GST remedial issues

An officials' issues paper

December 2012

Prepared by the Policy Advice Division of Inland Revenue

First published in December 2012 by the Policy Advice Division of Inland Revenue, PO Box 2198, Wellington 6140.

GST remedial issues – an officials' issues paper.
ISBN 0-478-39207-9

CONTENTS

CHAPTER 1 Introduction 1

CHAPTER 2 Hire purchase time of supply rule and land transactions 2

Scope of the “hire purchase agreement” 2
Timing advantages 3
Scope of definition 4

CHAPTER 3 GST treatment of directors’ fees 5

Suggested solution 6

CHAPTER 4 Apportionment rules 7

Wash-up rule for taxable or non-taxable use 7
Ensuring apportionment rules apply to all entity types 8
Output tax and the disposal of land 9
Non-profit bodies and the apportionment rules 11

CHAPTER 5 Zero-rating of land rules 12

Allowing inputs to registered persons subject to the domestic reverse charge 12
Clarifying section 11(8D) 13
Procurement of a lease 14

CHAPTER 6 “Dwelling” and “commercial dwelling” definitions 15

Rest homes and retirement villages 15
Requirement to be registered 16

CHAPTER 7 Credit notes 18

Suggested solution 18

CHAPTER 1

Introduction

1.1 This issues paper outlines a number of minor concerns relating to the GST rules and suggests some solutions on how these may be resolved. The matters raised do not give rise to significant policy questions, but are questions that require clarification or amendment to the legislation to ensure it operates as intended.[1]

1.2 The issues covered are:

- application of the hire-purchase time-of-supply rule to land transactions;
- treatment of directors' fees;
- consequential and remedial amendments following the introduction of the apportionment rules;
- consequential and remedial amendments following the introduction of the zero-rating for land rules;
- consequential and remedial amendments following the changes to the definitions of "dwelling" and "commercial dwelling";
- credit notes when GST is mistakenly accounted for.

1.3 Subject to consultation, we plan to recommend to Government that the issues be included in the first available tax bill in 2013.

1.4 Your comments on the solutions suggested in this paper are welcomed. In order to include any amendments in the first tax bill of 2013, we would appreciate your submissions by 1 March 2013. Submissions can be addressed to:

GST issues
C/- Deputy Commissioner
Policy Advice Division
Inland Revenue Department
P O Box 2198
Wellington 6140

1.5 Or email: policy.webmaster@ird.govt.nz with "GST issues" in the subject line.

1.6 Responses to this paper may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of responses on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you consider that any part of your letter should properly be withheld under the Act please clearly indicate this.

[1] All legislative references in this paper are to the Goods and Services Tax Act 1985 unless otherwise stated.

CHAPTER 2

Hire purchase time of supply rule and land transactions

Scope of the "hire purchase agreement"

2.1 There is currently some uncertainty over the scope of the term "hire purchase agreement" used in the Goods and Services Tax Act 1985 (the GST Act), specifically over whether an agreement for the sale of land on deferred terms can be a hire purchase agreement.

2.2 A hire purchase agreement is a contract in which a purchaser pays for goods, in parts, over a period of time. The Income Tax Act defines a "hire purchase asset" as "personal property which is the subject of a hire purchase agreement".[2] This is consistent with the now repealed Hire Purchase Act, which did not include real property (i.e. land) in the scope of "goods". For the purposes of the Income Tax Act, a sale of land on deferred terms is therefore not capable of being a hire purchase agreement.

2.3 The GST Act does not contain a separate definition of a "hire purchase agreement", but since 1 April 2005 has referred to the definition in section YA 1 of the Income Tax Act 2007. Before that, the GST Act referred instead to a definition in the Hire Purchase Act 1971.

2.4 The GST Act treats the time of supply for "goods and services which are supplied under a hire purchase agreement" to be the time the agreement is entered into. The word "goods" has a broad definition in the GST Act and includes real property.

2.5 The question of whether real property can be the subject of a hire purchase agreement therefore differs in the Income Tax Act and the GST Act.

2.6 When the GST Act was changed to use the Income Tax Act definition of a hire purchase agreement, rather than the Hire Purchase Act, it was not intended to widen the scope of hire purchase agreements to include land for GST purposes.

