POLICY AND REGULATORY STEWARDSHIP

Tax policy report: **Public release of an officials' issues paper on the GST apportionment and adjustment rules**

Date:	2 December 2021	**Priority:**	Medium
Security level:	In Confidence	**Report number:**	IR2021/510

Action sought

	Action sought	**Deadline**
Minister of Finance	**Agree** to recommendation	20 December 2021
Minister of Revenue	**Agree** to recommendation **Approve and lodge** the attached Cabinet paper and draft officials' issues paper	20 December 2021 10am Thursday 3 February 2022

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
Graeme Morrison	Policy Lead, Inland Revenue	s 9(2)(a)
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2 December 2021

Minister of Finance
Minister of Revenue

Public release of an officials' issues paper on the GST apportionment and adjustment rules

Executive summary

1. This report seeks your approval to release the *GST apportionment and adjustment rules* officials' issues paper, for public consultation. These rules apply when a GST registered business purchases an asset which is used for both business and for private or exempt use. A draft officials' issues paper and draft cabinet paper are attached to this report, for your consideration.

2. As outlined in our earlier report to you in February 2021 (*IR2021/060* refers), the GST apportionment and adjustment rules have been an issue of high priority for stakeholders for some time, with reform of the apportionment rules being ranked the highest priority in the recent GST stewardship review, as well as in submissions received in the February 2020 GST issues paper.

3. In recent months, we have been engaging with external stakeholders (including private sector GST advisors) in developing several policy proposals and technical amendments, with a view of making the rules simpler and easier for taxpayers to comply with, that now should be subject to public consultation.

4. We seek your approval to publicly consult on these proposals.

5. The draft officials' issues paper seeks submissions on:

   5.1 Allowing GST-registered persons to elect capital assets not to be subject to GST.

   5.2 Introducing a principal purpose test for assets worth less than $5,000, whereby an asset purchased for predominant business use will receive full input deduction.

   5.3 Establishing a 20% margin rule for assets worth more than $5,000, whereby businesses would not be required to make annual apportionment adjustments unless their business use of the asset has significantly changed.

   5.4 Introducing new rounding-based rules for assets that have less than 20% or more than 80% of taxable use, so they are effectively not subject to the apportionment rules.

   5.5 Proposing technical changes to the definitions of residential and commercial accommodation services, to provide more certainty to various commercial situations.

   5.6 Exploring potentially treating houses as fully private assets and GST exempt on sale.

   5.7 Simplifying the rules for residential property developers, while encouraging land to be developed within a reasonable timeframe.

   5.8 A number of other technical improvements that will reduce compliance costs.

6. If you agree to the recommendations in this report, the next step is to obtain Cabinet's approval to release the officials' issues paper for public consultation. A draft Cabinet paper is attached for lodgement with the Cabinet Office by 10.00am Thursday 3 February 2022, for consideration by the Economic Development Committee the following Wednesday 9 February 2022.

s 9(2)(f)(iv)

10. The Treasury has been consulted in the preparation of this report.

Recommended action

We recommend that you:

Recommendations		Minister of Finance	Minister of Revenue
(a)	**note** the contents of the attached draft Cabinet paper and draft GST apportionment and adjustment rules officials' issues paper	Noted	Noted
(b)	**note** the draft officials' issues paper is subject to minor technical and editorial changes	Noted	Noted
(c)	s 9(2)(f)(iv) [redacted]		
(d)			
(e)	**approve and lodge** the attached Cabinet paper and draft officials' issues paper to the Cabinet Office, for consideration by the Cabinet Economic Development Committee	N/A	Approved and lodged

s 9(2)(a) [redacted]

Graeme Morrison
Policy Lead, Indirect Tax
Policy and Regulatory Stewardship

Hon Grant Robertson
Minister of Finance
/ /2021

Hon David Parker
Minister of Revenue
/ /2021

Background

11. The Goods and Services Tax (GST) is a 15% tax on the consumption of most goods and services supplied to New Zealand consumers. To prevent businesses bearing the burden of GST, GST-registered businesses can claim back GST paid on their purchases (known as an input tax deduction), provided these goods and services are used in their business.

12. However, some businesses purchase goods and services that are used in both their business, known as taxable use, such as a delivery van supplying courier services during the week, and for private use[1], such as recreational use of the van in the weekend. Where the good or service has been used both for taxable use and non-taxable use, then the business must apportion the input tax deduction based on the estimated percentage of taxable use. This is known as apportionment.

13. Once the business has apportioned their input tax deduction based on their estimated taxable use, they are required to monitor their actual use of the asset over time (often several years). If their estimated use is inaccurate, then this must be accounted for in their GST return. This is known as adjustment or change in use.

