GST policy issues

An officials' issues paper

February 2020

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First published in February 2020 by Policy and Strategy, Inland Revenue, PO Box 2198, Wellington 6140.

GST policy issues – an officials' issues paper

ISBN 978-1-98-857312-0 (Online)

The Persistent URL for this document is https://purl.org/nzir-tp/2020-002

The document is available at https://taxpolicy.ird.govt.nz/publications/2020-ip-gst-issues/overview

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CHAPTER 1

Background

1.1 Goods and Services Tax (GST) is a consumption tax on goods and services which are supplied to consumers in New Zealand by registered persons (such as businesses).

1.2 New Zealand's GST is highly efficient and accounts for about thirty percent of tax revenues. However, specific provisions in the Goods and Services Tax Act 1985 (GST Act) need to be regularly maintained or updated in response to changing technology, business practices, jurisprudence, and other factors.

1.3 A number of issues have been identified where the legislation produces an outcome that does not reflect the underlying policy intent. These issues need to be addressed to maintain the certainty, efficiency and fairness of the tax system.

1.4 The purpose of this officials' issues paper is to outline technical tax policy issues and provide potential policy options and, where possible, proposed solutions to these issues.

Summary of issues, options and proposals

1.5 Officials' are seeking public feedback on the issues set out in this paper. The table summarises the issues, options and proposals.

Chapter and topic	**Issue**	**Option/proposal**
Chapter 2 – Tax invoice requirements	Aligning GST invoicing requirements with changes in business practices and technology.	Remove some of the requirements or make them more flexible.
Chapter 3 – Cryptocurrencies	Cryptocurrencies have an unfavourable GST treatment compared to money or other investment products.	Exclude cryptocurrencies from GST and the financial arrangement rules. Income tax will still apply to any profits made when cryptocurrencies are sold or traded.
Chapter 4 – Apportionment and adjustment	The apportionment and adjustment rules can be complex and difficult to apply. In addition, in some situations they can result in under or over-taxation.	A number of different amendments to specific apportionment and adjustment rules are considered. In addition, feedback is sought on further ways in which the rules could be simplified and improved.

Chapter and topic	**Issue**	**Option/proposal**
Chapter 5 – Domestic legs of the international transport of goods	Courier business practices involve sub-contracting part of the journey for an international delivery to other providers. The GST zero-rating rules for international transport do not accommodate these sub-contracting practices.	Zero-rating domestic transport services that are supplied to a non-resident transport supplier that has been contracted to provide international transport of goods to or from New Zealand.
Chapter 6 – Business conferences and staff training	It is impractical for non-resident businesses to register for GST to claim a GST refund for a one-off expense of sending their staff to a conference or training course in New Zealand.	Zero-rate conference and staff training services supplied to non-resident businesses.
Chapter 7 – Managed funds	The GST treatment of different types of management services supplied to managed funds is complex and applies inconsistently.	Develop new rules for fund manager and investment manager services. Several alternative options are discussed: 1. Taxable (15% GST). 2. Exempt financial services. 3. Deem a percentage to be exempt (and the remainder taxable). 4. Zero-rating or a reduced input tax credit mechanism.
Chapter 8 – Insurance pay-outs to third parties	Compliance difficulties from a GST-registered third party unknowingly receiving an insurance pay-out (which they treat as compensation).	Three alternative options are discussed: 1. Making the insurer responsible for the GST obligations. 2. Requiring disclosure that the payment is covered by insurance. 3. No law change but provide education and guidance.

