

# GST: A Review

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*A Government discussion document*

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## **PREFACE**

Since its introduction in 1986, goods and services tax (GST) has been an important part of New Zealand's tax system. It taxes, at a single rate, most supplies of goods and services in New Zealand, with few exceptions. Internationally, New Zealand's GST system is acknowledged as a well designed indirect tax, influencing the design of indirect taxes put in place in other countries.

The performance of tax legislation is monitored through the Government's generic tax policy process to ensure that the legislation meets its objectives. As a part of this process, a review of the Goods and Services Tax Act 1985 has been carried out, and proposed changes resulting from the review are presented in this discussion document for public consultation.

The twelve years since GST was introduced have highlighted areas where change may be needed: to make it easier to comply with, to bring it up to date with developments in the commercial world, and to ensure that its original policy objectives are being met.

The Government welcomes the public's views on these proposals and looks forward to receiving submissions.

**Rt Hon Bill Birch**  
Treasurer

**Hon Bill English**  
Minister of Finance and  
Minister of Revenue



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# Part I

## Introduction



# CHAPTER ONE

## INTRODUCTION

- 1.1 Since goods and services tax (GST) was introduced in 1986 it has proven to be an efficient and relatively problem-free tax to administer. It is also a key contributor to Government revenue.
- 1.2 This discussion document is the product of the first review of GST under the Government's generic tax policy process, which presents opportunities for public consultation at key stages in the formulation of tax policy. The document sets out proposals to improve the workability of GST for taxpayers and Inland Revenue and to give better effect in some areas to the policy intent underlying GST. It also signals possible future avenues for development and reform of GST.

### **Background**

#### ***The Red Paper (November 1984)***

- 1.3 The intended introduction of a broad-based consumption tax, GST, was announced in the 1984 Budget. A booklet known as the "Red Paper"<sup>1</sup> outlined the economic reasons for the introduction of GST.
- 1.4 The New Zealand tax system at the time consisted mainly of income tax and a wholesale sales tax which had many exemptions and a number of rates applying to different goods. With its narrow base and the exclusion of services, which represented a growing part of the economy, the wholesale sales tax was not capable of generating significant revenue.
- 1.5 Tax revenue relied more heavily on the income tax system, which featured rates of up to 66 percent and many rebates and deductions. It was relatively easy to reduce income tax liabilities, and the income tax system did not provide a good foundation for raising additional revenue.
- 1.6 Therefore the introduction of GST and income tax reforms were seen as significantly reducing the economic distortions created by the tax system, reducing compliance and administrative costs, and improving the ability of the Government to meet its revenue requirements.

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<sup>1</sup> *Goods and Services Tax: A Booklet Explaining Measures Announced in the 1984 Budget*, 8 November 1984.

### ***The White Paper (March 1985)***

- 1.7 The “White Paper”<sup>2</sup> was used to generate public debate on the proposed GST. The White Paper called for submissions on the proposals for the administration of the tax and ways in which those proposals could be improved and simplified.

### ***Advisory Panel on the Goods and Services Tax (June 1985)***

- 1.8 An independent advisory panel considered over 1400 public submissions resulting from the White Paper, and reported on these submissions in June 1985. There was general public support for a broad-based, single-rate GST.
- 1.9 The report focused mainly on making recommendations that would reduce or ease compliance costs in areas such as the basis of accounting for GST, return periods, invoicing requirements and the time of supply. It also suggested ways of minimising the general cash flow impact of GST for certain taxpayers. Most of these suggestions were accepted by the Government.

### ***Post-implementation changes***

- 1.10 A number of changes have been made to GST since it was introduced, most being of a remedial nature or for the purpose of reducing compliance costs (for example, the introduction of the hybrid basis of accounting for GST in 1991).

### **Policy objectives**

- 1.11 The primary objective of GST is to raise tax revenue in a manner that imposes the lowest possible costs on New Zealand as a whole.
- 1.12 To achieve that objective, GST was applied to as broad a range of goods and services as was considered feasible at the time of its introduction, at a uniform low rate. As the *White Paper* stated, GST was formulated with the intention of:

“...bring[ing] within its scope the widest range of goods and services supplied in New Zealand ... liability for GST aris[ing] every time goods and services are supplied in the course of conduct of a taxable activity.”<sup>3</sup>

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<sup>2</sup> *White Paper on Goods & Services Tax: Proposals for the Administration of the Goods and Services Tax* March 1985.

<sup>3</sup> *Ibid*, at page 11.

- 1.13 This broad-based, low-rate approach is intended to reduce the extent to which GST alters consumption decisions in New Zealand. Thus it seeks to reduce the extent to which GST affects consumption of particular goods and services, and alters patterns of consumption by changing the relative prices that consumers must pay for their goods and services.
- 1.14 The broad base and low rate of GST is also intended to reduce the extent to which GST distorts production and resource use decisions in New Zealand. In particular, the approach adopted seeks to reduce the extent to which GST alters the relative competitive position of a New Zealand business in both the markets for the goods and services it produces, and the markets for the purchases it makes to produce those goods and services. Thus it seeks to reduce the extent to which GST distorts the relative prices that New Zealand businesses are paid for their sales of goods and services, and the relative prices they pay for their purchases. It also seeks to reduce the compliance and administrative costs associated with raising GST revenue.
- 1.15 Another important objective of GST is to prevent the double taxation of goods and services that are traded between New Zealand and other countries. GST is designed in accordance with the “destination principle”, which seeks to eliminate double taxation by assigning the rights to tax the consumption of traded goods and services to the jurisdiction in which those goods and services are destined to be consumed.

### **Objectives of the review**

- 1.16 Several developments since the introduction of GST make it timely to review the tax. In particular, a number of issues that have arisen suggest the original policy intent of the legislation in some areas is either not being achieved, or is ambiguous and needs clarification.
- 1.17 The years since GST was introduced have also seen important changes in technology and the business environment which necessitate a review of the law in certain areas.
- 1.18 The objective of this review is to re-examine GST in light of those developments to determine whether it is possible to achieve further reductions in the costs of raising GST revenue. Specifically, the Government is seeking to develop proposals that will:
- reduce the compliance and administrative costs arising from the application of GST; and
  - limit the scope for erosion of the GST tax base.

## **The scope of the review**

1.19 As reflected in the structure of this discussion document, the scope of the review covers four broad subject areas:

- issues relating to working with GST in practice, including compliance cost savings measures;
- issues relating to giving effect to the policy underlying GST;
- remedial issues; and
- issues relating to the future for GST.

### ***Working with GST***

1.20 This part of the discussion document deals with issues arising from the application and administration of GST in practice. These are:

- *Compliance cost issues*: the thresholds for compulsory registration and other issues concerning compliance cost reduction measures.
- *Change in use adjustments*: issues arising from the requirement to make adjustments for changes in use.

### ***Maintaining the revenue base***

1.21 This part of the discussion document examines the potential for GST to create tax avoidance opportunities, and the operation of the general anti-avoidance provision, section 76 of the Goods and Services Tax Act 1985 (the GST Act). It then discusses four areas where effect needs to be given to the underlying policy of GST:

- *Second-hand goods input tax credit*: the credit for supplies of second-hand goods, particularly land.
- *Deregistration*: the value of a deemed supply on deregistration.
- *Exported services*: the effect of the decision in *Wilson & Horton v Commissioner of Inland Revenue*.<sup>4</sup>
- *Deferred settlements*: the treatment of deferred payments.

### ***Remedial issues***

1.22 This part of the discussion document deals with numerous remedial issues, including futures contracts, debt collection, factored debts, going concerns and software.

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<sup>4</sup> (1995) 17 NZTC 12,325.

## ***The future for GST***

- 1.23 This part considers the future scope and application of GST – issues relating to GST on imported services and the desirability of retaining the exemption for financial services. Specific recommendations in these areas are not proposed here because the complexity of the issues will require detailed consultation with those parties that are primarily affected.

### **Application date**

- 1.24 In general, the proposals in this discussion document will apply from the date the amending legislation is enacted. The exception is the proposal in chapter nine relating to services contracted for offshore with a non-resident and subsequently consumed in New Zealand. The Government intends to include this proposal in the next available taxation bill, and the change will take effect from the date that the legislation is introduced into Parliament.

### **Submissions**

- 1.25 The Government invites submissions on the proposals in this discussion document.
- 1.26 Specific issues on which comment is sought are highlighted at the end of each chapter, although this is not intended to limit the scope of submissions.
- 1.27 All submissions should be addressed to:
- GST Review  
C/- General Manager  
Policy Advice Division  
Inland Revenue Department  
PO Box 2198  
WELLINGTON
- 1.28 Submissions on the proposal in chapter nine should be made by 26 March. Submissions on all other proposals should be made by 30 April. They should contain a brief summary of their main points and recommendations. Submissions received by the due date will be acknowledged.

## **Summary of proposals**

### ***Compliance cost savings measures***

- Increase the compulsory registration threshold from \$30,000 to \$40,000.
- Provide the Commissioner with the power in certain circumstances to reverse a decision that allows registered persons to change the last day of their taxable period.
- Increase the existing \$1,000,000 turnover threshold for accounting on the payments basis to \$1,300,000.
- Remove the existing unrestricted right for local authorities to account for GST using the payments basis.
- Increase the threshold when an abbreviated invoice is acceptable to justify the deduction of input tax from \$200 to \$1,000.

### ***Change in use adjustments – compliance issues***

- Legislate the current administrative methods of allocation (direct attribution, turnover, or special method) for establishing the proportion of taxable and non-taxable use.
- Allow registered persons, at their option, to make output tax adjustments on a one-off basis subject to certain conditions.
- In relation to one-off output tax adjustments, include a requirement to make further adjustments at the time a significant change in use occurs.
- Generally require deemed supplies from a change in use of goods and services to be valued at market value.
- Allow period-by-period adjustments to be made annually.
- Increase the \$10,000 threshold for one-off input tax adjustments for changes from non-taxable to taxable use to \$18,000.
- Increase the minimum threshold for exempt supplies (over which adjustments must be made) from \$48,000 to \$90,000.

### ***Change in use adjustments – other issues***

- Limit the input tax credit allowed for changes from non-taxable to taxable use to supplies of goods and services on which GST has been charged and to supplies of second-hand goods.
- Ensure that output tax adjustments for any non-taxable use apply to goods and services acquired or produced as well as applied for the principal purpose of making taxable supplies.



- Determine adjustments for dual purpose goods and services by reference to their use rather than their application.
- Ensure that an adjustment is triggered by any change of use (not just a subsequent change of use).
- Ensure that fringe benefits provided to past employees (including associated persons) are subject to GST.

***The general anti-avoidance provision – section 76***

- Change from a subjective test of intention to the more objective test of the effect of an arrangement.
- Change the test of defeating the intent and application of the Act to that of defeating the “intended application” of the Act.
- Include a purpose provision in the Act to assist in clarifying the intended application of the Act.
- Clarify that the Commissioner’s specific reconstructive powers in section 76(2) do not limit the general reconstructive power in section 76(1).

***The second-hand goods input tax credit***

- Limit the notional credit in relation to supplies of second-hand goods made to an associated person to the lesser of:
  - the GST component (if any) of the original cost of the goods to the supplier; or
  - one-ninth of the purchase price; or
  - one-ninth of the open market value.

***Deregistration***

- Require any deemed supply on deregistration to be valued at market value.

***Exported services***

- Exclude from zero-rating the supply of a right to receive a service if any recipient of that service will be in New Zealand at the time it is performed.

***Deferred settlements***

- Require GST to be returned on an accrual basis for any supply exceeding \$200,000 in value.

***Financial services exemption***

- Exclude debt collection services from the definition of “financial services”.
- Include financial options in the definition of “financial services”.

- Provide that non-deliverable futures contracts will be exempt if they are tradeable on a defined market or are traded at arm's length.
- Clarify that deliverable futures contracts will be subject to GST unless the deliverable commodity is exempt.
- Treat penalty interest as being in respect of a financial service.
- Repeal the proviso in subparagraph (ii) of section 14(a) which excludes goods or services that are not themselves financial services from being financial services.

#### ***Factored debts***

- Require registered persons accounting for GST on a payments basis to pay GST on the remaining book value of a debt when it is factored.

#### ***Going concerns***

- Require the “going concern” test to be applied when the supply is deemed to be made.
- Require a business to be capable of being carried on by a purchaser for it to be transferred as a “going concern”.

#### ***Exported services: remedial issues***

- Allow the supply of services in relation to exported goods to be zero-rated.
- Include a definition of the phrase “outside New Zealand” in section 11(2)(e) and (fa).

#### ***The treatment of software***

- Treat copies of software programs as “goods” and copyright in relation to software programs as “services”. This is not intended to affect the current treatment of imported software under section 12.

#### ***The definition of “associated persons”***

- Replace the definition of “associated persons” for GST purposes with the broader definition used in the Income Tax Act 1994. This definition would include:
  - stronger provisions dealing with trusts;
  - a level of association between a shareholder and a company at 25 percent rather than 10 percent;
  - a rule to aggregate the rights held in a company by relatives.
- Include people in de facto relationships in the definition of “associated persons” in the GST Act.

***Unincorporated bodies: debt priority and members' liability for GST***

- Confirm the preferential status of GST debts recoverable from individual members of an unincorporated body.
- Ensure that preferential status for unpaid GST debts of an unincorporated body applies if a receiver is appointed other than by court order.
- Confirm that the liability of a member of an unincorporated body for GST payable during the time the person was a member extends beyond the period of membership.

***Personal representatives, liquidators, and receivers***

- Amend section 58(1A) (specified agent carrying on taxable activity) to include a receiver appointed to control only part of a taxable activity.
- Clarify when an agency period terminates.
- Allow personal representatives an input tax credit for the GST component of bad debts related to pre-agency period supplies.
- Clarify the relationship between section 58(1A) and section 5(2).

***Other issues***

- Amend the definition of “taxable activity” so that it includes both a premature ending of a taxable activity as well as a successful completion of a taxable activity.
- Amend the definition of “input tax” to allow importers who are acting as an agent for a non-resident to claim an input tax credit for any GST levied under section 12.
- Deem the time of supply for suspensory loans to be the time when the loan is made.
- Recognise the value of a voucher for services when the voucher is acquired.
- Allow the value of a voucher with a face value to be deducted from the gross proceeds of a lottery event.

## CHAPTER TWO

### KEY CONCEPTS IN THE GOODS AND SERVICES TAX ACT

- 2.1 GST is intended to apply to the change in value at each point in the production and distribution of goods and services, with the tax being ultimately paid by the final consumer. The GST Act gives effect to this broad objective through a number of key concepts including registered person, goods and services, taxable activity, taxable supply, and the time, value and place of supply. Section 8 is the core provision of the GST Act as it imposes GST by reference to these key concepts. An important aspect of measuring the amount of value added by a supplier is the ability to claim input tax credits for purchases.
- 2.2 This chapter describes these concepts and their place in setting the scheme of the GST Act.

#### Registered persons

- 2.3 Section 51 contains the requirements for registering for GST. Registration is required if there is a taxable activity involving taxable supplies of more than \$30,000 in a 12-month period. Anyone carrying on a taxable activity under that threshold may also choose to register.
- 2.4 The registration threshold minimises compliance and administrative costs by directing GST to those suppliers best able to comply with the requirements of the GST Act.

#### Goods and services

- 2.5 “Goods” is defined in section 2 as all kinds of real or personal property other than choses in action<sup>5</sup> or money. “Services” is defined as anything which is not goods or money. Therefore money is not subject to GST, and choses in action are deemed to be services. These definitions ensure that GST applies to a very wide range of supplies.

#### Taxable activity

- 2.6 The taxable activity test establishes the boundaries within which GST operates. It is similar to a business test but without the requirement that the activity be carried on for profit.

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<sup>5</sup> For example, leases of land, use of patent rights, an interest in a partnership, company shares, trademarks and copyrights.

- 2.7 A “taxable activity” is defined in section 6. Whether or not a taxable activity exists depends on whether:
- an activity is carried on continuously or regularly; and
  - it involves, or is intended to involve, supplies to another person for a consideration or payment.

### **Taxable supply**

- 2.8 A “supply” is defined in section 5 to include all forms of supply. A taxable supply is one which is made in the course or furtherance of a taxable activity and meets the other key elements of section 8. Taxable supplies are charged with GST either at the standard 12.5 percent rate or, in certain circumstances, at zero percent.
- 2.9 Taxable supplies include goods taken from a business by a registered person for private use and assets on hand at the time a person ceases to be registered. This treatment ensures that the principle of final consumption applies to the application of assets outside a taxable activity as well as to supplies to another person as a final consumer.

### **Exempt supplies**

- 2.10 Taxable supplies do not include exempt supplies. These include primarily:
- supplies of financial services;
  - supplies of residential accommodation; and
  - supplies of donated goods and services by non-profit bodies.

### **Zero-rated supplies**

- 2.11 Section 11 lists the supplies that are charged with GST but at a zero rate. The main zero-rated supplies are exported goods and services. No GST is charged on them because they are not consumed in New Zealand. Exporters can, however, claim input tax credits for the cost of acquiring or producing the exported goods or services.
- 2.12 For compliance and administrative reasons, zero-rated supplies also include the supply (in specific circumstances) of a going concern between two registered persons.

### **Time of supply**

- 2.13 Section 9 contains the rules that deem when a supply of goods or services has taken place. The time of a supply is generally the earlier of the time a supplier issues an invoice or the time the supplier receives any payment.

### **Value of supply**

- 2.14 Section 10 provides that the value of a supply is determined by the amount of consideration given in exchange for a supply. Consideration is generally the money received for the supply or the open market value of any non-monetary consideration received. Supplies between associated persons are deemed to be made at open market value except when the purchaser is entitled to an input tax credit.

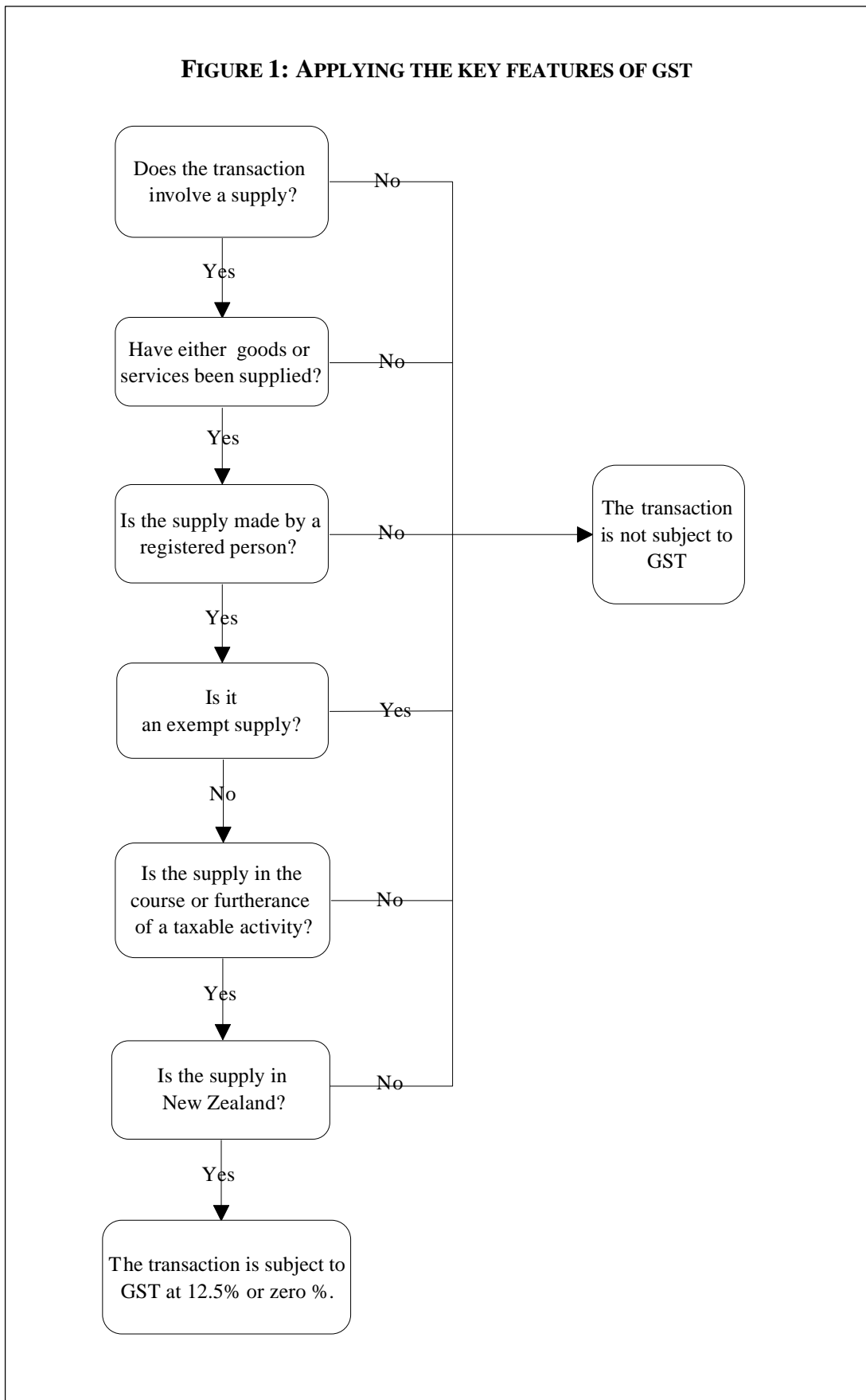
### **Place of supply**

- 2.15 GST applies to supplies made in New Zealand. This ensures that only consumption that occurs in New Zealand is subject to GST. The place of supply is determined first by reference to the residence of the supplier. Supplies by residents are deemed to be made in New Zealand.
- 2.16 Supplies by non-residents are generally deemed to be made outside New Zealand unless, in the case of goods, they are in New Zealand at the time of supply or, in the case of services, they are physically performed in New Zealand. If the goods and services are supplied by a non-resident to a registered person the supply is deemed to be made outside New Zealand unless the supplier and purchaser agree otherwise.

