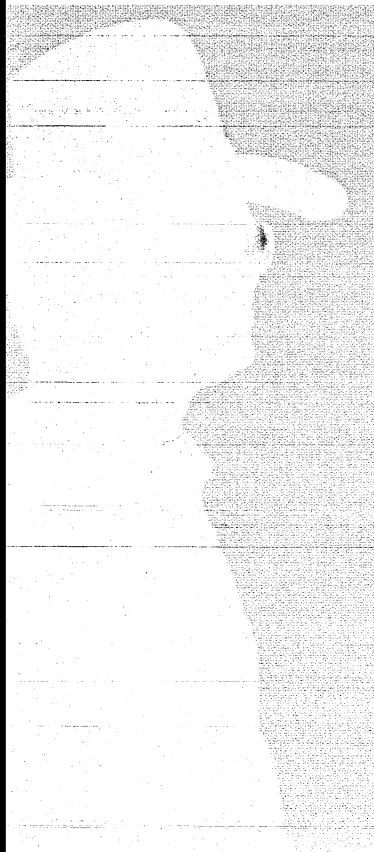


Cessation of registration

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For most business transactions it could be stated that the job is not complete until the paperwork is done. This is certainly true in relation to finalising any outstanding GST consequences when an entity ceases to be registered for GST. In *GST Today*, Issue 26, February 2001, [26.4] Bernard Kellerman discussed some of the consequences of ceasing to be registered for GST. This article takes this issue a little further by discussing the specific operation of Div 138 of the GST Act.

Overview of Div 138

The objective of Div 138 is to reverse the effect of previously allowed input tax credits on assets of the entity held at the time of ceasing registration. This is done by means of an increasing adjustment when the entity ceases registration for GST. The reason for the adjustment is that the assets are being taken out of the GST system, which is like going into final consumption. No input tax credits are available in respect of things outside of, or taken out of, the GST system. As the assets are not being used in the GST system, you should not have an input tax credit in respect of those assets. The adjustment operates to take back any input tax credits you have claimed.

Amounts not previously attributed

When an entity's registration is cancelled it is required that all outstanding GST liabilities and entitlements to input tax credits be finalised. This is provided in s 138-15 which states that the GST payable by you on a taxable supply, the input tax credit to which you were entitled for a creditable acquisition or an adjustment that you have, is attributable to a particular tax period, and no other, if:

- during the tax period, your registration is cancelled; and
- immediately before the cancellation, you were accounting on a cash basis; and
- the GST on the supply, the input tax credit on the acquisition, or the adjustment, was not attributable, to any extent, to a previous tax period during which you accounted on a cash basis; and
- it would have been attributed to that previous tax period had you not accounted on a cash basis during that period.

Example

Greg, a farmer, is registered for GST on a cash basis and reports for GST on a quarterly basis. He usually sells over \$30,000 worth of cattle every year. On 20 June 2002 he purchased 5 yearling cattle at a total cost of \$1,650 including GST and he sold 4 fat cattle for a total of \$2,640 on the same day. He had not received any payment for the cattle sold or paid any amount for the cattle purchased on or before 30 June 2002. He lodged his June 2002 BAS but did not include either of these 2 transactions because he was accounting for GST on a cash basis. Greg decided to cancel his registration for GST on 31 July 2002. The effect of s 138-15 on Greg ceasing to be registered is that the GST liability on the sale of 4 cattle (\$240) and the input tax credits (\$150) for the purchase of 5 cattle are attributed to the period in which his registration is cancelled or the tax period in which 31 July 2002 arises.

The primary focus of Div 138 relates to increasing adjustments arising as a result of the cessation of registration. The increasing adjustments are attributed to the concluding tax period in accordance with s 138-10.

Adjustments for cessation of registration

Section 138-5 provides that you have an increasing adjustment if:

- your registration is cancelled; and
- immediately before the cancellation takes effect, your assets include anything in respect of which you were or are entitled to an input tax credit.

Cancelling registration

There will be various reasons for cancelling registration, including:

- The entity ceasing to operate and the assets of the entity being used for a non-creditable purpose.
- The entity ceasing to be registered for GST but still carrying on an enterprise. This can happen when the entity satisfies the requirements of s 25-55 (Commissioner must cancel the registration) – for example where the annual turnover does not meet the registration turnover threshold of \$50,000 (set out in s 25-15).
- The entity may cancel registration after it sells all of the assets of the entity.

