Options for strengthening GST neutrality in business-to-business transactions

An officials' issues paper

June 2008

Prepared by the Policy Advice Division of Inland Revenue and by the New Zealand Treasury

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Chapter 1

OVERVIEW

1.1 One of the basic design principles of GST is that businesses should not be subject to the tax when producing goods and services.[1] The credit-invoice mechanism, which ensures that the legal incidence of the tax is removed on most business purchases, prevents that happening. It also prevents the tax from "cascading" as goods and services are supplied between businesses that are registered for GST.

1.2 The compliance costs inherent in the credit-invoice mechanism are a trade-off against the benefit that comes from the comprehensive application of GST to goods and services that are imported, produced and distributed in New Zealand. The mechanism also ensures that businesses are tax-neutral in the sense that when a business pays GST, it can deduct input tax.

1.3 The operation of GST in this manner is not, however, without its problems, particularly for transactions involving the supply of significant assets, such as the sale of businesses, land, or other high-value assets. These problems can include, for example, a transaction not qualifying under the legislation that would zero-rate a "going concern" or an invoicing error resulting in a purchaser's expected input tax (sometimes referred to as a GST "refund" or GST "credit") entitlement being denied. Because the assets are significant, they are infrequently traded and can create GST consequences that businesses may not have expected or planned for.

1.4 Such GST errors can be particularly costly for businesses, resulting in penalties and use-of-money interest being applied and the reduction of any profit margin on the transaction if the tax becomes an irrecoverable business cost. Government revenue losses can also occur if an input tax entitlement does not result in the corresponding payment of GST to Inland Revenue as a result of arrangements aimed at achieving this effect.

1.5 The purpose of this officials' paper is to suggest a number of options to solve the problems that can arise in connection with the supply of significant assets, and to improve the operation of the Goods and Services Tax Act 1985 for businesses and the government. As part of the discussion, we have suggested measures to help ensure business neutrality and reduce base maintenance risks associated with GST. The rules applicable to changes in taxable use and the supply of accommodation are also considered. Our objective is to seek public comment on a range of policy solutions before formal recommendations are made to the government.

[1] An obvious exception applies to purchases acquired for the purpose of making exempt supplies, such as financial services.

Business-to-business neutrality explained

1.6 Because GST is designed to tax consumption rather than production, transactions between businesses should generally be GST-neutral unless express exemptions are provided (for example, the supply of financial services). The terms "GST-neutral" and "business-to-business neutrality" describe the situation where GST paid by a business can be claimed against the GST payable on taxable supplies. A business is "neutral" about the purchase of goods and services if the GST it pays does not become a permanent business cost.

1.7 To reduce revenue risks to the government that could arise if GST were deductible by individuals or entities that make minimal or no supplies on which GST is charged, the GST Act prescribes the circumstances for neutrality to occur. These include the requirements to carry on a "taxable activity" and register for GST.[2] There should also be a connection with making taxable supplies.[3] These requirements set the necessary parameters for taxpayers to be viewed as being involved in the intermediate production of goods and services so that they are entitled to deduct input tax.

1.8 The ideal consumption tax system would ensure perfect neutrality for both businesses and the government in business-to-business transactions. Perfect neutrality would be achievable in practice if GST did not apply at every stage of production and distribution but applied only at the point of final consumption, as happens with retail sales taxes.[4] However, retail sales taxes are more likely to be exposed to evasion than is GST because of the opportunity for goods and services to be untaxed if acquired by consumers from wholesalers, importers or other providers who are not identified as "retailers".

1.9 The trade-off associated with the government preferring GST over a retail sales tax is the challenge of ensuring that business neutrality is achieved to the greatest extent possible. This includes the need to ensure that in all but exceptional business-to-business transactions, refunds of GST will be met by a corresponding payment of GST.

1.10 We have reviewed the treatment of business-to-business supplies and, in summary, consider that:

- GST is not designed to be a tax on business, with suppliers of exempt goods and services being the exception.
- GST-registered businesses have an expectation that GST should not be a direct cost on businesses. This means that input tax entitlements should be promptly refunded, subject to the appropriate level of Inland Revenue enquiry.

[2] See sections 6 and 51 of the Goods and Services Tax Act 1985.
[3] See section 3A.
[4] GST and sales taxes are generally economically equivalent when they function perfectly.

- Similarly, the government should have an expectation that transactions between GST-registered businesses are neutral.
- The GST Act should provide effective and clear rules that ensure that GST does not unnecessarily hinder transactions between GST-registered persons.

Problems considered

1.11 As we have noted, if GST-registered businesses are not entitled to input tax deductions, GST can have a direct negative operational effect on the distribution of resources and profitability. In line with this theme, this document considers:

- the cashflow cost associated with collecting GST (which can arise if GST is paid but is not recoverable as input tax until a later date);
- the treatment of high-value, one-off transactions (where neutrality is critical); and
- the potential for over-taxation when nominees are involved in transactions.

1.12 This issues paper places emphasis on aspects of the GST system that create a risk to the tax base. GST creates the unique situation whereby Inland Revenue regularly refunds GST-registered persons for excess input tax deductions. Another unique feature of the GST system is that it allows taxpayers to use different GST accounting bases and different taxable periods. Aggressive arrangements such as those present in the series of Court decisions concerning *Ch'elle*,[5] demonstrate that the government's revenue base is at risk from business structures that are designed to exploit these aspects of the GST system. The inevitable complexity and pace of litigation in this area suggests a need to address the issues not only at an operational level but in terms of possible amendments to the GST Act. "Phoenix fraud" (discussed in chapter 5) and the emergence of "carousel" or "missing trader" fraud (which has had a material effect on the revenue collections for some countries),[6] should, in our view, also be considered in developing any legislative changes.

1.13 Options canvassed in this paper include greater scope for setting off GST liabilities and corresponding deductions and a review of the accounting bases among the range of possible measures for addressing these tax base concerns.

[5] See *Ch'elle Properties (New Zealand) Limited v Commissioner of Inland Revenue* [2007] NZCA 299; *Ch'elle Properties (New Zealand) Limited v Commissioner of Inland Revenue* (2004) 21 NZTC 18,618 and *Case W22* (2003) 21 NZTC 11,212.

[6] Michael Keen, *VAT attacks!*, International Monetary Fund Working Paper WP/07/142 June 2007; Michael Keen and Stephen Smith, *VAT fraud and evasion: what do we know and what can be done?*, National Tax Journal, Vol. LIX, No 4 December 2006.

Other possible measures

1.14 Significant capital assets also present special concerns for the application of the change-in-use or apportionment rules as these assets can be consumed over a number of taxable periods and be applied for a variety of mixed purposes over their lifetime. This paper includes a number of suggestions to improve and clarify the application of the change-in-use rules to capital assets such as land.

1.15 The paper also considers the treatment of holiday and short-term accommodation. The changes suggested in this paper respond to concerns that have been raised in submissions about the correct legislative framework that applies to supplies of accommodation following the Inland Revenue's draft interpretation statement about the exemption for accommodation provided in a dwelling.[7]

Objectives of the possible solutions

1.16 In this paper we have considered a series of possible options to enhance the neutrality of some transactions and reduce the risk that GST can present to businesses and the government. In some cases, common solutions could deal with both business and government concerns. The current rules governing the supply of a "going concern" are an example of the GST Act providing both a business-to-business neutral solution and an anti-avoidance rule.[8]

1.17 The options outlined in this paper aim to provide a more certain GST outcome for both GST-registered persons and the government. The options discussed in the document have therefore been developed with the following principles in mind:

- preserving the policy objective that GST applies to the widest possible range of goods and services supplied in New Zealand, at a uniform low rate;
- reducing, as far as practical, compliance and administrative costs arising from the application of GST;
- ensuring that the obligations facing those required to comply with the GST Act are clear and straightforward; and
- limiting the scope for erosion of the GST base.

References

1.18 All section references in this paper refer to the GST Act unless otherwise specified. Amounts and values used in this document to describe transactions are also expressed as including GST.

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[7] IS0049 *GST Exempt Supply: Supply of accommodation in a dwelling*, released by Inland Revenue on 19 October 2006.

[8] See sections 2, 11(1)(m) and 78E.

SUMMARY OF SUGGESTED OPTIONS

This paper outlines a range of options to ensure that business-to-business transactions are GST-neutral. Submissions are invited on which options should be considered in preference to others.

Legislating for business-to-business neutrality – Chapter 4

Suggestions are made to improve the GST consequences arising from transactions involving high-value assets such as "going concerns", assets with a value of $50 million or more, and land, using a mechanism known as a "domestic reverse charge".

The GST treatment of nominee transactions is also discussed.

Managing the government's revenue risk – Chapter 5

"Phoenix" entities are a particular problem for GST systems that are based on the "credit-invoice" method. Three options for reducing this risk are suggested:

- Enforcing GST neutrality on certain transactions created between close associates.
- Allowing Inland Revenue to impose caveats on certain land transactions.
- Extending the time available before Inland Revenue is required to release a refund.

The accounting bases – Chapter 6

The incidence of "timing mismatches" created by the operation of the various accounting bases allowed under the GST Act is noted.

The policy reasons for the various accounting bases are discussed and two options are suggested to reduce revenue risk:

- Limiting access to the invoice basis of accounting.
- Strengthening the application of existing anti-avoidance measures accompanied by an increase in the payments basis threshold.

The payments basis – Chapter 7

Further adjustments to the current limitations for using the payments basis are considered.

Change-in-use adjustments – Chapter 8

A number of changes are suggested to simplify and clarify the change-in-use rules.

The relationship between the application of the change-in-use adjustment rules when the use of assets changes from non-taxable to taxable, and the deduction for second-hand goods are discussed.

Accommodation – Chapter 9

Options to clarify the GST treatment of short-term accommodation include:

- Redefining the terms "dwelling" and "commercial dwelling".
- Removing very small-scale and non-commercial activities involving the supply of accommodation from the definition of "taxable activity".

How to make a submission

1.19 Submissions are invited on the merits of the options suggested in this officials' paper. We also welcome submissions on alternative measures that meet the objectives of enhancing business neutrality as it affects the application of GST to day-to-day business activities. Those who make submissions are asked to:

- discuss whether, and how, the suggested changes would achieve GST neutrality without compromising the integrity of the GST base; and
- prioritise these initiatives and any others put forward.

1.20 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for officials from Inland Revenue and the Treasury to contact you about your submission to discuss the points raised.

1.21 Submissions should be made by 11 July 2008 and be addressed to:

GST: Strengthening business-to-business neutrality
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington

Or e-mail policy.webmaster@ird.govt.nz with "GST: Strengthening business-to-business neutrality" in the subject line.

1.22 Submissions may be the source of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you think any part of your submission should properly be withheld under the Act, you should indicate this clearly.

Chapter 2

GENERAL OPERATION OF GST

2.1 This chapter discusses the design principles underlying the operation of GST. The collection of GST in New Zealand is modelled on the "credit-invoice" method. Under this model, a liability for GST arises every time goods and services are supplied by a GST-registered person in the course of a taxable activity. GST is also imposed on imported goods and services. Tax is therefore paid throughout the production and distribution chain, but because GST-registered persons are able to deduct GST paid, the tax is ultimately passed on to the final consumer.

2.2 The deduction of GST (by way of a refund or credit) ensures that GST does not cascade as goods and services are supplied between GST-registered persons, and does not impose a cost on business. Therefore, unless the GST paid is connected with the supply of GST exempt goods or services, it does not directly tax the intermediate production of goods and services in New Zealand.

2.3 Other reasons why the credit-invoice method has been adopted over other alternative indirect tax systems are:

- It allows all goods and services to be included in the tax base.
- It is transparent.
- It requires businesses to maintain accounting records detailing sales and purchases, which helps improve financial management and managerial decisions.
- It provides a robust revenue stream for the government by taxing each stage of the production and distribution chain. As imports are taxed, it ensures that the tax is secured at the earliest stages of production.
- The requirement to issue tax invoices means that the tax generates its own audit trail, which assists in its administration and enforcement.

Accounting for GST

2.4 Because GST is a tax based on transactions, its operation, including input tax entitlements, depends on the contractual relationships between the supplier and the recipient.[9] Accounting for GST therefore requires an understanding and knowledge of:

- when a supply occurs (or is deemed to occur);
- when an entitlement to an input tax deduction arises; and

[9] *Wilson & Horton v Commissioner of Inland Revenue* (1995) 17 NZTC 12,325.

- when (and how) the calculation of GST less input tax needs to be made using the various accounting bases and filing frequencies allowed under the GST Act.

Time of supply and output tax

2.5 The GST Act contains a number of rules that determine the point in time when a GST-registered person must recognise a supply of goods and services that gives rise to an output tax liability. In the majority of cases, this will be when the supplier issues an invoice or receives payment.

2.6 The rules attempt to approximate when a transaction has been concluded and economic control of the goods and services has passed from the supplier to the recipient. When GST was being developed, a number of rules were considered necessary to reflect this concept.[10] Following the recommendation of the Advisory Panel on Goods and Services Tax,[11] which considered public submissions on the *White Paper*, the then government agreed to simplify the time of supply rules to the earlier of invoice or payment.