### **Input tax credits**

- 2.17 Registered persons are entitled to claim input tax credits for the GST component of the cost of goods and services acquired for the principal purpose of making taxable supplies. Allowing an input tax credit ensures that only the amount of value added by the registered person is subject to GST.
- 2.18 An input tax credit is defined in section 2 to include tax charged under section 8. To ensure equal treatment of supplies of new and second-hand goods a notional credit is allowed to registered persons in relation to second-hand goods they acquire from non-registered persons.
- 2.19 Adjustments are made under section 21 to alter, in effect, the amount of an input tax credit allowed for goods or services acquired for the principal purpose of making taxable supplies but applied to another purpose.

2.20 Figure 1 shows the application of these key features to a transaction.







## Part II

# Working with GST



## CHAPTER THREE

### COMPLIANCE COST SAVINGS MEASURES

#### **Proposed policy**

##### ***Registration threshold***

- Increase the compulsory registration threshold from \$30,000 to \$40,000.

##### ***Six-monthly taxable period***

- Retain the existing \$250,000 turnover threshold for the six-monthly taxable period.

##### ***One-month taxable period***

- Retain the existing one-month taxable period for registered persons with a turnover exceeding \$24 million or those who choose to file on this basis.

##### ***Other taxable periods***

- Review the two-monthly taxable period to see whether extending the period could reduce compliance costs.

##### ***Last day of taxable period***

- Provide the Commissioner with the power to reverse any decision that allows registered persons to change the last day of their taxable period.

##### ***Payments basis***

- Increase the existing \$1,000,000 turnover threshold for accounting for GST on the payments basis to \$1,300,000.
- Remove the existing unrestricted right for local authorities to account for GST using the payments basis.

##### ***Tax invoices***

- Increase the threshold when an abbreviated invoice is acceptable to justify the deduction of input tax from \$200 to \$1,000.

3.1 GST is a self-assessed tax in that registered persons are responsible for determining their own tax liability. This is appropriate as they are in a better position than the Government to know their own GST liability.

3.2 The Government acknowledges the costs that GST imposes on registered persons, and this chapter proposes a number of measures to ease that compliance cost burden. Easing this burden does not, however, come without a cost to Government revenue.

3.3 Therefore the aims of the reforms proposed in this chapter are to:

- maximise compliance cost savings to the widest range of registered persons at the least cost to the tax base; and
- ensure that the existing compliance cost savings measures are appropriately targeted.

### The GST profile

3.4 About 511,000 entities, including individuals, are registered for GST. From these entities over \$5,822 million of net GST revenue was raised in the last financial year.<sup>6</sup> A significant portion of this revenue (42.25 percent) is returned from registered persons with an annual turnover exceeding \$20 million, although this group represents only 0.33 percent of total registered persons. In contrast, registered persons with an annual turnover under \$1 million represent 94.49 percent of total registered persons but return only 26.17 percent of total GST revenue. Table 1 shows the turnover and number of registered persons against the amount and proportion of GST revenue that is collected.

**TABLE 1: THE GST PROFILE**

<i>Turnover</i>	<i>Number of Registered Persons</i>	<i>%</i>	<i>GST Collections \$</i>	<i>%</i>
<\$30,000	209,086	40.88	-378,573,616	-6.50
<\$250,000	204,424	39.96	745,396,957	12.80
<\$500,000	44,086	8.62	556,822,682	9.56
<\$1,000,000	25,749	5.03	600,343,593	10.31
<\$2,000,000	13,670	2.67	552,960,435	9.50
<\$5,000,000	8,573	1.68	637,201,158	10.94
<\$10,000,000	2,828	0.55	350,024,919	6.01
<\$20,000,000	1,408	0.28	298,373,055	5.12
≥\$20,000,000	1,700	0.33	2,460,426,251	42.25
<b>Total</b>	<b>511,524</b>		<b>5,822,975,434</b>	

### Compliance costs

3.5 GST, like other forms of taxation, imposes compliance costs on registered persons. These costs tend to be proportionately higher for taxpayers with a lower turnover.

<sup>6</sup> Source: Inland Revenue. All figures are based on IR 101 returns for the period July 1997 to June 1998, excluding GST collected by the New Zealand Customs Service (approximately \$2,936 million). Percentages may not add to 100 percent due to rounding.

- 3.6 Some compliance costs, however, are not directly caused by GST, but are part of general bookkeeping requirements. For example, the time taken to complete a GST return has a direct correlation with the standard to which the accounting records have been maintained.
- 3.7 Compliance costs are also partially offset by the deferral of the payment of GST collected on behalf of the Government.

### **Minimising compliance costs**

- 3.8 The variety of ways to reduce the compliance costs on smaller entities include:
- the threshold under which registration for GST is not required;
  - their ability to operate a six-monthly return cycle;
  - their ability to change the last day of a taxable period;
  - their ability to account for GST on the payments basis; and
  - the threshold for fully detailed “tax invoices”.
- 3.9 The remainder of this chapter sets out specific proposals for further reducing compliance costs and tightening the application of the concessions to ensure that they are appropriately targeted.

### ***Registration threshold***

- 3.10 Generally, if the supplies made by a person in the course or furtherance of a taxable activity exceed \$30,000 in any twelve-month period, that person is required to register for GST.
- 3.11 The point at which any threshold is set is a compromise between the revenue received by the Government and the compliance costs incurred by society in order to generate that revenue. The assessment of whether a particular entity can manage that compliance cost is usually made on the basis of its turnover.
- 3.12 When GST was introduced the registration threshold was set at \$24,000. In 1990 the Government increased the threshold to \$30,000, a figure in line with inflation between 1986 and 1990.
- 3.13 It has been nearly ten years since the threshold was last increased. If the threshold were raised in line with inflation it would be set at around \$35,000. The Government proposes to increase the threshold to \$40,000. This higher figure has been selected to ensure that the threshold remains current for another five to ten years. This increase will allow 25,000 entities to cease accounting for GST should they so wish.

### ***Six-monthly taxable periods***

- 3.14 The six-monthly return period was introduced as a compliance cost savings measure. Currently, registered persons with a turnover of less than \$250,000 may account on a six-monthly basis. This means that just over 400,000 entities can account for GST using a six-monthly return. Fewer than half of those eligible (166,000) have taken up this option.
- 3.15 Registered persons who account for GST on a six-monthly basis, although often having a cash flow advantage, tend to face higher compliance costs. Often the GST revenue they collect on the supply of goods and services is used to meet other expenses, causing difficulties in meeting their GST liability. These registered persons also tend to have poorer standards of bookkeeping.
- 3.16 More regular filing can have significant benefits in terms of reducing the cash flow impact on registered persons when returning GST, and improving their financial record-keeping.
- 3.17 Although these are good arguments to shorten the six-monthly taxable period, registered persons under the \$250,000 threshold should continue to have the option of six-monthly filing. However, it is not proposed to increase the turnover threshold under which six-monthly filing is allowed.

### ***One-month taxable period***

- 3.18 The Government does not propose any change to the one-month period applicable to registered persons with a turnover exceeding \$24 million, or those who choose to file on this basis.

### ***Alternative taxable periods***

- 3.19 The Government places a high priority on reducing compliance costs for small to medium-sized entities. For this reason the Government invites submissions on whether the standard two-monthly period is appropriate or whether the period should be extended to, say, three months.

### ***Last day of taxable period***

- 3.20 Registered persons can select a date seven days either side of the last day of the month before closing off the relevant taxable period (see section 15(7)).
- 3.21 Some have used this measure to engineer sizeable timing advantages between groups of registered persons who are not necessarily associated. Some purchasers who can influence the behaviour of other entities achieve this timing advantage by extending the last day of their taxable period. Effectively, purchasers are able to anticipate GST refunds without this giving rise to corresponding GST liabilities for the other entities. The larger the transaction the larger the timing advantage becomes.

- 3.22 In recognition that it is not always possible for some registered persons to harmonise their internal reporting with the last calendar day of their taxable period – because, for example, of industry practice or the expense otherwise involved – section 15(7) will be retained. It is proposed, however, to give the Commissioner the power to reverse any decision made concerning the granting of a change in a registered person’s last day of a taxable period if that registered person cannot provide sound commercial reasons, other than a tax advantage, for maintaining the change.
- 3.23 If the Commissioner reverses an earlier decision, the registered person must adopt a taxable period that ends on the last day of month in the next taxable period.

### *The payments basis*

- 3.24 Access to the payments basis of accounting for GST is restricted to registered persons with a turnover of less than \$1,000,000, local authorities and non-profit bodies. It is also possible for other registered persons to apply to the Commissioner for special consideration.
- 3.25 Since the introduction of the GST Act, the payments basis threshold has been raised twice. Originally set at \$250,000, the threshold was raised to \$500,000 with effect from 3 December 1985, the date the GST Act was enacted. The threshold was again raised to \$1,000,000, from 1 October 1990, as a result of recommendations from the Taxation Simplification Consultative Committee.
- 3.26 The present threshold allows up to 480,000 registered persons to account for GST on a payments basis. This represents approximately 94 percent of GST registered persons.
- 3.27 The continued necessity for a cash basis of accounting needs to be considered in this light and in the context of an increasing use of computer technology to meet internal accounting needs. This means that many entities are substantially more sophisticated than they were ten to twelve years ago. Some aspects of the payments basis have, therefore, been reviewed.

### *The payments basis threshold*

- 3.28 It is proposed to increase the payments basis threshold in line with inflation to \$1,300,000. Given the percentage of taxpayers that already have access to the payments basis, however, and the increasing sophistication of accounting systems, the Government will monitor whether future increases to this threshold are warranted.

### *Local authorities*

- 3.29 The unrestricted availability of the payments basis to local authorities was appropriate in the years when local and central government funded their activities by cash appropriation. In 1993 amendments to the Public Finance Act removed the ability of public authorities to be funded by cash appropriation. In 1995 this change was reflected in the GST Act by removing the automatic ability for public authorities to account for GST on a payments basis.
- 3.30 Similar reform is now occurring within local government. With the enactment of the Local Government Amendment Act (No 3) 1996 local authorities are now required to adopt generally accepted accounting practice.<sup>7</sup> This requires them to adopt an accrual basis for financial reporting purposes.
- 3.31 To reflect this reform in local government accounting, it is proposed to remove local authorities' unrestricted ability to account for GST using the payments basis.

### *Non-profit bodies*

- 3.32 Non-profit bodies will still be able to account for GST on a payments basis. This recognises that the majority of non-profit bodies tend to have less sophisticated accounting systems.

### *The Commissioner's discretion to allow the payments basis*

- 3.33 Registered persons who do not meet the turnover threshold may also be allowed to account for GST on a payments basis under certain circumstances. Section 19A(1)(c) gives the Commissioner the discretion to allow accounting on the payments basis if satisfied that the nature, volume, and value of the taxable supplies made by the registered person, and the person's accounting system, indicate that it would be appropriate for the person to do so. This discretion will be retained.

### *The tax invoice*

- 3.34 A tax invoice is an invoice that meets the requirements set out in section 24. A tax invoice must be held to verify any input tax credit claim made by a registered person.

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<sup>7</sup> Refer section 223E(5) of the Local Government Act 1974.



- 3.35 Section 24(3) requires the following to appear on a tax invoice:<sup>8</sup>
- (a) The words “tax invoice” in a prominent place:
  - (b) The name and registration number of the supplier:
  - (c) The name and address of the recipient:
  - (d) The date upon which the tax invoice is issued:
  - (e) A description of the goods and services supplied:
  - (f) The quantity or volume of the goods and services supplied:
  - (g) Either -
    - (i) The total amount of the tax charged, the consideration, excluding tax, and the consideration, inclusive of tax for the supply; or
    - (ii) Where the amount of tax charged is the tax fraction of the consideration, the consideration for the supply and a statement that it includes a charge in respect of the tax.
- 3.36 This detail is not always required. If the consideration paid for a supply of goods or services is less than \$50 a tax invoice is not needed to claim an input tax credit (section 24(5)). For supplies with a consideration of less than \$200 an abbreviated tax invoice may be used to claim an input tax credit (section 24(4)). An abbreviated tax invoice does not require the name and address of the recipient nor the quantity or volume of the goods and services supplied.
- 3.37 The Government is aware that some registered persons are experiencing difficulties in acquiring the correct documentation from some suppliers. In some cases they are incurring penalties because they make input tax credit claims that do not meet the documentation requirements in section 24.
- 3.38 Section 24 gives the Commissioner the flexibility to determine that if there are, or will be, sufficient records to establish the particulars of a supply of goods and services, a “tax invoice” may not be required, or some of the statutory requirements under section 24 may not be necessary.
- 3.39 Because the “tax invoice” is Inland Revenue’s primary method for verifying input tax credit claims, it is not proposed to amend the statutory requirements in section 24. Even so, the detail required in section 24(3) may not be necessary for all transactions above \$200. The Government proposes, therefore, that the current \$200 threshold under which an abbreviated “tax invoice” may be used be raised to \$1,000.
- 3.40 The proposed new threshold is intended to reduce the compliance cost burden of the requirement to hold detailed tax invoices for small, but regular, items of expenditure.

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<sup>8</sup> These requirements are modified with respect to “buyer created” invoices, “modified” invoices and second-hand goods (refer sections 24(2), 24(6A) and 24(7)).

- 3.41 It is not proposed to adjust the current \$50 threshold under which a tax invoice is not required. Although the amount of revenue involved in a transaction of less than \$50 is small, the large volume of these transactions means that the revenue risk of any increase to this threshold is significant. Although taxpayers must substantiate all claims, the benefits derived from increasing this threshold would not outweigh the Government's exposure to incorrect input tax credit claims.

**Specific issues for consultation**

- Whether (and, if so, how) the two-monthly period should be extended. Would a three-monthly period be appropriate?
- Compliance difficulties faced by taxpayers in relation to the current tax invoice requirements.

## CHAPTER FOUR

### CHANGE IN USE ADJUSTMENTS – COMPLIANCE ISSUES

#### Proposed policy

- Legislate the current methods of allocation (direct attribution, turnover, or special method) for establishing the proportion of taxable and non-taxable use in the GST Act.
- Allow registered persons, at their option, to make output tax adjustments on a one-off basis. The one-off adjustment would be made:
  - for goods and services that replace goods and services with an existing pattern of use, at the time of acquisition on the basis of the use of the replacement goods and services over the past 12 months; and
  - for other goods and services with no pattern of use, provisionally at the time of acquisition and recalculated after 12 months' use.
- In relation to one-off output tax adjustments, include a requirement to make further adjustments at the time a significant change in use occurs, which may be either:
  - a change in principal purpose; or
  - a change in use of, say, 20 percent or more.
- Generally require that deemed supplies on a change of use be valued at market value.
- Allow registered persons, at their option, to make adjustments annually rather than for each taxable period or on a one-off basis.
- Increase the \$10,000 threshold for one-off input tax adjustments for changes from non-taxable to taxable use to \$18,000.
- Increase the minimum threshold for exempt supplies (over which adjustments must be made) from \$48,000 to \$90,000.

- 4.1 A registered person can claim input tax credits for goods and services acquired for the principal purpose of making taxable supplies. In some cases goods and services acquired for the principal purpose of making taxable supplies are used partly or entirely for another purpose (either at the time they are acquired or some later time) such as for a private or exempt purpose. Conversely, goods and services acquired principally for a non-taxable purpose may be used in making taxable supplies.

- 4.2 The GST Act deems the non-taxable use of goods and services acquired by a registered person principally for a taxable purpose to be a taxable supply by the registered person, and output tax is charged accordingly.
- 4.3 If goods and services are acquired principally for a non-taxable purpose a registered person is not entitled to an input tax credit. If those goods and services are used for a taxable purpose, however, the GST Act allows an input tax credit to reflect that taxable use.

### **Objective of change in use adjustments**

- 4.4 The principal objective is to ensure that input tax credits reflect the extent of the taxable use of goods and services. This is achieved by making adjustments to output tax or input tax if the original intended use of the goods and services changes or if the goods and services are acquired for both taxable and non-taxable purposes.
- 4.5 The requirement to make output tax adjustments ensures that tax is borne by the final consumer when there is private or exempt use of goods or services. For example, the private use of goods or services acquired by a registered person for the principal purpose of making taxable supplies represents a supply of goods or services to the registered person in his or her private capacity and, as such, should be subject to GST.
- 4.6 Although these principles are generally well understood, the legislation does not clearly specify how the calculations are to be made, which creates high compliance costs. This chapter proposes a number of changes to reduce these costs.

### **The apportionment approach**

- 4.7 The current GST treatment of goods or services applied for dual purposes is to allow or deny an input tax credit depending on the principal purpose for which goods or services are acquired, and deem any application to the non-principal purpose to be a supply (the adjustment approach). An alternative approach (the apportionment approach) would be to provide that any non-taxable use is reflected in an apportionment of the initial input tax credit at the time of supply on the basis of the intended continuing use of the goods or services for each activity.

### ***Other jurisdictions***

- 4.8 The Canadian GST regime adopts an apportionment approach. Input tax credits are apportioned on the basis of intended use. Changes in use are taken into account only for capital property, with a distinction made between real and personal property.
- *Capital real property:* An input tax credit is allowed to the extent that the real property is applied for a taxable purpose. Any significant change (more than 10 percent) triggers a deemed supply.
  - *Capital personal property:* A full input tax credit is allowed if the property is acquired primarily (more than 50 percent) for a taxable purpose. Changes in use are taken into account only if there is a change in the primary purpose.
- 4.9 The United Kingdom's VAT legislation also provides that if goods and services are used partly for a taxable purpose and partly for a non-taxable purpose, input tax credits are apportioned. If a registered person's intentions regarding the use of goods or services change within six years of the original acquisition, an adjustment is made.

### ***The New Zealand position***

- 4.10 The adjustment approach used in New Zealand is difficult to apply in some circumstances and has resulted in considerable litigation. The apportionment approach may appear to be a simpler and more accurate approach to the calculation of input tax, but it has considerable complexities. First, it assumes that intended continuing use can be predicted. Second, the treatment on disposal may be complex as it is unclear whether apportionment should be calculated on the respective amounts of taxable and non-taxable use on acquisition, on disposal, or in the intervening period. Canada and the United Kingdom have incorporated detailed rules to make these calculations.
- 4.11 In addition, by not deeming a supply to occur when goods and services are used for non-taxable purposes, apportionment rules do not reflect the principle that GST is borne by the final consumer. The Government considers that this key principle should be retained but the compliance costs imposed by the current requirements need to be reduced. The remainder of this chapter discusses the current adjustment rules and the proposals for dealing with this and related issues.

### **Current adjustment rules**

- 4.12 The existing legislation is sufficiently broad to permit two methods of adjustment:
- calculating the estimated non-taxable or taxable use and making a one-off adjustment; or

- making adjustments in every taxable period in which goods and services acquired principally for making taxable supplies are used in making non-taxable supplies or vice versa.

