



Regulation Impact Statement

Improving the collection of GST on property transactions

OBPR ID: 19974

Introduction

This Regulation Impact Statement relates to the 2017-18 Budget measure to address GST integrity in the property development sector. The measure provided that from 1 July 2018, purchasers of new residential premises and new subdivisions would remit the GST owed on the purchase price directly to the ATO as part of the settlement process.

GST applies to the sale of new residential¹ and commercial premises (such as houses, hotels, office buildings), and new subdivisions. Special GST rules apply for property development,² reflecting the large value and complex nature of such transactions and the period of time between acquisition of land and development and sale of the land and any buildings.

1. The Problem

There have been a growing number of businesses in the property development industry that have failed to remit GST to the ATO after the sale of new residential premises or new subdivisions. This failure to remit is due to businesses intentionally dissolving before their next Business Activity Statement (BAS) is lodged to avoid remitting the GST, or through businesses having not sufficiently budgeted to meet their GST obligations.

The ATO has been using a range of strategies to tackle failure to remit due to both of these reasons, but with limited success. These strategies have included taxpayer guidance, improved debt collection practices and enforcement activities. The strategies are labour intensive, highly intrusive, and costly to undertake and sustain. More importantly, the risk has not abated. The “after the fact” nature of the activities has proven to be inadequate; as the problem usually emerges well after the property transaction has occurred.

By allowing vendors to remit GST after the sale of new residential premises and new subdivisions up to 3 months later through their BAS, there is time for businesses to dissolve and avoid paying the GST to the ATO (sometimes described as “phoenixing”). As the ATO is an unsecured creditor, they never receive the GST owed even though the vendor bears a legal obligation to pay the GST.

The high value nature of the transactions, and consequently the large amount of GST involved, magnifies the risk that the GST amount will be diverted to other purposes.

This issue is primarily concentrated in the residential premises development sector, due to the much larger size of this sector compared to the commercial premises development sector. The ATO considers there is less risk in the commercial premises development sector as the smaller size of this sector (about 1/12th the size of the residential property development industry) makes it easier to monitor. Therefore, the Budget measure specifically relates to the residential premises development sector where many of these issues frequently arise. A consideration for the future is whether commercial transactions should be included, which would require further assessment of the extent

¹ GST does not apply to the sale of residential property that is not new, which are input taxed instead.

² For example, as outlined below, vendors can elect to use the ‘margin scheme’ for the sale of certain new developments for GST purposes.

of the problem within the commercial development sector, and balance this with the costs of extending the withholding to business-to-business commercial property transactions.

2. Why is Government action needed?

As this problem poses regulatory failures, there is scope for Government action to correct these failures, which cannot be addressed by the market through private actors, or by any other means.

The problem is large enough to warrant addressing by the Government. Despite sustained compliance activity, the problem remains; for example, in April 2015, the ATO reported to the Senate Standing Committee on Economics, *“Inquiry into Insolvency in the Australian Construction Industry”*, that 3,355 individuals had been identified as being in control of over 13,000 entities with a history of insolvency in the property development industry. These entities are part of the population considered to be at risk of “phoenix” behaviour.

3. What policy options are being considered?

Option 1: Require purchasers of new residential premises and new subdivisions to remit GST to the ATO at the time of settlement

Under this option, purchasers of new residential premises or new subdivisions would be required to withhold 1/11th of the purchase price, and to pay this amount directly to the ATO as part of the settlement process. The GST would be credited by the ATO to the vendor's account. This would remove the opportunity for non-compliance by the developer.

As noted above in the problem identification section, since the main mischief of phoenixing has been found to occur in the residential premises development sector, this option applies only to sales that are new residential premises developments and new land subdivisions rather than new commercial premises development.

This option does not change the amount of GST owed, and keeps the legal obligation to pay GST on the vendor. It would apply to all new residential premises and new subdivision sales, and to all developers without any exemptions or carve-outs for developers who are perceived to be more compliant or have a turnover over a specified threshold. Carve outs were considered and raised by stakeholders but found not to be viable for the following reasons.