Chapter and topic	Issue	Option/proposal
Chapter 9 – Compulsory zero-rating of land	Some situations have been identified where the current compulsory zero-rating of land rules appear to produce flawed outcomes or the timing of when the relevant provision should apply could be improved.	Clarify that section 5(23) applies to place the output tax liability on the purchaser, in cases where a vendor incorrectly zero-rates land. Section 5(23) should apply to standard-rate the supply of land on the date that the original supply was incorrectly zero-rated. Adjustment of second-hand goods input credit in cases where land should have been zero-rated in the taxable period in which it became apparent that the amount of input tax deducted was incorrect. Clarify that section 20(3J), applies from the time of supply of the land.
Chapter 10 – Technical and remedial issues	Other technical or remedial changes are required to various rules in the GST Act to ensure these rules work as intended.	The proposals relate to: • GST grouping rules. • Input credits on goods not physically received yet at the time the GST return is filed. • Second-hand goods input credits on supplies between associated persons. • Providing more flexibility for the Commissioner to approve the end date of a taxable period. • Members of non-statutory boards. • Right to challenge Commissioner's decision to re-open time-barred GST returns.

1.6 Subject to submissions on this issues paper, the proposals would be included in the next suitable omnibus tax bill.

Making a submission

1.7 Submissions are invited on the options and proposals in this issues paper.

1.8 Submissions should include a brief summary of submitter's major points and recommendations. They should also indicate whether it is acceptable for officials from Inland Revenue to contact submitters to discuss the points raised, if required.

1.9 The closing date for submissions is **9 April 2020**.

1.10 Submissions can be made:

- by email to policy.webmaster@ird.govt.nz with “GST policy issues” in the subject line; or
- by post to:

  GST policy issues
  C/- Deputy Commissioner, Policy and Strategy
  Inland Revenue Department
  P O Box 2198
  Wellington 6140

1.11 Submissions 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 submission should properly be withheld under the Act please clearly indicate this.

CHAPTER 2

Tax invoice requirements

2.1 While tax invoices remain a useful tool both for Inland Revenue and businesses to ensure GST compliance and monitor refund claims, the standard requirements for invoices have not changed very much since 1986. Vast changes in business practices and the use of technology since then have given rise to a risk either of non-compliance with the legislation or excessive compliance costs on businesses, suggesting that a review of these requirements is needed.

2.2 As well as modern business practices, international developments make it timely to review GST invoicing requirements.

2.3 In other jurisdictions there is emerging interest in GST (or VAT) adopting some form of split-payment system where a vendor or an intermediary involved in an electronic payment can split the GST off from any payment to the vendor and remit the amount to the revenue authority.

2.4 The New Zealand and Australian governments are also working together to facilitate electronic invoicing (e-invoicing). These changes are intended to facilitate Trans-Tasman trade for small and medium businesses with an ABN or NZBN by allowing data exchange to be used in place of traditional invoices.

2.5 With e-invoicing, businesses will no longer need PDF or paper invoices that have to be scanned, posted or emailed, and entered manually. Instead, the suppliers' and buyers' finance systems will "speak" directly to each other, enabling faster delivery, processing and payment of invoices, helping save time and money.

Current invoice requirements

2.6 As an integrity measure, the GST Act denies an input tax credit claim unless the supplier has provided the registered person making the claim with a tax invoice and the tax invoice is held by the registered person at the time of making the relevant GST return (see section 20(2)(a)).

2.7 To be a tax invoice, the GST Act requires that documents with consideration exceeding $1,000 must contain:

- the words "tax invoice" in a prominent place;
- the name and registration number of the supplier;
- the name and address of the recipient of the supply;
- the date of issue;
- a description of the goods and services supplied;
- the quantity or volume of the goods and services being supplied; and
- the amount of the tax and the pre-tax consideration or the tax-inclusive amount with a statement that it includes GST.

2.8 Invoices are not required if the consideration is under $50, and a slightly simplified form of tax invoice can be used where the consideration is between $50 and $1,000.

2.9 The Commissioner does have some authority not to require a tax invoice (section 24(6)). This is where the Commissioner is satisfied that "there are or will be sufficient records available to establish the particulars of any supply or class of supplies, and that it would be impractical to require that a tax invoice be issued."

2.10 The authority not to require tax invoices to be issued may provide some flexibility in the use of invoices (for example, in allowing data exchange in place of a traditional invoice) but it is not a long-term solution. There is limited guidance about when it would be impractical to issue or obtain a tax invoice, as opposed to simply having relatively high compliance-costs.