2.7 In situations when the application of the general "earlier of invoice or payment" rule is not appropriate – for example, agreements for hire or regular periodic supplies of goods and services, the GST Act contains a range of supplementary rules.

Deduction of input tax

2.8 GST paid on purchased taxable supplies can be deducted as input tax when the GST-registered person holds a valid "tax invoice".[12] Unlike output tax, input tax is not generally subject to timing rules.[13] The point in time when input tax can be deducted is largely determined by the taxpayer holding evidence that tax has been paid. If the registered person does not hold a tax invoice or other documentation to support the purchase,[14] no deduction can be made.

2.9 In each taxable period, GST-registered persons aggregate the total output tax deemed to arise either under the time of supply rules or the accounting rules for that period and deduct from that amount any input tax invoiced or paid. The net of these two amounts is either the tax payable owed by the GST-registered person or, if input tax exceeds output tax, a refund.

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[10] *White Paper on goods and services tax: Proposals for the administration of the goods and services tax*, New Zealand Government, March 1985, p. 17.
[11] *Report of the Advisory Panel on Goods and Services Tax to the Minister of Finance*, June 1985, p. 12.
[12] See sections 24 and 24BA.
[13] Subject to the proviso applicable to section 20(3).
[14] Subject to the application of section 24(6).

The accounting bases

2.10 The accounting bases available in the GST Act determine how output tax and input tax should be attributed to a particular taxable period. Although the time of supply rules determine when GST-registered persons are required to recognise a liability for GST, the accounting basis adopted can alter the taxable period in which that liability needs to be disclosed to Inland Revenue.

2.11 The GST Act allows for three bases of accounting for GST, as described in Table 1. The current choice of accounting bases is largely a response to compliance cost concerns.

TABLE 1:
DESCRIPTION OF THE ACCOUNTING BASES PERMITTED UNDER THE GST ACT

Accounting basis	*Description*
The invoice basis	The standard basis of accounting for GST is the invoice basis. Output tax is accounted for at the time of supply. Input tax deductions may be claimed on the basis of payment or invoice – subject to the deduction being supported by a valid tax invoice. The invoice basis is similar to the accrual basis for financial accounting.
The payments basis	GST-registered persons may use the payments basis if they have annual taxable supplies of less than $1.3 million or are a non-profit body. Output tax is accounted for to the extent that payment is received. Input tax deductions can be claimed to the extent to which payment has been made – subject to the deduction being supported by a valid tax invoice. Inland Revenue has a discretion to allow GST-registered persons who have a turnover of greater than $1.3 million to account for GST using this basis after taking into account the nature, volume and value of the supplies made.
The hybrid basis	GST-registered persons may choose to use the hybrid basis if they do not qualify to account for GST using the payments basis and do not want to use the invoice basis. No turnover limitations are imposed on who may account for GST using the hybrid basis. Output tax is accounted for in a similar manner as under the invoice basis. Input tax deductions are claimed in a manner similar to the payments basis.

2.12 Table 2 shows the general distribution of GST-registered persons over the three accounting bases.[15]

[15] Source: Inland Revenue. Information was compiled from GST 101 returns for the year end 31 December 2007.

TABLE 2:
USE OF THE ACCOUNTING BASES BY REGISTERED PERSONS

Annual taxable supplies	*Payments*	*Invoice*	*Hybrid*
Up to $1.3 million	458,520	99,942	3,299
Over $1.3 million	13,230	24,145	462

Return filing

2.13 The last factor in accounting for GST is the frequency for calculating tax payable (including any refund) and filing the related return with Inland Revenue.[16]

2.14 For administrative convenience, the activities of GST-registered persons are broken down into periods of time, or "taxable periods". Depending on their size, as measured by annual taxable supplies, GST-registered persons generally have the choice of one of three taxable periods or filing frequencies.[17] The standard taxable period is two months, although shorter (monthly) and longer (six-monthly) periods may apply. At the end of every taxable period, GST-registered persons must assess whether they have GST to pay or are entitled to a refund.

[16] The obligation to file a GST return and calculate the amount of "tax payable" is imposed under section 16. The calculation of "tax payable" (as defined in section 2 includes any refund) is done by reference to section 20.

[17] The GST Act also requires other returns subject to the application of special supply rules, such as those in section 5(2).

Chapter 3

PROBLEMS WHEN NEUTRALITY IS NOT ACHIEVED

3.1 The credit-invoice method of collecting GST, while generally effective in achieving the objective of business neutrality, can present risks for both businesses and the government. For businesses, the risk is that if the GST consequences of a transaction are not properly taken into account, that could give rise to penalties or even produce a non-deductible GST liability. For the government, the risk is the possibility that Inland Revenue will refund an input tax deduction that may not be offset by an expected corresponding payment of GST.

3.2 This chapter describes these problems in more detail.

Risks to businesses

3.3 Transactions that are not neutral to businesses can result in GST becoming a fixed burden on production. This can affect business margins, distort business decisions and alter perceptions about voluntary compliance. Non-neutral business-to-business transactions can also have wider economic implications if the tax has the potential to cascade.

The "carrying" cost of GST

3.4 GST-registered businesses can face a cashflow cost if they are unable to immediately recognise input tax deductions when GST is paid on purchases. This cost is particularly relevant for exporters because zero-rated exports do not produce the usual offsetting cashflow benefits that arise by holding GST charged on supplies to customers until payment to Inland Revenue is required.

3.5 Another cashflow cost facing businesses that use the invoice or hybrid accounting bases arises if GST has to be returned to Inland Revenue in connection with supplies made over the taxable period in question, but payment has not yet been received from customers.

3.6 These costs are sometimes referred to as the "carrying" cost of GST. The GST Act attempts to deal with this cost by permitting a variety of accounting bases and filing frequencies. Other rules, for example, those applicable to the supply of "going concerns", further help to mitigate the carrying cost of GST.

3.7 When these legislative solutions do not provide the required degree of relief, administrative solutions can provide assistance. For example, exporters, who make predominantly zero-rated supplies do not receive the benefit of holding GST charged on their supplies of goods and services. To deal with the carrying cost of GST on their purchases, Inland Revenue has a practice of ensuring that excess input tax deductions are promptly refunded to exporters

on the receipt of a valid GST return. Exporter GST returns are therefore processed well within the 15-working day requirement.[18]

3.8 In other instances, Inland Revenue may permit the GST liability incurred by a GST-registered supplier on a transaction to be set off against the input tax deduction that would otherwise be available to the GST-registered recipient.[19]

3.9 The New Zealand Customs Service may provide administrative relief to importers by allowing the payment of GST on imported goods to be deferred for up to seven weeks.[20] The deferral allows qualifying importers to claim input tax deductions for GST levied under section 12 before the GST payment needs to be made to Customs.

Potential for over-taxation

3.10 Subject to a GST-registered person holding a valid tax invoice, a deduction of input tax is allowed when GST has been invoiced or paid or, in the case of imported goods, levied. It is important that these deductions are dealt with promptly, particularly when they give rise to a refund, so that GST does not become a cost of production rather than a tax on consumption, as intended.

3.11 If the input tax deduction arises by some other means – for example, from the purchase of second-hand goods or from adjustments for changes in use – Inland Revenue may need to give the deduction closer scrutiny. This is because these deductions do not arise from the payment of GST to another GST-registered person or to the New Zealand Customs Service and therefore do not immediately give rise to offsetting output tax.

3.12 Case law on the deduction of input tax by GST-registered persons has generally emphasised that legal ownership of the goods and services purchased is a prerequisite to deduction.[21] Businesses may therefore face problems when the legal entitlement to input tax cannot be established but the cost of the purchase has been incurred. For example, when a nominee provides consideration for a supply of goods and services to the vendor, but the contract treats the named purchaser – rather than the nominee – as the recipient, uncertainty can arise about the entitlement to deduct input tax and this can possibly even result in over-taxation.

3.13 Another area of uncertainty exists when a nominee provides the consideration for the supply of a "going concern", but is not the identified recipient on the agreement for sale and purchase. This can affect whether the going concern is zero-rated or subject to GST under the usual rules.

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[18] See section 46.

[19] GST offsets, or transfers of input tax deductions, may be made by the Commissioner under section 173M of the Tax Administration Act 1994. The facility is not available if the GST-registered recipient has outstanding returns or debt with Inland Revenue that limit the amount that can be used as an offset.

[20] Customs Fact Sheet number 17, *Deferred payment scheme*, 17 August 2006, New Zealand Customs Service.

[21] See *Commissioner of Inland Revenue v Capital Enterprises Limited* (2002) 20 NZTC 17,511 and *Case T35* (1997) 18 NZTC 8,235.

3.14 These uncertainties add to compliance costs as well as affecting businesses' ability to receive full input tax deductions. The risks of this uncertainty are exacerbated by the potential for short-fall penalties or use-of-money interest charges to apply if, for example, a decision to claim an input tax deduction or to zero-rate a supply ultimately proves incorrect.

Supplies of going concerns

3.15 The circumstances in which the supply of a "going concern" may be zero-rated are defined by the GST Act. Whether or not a supply is of a going concern may, however, be uncertain. If this uncertainty is identified at the beginning, the parties may, as discussed earlier, seek a set off of the GST-registered recipient's input tax deduction against the output tax owed by the GST-registered supplier. However, this may not always be possible.

Company grouping rules

3.16 The GST grouping rules play an important role in alleviating potential distortions between the treatment of single entities, branch structures and company group structures. The rules reduce compliance costs arising from transactions within a group by ensuring that intra-group supplies sourced completely from within a group's resources are not subject to GST unless the assets are used for private or exempt purposes. In this way, the GST grouping rules treat the group as if it were a single economic entity.

3.17 The grouping rules are, however, elective, and it may be the case that related entities who wish to group cannot do so because they are unable to satisfy one or more of the requirements in the GST Act.

3.18 The GST Act was recently amended in line with the principle of treating groups of companies as a single economic entity to deal with situations when the transfer of assets within a group gives rise to a GST liability because the recipient member of the group is not registered for GST.[22] However, despite this amendment, GST risks may still exist for businesses in entering into group transactions.

Revenue risks for the government

3.19 GST presents an inevitable risk to the government by requiring the issue of refunds from input tax deductions that may not be offset by the payment of GST in circumstances when that would be the expected outcome. This can occur for legitimate reasons, in the case of liquidations or bad debts of the type that can be faced by any business. However, there are situations when this offset does not occur for other reasons – for example, if timing mismatches created by the choice of accounting bases and filing frequencies is exploited or if "phoenix" entities are used to create tax advantages.

[22] See section 55(1) as amended by the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006.

3.20 The risk associated with timing mismatches was highlighted by the series of cases involving *Ch'elle Properties (New Zealand) Limited v Commissioner of Inland Revenue*.[23] These cases concerned an arrangement that was designed to produce a refundable input tax deduction of $9 million to the purchasing company (Ch'elle) but defer the requirement to account for GST by the 114 separate companies supplying the land in question to Ch'elle. The deliberate operation of the vendor companies so as not to require GST to be accounted for using the invoice basis on the transactions, together with the wider features of the arrangement, led the courts to the conclusion that there was tax avoidance.

3.21 In Australia, a similar arrangement was held to be avoidance under Division 165 of the A New Tax System (Goods and Services Tax) Act 1999 (the equivalent of section 76 of the New Zealand GST Act). In *VCE and Commissioner of Taxation*[24] the sale of property modified and leased as a medical centre by a taxpayer to a company owned by the taxpayer and his spouse was considered to be a scheme that had the sole or dominant purpose of achieving a GST benefit. The features of the arrangement involved an agreed selling price of $770,000 (including GST), although the market value was $250,000, with periodic payments scheduled for 2008, 2013 and 2018. A deposit of $550 was payable but the taxpayer retained ownership until the company made full payment in 2018. The Australian Appeals Tribunal Authority considered that the tax benefit of the scheme was a tax refund that was larger than could reasonably be expected.

3.22 These cases illustrate that Inland Revenue is able to use the relevant anti-avoidance provisions in the GST Act to deal with non-neutral transactions. This may limit the choices available to taxpayers when deliberately attempting to operate outside the business-neutral framework. However, because anti-avoidance rules may be highly fact-dependent and litigation can be both time consuming and costly, other measures are needed to protect the integrity of the GST system.

3.23 In 2007 the government allocated $14.6 million over three years to strengthen Inland Revenue's audit of property transactions.[25] From 2000 the number of persons registered for GST grew from about 500,000 to just over 660,000 for the year ended 1 April 2008.[26] Further, in the last financial year, Inland Revenue processed in excess of 3 million GST returns. Against such volumes, the effectiveness of current audit strategies can be tested. Further legislative solutions, as presented in this paper, are therefore worth exploring.

[23] Ibid footnote 5.
[24] [2006] AATA 821.
[25] See Budget speech, 17 May 2007.
[26] Including one-off returns.