**Example**

A motor vehicle purchased for the principal purpose of making taxable supplies is subsequently used (say, 49 percent) for private purposes. The cost of the vehicle was \$20,000. The adjustments required for the deemed supplies under each of the interpretations above would be:

- (i)  $\frac{20,000 \times 49\%}{9} = \$1088.89$  as a one-off adjustment
- (ii)  $\frac{20,000 \times 18\%}{6} \times 49\% = 294/9 = \$32.67$  per two-monthly taxable period

Note: 18 percent is the income tax straight-line depreciation rate for the motor vehicle.

- 4.13 Inland Revenue's policy<sup>9</sup> is that, for goods and services used partly for taxable and partly for non-taxable purposes, a deemed supply occurs in each taxable period in which the goods and services are used for non-taxable purposes.
- 4.14 However, various Taxation Review Authority cases have held that the adjustment required under the GST Act is a one-off adjustment calculated on the basis of the original input tax credit.<sup>10</sup>
- 4.15 Inland Revenue's requirement to make period-by-period adjustments is based on the underlying policy intent and the assumption that the words "to the extent" in the relevant provisions, section 21(1) and section 21(5), refer to application over time.
- 4.16 Under section 10(8) the value of the deemed supply is calculated as the lesser of cost or open market value. In relation to period-by-period adjustments, the supply of the goods or services is being valued, not the goods or services themselves. Therefore the "cost" is not the original cost to the registered person, but the cost of supplying the goods and services. To approximate this value a income tax straight-line depreciation rate is used. The open market value is the cost of hiring an asset, not the cost of acquiring it.
- 4.17 If there is a total and permanent change in use of goods and services a one-off adjustment based on the purchase price or production cost may be made. A one-off adjustment may also be made for goods that cost \$10,000 or less.

<sup>9</sup> As set out in *Tax Information Bulletin* Volume 6, No. 11, April 1995.

<sup>10</sup> For example, *Case N39* (1991) 13 NZTC 3,333.

4.18 Adjustment percentages may alter. Unless goods or services are used 100 percent for another purpose, continuing adjustments reflecting the change in use are required. For example, a registered person purchases a fax machine. On acquisition, the business use is 80 percent and private use is 20 percent. A full input tax credit is claimed and adjustments are made for the 20 percent private use. After the fax machine has been owned for a year, it is used 40 percent for business and 60 percent for private use. The registered person must make private use adjustments for the 60 percent of private use.

*Allocation between taxable and non-taxable supplies*

4.19 To calculate change in use adjustments it is necessary to establish the proportion of the use of goods and services in relation to taxable and non-taxable supplies. Inland Revenue’s policy<sup>11</sup> is that there are three possible methods of allocation:

- direct attribution;
- the turnover method; and
- a special method.

*Direct attribution*

4.20 Direct attribution involves allocating the cost of goods and services to taxable and non-taxable supplies on the basis of actual use. Apportionment percentages established for income tax purposes would generally be acceptable for GST purposes.

*Turnover method*

4.21 If the cost of goods and services cannot be directly attributed, the proportion of taxable and non-taxable use can be calculated on a turnover basis.

4.22 This method applies only for exempt use. The formula for the turnover method is:

$$\frac{\text{Total value of exempt supplies for taxable period}}{\text{Total value of all supplies for taxable period}} = \text{percentage of supplies which are exempt}$$

*Special method*

4.23 If the direct attribution or turnover methods are not suitable, a registered person may agree with Inland Revenue to use another method of allocation.

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<sup>11</sup> GST Guide – A guide to working with GST, GST 600, December 1997, pages 51-66.

### ***Legislating the methods of allocation***

- 4.24 At present, the rules on methods of allocation are administrative guidelines only. To provide more certainty, the methods could be set out in legislation.
- 4.25 The Government welcomes comments on this proposal and on any difficulties in using the prescribed methods or gaining approval to use a special method.

### **One-off adjustments**

- 4.26 Requiring registered persons to make adjustments in every taxable period creates compliance costs. In some cases the GST payable can be disproportionately low compared to the compliance costs involved in calculating the adjustments.

### ***Change from taxable to non-taxable use***

- 4.27 The Government proposes to allow registered persons to elect to make one-off output tax adjustments for all goods and services applied to a non-taxable use. The \$10,000 threshold in section 21(1) under which one-off adjustments can currently be made would be removed.
- 4.28 The one-off adjustment would be made:
- for goods and services that replace goods and services with an existing pattern of use, at the time of acquisition on the basis of the use of the replacement goods and services over the past 12 months; and
  - for other goods and services with no pattern of use, provisionally at the time of acquisition and, to increase the accuracy of the adjustment, recalculated after 12 months' use.
- 4.29 In relation to those goods and services for which period-by-period adjustments are currently made, transitional legislation would be required to ensure that the one-off calculation takes into account any previous adjustments that have been made.
- 4.30 Registered persons may prefer to continue to make period-by-period adjustments rather than making a one-off adjustment. Therefore it is proposed that the one-off output tax adjustment be optional.
- 4.31 A difficulty with one-off adjustments is that they anticipate that goods or services will be used for exactly their expected life span. That is, the private use is clawed back on the whole GST cost on acquisition, as opposed to only one-ninth of the annual depreciation.



**Example**

A delivery van costs \$22,500 and is used 40 percent for a non-taxable purpose. A one-off adjustment is made ( $\$2,500 \times 40 \text{ percent} = \$1,000$ ) regardless of whether the registered person holds the van for one year or for ten years.

***Change from non-taxable to taxable use***

4.32 There is less evidence of compliance cost concerns in relation to input tax adjustments allowed under section 21(5). In any event, one-off input tax adjustments could create a significant avoidance opportunity. Therefore the period-by-period adjustments should continue to apply, but the current \$10,000 threshold under which one-off input tax adjustments can be made will be increased in line with inflation to \$18,000.

***Subsequent changes in use***

4.33 Another difficulty with one-off adjustments is that goods and services may last for many years, during which time the proportion of their taxable and non-taxable use may vary significantly. Therefore a mechanism is needed to cater for any changes in use after the acquisition of goods and services. If the taxable use increases, an input tax credit would be allowed to reflect the extent of the change. If the taxable use decreases, output tax would correspondingly be payable.

4.34 It is proposed that an adjustment be required at the time a significant change in use occurs, which may be either:

- a change in principal purpose; or
- a change in use of, say, 20 percent or more.

4.35 Both options give rise to compliance and administrative costs, but these should be in most cases less than existing costs. The Government welcomes comment on which of the options for change in use adjustments is preferred.

**Example: adjustment for change in use of 20 percent or more**

A registered person purchases a computer system for \$45,000. The computer system is to be used 80 percent for making taxable supplies and 20 percent for private use.

In the first taxable period the full input tax credit is \$5,000 and the registered person makes a one-off adjustment of  $20 \text{ percent} \times 5,000 = \$1,000$ , reducing the input tax credit to \$4,000.

In the next taxable period, the computer system is used 60 percent for making taxable supplies and 40 percent for private use. The registered person must pay output tax of 20 percent (the change in application)  $\times \$5,000$  (the original input tax credit claimed) = \$1,000.

### **Change in use adjustments by property developers**

- 4.36 If a building acquired by a property developer is let for residential purposes before its sale the principal purpose of acquiring the building has not changed because the building is still held for the purposes of resale, although it is also used for an exempt purpose. Because the initial input tax credit must be adjusted to recognise the change in use, the practice is to require an adjustment to be made in each taxable period that the property is let.<sup>12</sup> No change to this practice is proposed.

### **Annual adjustments**

- 4.37 To reduce compliance costs further, the Government also proposes to allow registered persons to elect to make adjustments annually to coincide with the time an income tax return is due.
- 4.38 Annual adjustments would reduce the compliance costs incurred by registered persons with both GST and income tax filing obligations, although not all registered persons (such as some non-profit bodies) file income tax returns.
- 4.39 The Government welcomes comments on the compliance cost savings of allowing annual adjustments in substitution for period-by-period or one-off adjustments.

### **Value of deemed supplies**

- 4.40 The valuation rules used throughout the Act should be as consistent as possible. Chapter eight (Deregistration) proposes that market value be adopted for deemed supplies on deregistration so that such supplies are comparable to those made on an arm's length basis.
- 4.41 As the change in use adjustment approach is intended to reflect the value of the "supply" by registered persons to themselves, it is proposed that the deemed supply be treated as made at market value, other than in the situation discussed in paragraph 4.44. This is a change from the current option of valuing at the lesser of cost or open market value.
- 4.42 The Government invites submissions on this issue, particularly on any compliance cost concerns in relation to assets where the cost option may be more commonly used.

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<sup>12</sup> See "GST – section 21 and property developers who rent out property for residential purposes" *Tax Information Bulletin* Volume Five, No. 8, January 1994.

- 4.43 Any one-off adjustment made at the time goods and services are acquired on the basis of market value would be the same as if cost were used. (This assumes that the cost of the asset reflected its market value on acquisition.)
- 4.44 In relation to change in use adjustments subsequent to a one-off adjustment, however, it is proposed that the recorded cost of the goods and services be used to value the deemed supply. This means that the initial input tax credit would be adjusted to reflect the new proportions of taxable and non-taxable use.

### **Treatment on disposal**

- 4.45 The treatment of supplies of goods and services used in a taxable activity should be the same regardless of whether or not adjustments have been made during the period of ownership. The only exception should be when there has been a change to the principal purpose for which the goods or services were originally acquired. Therefore full output tax should be charged on taxable supplies in all cases. Consistently with GST being a tax on final consumption, it is likely in any event that any level of non-taxable use would result in a supply of a lesser value (and thus a lower GST impost) than if the goods had been used entirely for taxable purposes.

### **The threshold for exempt supplies**

- 4.46 A registered person is not required to make an adjustment for goods and services used for an exempt purpose if the value of exempt supplies does not exceed specified thresholds.
- 4.47 Under section 21(1) an adjustment is not required if, over a 12-month period, the value of exempt supplies does not exceed the lesser of:
- \$48,000; and
  - 5 percent of the total taxable and exempt supplies.
- 4.48 The threshold has not been amended since GST came into force. The Government proposes to increase the level to \$90,000 to reflect the inflationary effects since 1986.

### **Specific issues for consultation**

- Any difficulties in using the prescribed methods or gaining approval to use a special method.
- The proposal to allow one-off adjustments, and in particular if a one-off adjustment is made whether subsequent changes should be made to reflect:
  - a change in principal purpose, or
  - a change in use of, say, 20 percent or more.
- The compliance cost savings of the proposal to allow registered persons, at their option, to make adjustments annually rather than for each taxable period or on a one-off basis.
- Any compliance concerns with the proposed requirement that deemed supplies on a change of use generally be valued at market value.

## CHAPTER FIVE

### CHANGE IN USE ADJUSTMENTS – OTHER ISSUES

#### **Proposed policy**

- Limit the input tax credit allowed for changes from non-taxable to taxable use to supplies of goods and services on which GST has been charged and to supplies of second-hand goods.
- Ensure that output tax adjustments for any non-taxable use apply to goods and services acquired or produced as well as applied for the principal purpose of making taxable supplies.
- Determine adjustments for dual purpose goods and services by reference to their use rather than their application.
- Ensure that an adjustment is triggered by any change of use (not just a subsequent change of use).
- Ensure that fringe benefits provided to past employees (including associated persons) are subject to GST.

- 5.1 This chapter discusses a number of issues in relation to section 21 of the GST Act to clarify the scope and calculation of change in use adjustments.

#### **Input tax credit for changes in use**

- 5.2 Section 21(5) allows an input tax credit for goods and services not acquired principally for taxable purposes that are also used for taxable purposes. The provision appears to operate more broadly than intended to allow an input tax credit if goods and services are used for making taxable supplies irrespective of whether GST has previously been imposed (either by way of output tax or a general price uplift) in relation to the goods and services.
- 5.3 The input tax credit is restricted to goods and services acquired or produced after 1 October 1986. This assumes that the introduction of GST resulted in a cost to the registered person. Therefore it is proposed that the credit allowed under section 21(5) be limited to goods and services for which an input tax credit was not allowed for the sole reason that they were not acquired for the principal purpose of making taxable supplies. Following this approach, the input tax credit under section 21(5) would be restricted to acquisitions of goods and services on which GST has been charged and supplies of second-hand goods.

### “Goods and services applied”

- 5.4 Section 21(1) refers to goods and services *applied* by a registered person for the principal purpose of making taxable supplies which are subsequently applied for another purpose.
- 5.5 In 1987 the word “applied” was substituted for the phrase “acquired or produced”. Section 21(1) previously required an adjustment to be made for the non-taxable application of goods and services *acquired or produced* by a registered person for the principal purpose of making taxable supplies. Because it was not possible to register for GST until 3 December 1985, goods or services purchased before that date were not subject to the adjustment.
- 5.6 Further, as taxable supplies are those subject to GST, it was also possible that goods and services purchased before 1 October 1986 and after 3 December 1985 did not fall within the scope of the provision.
- 5.7 The 1987 amendment severed the link with the definition of “input tax”, which requires goods and services to be *acquired* for the principal purpose of making taxable supplies. Goods and services may be *acquired* for the principal purpose of making taxable supplies and never actually be *applied* for that purpose. For example, a property developer may acquire residential property for development purposes but let the property without ever actually applying it in the development activity.
- 5.8 Section 21(1) would be clearer if it referred to goods and services “*applied, acquired or produced* by a registered person for the principal purpose of making taxable supplies”.

### “Applied” or “used”

- 5.9 Section 21(1) refers to goods and services applied for the principal purpose of making taxable supplies which are subsequently *applied* for another purpose. Similarly, section 21(5) refers to goods and services for which no input tax deduction is claimed which are subsequently *applied* for the purpose of making taxable supplies.
- 5.10 The purpose to which goods and services have been “applied” is difficult to measure. For example, a property developer who buys a residential property for resale might let the property in the interim. The property could be regarded as wholly applied to the letting activity as well as wholly applied to the development activity.
- 5.11 The word “used”, on the other hand, could lead to a more objective assessment of the purpose to which particular goods or services are put. It is proposed, therefore, that the word “used” be substituted for the word “applied” in the second and third places it is used in section 21(1), with corresponding changes to section 21(2) and section 21(5).

### **Subsequent application**

- 5.12 Under section 21(1) a deemed supply occurs when goods and services applied for a taxable purpose are *subsequently* applied for a purpose other than that of making taxable supplies.
- 5.13 If interpreted literally the use of the word “subsequently” could mean that input credits in relation to services or goods wholly consumed in the taxable period they were acquired would never require adjustment under section 21(1). A corresponding issue arises under section 21(5).
- 5.14 These provisions should be clarified by removing the word “subsequently”. This would better reflect the requirement for an adjustment to account for any application of goods and services for a purpose other than the principal purpose.

### **Employee benefits**

- 5.15 Output tax must be paid when goods and services acquired for the principal purpose of making taxable supplies are provided as fringe benefits to employees.
- 5.16 Some benefits are subject to fringe benefit tax (FBT) but not GST. This arises because section 21(3) deems a supply to occur when a registered person provides a fringe benefit to any other person and “that other person is employed under a contract of service by that registered person”.
- 5.17 An FBT liability arises for fringe benefits provided by an employer to “a person who will receive, receives, or has at any time received ...a source deduction payment”. Because of the limitation in section 21(3) to contracts of service, fringe benefits provided to past employees or their associates are not subject to GST.
- 5.18 It is proposed that the reference to persons employed under contracts of service be removed from section 21(3) to better align the deemed supply rules with the FBT rules.

### **Other issues**

- 5.19 Table 2 lists minor clarifications and corrections needed in section 21.

**TABLE 2: MINOR CLARIFICATIONS AND CORRECTIONS**

<i>Issue</i>	<i>Proposed solution</i>
Section 21 could give rise to an unintended output tax liability for services provided by employees. For example, employee services are acquired for the principal purpose of making taxable supplies for which no input tax credit is available. Some employee services are then used in relation to exempt supplies.	The anomaly will be corrected by specifying that sections 21(1) and 21(5) do not apply to services provided by employees.
Section 21(1) can be activated to the detriment of a registered person by a legislative amendment that makes a supply exempt (for example, service occupancy agreements are exempt from 19 December 1989) and therefore triggers a section 21 adjustment.	Section 21(1) will be amended to provide that it does not apply if the deemed supply has arisen because of a change in the legislation.
It is not clear whether the thresholds in section 21 are GST inclusive or exclusive.	The thresholds in section 21 will be amended to clarify that they are GST inclusive.
There is inconsistency in relation to section 21(3B) (adjustments for non-deductible entertainment expenditure) and the time of supply depending on whether income tax returns are filed early or on time.	To minimise compliance costs, the time of supply should be the same time as when the income tax return is due. Section 21(3B) will be amended to provide that the time of supply is the earlier of the time the income tax return is due or is furnished.
Section 21(5) applies if no deduction has been made for goods and services acquired or produced after 1 October 1986.	The subsection will apply to goods and services acquired or produced <i>on or after</i> 1 October 1986, the date on which the GST Act took effect.
There is a drafting error in section 21(6) (the re-application of goods and services to a taxable activity).	Section 21(6) refers to “goods and services deemed to be supplied <i>to</i> a person under section 5(3)”. It should refer to “goods and services deemed to be supplied <i>by</i> a person under section 5(3)” and will be amended accordingly.



## Part III

# Maintaining the Revenue Base



## CHAPTER SIX

### THE GENERAL ANTI-AVOIDANCE PROVISION – SECTION 76

#### Proposed policy

- Change from a subjective test of intention to the more objective test of the effect of an arrangement.
- Change the test of defeating the intent and application of the GST Act to that of defeating the “intended application” of the Act.
- Include a purpose provision in the Act to assist in clarifying the intended application of the Act.
- Clarify that the Commissioner’s specific reconstructive powers in section 76(2) do not limit the general reconstructive power in section 76(1).

- 6.1 Tax avoidance opportunities under the GST Act are created by boundaries including those between taxable and non-taxable transactions and between registered and non-registered persons.
- 6.2 Ideally, to remove tax avoidance opportunities these boundaries would be removed. This is not possible, however, for compliance cost and administrative reasons, so anti-avoidance provisions are necessary.

#### Policy intent

- 6.3 Specific anti-avoidance provisions should be the principal means of countering GST avoidance. Because taxpayers can use various measures, including the valuation rules, to structure transactions in ways that will give them tax advantages, specific anti-avoidance provisions are necessary. An example of such a provision is section 10(3), which deems supplies between associated persons to be made at market value.
- 6.4 An argument raised against some specific anti-avoidance provisions is that their application can extend to more than avoidance arrangements. Their advantage, however, is that they rely on objective criteria rather than a subjective view of the arrangement, so they tend to be more certain in their application.

- 6.5 The general anti-avoidance provision, section 76, was intended to be a “back stop” provision used to fill the gaps that specific anti-avoidance provisions did not cover. It was intended to counteract any abuse of the types of tax advantages inherent in GST, but it does not fully achieve these objectives. This chapter, therefore, proposes a number of changes to make the provision more effective.

### **The section**

- 6.6 Section 76 gives the Commissioner the power to disregard, for GST purposes, any “...arrangement [that] has been entered into between persons to defeat the intent and application of this Act, or of any provision of this Act...”

### **Problems with the avoidance test**

- 6.7 Several problems with section 76 preclude its application in all but the most obvious cases of avoidance. These problems result from both the wording of the section and from the nature of GST and transaction taxes in general.

#### ***“Entered into to defeat”***

- 6.8 Section 76 uses a *subjective* test of the person’s intention in entering into an arrangement, stating that avoidance occurs if the arrangement is “...entered into ... to defeat the intent and application of the Act...”
- 6.9 Section 76 is worded in such a way that the Commissioner must demonstrate that it was the person’s *subjective* intention to defeat the intent and application of the Act.
- 6.10 In addition, looking at the interpretation of other subjective intention tests in taxation law, notably section CD 4 (Personal Property) of the Income Tax Act,<sup>13</sup> it is arguable that the intention to defeat the Act must be the *dominant* intention of the person. Section 76, by providing that the person must enter an arrangement “to defeat” the Act, assumes that tax avoidance was the dominant intention.
- 6.11 This subjective test of dominant intention means that it is difficult to show that an arrangement is an avoidance arrangement. Arrangements that can be shown to be motivated by commercial or family reasons, even if the tax advantage to be gained was a significant but perhaps not dominant factor, may not fall within the scope of section 76.

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<sup>13</sup> As interpreted by the Court of Appeal in *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346.

