

In Confidence

Office of the Minister of Revenue

Chair, Cabinet Economic Development Committee

## **GST APPORTIONMENT: AN OFFICIALS' ISSUES PAPER**

### **Proposal**

1. This paper seeks the Cabinet Economic Development Committee's agreement to the release of an officials' issues paper *GST apportionment and adjustment rules*, which is attached. The consultation document discusses policy issues with the existing goods and services tax (GST) apportionment and adjustment rules and suggests potential solutions.
2. I seek Cabinet's approval for the officials' issues paper to be finalised and publicly released for consultation. Subject to Cabinet's approval, I plan to direct officials as to when the officials' issues paper should be released for consultation.

### **Relation to Government Priorities**

3. This proposal supports the Government's Fiscal Strategy<sup>1</sup> and the following workstream in the Government's 2021–22 tax policy work programme: Maintaining the tax system: tax legislation needs to be regularly maintained and updated in response to changing technology and business practices. It is important that the tax legislation reflects the principles of fairness and certainty.
4. The attached officials' issues paper supports this workstream as the proposed policy options it consults on seek to update the existing GST rules to improve fairness, reduce compliance costs and better reflect commercial practices.

### **Executive Summary**

5. Goods and Services Tax is a consumption tax on most goods and services which are supplied by registered persons (such as businesses), at a single rate of 15%, under the Goods and Services Act 1985 ("GST Act"). A GST registered taxpayer can claim GST input tax deductions on purchases of assets (such as buildings and vehicles) that they intend to use in their business.
6. Where the asset is used both for business use and for private use (or making exempt supplies), then the taxpayer can only deduct a percentage of the total deduction, based on their estimate of the percentage of business use. This is known as apportionment.
7. Once the taxpayer has apportioned their input tax deduction based on their estimated business use, they are required to monitor their actual use of the asset

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<sup>1</sup> See <https://treasury.govt.nz/publications/wellbeing-budget/wellbeing-budget-2019-html#section-13>

over time, and if their estimate is inaccurate, then the taxpayer must account for this difference in their GST return, annually. This is known as an adjustment or change in use.

8. The current GST apportionment and adjustment rules are complex and have high compliance costs. Submissions on the February 2020 *GST policy issues paper* suggested the current apportionment rules should be replaced with simpler rules. Additionally, the recent stewardship review of the GST system identified the apportionment and adjustment rules as the number one issue that needed revision.
9. In recent months, my officials have met with key stakeholders such as private sector GST advisors to discuss what practical reform options are available, for inclusion into an officials' issues paper.
10. The attached officials' issues paper consults on options for simplifying the rules. To address some of the gaps and weaknesses of each option, it is likely that a combination of potential solutions will be required, as a reform package. The policy options in the officials' issues paper include:
  - 10.1 Allowing GST registered businesses to elect that their capital assets not be subject to GST on sale, by not claiming input tax deductions when the asset is purchased (**the election method**).
  - 10.2 Introducing a simple **principal purpose test** for assets purchased for less than \$5,000 (GST exclusive), where for assets which are principally acquired for business purposes the business would claim a full GST input tax deduction (rather than applying the apportionment rules).
  - 10.3 A **20% margin rule**, whereby GST registered businesses would no longer be required to make annual adjustments unless their business use of the asset has significantly changed (by more than 20 percent).
  - 10.4 Introducing **rounding-based rules** for assets purchased for \$5,000 or more (GST exclusive), that seek to remove most assets from the apportionment and adjustment rules:
    - 10.4.1 Assets with 80% or more of business use would be deemed to have 100% business use, allowing the taxpayer to claim full input tax deductions while having a small amount of private or exempt use.
    - 10.4.2 Likewise, assets with 20% or less of business use would be deemed to have 0% business use and consequently the asset is treated like a private asset.
  - 10.5 Several potential, technical changes to the **definitions of residential and commercial accommodation services**, which are more certain and easier to apply to various commercial situations, than the existing definitions.
  - 10.6 **Discussing if special GST rules should apply to the sale of houses** (and other types of dwellings), whereby these could be treated as fully private assets and GST exempt on sale, unless the house has been built or developed by a property developer for sale.

- 10.7 Several proposals aimed at simplifying the **rules for residential property developers**, whilst also encouraging land to be developed and sold sooner (generally within 36 months).
- 10.8 As well, the paper also contains **several minor changes to the apportionment and adjustment rules** that seek to reduce compliance costs for GST registered businesses.
11. The estimated overall fiscal impact of the potential solutions is uncertain as it depends on which options are progressed and how they compare to current taxpayer practices.
12. Subject to Cabinet's approval, officials will release the issues paper to seek feedback on these potential solutions. Following public consultation, I will report back to Cabinet with recommended policy decisions and their estimated fiscal implications. These decisions could apply from the 2022/23 fiscal year onwards.