- The ATO has noted this type of phoenixing activity occurs across the industry, and not only in the smaller or medium end of the market.
- Introducing exemptions creates competition concerns by favouring larger businesses over small businesses and imposes barriers to entry for newer developers.
- There are also difficulties in the case of Joint Ventures (JV), where one party is exempt and the other is not.
- Carving out larger entities adds to complexity for conveyancers, purchasers, developers and would add to the tax administration cost and complexity for the ATO. For example:
 - Conveyancers would have to make further enquiries for each transaction to discover whether developers were in or out of the regime.
 - Developers would have to prove their compliance history with the ATO in order to get an exemption certificate (depending on the operation of the model). Developers would face additional burdens in seeking to extend compliance certification on their special purpose vehicles (SPVs) and in joint venture arrangements which are distinct entities for tax compliance purposes.
 - The ATO would have to continually monitor developers to discover whether they were complying with their requirements.

Other features of this model include:

- Processing refunds through the BAS, where the GST owing is less than 1/11th due to the margin scheme applying.
- Not making the transfer of title conditional on the payment of the GST by the purchaser, as this poses legal and practical difficulties in addition to compliance costs for State Governments in updating IT systems and changing their conveyancing Acts.
- Ensuring the interpretation of where GST is payable on new residential properties and new subdivisions remains consistent with existing definitions under the GST Act.
- Introducing a two-year transitional arrangement so that the option applies to contracts entered into from the announced start date (1 July 2018), and to all settlements that take place from 1 July 2020.

Option 2: Expand the ATO compliance function

This option proposes to expand the ATO's compliance function in the property industry. The ATO's compliance resources could be increased by 9 full-time equivalent staff, which would need to be funded by States and Territories.

The ATO uses a range of tools to deal with vendors that avoid paying GST on property transactions. This includes:

- collecting information about current and planned developments from property developers to assist in identifying future sales;
- using ATO formal investigation powers to seek information from individual developers and third parties;
- enforcing tax requirements through garnishee notices;
- undertaking prosecution action when required; and
- making an assessment for part of a net amount in a tax period when a vendor has a previous history of poor compliance.

This option would supply additional resourcing that would enable the ATO to carry out these and additional activities, such as:

- utilising policy 'nudges' such as sending letters, or incentivising compliance through education campaigns to support and encourage compliance; and
- enforcing higher penalties for non-compliance, through regulatory change and enforcement by exercising the Commissioners discretion.

Option 3: No change – continuing the current approaches

Under this option, no changes would be made. The ATO would continue with its current compliance and enforcement activities.

4. What is the likely net benefit of each option?

Option 1: Require purchasers of new residential premises and new subdivisions to remit GST to the ATO at the time of settlement

Benefits

This option directly addresses the core problem of the growing number of businesses in the property development sector failing to meet their GST obligations. By requiring purchasers to remit GST at settlement, it removes the opportunity for vendors to fail to remit GST through phoenixing or inadequate budgeting. This option also strengthens existing GST payment arrangements to ensure streamlined compliance processes that do not impact on the wider economic or business activities of the industry. The proposal does not alter the fundamentals of the GST system, nor the rate or amount of GST legally required to be paid. It will reduce unnecessary and additional intervention through ATO enforcement to bring GST compliance in line with the rest of the business community. In this way, this option will have no indirect or secondary effects on this market.