**“Intent and application”**

- 6.12 Section 76 does not attack a prohibited effect, but a *prohibited intention* – the intention of defeating the intent and application of the Act. Once this intention has been established, any tax advantage flowing from it can be counteracted, but a tax advantage without this intention is not void.
- 6.13 An arrangement can be voided only if it defeats the “intent and application” of the Act. The phrase is not defined, nor does the Act have a purpose provision, so the meaning of “intent and application” must be inferred from the scheme of the Act itself.
- 6.14 This is a problem because in many circumstances the general scheme of the Act is clouded by exceptions and boundaries which create uncertainty as to the true “intent and application” of the Act.

**“Defeat the intent and application”**

- 6.15 For section 76 to apply, the transaction must be entered into to defeat both the intent *and* the application of the Act. This causes particular problems in the context of GST, since the vast majority of transactions that could be called tax avoidance rely not on defeating the Act, but are intentionally structured so that the provisions of the Act apply to give a favourable GST treatment.

**Proposed reform**

***Objective test***

- 6.16 It is proposed to change the wording of section 76(1) so that any arrangement that has the *effect* (or an effect) of avoiding tax is covered by the section. This will lower the currently high evidentiary barriers to the application of the section.

***Intended application***

- 6.17 The use of the phrase “defeat the intent and application” in the section as it is currently worded means that many arrangements that could reasonably be adjudged to be tax avoidance are not, since they do not defeat the Act’s application.
- 6.18 Changing the test from defeating the intent and application of the Act to defeating the “intended application” of the Act will go some way to ensuring that adherence to the letter of the law will not by itself save an avoidance arrangement from being voided.

### ***A purpose provision***

6.19 The phrases “intent and application” and “intended application” highlight a possible need in the Act for a purpose provision to assist in clarifying the intended application of the Act. A purpose provision would assist in the interpretation of the Act in situations such as those described by McKay J in *Commissioner of Inland Revenue v Alcan New Zealand Ltd*, when interpreting an Act where the words of the Act are:

“...capable of more than one meaning and the object of the legislation is clear, the words must be given “such fair, large and liberal construction” as will best ensure the attainment of the object of the Act ... One should always have regard to the total context of the words used and to the purpose of the legislation in order to arrive at the meaning intended. This does not mean some forced meaning to fit a preconceived idea of purpose ... The true meaning must be consonant with the words used, having regard to their context in the Act as a whole, and to the purpose of the legislation to the extent that this is discernible.”<sup>14</sup>

6.20 Any purpose provision would be based on the fundamental principle underlying GST – that it intends to tax, in a non-distortionary manner, consumption in New Zealand through the amount of value added by registered persons. Beyond this broad principle, however, the purpose of the Act and how it is represented in the scheme of the Act becomes less clear. Where boundaries and exemptions occur in the Act the relationship between them and the fundamental principle of GST must be clarified.

6.21 The Government invites submissions on what a purpose provision in the GST Act should contain.

### **Applicability of case law dealing with sections BG 1 and GB 1 (section 99)**

6.22 There are conceptual differences between GST and income tax, and differences in the avoidance tests in the GST Act and the Income Tax Act (which will continue to exist in the reworded section 76). For example, as the Court of Appeal stated in *Commissioner of Inland Revenue v New Zealand Refining Co Ltd*:

“It is fundamental to the GST Act that the tax is levied on or in respect of supplies. It is not a tax on receipts or on turnover; it is a tax on transactions...”<sup>15</sup>

6.23 However, the broad principles underlying general anti-avoidance provisions – for example the meaning of “effect” and how an effect is established – are applicable both to GST and income tax.

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<sup>14</sup> (1994) 16 NZTC 11,175 at 11,178 – 11,179.

<sup>15</sup> (1997) 18 NZTC 13,187 at 13,193.

- 6.24 Therefore taxpayers and Inland Revenue should receive guidance, and gain some certainty, concerning the application of section 76 from case law dealing with sections BG 1 and GB 1 of the Income Tax Act 1994 (section 99 of the Income Tax Act 1976).

## **The Commissioner's reconstructive powers**

### ***Policy intent***

- 6.25 Section 76(1) gives the Commissioner the power to adjust the amount of GST payable by, or refundable to, any registered person affected by an arrangement voided by section 76, in such manner as the Commissioner considers appropriate to counteract any tax advantage obtained. This power can be exercised even if the registered person was not a party to the avoidance arrangement.
- 6.26 In addition to this general power to adjust GST liabilities, the Commissioner has four specific powers under section 76(2) to deem:
- anyone who has participated in any arrangement in any way to be a registered person;
  - any supply of goods and services affected by, or part of, any arrangement to have been both supplied by any registered person and supplied to any registered person – whether or not the supply was a taxable supply;
  - any goods and services to be supplied in the taxable period in which they would have been supplied but for any avoidance arrangement; and
  - any supply of goods and services to have been made at, or the consideration for the supply to be given at, open market value.
- 6.27 The exact scope of these powers, and their effectiveness in counteracting tax advantages, is somewhat uncertain.
- 6.28 The policy intention behind the Commissioner's powers is, however, clear – any tax advantage flowing to any person, whether or not that person is a party to an avoidance arrangement, is to be counteracted.

### ***Issue***

- 6.29 The hierarchy of the Commissioner's powers under the current formulation of reconstructive powers is blurred. The relationship between the broad power to counteract tax advantages in subsection (1) and the specific powers in subsection (2) is not clearly set out.

- 6.30 The fundamental principle to be applied to reconstructions is that any tax advantage to any person is to be counteracted. To this end subsection (1) provides the Commissioner with a general counteracting power, and subsection (2) contains specific examples of the Commissioner's powers within this general power.

***Proposed reform***

- 6.31 It is proposed to amend subsection (2) of section 76 to clarify that the powers contained in it do not in any way limit the Commissioner's broad power of reconstruction under subsection (1).

**Specific issue for consultation**

- What should a purpose provision in the GST Act contain?



## CHAPTER SEVEN

### THE SECOND-HAND GOODS INPUT TAX CREDIT

#### Proposed policy

- Limit the notional credit in relation to supplies of second-hand goods made to an associated person to the lesser of:
  - the GST component (if any) of the original cost of the goods to the supplier; or
  - one-ninth of the purchase price; or
  - one-ninth of the open market value.
- If second-hand goods have been acquired from an associated person previously registered for GST (and who has paid output tax on deregistration), the amount of the notional credit allowed should be, as under the current law, one-ninth of the lesser of the purchase price or the open market value. A proposal to require output tax on deregistration to be paid by reference to market value is discussed in the next chapter.

- 7.1 If a registered person acquires second-hand goods from a non-registered person a notional input tax credit is allowed for the amount of the tax fraction (one-ninth) of the consideration paid.
- 7.2 The notional input tax credit has been used by some registered persons to claim large GST refunds in various circumstances, including for goods on which GST has not previously been paid. In some cases it appears that second-hand goods are sold to an associated person primarily to claim a second-hand goods input tax credit. This chapter discusses proposals for reform in relation to supplies of second-hand goods.

#### Policy intent

##### *Allowing a notional credit*

- 7.3 The 1985 White Paper proposed a modification to the general definition of “input tax” to ensure comparability between the treatment of new and used goods.

- 7.4 If a registered person acquires new or second-hand goods from a GST registered person the GST component is shown on the tax invoice<sup>16</sup> and can be claimed as an input tax credit.
- 7.5 If a registered person purchases second-hand goods from a non-registered person the supply is not subject to GST. The registered person may claim one-ninth of the purchase price as a notional input tax credit, however, provided sufficient records of the supply are kept.<sup>17</sup>
- 7.6 Allowing a credit avoids the double taxation that would arise on the resale of goods already subject to GST when acquired by the non-registered supplier. In other words, the credit limits the GST paid by the final consumer to the amount of value added by registered persons.

### ***The meaning of second-hand goods***

- 7.7 The second-hand goods credit was intended to apply to goods commonly regarded as second-hand, such as used motor vehicles, household furniture and appliances.
- 7.8 The original definition of “second-hand goods”, repealed in 1988, read:
- “In relation to any goods acquired by any registered person, means goods that have previously been used, or acquired for use, or held for use, by any other person.”
- 7.9 Exclusions for fine metal and livestock were added in 1986 and 1989 respectively to provide certainty and remove avoidance opportunities.
- 7.10 Several court cases have involved second-hand goods credits for land. In some of these cases the courts have held that the credit for second-hand goods is allowed but without specifically deciding that land is second-hand goods. Some doubts have been cast on whether land is really “second-hand”.<sup>18</sup>
- 7.11 The Court of Appeal in *LR McLean*<sup>19</sup> noted that there is nothing in the purpose or scheme of the Act that would justify ignoring the ordinary meaning of the words “second-hand goods”.

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<sup>16</sup> Alternatively, the GST component can be calculated from the “GST inclusive” amount.

<sup>17</sup> Section 24(7) specifies the type of information that must be provided (including a description of the goods, the date of the supply, and the name and address of the supplier).

<sup>18</sup> Bathgate DJ in *Case LI08* (1989) 11 NZTC 1,608: “ ‘Second-hand’ is not a word used to describe the character of land that has been previously farmed or used in some way or other by predecessors in title or occupation.”

<sup>19</sup> *LR McLean and Co Ltd and Ors v CIR* (1994) 16 NZTC 11,211.

- 7.12 The ordinary meaning of “second-hand” was described by Barber DJ as:
- “...used or treated or stored by a previous owner in such a manner that it can no longer be regarded as new.”<sup>20</sup>
- 7.13 The *Concise Oxford Dictionary* (9th ed.) definition of “second-hand” in relation to goods is “having had a previous owner; not new”.
- 7.14 “New” is defined as “made, discovered, acquired, or experienced recently or now for the first time, in original condition; not worn or used”.
- 7.15 Although title to land is capable of prior ownership, it is not “used” in the sense of ordinary consumption having occurred.

### **Options for change**

- 7.16 Three broad approaches to countering avoidance opportunities in relation to credits for second-hand goods are discussed in this chapter:
- a review of the treatment of land specifically;
  - the replacement of the current notional credit scheme with a margin scheme; and
  - limiting the amount of the notional credit allowed in certain circumstances.

### ***Options for the treatment of land***

#### *Exclude land from the definition of second-hand goods*

- 7.17 As discussed earlier, it was intended that the second-hand goods credit would apply only to sales of goods commonly considered to be second-hand.
- 7.18 Therefore one option is to exclude land from the definition of second-hand goods. This would preclude registered persons from claiming a second-hand goods input tax credit for non-taxable supplies of land. However, they would still be required to charge output tax on any subsequent sale of that land, so denying the input tax credit could result in double taxation.

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<sup>20</sup> *Case N16* (1991) 13 NZTC 3,142 at 3,147.

**Example (excluding land from the definition of second-hand goods)**

In 1990 A (a non-registered person) buys farm land for \$200,000. Output tax is paid but no input tax credit is allowed.

In 1995 A sells the land to B (a registered person) for \$300,000. No output tax is charged because A is not a registered person, and because land is excluded as a second-hand good, no input tax credit is allowed to B.

In 1999 B sells the land to C (a non-registered person) for \$360,000. Output tax is charged because B is a registered person, but no input tax credit is allowed.

Result:

Both A and C pay GST in relation to the land. There is no offsetting input tax credit.

*Exempt land from GST*

7.19 The original proposed treatment for the sale of land was set out in the White Paper:

“In recognition that land is not “consumed” in the normal sense, transactions involving the supply of land, excluding buildings, will not be subject to GST.”<sup>21</sup>

7.20 The Advisory Panel on GST accepted the conceptual logic of not subjecting the sale of unimproved land to GST but identified some “very considerable practical difficulties”.

7.21 These difficulties primarily concerned the need for apportionment rules to differentiate between land and improvements. Submissions made at the time GST was introduced suggested that to obviate the need for such rules land should be subject to GST. Those submissions were accepted by the Government of the day.

7.22 In the *Coveney* case<sup>22</sup> the Court of Appeal ruled that the consideration for the supply of land used in a taxable activity and a dwelling and its curtilage on that land<sup>23</sup> could not be apportioned. Because the land in that case was acquired for the principal purpose of making taxable supplies a full input tax credit was allowed.

7.23 Legislation overturning this decision was enacted in 1995. Apportionment between land and a dwelling and its curtilage is now a feature of the GST Act. Therefore the original reasons for not introducing an exemption for land no longer apply to the same extent.

<sup>21</sup> *White Paper on Goods & Services Tax: Proposals for the Administration of the Goods and Services Tax* March 1985, at page 36.

<sup>22</sup> *CIR v NW Coveney; CIR v JF Dooley; CIR v NP Swain & Anor* (1995) 17 NZTC 12,193.

<sup>23</sup> The land on which the dwelling stands and the surrounding land used for domestic purposes.

- 7.24 Treating land sales as exempt supplies, however, is inconsistent with the Government's objective of a broad-based tax with minimal exemptions.

***A margin scheme for supplies of second-hand goods***

- 7.25 Suppliers of goods in a second-hand market largely act as intermediaries between purchasers and sellers acting in a private capacity. The United Kingdom's VAT system includes a margin scheme that recognises this and ensures that double taxation is not in effect imposed on goods that have previously borne VAT when sold as new.

- 7.26 Under the United Kingdom's margin scheme a registered person may opt to charge VAT on eligible goods based on the profit margin instead of the value of the supply. If an item is sold for less than the purchase price no VAT is charged. If the scheme is not used no input tax deduction is available, and VAT must be charged on the full sale price.

- 7.27 Eligible goods are:

- works of art, antiques or collectors' items (for example, postage stamps, collectors' pieces of historical interest);
- motor vehicles; and
- second-hand goods (tangible moveable property other than precious metals or precious stones that is suitable for further use).

- 7.28 Generally, land is not subject to VAT in the United Kingdom.

- 7.29 A "global accounting scheme" applies because of the low-value, large-volume goods some suppliers handle and the impracticality of keeping detailed records of purchases and sales. Under the global accounting scheme, VAT is calculated on the difference between the total purchases and sales of eligible goods in each VAT period rather than on an item-by-item basis.

- 7.30 A margin scheme has a number of practical difficulties, such as the documentation required to trace the supply of eligible goods. These would impose high compliance costs. Although a margin scheme is not the preferred option, the Government welcomes comment on whether the current second-hand goods credit should be replaced with a margin scheme similar to that operating for VAT purposes in the United Kingdom.

***Limit the credit in relation to supplies between associated persons (the preferred option)***

- 7.31 An input tax credit is triggered by the sale of second-hand goods from a non-registered to a registered person. It is common for such sales to be made to associated persons in circumstances where the effective ownership or control does not change.<sup>24</sup>
- 7.32 The definition of input tax provides that if the supplier and purchaser are associated persons the consideration for the supply is deemed to be the lesser of the purchase price or the open market value of the supply. This counters any over-inflation of the price in order to increase the value of the credit. If the purchase price exceeds the open market value, a credit of one-ninth of the open market value of the supply is allowed.
- 7.33 The Government's preferred option is to limit the amount of the credit allowed in these circumstances to the lesser of:
- the GST component (if any) of the original cost of the goods to the supplier; or
  - one-ninth of the purchase price; or
  - one-ninth of the open market value.
- 7.34 Accordingly, if the open market value of the supply is less than the original cost (assuming GST was charged on the original supply) the amount of the credit would remain the same as that allowed under the current legislation. In comparison, if the open market value exceeded the original cost the credit would be less than that currently allowed. Therefore this proposal would affect only goods that appreciate in value, such as land.
- 7.35 This approach means that the GST treatment is the same as if the supplier, having acquired the goods for non-taxable purposes, had applied the goods in a taxable activity instead of selling them to an associated person. In these circumstances an input tax credit for the change in use would be allowed under section 21(5). That provision allows a credit of one-ninth of the cost of goods acquired or produced after 1 October 1986 that are not acquired for taxable purposes but are subsequently applied for taxable purposes.
- 7.36 Assuming this option were adopted, the full GST cost incurred by the supplier would be allowed as a credit to the associated purchaser in relation to goods acquired after 1 October 1986. For goods acquired before that date the cost would not have included a GST element, and an input tax credit should not, therefore, be allowed.

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<sup>24</sup> Chapter sixteen (The Definition of "Associated Persons") discusses the proposed changes to the current definition of "associated persons".

- 7.37 The next chapter discusses proposed changes to the value of a deemed supply on deregistration. It is proposed to value all such supplies at market value rather than, as currently, at the lower of cost or open market value. The increased output tax liability for assets that have appreciated in value would reduce the overall tax advantage in on-selling an asset after deregistration in order to trigger a second-hand goods input tax credit. Therefore in these circumstances the amount of the second-hand goods credit should be the same as that currently provided, that is, the lesser of the purchase price or open market value.

**Specific issues for consultation**

- Which of the following options is preferable?
  - Review the treatment of land to:
    - exclude land from the definition of second-hand goods; or
    - exempt land from GST.
  - Replace the current scheme to allow a second-hand goods input tax credit with a margin scheme.
  - Limit the credit in relation to supplies between associated persons to the lesser of :
    - the GST component (if any) of the original cost of the goods to the supplier; or
    - one-ninth of the purchase price; or
    - one-ninth of the open market value.
- The Government's preferred option is to limit the credit for transactions between associated persons. What issues (in addition to those outlined) does this raise?

## **CHAPTER EIGHT**

### **DEREGISTRATION**

#### **Proposed policy**

- Require any deemed supply on deregistration to be valued at market value.

- 8.1 Registered persons may apply to deregister if their taxable activity ceases or the value of their taxable supplies falls below the registration threshold. Alternatively, deregistration may be initiated by the Commissioner if a registered person is not carrying on a taxable activity.
- 8.2 Any goods and services forming part of the assets on hand at the time of deregistration are deemed to be supplied in the course of the taxable activity. The value of the supply is deemed to be the lesser of the cost of the goods or services, including any GST, or their open market value.
- 8.3 This chapter proposes that supplies that are deemed to occur on deregistration be valued in all cases at market value.

#### **Policy intent**

- 8.4 The 1985 White Paper proposed that the value of a deemed supply on deregistration be the cost of the goods to the registered person making the supply.
- 8.5 The Advisory Panel on GST considered that valuing the supply at cost was inappropriate as the goods could have declined in value following their use in the taxable activity. The Panel proposed that the tax depreciated cost be used in relation to capital assets.
- 8.6 The current rule that the value be the lesser of cost or open market value is based on the assumption that goods and services might also decrease in value.
- 8.7 The purpose of the deregistration rules can be regarded as to either to:
- recapture the amount of the input tax already claimed on assets that are part of a taxable activity; or



- ensure that output tax is paid on the deemed transfer of an asset out of a taxable activity as well as on supplies made to another person.

8.8 The better view is that on deregistration, registered persons in effect make a supply to themselves in their private capacity and thus as a final consumer.

### **Arrangements involving second-hand goods**

8.9 As discussed in this chapter, on deregistration, output tax is payable on the lesser of the cost or open market value of goods held by a registered person (under section 10(8)). If the goods are then on-sold to a registered person, a second-hand goods input tax credit may be claimed for one-ninth of the purchase price, or, if the parties are associated, one-ninth of the lesser of the purchase price or the open market value. If the cost option is used on deregistration significant gains may arise from the sale of goods which appreciate in value, such as land.

8.10 The scope for both associated and non-associated parties to take advantage of this mismatch needs to be addressed.

### **Proposed reform**

#### ***Value supply at market value***

8.11 The Government proposes to require GST charged on deregistration to be based on the market value of the goods and services at that time. This would ensure that the output tax liability reflected the value that had been added by the registered person. It would also ensure that supplies by registered persons to themselves and to another person had equivalent GST treatments.

8.12 This change would affect only deemed supplies of goods that have increased in value – such as land. The output tax liability of a deregistered person in relation to goods and services that have declined in value would remain unchanged.

8.13 The GST Act provides no guidance on acceptable criteria for determining a market value. This can create compliance and administrative difficulties for taxpayers and Inland Revenue alike. Therefore it may be useful to consider developing a definition of “market value” drawing on precedents such as the arm’s length principle used in the transfer pricing rules (section GD 13(6) of the Income Tax Act). Comments on this issue are invited.

**Specific issues for consultation**

- What compliance cost concerns would arise if deemed supplies on deregistration were valued at market value?
- Should the meaning of the term “market value” be more clearly defined in the Act?

## CHAPTER NINE

### EXPORTED SERVICES

#### **Proposed policy**

- Exclude from zero-rating the supply of a right to receive a service if any recipient of that service will be in New Zealand at the time it is performed.

9.1 The aim of GST is to tax consumption in New Zealand. For services, this is achieved by taxing the supply of services if they are physically performed in New Zealand. It is possible, however, to zero-rate a supply of services physically performed in New Zealand but contracted for with a non-resident who is outside New Zealand. This result is inconsistent with the aim of GST.