Suggested solution

2.7 We consider that the definition of "hire purchase" agreement in section 2(1) of the GST Act should be amended to clarify that, to avoid any doubt, land is specifically excluded from the scope of hire purchase agreements. This will ensure that a sale of land on deferred terms is not a hire purchase agreement for the purposes of the GST Act, and the use of the term is therefore consistent between the GST and Income Tax Acts.

[2] Section YA 1, Income Tax Act 2007.

Timing advantages

2.8 Providing that land cannot be the subject of hire purchase agreements for GST purposes, providers of some long-term sale and purchase agreements for land could enjoy a GST timing advantage. This situation would arise if an up-front tax deduction for GST were claimed for the purchase of land, but the corresponding output tax were able to be paid in the distant future, resulting in a timing advantage. The example below describes this.

Example

A mortgage provider (sometimes referred to as a "wrap mortgage provider") provides a property to a purchaser but retains the title to the property until the purchaser completes the required payments. Ultimate settlement can sometimes occur up to 30 years after the date of the initial agreement.

The transaction is arguably a "hire purchase agreement", under which the mortgage provider would be required to account for the full amount of output tax on the date the agreement was entered into.

If this was not a hire purchase agreement, the mortgage provider could claim a full input tax deduction on the date of the initial agreement to purchase the property. However, the mortgage provider would not be required to account for the full amount of the corresponding output tax until the date of settlement although GST will be returned on payments made before the date of settlement.

2.9 Section 19D of the GST Act was intended to prevent timing advantages on significant deferred settlement transactions, particularly involving vendors on the payments basis and purchasers on the invoice accounting basis. Section 19D achieves this by requiring the supplier of goods sold for a consideration of more than $225,000 to account for GST on an invoice basis.

2.10 The section also prevents people from avoiding the provision by splitting up the supply so that each supply falls below the $225,000 threshold. In these cases, the Commissioner may treat the supply as having been made for consideration of more than $225,000 if the Commissioner believes that the person made more than one supply to avoid the application of section 19D.

2.11 However, since mortgage providers may have legitimate commercial reasons for splitting transactions into more than one supply or the value of the mortgages falls below $225,000, this subsection may not apply.

Suggested solution

2.12 It is suggested that section 19D of the GST Act be amended so that where transactions involve the deferred settlement of land and periodic payments, the registered supplier will be required to account for GST on the supply at the time the agreement is entered into, rather than periodically. This achieves a similar outcome as hire purchase agreements but in a more appropriate context.

Scope of definition

2.13 There is also a separate concern with the scope of the definition of "hire purchase agreement" in the Income Tax Act 2007.[3] It is arguable that this definition does not adequately cover agreements with an option to purchase.

2.14 As discussed previously, the definition of "hire purchase agreement" originates from the Hire Purchase Act 1971 and is intended to cover two types of agreement. The first is one where the goods are let or hired to a person with an option to purchase (the "option to purchase agreement"). The second is when a person has agreed to purchase the goods with a condition (a "conditional contract of sale"). The main difference between the two is whether the person has agreed to purchase the goods at the time the relevant contract is entered into.

2.15 The rewrite of the hire purchase agreement definition contained a drafting error, which arguably means the person's upfront agreement to purchase the goods is also required in order for the arrangement to be an option to purchase agreement. This interpretation is inconsistent with the policy intent behind the definition, which (as stated) is to capture both forms of agreement.

Suggested solution

2.16 The definition should be clarified to achieve the policy intent, so that paragraph (a)(i) explicitly incorporates contracts when the person has an option to purchase, but that option is not exercised until a later date.

Suggested application date

2.17 We consider that the amendment suggested above (concerning the scope of the definition) should apply from 1 April 2005, as this was the date that the GST Act adopted the Income Tax Act definition of "hire purchase agreement".

2.18 In our view this application date should apply universally. This is because the definition of "hire purchase agreement" arguably does not include "option to purchase agreements" and is:

- contrary to the former Hire Purchase Act; and
- contrary to the position adopted by many taxpayers, on the basis of a clearly understood policy.

2.19 However, we are aware that some taxpayers have adopted the opposite position. To allow disputes on the existing wording to run their course, we suggest a "savings" provision for taxpayers that have filed returns on a contrary basis.

[3] Section YA (1) and, before that, section OB 1 of the Income Tax Act 2004.