Chapter 4

LEGISLATING FOR BUSINESS-TO-BUSINESS NEUTRALITY

4.1 This chapter makes suggestions for improving the neutrality of certain business-to-business transactions. These are:

- replacing the going concern rules with an expanded set of rules that are applicable to a wider range of transactions; and
- ensuring input tax deductions are not denied for nominee and related transactions.

The going concern rules

4.2 The supply of goods as a "going concern" may be zero-rated under the GST Act if the parties agree to treat the supply as such.[27]

4.3 The purpose of the going concern rules is to:

- remove the cashflow cost to businesses, in what are generally high-value transactions, of financing the GST component of the purchase price for the period between making payment for the goods and when the entitlement to deduct input tax arises; and
- reduce the risk to the government of a GST-registered person charging GST on the sale of goods and retaining the tax component.

4.4 Despite these objectives, the application of the going concern rules has been an area of uncertainty – for example, most GST cases before the courts have concerned disputes about whether a going concern was supplied.[28] Changes made to the rules in 1995 and 2000[29] have improved the operation of the going concern rules and gone some way to reducing the number of disputes in this area. However, concerns about the rules remain.. For example, the definition of a "going concern" in section 2 of the GST Act requires that the supplier carries on, or is carrying on, a taxable activity, or part of a taxable activity that is capable of separate operation, up to the time of its transfer to the recipient. If the transaction does not comply with these requirements, the supplier can face an unexpected GST liability and the risk of shortfall penalties and use-of-money interest. These consequences have prompted some to suggest that the operation of the rules should be reconsidered.[30]

[27] See sections 2, 11(1)(m) and 78E.
[28] See *Appellate interpretation of New Zealand's GST legislation: an initial survey: 1986-2005* (2005) 5(10), Australian GST Journal pp. 205 to 224, D White.
[29] As amended by the Goods and Services Tax Amendment Act (No 2) 1995 and the Taxation (GST and Miscellaneous Provisions) Act 2000.
[30] See *"GST update"* A Bullôt, 2007 New Zealand Institute of Chartered Accountants Tax Conference, 26 and 27 October 2007, p. 10.

Other options

4.5 These concerns suggest that the rules are unlikely ever to provide legislative certainty in all cases. Therefore the following suggestions for achieving and extending the policy behind the rules are considered:

- suspending the liability for GST on certain transactions, with consequent denial of input tax to the purchaser; and
- "domestic reverse charging" whereby the liability for tax is shifted to the purchaser, who would also deduct the self-assessed GST.

4.6 The options seek to ensure a GST-neutral outcome for both going concerns and a wider range of transactions involving significant assets when the risks associated with GST may be particularly high.

Suspending GST liabilities on business-to-business supplies

4.7 Suspending the requirement to charge GST on a transaction would be similar in principle to the operation of a retail sales tax. GST would be suspended when goods and services are supplied between GST-registered businesses, with the effect that the tax is not charged and the GST-registered recipient is unable to deduct input tax (because no GST has been charged).

4.8 To prevent goods and services leaving the revenue base untaxed, there would be a need to verify and certify the status of the purchaser and retain evidence supporting the decision to suspend the charging of GST (for example, exemption certificates). Because these requirements could be onerous on businesses and because of the risk of evasion we do not favour this option.

"Domestic reverse charging" – shifting the tax obligation onto the recipient

4.9 An alternative option, referred to in this paper as "domestic reverse charging", involves shifting the obligation to charge GST from the GST-registered supplier to the GST-registered recipient. It would require the recipient of the goods and services, who would need to be registered for GST at the time of supply, to self-assess GST on the purchase and deduct, if entitled to do so, input tax in the same taxable period.

4.10 The advantage of domestic reverse charging is that GST neutrality is achieved in a manner consistent with the credit-invoice method. Businesses would benefit from a more certain rule and the carrying cost of GST would be reduced. For Inland Revenue, the risk of refunding an input tax deduction on a transaction when there is a risk that GST will not be paid would be similarly reduced.

4.11 A similar system has recently been implemented in the United Kingdom to deal with fraudulent transactions involving the supply of mobile telephones, computer components and other electronic goods.

Suggested change

4.12 It is suggested that the current "going concern" rules be removed. The wider domestic reverse charge mechanism would be introduced with application to transactions involving:

- going concerns;
- extremely high-value transactions – for example, supplies of goods and services when the value of the transaction exceeds, say, $50 million (excluding GST); and
- improved or unimproved land irrespective of value.

4.13 These transactions have been identified because they may pose a cashflow risk to both GST-registered persons and the government. The suggested approach would have mandatory application to these transactions when both the supplier and the recipient were registered for GST. In the case of transactions between associates, we may need to consider the extent to which both the supplier and the recipient should be treated as registered for GST.

4.14 The objective of domestic reverse charging would be to eliminate the cashflow consequences created by GST and provide a mechanism to ensure that business-to-business taxable supplies between GST-registered persons are neutral. Accordingly, GST-registered recipients will not face a delay between paying GST on the supply and claiming the related input tax deduction.

4.15 It is also expected that the suggested approach would remove the need for GST-registered persons to obtain Inland Revenue's approval to set off the supplier's GST liability against the recipient's input tax entitlement.

4.16 No exceptions or exclusions would be provided other than for cases when neutrality is not an appropriate outcome (for example, financial services, exports and supplies to final consumers).

4.17 Special time-of-supply rules are likely to be needed to determine the time when the purchaser would be required to self-assess GST. It is suggested that the time of supply should be treated as the settlement date for the transaction, although we are aware that this would need to be carefully defined. Consideration would also need to be given to valuation rules. Using the GST-exclusive value of the contract or agreement for the sale of the goods and services could be a good starting point. Submissions are invited on how these suggestions could be developed to provide sufficient legislative certainty.

4.18 The following example illustrates how the suggested domestic reverse charge mechanism might work.

Example: How the proposed domestic reverse charge mechanism might apply

Company B acquires land from Company A with the intention of using the land to develop a new branch office to facilitate the supply of car parts to the upper South Island.

Company A confirms that Company B is registered for GST, and the transaction is subject to the domestic reverse charge mechanism. The GST-registration numbers of the parties to the transaction and the fact that it is subject to the domestic reverse charge mechanism are confirmed in the agreement for sale and purchase. The agreed value of the land is $800,000 excluding GST.

The contract is signed on 25 August 2010, and settlement occurs on 11 October 2010. As this transaction involves the sale of land, the domestic reverse charging applies. 11 October 2010 is the date that the time of supply is triggered for GST purposes.

Under the reverse charge mechanism, Company A does *not* charge GST on the transaction. Instead, Company B records a liability for GST of $100,000 ($800,000 x 12.5%) in its GST return for October 2010. Company B claims a corresponding input tax deduction of $100,000 in the same GST return.

Both parties maintain a copy of the agreement for sale and purchase to support the GST treatment adopted.

The supplier's obligations

4.19 Under the domestic reverse charge mechanism, the supplier would still be treated as making a taxable supply of goods and services in order to protect any input tax entitlements.[31] The supplier would be required to confirm that the purchaser is registered for GST and retain supporting documentation.

4.20 If the supplier was unable to verify the registration number of the purchaser at the time of supply, the supplier would need to charge GST under the normal rules.

The purchaser's obligations

4.21 As we have noted, the domestic reverse charge mechanism would shift the obligation to charge GST away from the GST-registered supplier to the GST-registered purchaser and the purchaser would be required to self-assess GST in the taxable period in which the transaction occurred.[32] The GST-registered purchaser would, subject to holding a valid tax invoice or other relevant documentation, be able to claim an input tax deduction in the same taxable period for goods and services that were acquired for the principal purpose of making taxable supplies.

[31] Supplies made under this approach could be disclosed in box 6 (zero-rating) of the GST 101 or GST 103 return.

[32] Supplies received under this approach could be disclosed in box 5 of the GST 101 or GST 103 return and an offsetting input tax deduction would be allowed under box 11 (subject to the tax invoice requirements).

Documentation

4.22 Regarding the documentation to support the domestic reverse charge, one option would be for the obligation to issue a tax invoice to remain with the supplier, notwithstanding the purchaser's obligation to account for both output tax and input tax. Additional requirements would be that the registration numbers of both the supplier and purchaser are disclosed together with a statement that the transaction has been subject to the domestic reverse charge mechanism. If there was a delay in the issue of the invoice, however, the purchaser might suffer a delay in claiming the input tax deduction. This option may also have GST accounting system implications, and there is also the potential for error and confusion when the supplier is required to issue a tax invoice inclusive of GST but is not required to account for GST.

4.23 Another option is for the purchaser to create a buyer-created tax invoice to support the deduction of input tax. Again, the registration numbers of the supplier and the purchaser would need to be recorded on the invoice, together with a statement that the transaction was subject to the domestic reverse charge mechanism. This option would ensure that the purchaser had the documentation to support the deduction of input tax in the same taxable period in which the tax liability under the domestic reverse charge arose.

4.24 A further option is to dispense with the requirement for a formal tax invoice altogether and rely on the agreement for sale and purchase. If the agreement for sale and purchase contains the core details about the supplier and the purchaser (for example, registration numbers, names and addresses) and details about the transaction, including the value of the transaction and the date of settlement, this document could be sufficient to establish the supplier's and purchaser's obligations under the domestic reverse charge mechanism. This alternative would be broadly consistent with the proposal in the government discussion document *Reducing tax compliance costs for small and medium-sized enterprises*,[33] to use documents produced in the ordinary course of business to support the deduction of input tax.

Additional provisions

4.25 As the domestic reverse charge mechanism would represent a departure from the usual operation of the GST system, additional provisions are likely to be required. These would address, for example, the situation where a GST-registered person accidentally charges GST on supplies that should be subject to the domestic reverse charge mechanism.

4.26 Other situations that may need to be addressed include those where goods and services supplied using the domestic reverse charge mechanism might be subject to a post-sale discount or are returned.

4.27 Submissions on these matters are welcome.

[33] Chapter 5, *Reducing tax compliance costs for small and medium-sized enterprises*, December 2007.

Specific points for consultation – domestic reverse charge mechanism

- Submissions are invited on the practicality of the suggested domestic reverse charge mechanism and any specific rules necessary to ensure its effectiveness.
- Would the domestic reverse charge mechanism deal with the concerns identified in Chapter 3, including the cashflow impact GST has on high-value transactions?

Ensuring input tax deductions in nominee transactions

4.28 In cases involving nominations, there may be uncertainty around who the recipient of the supply is and, therefore, who is entitled to deduct input tax.[34] For example, depending on the interpretation adopted, a transaction involving a nominee or an assignee may involve either one or two supplies for GST purposes. Where the nominee pays the purchase price under a contract between the supplier and contractual recipient, the two possible supplies for GST purposes are one from the vendor to the purchaser under the original contract, and one from the purchaser to the nominee under the nomination agreement. The same analysis potentially applies in connection with assignments.

4.29 Although the argument that there may be two supplies in these situations follows the GST rules, it does not reflect the economic reality of there being a single supply and may also be inconsistent with our neutrality argument.

Suggested change

4.30 We are considering whether legislative clarification is needed for situations involving nominations and assignments. A change to the GST Act could be introduced for transactions involving nominations and assignments when the nominee or assignee pays the purchase price to the vendor. Under the suggested change, the goods and services would be treated as being supplied by the vendor to the nominee. As a result, the vendor would have to account for the GST, if any, and the nominee would have the right to demand a tax invoice from the vendor in order to deduct input tax on the value of the consideration paid for the supply.

4.31 The two-supply analysis would be treated as applicable in certain situations, such as when both the purchaser and the nominee have contributed to the purchase price or when the purchaser has already claimed an input tax deduction because a tax invoice has been issued by the vendor to the purchaser before the nominee becomes known.

[34] For different opinions on the topic among practitioners, see G Bracken, *GST, Nominations and Assignments* New Zealand Tax Planning Report, No 1, May 2005 and G Olding, *GST Issues with Nominations and Assignments – Another View* New Zealand Tax Planning Report, No 2, August 2005.

Specific point for consultation – nominee transactions

Submissions are sought on possible amendments to the GST Act to clarify the position for transactions involving nominations and assignments.

Chapter 5

FURTHER OPTIONS FOR MANAGING THE GOVERNMENT'S REVENUE RISK

5.1 A crucial element of the credit-invoice tax framework is the GST-registered person's ability to obtain refunds when input tax deductions exceed the output tax charged in a given taxable period. Inland Revenue has an obligation to be vigilant in the payment of GST refunds, given the revenue risks that would otherwise arise.

5.2 An example of these revenue risks includes the use of "phoenix" entities (see Figure 1) to create input tax and "carousel fraud", which has been a particular problem for governments in the European Union.

5.3 This chapter outlines, for comment, possible solutions (in addition to the domestic reverse charge discussed in paragraph 4) to address the risks such as:

- treating legally separate entities as a single economic entity in specific situations;
- using caveats to improve Inland Revenue's information-gathering for certain types of transactions; and
- increasing the time available to Inland Revenue to process refunds.