## Background

13. Goods and Services Tax is a 15% consumption tax on most goods and services supplied to New Zealand consumers by registered persons (such as businesses). To ensure GST is not a cost on business production, businesses can claim back GST input tax deductions on purchases of goods and services they use in their business.
14. However, where the asset is used both for business use (known as taxable use), such as a van delivering packages during the week, and for private use, such as recreational use of the van in the weekend (or making exempt supplies), then the taxpayer must apportion (by way of a percentage) the total deduction, based on their estimate of the percentage of taxable use. This is to ensure GST is collected on the portion of the asset's private use, as would be the outcome if it was bought outright for non-business use.
15. Once the taxpayer has apportioned their input tax deduction based on their estimated business use of the asset, they are required to monitor their actual use over time. If there is a difference in the actual use, then an adjustment to the original apportionment percentage is required and the change included in their GST return.
16. Public submissions received on the February 2020 *GST Policy Issues: an officials' issues paper* explained that in many situations, the current rules are complex and impose unreasonable compliance costs. The recent stewardship review of the GST system identified the apportionment and adjustment rules as the number one issue that needed revision. Stakeholders were clear that the existing apportionment rules needed to change. A redesign of the existing rules is required to ensure they support emerging commercial practices, such as the gig and sharing economy.
17. Last year, my officials met with key stakeholders such as private sector GST advisors to discuss what simpler, practical options could be further explored, for inclusion into an officials' issues paper.

18. Several reform options have been identified and are further explained below. Many of the proposed options seek to remove most assets from the apportionment rules and reduce the need for annual monitoring by GST registered businesses.
19. These policy options have been included in the attached officials' issues paper, *GST apportionment and adjustment rules*. Resolving these issues would reduce compliance costs for taxpayers while ensuring GST is continues to be collected on the private consumption of goods and services.

### **GST apportionment and adjustment rules: An officials' issues paper**

#### **The election method**

20. The UK and Singapore's GST rules allow taxpayers to exclude assets from being subject to the apportionment rules, and GST on sale, by choosing not to claim an input tax deduction at the time of purchase. The issues paper proposes a similar election method could be introduced in New Zealand. Taxpayers would be electing to be taxed on the asset as if it only had private use.
21. Officials anticipate the method would mainly be applied to residential land and dwellings which may have some minor business use (e.g. a home office or workshop). This would ensure GST registered sole traders are not disadvantaged compared to other types of ownership structures where houses and other private assets are usually held by a different person to the entity which is GST registered.
22. It is anticipated that historically, many of the affected taxpayers (e.g. GST registered sole traders) have not claimed input tax deductions on assets that are predominantly private (e.g. the family home with a home office), and so this method could be applied retrospectively, that is, where no input tax deductions have been claimed on existing assets, then these assets would not be subject to GST on sale. This should be positively received by taxpayers that could otherwise, under the existing rules, be subject to GST on sale despite not previously claiming input tax deductions.
23. The issues paper also proposes an option whereby taxpayers that have previously claimed input tax deductions on their assets could repay these input tax deductions within 12 months of the reforms taking effect, and in return, their existing assets would not be subject to GST on sale in the future.

#### **Principal purpose test for assets less than \$5,000**

24. Another proposed option consulted on in the issues paper is that businesses could claim a full GST input tax deduction (rather than apportioning the deduction) for any asset costing less than \$5,000 (GST exclusive) which they principally acquired for business purposes.
25. This test would reduce compliance costs for taxpayers by greatly reducing the number of assets subject to the apportionment and adjustment rules. Instead, a GST adjustment would only be made if the principal purpose that the asset was acquired for changed (which would be uncommon).
26. It is anticipated that many GST registered businesses may already be claiming full input tax deductions on low-value business assets (on the basis that these assets

have no or very little private use), rather than applying the existing apportionment and adjustment rules.

**20% margin for assets above \$5,000**

27. For higher value assets it is proposed that rather than being required to make annual GST adjustments if there is any increase or decrease in business use, the taxpayer would only make an adjustment if the change in use of the asset 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. A 20% threshold has been proposed as it is understood that for an asset to experience a 20% change in use, then it is likely a deliberate change in use of the asset has occurred, rather than an unintended change. Consequently, a 20% threshold should remove most compliance costs associated with closely monitoring the use of each asset, and from being required to file adjustments each year.