CHAPTER 3

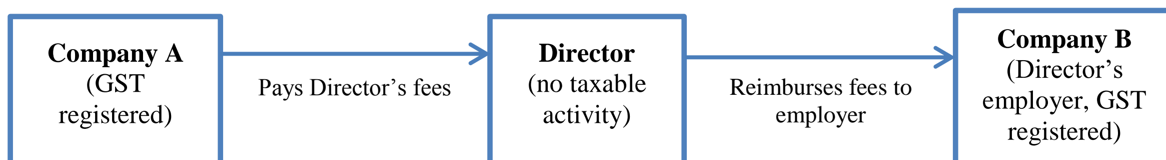
GST treatment of directors' fees

3.1 The GST Act provides that a person engaged as a director is not carrying on a taxable activity. This rule is designed to keep directors out of the GST net, unless their activities as a director are performed as part of a broader taxable activity, in which case their directorship will form part of that activity.

3.2 Inland Revenue has issued a Public Ruling on the tax treatment of payments to directors (BR Pub 05/13). The Ruling largely achieves an outcome that reflects the policy intent of the provisions: directors that are not carrying on a taxable activity are not generally required to charge GST for their services.

3.3 When GST is charged, the paying company will generally be entitled to an input deduction, so GST is not an economic burden on business.

3.4 However, there is one circumstance when the correct GST outcome, from a policy perspective, is not achieved. This arises when an employee is engaged by a third-party company who is not their employer and the employee is required to account to the employer for the directors' fees received. The diagram below illustrates the arrangement.



3.5 In the above scenario, the directors' fees paid to the employee are not subject to GST, because section 6(3)(b) precludes them from having a taxable activity. However, when the employee passes these fees on to the employer (Company B), Company B is, under the Ruling, required to account for output tax on the supply of "permitting the employee to be a director".

3.6 This result means that Company A will not receive an input deduction for the fees paid, because they are paid to a non-registered person who will not be able to provide a tax invoice. Company B will, however, have to account for output tax on the amount reimbursed by the employee. This lack of input deduction on an amount that ultimately generates output tax liability means that either Company A, Company B or both companies will bear GST as a cost.

3.7 The Ruling is also applied in comparable circumstances when an employee has been engaged as a member of a local authority or statutory board under section 6(3)(c). The situation with members of local authorities or statutory boards is slightly complicated by the fact that there is no proviso to section 6(3)(c) – meaning these members can never be registered. Our suggested solution below seeks to address the application of both sections.

Suggested solution

3.8 To avoid altering established contractual relationships or forcing directors to register for GST when they otherwise would not be required to do so, the simplest solution would be to treat Company B as making a supply to Company A (permitting their employee to be a director/member) to the extent that Company B is either paid directly by Company A or reimbursed by the employee. This supply would be treated as having been made for all relevant 6(3)(c) supplies and when a director was prohibited from registering under section 6(3)(b).

3.9 This would allow Company B to issue a tax invoice for the fees (or the relevant portion of the fees), and the related input tax deductions could be claimed by Company A. This suggestion could be workable because it is unlikely that Companies A and B will be unaware of their respective involvement. The practicalities, such as invoicing, could therefore be arranged at the time of the appointment. The suggestion could achieve a neutral outcome without imposing the compliance and administration costs of requiring the director to register for GST.

3.10 The rule should also logically extend to situations when Company B is a registered partnership or trust and the employee is a partner/trustee released to act as a director (or member of a local authority or statutory board). This would provide greater consistency in the GST treatment, irrespective of the commercial structure used.

3.11 It is important to note that the solution suggested would be aimed solely at ensuring GST neutrality in the transaction. It is not intended to alter the contractual relationships and, as such, would not affect the income tax treatment of any of the parties or the withholding obligations of the party making the payment.

CHAPTER 4

Apportionment rules

Wash-up rule for taxable or non-taxable use

4.1 An issue has arisen with the GST treatment of land that has been purchased for both taxable and non-taxable use, but is later used solely for one or the other and is subject to on-going adjustments.[4] The question that arises is whether there reaches a point when a wash-up calculation should be performed to eliminate the need for continual adjustments.