Options for simplification

2.11 It is proposed that a wider range of ordinary business-to-business information, predominantly electronic information, should be able to be used to support GST output tax and input tax. To achieve this, we are suggesting a number of changes to the GST Act requirements for tax invoices.

Required information on the tax invoice

2.12 The current requirement of the name and registration number of the supplier and the name and address of the recipient should remain as key requirements of a tax invoice. The former is needed to identify the taxpayer who supplies the goods and services and is therefore liable for the GST charged. The latter is needed to ensure that the correct person receives any corresponding input tax deduction.

2.13 The requirement to state the GST-exclusive amount of the consideration and the tax or the GST-inclusive amount of the consideration is necessary to identify that the supply has been subject to GST and therefore any related output or input tax.

2.14 On the other hand, the requirement to provide details of the quantity and volume of goods and services supplied could be removed.

2.15 The quantity and volume of goods and services would normally be found in commercial documents and so it seems unnecessary to have this as a set requirement in the GST legislation. There are already general tax record-keeping requirements in the legislation, and these should largely suffice when information is required to support the information in a GST return.

Use of electronic invoicing

2.16 With invoices now being largely electronically generated it would make sense to also remove the requirement that a "copied" invoice be marked as "copy only" since the requirement makes little sense in the electronic environment.

2.17 The requirement in section 20(2)(a) that the recipient seeking an input tax claim "hold" a tax invoice has been interpreted by some to suggest that, although hard-copy invoices are not required, a hard copy (for example, in PDF format) must be able to be downloaded. It is questionable whether this requirement is suitable for modern business practices and we are interested in views about whether the wording can be modified by, for example, requiring only that the information required to be kept on a tax invoice be retained.

Buyer-created tax invoices

2.18 With the tax system becoming increasingly automated, it seems unnecessary for taxpayers to obtain Inland Revenue approval to use buyer-created tax invoices. A key requirement of this approval is for the parties to demonstrate why it is preferable for the buyer to provide the invoice rather than the supplier. For example, in the dairy industry, this is likely to be because the buyer has better information about what is being purchased (including quantity and price) than the seller.

2.19 Rather than involving Inland Revenue, buyer-created invoices should be based on what is most appropriate for the businesses in question.[1] However, for revenue integrity reasons some requirements should be retained, such as agreements:

- between the supplier and the recipient that the recipient should issue the tax invoice along with a shared understanding of the commercial reasons for this; and
- that both parties retain a copy of the buyer-created invoice (or the information required to produce the document).

Shared invoices

2.20 In some circumstances, shared invoices will be used for more than one supply by more than one supplier. Section 24BA treats a shared invoice that meets the tax invoice requirements as a tax invoice, but only in the limited circumstances of the suppliers being part of the same group of companies or the shared invoice being a practical response to statutory requirements.

2.21 It is proposed that shared invoices should be able to be used in a wider range of circumstances. The proposed new requirements could include:

- An agreement between the relevant GST-registered parties that a shared invoice be used.
- Requiring the supplier that issues the invoice to retain all the information that would be required to be retained if a separate tax invoice were required for each supply.
- Requiring the underlying suppliers to hold the information relevant to their supplies. This seems reasonable given that the information would be generated from the underlying suppliers.
- Making clear that the underlying supplier would remain ultimately responsible for the GST, while otherwise allowing the supplier issuing the invoice to pay the tax as their agent.

[1] This is consistent with the 2019 recommendation of the Government's Tax Working Group, that the requirement for taxpayers to seek the approval of the Commissioner to issue buyer-created tax invoices be removed.

Tax invoice related penalties

2.22 Knowledge offence penalties can arise if the supplier does not provide a recipient with a tax invoice within 28 days of a request to do so or if the supplier issues more than one tax invoice in relation to the same supply.

