable portion of a supply. The result is an amount of GST payable that bears no apparent relationship with the taxable proportion of the supply, whether discounted or not. (A detailed working of the Commissioner's view, applied to an example, is set out at para 16 of the decision.)

Fortunately, the AAT was willing to adopt a "commonsense" and "practical" approach to statutory interpretation where the legislative drafting and the view put forward by the Commissioner demonstrate neither. The AAT states at para 39:

"In the context of this case, commonsense dictates that the taxable proportion is to be calculated by dividing the discounted frame price (less GST) by the actual selling price of the complete pair of spectacles (less GST)... We reject the Commissioner's submission that the undiscounted frame price (sometimes referred to in the hearing as 'yesterday's price') has any role to play in the calculation of the taxable proportion. This is because the undiscounted frame price, yesterday's price, is just that; a price which would have been applicable but for the promotion and it would no doubt be the price if the customer purchased the frame alone. But the customer does not on our example purchase the frame alone and the fact that he could do so is not relevant."

To put it simply, if a supplier decides to discount frames to the GST-inclusive price of $110, then the GST associated with that sale will be $10 (in the absence of tax avoidance and in the context of an arm's length transaction). The AAT did not consider the undiscounted price to be relevant, nor was it relevant that a customer was required to purchase lenses in the same transaction in order to take advantage of the promotion.

The AAT considered this approach to be consistent with the terms of s 9-80 which it considered to be more relevant in circumstances where there has been no apportionment of value by the supplier. Further, the same outcome would have been achieved under s 9-75 had the sale of frames and lenses been characterised as two separate supplies.

Refund provisions

Under s 105-65 of Sch 1 to the *Taxation Administration Act 1953* (TAA), the Commissioner "need not" refund a taxpayer for an overpaid amount of GST where, relevantly, the supplier has not reimbursed the recipient a corresponding amount. As customers were not reimbursed by Luxottica, the Commissioner argued he was not *required* to refund the overpaid GST and chose not to exercise his residual discretion to do so.

The AAT disagreed with the Commissioner's position and considered that upon entering into the relevant transactions, Luxottica's customers paid the correct contract price. Any reimbursement would result in further adjustments to the selling price, resulting in a windfall gain to an "undeserving customer".

Consequently, the AAT decided that the discretion in s 105-65 of the TAA should be exercised to provide a refund to Luxottica for the overpaid GST. (Unlike the Federal and High Courts, the AAT can step into the shoes of the Commissioner and re-exercise a discretion under the TAA.)

The reasoning of the AAT on this point allows a very broad scope for taxpayers to obtain and retain a refund of overpaid GST, regardless of whether that GST has effectively been borne by the supplier or the recipient. It remains to be seen where the parameters of the discretion in s 105-65 of the TAA will be drawn.

A rational and commercial outcome

Arguably, if the Commissioner wishes to demonstrate that a taxpayer has understated the value of a taxable component of a mixed supply for the purpose of obtaining a GST benefit, he should be in a position to make his case under anti-avoidance provisions of Div 165 of the GST Act. This approach would be consistent with GSTR 2001/8 (Apportioning the consideration for a supply that includes taxable and non-taxable parts), which states at para 96:

"Where consideration is apportioned in a manner that cannot be justified in terms of reasonableness, the general anti-avoidance provisions of the GST Act may have application..."

To argue, rather, that the relevant value of a taxable component under s 9-80 is the value *historically* applied by the supplier, rather than the value *currently* applied by the supplier, seems to be an arbitrary second guessing of a supplier's discretion to negotiate a commercial price in respect of arm's length transactions. This is an approach that, if successful, would have created considerable ambiguity for many taxpayers.

The AAT decision signifies a broader win for taxpayers as it suggests the Commissioner should allow taxpayers a degree of autonomy when making commercial decisions. The case recognises that, practically, the value of a supply will be best determined with reference to the consideration agreed between a supplier and recipient, where the parties are acting at arm's length and in the absence of tax avoidance.

Accordingly, the AAT has constrained the Commissioner from recasting arrangements for the purpose of increasing the associated GST liability, where a taxpayer is able to show that the structuring of its activities is commercially and economically appropriate in the context of its business. Ideally, this result will signal to the Commissioner that taxpayers should not be put to the cost of defending their activities before a tribunal or court simply because the GST outcomes happen to be favourable.

5 February 2010