> **Example**
>
> John purchases a building that is used 50 percent for commercial use and 50 percent apartments. On the basis that the apartments will be leased as dwellings, an input deduction of 50 percent is taken at the time of purchase. After two years, John gives notice to his tenants and signs an agreement with a management company that will operate the apartments as serviced apartments for business travellers.
>
> As serviced apartments are commercial dwellings, the building is now being used solely for making taxable supplies. John makes the necessary adjustments in subsequent adjustment periods to reflect the taxable and non-taxable proportion of use over his ownership period. Because of the two years of part non-taxable use, John will never be in a position to claim 100 percent of his inputs in relation to the building.

4.2 John is not compelled to make an adjustment in each period, because eventually the adjustments will fall within the $1,000 or 10% de minimis rule in section 21(2)(d). However, because John's "percentage taxable use" is always increasing, he may be motivated to claim the small additional amount of input tax at the end of each adjustment period.

4.3 We consider that the on-going adjustment requirement in these circumstances causes disproportionately high compliance costs for the revenue actually at risk.

Suggested solution

4.4 We consider that there should be a wash-up calculation that a registered person must perform if they meet the following criteria:

- their taxable use of the asset is 100 percent or 0 percent in both the relevant adjustment period and the adjustment period immediately prior; and
- their percentage actual use over the course of their ownership of the asset is over 90 percent or under 10 percent, as the case may be.

[4] This issue potentially applies to assets generally, but is most prevalent with land because of the rule in section 21G(5) that requires indefinite adjustments.

4.5 If the calculation were to be optional, registered persons could take advantage of it to complete their input claims, but would be less likely to use it if the result was an output tax liability. We therefore suggest making the calculation compulsory to capture both ends of the spectrum.

4.6 The adjustment calculations would need to begin again if the person again changed the use of the asset beyond the levels in the section 21(2) de minimis rules.

Ensuring apportionment rules apply to all entity types

4.7 There is some confusion over how, or if, the apportionment rules apply to all GST-registered persons. In particular, there is a question over whether non-natural registered persons (such as a company) can have "private" use of an asset and, if so, how to measure it.

Example

ABC Ltd is registered for GST. Sam and his brother Tim are the only shareholders in ABC Ltd. ABC Ltd buys a company car. It is anticipated that the car will be used 50 percent of the time for business purposes, 25 percent by Sam for his private use and 25 percent by Tim for his private use.

4.8 The policy intent behind the apportionment rules would see ABC Ltd claiming 50 percent of the input tax for the car, with the remaining 50 percent being unable to be claimed because of the private nature of the use.

4.9 However, there is an alternative interpretation that would allow ABC Ltd to claim all of the inputs. This comes about because the GST Act arguably treats the 50 percent "private" use as taxable for the purposes of the apportionment rules. The supply of the car by ABC Ltd to Sam or Tim is an associated supply, to which the market value rules apply and for which ABC Ltd would be required to return output tax.[5]

4.10 Although the supplies to Sam and Tim will generate an output tax liability for ABC, they also mean that the company is using the asset for 100 percent taxable supplies, so will not have to apply the apportionment rules to the car.

4.11 Over the life of most assets there may not be a materially different revenue impact between the two approaches. However, the alternative approach increases the compliance costs to ABC Ltd because, instead of simply being denied 50 percent of the input tax upfront, it is required to account for output tax on an on-going, per-use basis.

[5] Section 10(3) Goods and Services Tax Act 1985.

Suggested solution

4.12 We consider that the definition of "percentage actual use" in section 21G(1) should be clarified so that associated supplies are not treated as being taxable supplies. However, we recognise that creating a blanket rule could create difficulties because it may not be desirable to have all associated supplies dealt with through the apportionment rules.

4.13 The simplest approach, which also deals with the policy concerns around private use, would be to amend section 21G to exclude associated supplies, from being "taxable supplies", when the recipient of the supply is a natural person.

4.14 Consequential amendments would be necessary to "switch off" the output tax liability on the relevant supplies. The interplay between the associated supply rules and the fringe benefit rule in section 21I would also need to be considered to ensure that there is not effective double taxation by denying input deductions and then still charging output tax on the private use on the basis that a fringe benefit is being provided.

Suggested application date

4.15 In order to reduce confusion and compliance costs for taxpayers who have, since the apportionment rules took effect, been apportioning input tax in accordance with the intended policy outcome, we consider that the revised rule should be retrospective to 1 April 2011.