14. The goal of the apportionment rules is to ensure that GST is collected on the portion of the good or service's use that is not for making taxable supplies, as would be the outcome if the asset was bought outright for non-taxable use.

Calls to reform the apportionment and adjustment rules

15. As outlined in our earlier report (*IR2021/060* refers), public submissions received on proposed technical amendments to the apportionment rules in the 2020 *GST Policy Issues: an officials' issues paper* were that in many situations, the existing rules are complex and impose unreasonable compliance costs, and that more substantial reform was required.

16. Submissions received on the 2020 GST Policy Issues: an officials' issues paper made it clear that substantial reform of the apportionment and adjustment rules is a priority. Submitters said the focus needs to be creating rules that are simpler and practical to apply, especially for small and medium-sized businesses.

17. Importantly, reform to the apportionment and adjustment rules was the number one issue identified by private sector stakeholders in the recent GST system stewardship review. A redesign of the existing rules is required to ensure they support emerging commercial practices, such as the gig and sharing economy.

18. Since our earlier report we have been regularly engaging with key stakeholders, such as private sector GST advisors, to discuss what reform options are available. This has included removing assets from the apportionment rules and reducing the need for annual monitoring by businesses.

19. The four significant proposals are further explained in this report.

The election method

20. It is proposed that a GST-registered business can elect whether to exclude certain capital assets[2] from GST. An election to exclude the asset would have the same GST outcome as the scenario where an asset was purchased by an unregistered person - no GST input claimed, no GST charged on sale or disposal. The proposal

[1] Or for making GST-exempt supplies.
[2] Such as private homes, holiday homes and other mainly private and appreciating assets.

would apply to capital improvements and would exclude certain assets such as trading stock.

21. It is anticipated that historically, many affected taxpayers have not claimed input tax deductions on predominantly private assets, and so potentially this method could be applied retrospectively (where no inputs have been claimed on existing assets).

22. This proposal seeks to resolve a current concern of Chartered Accountants Australia and New Zealand and private sector tax advisors known as the "farmhouse or home-office issue" whereby predominately private properties have been used to support a taxable activity (including where some have only claimed GST input deductions on the property's operating expenses) but can unexpectedly result in the whole property being subject to GST on sale (including any capital gain). The current rules are complex and unfair, with stakeholders seeking a policy solution to this issue with some urgency.

23. The effectiveness of the election method will ultimately depend on the extent to which taxpayers choose to use it. If take-up is high, then the election method would remove GST liabilities from mainly private assets and reduce compliance costs; however, if take-up is low, then the benefits are not likely to be realised.

24. It is expected that stakeholders will be supportive of this proposal, as it will allow predominantly private capital assets to be kept outside the GST base.

Principal purpose test for low-value assets

25. It is proposed that a principal purpose test would apply for assets that cost less than $5,000 (excluding GST). For example, if the asset was purchased for the principal purpose of making taxable supplies, then a full input tax deduction could be claimed, and the asset would effectively not be subject to the apportionment rules[3]. A $5,000 limit means the maximum GST adjustment would be $750 per asset.

26. It is expected that stakeholders will be supportive of this proposal, as it will reduce compliance costs as well as aligning the law to reflect current commercial practices.

20 percent margin rule and rounding rules for near exclusive business or private use

27. It is proposed that a +/-20% margin (or buffer) is applied to a chosen apportionment percentage, for assets that are not subject to the principal purpose test. Essentially, the mix of taxable use and non-taxable use can move freely within this range without consequence. The GST-registered person would only make an adjustment if the change in use was greater than 20%.

28. For example, if an asset had an initial apportionment of 66% business use, then an adjustment would only be made if the business use dropped below 46% (-20%) or increased above 86% (+20%).

29. Additionally, it is proposed that rounding rules apply to assets not subject to the principal purpose test, that have an overwhelming taxable or non-taxable use. Where an asset has a taxable use of 80% or more, then the asset's taxable use would be rounded up to 100%. This rounding-up rule would be taxpayer-friendly

[3] Unless the asset then became no longer principally used to make taxable supplies – then the input would be repaid.

because businesses would receive full input tax deductions; whilst allowing a limited amount of private use (such as most work-related vehicles).

30. Likewise, where an asset has a taxable use of 20% or less, then the asset's taxable use would be rounded down to 0%, meaning the GST-registered person would treat the asset like a private asset. It is anticipated that this rule would remove most residential property that has limited taxable use (such as a home office or farmhouse). If a dwelling has higher than 20 percent taxable use, but still has mainly private use (such as a holiday home rented to guests and used privately) it could be removed from GST on sale by using the election method discussed above.