Threats to business-to-business neutrality

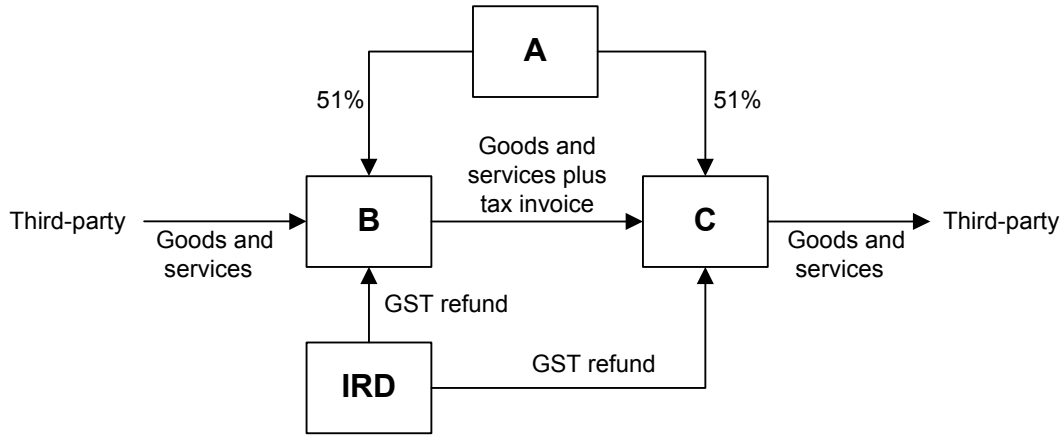
"Phoenix" entities

5.4 "Phoenix" entities can be problematic for the operation of GST because the purchase of assets from the failed entity by the "re-born" entity can give rise to an input tax entitlement without the corresponding payment of GST. This asymmetrical treatment is a cost to the government, but when it occurs because of a genuine business failure it is a recognised trade-off for the wider benefits that come from the comprehensive application of GST. On the other hand, if the entity becomes insolvent as a result of the conscious actions of its owners and/or the entity's assets are transferred to an associated entity, the result may be inconsistent with the objective of providing business neutrality.

5.5 The government has recently responded to some of the general problems created by phoenix entities by changing the laws governing the appointment of liquidators and introducing a framework of "voluntary administration" to assist creditors of financially troubled companies.[35] Nevertheless, specific measures may be needed to deal with the GST concerns discussed in this paper.

[35] See Part 15A of the Companies Act 1993.

FIGURE 1:
ILLUSTRATION OF A POSSIBLE "PHOENIX" ARRANGEMENT



Notes:

- Company B claims an input tax deduction in the usual manner in connection with its purchases from third parties and supplies goods and services to Company C.
- Company C does not immediately pay Company B – who accounts for GST using the payments basis. Company C claims an input tax deduction on the basis of the tax invoice provided by Company B.
- Person A decides to wind up Company B leaving an unpaid tax debt.
- The transaction between companies B and C therefore creates an input tax deduction which is not met by a corresponding payment of GST from B.

"Carousel fraud"

5.6 Internationally, there have been high-profile instances where government revenues have been affected by fraud and aggressive structures designed to exploit the refunds that can arise from input tax deductions.[36] These arrangements, commonly referred to as "carousel fraud", are deliberately designed not to be neutral.

5.7 As reported in the European Union, carousel fraud works like this:

- An entity (entity A) based in, say, Germany supplies goods to entity B, which is based in the United Kingdom. Entity A zero-rates the supply as it is an export.
- As the supply is an intra-community transaction between European Union businesses, entity B is required to self-assess VAT using the relevant rate of VAT for that member state. Entity B would generally recognise an input tax deduction for self-assessed VAT in the same return period.

[36] Ibid footnote 6. See also *The serious research gap on VAT/GST: A New Zealand perspective after 20 years of GST*, International VAT monitor, September/October 2007. Carousel fraud reportedly cost the United Kingdom an estimated £3 billion in 2005 to 2006.

- Entity B on-sells the goods to entity C, which is based in the United Kingdom. Entity B charges VAT on the transaction and ceases operation as soon as the goods are sold. Entity B retains the VAT charged and does not file a return.
- Entity C claims a deduction for the VAT charged by entity B and exports the goods to entity A. The supply is zero-rated.
- These steps are then repeated.

5.8 Technically, it is possible for carousel fraud to occur in New Zealand. While this has not been a significant concern to date, the possibility that it could occur should, in our view, be taken into account in developing any base protection measures.

Current methods of managing GST risk

5.9 Aside from the general tax-neutral framework provided by the GST system, an important tool in managing GST risk is the Crown's status as a preferential creditor in collecting tax payable that is unpaid at the time of a bankruptcy, liquidation or receivership. "Tax payable" is the net difference between GST charged and input tax deductions assessed by a GST-registered person for a taxable period. The Crown's preference reflects that GST, while not held on trust like PAYE or other withholding payments, is charged by businesses on the goods and services they supply to their customers. GST charged can be used by GST-registered persons in their day-to-day cash management. The use of GST monies in this way means that the government does not have the benefit of the tax at the time it is charged.

5.10 The GST Act contains provisions that allow for refunds arising from excess input tax deductions to be set off against other outstanding tax debts owed by the GST-registered person. These rules are designed to apply before a GST-registered person encounters financial difficulties and is an efficient means of collecting the debts.

5.11 However, Inland Revenue's current powers to enforce the payment of tax are premised on the entity having sufficient financial assets on which to make payment. In the case of phoenix and carousel fraud, the purpose is to leave the entities involved without any financial assets that could be subject to the Crown's preference or the Inland Revenue's powers to set off.

5.12 As the problems created by such fraud stem from the operation of the GST Act, tax-specific changes are needed in addition to the previously discussed changes to commercial law.

Options being considered

5.13 The domestic reverse charge discussed in chapter 4 will partially address our concerns with phoenix and carousel fraud but we have outlined in the remainder of this chapter some further possible measures. We acknowledge that legislative solutions for addressing fraud have their inherent limitations which can only be dealt with administratively.

Enforcing business-to-business neutrality

5.14 When outstanding GST debts have been deliberately created to provide corresponding input tax deduction entitlements to closely associated entities, one option would be to treat such associated GST-registered suppliers and recipients as the same economic entity. That could be achieved by widening the set-off powers available to Inland Revenue for associated persons' transactions.

5.15 The intention is to ensure that the net effect of transactions between close associates is neutral so that they do not create a GST liability or corresponding input tax entitlement, in much the same way that transactions between a group of companies should not result in GST consequences – change-in-use adjustments being the exception. We would not suggest, however, that close associates be made liable for each other's tax debts or that Inland Revenue's priority in the event that a supplier becomes insolvent be advanced.

5.16 Widening the current set-off powers would include:

- Making a GST-registered company liable for GST if it acquires goods or services from an associated company that is unable to meet its tax liability. The supplier and the recipient would be treated as the same economic entity, and the input tax deduction claimed in respect of the transaction between the associated companies would be reversed.
- Making an associated person (not a company) – for example a GST-registered trust[37] – liable for GST if it acquires goods and services from a GST-registered settlor that is unable to meet its GST obligations. The settlor and the trust would be treated as the same economic entity, and the input tax deduction claimed be similarly reversed.

5.17 In these situations, the set-off power would be specific to transactions between associated persons in which there had not been a genuine economic exchange and/or when Inland Revenue is the principal creditor. When the input tax deduction claimed by the recipient was reversed, a corresponding adjustment would be made to the supplier's GST liability to ensure that the transaction between the two parties was neutral.

[37] The term "trust" is used as a short-hand expression to describe the trustees of the trust.

5.18 To appropriately target this possible measure, a narrower definition of "associated persons" that focuses on entities under the control of the others, could be used. The suggested definition of "associated persons" that applies to land sales in the Income Tax Act 2007 would be a possibility.[38] We are considering an exclusion to the measure of widely held companies.

Specific points for consultation – enforcing business-to-business neutrality

- Do you agree with this option?
- What are the likely costs and risks with this option?

Power to impose caveats

5.19 Inland Revenue relies on the information collected from GST returns in determining its audit strategies. Much of the information contained in the return is aggregated and does not give Inland Revenue an insight into when certain types of property transactions are undertaken.

5.20 If Inland Revenue were given earlier notice of a property transaction it would be possible to detect transactions that might be viewed as detrimental to the GST base at a much earlier stage.

5.21 The intention of using caveats would not be to enforce the collection of GST, but to provide Inland Revenue with information that a transaction is likely to occur and that output tax is payable. Inland Revenue would have a discretion to lodge a caveat and would consider its application if the taxpayer had been engaged in activities that posed a risk to the integrity of the GST base.

5.22 The use of caveats could take a range of forms. For example, a caveat could be a notice that Inland Revenue lodges on the land title against the name of certain owner of land when that person acquires the land and claims a deduction either as input tax or as a change-in-use adjustment. The notice will ensure that Inland Revenue is informed when the land is sold. Subsequent to the sale, the notice would be removed automatically without the owner of the land having to contact Inland Revenue.

5.23 Alternatively, a caveat could take the strict legal form of being a restriction against dealing in land. Such caveats lodged by Inland Revenue would be removed once the owner had given Inland Revenue notice of an impending sale of property. Having received notice, Inland Revenue would direct the Land Registrar to remove the caveat, and the supplier would be able to proceed with the sale.

[38] See the officials' issues paper *Reforming the definition of associated persons*, Policy Advice Division and the Treasury, March 2007.

5.24 Since this option could otherwise result in significant compliance costs for taxpayers we have, as mentioned earlier, limited its scope. Limiting the scope of the option does, however, have the following disadvantages:

- ***Knowledge that the GST-registered person poses a compliance risk*:** Inland Revenue may not always have the necessary information to make a reasonable decision about whether a particular GST-registered person poses a risk to the GST base.
- ***Impact on the freedom to contract*:** Lending institutions may be reluctant to provide finance for transactions involving land subject to a caveat as they would know that the vendor may be a party to activities that could be the subject of a dispute between the GST-registered person and Inland Revenue.

Specific points for consultation – power to impose caveats

- Do you agree with this option?
- Would it be preferable to use a caveat in the form of a notice or a caveat against dealing in land as a mechanism for Inland Revenue to be notified of a sale?
- Do you agree that the proposal should only to transactions by those persons who are likely to pose a risk to the GST base?
- What modifications would you make to the suggested changes?
- What commercial implications would the proposal have?

Extending the timeframe for the release of refunds

5.25 When the calculation of tax payable results in a refund of GST – that is, when input tax deductions exceed output tax – Inland Revenue is required to pay that refund within 15 working days from the day following Inland Revenue's receipt of the relevant return.[39] The GST-registered person must be notified within 15 working days if Inland Revenue intends to investigate the return and withhold payment. Inland Revenue is not precluded from investigating a return after the 15-working day period – subject to the four-year time bar.[40]

5.26 A working-day rule is used as it overcomes problems associated with public holidays that can occur using a test that is generally referenced to calendar days.

[39] It is at the Commissioner's discretion whether refunds may be used to offset other tax debts.
[40] See section 108A of the Tax Administration Act 1994.

5.27 Imposing a statutory timeframe for the payment of refunds is common international practice, with the average timeframe being 30 calendar days.[41] Longer periods are also not uncommon.[42] These timeframes are important as they give GST-registered persons the confidence that returns will be processed promptly.

5.28 Following the *Seahunter* cases[43] notice must be received by the GST-registered person within 15 working days. Inland Revenue's policy is therefore that notices informing GST-registered persons that it is not satisfied with a return must be issued before the end of 10 working days from the date the relevant return is received. This means Inland Revenue now has less time than originally intended to be satisfied about the correctness of any GST return.

5.29 Timeframes that are too tight may provide Inland Revenue with insufficient time to respond to transactions that could affect the integrity of the tax base.

5.30 Given the need to ensure that notice is received by GST-registered persons in the statutory period, extending the period to 20 working days may be appropriate. This would allow Inland Revenue more time to investigate and to be satisfied with the payment of refunds in order to meet its tax administration obligations. Twenty working days is also broadly consistent with international norms.

5.31 We recognise that this approach could be perceived as having an effect on the carrying cost of GST for exporters. Any extension to the timeframe determining when refunds are released should not, however, affect the processing of the vast majority of GST-returns and should not preclude Inland Revenue from continuing to enhance its processes and systems to allow the earlier release of refunds. Current response periods, particularly those applicable to exporters, should be improved over time. On the other hand, GST-registered persons that have a documented history of non-compliance (including significant outstanding debt) are likely to experience delays if Inland Revenue considers a GST-return warrants greater scrutiny.

Specific point for consultation

What concerns would you have if Inland Revenue had 20 working days to notify that it intends to investigate a GST return and withhold payment and applied this in limited cases where there are possible tax base risks?

[41] *VAT refunds: A review of country experience*, International Monetary Fund WP/05/218, November 2005, G Harrison and R Krelove.

[42] For example, the French value added tax system provides a 90-day timeframe. An administrative performance standard that reduces the time to 30 days applies.

[43] See *Seahunter Fishing Limited v Commissioner of Inland Revenue* (2001) 20 NZTC 17,206 and *Commissioner of Inland Revenue v Seahunter Fishing Limited* (2002) 20 NZTC 17,478.

