

Australian Tax Office Private Ruling on Applicability of GST to an Arbitration Award

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Background

In a recent private Arbitration conducted pursuant to the *Victorian Commercial Arbitration Act*, the Respondent decided of its own volition to seek a Private Ruling from the Australian Tax Office as to whether or not the Respondent would be liable to pay GST on the Award.

The Arbitration was in respect to two separate contracts for equipment to be designed, supplied and commissioned for the Respondent by the Claimant. The Respondent intended to use the equipment to manufacture its product range for wholesale and retail sale. The Respondent had withheld certain payments as it alleged the equipment had not been satisfactorily commissioned by the Claimant in accordance with the terms of the Contracts. The Respondent's counterclaim was for a range of losses arising from the failure of the Claimant to satisfactorily design, supply and commission the various items of equipment.

An Award was made upholding the Respondent's counterclaim in excess of \$1 million.

Tax Office Private Ruling

The Tax Office ruled that the out-of-court settlement was NOT subject to GST.

The following extract of key parts of the Private Ruling may be of interest to Arbitrators. (The full ruling is available in edited form on the Australian Tax Office web site at <http://ato.gov.au/rba/> by entering Advice No 28187 (details of the parties have been deleted). A related and very similar ruling can be found by entering Advice No 27939.)

“Question at Issue:

Is the payment awarded in an out-of-court settlement subject to goods and services tax (GST)?

Reasons for Decision:

Section 9-40 of the New Tax System (Goods and Services Tax) Act 1999 (GST Act) provides that you must pay GST on any taxable supply that you make.

Section 9-5 of the GST Act provides that you make a taxable supply where:

- a) you make the supply for consideration; and*
- b) the supply is made in the course or furtherance of an enterprise that you carry on; and*

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- c) *the supply is connected with Australia; and*
- d) *you are registered or required to be registered for GST.*

However, the supply is not a taxable supply to the extent that it is GST-free or input taxed.

If one of the above requirements is not met, then the supply is not subject to GST.

When considering if an out-of-court settlement will give rise to a GST liability, it is necessary to firstly establish if the requirement at (a), that there is a supply for consideration, has been met. For there to be a supply for consideration, the following three fundamental criteria must be met:

- a) *there must be a supply; and*
- b) *there must be a payment; and*
- c) *there must be sufficient nexus between the supply and the payment for it to be a supply for consideration.*

Is there a supply for consideration?

The term 'supply' is defined in subsection 9-10(1) of the GST Act as 'any form of supply whatsoever'. Generally, all supplies that are related to an out-of-court settlement will fall within one of three categories. These are described in Goods and Services Ruling GSTR 2001/4 as:

- a) *Earlier supply.*
Where the subject of the dispute is an earlier transaction in which a supply was made involving the parties, the supply is an earlier supply.
- b) *Current supply.*
A current supply is a new supply that may be created by the terms of the settlement.
- c) *Discontinuance supply.*

The terms of a settlement will generally ensure that no further legal action in relation to that dispute can be taken, provided there is compliance with the terms of the settlement. Where the terms of a settlement does include a clause to this effect, a discontinuance supply will exist.

In your case, the subject of your claim against the claimant is for losses incurred due to faulty equipment. There is no earlier supply made to the claimant which is relevant to the out-of-court settlement. In addition, no current supply has been created by the settlement.

The terms of the settlement provide that the total amount payable is specifically attributable to the losses suffered in relation to the pieces of equipment, either by way of additional expenses incurred or sales revenue lost.

GSTR 2001/4 addresses the issue of whether a successful claim for losses by an aggrieved party can constitute a supply. It states at paragraphs 71 to 73 that:

- 71. *Disputes often arise over incidents that do not relate to a supply. Examples of such cases are claims for damages arising out of property damage, negligence causing loss of profits, wrongful use of trade name, breach of copyright, termination or breach of contract or personal injury.*

72. *When such a dispute arises, the aggrieved party will often assert its right to an appropriate remedy. Depending on the facts of each dispute a number of remedies may be pursued by the aggrieved party in order to ensure adequate compensation. Some of these remedies may be mutually exclusive but it is still open to the aggrieved Party to plead them as separate heads of claim until such time as the matter is Resolved by a court or through negotiation.*
73. *The most common form of remedy is a claim for damages arising out of the termination or breach of a contract or for some wrong or injury suffered. This damage, loss or injury, being the substance of the dispute, cannot in itself be characterised as a supply made by the aggrieved party. This is because the damage, loss or injury, in itself does not constitute a supply under section 9-10 of the GST Act.*
- The out-of-court settlement received by you will not be subject to GST as the entire settlement is attributable to damages which is not a supply. It follows that there is no supply for consideration and the requirements of section 9-5 of the GST Act are not met.*