2.23 Deeming the issuing of more than one invoice to be an offence, in the same way as the "copy only" requirement, seems outdated for electronic transactions. Historically, the concern was not with issuing an invoice for the same supply more than once, but for claiming more than one input tax deduction in respect of a supply. It is therefore proposed that any penalty (which would generally be placed on the purchaser) be limited to multiple claims for the same supply.

Questions for submitters

- Do you agree with the proposals outlined in this chapter?
- Are there further proposals which should be developed that would simplify or enhance the tax invoice requirements, keeping in mind the likely impact on compliance costs and the implications for Inland Revenue in administering the tax system?

CHAPTER 3

Cryptocurrencies

3.1 This chapter discusses proposals to exclude cryptocurrencies (crypto-assets) from GST and the financial arrangement rules to ensure these rules do not impose barriers to developing new products, raising capital or investing through crypto-assets. The tax system strives for neutrality and to minimise distortions.

3.2 Income tax will still apply to any profits made when cryptocurrencies are sold or traded (this is further discussed in paragraphs 3.60–3.62).

3.3 The proposed GST changes would only apply to supplies of crypto-assets. Other services related to crypto-assets, that are not in themselves supplies of crypto-assets such as mining, providing crypto-asset exchange services or providing advice, general business services or computer services will continue to be subject to the existing GST rules.

3.4 GST will continue to apply to supplies of goods and services which are bought using a crypto-asset (the same as if those goods or services had been purchased using money or swapped for another good or service).

Crypto-assets are a fast-growing sector

3.5 Crypto-assets are digital assets (commonly known as coins or tokens) that use cryptography to secure transactions and verify the transfer of the coins or tokens. Instead of relying on a financial institution to verify transactions, crypto-asset transactions are confirmed by computers operating on the currency's network.

3.6 At the time of writing, there are currently over 5,000 crypto-assets and the total global market value of all crypto-assets exceeds US$300 billion.

3.7 The use and development of crypto-assets are growing in New Zealand, including investors, exchanges and start-ups.

Should different types of crypto-assets have different GST treatments?

3.8 Tax rules in New Zealand and overseas do not contemplate crypto-assets and can be difficult to apply as crypto-assets will often not fit into existing definitions that were designed for other investment products such as currency, shares, debt or equity securities. Because of their innovative nature, they will often also have different features to these other investment products.

3.9 This means that some existing tax rules can be difficult to apply, involve very high compliance costs or may provide policy outcomes for some crypto-assets that lead to over-taxation compared to other alternative investment products.

3.10 More simple and certain tax rules could contribute to the further growth and development of the crypto-asset sector in New Zealand by:

- Ensuring New Zealand businesses, investors and crypto-asset users are not disadvantaged from issuing or selling tokens in New Zealand (relative to selling the tokens outside New Zealand or raising capital through other means).
- Making it more attractive for businesses to issue their initial coin offerings or other token generating events from New Zealand, which could facilitate increased investment, business growth and technology development in New Zealand.
- Making it easier to buy or sell crypto-assets with New Zealand dollars as opposed to having to exchange New Zealand dollars into foreign currencies and incur foreign exchange fees.

3.11 It is intended that crypto-assets should have a similar tax treatment to other investment products or asset classes which are close substitutes for the crypto-asset. It is not intended that crypto-assets would receive a concessionary tax treatment.

3.12 A key question is whether the same tax treatments should be applied to most types of crypto-assets or apply different tax treatments depending on the key features of the particular crypto-asset, such as whether it is a payment token, a utility token, security token, an asset token or a hybrid token with a mix of features.

3.13 Two potential approaches to this issue are discussed.

Token classification framework and deeming rules

3.14 One option would be to develop a framework for categorising different types of crypto-assets and use this to create some deeming provisions that apply across all Revenue Acts. For example, rules that deem certain types of crypto-assets to be included in the Revenue Act definitions of securities, or currency, depending on whether the crypto-asset has some particular features.