Chapter 6

ACCOUNTING FOR GST AND TIMING MISMATCHES

6.1 Chapter 2 broadly described the range of accounting bases that are available to GST-registered persons. These bases determine when registered persons are required to account for output tax and when they are entitled to deduct input tax. This chapter considers the effect of those choices and the opportunities they present in creating what we refer to as "timing mismatches" between GST-registered persons.

6.2 It also considers two options that would reduce these timing mismatches:

- limiting the choice of accounting bases; and
- strengthening the application of existing anti-avoidance measures.

Timing mismatches

6.3 The consequences to the revenue base of providing a choice of accounting bases and, to a lesser degree, taxable periods has been well documented by the New Zealand courts, tax practitioners and the government.[44] What we refer to as "timing mismatches" involves a GST-registered person who accounts for GST using the payments basis making a supply to a GST-registered person who accounts for GST using the invoice basis. The payment basis supplier provides the invoice basis purchaser with a tax invoice. The purchaser claims an input tax deduction following receipt of the tax invoice, but payment of GST is deferred. In some cases, payment may be deliberately deferred for a significant period of time or even indefinitely.

6.4 In cases when the timing difference created by the arrangement is clearly inconsistent with the policy intent of the GST Act, the general anti-avoidance provision has been successfully applied.[45] Questions remain, however, about the long-term desirability of using the general anti-avoidance provision for this purpose and whether policy changes that would have more certain application are required. Several tax commentators have noted that the outcomes created by general anti-avoidance provisions have the potential to create uncertainty.[46] Uncertainty is unhelpful in promoting voluntary compliance.

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[44] See the Court of Appeal decision *Shell New Zealand Holdings Co Ltd v Commissioner of Inland Revenue* (1993) 13 NZTC 10,136; "Dilemmas for GST tax policy designers – land transactions" G Harley, published in *GST in retrospect and prospect*, 2007 pp. 232 to 233; and *GST: A review*, New Zealand Government March 1999, pp. 65 to 66.

[45] Ibid footnote 5 and see section 76.

[46] See "Dilemmas for GST tax policy designers – land transactions", G Harley, published in *GST in retrospect and prospect*, 2007, and "The role for a general anti-avoidance rule in a GST", E Trombitas, published in *GST in retrospective and prospect*, 2007.

6.5 A more fundamental approach to business neutrality may therefore be required, with solutions not necessarily limited to transactions involving the supply of specific goods and services such as "going concerns", extremely high value transactions and land, as discussed in Chapter 4.

6.6 One possible response to the problems presented by deliberate timing mismatches would be to move to a single compulsory basis of accounting for GST, coupled with a single taxable period. However, this could give rise to significant revenue losses for the government as well as increased compliance costs for taxpayers. It is possible that a combination of proposals in this paper will strike an adequate balance between tax base risks, revenue costs and compliance costs. Accordingly, the potential single accounting basis, single taxable period approach is not being explored further at this time. Submissions are, however, welcome on the issue.

6.7 Assuming the current position is retained whereby businesses are free to make their own decisions about the accounting bases and taxable periods that best suit them (within the confines of the GST Act), we have suggested other measures that could minimise the revenue risks connected with timing mismatches.

6.8 The relative advantages and disadvantages of the accounting bases permitted under the GST Act are discussed next.

Policy objectives of the accounting bases

6.9 Day-to-day accounting for GST depends on the size of the GST-registered person and whether it is a retailer, a service provider, manufacturer, distributor, importer or exporter. Accounting practices may also vary depending on whether the GST-registered person is a non-profit body, a public sector organisation or a private enterprise.

6.10 The GST Act currently caters for these differences by allowing for a variety of accounting bases and filing frequencies, including a grace period before payment is required.

The invoice basis

6.11 Of the three accounting bases allowed by the GST Act, the invoice basis is most closely aligned with the principle that GST should apply, and a deduction correspondingly be allowed, when the economic benefits of the goods and services have been transferred from the supplier to the recipient. The invoice basis reflects not only a GST-registered person's present GST obligations and entitlements but also future GST commitments and benefits.

6.12 The basis is consistent with the rules that apply to businesses for the purposes of complying with income tax and with any external financial reporting requirements and assumptions. This means large businesses do not need to maintain dual accounting systems – one for GST and one for general accounting purpose.

6.13 The benefits of the invoice basis are also apparent for businesses that rely on the prompt recognition of input tax deductions, such as importers, who may be permitted by the New Zealand Customs Service to defer the payment of GST levied on imported goods, and exporters.

The payments basis

6.14 Although the invoice basis recognises the economic consequences of transactions, for some businesses it can increase the carrying cost of GST, particularly when GST liabilities have to be recognised well in advance of the related payment being received. This earlier obligation to account for GST can present a problem if the regular terms of trade provide for a period of credit that is longer than the GST payment date.

6.15 This concern was recognised in 1986 by the Advisory Panel on Goods and Services Tax, which noted that dairy farmers, builders and non-profit bodies would be at a financial disadvantage if the obligation to pay GST to Inland Revenue was triggered by an invoice when payment from the customer was not immediately forthcoming.[47] The solution to this problem was the payments accounting basis, which allows GST-registered persons to account for GST on the basis of cash receipts and cash payments.

6.16 Apart from addressing the potential cashflow effects, the payments basis dispenses with the need to maintain debtors' or creditors' ledgers to complete the calculation of "tax payable" at the end of each taxable period.

6.17 Aligned to this, the payments basis is also the simplest basis for determining the time of supply for certain transactions such as agreements to hire and supplies that provide for periodic payment. The benefits offered by the payments basis in reducing the carrying cost of GST would be enhanced if the time of supply rules were replaced by using payment as a means of determining when supplies should be recognised in a taxable period. Special rules would in that case need to be retained for associated persons and other special transactions, such as gaming and gambling.

6.18 The main criticism of the payments basis is that it is less accurate than accrual accounting in measuring the majority of transactions that come within the GST Act. This concern is, in part, overcome by the GST Act requiring GST-registered persons to file more frequently than they do for income tax.

The hybrid basis

6.19 In 1991, a further accounting basis was added to the GST Act, giving GST-registered persons the option of not maintaining a creditors' ledger to complete their GST return.[48]

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[47] *Report of the Advisory Panel on Goods and Services Tax to the Minister of Finance*, June 1985, pp. 12 to 13.

[48] The change was implemented following the recommendations of the Tax Simplification Consultative Committee in its report, *Tax simplification report of the Consultative Committee*, July 1990.

6.20 The advantage of the hybrid basis is that it can approximate the accounting practice of some businesses whereby income is recognised at the time a transaction occurs and expenses are recorded when they are paid. The basis does, however, have the potential to increase the carrying cost of GST as it defers the recognition of input tax deductions until payment is made but brings output tax into account at the earlier time at which an invoice is issued or payment is received.

Taxable periods

6.21 Taxable periods establish the frequency with which GST-registered persons are required to file GST returns. They are based on competing objectives that seek to minimise the effect of GST on working capital and balance compliance and administration costs.

6.22 Shorter return periods help to reduce the effect that GST has on businesses – for example, the need to find cash to settle GST liabilities or, in the case of refunds, minimise the carrying cost of GST. For this reason, filing monthly GST returns is a popular option for exporters and is a requirement for businesses with annual taxable supplies of $24 million or more.[49]

6.23 Shorter return periods, however, increase compliance and administration costs because of the requirement to complete GST returns more often. For example, requiring all GST-registered persons to file GST returns every month would increase the annual number of GST returns from three million to nearly seven million. For GST-registered persons who are involved in seasonal activities or whose pattern of invoicing is intermittent, the requirement to file monthly returns would result in the completion of a large number of unnecessary nil returns. The option to file on a six-monthly frequency therefore reduces the need for unnecessary returns.

6.24 Longer return periods affect the government's collection of revenue and pose a greater risk that GST will not be returned. For this reason, the six-monthly basis is generally limited to businesses whose activities are small-scale and involve annual taxable supplies of $250,000 or less.[50]

Options being considered

6.25 As we have noted, using the accounting base options to create deliberate timing mismatches can have a detrimental effect on the tax base. Because GST applies to the gross value of transactions, non-compliance can also have a material effect on the competitiveness and profitability of those that do comply. We now outline some further options, beyond those outlined in Chapter 4 and 5, for dealing with these concerns.

[49] See section 15(4).

[50] The government is proposing to raise this threshold from $250,000 to $500,000. See *Reducing tax compliance costs for small and medium-sized enterprises*, New Zealand Government, December 2007, pp. 14 and 15.

Limiting the choice of accounting bases

6.26 One option that we have considered but do not favour is to make one of the three bases of accounting compulsory for all GST-registered persons. This option has the benefit of reducing deliberate timing mismatches, but it is not obvious that any single basis would suit the majority of GST-registered persons. For example, while the payments basis is widely used, with about 79 percent of all GST-registered persons electing to use it, larger businesses, which contribute a substantial portion of GST to the revenue base, as well as exporters, are likely to have a strong preference for the invoice basis. Ultimately, the strong preferences exhibited by GST-registered persons at either end of the business spectrum suggest that such a change would not be workable.

6.27 As an alternative, access to certain accounting bases could be restricted – for example, GST-registered persons with annual taxable supplies below a specified threshold could be required to account for GST using the payments basis.

6.28 We have not in this paper suggested any particular threshold because, at this stage, we are more interested in submissions on the idea in principle rather than the precise spectrum of taxpayers to which it could apply. We recognise that under any compulsory threshold level, however, exclusions would be needed for exporters and other GST-registered persons whose input tax deductions regularly exceed output tax. Exclusions would also need to be considered to preserve the operation of the GST grouping rules.[51] This may make the option unduly complex relative to the problem we are aiming to solve.

6.29 On the other hand, applying the payments basis to a wider range of businesses might reduce compliance costs for a number of GST-registered persons because businesses under the threshold would not have to complete accrual accounting adjustments for debtors and creditors for each taxable period.

6.30 If the change were made, affected GST-registered persons that did not wish to use the payments basis would still have the option of using the hybrid basis.

Specific points for consultation – limiting the choice of accounting bases

- If limitations were placed on who could account for GST using the invoice basis, what should those limitations look like?
- In the context of these limitations, what special rules would be required for exporters and other business for whom input tax regularly exceeds output tax?

[51] See section 55.

Strengthening the application of section 19D

6.31 A further option is to maintain the current choice of accounting bases but review the application of the specific anti-avoidance provisions, section 19D. Section 19D preserves the current options for accounting but seeks to restrain taxpayer choice when the application of the GST accounting principles could give rise to base maintenance risks. Specifically, section 19D requires GST-registered persons accounting for GST using the payments basis to use hybrid accounting principles when high-value transactions are involved. These are prescribed as being when the consideration payable for a supply of goods and services is $225,000 (including GST) or more and payment by the customer is deferred under the agreement for more than one year. By being quite prescriptive, the application of the section is limited.

6.32 Possible options for improving the application of section 19D include:

- lowering the threshold when the section becomes effective – for example, from $225,000 to a lesser amount, say $90,000, and when payment is to be deferred for more than one year; or
- altering the section so that it instead affects the rules governing the recognition of input tax deductions. Under this option, input tax deductions would be limited to one-ninth of the payments made by the recipient. The section would apply to transactions that exceeded $225,000 (or $90,000) and would continue to be limited to situations when the contract deferred payment for more than one year.

6.33 An increase in the current payments basis threshold – possibly to $2 million – would accompany any change to the application of section 19D. Increasing the payments basis threshold is discussed in more detail in Chapter 7.

Specific point for consultation – strengthen the application of section 19D

If section 19D were to be changed, which option do you prefer and why?

Chapter 7

THE PAYMENTS BASIS THRESHOLD

7.1 Chapter 6 introduced the possibility of what would in effect be a compulsory payments basis threshold for addressing GST base maintenance concerns. On the basis that significant tax base risk reductions will occur through the adoption of some of the other suggestions (such as the domestic reverse charge mechanism) outlined in this paper, this chapter considers whether changes to the payments basis threshold on the current non-compulsory basis should also be made.

The payments basis

7.2 The operation of the payments basis was briefly detailed in Chapter 2 (see Table 1) and the policy reasons for its inclusion in the GST system set out in Chapter 6.

7.3 Briefly, the payments basis permits a GST-registered person to recognise a GST liability on the supply of goods and services when payment is received from the customer. Similarly, a registered person accounting for GST on the payments basis is allowed an input tax deduction on its purchases only when the registered person makes payment.

7.4 Generally, a GST-registered person may account for GST on a payments basis if, during any 12-month period, the total value of its taxable supplies does not exceed $1.3 million or it is a non-profit body.[52] Provision is also made for certain local authorities to account for GST using the payments basis.[53]

7.5 The payments basis threshold was raised from $1 million to $1.3 million in 2000 to reflect movements in purchasing power since 1990 (when the threshold was last reviewed).[54] The increase to $1.3 million also included an amount for expected inflation to 2007. It is therefore timely that the current threshold be reviewed to ensure that it continues to meets its policy objectives.