Some key strengths of this option include:

- Incorporating a withholding mechanism backed by penalties for non-compliance, this is likely to increase compliance with the GST system. This directly addresses the problem of the growing number of vendors failing to pay GST through intentional phoenixing or inadequate budgeting.
- Leveraging existing settlement processes minimises compliance costs and education for relevant stakeholders. The compliance level of other government taxes collected using the existing settlement process is approximately 98%.
- Minimising the opportunity for significant GST shortfalls (and late payments) in relation to the sale of new residential property and land. The correct amount payable under the legislation will be collected and this is estimated to result in additional transfers to the States and Territories.
- Avoiding the consequences of poor budgeting by vendors who might be unable to meet their obligation to pay GST to the ATO when it's due.
- Removing the incentive for vendors to phoenix to avoid their GST obligations, as they no longer have access to those funds.
- Utilising a withholding mechanism, which is familiar to industry as an effective tax collection model, this option has the benefit of being easily understood and applied by industry.
- Applying the option to all vendors without exemptions, which reduces complexity and regulatory burden for industry, reduces administration costs and complexity for the ATO, and avoids the perception that the system favours some groups of tax payers over others.

Furthermore, the administrative costs in ensuring compliance with the law would be materially reduced. The net ongoing saving from a reduction in staffing levels is estimated to be \$9.2 million over the forward estimates period.

Costs for taxpayers and purchasers

This option has some impacts on purchasers, vendors and conveyancers.

Purchasers

Purchasers would need to comply with the withholding requirement. However, as this option is not linked to title transfer but leverages the settlement system that currently exists, this impact should be minimised. Therefore, this policy is easily integrated into the current system. As most purchasers use conveyancing services to complete their property transaction, this impact is further minimised.

While it is difficult to quantify the price impacts of this option for purchasers as a result of added conveyancing tasks, it is unlikely to significantly increase conveyancing costs. This is because this option is integrated into the conveyancing process and can be streamlined through the use of online forms to simplify requirements on purchasers. Over the next few years, the rollout of electronic conveyancing for all property transactions also provides further opportunity for the efficient and timely management of this process, further reducing any additional costs for purchasers.

Withholding and payment of the GST directly to the ATO on behalf of the vendors would be a relatively minor additional cost during this process.

Service providers (e.g. conveyancers)

The average annual regulatory costs are summarised in Table 1 below. The compliance costs of this option are equivalent to a net increase in regulatory burden of about \$4 million per year on an annualised basis over 10 years.

These impacts are expected to fall on vendors, conveyancers and other legal professionals involved in the settlement process. This represents about 40,000 businesses out of a business population of about 3 million entities.

It is expected that these businesses would need time to implement the new arrangement; to learn and understand what is required, and adapt processes and forms appropriately to deal with the changes to withholding GST.

Conveyancers and solicitors will need to adapt standard contracts and other documentation to include the withholding and payment of GST to the ATO. This process is likely to be more streamlined by using PEXA.

Property developers

Developers will no longer enjoy the cash-flow benefit that they currently gain from holding onto the GST from the sale until remittance to the ATO. Currently, at settlement, developers collect GST on behalf of the ATO and are able to retain that amount in their account until it becomes payable through their Business Activity Statement (BAS). Larger businesses with turnover greater than \$20 million are required to lodge their BAS monthly, while smaller and medium-sized businesses can lodge quarterly. This creates a temporary cash-flow benefit that increases the risk that these businesses would phoenix to retain the GST that was paid to them.

In consultation, finance representatives noted that removing this cash-flow benefit is unlikely to affect the ability for developers to secure finance, as banks exclude the GST component of a developer's account when making lending decisions.

Developer representatives also noted that most developers manage their cash flows so that financial decisions are not reliant on GST flows to meet their financial obligations. For those that are unable to manage finances effectively, this option ensures these businesses are compliant with their GST obligations. This option will also reduce the risk to the system from phoenixing as the GST that was paid is not lost.

Furthermore, this option evens the playing field for compliant developers because developers that did not remit the GST to the ATO received an unfair advantage due to retaining that amount of money.

Developers will also need to update their systems, contracts and practices to build the withholding mechanism into their transaction processes.

Transitional relief

This option includes a transitional arrangement, so as to minimise transitional costs on existing contracts for purchasers, service providers and property developers. Contracts signed before 1 July 2018 can continue under existing arrangements so long as they settle before 1 July 2020. This will allow most existing contracts to wash through (e.g. off the plan apartment purchases that often take 1-2 years between contract and settlement), whilst preventing potential mischief from long dated contracts being signed and ensuring all new residential property contracts come under the withholding regime by 2020.