3.15 This approach could mean:

- Crypto-assets deemed to be currency would be subject to income tax on disposal for those who are cash-basis persons and on an accrual basis for those who are not. Currently, supplies of currency are not subject to GST and the exchange of currency is an exempt financial service for GST purposes.
- Crypto-assets deemed to be shares would not be financial arrangements for income tax purposes (so would generally be taxed on a realised basis) and would be exempt financial services for GST purposes.
- Other types of crypto-assets could be deemed to have a different GST or income tax treatment.

3.16 An advantage of this approach is that it should provide a neutral tax treatment for those crypto-assets which are close substitutes for existing financial products such as currency or shares.

3.17 However, this approach assumes that crypto-assets generally have similar uses or features to existing financial products (which may not be the case), and that the existing tax rules for these other financial products are practical to apply and provide sensible policy outcomes when applied to crypto-assets.

3.18 In addition, because of the specific definitions that apply for different tax rules, this approach could still lead to different tax treatments between a crypto-asset and the financial product they are deemed to be for the purposes of the Revenue Acts. For example, a particular crypto-asset could be deemed to be a share, but if it does not provide an interest in a foreign company or partnership, it would still be taxed very differently to other foreign equity investments which will often be foreign companies subject to the FIF rules or partnerships subject to flow-through tax treatment.

3.19 There may also be practical limitations from trying to accurately classify tokens and apply differing tax treatments to different types of token.

3.20 There are over 5,000 crypto-assets – many which have different rights or features. In contrast other investment products, such as a portfolio consisting of shares in listed companies, are much more standardised. There is no universal standard for classifying tokens. This means an investor who buys a lot of different crypto-assets may find it difficult to identify whether a deeming rule in the New Zealand tax legislation applies or not. Some tokens will be hard to classify as they are hybrid. The legal or economic features of a crypto-asset may change as it is developed, leading to a change in tax treatment. For example, some of the proposed features of a particular crypto-asset will not exist yet at the time of investment and may change as the underlying software is developed.

Broad definition

3.21 An alternative approach would be to prioritise specific changes to those tax rules and provisions which are identified as creating the most significant policy issues when applied to crypto-assets.

3.22 For example, it appears that the GST and financial arrangement rules lead to significant policy and practical issues when applied to crypto-assets. Some of these issues are explained in the next section. Therefore, there appears to be a case to exclude most types of crypto-asset from the GST and financial arrangement rules by developing a broad definition of crypto-assets for this purpose.

Issues with applying GST to crypto-assets

3.23 New Zealand has a broad-based GST system that applies to nearly all goods and services. A service is broadly defined to mean anything which is not goods or money.

3.24 GST does not apply to money or financial services, but the existing definitions of money and financial services were not designed with crypto-assets in mind. It is likely that many crypto-assets have a different GST treatment to money or financial services.

3.25 When a crypto-asset is traded or sold, the GST treatment may vary depending on the specific facts and features of the crypto-asset and the residency of the buyer and seller. The supply of a crypto-asset could be an exempt financial service, subject to 15% GST, or a zero-rated supply to a non-resident.

3.26 In this regard, the current GST rules provide an uncertain and variable GST treatment making, using or investing in crypto-assets less attractive than using money or investing in other financial assets. The variable GST treatment may distort decisions around the type of crypto-assets a business may choose to develop and issue, whether they issue the token in New Zealand or offshore, and what type of tokens New Zealand investors choose to buy or sell.

3.27 The final issue is that, because of the complexity of the GST treatment and the limited information available about the specific features of a crypto-asset and the residency of the seller or purchaser, the current GST rules can be difficult to apply or impractical to comply with.

Issues from applying financial arrangement rules to crypto-assets

3.28 Financial arrangements are broadly defined, and this broad definition means that some types of crypto-assets are likely to be financial arrangements under the current rules.

3.29 Many security, asset, or utility tokens could be considered financial arrangements between the holder who provides money and another person who provides money or money's worth in the future. Payment tokens such as bitcoin are unlikely to be financial arrangements as they do not involve an arrangement between two persons.