4.16 However, to reflect the fact that genuine uncertainty exists, it may not be appropriate to force a registered person that has adopted the alternative interpretation to revisit their returns. We therefore consider that the amendment should include a "savings" provision to preserve the position of people who have adopted the alternative interpretation.

4.17 Any savings provision that is enacted would generally only apply until the new rule is enacted. At that point, people whose position in respect of certain assets has been preserved may (depending on the value of the asset) need to make adjustments subsequent to the clarification to reflect use that is now confirmed as non-taxable. We welcome views on whether a grandparenting rule should be allowed for these assets.

Output tax and the disposal of land

4.18 There appears to be a risk that a person can dispose of land (and other assets) outside the course or furtherance of their taxable activity, while still not returning all of the input claimed in relation to that asset. From a policy perspective, when input tax has been claimed on an asset and that asset is then on-sold, the on-selling should generally be subject to output tax.

4.19 Imposing output tax on the sale achieves broadly the right policy result because the registered person will already have an input deduction that reflects their taxable use of the asset and the wash-up calculation that occurs on sale may provide further input tax deductions to recognise the fact that:[6]

- the non-taxable use of the asset has contributed to its depreciation (assuming it is depreciating); and
- further consumption of the asset is being enjoyed further down the supply chain.

4.20 Under these rules, if the asset is appreciating, the person will generally be entitled to a full input deduction on disposal. Even if the asset has depreciated in value, the calculation will give the person an additional input deduction.

4.21 A problem arises when a person uses land for making taxable supplies and then fully devotes it to a non-taxable purpose before disposal. In an extreme example, the person will have claimed a full input tax deduction for the land, and will use it for non-taxable purposes for a year or two and then dispose of it. The nature of the apportionment rules means that the person will still not have returned all of the acquisition input tax (they might have been using it in their taxable activity for a number of years).

4.22 However, on disposal, the person will arguably not be disposing of the land in the course or furtherance of their taxable activity – it having been taken out of that activity and devoted to private use. In these circumstances, it may be that no output tax is returnable on the sale and the calculation under section 21F does not have to be performed.

4.23 This factual scenario and possible interpretation does not produce the correct policy outcome. The person's input position will reflect their use of the asset, but they will not be given the benefit of the additional input tax under section 21F. Equally, the consumption of the asset further down the supply chain will not be taxed appropriately. If the purchaser is not a registered person, they may not have to pay GST to the registered vendor, despite the fact that they are effectively a final consumer purchasing an asset from a registered person.[7]

Suggested solution

4.24 Although this issue potentially arises for other assets, we consider a targeted solution that deals with land would be the most appropriate way to address the issue. Such a solution would recognise the fact that land is the most problematic area and would also avoid confusion for registered persons, such as financial service providers, that have claimed some inputs in respect of assets but may not consider their subsequent disposal as being the course or furtherance of a taxable activity (for example, a bank selling surplus office furnishings or computer equipment).

[6] This wash-up calculation is contained in section 21F.
[7] Note that this situation would not arise when the vendor is deregistering because of the deemed supply rule in section 5(3).

4.25 We therefore consider that the most appropriate way to resolve the issue would be to extend the scope of section 5(16) so that it applies to all subsequent supplies of land when input tax has been claimed (at present it is limited to dwellings). An amendment that treated such supplies as being in the course or furtherance of a taxable activity would require the supplier to charge output tax and also perform the wash-up calculation in section 21F.

4.26 We consider that a carve-out will be necessary for registered persons that have performed the wash-up calculation proposed on pages 7–8. In other words, if a person has already returned all of the output tax on their original purchase, the proposed rule automatically treating the subsequent disposal as being in the course or furtherance of their taxable activity should be switched off. In practice this would be determined on a case-by-case basis. If the disposal is in fact part of a taxable activity, sections 8 and 21F would apply in the usual way.

Non-profit bodies and the apportionment rules

4.27 Non-profit bodies are able to take advantage of a special input deduction rule that allows them to claim all of their inputs except to the extent that the goods or services in question are used for making exempt supplies.[8] There is an argument, however, that a non-profit body to whom this rule applies may then have to return some or all of the input tax claimed under the apportionment rules.

4.28 This result could arise because, unless it intends to use, or uses, the goods or services for actually making taxable supplies, its use will fall outside the definitions of "percentage actual use" and "percentage intended use" in section 21G(1). This argument is potentially relevant for "regular" taxable supplies as well as supplies of land to which section 20(3J) applies.