9.2 This chapter discusses the manner in which GST is imposed on supplies of services, how the decision in *Wilson & Horton v Commissioner of Inland Revenue*<sup>25</sup> leads to a departure from this rationale, and options for realigning the legislation with the original policy intent.

#### **Policy intent**

##### *The destination principle*

9.3 The broad aim of GST is to tax at a single rate all final consumption that takes place in New Zealand. This is known as the “destination principle” and means that all supplies of goods and services in New Zealand, regardless of whether they are supplied to New Zealand residents or tourists, are taxed at the standard rate of 12.5 percent.

##### *The taxation of services: the application of the destination principle*

9.4 The destination principle in relation to services is reflected in the GST Act by reference to the “place of supply”. The place of supply rules are based on the residence of the supplier. If the supplier is a New Zealand resident,<sup>26</sup> the supply is deemed to be made in New Zealand, although services physically performed by a New Zealand resident outside New Zealand are zero-rated.

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<sup>25</sup> (1995) 17 NZTC 12,325.

<sup>26</sup> Persons, including companies and unincorporated bodies, are resident in New Zealand if they carry on an activity in New Zealand and have a fixed or permanent place in New Zealand relating to that activity.

- 9.5 If the supplier is a non-resident, supplies of services are deemed to be made outside New Zealand unless the services are physically performed by the non-resident in New Zealand. When such supplies by a non-resident are made to a registered person those supplies may, because of the neutral revenue effect, be treated as made outside New Zealand unless otherwise agreed between those parties.
- 9.6 Therefore the performance of services in New Zealand is subject to GST, and services performed outside New Zealand are outside the scope of GST.

### ***Services supplied to non-residents outside New Zealand***

- 9.7 Section 11(2)(e) is aimed at ensuring that services performed in New Zealand that would otherwise be subject to GST at the standard rate are zero-rated when the consumption of those services occurs outside New Zealand. Specifically, it zero-rates services provided to a non-resident who is outside New Zealand at the time the services are performed. The provision then excludes certain services that are directly related to land and moveable personal property in New Zealand, and restraints of trade relating to business in New Zealand.<sup>27</sup> This is because of the closer relationship these services may have with consumption in New Zealand.
- 9.8 It was not contemplated at the time GST was introduced that section 11(2)(e) would apply to services consumed in New Zealand but contracted by a non-resident outside New Zealand. Nevertheless, that was the outcome of the Court of Appeal decision in *Wilson & Horton*.

### **The Wilson & Horton decision**

- 9.9 *Wilson & Horton* concerned the zero-rating of advertising services that were supplied to a non-resident in relation to advertisements published in *The New Zealand Herald*. The Court of Appeal held that the zero-rating provisions, in particular section 11(2)(e), were directed to the contractual arrangements between the supplier and the recipient. Any benefits that accrued in New Zealand arising from the advertising were disregarded because of the indirect relationship that the benefits had with the contract between Wilson & Horton and the non-resident.
- 9.10 As such, the court found that the words “for and to” in section 11(2)(e) were a composite phrase. “For” does not mean “beneficially for”; it simply emphasises “to”.

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<sup>27</sup> The exceptions do not apply to services rendered to temporary imports, such as ships, aircraft and goods covered by section 166 of the Customs and Excise Act 1996.

- 9.11 Therefore if services are contracted with a non-resident who is outside New Zealand at the time of supply, section 11(2)(e) may zero-rate the supply under that contract, regardless of any benefits that may be enjoyed in New Zealand. (This is provided the services are not supplied directly in connection with land or moveable personal property in New Zealand or are otherwise excluded.)
- 9.12 This interpretation can, in a number of situations, allow the zero-rating of services that are consumed in New Zealand when the contract is made with a non-resident who is outside New Zealand.

#### **Examples**

- An educational institution offers a training course to non-residents. A non-resident firm pays the educational institution to make 20 places on the course available to employees of the non-resident firm. The employees must come to New Zealand to attend the course. The supply between the educational institution and the non-resident firm is likely to be zero-rated.
- A non-resident health provider contracts with a New Zealand resident doctor to provide specialist health services in New Zealand. Any patients requiring the specialist treatment are brought to New Zealand. The doctor invoices the health provider for any services rendered. Since the contract is with the non-resident health provider, the services are likely to be zero-rated, even though the patient is in New Zealand at the time the services are performed.
- A resident tourist operator issues rights for several nights' accommodation in a New Zealand hotel to a non-resident travel wholesaler. These rights are bundled by the travel wholesaler into a New Zealand travel package in which the accommodation is redeemable by the presentation of a travel voucher. Because the contract for supply is between the tourist operator and the overseas travel wholesaler, the supply is likely to be zero-rated, even though redemption of those rights (the accommodation) occurs in New Zealand.

- 9.13 The common element in these transactions is that a New Zealand resident arranges with a non-resident (who is outside New Zealand at the time of supply) to physically perform services that will be provided to a third party in New Zealand. This result is contrary to the policy aim of imposing GST on consumption in New Zealand.

## Options for change

9.14 Although Inland Revenue has followed the Court of Appeal's decision,<sup>28</sup> the Government proposes that the legislation be aligned with the original policy intent. There are two possible ways of achieving this. The first is to amend the place of supply rules. The second is to amend the zero-rating provisions.

### *Place of supply rules*

9.15 The place of supply is determined in New Zealand first by reference to the residence of the supplier. In the case of non-residents the test is where the services are physically performed.

9.16 The place of supply rules can be represented in other ways. One way is to provide a detailed list of where services are deemed to be supplied, as has been done in the United Kingdom and other European Union jurisdictions.

9.17 Nevertheless, the current approach has the advantage of enabling the place of supply to be defined by way of exclusion rather than inclusion and thereby ensures that the legislation provides a place of supply rule for all supplies.

### *Zero-rating provisions*

9.18 A preferable approach is to amend the zero-rating provisions relating to the treatment of exported services. The options for doing so include amending the zero-rating provisions to exclude the supply of services that although:

- supplied to a non-resident, also *benefit* a person in New Zealand;
- supplied to a non-resident, are *physically performed* in New Zealand;  
or
- involves a right to the service being supplied to a non-resident, also involves any *recipient being present in New Zealand* at the time the services are performed.

9.19 These options are described below.

### *Benefit*

9.20 As noted by the Court of Appeal in *Wilson & Horton*, any requirement to consider where the actual benefit of a service is enjoyed would raise major complications from a practical perspective. It would require a supplier to look beyond the purchaser of the supply (the person who has contracted and paid for it) to determine who is actually benefiting from the supply. A complicating factor is that a resident supplier would be required to seek this information from a non-resident and it could, therefore, be difficult to obtain

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<sup>28</sup> See the public binding ruling "GST – advertising space and advertising time sold to non-residents", BR Pub 96/10 in *Tax Information Bulletin* Volume 8, No. 8, page 13.

and verify. Therefore this option, although more clearly focused on the place of consumption, is not feasible.

#### *Physical performance*

9.21 The second option is to exclude from the zero-rating provisions the supply of services that, although supplied to a non-resident, are physically performed in New Zealand. However, this could apply more widely than is desirable in view of the broad aim of GST to tax consumption in New Zealand. For example, the supply of professional services such as legal or accounting services to a non-resident would not be zero-rated because the physical performance of those services occurs in New Zealand. It is also arguable that this approach would disadvantage New Zealand suppliers in the international market.

#### *Recipient of service in New Zealand (preferred option)*

9.22 The Government's preferred option is to distinguish clearly between the receipt of the right to the service and the receipt of the service itself. This would involve excluding from the zero-rating provisions the supply of a right to receive a service if any recipient of that service will be in New Zealand at the time it is performed. This would remove the practical difficulties noted in *Wilson & Horton* and the potentially distortionary effect of a test based on physical performance in New Zealand.

9.23 Therefore if the intended recipient of the services will be in New Zealand at the time the services are performed, the services would be subject to GST at the standard rate. Conversely, if the recipient is outside New Zealand at that time those services would be zero-rated.

9.24 For individuals, presence in New Zealand is a straightforward matter. For companies and other non-individuals it will be necessary to distinguish between a presence in New Zealand that is linked to the supply and a presence that is merely incidental to the supply. This issue is discussed in chapter fourteen (Exported Services: Remedial Issues).

#### **Application date**

9.25 As noted earlier, the Government intends introducing legislation to address the issue in the next available taxation bill, with the legislation to apply from the date of introduction.

**Specific issues for consultation**

- The proposal to exclude from zero-rating the supply of a right to receive a service if any recipient of that service will be in New Zealand at the time it is performed.
- The alternative options for removing the zero-rating treatment of such supplies.



## **CHAPTER TEN**

### **DEFERRED SETTLEMENTS**

#### **Proposed policy**

- Require GST to be returned on an accrual basis in relation to any supply exceeding \$200,000 in value.

10.1 Since GST came into effect it has been possible in relation to transactions involving two registered persons using different bases of accounting for GST to claim an immediate input tax credit but defer the payment of output tax. Because of the tax avoidance opportunities this creates it is proposed to modify the application of the payments basis of accounting. This chapter discusses proposed reform in this area.

#### **Policy intent**

10.2 The primary rule for determining when GST is recognised by a registered person on a supply of goods or services is the earlier of invoice or any payment. Taxpayers on a cash or payments basis of accounting, however, need to recognise a GST liability only when payment is received for a supply of goods or services. The payments basis was introduced to facilitate compliance with GST, and is directed at registered persons whose turnover consists of high-volume but low-value sales.

#### **Deferred settlements**

10.3 An indefinite timing advantage can be created when a registered person who accounts for GST on a payments basis makes a supply to a registered person who accounts on an invoice basis. The payments basis supplier provides the invoice basis purchaser with a tax invoice. The purchaser promptly claims an input tax credit on the basis of the tax invoice, but payment is significantly deferred. The supplier, who accounts for GST on the payments basis, does not return any GST until payment is made.

10.4 Substantial GST refunds are being made in relation to deferred property settlements. Although in most cases settlement is deferred for only 12 to 24 months, some settlements have been deferred for periods as long as 10 to 30 years, at times with little apparent commercial justification other than that of a GST timing advantage. The Government is concerned at the revenue loss created by these transactions. This revenue loss arises not only from the deferral of revenue resulting in the loss of the time value of money but also

from the increased possibility that output tax from the supplier may not be returned because payment is never received.

## **Proposed reform**

### ***Restrictions on using the payments basis***

- 10.5 The obvious weakness in the legislation that is exploited by deferred property settlements is the interaction between registered persons who account for GST on an invoice basis and registered persons who account for GST on a payments basis. It is proposed to modify the application of the payments basis by requiring that GST be returned on an accrual basis (under either the invoice or hybrid methods) in relation to any supply exceeding \$200,000.
- 10.6 Transactions in excess of \$200,000 will be readily identifiable, and a person making a supply of this value should have adequate records of the transaction to account for it on an accrual basis.

### ***Section 76***

- 10.7 To prevent registered persons from entering into arrangements to avoid the \$200,000 threshold by splitting a supply of goods or services between a number of entities or transactions it is proposed to amend section 76 to give the Commissioner a specific power to consolidate those entities or transactions.

#### **Specific issue for consultation**

- The proposed threshold for accounting on an accrual basis in relation to a taxable supply and any compliance concerns with the proposal.

# Part IV

## Remedial Issues



## CHAPTER ELEVEN

### THE FINANCIAL SERVICES EXEMPTION

#### **Proposed policy**

- Exclude debt collection services from the financial services exemption.
- Include financial options in the financial services exemption.
- Provide that non-deliverable futures contracts will be exempt if they are tradeable on a defined market or they are traded at arm's length.
- Clarify that deliverable futures contracts will be subject to GST unless the deliverable commodity is exempt.
- Treat penalty interest as being in respect of a financial service and, therefore, exempt.
- Repeal the proviso in subparagraph (ii) of section 14(a) which excludes goods or services that are not themselves financial services from being “financial services”.

- 11.1 This chapter deals with issues relating to the definition of “financial services” in section 3 of the GST Act. If a service falls within the definition it qualifies as an exempt supply under section 14(a).
- 11.2 Financial services are exempt from GST because of the practical difficulties involved in identifying the amount of value added by suppliers of financial services, since the margin that is charged by the supplier is hard to separate from the total funds transferred.
- 11.3 The broad policy underlying the definition of “financial services” is to encompass services provided under agreements involving the exchange of money or substitutes for money, such as shares. In contrast, agreements that involve the supply of a commodity should generally be included in the GST base.
- 11.4 This chapter highlights areas where change is needed to ensure that the intended scope of the definition, and therefore the scope of the exemption, is maintained. The need for such changes is inevitable as there will always be innovations in the financial services area that could not have been contemplated when the definition was originally enacted.

## **Debt collection**

### ***Policy intent***

- 11.5 The collection of interest, dividends and principal was made an exempt supply in 1986 by inserting section 3(1)(ka) into the GST Act. The mere receipt of money is outside the scope of the Act, since money is expressly excluded from the definitions of “goods” and “services”. If money were included, a single transaction would result in two taxable supplies – the supply of money and the supply of goods or services.
- 11.6 Since that amendment was made, debt collection services have generally been considered to be an exempt supply, as stated in *Public Information Bulletin* 164.

### ***Issue***

- 11.7 The supply of debt collection services should be a taxable supply because more than the mere receipt of money is involved. Thus the rationale for exempting the collection of interest, dividends and principal does not apply.
- 11.8 Because a commission is usually charged for debt collection services, valuation issues that underpin the need for the exemption for “financial services” should not be a significant concern.
- 11.9 It is also considered that debt collection is not reasonably incidental to the actual *supply* of debt securities and credit contracts. For example, services provided in relation to drafting a mortgage agreement could be seen as being incidental to the supply of a debt security, whereas debt collection services for the repayment of arrears is a step removed from that, and can be seen as a separate transaction.

### ***Proposed reform***

- 11.10 It is proposed to change the reference in section 3(1)(ka) from “collection” to “receipt”. For the avoidance of doubt, section 3 will be further amended by inserting a new subsection specifically excluding the activity of debt collection from the definition of “financial services”.

## **Derivatives**

### ***Policy intent***

- 11.11 The broad policy underlying the definition of “financial services” is to encompass services under contracts involving the exchange of money or substitutes for money (such as shares). In contrast, contracts that involve the supply of a commodity should generally be included in the GST base.

- 11.12 The only reference to financial derivatives in the definition of “financial services” is in section 3(1)(k), which includes in the definition the provision or assignment of a futures contract through a futures exchange. The terms “futures contract” and “futures exchange” are not defined in the Act.
- 11.13 When the definition of “financial services” was first formulated in 1985 it was assumed that any new financial derivatives developed would fall within the term “futures contract” and would, therefore, be exempt from GST.
- 11.14 It is uncertain, however, whether some derivatives, such as options, can in fact be described as futures contracts and, therefore, whether they are exempt from GST.
- 11.15 The use of the term “futures contract” also incorrectly assumes that all futures contracts are of the same nature, so should be treated in the same way for GST purposes.
- 11.16 It is also arguable that the requirement that a futures contract be provided or assigned through a “futures exchange” is too restrictive.

### ***Financial options***

#### *Issue*

- 11.17 The buying and selling of financial options on recognised markets has been treated by taxpayers as an exempt activity under section 3(1)(k), since all that is being supplied is the right either to buy or sell a given amount of a specified commodity on a specified date. This is an acceptable policy result because an option is comparable to a futures contract.
- 11.18 Nevertheless, the technical nature of a financial option is distinct from a futures contract. Unlike the holder of a futures contract, the option holder is not obliged to exercise the rights or obligations under the contract. This technical distinction between futures contracts and financial options is recognised under the accrual rules in the Income Tax Act.

#### *Proposed Reform*

- 11.19 It is proposed to amend section 3(1) to specify that financial options are included in the definition of “financial services”. This amendment would prevent a strained interpretation being taken of the term “futures contract”, thus helping to guard against any unintended broadening of the financial services definition.

### ***Deliverable and non-deliverable futures contracts***

#### *Issue*

- 11.20 Futures contracts fall into two categories:
- contracts that provide for the delivery of a commodity (deliverable contracts); and
  - contracts that do not provide for the delivery of a commodity (non-deliverable contracts).
- 11.21 The present definition of “financial services” does not specify any distinction between deliverable and non-deliverable contracts. All that is required under section 3(1)(k) is that a “futures contract” be traded on a futures exchange.
- 11.22 When a futures contract is non-deliverable, all that is being traded is a financial service, and no underlying commodity is exchanged. A deliverable contract, in contrast, involves the trade of an underlying commodity and is, therefore, equivalent to a contract for the supply of goods or services.
- 11.23 If the distinction between non-deliverable and deliverable futures contracts were recognised, non-deliverable contracts would continue to be exempt from GST, since all that is being traded is a pure financial service. Deliverable contracts would be exempt only if the underlying commodity being traded – for example, foreign currency – were exempt.

#### *Proposed reform*

- 11.24 It is proposed that non-deliverable contracts be exempt from GST, since all that is being traded is money or a substitute for money. On the other hand, deliverable contracts will be exempt only if the underlying commodity being traded is exempt.

### ***Futures exchanges***

#### *Issue*

- 11.25 The requirement that a futures contract be traded through a futures exchange ensures that there is a genuine market trading in derivatives, and that there are arm’s length terms of trade so avoidance opportunities are minimised.
- 11.26 Without the market requirement, the price for a derivative might not reflect its true value. Taxpayers might be able to claim greater input tax credits by manipulating the relative values of their exempt and taxable supplies. The lack of a market requirement could also create opportunities for taxpayers to recharacterise taxable supplies of commodities (contracts for the sale of goods or services) as exempt supplies under a derivatives contract.



- 11.27 Moreover, the lack of a formalised market could make it difficult, from an audit perspective, to track transactions in derivatives.
- 11.28 The GST Act does not include a definition of “futures exchange”. In the past, Inland Revenue’s *Technical Rulings* described a futures exchange as an exchange regarded by the commercial community as a futures exchange. The lack of a definition has created uncertainty as to the meaning of the term. Because arm’s length transactions can occur outside a recognised exchange, the reference to a futures exchange is also arguably too restrictive.
- 11.29 Both the Securities Amendment Act 1988, in its use of the term “authorised futures exchange”,<sup>29</sup> and the Income Tax Act, in its definition of a “recognised exchange”,<sup>30</sup> provide some guidance as to possible definitions of suitable markets and factors to be taken into account in formulating an arm’s length principle.

*Proposed reform*

- 11.30 It is proposed to insert a requirement in the definition of “financial services” that derivatives be traded on a defined market or otherwise be traded at arm’s length.

**Penalty interest**

- 11.31 If a purchaser fails to make payment under a contract the supplier may, if the contract permits, charge the purchaser interest for the use of the money and to induce payment. The interest is generally called penalty or default interest.

*Issue*

- 11.32 The nature of penalty interest is conceptually indistinguishable from that of other forms of interest, which the Act exempts under section 3(1)(ka).
- 11.33 The provision of a credit contract<sup>31</sup> and certain services relating to credit contracts are within the definition of “financial services” and thus exempt from GST. However, penalty interest charged under a contract does not necessarily make the contract a “credit contract”, so penalty interest may be subject to GST when the underlying supply is taxable.

*Proposed reform*

- 11.34 It is proposed to exempt penalty interest from GST.

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<sup>29</sup> Section 37.

<sup>30</sup> Defined in section OB 1 for the purposes of sections CF 3, CG 17, OD 5, and the definitions of “market value” and “on-market acquisition”.

<sup>31</sup> As defined in the Credit Contracts Act 1981.

## Exemption for financial services – section 14(a)(ii)

### *Issue*

- 11.35 Section 14(a) exempts from GST the supply of goods and services that are “reasonably incidental and necessary” to the supply of “financial services”. The section was amended in 1989 as a result of the Court of Appeal decision in *Commissioner of Inland Revenue v Databank Systems Limited*.<sup>32</sup> In that decision it was held that a company supplying computer processing services to trading banks providing financial services to its customers was itself supplying “financial services”. Therefore the company’s supplies were exempt.
- 11.36 Subparagraph (ii) of section 14(a) excludes from being a financial service goods or services that are not themselves “financial services”. The provision was inserted so that, in the words of the Privy Council reversing the Court of Appeal decision in the *Databank* case, “...*exemption is not afforded to ‘a person’ who is ‘involved’ in ‘an activity’ which ‘results in’ the supply of financial services...*”.<sup>33</sup> The Privy Council also stated that if the Court of Appeal decision was reversed subparagraph (ii) “would cease to be necessary”.<sup>34</sup>
- 11.37 The Privy Council did reverse the Court of Appeal decision, holding that Databank merely provided services which enabled its client banks to provide financial services. The supplies in question were neither financial services in themselves nor reasonably incidental to such a supply because they were not provided by the same person. Subparagraph (ii) is, therefore, no longer necessary.
- 11.38 Subparagraph (ii) also creates ambiguity, since there is an uncertain relationship with the preceding reference to the supply of any other goods or services that are reasonably incidental and necessary to the supply of “financial services”.