[52] See section 19A.
[53] See the Goods and Services Tax (Local Authorities Accounting on Payments Basis) Order 2005.
[54] Before 1990 the threshold was $500,000.

Base maintenance and increases to the payments basis threshold

7.6 One of the key concerns associated with increasing access to the payments basis threshold is base maintenance – as illustrated in the *Ch'elle* cases.[55] The absence of proposals dealing with the payments basis in the discussion document *Reducing tax compliance costs for small and medium-sized enterprises*[56] largely resulted from this concern. The simplification discussion document anticipated the completion of further policy work, which now forms the basis of this paper.

7.7 If the tax base concerns are addressed by the measures outlined in the previous chapters, there is little reason why access to the payments basis should not be offered to a greater number of GST-registered persons. (This would not of course be a logical consequence of our suggestion in chapter 6 to limit access to the invoice basis.)

7.8 The clear objective of extending the payments basis as an option to GST-registered persons would be to reduce compliance costs. Being optional, the extension would allow taxpayers greater flexibility to use an accounting base that best met their business needs.

7.9 The current threshold allows about 93 percent of GST-registered businesses to use the payments basis of accounting. Raising the threshold to $2 million would cover about 96 percent of GST-registered businesses. This coverage is consistent with the definition of "small to medium-sized enterprises" used by the Ministry of Economic Development.[57]

7.10 The increase in the threshold will also help eliminate the costs associated with being forced to change the accounting basis to either the invoice or hybrid base in the taxable period immediately after reaching the threshold. Ongoing threshold increases would facilitate this further.

7.11 Ongoing increases will, however, need to be considered against the potential success of the options discussed in this paper and would also be subject to their fiscal sustainability.

Specific point for consultation

What benefits (or costs) would result if the current limitations on using the payments basis of accounting were adjusted?

[55] Ibid footnote 5.
[56] New Zealand government, December 2007.
[57] See *SMEs in New Zealand: Structure and Dynamics* Ministry of Economic Development, July 2007.

Chapter 8

CHANGE-IN-USE ADJUSTMENTS

8.1 GST-registered persons may claim an input tax deduction for GST paid on goods and services acquired for the principal purpose of making taxable supplies.

8.2 In some cases, goods and services acquired for the principal purpose of making taxable supplies may be used partly or entirely for another purpose, such as for private and exempt purposes (non-taxable purposes).

8.3 The GST Act treats the non-taxable use of goods and services as a taxable supply by the registered person, and output tax is charged accordingly. In this way, goods and services that are "self-supplied" are treated in the same manner as other supplies.

8.4 Conversely, goods and services acquired principally for a non-taxable purpose (for which the GST-registered person is not entitled to an input tax deduction) may be partly or entirely used to make taxable supplies. In these circumstances, the GST Act allows a deduction to reflect that taxable use.

8.5 New Zealand's approach to change-in-use adjustments is based on the principle that GST needs to reflect the consumption of goods or services in a given period. The change-in-use rules therefore apply to those that make a mixture of taxable and exempt supplies – such as financial service providers and some property developers. The change-in-use rules also ensure that private use is taxed. For example, a luxury yacht used in a chartering business but also used privately is subject to the GST change-in-use rules to ensure that the parity of treatment exists with a similar yacht purchased and used exclusively for private purposes.

8.6 New Zealand's adjustment approach is unique among countries with GST or VAT systems. Other countries adopt an apportionment approach to mixed use. The apportionment approach is not aimed at taxing consumption, but simply seeks to apportion the initial input tax deductions received by GST-registered persons for goods and services according to their actual use. Depending on how the adjustment or apportionment process is undertaken, the result of the two approaches is usually similar. However, there are some specific differences.

8.7 In this chapter we review the treatment of changes-in-use in New Zealand, comparing New Zealand's rules with Australia's, and suggest some changes to improve and clarify our rules. We also compare the change-in-use adjustment rules with the second-hand goods input tax deduction and suggest some changes in this area.

Overview of New Zealand's change-in-use rules

8.8 New Zealand's change-in-use adjustment rules are summarised in Table 3.

TABLE 3:
THE CHANGE-IN-USE FRAMEWORK

Test	Input tax that can be claimed	Adjustment required?	Timing of any adjustment
The goods and services are acquired for the principal purpose of making taxable supplies.	100% of the GST paid may be deducted.	Yes, if the goods and services are applied for a purpose of making supplies of **non**-taxable goods and services.	At any one of the following times: – period-by-period – annually – one-off.
The goods and services are **not** acquired for the principal purpose of making taxable supplies.	No deduction is available.	Yes, if the goods and services are applied for a purpose of making taxable supplies of goods and services.	At any one of the following times: – period-by-period – annually – one-off if less than $18,000 or Inland Revenue agrees.

Timing of change-in-use adjustments

Changes from taxable to non-taxable use

8.9 The GST Act allows three timeframes for returning output tax when goods and services acquired principally for making taxable supplies are used for non-taxable purposes:

- ***Periodic adjustments*** – output tax is imposed in every taxable period in which the goods and services are used in making non-taxable supplies.
- ***Annual adjustments*** – output tax is imposed in every 12-month period in which goods and services are used in making non-taxable supplies.
- ***A one-off adjustment*** – output tax is imposed once on the non-taxable use of the goods and services.

Example: Adjustment frequency

A motor vehicle purchased for the principal purpose of making taxable supplies is subsequently used (49 percent of the time) for private purposes. The cost of the vehicle was $20,000 and the depreciation rate is 21 percent. The adjustments required for the deemed supplies under each of the above methods are:

(1) One-off adjustment:

$20,000 x 49% = $9,800;
$9,800 / 9 = $1,088 one-off GST payment.

(2) Periodic – for example, each two-monthly taxable period:

($20,000 x 21%) / 6 = $700 – depreciation value each taxable period;
$700 x 49% = $343 – non-taxable portion of depreciation;
$343 / 9 = $38.1 – two-monthly GST payment.

(3) Annual:

($20,000 x 21% x 49%) / 9 = $229 annual GST payment.

Changes from non-taxable to taxable use

8.10 In common with changes from taxable to non-taxable use, adjustments for changes from non-taxable to taxable use may be made on a period-by-period, annual or one-off basis. The one-off basis is, however, available only for goods and services that cost up to $18,000, or above that amount with Inland Revenue's agreement.

Calculating the value of the asset to be adjusted

8.11 Adjustments are calculated by treating goods or services as having been supplied to the extent that they are not used for taxable purposes (output tax adjustments) or are used for taxable purposes (input tax adjustments). Therefore, the value of the goods or services has to be determined. The GST Act stipulates that the value may be calculated on the basis of the cost or the market value of the goods or services – whichever value is lower.

8.12 For period-by-period adjustments, depreciation is generally used to approximate the value (based on the lower value of cost or market) of the change in use of the goods and services over the adjustment period.

Allocation between taxable and non-taxable supplies

8.13 The GST Act provides for three methods of allocating input tax deductions between taxable and non-taxable supplies:

- actual use;
- turnover method; and
- an alternative (or special) method.

8.14 In each case, the method of allocation used must result in a fair and reasonable allocation of input tax between taxable and other supplies.[58]

[58] See section 21A(3).

8.15 In certain circumstances, goods and services may be simultaneously used for taxable and non-taxable purposes. In *Lundy Family Trust*,[59] for example, the buildings and the land were simultaneously rented out (an exempt purpose) and available for sale (a taxable purpose). Therefore, the Court of Appeal considered that the properties were used 100 percent for taxable purposes and 100 percent for non-taxable purposes. The Court directed that a 50/50 apportionment of the depreciation on the building was appropriate.

Adjustment approaches used in other countries

8.16 The apportionment approach used in other countries requires any non-taxable use to be reflected in the apportionment of the initial input tax deduction when the goods or services are acquired. Subsequent adjustments are made, as necessary, to reflect the actual use of the goods and services.

8.17 The apportionment approach looks backward and attempts to put GST-registered persons in the position where they would have been had they correctly predicted the extent to which they would use the goods and services for taxable and non-taxable purposes at the time they acquired them. Different countries adopt different variations of the apportionment approach. Apportionment rules were considered by the government in 1999[60] but were thought to have certain disadvantages, including:

- the difficulty for GST-registered persons in predicting future use;
- the complex treatment of apportioned goods and services on disposal; and
- the fact that the apportionment approach did not adhere to the GST principle that GST should be a tax on consumption.

8.18 At that time it was agreed that there should be a further review of the change-in-use rules, and this is outlined in this chapter.

8.19 In July 2000, Australia introduced a GST tax system that includes a set of comprehensive rules using the apportionment approach. In Australia, the amount of the input tax deduction that a GST-registered person receives depends on the extent to which the acquisition or importation is for a taxable purpose.[61] Following the initial apportionment of input tax, the person may need to make subsequent input tax adjustments when there is a difference between the actual use and the planned use of the goods and services for a taxable purpose.

[59] (2005) 22 NZTC 19, 637.
[60] See *GST: A Review*, A government discussion document, March 1999, pp. 28 to 29.
[61] See GSTR 2006/4 *Goods and services tax: determining the extent of creditable purpose for claiming input tax credits and for making adjustments for changes in extent of creditable purpose*, Australian Tax Office.

8.20 It might appear that the apportionment approach is conceptually simpler than the adjustment approach because it is based on the initial input tax deduction and cost of the goods and services that are being adjusted. This approach has its advantages, including being able to use a single valuation measure when making any adjustment.

8.21 However, making input tax adjustments under the apportionment method may not be as simple in practice. In Australia, in order to accurately calculate an entitlement to deduct input tax, a taxpayer must ascertain the extent to which the asset has been applied for a taxable purpose, from the time of acquisition until the end of the relevant adjustment period. These calculations may become progressively complicated with every subsequent adjustment for a particular asset and any ultimate sale or disposition of the assets. This complication, and the fact that GST-registered persons have to keep continuous records of the use of their assets from the date of acquisition (which is also a requirement under the New Zealand approach), may make adjustments under the apportionment approach compliance intensive.

8.22 For these reasons, we do not consider that the benefits of the apportionment approach outweigh the disadvantages. We do consider, however, that some of the elements of the apportionment approach can be used to improve the New Zealand approach.

Problems with New Zealand's adjustment approach

8.23 We have identified a number of concerns with New Zealand's change-in-use adjustment rules. Some of these arise from the legislation itself. Additional concerns were highlighted in the decision of the Court of Appeal in *Lundy Family Trust*,[62] and it is useful to review whether aspects of that decision achieve the desired policy outcome. With this in mind, some potential problem areas are discussed below.

The maximum amount of adjustments

8.24 Since adjustments may be made on the period-by-period or annual basis for an indefinite period, it is possible that the value of adjustments could accumulate to more than the original GST paid on the purchase of the property.

8.25 The Court of Appeal in *Lundy Family Trust*[63] has effectively rejected this possibility and suggested capping the maximum amount of the adjustments to the original amount of GST paid. Greater certainty is needed to deal with possible ambiguities in the legislation in this area.

[62] Ibid footnote 59.
[63] Ibid footnote 59.

Adjustments do not necessarily refer to the initial input tax deduction

8.26 As with the previous issue, the change-in-use adjustment approach may ignore the original input tax deduction claimed by the GST-registered person. Change-in-use adjustments may not relate to the amount of the initial input tax deduction, as the purchase of goods and services and their use for a non-principal purpose are treated as, in effect, separate supplies. Accordingly, the rules are intended to measure the current consumption of the goods and services.

8.27 Determining an open market value for every adjustment period could be quite compliance-intensive. For this reason, the GST Act allows GST-registered persons to use either the cost or market value of the goods or services, whichever is lower.

8.28 If it is accepted that the adjustment should make reference to the original deduction claimed, as occurs in the apportionment approach, the question of whether there should be a choice of valuation methods should be reviewed.

Treatment of adjustments on return to the original taxable purpose

8.29 The Court of Appeal in *Lundy Family Trust*[64] held that when a GST-registered person who has been making output tax adjustments to reflect non-taxable use changes the use of the asset back to making taxable supplies, the GST-registered person may claim back any output tax adjustments that they paid.

8.30 The outcome of this decision is that the benefit that the registered person has received from the consumption of the goods or services for non-taxable purposes is ultimately disregarded. This outcome is generally inconsistent with the adjustment framework, which is based on taxing any non-taxable use of the goods and services in question at any point in time.

One-off output tax adjustments

8.31 The GST Act requires a GST-registered person to base the timing of output tax adjustments on a period-by-period, annual or one-off basis.

8.32 Although a registered person may currently choose which of the three bases for adjustment to use, there may be circumstances when only the one-off adjustments basis may be suitable, such as when there is total change of use of the goods or services.

8.33 Currently, one-off output tax adjustments can be valued on the basis of the lower of cost or market value and are not limited to total changes in use. This may provide opportunities to reduce the amount of the adjustment. Since the adjustment effectively reflects that the asset is leaving the GST base (just as it would if the asset was sold), the choice of valuation method available to GST-registered persons should be reviewed.