**Deeming rules for assets that are almost exclusively taxable or private**

30. Another simplification option proposed is that where an asset that cost more \$5,000 (GST exclusive) that has at least an 80% taxable use, it could be rounded up and deemed to have 100% taxable use.
31. This would be a taxpayer-friendly rule because businesses could receive full input tax deductions, whilst allowing a limited amount of private use (such as for most work-related vehicles).
32. Likewise, where an asset has 20% or less taxable use, then the asset would be deemed to have no taxable use (0%) and therefore treated like a private asset (GST is collected on purchase, but not when the asset is subsequently sold).
33. Essentially, under both of these rules, qualifying assets would be effectively removed from the GST apportionment and adjustment rules entirely.

**Changes to the definition of residential and commercial accommodation services**

34. GST apportionment issues can arise when the same premises is used to make both taxable supplies of commercial accommodation (e.g. a hotel) and non-taxable supplies such as private use or exempt supplies (e.g. a live-in hotel manager).
35. The GST treatment in such cases depends on the definitions of “dwelling” and “commercial dwelling” which can overlap and be uncertain.
36. The issues paper outlines several potential, technical-based amendments to the existing definitions, as well as seeking submissions on whether any alternative definitions could be developed which could provide more certainty or be easier to apply than the existing definitions.

### Special GST rules for sales of houses

37. The GST system does not tax most private assets such as houses and dwellings. This is because they are not usually used by a GST registered business to conduct their business. However, some GST registered sole traders may use part of their home such as a home office or workshop to conduct their business which can cause the sale of that home to become subject to GST, even though it is mostly used for private purposes.
38. One way that other countries have addressed this is by making the sale of houses (and other types of dwellings) an exempt supply, unless the house has been built or developed by a property developer for sale.
39. The issues paper discusses a potential exemption and notes that the other reform options discussed above may be a simpler way to remove GST compliance costs and liabilities on private houses which have some business use. The feedback received from a small group of tax advisors, was that developing a specific exemption for houses may not be necessary and would require some new definitions to be developed which would add complexity and uncertainty to the GST rules for land.

### Land which is developed and sold by property developers

40. Land that is developed and sold by a GST registered property developer would remain subject to GST to ensure the GST system correctly taxes the value-added from this activity. This rule would apply regardless of any of the other proposals discussed in the issues paper.
41. However, the current GST apportionment rules are complex to apply if land that is being developed to be sold by a GST registered residential property developer, also has some non-taxable use (such as owner-occupation of the existing dwelling or an on-going residential tenancy) during the period of the registered person's ownership.
42. The issues paper consults on a proposed simplification, whereby GST registered property developers would claim a full input tax deduction for the purchase the land and for other capital development costs once their development activity had commenced, instead of applying the apportionment rules.
43. This proposal could encourage more efficient use of housing. For example, property developers may currently prefer vacant properties (to get a full input tax deduction and simpler GST compliance) than letting the house to a residential tenant (e.g. by maintaining an existing tenancy or entering a new one) until the house is ready to be developed or sold (as this non-taxable use would mean GST apportionment would apply to the land).
44. Another issue is that under the current GST rules, Inland Revenue can have difficulty distinguishing between 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 land. This represents a fiscal risk as large GST deductions / refunds are claimed on purchase, but no subsequent GST is collected as the land is not ultimately developed or sold.

45. The issues paper consults on some potential timing and information changes which could reduce this risk, whilst also encouraging land to be developed and sold in a reasonable timeframe.
46. Currently, a GST registered person can claim an input tax deduction at the time they purchase land. Under the proposed option, if a GST registered person had an existing business of developing land for sale they would still be able to claim an input tax deduction at the time of purchase.
47. However, if they did not have an existing land development business (e.g. a first time developer) they would not initially be able to claim an input tax deduction for the cost of the land. Once they begin developing the property and have an intention to sell the property when they finish this development, they would then be able to claim a full input tax deduction on the purchase price of the property in their next GST return (rather than apportioning the deduction).
48. This proposed change could have negative cashflow implications for some smaller or first-time property developers as it would delay when they are able to claim a GST deduction from the date of purchase to the date development commenced. However, it could also encourage the development to commence sooner (rather than simply holding the land).
49. The issues paper also proposes a time limit could be introduced so if a registered person claims a full input tax deduction for land under the proposed new residential property development rules, they will generally need to sell the land within 36 months of the deduction being claimed. The GST registered developer could apply to Inland Revenue for an extension to this time limit if they can provide evidence that they have actually developed the property (or are continuing to develop it) and intend to sell the property within a certain timeframe.
50. To support compliance with the new rules, the issues paper also proposes that GST registered taxpayers would be required to provide certain information to Inland Revenue when they have claimed input tax deductions on land (as well as luxury yachts or aircraft) as this information will assist Inland Revenue to monitor if these taxpayers account for GST on any subsequent non-taxable use, or when the asset is sold.
51. Stakeholders may raise concerns with some of these proposals. The consultation process will allow officials to better refine the proposals towards areas of concern, while mitigating unintended consequences.