### *Proposed reform*

- 11.39 It is proposed to repeal subparagraph (ii) of section 14(a).

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<sup>32</sup> (1989) 11 NZTC 6,093.

<sup>33</sup> *CIR v Databank Systems Limited* (1990) 12 NZTC 7,227 at 7,232.

<sup>34</sup> *Ibid* 7,236.

## **CHAPTER TWELVE**

### **FACTORED DEBTS**

#### **Proposed policy**

- Require registered persons accounting for GST on a payments basis to pay GST on the remaining book value of a debt when it is factored.

12.1 Debt factoring involves the sale of debt to a third party. It can be an integral part of the cash and liquidity management of a business. The person selling the debt may be prepared to receive a lesser, but certain, sum immediately rather than wait for a possibly greater, but uncertain, sum in the future.

12.2 When a debt is factored, there are three main parties:

- the “assignor” – the supplier of the goods or services;
- the “debtor” – the person who is liable to pay for the goods or services; and
- the “factor” – the person who buys the debt from the assignor and has the right to receive payment from the debtor.

12.3 This chapter discusses three issues relating to the GST treatment of debt factoring:

- whether there should be a difference in the treatment of registered persons who account for GST on an accrual (invoice or hybrid) basis and those who account on a payments basis;
- the tax advantages that can arise as a result of recharacterising credit sales as exempt supplies of debt; and
- the fact that accrual basis taxpayers may have to pay GST on the full consideration for the supply, irrespective of the fact that full payment is not received.

#### **Difference between the accounting bases**

12.4 Debt factoring is generally a financial service and, as such, is an exempt supply. However, section 3(4) of the GST Act excludes debt factoring as a financial service if the result of the assignment would be that output tax is not payable on the underlying taxable supply. This means that when a debt is factored the application of GST to the supply of debt will differ according to whether the assignor is on a payments or accrual basis of accounting.

### ***Accrual basis***

- 12.5 If the assignor is on an accrual basis, any output tax liability on the assignment of debt will have arisen before the assignment. The assignment of debt is an exempt supply, but GST is payable on the full value of the underlying supply, irrespective of whether full payment is received. For example, a microwave oven is sold to a consumer for \$1,000. The fact that the debt created by the consumer is subsequently sold to a third party for \$900 does not affect the value of, and hence the GST payable on, the original supply. The value of the taxable supply is still \$1,000, not \$900.

### ***Payments basis***

- 12.6 If the assignor is on a payments basis, output tax must be paid on any amount received for that debt before the assignment and any amount received on the assignment. This means that GST is not payable on the discount component of a factoring transaction. Using the example above, GST must be returned on the consideration received on the assignment (\$900) rather than on the value of the taxable supply (\$1,000).

### ***Inland Revenue's previous policy***

- 12.7 Inland Revenue's previous policy,<sup>35</sup> aimed at ensuring equity between taxpayers on different accounting bases, was to allow a bad debt adjustment for debts factored by registered persons accounting for GST on an accrual basis. The bad debt adjustment reduced the registered person's GST liability by one-ninth of the amount by which the debt was discounted.
- 12.8 The Taxation Review Authority in *Case T27*,<sup>36</sup> which concerned the sale of debts from credit card sales, indicated that this practice was incorrect, since the debt factored in that case was a good debt, not a bad debt. As a result, Inland Revenue has withdrawn this policy.<sup>37</sup>

### **Recharacterising credit sales**

- 12.9 Under Inland Revenue's previous policy, debt factoring could have effectively allowed registered persons to convert taxable supplies of goods and services into exempt supplies. This was possible because the sale of debt is generally an exempt financial service. Although this problem has to some extent been resolved for accrual basis taxpayers, the issue remains in relation to registered persons that account for GST on a payments basis.

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<sup>35</sup> As stated in *Public Information Bulletin* 164.

<sup>36</sup> (1997) 18 NZTC 8,188.

<sup>37</sup> *Tax Information Bulletin* Volume 10, No. 5, May 1998, page 23.

### **Payment of GST on amounts not received**

- 12.10 The Government acknowledges the argument that it could be disadvantageous for registered persons to factor debt if no bad debt deduction is available. However, it is difficult to deal legislatively with the problem of assignors of debt having to pay GST on amounts not received at the point of assignment without introducing other problems. They include making it easier for taxpayers to recharacterise credit sales as debt, creating a risk for the debt factor of an increased imposition of GST, and significant compliance costs.
- 12.11 Accordingly, the preferred approach is to leave it to the assignor and factor to agree as to whether the GST paid by the assignor should be discounted or otherwise taken into account in setting the price at which the debt is factored.

### **Proposed reform**

- 12.12 To re-establish parity between the two accounting bases and remove opportunities for recharacterising credit sales, it is proposed to require assignors on the payments basis to pay GST on the remaining book value of a debt when it is factored.

## CHAPTER THIRTEEN

### GOING CONCERNS

#### Proposed policy

- Require the going concern test to be applied when the supply is deemed to be made.
- Require a business to be capable of being carried on by a purchaser for it to be transferred as a going concern.

13.1 Under section 11(1)(c) the supply of goods between registered persons as a going concern is zero-rated.

13.2 Changes to the legislation in 1995 substantially improved the operation of the provision. Even so, some uncertainties remain, especially as to when the test is to be applied and the meaning of “going concern” – as evidenced by the Court of Appeal decision *K R Pine v Commissioner of Inland Revenue*.<sup>38</sup> This chapter proposes remedial changes to address these uncertainties.

#### Policy intent

13.3 The original purpose behind zero-rating supplies of going concerns was:

- to eliminate the cash-flow cost to purchasers of going concerns in financing the GST for the period between making payment and receipt of the GST refund;
- to reduce the risk of fraud when a vendor charges GST on sale of a business but retains the GST component; and
- to ensure parity with the treatment of sales of shares, which are exempt financial services.

13.4 In 1995 three changes were made:

- A definition of “going concern” was inserted in section 2(1).
- Section 11(1)(c)(ii) was inserted, providing that a sale of a taxable activity can be zero-rated only when both parties to the sale agree that it is the sale of a going concern.

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<sup>38</sup> (1998) 18 NZTC 13,570.

- Section 78E was inserted, allowing a registered person who has zero-rated the supply of a taxable activity to increase the consideration payable if the supply is not in fact a going concern.

13.5 These reforms have worked well in practice, and have gone a long way to alleviating compliance and administrative costs in this area. Some uncertainties remain, however, and they should be resolved.

## Issues

### *Timing of test*

13.6 The current wording of section 11(1)(c)(i) creates uncertainty as to when the going concern test is to be applied, by using the phrase “supply to a registered person of a taxable activity, *that is, or is to be*, transferred”.

13.7 Cases dealing with the pre-1995 provision, such as *Belton v Commissioner of Inland Revenue*<sup>39</sup> and *K R Pine*, have stated that the test is to be applied at settlement.

13.8 Whether a taxable activity is supplied as a going concern was intended to be determined at the time of supply – generally the earlier of invoice or payment.<sup>40</sup> The time of settlement or transfer is not relevant to determining the status of the supply, although the taxable activity must continue to be carried on by the vendor until the time of transfer for the supply to be zero-rated.

13.9 The time of supply appears to be the better time at which to apply the going concern test. The time of supply will generally be when the parties enter into an agreement to transfer a taxable activity. It will also be the time at which the parties consider whether the taxable activity is a going concern.

13.10 In addition, this approach provides consistent treatment between deferred settlements and other transactions.

### *Receipt of a going concern*

13.11 The policy intent behind the going concern provisions was that the taxable activity must be received as, and capable of being operated as, a going concern by the purchaser for the zero-rating provisions to apply. The taxable activity must be capable of seamless operation during its transfer, although it is not necessary that the purchaser in fact operate the taxable activity after its transfer.

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<sup>39</sup> (1997) 18 NZTC 13,403.

<sup>40</sup> As stated in *Tax Information Bulletin*, Volume 6, No. 12, May 1995, page 31.

- 13.12 The majority of the Court of Appeal in *K R Pine*, however, held otherwise.
- 13.13 In that case a registered person sold a taxable activity of commercial leasing to another registered person whose partnership had been the tenant of the commercial property. The partnership had, however, been terminated by agreement before the purchase of the lease, and the purchaser had become the lessee.
- 13.14 On purchase of the taxable activity, the purchaser's legal estates as lessor and lessee merged and, therefore, at law, the purchaser could not carry on the taxable activity as a going concern.
- 13.15 The majority of the Court of Appeal, however, held that the transfer of a going concern had still occurred, stating that it did not matter that a taxable activity could not be operated as a going concern. The test was the form of the taxable activity supplied by the vendor, and in *K R Pine* the vendor had supplied a going concern.

### **Proposed reform**

- 13.16 It is proposed to amend the "going concern" provisions by:
- applying the test for a "going concern" at the time of supply; and
  - requiring that the purchaser be able to continue the activity that has been supplied by the vendor for it to qualify as a going concern.



## CHAPTER FOURTEEN

### EXPORTED SERVICES: REMEDIAL ISSUES

#### Proposed policy

- Zero-rate the supply of services in relation to exported goods.
- Insert a definition for the phrase “outside New Zealand” in section 11(2)(e) and (fa).
- Zero-rate services that are supplied directly in connection with a temporary import when supplied to a New Zealand resident.

14.1 This chapter looks at a number of remedial issues involving cross-border transactions including:

- the treatment of services performed in relation to exported goods;
- the meaning of the phrase “outside New Zealand” in section 11(2)(e) and (fa); and
- the treatment of services supplied in relation to temporary imports.

#### Services in relation to exported goods

14.2 Services provided to a non-resident, including those supplied in relation to exported goods, are not zero-rated if they are supplied directly in connection with moveable personal property in New Zealand. However, if the value of the services were included in the price of the goods they could be zero-rated. Although substantially the same supply is being made, this anomaly requires registered persons to structure transactions to achieve zero-rating.

14.3 Currently, it is permissible to zero-rate the supply of services in relation to exported goods in limited circumstances only. These include under sections 11(2)(a) to (ac), when the services involve the arranging of transportation and insurance or the actual transportation and insurance of goods for export. Also included under section 11(2)(ca) are services to a non-resident supplied directly in connection with temporary imports entered under section 116 of the Customs and Excise Act 1996. In either case this treatment can be justified because the goods are almost certain to leave New Zealand, so the services will ultimately be consumed outside New Zealand.

- 14.4 This treatment does not extend to situations where a registered person in New Zealand supplies services in relation to exported goods to an offshore importer. For example, a New Zealand fruit grower exports 1,000 crates of fruit. The offshore recipient wants to ensure the quality of the fruit and so contracts a New Zealand horticultural firm to inspect the fruit independently and prepare a report. In this situation the services performed by the horticultural firm are in connection with moveable personal property in New Zealand and so cannot be zero-rated. This is not appropriate since the services are consumed outside New Zealand. Therefore it is proposed to zero-rate the supply of services that are performed directly in connection with goods that are, or will be, entered for export, provided the recipient of those services is outside New Zealand at the time of supply.
- 14.5 The application of sections 11(2)(a) to (ac) will need to be reviewed in light of this proposal. This is because the supply of ancillary services, although supplied directly in connection with exported goods, may not be supplied to a recipient who is outside New Zealand at the time of supply. Using the example above, if the New Zealand horticultural firm subcontracted another entity to provide transportation services (such as the loading and unloading of the goods destined for export) the services supplied by the subcontractor should not be zero-rated because they are received by a recipient who is inside New Zealand.

#### **“Outside New Zealand”**

- 14.6 Under section 11(2)(e) services supplied to a non-resident who is outside New Zealand may be zero-rated subject to restrictions, including those relating to land and moveable personal property situated inside New Zealand.
- 14.7 Applying the term “outside New Zealand” to individuals is relatively easy. If they are physically inside New Zealand, they cannot be “outside New Zealand”.
- 14.8 The situation with companies and unincorporated bodies, however, is more difficult. If a non-resident company has a branch in New Zealand it is arguable that supplies to the non-resident company that are not linked to the New Zealand branch’s taxable activity cannot be zero-rated because the company is not “outside New Zealand”. There is also potential uncertainty as to the application of zero-rating if a supply is made to a company based outside New Zealand which has a minor presence only in New Zealand.
- 14.9 It is proposed to clarify the phrase “outside New Zealand” in section 11(2)(e) to ensure that supplies to a non-resident company or unincorporated body are zero-rated if their presence in New Zealand is not linked to the supply. This treatment will also extend to section 11(2)(fa) (services relating to intellectual property rights).

**Goods and services provided in connection with goods in transit and temporary imports**

- 14.10 Sections 11(1)(ba) and 11(2)(ca) zero-rate the supply of goods and services used to repair temporary imports.
- 14.11 Although goods used to repair temporary imports can be zero-rated whether provided to a resident or a non-resident, repair services can be zero-rated only if they are provided to a non-resident. This can create compliance costs by requiring the supplier to charge two rates of tax (12.5 percent and zero percent) for a single supply to a resident involving charges for labour and parts.
- 14.12 To reduce compliance costs, the GST treatment of services relating to temporary imports should mirror that of goods. It is proposed to zero-rate all services supplied as part of the repair of temporary imports. For example, if a New Zealand-owned boat that normally operates in the Cook Islands is put into dry dock in New Zealand for repairs to its propulsion system any services involved in the repair would be zero-rated if the boat is temporarily imported.

## CHAPTER FIFTEEN

### THE TREATMENT OF SOFTWARE

#### **Proposed policy**

- Treat copies of software programs as “goods” and copyright in relation to software programs as “services”. This is not intended to affect the current treatment of imported software under section 12.

15.1 Generally, there is no need to distinguish between the supply of goods and the supply of services because the domestic supply of both goods and services by a registered person is subject to GST.<sup>41</sup> A distinction is often required, however, for cross-border transactions and in determining whether an input tax credit is available for second-hand goods. Software is a particular area of concern. This chapter looks at the nature of software programs and makes proposals to clarify the treatment of transactions involving the supply of software programs. It also comments on the applicability of the second-hand goods input tax credit to software.

#### **Software programs: goods or services?**

15.2 Software programs can be supplied in two forms. The first form of supply is by way of media such as disc, magnetic tape, and compact disc. The second form of supply is by electronic pulse. Software in the latter form can be delivered to a computer through the Internet, by way of a telephone or cable network, or by satellite.

15.3 The classification of software programs as either goods or services can create different GST results. For example, imported goods are subject to GST but imported services are not. A notional input tax credit is available for goods that are second-hand, but not for services. Services to non-residents that are to be zero-rated must satisfy several conditions, including that they are not supplied directly in connection with moveable personal property in New Zealand.

15.4 Problems may also arise with respect to used software programs. Because software can vary in form it may be uncertain whether on disposal it should be treated as new or second-hand goods or as the supply of services.

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<sup>41</sup> “Goods” means all kinds of personal or real property, but does not include choses in action or money. “Services” means anything that is not goods or money. By exclusion, since choses in action are not “goods”, but “services”.

## The nature of software programs

- 15.5 Over the last couple of decades various courts have attempted to classify software programs as goods or services. Initially, the more prevalent view was that software was intangible property usually in the form of “know how”, and was therefore a service. However, issues related to sales tax and certain consumer protection legislation have led to the current predominant view appearing to be that copies of software programs are tangible property. The courts have emphasised that it is the transfer of software programs onto a physical medium such as a disk, tape or compact disc that determines its nature as being goods.
- 15.6 In *St Albans City and District Council v International Computers Limited*,<sup>42</sup> it was held that software was “goods” for the purposes of the United Kingdom sale of goods legislation. The court concluded the customised software program acquired by St Albans was “goods”, noting that the software was defective and in breach of the terms as to quality and fitness for the purpose implied under the 1979 Act and 1982 Act. The court commented that a computer disk fell within the meaning of “goods”, but the copyright in a computer program did not.
- 15.7 In another case, *South Central Bell Telephone Company v Barthelemy*,<sup>43</sup> it was held that software becomes “tangible personal property” when it is physically manifested in a recorded form. The court held that the mode of delivery did not affect this outcome.

## Intellectual property rights in relation to software programs

- 15.8 The Taxation Review Authority in *Case T28*<sup>44</sup> considered in some detail whether the supply of a business package by an unregistered person to a registered person was goods and, if so, whether those goods were second-hand. The business package consisted of a provisional patent, registered trademark and computer programs.
- 15.9 Barber DJ considered that the supply of the business package, in particular the provisional patent and the registered trademark, was the supply of a chose in action and was thereby excluded from the definition of “goods”. He also considered the supply of the computer program in the package was not the supply of “goods” but was the supply of intellectual property in the form of “know how”. Naming these components as “a business package” did not convert them into goods. Consequently, a second-hand goods input tax credit was not available.

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<sup>42</sup> (1996) 4 All ER 481 (Court of Appeal Civil Division).

<sup>43</sup> 643 So.2d 1240 (La 1994), Louisiana Supreme Court.

<sup>44</sup> (1997) 18 NZTC 8,197.

### Proposed reform

- 15.10 It is proposed that the supply of copies of software programs be specifically included in the definition of “goods”, and the supply of copyright in relation to software programs be included in the definition of “services”.
- 15.11 In *South Central Bell Telephone Company* and *St Albans*, the supply related to the sale of “goods”, being software programs. *Case T28* involved the supply of a chose in action in the form of copyright. The supply of copyright in a software program and the supply of a copyrighted article such as a copy of a software program are distinguishable; in the latter there is no transfer of copyright rights.
- 15.12 The supply of a mass marketed software program product (commonly referred to as “shrinkwrapped software”) often includes a licence. These licences may allow the purchaser to make further copies as necessary for use within the purchaser’s business. These kinds of rights are commonly referred to as “site” or “network” licences. They should not change the nature of the supply as one of goods.
- 15.13 This distinction between the supply of copyright and the supply of a copyrighted article is not intended to affect the current treatment of imported software under section 12.
- 15.14 Software physically imported into New Zealand is considered to be “goods” and liable to duty (in this case GST) collected by the New Zealand Customs Service under section 12 of the Act. GST is levied on the price paid or payable for the imported software package. However, for valuation purposes, if the value of the contents (the message or data) is declared or invoiced in a manner which distinguishes it from the value of the carrier medium, the legislation allows Customs to deduct the value of the contents from the price paid or payable. Customs will then levy GST only on the value of the carrier medium, plus the cost of freight and insurance incurred in bringing the goods to New Zealand.<sup>45</sup>

### Second-hand goods and software

- 15.15 If a registered person purchases a copy of a software program from an unregistered person the issue of the availability of the second-hand goods input tax credit arises. The registered person must give careful consideration as to what is being acquired.

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<sup>45</sup> Second Schedule, cl 3(1)(c) of the Customs and Excise Act 1996. This method of valuation is a requirement under the World Trade Organisation General Agreement on Trade and Services, to which New Zealand is a signatory. The distinction between content and media does not apply to imported sound, cinematic or video recordings.

- 15.16 If the purchase relates to the supply of copyright rights it is not the supply of second-hand goods but the supply of a chose in action. Therefore a second-hand goods input tax credit would not be available.
- 15.17 Conversely, if the registered person purchases a copyrighted article, a second-hand goods input tax credit would be available if the copy of the software program in question would ordinarily be considered to be second-hand. That is, the goods have been used or cannot otherwise be considered to be new.
- 15.18 Chapter seven (The Second-Hand Goods Input Tax Credit) considers the meaning of “second-hand” and sets out proposals concerning the availability of the credit.

## CHAPTER SIXTEEN

### THE DEFINITION OF “ASSOCIATED PERSONS”

#### Proposed policy

- Replace the definition of “associated persons” for GST purposes with the broader definition used in the Income Tax Act. This definition would include:
  - stronger provisions dealing with trusts;
  - a level of association between a shareholder and a company at 25 percent rather than 10 percent; and
  - a rule to aggregate the rights held in a company by relatives.
- Include people in de facto relationships in the definition of “associated persons” in the GST Act.