The date on which an entity's registration is cancelled will be determined in accordance with Subdiv 25-B. Section 25-50 provides that where an enterprise ceases you must request cancellation of your registration within 21 days after you ceased carrying on an enterprise. Alternatively if you are still carrying on an enterprise but wish to cancel your registration you can apply under s 25-55 or s 25-57 to have the Commissioner cancel your registration. The actual date of cancelling your registration will depend on the date that your enterprise ceased or the date that the Commissioner decides as provided in s 25-60.

Your assets

For s 138-5 to apply an entity must immediately before the cessation of registration have an asset in respect of which the entity was entitled to input tax credits. The term "asset" is not defined in the GST Act and similarly it is not defined in the *Income Tax Assessment Act 1997* (ITAA 97) even though the term "CGT asset" is defined in s 108-5 ITAA 97. In the absence of a clear definition of the term "asset" in the GST legislation it is necessary to look to a more generic definition of what constitutes an asset. This may involve using an accounting definition of an asset that includes the concept of an item that can deliver future economic benefits to the entity. There are at least 5 classes of items that require consideration to determine if they are assets:

- real property
- intangible assets
- depreciating assets
- trading stock
- other rights and legal entitlements.

In relation to some of these items it is very clear that they are assets. For example real property and intangible assets will clearly be assets of the entity. It is noted however that if the cancellation of registration arises as a result of the cessation of a business then some of the intangible assets may cease to exist on the cessation of business. Consider the scenario where an entity purchased a franchise licence, claimed input tax credits on the acquisition of the licence and upon cessation of business the asset ceased to exist because it expired or was forfeited. In this situation, immediately before the cancellation of registration there would be an asset of the business which would attract an increasing adjustment, but no asset would exist after cessation of business. This may appear to be inequitable as the asset does not have any value post cessation of business. There may of

course be capital gains tax consequences due to the forfeiture of the franchise licence: see s 104-25 ITAA 97.

Depreciating assets defined in s 40-30 ITAA 97 are also clearly assets for the purposes of s 138-5. In addition trading stock could be considered to be an asset of a business just before the cancellation of registration.

Some difficulty in determining whether an asset exists may arise in relation to other rights of a business. These may exist where the business is being carried on as a going concern but when the business ceases they cease to exist. For example a payment made under a 12-month insurance policy or another prepayment may be considered to be an asset of the business (under the accounting concept of an asset) while the business is operating as a going concern but once the business ceases the right created by the payment of an insurance premium or other prepayment may cease to exist. Here again there is a concern that s 138-5 would operate to calculate an increasing adjustment but there would be no asset remaining after cessation of business and cancellation of registration.

It would appear that s 138-5 operates irrespective of whether an asset exists after the cancellation of registration. This suggests that the legislation as it is currently written creates an inequity where assets that cease to exist or cease to provide any benefit after the cancellation of registration will still attract an increasing adjustment.

Calculation of the increasing adjustment

Section 138-5 provides that the amount of the adjustment is calculated as follows:

$$1/11 \times \text{Actual application of the thing} \times \text{Applicable value}$$

The actual application of the thing is the extent to which you have applied the thing for a creditable purpose. The concept of creditable purpose is discussed in s 11-15.

The applicable value is:

- the GST inclusive market value of the thing immediately before cancellation takes effect; or
- if you were or are entitled to an input tax credit for acquiring the thing – the amount of the consideration that you provided, or were liable to provide, for your acquisition of the thing but only if it is less than the CGT inclusive market value; or
- if you were or are entitled to an input tax credit for importing the thing – the cost to you of acquiring or producing the thing plus the GST paid on its importation but only if it is less than the GST inclusive market value.

Example

Let us continue the earlier example in relation to Greg with particular reference to the 5 cattle purchased on 20 June 2002. Based on s 138-15 he will attribute entitlement to the input tax credits of \$150 in the concluding tax period. However if we conclude that the cattle as trading stock of the business are assets of the business immediately before the cancellation of registration then s 138-5 will apply to impose an increasing adjustment on Greg. As the cattle are used 100% for a creditable purpose their actual application in accordance with s 138-5(2) will also be 100%. The question of course will be what is the applicable value just before the cancellation of registration. Let us assume that the cattle had consumed additional fodder and the GST inclusive market price of the cattle increased to \$2,200 on 31 July 2002. In this case it would appear that s 138-5(2)(b) would apply as the GST inclusive market value immediately prior to the cancellation of registration is greater than the consideration paid for the purchase of the cattle. In this case we take the value

of consideration paid for the cattle or \$1,650 which gives rise to an increasing adjustment of \$150. This completely offsets the \$150 in input tax credits claimed on the acquisition of the cattle.