[64] Ibid footnote 59.

Suggested changes

8.34 The options below, which share some of the advantages of the apportionment approach, may deal with some of the uncertainty when using the change-in-use adjustment rules. We favour retaining the change-in-use adjustments approach, with some modifications to provide a closer link between the adjustments, initial input tax deductions and the cost of goods to the taxpayer.

Recognising earlier output tax adjustments for appreciating goods and services

8.35 When GST was introduced the intention was that a GST-registered person's output tax adjustments would be made for as long as the goods or services remain a part of its business activity, to reflect the consumption that occurs in each period. This principle was not accepted by the Court of Appeal in the *Lundy Family Trust* decision.[65]

8.36 We agree with the outcome determined by the Court of Appeal because of the cashflow disadvantage that arises if market value is taxed before disposition to a third party. However, we are concerned that the legislation could be interpreted in a number of ways. Therefore, it is suggested that the legislation be modified in line with the *Lundy Family Trust* decision by capping the output tax adjustments to the amount of the original input tax deduction received by the registered person.

8.37 The cap would apply on the realisation of the asset only.[66] That would ensure that the goal of taxing consumption is achieved for as long as a person keeps a business asset in the tax base and uses it for non-taxable purposes. If the asset is realised and taken out of the GST base the GST-registered person will be able to use any adjustments paid in excess of the cap as a deduction in the calculation of "tax payable".

8.38 Allowing registered persons to cap their output tax adjustments should provide them with certainty on their final liability for adjustments (if they choose to realise the asset).

8.39 Our suggestion to cap periodic output tax adjustments would not change the obligation to pay output tax on disposal of the asset.

Valuation of supplies

8.40 In the case of goods and services that are consumed over a number of taxable periods or years, output tax adjustments are frequently made on the cost basis, by using depreciation as a measure of the use of those goods and services over the relevant period. While depreciation may not be a precise estimation of the actual consumption of an asset, it is a verifiable and reliable method to approximate the value of a consumed asset. In that regard, using the cost basis for valuing assets subject to periodic adjustments is less compliance-intensive than using the market value basis, under which the taxpayer must find the market price of the asset at the time of the adjustment.

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[65] Ibid footnote 59.

[66] A one-off output tax adjustment for the whole of the asset would be treated as the realisation of an asset.

8.41 Therefore it is suggested that all valuations for the purposes of periodic output tax adjustments should be made using the cost basis. Requiring businesses to value goods and services on the cost basis should remove any uncertainty for them over what valuation method to use, and links the valuation method for change-in-use adjustments with the initial input tax received.

Refunding output tax adjustments on return to the taxable purpose

8.42 In the *Lundy Family Trust*[67] decision, the Court of Appeal held that when a GST-registered person who has been making output tax adjustments changes the use of the asset back to the taxable purpose, the registered person may claim back any output tax adjustments that it paid.

8.43 This outcome seems inconsistent with the objective of taxing consumption, as it appears to treat the exempt or non-taxable supplies as having no value for GST purposes. We suggest that output tax adjustments paid in earlier taxable periods be treated as not refundable and that, if submissions consider it necessary, a clarifying legislative amendment be made.

One-off output tax adjustments in relation to low-value mixed use assets

8.44 The purpose of the threshold is to remove the need to make compliance costly periodic adjustments when tax arising from adjustments would be relatively small. A threshold of $20,000 is suggested, to remove most consumable assets such as computers, office equipment and low-value cars from the need for regular adjustment.

8.45 The calculations required by the change-in-use rules impose compliance costs for, at times, very low amounts of revenue. For this reason, we suggest retaining the option of allowing registered persons to make one-off adjustments for low-value assets.

One-off output tax adjustments in relation to total change-in-use

8.46 If a GST-registered person partly uses an asset that was acquired for a taxable purpose for a non-taxable purpose, the asset still forms part of the business activity of the registered person, and it is appropriate that periodic adjustments are made (either in each taxable period or annually). The situation is different when an asset acquired for a taxable purpose is used exclusively for a non-taxable purpose. In the latter situation, the asset stops being used in the registered person's taxable activity and is, in effect, removed from the tax base.

8.47 To reflect this, GST-registered persons should be required to make one-off output tax adjustments when there is a total change-in-use of the goods or services.

[67] Ibid footnote 59.

Valuation basis for one-off output tax adjustments

8.48 When a business deregisters, its assets are valued at market value. This treatment ensures that the output tax liability reflects the value that has been added by the registered person. It also ensures that supplies made by GST-registered persons to themselves are treated in an equivalent way to those made to another person.

8.49 In contrast, taxpayers may choose to value one-off output tax adjustments at the lesser of the cost of the goods or services or the open market value of the supply. In the case of a total change-in-use, however, the asset is removed from the tax base and an equivalence in treatment with a sale of the asset or business deregistration is warranted.

8.50 We therefore suggest that GST-registered persons should be required to value the goods and services entirely applied for non-taxable purposes at their market value. As we have noted, goods and services with a value of less than $20,000 could still be valued at the lower of cost or market value.

One-off output tax adjustments and adjustment capping

8.51 We consider that if an asset that is subject to a one-off output tax adjustment for a total change-in-use is treated similarly to an asset that is realised in some other way, any previous periodic output tax adjustments in relation to that asset should be subject to the input tax deduction cap. This means that if a registered person has made periodic output tax adjustments in excess of the initial input tax deduction, the excess would be a deduction in the calculation of "tax payable". The amount of the output tax received from the one-off adjustment on the total change-in-use of the asset, on the other hand, should be treated in the same manner as output tax received from the sale of the asset. Therefore this amount should not count for the purpose of calculating whether output tax adjustments exceeded the initial input tax deduction.

Example: Making one-off output tax adjustments

Alison purchased a building for use in her business and received an input tax deduction of $60,000. In subsequent years, she converted a part of the building to residential dwellings and rented them out. During that period, she made output tax adjustments on the exempt use of the building on a period-by-period basis, totalling $70,000. At the end of that period, she decides to use the asset 100 percent of the time for the purpose of providing residential accommodation. She makes a one-off output tax adjustment of $80,000, calculated on the basis of the market value of the asset.

Since her periodic adjustments ($70,000) exceed the initial input tax credit ($60,000), Alison may use the excess amount ($10,000) as a deduction in the calculation of "tax payable". Her final GST liability on the total change-in-use is therefore $70,000.

Under the suggested rules, the same result would be achieved if, instead of a 100 percent change-in-use, Alison either sold the asset or deregistered her business.

Period-by-period and annual deduction (input tax) adjustments

8.52 For input tax deduction purposes, GST-registered persons will still be able to base their adjustments on the lower of the cost or market value. This divergence from the suggested valuation of periodic output tax adjustments (that is, the cost basis only) is necessary for practical reasons – registered persons may not have retained records of the original price of assets that were acquired for non-taxable purposes, and may not recall details of their acquisitions by the time the need for input tax adjustments arises. If the original price of an asset is not known, GST-registered persons will be able to calculate adjustments by reference to their market value.

8.53 On the other hand, consistent with the suggested change to the output tax adjustment rules, however, input tax adjustments should also be capped. It is suggested that the amount of the cap should depend on the valuation method adopted by the GST-registered person so that:

- if the registered person chooses the cost method of valuing an asset, the input tax adjustments should be capped at an amount equal to the input tax deduction that the person would have been eligible for if it had acquired the asset for the principal purpose of making taxable supplies; and
- if the registered person decides to value the asset on a market value basis, the cap would be equal to the amount of the input tax deduction that the person would have received if it acquired the asset at market value at the time the first deduction by way of change-in-use adjustment is made.

8.54 In contrast to the suggested treatment of periodic output tax adjustments where a person would be required to make adjustments until the asset is realised, the GST-registered person making input tax adjustments would be required to stop making input tax adjustments when the cap is reached.

8.55 When a person is making input tax adjustments on a periodic basis without exceeding the cap, and subsequently is able to make a one-off adjustment in relation to a 100 percent change in use of the same asset, both the periodic adjustments and the one-off adjustment would count for the purpose of the cap.

Specific points for consultation

- Do the suggested rule changes outlined in this chapter improve the operation of the change-in-use rules?
- Do the suggested changes provide enough certainty about the consequences of a change in use?

Relationship with the second-hand goods input tax deduction

8.56 GST-registered persons are allowed to deduct input tax in connection with the purchase of second-hand goods from unregistered persons, even though GST is not directly charged on that supply. This deduction is intended to recognise the GST paid when the unregistered supplier acquired the goods. Allowing deductions removes the potential for double taxation during the lifecycle of goods acquired by unregistered persons. Previously, one of the risks of the deduction was that it allowed some GST-registered persons (particularly in transactions involving associated persons) to claim large GST refunds in various circumstances, including for goods on which GST had not previously been paid – for example, when the goods had been acquired by the unregistered vendor before the introduction of GST.

8.57 The problem was dealt with in 2000 by limiting the input tax deduction available in relation to supplies of second-hand goods between associated parties to the lesser of:

- the GST component (if any) of the original cost of the goods to the supplier;
- one-ninth of the purchase price; or
- one-ninth of the open market value.

The problem

Disparity in treatment of associated and non-associated persons

8.58 One criticism of the current rules in relation to the input tax deduction for second-hand goods is that there is a disparity between the treatment of associated and non-associated person transactions. A GST-registered person buying second-hand goods from an associated unregistered person receives no input tax deduction if GST has not been paid on the original cost. On the other hand, a registered person buying the same second-hand goods from a non-associated unregistered person would receive an input tax deduction based on one-ninth of the amount paid to acquire the goods.

Using change-in-use adjustments to increase input tax deductions

8.59 As outlined earlier in this chapter, when goods and services are acquired by a registered person principally for a non-taxable purpose, the person is not entitled to an input tax deduction. If, however, the goods and services are later used in making taxable supplies, the GST Act allows the registered person to make input tax adjustments that would reflect that taxable use.

8.60 In contrast to the rules governing the second-hand goods deduction, which may require a taxpayer to calculate a deduction on the basis of the GST component in the original cost of the goods to the supplier, the change-in-use rules provide GST-registered persons with the option of using a cost or market valuation basis.[68]

[68] Section 21E of the GST Act.

8.61 These inconsistencies between the input tax treatment of second-hand goods and the change-in-use adjustment rules can result in unintended tax consequences and even in some cases distort the behaviour of GST-registered persons in certain transactions.

Possible solutions

8.62 The following changes are suggested in response to these problems:

- The rules for associated-party supplies of second-hand goods, should apply only in connection with transactions involving the purchase of land. To deal with consistency concerns in the treatment of purchases between associated and non-associated unregistered persons, we suggest that purchases of land from non-associated persons also be brought within the scope of the changes made in 2000. The reason for treating land differently from other types of goods is the relative ease with which a person can find the cost of the land to the original supplier from records and land deeds. Requiring taxpayers to find original costs for other types of goods and provide this information to the purchasers of those goods would be impractical.
- For purchases of second-hand goods from unregistered persons (associated or un-associated) that do not involve land, the deduction available would be calculated on the basis of the lesser of the tax fraction of the purchase price of the goods or their open market value.
- These changes will also be reflected in the rules that provide the deductions for changes in use. Thus, change-in-use adjustments for land would be based on the lesser of the original cost of the goods to the supplier, the tax fraction of the purchase price of the goods, or the tax fraction of the open market value of the supply of the goods.

8.63 If these suggestions were to be implemented, GST-registered persons would be treated equally whether buying second-hand goods from associated or non-associated unregistered persons. The changes would also deal with transactions involving land that make use of the change-in-use rules to obtain a more favourable tax treatment than that applicable to a deregistration or sale.

Specific points for consultation

- Do you agree that the treatment of second-hand goods acquired by associated and unassociated persons should be aligned in the manner suggested?
- What are the costs or benefits connected with suggested changes?

Chapter 9

ACCOMMODATION

9.1 In October 2006, Inland Revenue released a draft interpretation statement about the exemption of GST for accommodation provided in a dwelling.[69] The draft statement set out the Commissioner's preliminary, but considered, interpretation of the relevant provisions in the GST Act concerning the supply of accommodation in a "dwelling" or in a "commercial dwelling".

9.2 Inland Revenue received a number of comprehensive submissions on the exposure draft, many of which requested that the policy underlying the GST treatment of accommodation be reviewed.

9.3 Most submissions were concerned that the current legislative framework did not give taxpayers enough certainty about when the supply of accommodation should be treated as a taxable or exempt supply. The correct treatment of small-scale or non-commercial activities involving the supply of accommodation was also raised in submissions.

9.4 As part of the normal consultation process, the Office of the Chief Tax Counsel has reconsidered the draft statement in light of the submissions received. In response to these submissions, officials have reviewed the policy underpinning the GST treatment of accommodation. This chapter suggests two options that would clarify the boundary between taxable and exempt supplies of accommodation. The treatment of small-scale or non-commercial accommodation is also discussed.

9.5 Work on the exposure draft is not being advanced for the present, to provide an opportunity for the options presented in this chapter to be developed. It is likely that the suggestions in this chapter, if implemented, will largely supersede the draft statement.