31. It is expected that stakeholders will be supportive of the proposal, as it will effectively remove assets that are 80% or more taxable or private from the apportionment rules.

Rules for residential property developers

32. Currently, GST apportionment rules are complex to apply if land that is being developed by a residential property developer also has some non-taxable use (such as owner-occupier or an on-going residential tenancy) before the improved property is sold.

33. The issues paper proposes to simplify the rules, whereby GST-registered property developers would no longer apply the apportionment rules and instead claim a full input tax deduction for the purchase of the land and for other capital development costs once their development activity had commenced. This simplification proposal is expected to be supported by stakeholders.

34. Another issue is that currently, Inland Revenue can have difficulty distinguishing between GST-registered persons who are *bona fide* property developers and those who intend to develop land. Both groups claim input tax deductions when purchasing the land but some ultimately don't commence the development or don't sell the developed property. This represents a fiscal risk as large GST deductions / refunds are paid on purchase, but no subsequent GST is collected as the land is ultimately not improved and sold.

35. The issues paper proposes potential timing and information changes which could reduce this risk, whilst also encouraging land to be developed and sold in a reasonable timeframe (such as 36 months with an ability to apply to Inland Revenue for an extension).

36. Where the developer has an established property development business, they would continue to receive their input deduction at the time of purchase, however the issues paper proposes that other first-time or small-scale developers could have to wait until their development activity has commenced (rather than claiming deductions at the time the land is purchased as per current rules).

37. This delay may negatively impact their cash flow. Stakeholders are likely to raise concerns about this proposal because developers use the input tax deduction to partly fund the purchase and/or initial development costs.

38. Stakeholders may also raise concerns with the proposed deadline for developing and selling the land, given some property developers prefer to hold land until it is commercially suitable to undertake the development activity. The consultation process will allow us to better refine the proposals towards areas of concern, while mitigating unintended consequences.

Other proposed changes

39. The officials' issues paper also includes several proposed changes that seek to reduce compliance costs for businesses. These issues are listed below, under the same headings and in the same order as in the officials' issues paper. These are:

    39.1 Accommodation services supplied in dwellings and commercial dwellings.

    39.2 Sale of a dwelling an exempt or separate supply.

    39.3 Reduce the required number of adjustment periods.

    39.4 Expand the wash-up rule eligibility.

    39.5 Repeal the mixed-use asset rules in section 20G; Repeal the concurrent use of land rules in section 21E.

    39.6 Allowing a wider range of apportionment methods to be approved by Inland Revenue.

Consultation

40. The Treasury has been consulted in the preparation of this report.

41. The Ministry of Housing and Urban Development has been consulted on the proposals and has not raised any concerns. We will continue to work with the Ministry of Housing and Urban Development before seeking final policy decisions.

42. We have also had preliminary discussions with several private sector GST advisors and the Chartered Accountants of Australia and New Zealand, where they have provided feedback and advice on various policy issues and proposals. We intend to continue to meet with stakeholders after the officials' issues paper has been released for public consultation, as part of developing final policy decisions.

s 9(2)(f)(iv)

[redacted]

s 9(2)(f)(iv)

Timing of the officials' issues paper

48. Subject to your approval, the next step is to obtain Cabinet's approval to release the officials' issues paper for public consultation.

49. Subject to Cabinet approval, the preferred date to release the officials' issues paper is February 2022, with public submissions closing in April 2022. This will allow sufficient time to undertake further policy development.

50. Below is an indicative timetable, based on a release date in February 2022.

Milestone	**Date**
Cabinet Economic Development Committee	9 February 2022
Cabinet	14 February 2022
Release of officials' issues paper	February 2022
Submissions close	April 2022
Seek final policy decisions from Ministers and Cabinet	June / July 2022
Introduction of the next omnibus tax bill	August 2022
Legislation enacted	March 2023

Next steps

51. If you agree to the inclusion of the proposals outlined above, the next step is to obtain Cabinet approval to release the officials' issues paper for consultation. For the paper to be considered by the Cabinet Economic Development Committee on Wednesday 9 February 2022, it would need to be lodged with the Cabinet Office by 10.00am Thursday 3 February 2022.

52. If Cabinet approval is obtained, you will have the delegated authority to prescribe the date for officials to release the officials' issues paper for public consultation.

53. We propose to proactively release the cabinet paper, cabinet minute and key advice papers when the officials' issues paper is released.

54. We will report back to you on public submissions received. The feedback will support the development of final policy decisions, with a view of obtaining Cabinet approval in time for their inclusion in the next available tax bill.