3.30 Requiring the financial arrangement rules to be applied to some crypto-assets would lead to accrual-based taxation on large unrealised gains and losses from crypto-asset values, which can be very volatile. It could also bias investment decisions about which types of crypto-assets New Zealand investors may prefer to invest in, if some tokens are only taxed on realised gains or losses when they are sold or exchanged for other tokens, and others that are subject to tax on accrued gains or losses.

3.31 If they apply to a crypto-asset, the financial arrangements rules would require the person to convert the value of their crypto-asset into NZD, spread income and expenditure over the term of the arrangement and undertake a base price adjustment on maturity.

3.32 From an income tax policy perspective, it seems more appropriate and practical to tax crypto-assets at the time they are sold (or exchanged for other tokens) rather than on accrued gains or losses.

3.33 Traders who have a business of dealing in crypto-assets should be taxed under the trading stock rules the same way that share traders are.

3.34 Some crypto-assets may have features that make them economically equivalent to debt arrangements – for example a token that is issued at $1 of value (in money, other tokens or services) and can be redeemed for $1.20 of value in two years' time. Such tokens should continue to be taxed under the financial arrangement rules. This could be achieved by excluding such tokens from the definition of crypto-assets which qualify as excepted financial arrangements.

How should a crypto-asset be defined?

3.35 It is proposed that a broad definition of crypto-assets be developed which captures nearly all the crypto-assets that are used or invested in.

3.36 This broad definition would then be used to remove crypto-asset from both the GST rules (by making crypto-assets an exempt supply) and the financial arrangement rules (by making a “crypto-asset” a new type of excepted financial arrangement).

3.37 A crypto-asset could be defined based on a requirement that the token use cryptography and a block chain.

3.38 The proposed definition is broader than the definition of “digital currency” which Australia has legislated to remove GST on certain types of crypto-assets as well as the proposed definition of “digital payment token” which Singapore has developed for the same purpose.

3.39 Australia’s and Singapore’s definitions exclude crypto-assets whose value is pegged to or dependent on a fiat currency (for example, stable coins) as well as tokens that give a right or entitlement to receive something else. This means their definitions exclude utility tokens which can be redeemed for specific goods and services and asset-backed coins which can be redeemed for gold or other specific assets.

3.40 Singapore’s draft guidelines clarify that some “hybrid” utility tokens may still qualify as digital payment tokens so long as they can still potentially be used as a medium of exchange even after they have been used to obtain a product or service.

3.41 Australia’s and Singapore’s definitions are not explicitly limited to crypto-assets as they do not require cryptography or block chain. However, they do exclude tokens that are not generally available to be used without substantial restrictions. This requirement excludes tokens issued on private block chains, currency that can only be redeemed within an online game, or loyalty points that can only be redeemed at certain merchants.

3.42 We consider it could be complex to require a crypto-asset to be generally available without restriction. For example, initial coin offerings are often made to a select group of investors before they later become available on an exchange. In this context a requirement that the coins be “generally available” could lead to the tax treatment for particular crypto-asset changing over time or being uncertain at a particular point in time.

3.43 We welcome submissions on how a crypto-asset should be defined including whether there are other distinguishing features of a crypto-asset which should be included in the definition.

How should GST be removed from supplies of crypto-assets?

3.44 There are two main options for removing GST on crypto-assets:

- Making all supplies of crypto-assets not subject to GST. Under this option supplies of crypto-assets would have the same GST treatment as supplies of money, which are not subject to GST.

- Making supplies of crypto-assets to New Zealand residents exempt from GST and supplies to non-residents zero-rated supplies (subject to GST at 0%). Under this option supplies of crypto-assets would have the same GST treatment as financial services.

3.45 The key difference between these two options is the GST treatment of supplies of crypto-assets to non-residents. To the extent that a GST-registered person makes zero-rated supplies of crypto-assets to non-residents, they would be able to claim GST input credits (a refund on the GST charged on goods and services) in relation to inputs that they use to make these zero-rated supplies.