#### 16.1 “Associated persons” for the purposes of GST are:

- two companies if there is a group of persons with aggregate voting interests or market value interests (or another form of control) of at least 50 percent in each company;
- a company and anyone who holds at least 10 percent of the voting or market value interests of the company, either:
  - individually, or
  - with a spouse and/or infant children, or a trustee for the person/spouse/children;
- two people one of whom is the spouse or child (or the trustee of the spouse or child) of the other;
- a relative by blood to the fourth degree, by marriage, or adoption;
- two persons one of whom is the trustee of a trust under which the other has benefited or is eligible to benefit;
- a partnership and anyone who is:
  - a partner in the partnership, or
  - associated with a partner in the partnership;
- a company and anyone who is associated with a person associated with the company.



- 16.2 This definition is largely based on that used for the land provisions of the Income Tax Act (section OD 8(4)).
- 16.3 The current definition of “associated persons” in the GST Act is deficient in relation to some trust arrangements and does not apply to de facto relationships. Nor does it deal adequately with nominees. This chapter proposes legislative changes to address these deficiencies.
- 16.4 Furthermore, the definition treats as associated persons individuals who have a minor level of association with a company (a voting or market value interest of 10 percent or more). This percentage is no longer appropriate, given changes to the fringe benefit tax (FBT) rules.

### **Application of the “associated persons” definition in the GST Act**

- 16.5 The GST Act contains a number of rules that apply to supplies of goods and services between associated persons, particularly when the consideration is not equivalent to the open market value of the supply. In that case the value of the supply is deemed to be its open market value.

### **The income tax definitions**

- 16.6 Apart from being used for GST purposes, the section OD 8(4) “associated persons” definition is confined to land transactions. The definition of “associated persons” in section OD 8(3), developed in 1988 (after the enactment of the GST Act) for the international tax rules, has much broader application, being used for the international tax rules and other rules including depreciation and the tax liability of companies left with insufficient assets.
- 16.7 The section OD 8(3) definition addresses many of the deficiencies in the definition used for land transactions and in the general associated persons definition in section OD 7.

### **Proposed reform**

- 16.8 Ideally, the “associated persons” definitions throughout the Inland Revenue Acts should be based on a standard definition. Until that can be achieved, however, the GST Act should be strengthened to ensure that transactions between related parties are treated as if they were made at arm’s length.

### ***Strengthening the existing definition***

- 16.9 Incorporating the section OD 8(3) “associated persons” definition into the GST Act would introduce the following relationships into the GST definition:
- a trustee of a trust and a settlor of that trust;
  - a trustee of a trust and a trustee of another trust if there is a common settlor of both trusts; and
  - two persons who habitually act in concert. (This would need to be modified to relate to supplies subject to GST.)
- 16.10 The definition used in the international tax rules, however, does not contain a rule to aggregate the rights held in a company by relatives. Therefore it is proposed that a rule similar to the aggregation rule in section OD 7(2) be included in the GST Act. That provision deems rights held by a nominee (defined to include a relative) to be held by the principal as well as the nominee, as if they were one person.
- 16.11 The existing “relatives” and “trustee-beneficiary” tests in the GST Act definition will be retained.

### ***Replacing the 10 percent threshold***

- 16.12 A deemed supply arises under section 21(3) in relation to fringe benefits that are subject to FBT. The value of the deemed supply is the same as the taxable value of the fringe benefit calculated under the FBT rules in the Income Tax Act.
- 16.13 Before 1 April 1989 “major shareholders” were excluded from the FBT rules. The term “major shareholder” broadly included anyone with a 10 percent or greater shareholding in a company.
- 16.14 However, the definition of “associated persons” specifically included a company and a person holding a 25 percent or greater interest in the company. Therefore supplies made to employees with shareholdings of between 10 percent and 25 percent could be made at less than cost (including no cost), and recipients would thus have paid less GST than they should have on that consumption. They also escaped GST on the value of any fringe benefits. This gap in the GST base was addressed by a change in 1986 to the definition of “associated persons” so that it included a company and a shareholder with a 10 percent or greater interest in that company.

- 16.15 The definition of “major shareholder” in the Income Tax Act was repealed in 1988 with effect from 1 April 1989. This means that shareholder employees, regardless of their shareholding, are now subject to FBT in the same manner as other employees.<sup>46</sup> For this reason the 10 percent threshold in the company-shareholders test in the definition of “associated persons” in the GST Act should be removed and replaced with the 25 percent threshold used in the general associated persons definition.

***Extension to de facto relationships***

- 16.16 The De Facto Relationships (Property) Bill seeks to extend the treatment of property in the Matrimonial Property Act to de facto relationships. The definition of “spouse” also includes de facto relationships in certain income tax contexts.
- 16.17 De facto relationships should also be recognised in the GST Act because there is a sufficient connection between the parties to justify the application of the associated persons rules.

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<sup>46</sup> In certain circumstances an employer may elect to treat non-cash benefits as a dividend rather than as a fringe benefit subject to FBT.

## CHAPTER SEVENTEEN

### UNINCORPORATED BODIES: DEBT PRIORITY AND MEMBERS' LIABILITY FOR GST

#### **Proposed policy**

- Confirm the preferential status of GST debts recoverable from individual members of an unincorporated body.
- Ensure that preferential status for unpaid GST debts of an unincorporated body also applies if a receiver is appointed other than by court order.
- Confirm that the liability of a member of an unincorporated body for GST payable during the time the person was a member extends beyond the period of membership.

- 17.1 Section 42 provides that the Commissioner is a preferential creditor in relation to GST that is unpaid at the time of a bankruptcy, liquidation, or receivership. This ranking is due to GST being effectively held in trust for the Crown and is consistent with the treatment of unpaid PAYE.
- 17.2 Section 57(3) provides that members of unincorporated bodies are liable jointly and severally for all tax payable by the body while they are members. The estate of a deceased member is severally liable for any unpaid liabilities of the member.
- 17.3 This chapter proposes minor legislative changes to clarify the recovery of GST debts of an unincorporated body and the extent of a member's liability for GST.

#### **Debt priority**

##### ***Individuals adjudged bankrupt***

- 17.4 Part IX of the Insolvency Act 1967 deals with the distribution of assets of an individual who has been adjudged bankrupt. Section 104 of that Act sets out how the money received by the official assignee from the realisation of the property is to be applied. Ten categories of payments are listed in order of priority. The fifth category consists of various amounts including PAYE, student loan repayments, ACC payments and customs duty.

- 17.5 Each of these amounts has priority ranking immediately after the preferential debts relating to employee claims.
- 17.6 Although there is no express reference to GST in the Insolvency Act, section 104 is subject to other enactments. Section 42(2)(a) of the GST Act provides that any unpaid GST also ranks immediately after preferential employee claims.

***Companies in liquidation or receivership***

- 17.7 In relation to a company in liquidation, section 42(2)(b) provides that GST debts have the ranking set out in the Seventh Schedule of the Companies Act 1993. The Schedule lists certain amounts as having priority after employee claims but before amounts under a floating charge or amounts in respect of an unsecured debt. These are GST, PAYE, non-resident withholding and resident withholding tax deductions and customs duty.
- 17.8 This ranking also applies in the case of the appointment of a receiver.

***Unincorporated bodies***

- 17.9 Section 42(2)(c) was inserted in 1990 to recognise the situation where the court appoints a receiver to manage the business activities of a partnership, trust or unincorporated society. The GST debts of these entities rank similarly to those of individuals and companies.

***Issues***

- 17.10 Two issues have arisen in relation to the recovery of GST debts of an unincorporated body:
- Paragraph (c) applies only on the appointment of a receiver. If an unincorporated body – say, a partnership – becomes insolvent and a receiver has not been appointed, the only situation in which preferential status for GST could be provided is if the individual partners are adjudged bankrupt. Paragraph (a) applies to individuals, although it is arguable that paragraph (c), specifically enacted to cover unincorporated bodies, creates an adverse inference against the application of paragraph (a).
  - A mortgagee or other debt holder, as well as a court, may initiate the appointment of a receiver. The current application of section 42(2)(c) to receivers appointed by court order only may, therefore, be unintentionally limited.

### ***Proposed reform***

#### *Recovery of GST from individual members*

- 17.11 It is proposed that section 42(2)(a) be amended to confirm the preferential status of GST debts recoverable from individual members of an unincorporated body.
- 17.12 For partnerships a distinction would be drawn, as in section 82 of the Insolvency Act 1967, between the joint estate and the separate estate of the bankrupt partner. The joint estate would be applied in the first place in satisfaction of the debts due by the bankrupts jointly. The separate estate would be applied to satisfy any shortfall in the joint estate after it has been applied to any debts the partner incurred in his or her non-partnership capacity.

#### *Type of receivership*

- 17.13 To ensure that the application of the legislation is not unintentionally limited, the reference to court appointments in section 42(2)(c) should be removed. A general reference to receivers, to encompass any form of appointment, is proposed.

### **A member's liability for GST**

#### ***Issue***

- 17.14 A member of an unincorporated body is defined in section 57(1) as a partner, a joint venturer, a trustee, or a member of any unincorporated body.
- 17.15 Inland Revenue has experienced difficulties in recovering unpaid GST from retired trustees. There is an argument that joint and several liability applies only for the period of membership. Therefore on a trustee's retirement the liability rests with the new or remaining trustee/s.

#### ***Proposed reform***

- 17.16 The intention of section 57(3) is that a member's liability is referable to the taxable period/s in which that person was a member of an unincorporated body, and the liability is not extinguished by ceasing to be a member. The Commissioner should, therefore, have recourse for payment to the person acting as trustee when the GST liabilities were first payable. To remove any doubt it is proposed that section 57 be amended to confirm that a member's liability extends beyond the period of membership for GST payable (including any penalties) during the time the person was a member.

## **CHAPTER EIGHTEEN**

### **PERSONAL REPRESENTATIVES, LIQUIDATORS AND RECEIVERS**

#### **Proposed policy**

- Amend section 58(1A) (specified agent carrying on taxable activity) to include appointments of receivers to control only part of a taxable activity.
- Clarify when an agency period terminates.
- Allow personal representatives an input tax credit for the GST component of bad debts related to pre-agency period supplies.
- Clarify the relationship between section 58(1A) and section 5(2).

18.1 Section 58 provides that the “specified agent” of an “incapacitated person” personally carries on the taxable activity of the incapacitated person during an “agency period”, so has all the obligations and liabilities of a registered person carrying on the taxable activity. Without the section persons making taxable supplies on behalf of others might not be liable to account for GST.

18.2 An incapacitated person is defined as “a registered person who dies, or goes into liquidation or receivership, or becomes bankrupt or incapacitated”. A specified agent is defined as “a person carrying on any taxable activity in a capacity as the agent, personal representative, liquidator, or receiver of an incapacitated person”.

18.3 This chapter deals with four areas where clarifications to section 58 are required:

- partial receiverships;
- the termination of an agency period;
- bad debt deductions; and
- the relationship between section 58(1A) and section 5(2).

#### **Partial receiverships**

18.4 A receiver is appointed in relation to property, rather than in relation to a debtor. Thus a debenture holder may appoint a receiver to administer the assets secured by the debenture.

- 18.5 However, section 58(1A) deems a specified agent to be a registered person carrying on the taxable activity of an incapacitated person. This implies that the receiver has control over the entire taxable activity and, therefore, makes the specified agent liable for all GST obligations in relation to a taxable activity, not just those relating to the property which is the subject of the receivership.

### **Termination of agency period**

- 18.6 Section 58(1) defines the “agency period” as:

...the period beginning on the date on which a person becomes entitled to act as a specified agent carrying on a taxable activity in relation to an incapacitated person and ending on the earlier of-

(a) The date on which some person other than the incapacitated person or the specified agent is registered in respect of the taxable activity; or

(b) The date on which the person ceases to be a specified agent in relation to the incapacitated person:

- 18.7 When both a receiver and a liquidator are appointed it is not always clear whether the appointment of the liquidator terminates the agency period of the receiver.

### **Continuity of taxable activity**

- 18.8 Section 26 provides relief from bad debts by allowing an input tax credit for the GST component of an amount written off as a bad debt. Because goods or services to which the debt relates would have been supplied to the debtor by the incapacitated person, and the latter is no longer carrying on the taxable activity, it is unclear whether the specified agent is entitled to a deduction under section 26.

### **Relationship between section 58(1A) and section 5(2)**

- 18.9 Section 5(2) provides that if goods that are owned by a debtor are sold by or for a creditor, those goods are deemed to be supplied in the course of the debtor’s taxable activity.
- 18.10 This provision could conceivably apply to the sale of assets by a receiver, deeming them to be supplied by the debtor, contrary to section 58(1A), which was intended to deem the supply to have been made by the receiver.



## **Proposed reform**

### ***Partial receiverships***

- 18.11 It is proposed that section 58(1A) be amended to encompass appointments of receivers to control only part of a taxable activity. This will limit the specified agent's GST obligations to those arising from taxable supplies made in relation to the part of the taxable activity subject to the receivership.

### ***Termination of agency period***

- 18.12 This issue will to some extent be resolved by the amendments relating to partial receiverships, since an agency period can relate to the situation in which both a liquidator and a receiver are appointed, with each party having GST obligations in relation to the taxable supplies they make.
- 18.13 If on liquidation a receiver continues to act as a specified agent in relation to all property, section 58 will apply only to the receiver.

### ***Continuity of taxable activity***

- 18.14 In enacting section 58 it was intended that a specified agent be entitled to claim input tax credits on behalf of the incapacitated person for supplies made before the agency period began. In effect the specified agent is acting as an agent for the incapacitated person in respect of pre-agency period supplies, yet acting as a principal in relation to agency period supplies.<sup>47</sup>
- 18.15 To give better effect to the policy intent it is proposed to amend section 26 to allow specified agents to claim input tax credits for pre-agency period supplies.

### ***Relationship between section 58(1A) and section 5(2)***

- 18.16 It is arguable that section 58(1A) would override section 5(2), since it is a more specific provision. Therefore assets supplied by a receiver would be deemed to be supplied by the receiver as specified agent, not by the incapacitated person. However, for the avoidance of doubt and to aid clarity, section 58(1A) should be amended to provide that it overrides section 5(2).

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<sup>47</sup> A specified agent is not personally liable for pre-agency period debts; instead section 42 applies.

## CHAPTER NINETEEN

### OTHER ISSUES

#### **Proposed policy**

##### ***Termination of a taxable activity***

- Amend the definition of “taxable activity” so that it includes a premature ending of a taxable activity as well as a successful completion of a taxable activity.

##### ***Goods imported by agents***

- Amend the definition of “input tax” to allow an importer who is acting as an agent for a non-resident to claim an input tax credit for any GST levied under section 12.

##### ***Suspensory loans***

- Deem the time of supply for suspensory loans to be the time when the loan is made.

##### ***Vouchers for services***

- Recognise the value of a voucher redeemable for services when the voucher is acquired.

##### ***Vouchers as prizes***

- Allow the value of a voucher with a face value to be deducted from the gross proceeds of a lottery event.

19.1 This chapter looks at a number of other technical issues.

#### **Termination of a taxable activity**

19.2 Under section 6(2) anything done in connection with the termination of a taxable activity is deemed to be carried out in the course or furtherance of that taxable activity. This provision ensures that GST applies to supplies made in completing a taxable activity as well as to supplies made as part of normal trading activities. As discussed in chapter eight (Deregistration), because the completion of a taxable activity by a registered person is regarded as involving a taxable supply, an output tax liability should arise.

19.3 Under section 51(1)(c) a person who carries on a taxable activity does not have to register if the registration threshold is exceeded because of unusual circumstances such as the sale of a substantial capital asset.

- 19.4 In *Commissioner of Inland Revenue v Drummond and Ors*<sup>48</sup> the High Court found that the objectors' forestry activity had ceased earlier than planned for a number of reasons outside the objectors' control. By satisfying the conditions of section 51(1)(c) the objectors were not required to register for GST.
- 19.5 The court suggested that an activity is terminated only when it has run its intended full course. A supply made because of a premature conclusion of a business would be made on "cessation" of the activity rather than its "termination". Therefore the application of section 6(2) may be unintentionally limited to the completion of a taxable activity in the ordinary course of events.
- 19.6 It is proposed to amend section 6(2) by inserting the word "cessation", so that the provision applies to both a premature ending of a taxable activity as well as to a successful completion of a taxable activity.

### **Input tax credits for goods imported by agents**

- 19.7 Goods that are imported into New Zealand are subject to GST under section 12. The importer may claim an input tax credit for the GST if the goods were acquired for the principal purpose of making taxable supplies. The Taxation Review Authority in *Case T35*<sup>49</sup> held that the word "acquired" meant that legal title to the goods had to pass to the importer. This can have adverse consequences for an importer who acts as agent for a principal who is outside New Zealand – for example, for the purposes of consumer warranty agreements with a non-resident manufacturer.
- 19.8 It is proposed that the definition of "input tax" be amended to allow a GST refund when goods are imported into New Zealand but are not actually acquired by the importer. This would be subject to meeting appropriate record-keeping requirements.

### **Suspensory loans**

- 19.9 The time of supply in respect of a suspensory loan is unclear. A suspensory loan is a loan made by a public authority to encourage certain types of activity. If the conditions under the loan are met, the loan converts into a grant. If the conditions are not met, the loan must be repaid.
- 19.10 When a loan is made, it is arguable that the recipient is receiving a financial service and, therefore, the supply is exempt. Again, if the conditions under the loan are not fulfilled and the loan must be repaid, no taxable supply occurs.

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<sup>48</sup> (1998) 18 NZTC 13,745.

<sup>49</sup> (1997) 18 NZTC 8,235.

- 19.11 Conversely, it is arguable that the expected outcome of the suspensory loan is in substance a grant with conditions attached and, as such, it should be treated as a taxable supply from the outset.
- 19.12 Both arguments have merit, although it is likely to be more efficient from the taxpayer's perspective to pay the GST when the loan is granted. Therefore it is proposed to deem the time of supply for suspensory loans to be when they are made and not when they convert into a grant. If a suspensory loan does not convert into a grant, the recipient would be entitled to claim an adjustment for the GST previously returned.

## **Vouchers, stamps and tokens**

### ***Timing of output tax***

- 19.13 Vouchers, stamps and tokens (vouchers) involve two supplies. The first supply is when they are acquired, and the second when they are redeemed for goods or services. Whether or not a voucher has a face value determines which supply is subject to GST.
- 19.14 Vouchers with a face value (except postage stamps) are subject to GST at the time of redemption, since section 10(16) disregards the acquisition of vouchers.<sup>50</sup> This avoids double taxation.
- 19.15 Vouchers without a face value and postage stamps are subject to GST on acquisition. Section 10(17) deems the supply of goods and services resulting from redemption to have a nil value. This also prevents double taxation.

### ***Vouchers for services***

- 19.16 The legislation requires that output tax on a progressively redeemable voucher with a face value be returned as the voucher is used. This is because the legislation recognises the value of such vouchers when they are redeemed for goods or services. Since these vouchers can be used many times, the supplier will incur costs in progressively returning GST.
- 19.17 It is proposed, therefore, to amend section 10 to deem supplies of services in relation to vouchers to occur at the time of acquisition. This is consistent with the existing treatment of postage stamps.
- 19.18 The existing treatment for the redemption of vouchers for goods will be retained.

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<sup>50</sup> If the consideration paid for the token exceeds its face value, GST should be returned on the difference between the consideration paid and the face value of the token at the time the token is sold.

### **Vouchers as prizes**

- 19.19 When goods and services are given away as prizes in a lottery, the lottery organiser may deduct as input tax the GST paid in respect of those prizes. When money is offered as a prize, section 10(14) provides that the prize money may be deducted from the gross proceeds of the lottery event. In this way lotteries offering cash and non-cash prizes are treated equally.
- 19.20 When a voucher such as a book token is given as a prize, however, the lottery organiser has not paid any GST: the supply on acquisition is disregarded, so the ordinary procedure of claiming input tax credits does not apply. In addition, since vouchers are not money, the lottery organiser cannot rely on section 10(14).
- 19.21 It is proposed to amend the legislation to correct this anomaly and allow the value of a voucher to be deducted from the gross proceeds of a lottery event.