There may be small costs for service providers in the short term who will be required to apply both systems for a period of two years. This cost is expected to be small compared to the reduction in costs for conveyancers and developers in no longer needing to change contracts signed before 1 July 2018.

Table 1: Regulatory burden estimate for Option 1

Average annual regulatory costs (from business as usual)				
Change in costs (\$ million)	Businesses	Community organisations	Non-business individuals	Total change in costs
Total, by sector	\$4	\$0	\$0	\$4

Note: Estimated average annual regulatory costs have been rounded.

Compliance cost impacts were assessed using a standardised compliance cost assessment methodology. The assessment provides many of the parameters that are used in the quantitative component that models the likely impact based on estimates drawn from the ATO General Compliance Cost Model.

To implement the changes, conveyancers and property developers would need to learn and understand the changes. It was anticipated that most would be familiar with GST processing and the preparation of the Business Activity Statement. The impact of this change was considered to be low.

It is possible that some conveyancers will pass on the additional compliance activity by increasing fees payable by purchasers. However, the impact of the change is considered minor and is occurring at a time when a range of disbursements are occurring as part of the transfer of property. For property developers it was considered that once they have learned and understood the changes there will be little or no on-going compliance cost impacts on top of their existing GST compliance processing.

For quantification purposes, aggregate impacts included conveyancers and property developers and these were placed with market segments of Large, Small and Medium and Micro businesses and totalled about 4,000 conveyancers and 36,500 developers and involved about 80,000 transactions. This produced aggregate potential compliance cost impacts of just under \$4 million per year and this equated to an average cost of about \$90 per year for each affected business or entity.

Option 2: Expand the ATO compliance function

This option would expand the compliance activities the ATO undertakes to address the risks in the property industry.

Benefits

As this option retains the current settlement and GST remittance processes, it has a limited benefit in that vendors and others in the property transfer process would not need to alter their procedures and processes.

Costs for taxpayers and purchasers

Depending on the scale of this option, the costs could be in the millions for the ATO.

However, this is anticipated only to lead to a relatively minor increase in GST liabilities – and is unlikely to adequately address the GST risk in the industry. There would continue to be a significant cost in revenue foregone as non-compliance continues.

This is because this issue arises due to regulatory failure, and merely increasing regulatory activities will not address the opportunity to commit, and the incidence of, the mischief in any meaningful way. Crucially, increasing compliance activities does not address the time-lag between the collection and remittance of GST which provides the benefit in phoenixing. Additional compliance would only provide “after-the-fact” remedies that often fail as the business in question has no remaining assets (and often has ceased to exist) to meet their GST obligations.

This option is very resource intensive, and all of the risks that are known in the industry are unchanged. ATO compliance/enforcement action in relation to a property vendor can be severely impeded by a lack of ‘real-time’ information; and after finalising an audit/investigation there is a real risk of not collecting taxes owed because the taxpayer goes into liquidation. Compliance activities to date have proven to be rather ineffectual despite the resources applied and the penalties available.

The use of Special Purpose Vehicles (SPVs) that is most commonly used in the property industry makes it difficult to collect the GST as there is no compliance history or linkage to persons running the company as each new SPV has different Directors.

Investment in infrastructure and reporting to provide real-time information would be expensive for the ATO and industry and would require legislative change.

Under this model, policy nudges will have little effect due to the very high financial rewards of failing to withhold. Higher penalties are also unlikely to deter this behaviour as they often fall on individuals that are placed as directors who have no financial assets, with the controlling mind being legally separated from the dealings.

Table 2: Regulatory burden estimate for Option 2³

Average annual regulatory costs (from business as usual)				
Change in costs (\$ million)	Businesses	Community organisations	Non-business individuals	Total change in costs
Total, by sector	\$0	\$0	\$0	\$0

Option 3 – No change

Under this option, no change in the GST law would be required and no change in the reporting and payment arrangements by vendors. However, under this option the problem of non-collection would persist.