It is noted that the fodder consumed by the cattle since acquisition if purchased may have given rise to input tax credits on its acquisition but as these consumables are not assets immediately prior to the cancellation of registration there is no need for any adjustment. This position is based on the fact that s 138-5(2)(b) calculates the increasing adjustment on the basis of the acquisition cost of the item disposed. As the acquisition cost is \$1,650 this is the figure used. Note however that there appears to be no claw back of any input tax credits claimed on the purchase of fodder as these are not the items being disposed of.

GST inclusive market value

The GST inclusive market value is defined in s 195-1 to mean the market value of the thing without any discount for any amount of GST or luxury car tax payable on the supply. Earlier we discussed the fact that the increasing adjustments only applied to assets of the business held immediately before the cancellation takes effect. Assuming that such assets exist then we need to determine the GST inclusive market value of those assets. The question of course arises as to what is the market value of the assets. As discussed earlier some of the assets may cease to exist as a result of the cancellation of registration and this causes difficulty in establishing a GST inclusive market value if that valuation is based on a going concern valuation method. In addition where assets such as prepayments cannot be transferred a question arises as to whether a market value can be established. It would appear that clarification by the ATO of the application of market value is required for the operation of Div 138.

Immediately before cancellation

The timing of the cancellation of registration would appear to be critical to the operation of Div 138. If the Commissioner provides a time for cancellation of registration being a time just after the business ceased then, at that time, some of the assets may have already ceased to exist. In addition, the market value of the assets that continue to exist may have been readjusted for the fact that the business has ceased. In this case the application of Div 138 may not be as onerous as it would be when cancellation occurs at the same time as the business ceases to operate.

Limitation on the application of increasing adjustments

Section 138-5(3) limits the application of increasing adjustments and states that an adjustment does not arise in respect of an asset if:

- there is one or more adjustment periods for your acquisition or importation of the asset; and
- the last of those adjustment periods has ended before the cancellation of your registration takes effect.

The adjustment periods referred to in s 138-5(3) are the adjustment periods in Div 129 and these relate to changes in the extent of creditable purpose. It is noted that under s 129-10(2) an adjustment cannot arise under Div 129 for an acquisition that does not relate to business finance unless the acquisition or importation had a GST exclusive value of more than \$1,000.

In other words the acquisition must cost \$1,000 or more prior to adjustment periods in Div 138 applying to it.

Example

Let us continue the previous example. Greg purchased a new John Deere 8500 tractor for \$110,000 including GST on 5 July 2000, and claimed back the \$10,000 GST on his September 2000 BAS. Greg on ceasing his registration for GST on 31 July 2002 will not come within the exception outlined in s 138-5(3) because there will be 5 adjustment periods applicable to the tractor and these will not have expired prior to the cancellation of his GST registration. Accordingly he will have an increasing adjustment in accordance with s 138-5 on cessation of registration.

Assets costing \$1,000 or less

As noted earlier there will be no increasing adjustment under s 138-5 if the last adjustment period under Div 129 has expired. This appears clear in itself however it poses the question: How does s 138-5(1) apply to assets that are not subject to adjustment periods in Div 129 because their acquisition cost was \$1,000 or less, exclusive of GST? Does this mean that it is only where an asset is subject to an adjustment period that the exemption in s 138-5(3) will apply? If so, all items costing less than \$1,000 which are not subject to adjustment periods will still come within the application of s 138-5(1). This would appear to place a very onerous long-term compliance cost on owners of small value items, in addition to the impact of the increasing adjustment.

We discussed already the operation of s 138-5 and calculated the increasing adjustment on the cattle on hand (trading stock) on the date that the registration was cancelled. It would appear appropriate that there should be an increasing adjustment in this case as the cattle are likely to be sold in the future at a time when the entity is not registered for GST; therefore there will not be any liability to charge GST when the registration has been cancelled. The calculation of the increasing adjustment in relation to the trading stock appears straightforward due to the fact that their acquisition is relatively recent and they are clearly identifiable. However in relation to small items of depreciating assets the compliance burden appears too great. One could suggest that there is an argument for legislative change to exclude assets costing \$1,000 or less (other than trading stock) from the operation of the increasing adjustments, in accordance with s 138-5(1). This would significantly assist in reducing compliance costs and would have a very minimal effect on the amount of GST recovered by operation of the provision.

Concluding comments

This article analysed the operation of Div 138 of the GST Act, which provides for an increasing adjustment on cancellation of GST registration. The article concludes that there is a need for clarification from the ATO in relation to the operation of the provision and, in addition, there is a valid argument for legislative change to:

- remove assets that cease to exist at the time of cessation of business from the operation of Div 138; and
- introduce a de minimis exemption rule which would exclude items (other than trading stock) costing \$1,000 or less (exclusive of GST) from the operation of Div 138 as this would simplify compliance with the provision.

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