## Part V

# The Future for GST





## **CHAPTER TWENTY**

### **TAXING IMPORTED SERVICES**

- 20.1 Unlike imported goods, most imported services are not subject to GST, except for freight and insurance services associated with imported goods. This treatment largely reflects the limited volume of imported services that existed when GST was introduced, as well as the practical difficulties associated with levying and collecting GST on them. At the time GST was introduced, most services, except for transportation services, were consumed in the jurisdictions in which they were produced in view of the legal and technological constraints that either prevented international trade in services or made it uneconomic.
- 20.2 Since the introduction of GST, however, several developments have promoted a considerable growth in the volume of services being imported into New Zealand. Deregulation of the telecommunications and financial services markets in New Zealand, coupled with rapid advances in communication and computer technology, mean that it is now possible to consume a wide range of services in New Zealand that have been produced offshore.
- 20.3 This chapter examines the problems created by these developments and some of the possible solutions to those problems that have been tried in other jurisdictions.

#### **Problems arising from the current treatment of imported services**

- 20.4 As discussed in chapter one (Introduction), the primary objective of the GST system is to raise tax revenue in a manner that imposes the lowest possible cost on New Zealand as a whole.
- 20.5 Ideally, the GST system should not affect the decisions of domestic consumers and producers. In practice, however, the absence of GST on imported services does distort consumption and production decisions.
- 20.6 This absence encourages domestic consumers to substitute imported services that are not subject to GST for domestically produced services that are subject to GST. In other words, it encourages inefficient patterns of consumption by discouraging the consumption of domestically produced services in favour of imported services.
- 20.7 The absence of GST on imported services also tends to encourage inefficient patterns of production and resource use in New Zealand. In particular, it discourages the domestic production of services, since domestic producers may not be able to pass on the GST cost to consumers, who are able to switch to imported services that are not subject to GST. It also discourages

the use of domestically produced services by some New Zealand businesses. Domestic producers who are either unable to claim input tax credits, or are unwilling to incur the compliance costs associated with claiming those credits, will tend to substitute imported services for domestically produced services.

- 20.8 Some practical examples of these distortions in patterns of consumption, production and resource use are highlighted below.

***Example 1***

- 20.9 Advances in telecommunications and computer technology have increased the range of imported services available to private individuals in New Zealand. A New Zealand consumer who wants to purchase architectural, legal or other advisory services now faces the choice between purchasing them from domestic suppliers, or from overseas producers who offer to supply them via the Internet.
- 20.10 If those services are purchased from domestic producers they are subject to GST. By contrast, if they are purchased from offshore suppliers and downloaded via the Internet they are not subject to GST.
- 20.11 The absence of GST on such imported services distorts patterns of consumption in New Zealand. It does this by lowering the price of those imported services in relation to services produced in New Zealand. This encourages New Zealand consumers to substitute imported architectural and legal services for domestically produced services. The magnitude of this change in the pattern of consumption will depend on the extent to which consumers think those imported services are substitutable for domestically produced services. The greater the degree of substitutability, the greater the shift towards imported services.
- 20.12 The absence of GST on imported services also distorts patterns of production and resource use in New Zealand. The ability of New Zealand consumers to import such services free of GST prevents New Zealand producers of those services from passing on the full burden of the GST to consumers. This makes it more difficult for those producers to compete in the markets for their products and affects their ability to acquire resources.

***Example 2***

- 20.13 Advances in technology also mean that it is now possible for New Zealand businesses to import services that in the past would have had to be supplied by domestic producers. A New Zealand financial institution wanting to overhaul its existing software systems now faces a choice between obtaining the necessary services from domestic providers or importing them.

- 20.14 If the financial institution decides to obtain those services from a New Zealand programmer who is a registered person, GST will be charged on the software development. However, if the services are being used to overhaul the financial institution's treasury operations, it cannot claim an input tax credit for those services because treasury operations are exempt from GST. By contrast, if the financial institution, assuming it is registered for GST, contracts with a non-resident programmer who performs the services either outside New Zealand or inside New Zealand, the services may not be subject to GST since the supply may be deemed to occur outside New Zealand.
- 20.15 The absence of GST on imported programming services has the potential to distort the resource use decisions of financial institutions that may need to purchase programming services. In particular, it lowers the price of imported programming services in relation to domestically produced services for those financial institutions that are either unable to claim input tax credits, or are unwilling to incur the additional compliance costs associated with claiming them.
- 20.16 The absence of GST on imported programming services also distorts patterns of production and resource use in New Zealand. In particular, it means that domestic programmers may not be able to pass on the full burden of the GST to businesses that use their services. This places domestic programmers at a competitive disadvantage in the markets for both their outputs and their inputs.

***Example 3***

- 20.17 Deregulation of the telecommunications market in New Zealand, when coupled with advances in telecommunications technology, has encouraged the emergence of competition not only from other domestic service providers, but also from international providers offering call-back services.
- 20.18 New Zealand consumers wanting to place an international call may now choose between domestic service providers and international providers, who once called, will call them back and connect them to an international number.
- 20.19 The absence of GST on imported call-back telephone services may encourage consumers to substitute imported call-back telephone services for domestically produced services. The extent of this distortion in patterns of consumption depends upon how substitutable New Zealanders consider call-back services to be for domestically produced services. In particular, it will depend on the extent to which consumers must incur additional compliance costs in order to use call-back services. The lower the compliance costs associated with using a call-back service, the greater the potential bias towards using imported rather than domestically produced services.

20.20 The absence of GST on imported call-back services would also distort patterns of production and resource use in New Zealand. In order to stay competitive with imported call-back services, New Zealand telecommunications companies would be forced to lower their prices, thereby eroding their ability to pass on the full burden of the GST levied on the international call services they supply to New Zealanders. This means that the GST system would impose a relatively higher rate of tax on the value added by domestic telecommunications companies. This would reduce their ability to compete not only in the market for their products, but also in their ability to purchase resources.

### ***Double and non-taxation***

20.21 Another important objective of the GST system is to prevent the double taxation of goods and services that are traded between New Zealand and other jurisdictions.

20.22 It is relatively easy to prevent the double taxation of goods. Most jurisdictions, including New Zealand, zero-rate the export of goods and impose GST or VAT on imported goods. It is more difficult, however, to prevent the double taxation of services because the import and export of services may not be accompanied by any physical movement between jurisdictions.

20.23 Double taxation can arise when the supplier's jurisdiction charges GST or VAT on the basis of the supplier's place of establishment and the recipient's jurisdiction taxes according to the recipient's place of establishment. There are no double tax agreements, as there are for income tax, to determine who has the principal right to impose GST or VAT on a supply of goods or services. Non-taxation can arise when the recipient's jurisdiction does not tax imports and the supplier's jurisdiction zero-rates the supply because consumption occurs outside its jurisdiction.

20.24 The OECD is gathering information on internationally traded services that are potentially subject to double taxation and those that are not subject to taxation at all. New Zealand is participating in this research.

20.25 Associated with the taxation of international goods and services is the issue of distinguishing goods from services. This has become topical internationally, because of the increasing ability to send and receive commodities (such as literature, music and video) in a digitised form through the Internet. Differences in definitions of "goods" and "services" can create different tax consequences, especially for those jurisdictions that determine the place of supply according to the nature of the supply, rather than the residence of the supplier.

20.26 Although issues of classification have not so far been a major problem under New Zealand law, the discussion on the treatment of software programs in chapter fifteen (The Treatment of Software) demonstrates that New Zealand is not immune to these problems.

- 20.27 The Government invites comment on whether digitised commodities should be treated as “goods” or, whether New Zealand should treat them as “services”. Comment is also invited from exporters and importers on any circumstances in which supplies have been potentially subject to double taxation.

### ***Compliance and administration costs***

- 20.28 Although the taxation of imported services has the potential to reduce current distortions in patterns of consumption, production and resource use, it also raises some challenging administrative and compliance issues.
- 20.29 In 1985 the decision not to impose GST on imported services resulted from concerns that the revenue derived from GST on imported services would not exceed the costs incurred by business and the Government in collecting that tax. Most of these costs are involved in the level of enforcement that would be required to impose GST successfully on all services imported by registered and unregistered persons.
- 20.30 It has been the experience of other jurisdictions, however, that GST or VAT can be successfully imposed on certain types of imported services, particularly telecommunication services. Possible solutions to the problems caused by the non-taxation of imported services are discussed below.

### **Possible solutions**

#### ***Reverse charge***

- 20.31 Some countries, including Canada and the member states of the European Union, apply what is known as a “reverse charge” on imported services. Under a reverse charge system, services imported by a registered person in the furtherance of a taxable activity are deemed to be supplied by that person. The registered person must self-assess GST but can claim an input tax credit to the extent that the services were acquired for the principal purpose of making taxable supplies. A similar obligation is imposed on suppliers of exempt goods and services and in some countries, such as Canada and Switzerland, on private individuals. In these circumstances an input tax credit for the self-assessed GST would not generally be available.
- 20.32 A reverse charge mechanism has the advantage of reducing, to some degree, production distortions created by the preference exempt suppliers may have for internationally provided services over domestically provided services.
- 20.33 However, a reverse charge also has a number of disadvantages including whether it can be effectively applied to supplies of imported services to private individuals. A further concern is that the potential absence of invoices or similar documentation could create difficulties in administering a reverse charge.

### ***Register offshore non-resident suppliers***

- 20.34 An alternative to using a reverse charge is to change the current place of supply rules so that an obligation to register for GST is imposed on offshore non-residents when they supply services for use in New Zealand.
- 20.35 As mentioned in chapter nine (Exported Services), in New Zealand the place of supply is determined by reference to the residence of the supplier. In the case of non-residents the test is where the services are physically performed. In other jurisdictions, such as the members of the European Union, the place of supply is determined by reference to the “establishment” of the supplier. These rules are based on the principle that the majority of supplies will be made in the GST or VAT jurisdiction in which the supplier resides.
- 20.36 These rules do not generally require offshore non-residents to charge GST or VAT when they supply services within the taxing jurisdiction. This could be addressed by introducing a place of supply rule that is based on the effective use of goods or services supplied within the taxing jurisdiction.
- 20.37 A major difficulty with an effective use test is determining where the service is in fact used. This is generally feasible if the service that is supplied is not transferable from one jurisdiction to another. For example, services in relation to land are less easily transferred to another jurisdiction, whereas services in the nature of, say, insurance, can be effectively used in a number of jurisdictions.
- 20.38 A test of effective use could be targeted to apply to certain types of imported services, such as telecommunications. Although this may remove some of the difficulties that a general rule may create, it could confuse the general application of the place of supply rules.
- 20.39 In addition, imposing GST in this manner could raise significant compliance concerns for non-residents liable to charge GST or VAT, and problems for New Zealand in enforcing its taxation laws offshore.

### ***Origin principle***

- 20.40 A further theoretically possible solution would be to apply the “origin principle”. Rather than taxing supplies according to their destination (as under the “destination principle” adopted by New Zealand), the origin principle imposes tax according to the origin of supplies, and at the GST or VAT rate of the originating jurisdiction. This means that exports are taxed according to the rate of the jurisdiction of origin, but imports are zero-rated.
- 20.41 This system of indirect taxation can be used when there is a close concentration of countries with comparable GST or VAT systems. However, the practical considerations necessary to implement an origin principle approach to taxation are prohibitive. This is because to operate under the principle requires the almost identical incidence of the tax to fall equally on all consumers and businesses in all of the participating jurisdictions.

20.42 It is often perceived that the European Union operates under this principle. With respect to supplies to non-registered consumers within the European Union this is generally true, although supplies between businesses are not taxed under this principle. Instead taxation is applied by using a reverse charge mechanism that applies to both services and goods supplied within the European Union. The application of indirect taxation in this manner is not an “origin” system in the strict sense of the word, but is more representative of an attempt to move toward a single internal market.

### **Taxing imported services – conclusions**

20.43 The Government is committed to maintaining a broad-based GST. As part of this commitment it is essential to ensure that the international boundaries that determine whether consumption occurs in New Zealand are well defined and accommodate continuing technological and commercial developments. Because the taxation of imported services involves the need to address potential double-taxation and non-taxation, New Zealand would be in a difficult position, as would other countries, if it were to impose reforms unilaterally. As such, the Government is keeping a watching brief on developments in the European Union and the OECD.

20.44 Work is under way in the OECD to determine which international services are likely to be exposed to anomalous taxation consequences, with a view to releasing guidelines for the treatment of supplies made through the Internet and by the telecommunications industry. The Government will consider these developments and will implement these guidelines if they are considered desirable, or when multilateral action is required to improve the effectiveness of the world’s GST or VAT systems. Such reforms will be discussed with interested parties as part of the generic tax policy process.

#### **Specific issues for consultation**

- In what circumstances have exporters and importers found that their supplies of goods and services have been potentially subject to double taxation?
- What compliance cost concerns are suppliers of international services currently experiencing?
- Should digitised commodities be treated as “goods” or “services”?
- Should New Zealand introduce a reverse charge mechanism or other method of taxing imported services?

## **CHAPTER TWENTY-ONE**

### **FINANCIAL SERVICES**

- 21.1 Making any specific recommendations concerning the desirability of retaining the present exemption of financial services is a complex matter outside the scope of this review of GST. The Government does, however, propose to undertake a longer-term review of the treatment of financial services.
- 21.2 Even so, there is an immediate need for the definition of “financial services” to better reflect the policy of excluding transactions involving the supply of money or money substitutes. Consequently, this discussion document contains a number of remedial proposals such as the exclusion of debt collection services and deliverable futures contracts from the definition. The Government welcomes submissions on the proposals in chapter eleven (The Financial Services Exemption) and on any other aspects of the financial services definition that may be causing concern.

#### **Taxing value added**

- 21.3 Applying GST to supplies of financial services is difficult because of the complexities involved in identifying and measuring the value that is added by the supply. This is because the added value is often not separately identifiable in the charges made by financial intermediaries (including banks, finance houses, life insurers and fund managers) for the services they supply.
- 21.4 Amounts charged for supplies of financial services usually consist of a mixture of fees, commissions and interest rate margins. Interest rate margins may include pure interest (which represents the time value of money), a pure risk premium, and cost recovery and fees.
- 21.5 The value added by a financial institution which should be subject to GST is in cost recovery and fees, less any relevant capital costs. Identifying this component for specific transactions is difficult.
- 21.6 In the absence of an effective tax on margins, taxing only fees and commissions for financial services could simply result in a change to charging structures.



## **Current GST treatment of financial services in New Zealand**

- 21.7 Financial services provided in New Zealand are exempt from GST. This means that input tax credits cannot be claimed for the costs of producing such services, and output tax cannot be charged on the sale price. Exported financial services may be zero-rated, meaning input tax credits can be claimed for the costs of producing such services, but tax is charged on the sale price at a zero rate.

### ***Effects on financial intermediaries***

- 21.8 The exemption of financial services creates a number of distortions that affect the manner in which financial intermediaries operate. This in turn affects relative prices faced by consumers for financial services.
- 21.9 International experience has shown that the fact that financial intermediaries cannot claim a large proportion of their input tax credits means that they are likely to prefer imported services and other supplies that do not attract GST. They may also seek to minimise their GST exposure by vertically integrating necessary production functions.
- 21.10 This behaviour affects the price of financial services. Financial intermediaries that find it difficult to purchase GST-free supplies will attempt to pass on the GST they incur to their customers. However, this exposes them to the risk that the price charged for their financial services is higher than that charged by a competitor. With respect to financial services, the competition arises not only from domestic sources but also from international suppliers that may not face the effects of GST on their purchases.
- 21.11 Because exemption distorts the choices that financial intermediaries make, the definition of “financial services” in section 3 is designed in such a way that it does not specifically refer to financial institutions, but affects all businesses that supply some form of financial service in New Zealand.
- 21.12 This boundary between exempt and taxable supplies also creates substantial compliance costs in the form of allocating operating and direct costs between the two types of supply.

### ***Effects on consumers***

- 21.13 Exempting financial services also creates distortions in the investment decisions that are made by consumers. From a private consumer's point of view, financial investments tend to be cheaper than investments in other property, such as commercial buildings, because GST is not payable on the former. Businesses, on the other hand, can find that financial investments are more expensive than other forms of investment because the business cannot claim input tax credits.

***“Tax cascades”***

- 21.14 Exempting financial services also creates what is known as a “tax cascade” if a financial institution passes on the GST cost of its inputs through higher prices. The higher price for the financial service increases the operating costs of the purchaser. If the purchaser is required to charge GST when selling its goods and services this price will also be inflated. The severity of the cascade depends on the number of times exempt financial services are used before a sale to a final consumer takes place.

**Zero-rating and full-invoicing approaches to taxing financial services**

- 21.15 Zero-rating and full-invoicing are possible alternatives to exemption within the existing GST framework.

***Zero-rating***

- 21.16 Zero-rating would extend the current treatment of exported financial services to all financial services supplied from or in New Zealand. Input tax credits could be claimed for the costs of producing all financial services, and tax at a zero rate would be charged.
- 21.17 This approach would eliminate some of the inefficiencies created by exemption and would make domestic suppliers of financial services more competitive with offshore institutions in the New Zealand market. However, zero-rating would be very costly to the Government and could create an incentive for over-investment in the financial sector. It is, therefore, not a realistic option.

***Full-invoicing***

- 21.18 Under full-invoicing, input tax credits would be claimed for the costs of producing all financial services, and 12.5 percent output tax would be charged on their supply.
- 21.19 The choice for registered persons between domestic and international sources of finance would be a neutral one because input credits would be available on the cost of obtaining funds domestically. Final consumers, however, would face very strong incentives not to borrow from domestic financial intermediaries. Instead final consumers would be motivated to obtain debt finance offshore. Consequently, domestic financial institutions would be heavily disadvantaged in supplying final consumers.
- 21.20 In addition, many private investors would be required to register for GST because they would then exceed the GST registration threshold. Interest rates and share prices would increase by 12.5 percent.

- 21.21 The major difficulties, however, would be in distinguishing capital flows from flows of financial services and determining in all cases where the international boundary lay.

### **Options for taxing the value of financial services**

- 21.22 As noted earlier, the main difficulty in the financial services area is valuing the service. A discussion of options for valuing financial services follows.

#### ***Taxing fees***

- 21.23 Charging GST on commission and fee income involves the risk of fees and commissions becoming integrated into the general margin for a transaction should that result in a more favourable treatment.

#### ***Taxing margins***

- 21.24 An alternative form of taxing financial services involves taxing, at the appropriate rate of GST, financial institutions on the wages that they pay and their annual profits. This method of taxation is used in Israel. Rather than imposing VAT on a transaction-by-transaction basis, this form of taxation uses the financial intermediary's annual income tax return. VAT is payable on profit (which is deemed to be the taxable income figure disclosed in the financial intermediary's tax return less any dividends received) plus the amount of wages paid for the year.
- 21.25 Another method of taxing margins using annual financial statements involves taxing the margin between the revenue earned from supplying financial services and the costs directly attributable to supplying those services.
- 21.26 Although Israel does not allow financial intermediaries to claim notional input tax credits for any GST incurred in supplying financial services, in theory input tax credits could be allowed under both methods.
- 21.27 Issues with such a method include the treatment of annual tax losses, how to treat fixed assets (if input tax credits are allowed) and supplies of exported financial services.

#### ***Cash-flow***

- 21.28 The cash-flow method avoids the problem of identifying the margin on individual transactions, by bringing all cash flows from financial transactions (except those involving a company's own equity) into the tax net. Transactions with non-residents are ignored (effectively zero-rated) and non-financial transactions are subject to GST in the usual manner.

- 21.29 The mechanism requires the banking system to pay tax on deposits it receives and allows an input tax credit for approved loans. Businesses, conversely, pay tax on loans received and receive credits for repayments. These effects cancel each other out. Repayments of loans are similarly cancelled out by the offsetting reduction in deposits. Interest paid on deposits (credited) offsets most of the interest charged on the loans (tax due), which has the benefit of excluding the time value of money from the tax base. The final tax is effectively the tax rate multiplied by the bank's margin after deducting its cost of funds. For individual transactions the net effect is the same as if the added value had been separately identified, invoiced and tax paid.
- 21.30 Under this approach the present value of tax payments would be the same as the standard method of applying GST if no uncertainty existed in the capital markets. To the extent actual returns differed from expected returns, added value would be under-taxed or over-taxed.
- 21.31 Problems with the cash-flow methods include adjusting for tax-rate changes (including the introduction of the system), the cash-flow implications of taking out a loan (paying tax on the amount drawn down and getting a credit on repayment) and the calculation requirements. The cash-flow method has been developed through work commissioned by the European Union, and further work should identify whether these problems can be overcome.
- 21.32 The Government is monitoring these developments in the European Union and elsewhere where there has been some movement towards the application of value-added taxes to the supply of financial services.

**Specific issues for consultation**

- What are the problems of continuing to exempt financial services from GST?
- Which option for estimating the value of financial services is preferred?