Policy intent as reflected in the GST Act

The boundary between taxable and exempt supplies of accommodation

9.6 When accommodation is supplied by a GST-registered person, the GST Act determines which supplies should be treated as exempt and which should be treated as taxable by using two definitions – "dwelling" and "commercial dwelling".

[69] IS0049 *GST Exempt Supply: Supply of accommodation in a dwelling*, released by Inland Revenue on 19 October 2006.

9.7 Accommodation provided by GST-registered persons is generally taxable unless it is expressly treated as an exempt supply.[70] Section 14 exempts the supply of accommodation in a dwelling. The exemption is reinforced by section 6(3), which removes from the definition of "taxable activity" any activity to the extent that it involves making exempt supplies. Persons engaged in activities that entirely involve making supplies of residential accommodation are unable to be registered for GST.

9.8 Accommodation of this nature was described in the *White Paper* as "residential rental accommodation"[71] and was not included in the GST base because of concerns if GST applied to rents, that it would give owner-occupiers of residential dwellings a tax preference over tenants who reside in rental properties.

9.9 The exemption for accommodation provided in a "dwelling" is determined by reference to the use of the dwelling and applies if the purpose of the accommodation is to provide a residence or abode to an individual.

9.10 "Short-term accommodation", as described in the *White Paper*, on the other hand, is included in the GST base. That is, the services associated with providing short-term accommodation are taxable. This policy is encapsulated in the definition of "commercial dwelling", and special provision is made if the accommodation exceeds four weeks by limiting the application of GST to goods and services that are ancillary to the provision of accommodation.

Commercial dwellings

9.11 The GST Act defines the term "commercial dwelling" as:[72]

> "(a) Any hotel, motel, inn, hostel, or boardinghouse; or
> (b) Any camping ground; or
> (c) Any convalescent home, nursing home, rest home, or hospice; or
> (d) Any establishment similar to any of the kinds referred to in paragraphs (a) to (c) of this definition;—
> but does not include—
> (e) A hospital except to the extent that that hospital is a residential establishment:
> (f) A dwelling situated within a retirement village or within a rest home, where the consideration paid or payable for the supply of accommodation in that dwelling is for the right to occupy that dwelling:"

9.12 The supply of accommodation in a commercial dwelling is not exempt from GST predominantly because goods and services other than accommodation are likely to be provided. Operators of commercial dwellings are therefore treated in the same way as other businesses.

[70] See section 14.
[71] Ibid footnote 10, p. 36.
[72] See section 2.

9.13 Long-term accommodation (accommodation that exceeds a period of four weeks) in a commercial dwelling is taxable, but the value of the supply is reduced.[73] The purpose of the valuation rule is to recognise that the supply of this type of accommodation could, in principle, be similar to the supply of residential rental accommodation. Therefore supplies of "domestic goods and services"[74] in these establishments, and defined as "the right to occupy" – including the supply of cleaning and maintenance, utilities and chattels – are taxed at up to 60 percent of the normal taxable value.

9.14 Operators of commercial dwellings therefore do not have to incur the otherwise substantial compliance costs associated with apportioning the taxable and potentially exempt components of providing long-term accommodation, but can still preserve their input tax entitlements.

Problems with the current GST treatment of accommodation

The taxable/exempt boundary

9.15 Following concerns raised in submissions in response to Inland Revenue's exposure draft, we have reviewed the legislative framework governing the GST treatment of accommodation. The problem is how the GST Act should define the boundary between taxable and exempt accommodation so that the various policy objectives described in Chapter 1 can be met with as much clarity and certainty as possible.

Small-scale or non-commercial activities involving the supply of short-term accommodation

9.16 We are also concerned that the current GST treatment of accommodation may be causing some taxpayers to GST-register activities that are of a minor nature, either because of uncertainty or because of the ability to deduct input tax. Providing an input tax deduction in connection with the private use of goods and services is inconsistent with the objective of taxing final consumption.

Options being considered

The taxable/exempt boundary

9.17 The current legislation governing the supply of accommodation could mean the application of GST is based on the functional nature of the premises in which the accommodation is provided, rather than on the intention of the supplier and the recipient in regard to the use of the property.

[73] See section 10(6).
[74] See section 2.

9.18 Consistent with the objective that GST applies to the widest range of goods and services supplied, the exemption for accommodation provided in a dwelling should be narrowly defined. The definition should apply only to situations where there is a reasonable level of substitutability between renting and owning a home. This substitutability is more appropriately based on the use of the accommodation rather than the functional nature of the premises.

9.19 In recent years, there have been observable changes in the way tourist accommodation is provided in New Zealand, including greater demand for "boutique" or luxury accommodation provided in stand-alone dwellings. This would again support a test based on the use rather than the function of the premises. In these situations, the use of the accommodation is generally short-term rather than residential rental accommodation. Excluding this accommodation from the GST base because of its function would affect the entitlement to input tax deductions and would be inconsistent with the principle of the GST system not being a direct fixed cost on business.

9.20 Two options are suggested to help define the taxable-exempt boundary for accommodation. These options start from the viewpoint that the accommodation is supplied as part of a taxable activity, unless the accommodation is expressly exempt.[75]

9.21 Both options respond to changes in the way that tourist accommodation is currently provided in New Zealand. The options recognise that boutique or luxury accommodation provided in stand-alone dwellings competes against more traditional forms of commercial accommodation such as hotels, motels and camping grounds.

Option 1

9.22 The first option would involve making relatively minor changes to the current terms "dwelling" and "commercial dwelling".

9.23 The definition of "dwelling" could be revised so that it is defined by reference to the residential use of the accommodation instead of as a "place".

9.24 The definition of "commercial dwelling" could also be amended by making specific reference to a greater range of premises in which short-term accommodation may be supplied (such as bed-and-breakfasts, serviced apartments and homestays or farmstays). This could be achieved by amending the list of premises included in the definition of "commercial dwelling" and inserting descriptive criteria to cover accommodation that is not expressly provided for in the list but is nevertheless short-term.[76] The problem with this type of schedular approach is that:

- the policy objective can become obscured by the meaning or characteristics of the items listed in the definition; and

[75] See section 14.
[76] This would most likely involve retaining paragraph (d) of the definition but in a modified form.

- the list could start to become less relevant as a result of market-place changes, which could result in inappropriate omissions or inclusions in the GST base of certain supplies of accommodation.

Option 2

9.25 A second option would involve replacing the current legislative framework with terms that are more descriptive of the normal use of the premises. For example, the term "commercial dwelling" would be replaced with the term "guest accommodation". Accommodation provided in a hospice, rest home or similar – but not including a hospital or a dwelling in a retirement village – would be treated as "care accommodation". The supply of "guest accommodation" and "care accommodation" would be taxable.

9.26 The treatment of long-term accommodation exceeding four weeks either as guest accommodation or care accommodation would broadly remain the same as it is currently under the term "commercial dwelling". Long-term stays in hospitals (excluding those that form part of a "residential establishment") would therefore continue to remain outside the scope of the reduced valuation rule. Hospitals have a different function from providing accommodation and would therefore be excluded.

9.27 "Guest accommodation" would be given its ordinary meaning and would broadly encompass situations when hospitality is extended to an individual. The term would imply that the provider of the accommodation has greater control over the use of the premises compared with a tenancy situation. Although "guest accommodation" will not be extensively defined in the GST Act, it would generally extend to accommodation in the types of premises currently included in the definition of "commercial dwelling".

9.28 "Care accommodation" would include accommodation that is connected with the services provided within a hospice, rest home, convalescent or nursing home. Accommodation provided in a retirement village or complex would also be included, with the exception of the provision of residential rental accommodation in such a village or complex.

9.29 "Care accommodation" would also include any "residential establishment".[77] Residential establishments are facilities that provide an established community for individuals to whom "domestic goods and services" are supplied. The current requirement that 70 percent or more of the individuals reside or are expected to reside for four weeks or more and receive "domestic goods and services" would be retained.

[77] See section 2.

9.30 Exempt accommodation supplied to an individual would be described as "residential accommodation", and would broadly follow the suggested change to the definition of "dwelling" described under option 1. The intention, however, would be to ensure consistency with the terminology suggested under option 2.

9.31 Table 4 illustrates the scope of the terms suggested under option 2.

TABLE 4:
SUGGESTED GST TREATMENT OF VARIOUS TYPES OF ACCOMMODATION

Description	Includes	Application of section 10(6)	Does not include
Residential accommodation	Any premises used predominantly as an abode or residence by an individual.	N/A – supply is exempt from GST.	Guest accommodation or care accommodation.
Guest accommodation	Accommodation provided to guests on any premises.	Applies from the 1st day after the fourth week of a continuous stay.	Care accommodation.
Care accommodation	Accommodation provided in a convalescent home, nursing home, rest home, hospice or retirement complex and includes a "residential establishment".	Applies from the 1st day after the fourth week of a continuous stay.	A hospital not included in a "residential establishment" or guest accommodation. Residential rental accommodation supplied in a dwelling situated within such a facility, home or complex.

Specific points for consultation – the taxable/exempt boundary

- Do you agree that the rules governing the supply of accommodation need changing?
- If so, which of the two options discussed do you prefer and why?
- Are there alternative legislative solutions? If so, please describe these alternatives and explain why they are suitable.

Small-scale and non-commercial activities involving short-term accommodation

9.32 The options described in this chapter may still result in some uncertainty about when activities involving the supply of accommodation should be treated as taxable supplies. This uncertainty could lead to decisions to register for GST to avoid the possibility of shortfall penalties and use-of-money interest when the activity is of a very small-scale nature or non-commercial. It could also lead to a greater number of GST registrations in order to obtain input tax deductions, and so doing, create the requirement to make regular and ongoing change-in-use adjustments for any private or non-taxable use.

9.33 For these reasons, we suggest excluding from the definition of "taxable activity" activities involving the supply of commercial accommodation (either in a "commercial dwelling" or as "guest accommodation") to individuals when the taxable supply from these activities is less than a specified threshold – for example, $10,000 in any 12-month period (including the relevant current taxable period). Affected supplies would be treated as not being a "taxable activity" or an excluded part of a "taxable activity". Submissions are invited on where the specified threshold is best set and whether there are any competition concerns associated with introducing an explicit threshold of this nature. The measure would not apply to care accommodation.

9.34 Table 5 illustrates the range of possible outcomes that could apply to businesses that supply accommodation when making the decision whether to register for GST under the options presented in this chapter.

TABLE 5:
DECISION MATRIX FOR REGISTERING FOR GST

	Option 1		**Option 2**		
Taxable supplies in any 12-month period	*Activity involves the supply of accommodation in a "commercial dwelling"*	*Activity involves the supply of accommodation in a "dwelling"*	*Activity involves the supply of "guest accommodation"*	*Activity involves the supply of "care accommodation"*	*Activity involves the supply of "residential accommodation"*
Over $40,000	Required to register for GST.	Unable to register for GST.	Required to register for GST.	Required to register for GST.	Unable to register for GST.
Between $10,000 and $39,999	May voluntarily register for GST.	Unable to register for GST.	May voluntarily register for GST.	May voluntarily register for GST.	Unable to register for GST.
Under $10,000	Unable to register for GST or required to deregister for GST.	Unable to register for GST.	Unable to register for GST or required to deregister for GST.	May voluntarily register for GST.	Unable to register for GST.

9.35 The suggested changes would not affect the income tax treatment of taxable income arising from accommodation-related activities.

9.36 Businesses that incur GST as part of developing an activity that involves or will involve the supply of commercial accommodation would still be able to register for GST and claim input tax deductions. However, the business would be required to deregister if, in a 12-month period, the turnover from that activity fell, or was likely to fall, below the specified threshold. Businesses required to deregister for GST under this suggestion would be required to return GST on the open-market value of any assets held at the time of deregistration.

9.37 If the supply of short-term accommodation is part of a wider taxable activity, only the short-term accommodation would be excluded from being part of a "taxable activity". So, for example, a person who had a $9,000 turnover from renting out a holiday home and a $31,000 turnover from other business activities may have previously registered for GST in respect of both activities. Under the suggested measure the person would only need to choose whether or not to register in respect of the other business activities.

Transitional rules

9.38 We are aware that the suggested changes in this chapter could result in GST being payable on unrealised assets. Consistent with the announcement by the Minister of Revenue in October 2006, when the Inland Revenue draft interpretation statement was released, we are considering legislative options that would seek to preserve the status quo for GST-registered persons who had registered for GST and claimed GST for expenses associated with the accommodation before final decisions are made by the government.

9.39 We invite submissions on the transitional rules that should be introduced to assist GST-registered persons who may be affected by the changes suggested in this chapter.

Specific points for consultation – small-scale and non-commercial activities involving short-term accommodation

- Do you agree that small-scale and non-commercial activities involving the supply of accommodation should be excluded from the definition of "taxable activity"?
- Do you agree with the idea of a threshold for these activities, and if so, where do you think it should be set?
- What transitional rules should be taken into account if small-scale and non-commercial activities are required to deregister as a result of this suggestion?