Suggested solution

4.29 The apportionment rules were not intended to alter the input entitlements of non-profit bodies. We therefore consider that section 20(3K) should be amended to specify that it applies for the purposes of subsections (3) and (3C) and the definitions of "percentage intended use" and "percentage actual use" in section 21G(1).

Suggested application date

4.30 We are not aware of any non-profit bodies having filed GST returns on the basis of the interpretation set out above. However, to provide clarity to this group, we consider this amendment should be made retrospective to 1 April 2011.

---

[8] Section 20(3K).

CHAPTER 5

Zero-rating of land rules

Allowing inputs to registered persons subject to the domestic reverse charge

5.1 The GST Act provides for what is effectively a "domestic reverse charge" in circumstances when a person purports to be registered in order to zero-rate a land transaction, when they are in fact not registered. The effect of the domestic reverse charge is that the recipient is treated as the supplier, so has to return GST on the sale. This outcome was designed to prevent a purchaser representing that they are GST registered to take advantage of the lower price that might be available if the land was zero-rated.

5.2 Mechanically, this outcome is achieved through the following provisions:

- When a transaction is incorrectly zero-rated, the recipient is treated as having supplied the relevant goods and services to themselves (section 5(23)).
- On the assumption that the recipient is not otherwise a registered person, the recipient is treated as being registered from the date of the supply (section 51B(4)).
- The person is then denied the ability to claim an input tax deduction in respect of the supply (section 20(4B)).
- Once the tax is accounted for, the person may apply to be deregistered (section 51B(5)).

5.3 As recognition of the fact that the person might later use the land as part of a taxable activity, the proviso to section 20(4B) allows inputs to be claimed if the person "later becomes a registered person… and uses the relevant goods for making taxable supplies".

5.4 What is not catered for under section 20(4B) is the fact that the purchaser may already be a registered person and the transaction may have been zero-rated as a result of a genuine error.

Example

Company A contracts to sell Company B various assets, including an interest in land. Both parties are GST-registered and make only taxable supplies. For GST purposes, it is not completely clear whether the transaction involves one or two supplies. If there is one supply, it should be zero-rated. However, if there are two supplies only the one containing the interest in land should be zero-rated.

The parties treat the transaction as a single supply, but it is later determined that this treatment was incorrect.

5.5 Under a strict interpretation of the relevant provisions, section 5(23) would treat Company B as making the relevant supply to itself, but section 20(4B) would deny an input deduction – the proviso would not apply because Company B is already registered, rather than later becoming registered. This is despite the fact that Company B is using the relevant goods for making taxable supplies.

Suggested solution

5.6 We consider that the proviso in section 20(4B) should be extended to cater for both a person that later becomes registered and a person already registered (in both cases only to the extent that they use the goods for making taxable supplies). Although it would be undesirable for the domestic reverse charge to become the default position for transactions where the parties are unsure of the legal status of the supply, the approach will provide the necessary certainty should an unintended error in the treatment arise.

Suggested application date

5.7 Given the proposed change would reinforce existing policy, and is concessionary to taxpayers, we consider it should have an effective date of 1 April 2011.

Clarifying section 11(8D)

5.8 It has been suggested that under the current wording of the Act, all assignments or surrenders of interests in land should be zero-rated – even if the other requirements for zero-rating land transactions are not met.

5.9 Section 11(8D) provides that:

For the purposes of the zero-rating of land rules,—

(a) a supply that is an assignment or surrender of an interest in land, is a supply chargeable with tax at 0%:

5.10 The section is designed to clarify that assignments and surrenders of interests in land are "land" transactions for the purpose of the zero-rating rules. The policy intent of this section is that it should apply when the requirements for the zero-rating of land rules are met.

5.11 However, we are aware that the section could be interpreted more widely. In particular, it could be read to mean that all assignments or surrenders of an interest in land should be zero-rated even if, for example, the recipient of the supply is not GST-registered.

Suggested solution

5.12 We consider that the words "chargeable with tax at 0%" should be replaced with "of land". This would clarify that the assignment or surrender is a land transaction. Whether it should be zero-rated would then be determined on whether the requirements in section 11(1)(mb) are met.