**Other potential simplification changes to the existing rules**

52. Finally, the issues paper contains several minor and incremental improvements to the existing apportionment rules. These include allowing taxpayers to make an adjustment for a permanent change in use in a wider range of circumstances and 12 months earlier than the current rules; and repealing certain special rules for land and mixed-use assets because the policy solutions contained in the officials' issues paper would supersede them.

## Implementation

53. The proposals in the officials' issues paper would require legislative amendments to the Inland Revenue Acts. Several proposals would also require the affected GST registered persons to disclose information to Inland Revenue on certain purchases of land.
54. The purpose of the issues paper is to seek feedback on the proposals, including implementation implications, which will be reported back to Cabinet when final policy decisions are sought.

## Financial Implications

55. There are no financial implications associated with releasing the GST apportionment and adjustment rules, officials' issues paper. However, if following public consultation certain policy options are progressed, then their introduction will likely have an impact on forecast Crown revenue. If these options have a net fiscal cost, then consideration will be given to funding the changes through the Tax Policy Scorecard. Any final policy decisions are likely to be effective from the 2022/23 fiscal year onwards at the earliest.

## Legislative Implications

56. The decision to consult on the various GST proposals do not give rise to any immediate legislative implications. If, following consultation, Cabinet decides to implement the changes contained in the officials' issues paper, enabling legislation will be required. Proposals could be included in an omnibus tax bill in late 2022.

## Impact Analysis

### Regulatory Impact Assessment

57. The Regulatory Impact Analysis panel at Inland Revenue has reviewed and confirmed that the *GST apportionment and adjustment rules* officials' issues paper can substitute for an interim Regulatory Impact Statement. It will lead to effective consultation and support the eventual development of a quality Regulatory Impact Statement.

### Climate Implications of Policy Assessment

58. The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply to this proposal as the threshold for significance is not met.

## Population Implications

59. Releasing the issues paper does not have any population implications. Any populations implications resulting from the proposals will be included in final policy advice to Cabinet following consultation.



## Human Rights

60. The issues contained in the officials' issues paper and their policy solutions do not give rise to any human rights implications.

## Consultation

61. The attached officials' issues paper has been prepared by Inland Revenue.
62. The Treasury and the Ministry of Housing and Urban Development have been consulted about the policy options in this cabinet paper and the attached officials' issues paper.

## Communications

63. Subject to Cabinet's approval, I will direct officials as to when the officials' issues paper should be published for consultation on Inland Revenue's website.

## Proactive Release

64. I propose to proactively release this Cabinet paper, associated minutes, and key advice papers, with appropriate redactions, within 30 working days of the release of the officials' issues paper.

## Recommendations

The Minister of Revenue recommends that the Committee:

1. **Note** that a number of policy issues have been identified with the existing GST apportionment and adjustment rules;
2. **Note** that the attached officials' issues paper, consults on a range of options for simplifying the existing apportionment and adjustment rules, including:
  - 2.1 Allowing GST registered businesses to elect capital assets not be subject to GST on purchase or sale (**the election method**)
  - 2.2 Introducing a **principal purpose test** for assets purchased for less than \$5,000 (GST exclusive), where an asset that is principally acquired for business purposes would claim a full GST input tax deduction
  - 2.3 Introducing a **20% margin rule**, whereby GST registered businesses would no longer make annual adjustments unless their business or private use of the asset has significantly changed (by more than 20%)
  - 2.4 Introducing **rounding-based rules** for assets that are close to being either fully taxable (80% or more taxable use) or fully non-taxable (20% or less taxable use)
  - 2.5 Potential options for improving the **definitions of residential and commercial accommodation services**

- 2.6 Discussing if **special rules should apply to the sale of houses** and other types of dwellings, where they are treated as fully private assets and GST exempt on sale by a registered person other than a property developer
- 2.7 Potential options for **simplifying the GST apportionment rules for residential property developers** whilst also encouraging land to be developed and sold sooner
- 2.8 Other **minor and incremental improvements** that seek to reduce compliance costs for GST registered businesses and remove rules that are superseded by policy options outlined in the officials' issues paper;
3. **Approve** that, subject to minor editorial changes, the attached officials' issues paper *GST apportionment and adjustment rules*, be approved to be released on Inland Revenue's website for public consultation;
4. **Authorise** the Minister of Revenue to approve minor changes to the officials' issues paper prior to its release;
5. **Authorise** the Minister of Revenue to prescribe the date for when the officials' issues paper will be released.

Authorised for lodgement

Hon David Parker  
Minister of Revenue