Benefits

Vendors and others in the property transfer process would not need to alter their procedures and the processes they currently use.

Costs

There would be a cost in revenue foregone as non-compliance continued, as the risk cannot be mitigated under the current law. Continued management of the risk would be evaluated and prioritised against other GST risk areas and those that emerge in the future. Phoenixing in the property construction industry will continue because of the time delay between receiving the GST, being required to pay the GST to the ATO, and consequently detecting the pattern of non-payment and undertaking reasonable enquiries to satisfy the nature and extent of non-compliance and taking corrective action.

³ See the explanation under Option 1 for the rationale behind calculating compliance cost impacts. Since Option 2 maintains the status quo it is expected that there is no further compliance cost impact for this option.

Vendors complying with the existing law would continue to be at a GST/taxation disadvantage in comparison with vendors not complying with the law. As well, there is potential for an increase in dissatisfaction in the industry and the wider community as the GST is being paid by the purchaser to the vendor to gain title to the property but is not being paid by the vendor to the Government.

No regulatory burden or cost offset estimate table has been provided for this option as there is no change to current administrative and compliance arrangements.

5. Who has been consulted about these options?

The ATO undertook initial consultations in late 2015 with a range of stakeholders, including the property development sector, lawyers, conveyancers, financiers and State and Territory Governments. These consultations canvassed a number of potential solutions.

Of the options canvassed, all stakeholders at the time agreed that the option involving a withholding model not linked to the transfer of title would be the most effective solution that would have minimal impacts on vendors, purchasers and the sector generally.

Targeted consultation took place since the announcement of this measure in the 2017-18 Budget. This confirmed the industry's preference for a withholding model as discussed earlier and these consultations further refined their preferred approach to include a transitional arrangement.

Some stakeholders raised the possibility of introducing carve-outs for certain cohorts of developers perceived to be more compliant with the policy. While this was considered in that context, it was recognised there were costs and complexities in applying carve-outs, particularly on certain groups of developers and on purchasers and service providers who would face additional compliance burdens.

Consultations in this phase included a range of affected stakeholders from the legal, accounting, financial and the property development sector, such as:

- Property developers
- Law Societies (various);
- Conveyancers;
- Housing associations
- Banking, Accounting and Taxation Bodies.

Consultation sessions were held via phone conference and face-to-face meetings. One-on-one feedback was also obtained.

Public Consultations also took place on exposure draft legislation between 6 November 2017 and 20 November 2017. These consultations involved a combination of face-to-face meetings, phone conferences and emails with key industry stakeholders, and provided an opportunity for industry and the public to provide written submissions on the exposure draft legislation for consideration.

6. What is the best option from those considered?

Option 1 is recommended, it has the highest net benefit.

Option 1 imposes low regulatory costs and a process that is straight-forward, easy to apply and fits within existing conveyancing processes. A withholding mechanism is

- well understood by the development industry,
- fits with existing conveyancing processes,
- is simple for purchasers who would not need to register for GST to apply a withholding payment,
- leverages the existing disbursement process,
- can be backed by penalties, and
- is likely to lead to greater compliance with the law flowing through to higher GST collections.

A key advantage is that it fits within the existing business processes for transferring property ownership but applies to all vendors – keeping it simpler and more straight-forward and removing from purchasers the need to make inquiries about the status of the vendor.

Option 2 and 3 either retain the status quo or do not address the tax compliance risks in any systematic manner.

7. How will the proposal be implemented and evaluated?

Changes to legislation will be required, but these are anticipated to be relatively straightforward.

The ATO would be responsible for administering the new arrangements. The ATO has considerable experience with this area of GST law and the problems that have occurred, as well as the operation of withholding systems across the taxation system. It will provide guidance and advice to stakeholders to support their implementation efforts.