5.13 It has also been suggested that the wording of section 11(8D) requires leases to be zero-rated when there is no extra payment made in advance, or contemporaneously, with the supply being made. We suggest that the provision should also be clarified to reflect the policy intent that standard commercial leases are not zero-rated unless there are significant lump-sum payments that pass under the agreement.

Suggested application date

5.14 Section 11(8D), recently enacted, is itself a clarification amendment, recently introduced with retrospective application to 1 April 2011. As this is a further clarification and does alter the intended scope of the provision, we therefore consider that this change should have the same effective date.

Procurement of a lease

5.15 In some transactions when a vendor/lessee is selling its business, the lease will not be assigned. Instead, as a condition of the business being sold, the vendor will procure that the lessor will enter into a new lease with the purchaser. Part of the consideration for the sale will be for this procurement or to compensate the vendor for fees payable for the early termination of the existing lease.

5.16 Because a new interest in land is created through this transaction (the lease between the lessor and the purchaser) there is no transfer of an interest in land between the vendor and the purchaser. Any consideration payable in respect of this supply will therefore not be subject to the zero-rating rule, even though the practical effect of the transaction is similar to an assignment of a lease.

Suggested solution

5.17 We consider that payments for the procurement of a lease should be added to the list of "land" transactions in section 11(8D), and amended in the manner referred to above. This would ensure that such transactions are zero-rated, subject to the requirements of section 11(1)(mb) being met.

CHAPTER 6

"Dwelling" and "commercial dwelling" definitions

Rest homes and retirement villages

6.1 The definitions of "dwelling" and "commercial dwelling" were amended with effect from 1 April 2011. The purpose of these changes was to provide clarity in the boundary between these definitions. This was achieved by narrowing the definition of "dwelling" and updating the types of accommodation that should be treated as "commercial dwellings".[9]

6.2 It has always been the intention of the GST system that exempting a "dwelling" provides substitutability between renting and owning a house.[10] Narrowing the "dwelling" definition was therefore consistent with this policy objective.

6.3 Part of the amendment to the definition was importing the idea of "quiet enjoyment" from section 38 the Residential Tenancies Act 1986 (RTA). This concept was considered to encapsulate the distinction between a property that a tenant would genuinely consider to be their "home" and one where their occupancy was more temporary.

6.4 However, a question has arisen that "quiet enjoyment" may not always be able to be demonstrated in relation to the provision of accommodation of retirement villages and residential rest homes.

6.5 The definition of "commercial dwelling" excludes (in paragraph (b)(ii)) "a dwelling situated in a retirement village or rest home…". It has therefore historically been contemplated that it was possible for a retirement village or rest home to be comprised of both "dwellings" (for occupants that were essentially independent) and "commercial dwellings" (for occupants that require active care).

6.6 It is arguable that, in some cases, "independent living" rest home accommodation fails to satisfy the "quiet enjoyment" test. This is where rest home operators impose contractual obligations on tenants that allow the operator or its agents to enter the property with no (or very limited) notice to, for example, carry out maintenance checks. These contractual rights can be interpreted as being in contradiction to section 38 of the RTA, in particular when that section is read in conjunction with the "landlord's right of entry rules" in section 48 of that Act.

---

[9] See commentary to the Taxation (GST and Remedial Matters) Bill 2010, page 10.

[10] *White Paper (Proposals for the Administration of the Goods and Services Tax)* Advisory Panel on Goods and Services Tax, March 1985 [B. 27].

6.7 It is therefore arguable that rest homes that have these contractual terms would only operate "commercial dwellings". Although this would entitle the operators of these homes to input deductions, it would also mean they would be required to charge output tax on the rental payments by their tenants. This would be an unintended policy outcome from the 2011 changes to the definitions.

Suggested solution

6.8 We consider the "dwelling" definition should be clarified to include retirement village and rest home accommodation that could broadly be described as a principal place of residence where the occupant is living independently.

Suggested application date

6.9 We suggest an application date of 1 April 2011 with a "savings" provision for taxpayers who may have filed their tax returns on the basis that independent living arrangements are not "dwellings" as defined.

Requirement to be registered

6.10 When the definitions of "dwelling" and "commercial dwelling" were amended, it was recognised that these changes would mean that some premises that were "dwellings" would become "commercial dwellings". To cater for this, a person that is, as a result of the change, making taxable supplies (of a commercial dwelling) is allowed an input tax deduction in relation to the relevant premises.[11] This compensates the person for the fact that their supplies going forward would attract output tax.

6.11 To avoid people claiming large deductions while only making minimal supplies, section 21HB provides that the input tax is only available if the person is "registered under section 51(1)…" (section 51(1) being the compulsory registration provision). The intended effect of this rule is that a person may only claim the input tax if their supplies in relation to the commercial dwelling were over the $60,000 registration threshold.

6.12 However, a concern has been raised over whether the expanded definition of "commercial dwelling" might adversely affect sole traders otherwise operating below the registration threshold. For example, a registered architect who is "registered under section 51(1)" in respect of her architectural business also owns a holiday home that she occasionally rents out. Because of the changed definitions, the architect is required to bring the holiday home into her broader taxable activity – claiming an input deduction on the purchase price and returning output tax on subsequent rental arrangements.

6.13 It may be the case, however, that the architect would prefer not to be forced to incorporate the holiday home into her taxable activity for GST purposes.

[11] Section 21HB of the Goods and Services Tax Act 1985.

Suggested solution

6.14 We do consider that an amendment to section 21HB is justified so that a sole trader who owns a rented property is not automatically registered for GST in relation to that property.

6.15 Section 21HB should be amended so that a person has the option of including the commercial dwelling as part of a broader taxable activity if their supplies of the commercial dwelling are under $60,000. This option should only be available if the person:

- is affected by the changes to the "dwelling" and "commercial dwelling" definition; and
- is required to be registered for reasons other than the supply of a commercial dwelling.

Suggested application date

6.16 The suggested amendment can only operate in favour of the taxpayer and addresses an unexpected outcome. Therefore, we suggest an application date of 1 April 2011.

CHAPTER 7

Credit notes

7.1 Credit or debit notes are issued in a range of circumstances to reflect that the payment for a supply may have been incorrectly stated and to allow the issuer to adjust their position accordingly.[12]

7.2 One of the requirements of issuing a credit note under section 25(1) is that there must be a "supply of goods and services" by a registered person. The section arguably does not apply when no supply has taken place, but GST has nevertheless been charged. For example, a registered person issues an invoice for an amount, plus GST, to a person on the assumption that a supply has taken place. However, it is later determined that the payment actually represented liquidated damages, which is not a "supply" for GST purposes.

7.3 Under the current wording of section 25(1), the person that has provided the invoice is arguably not required to remedy the situation by providing a credit note. Although it may be possible for the Commissioner to return the GST to the "supplier" by amending the relevant assessment, the amount may not be passed on to the person who actually bore the GST cost, providing the supplier with a windfall gain. A requirement to issue a credit note would achieve the right policy outcome of returning the GST to the person who originally paid it.

7.4 It has been suggested that section 25(1) does not cater clearly for situations when a supplier is simply mistaken about the GST treatment of a supply – for example, if a supply is incorrectly zero-rated or treated as exempt for GST purposes. These situations may result in an alteration of consideration for the purposes of section 25(1)(b), but it is not immediately apparent that that is the purpose of the provision.

7.5 Section 25(1)(ab) was introduced to cater for land transactions incorrectly accounted for. Although that section was directed at changes relating to land, there is nothing in theory that makes land a special case when it comes to issuing credit/debit notes.

7.6 We are aware that a provision requiring credit/debit notes to be issued when there has been no supply or when GST was incorrectly accounted for would operate as a general "unjust enrichment" rule. However, if the GST treatment between the parties to a supply is incorrect the outcome should, in our view, be the same as for a change in consideration or value.

Suggested solution

7.7 We consider section 25(1) should be amended to clarify that it also applies in situations when the GST treatment of a supply has been incorrectly accounted for.

[12] Section 25(1), Goods and Services Tax Act 1985.

7.8 Consequential amendments may also be necessary to section 25(3) (relating to the specific requirements of credit and debit notes) so that credit and debit notes that deal with the instances set out above are valid.

7.9 When credit/debit notes are issued in the circumstances set out above, there is a question as to whether the adjustment should be treated as taking place in the same period as the original supply. Submissions on this point would be welcome.

7.10 One issue that may require further consideration is that of the compliance costs that might arise if the incorrect GST accounting were minor and spread over a wide customer group. The requirement for debit or credit notes needed, in order to deal with such cases, could be limited to situations when the supplier has sought an adjustment in their favour in their return.