3.46 Zero-rating of supplies to non-residents could therefore make it more attractive for GST-registered persons to sell crypto-asset to non-residents than New Zealand residents or discourage New Zealanders from using New Zealand-based exchanges. This could hinder the development of the New Zealand dollar market for crypto-assets which would make it more difficult and costly for New Zealand businesses and investors to convert crypto-assets to New Zealand dollars.

3.47 In addition, zero-rating supplies of crypto-assets to non-residents would mean that New Zealand investors who traded more than $60,000 of crypto-assets in a 12-month period on international exchanges would typically be required to register for GST (assuming most of their trades were with non-resident persons), and incur the compliance costs of filing GST returns and returning GST on any other taxable supplies they may make.

3.48 Furthermore, the global nature of crypto-asset markets means that businesses and investors who trade crypto-assets could potentially have a mix of supplies to non-residents and supplies to New Zealand residents. In many cases, it will be impractical to identify if the supply of a crypto-asset is to a resident or a non-resident.

3.49 It is therefore proposed that all supplies of crypto-assets be made not subject to GST, including supplies to non-residents.

3.50 This would ensure New Zealand businesses and investors are not disadvantaged when they sell crypto-assets to other New Zealand residents, which should facilitate the exchange of crypto-assets for New Zealand dollars. It would also reduce compliance costs and would be consistent with the GST treatment of money. In addition, making crypto-assets not subject to GST would be consistent with existing market practices.

Input credits for capital raising

3.51 The GST rules were amended in 2017 to allow GST-registered persons to claim input credits for inputs such as legal or advisory services used to raise capital using equity or debt securities (see section 20H of the GST Act). It is proposed that GST-registered businesses that raise funds through issuing security tokens which have features that are similar to debt or equity securities (such as a right to a share of the profits of a project) should also be able to claim input credits on their capital raising costs.

3.52 This would ensure that businesses are not disadvantaged if they choose to raise capital through issuing crypto-assets which are close substitutes for debt or equity securities. These input credits for inputs related to capital raising costs could be claimed regardless of whether the GST-registered person issued the qualifying securities tokens to residents or non-residents.

Other services related to crypto-assets

3.53 The proposed changes would only apply to supplies of crypto-assets.

3.54 Although the simple fact of owning a crypto-asset is not itself a financial arrangement, crypto-asset can still be used as part of a financial arrangement (in the same way that money or money's worth can form part of a financial arrangement). For example, lending funds in the form of crypto-assets and derivatives based on the value of crypto-assets will still be treated as financial arrangements.

3.55 Similarly, for GST purposes, other services related to crypto-assets, that are not in themselves supplies of crypto-assets such as mining, providing crypto-asset exchange services or providing advice, general business services or computer services will continue to be subject to the existing GST rules.

3.56 Under the existing GST rules these services could be either taxable supplies to New Zealand residents subject to 15% GST or zero-rated supplies to non-residents. Because of the global nature of crypto-asset markets, many of these services are likely to be zero-rated supplies to non-residents.

3.57 The intention is that the change in the GST treatment of the supply of crypto-assets should not change the GST treatment of the supply of these other services, even though the service provider may receive crypto-assets as consideration for performing these services. This is consistent with the fact that supplies of goods and services have the same GST treatment regardless of whether the consideration was paid in money or another form of payment (such as barter or crypto-assets). If the GST treatment changed depending on the type of payment received it could create a tax bias for preferring some payment types over others.

3.58 The standard GST rules will therefore continue to apply to supplies of goods and services which are bought using a crypto-asset (the same as if those goods or services had been purchased using money or swapped for another good or service).

3.59 However, the changes proposed above will mean that if a person has received a crypto-asset as a payment for goods or services, they will be able to exchange the crypto-asset for money or another crypto-asset with no GST consequences.

Other tax rules will continue to apply to crypto-assets

3.60 Under the proposed changes, crypto-assets would only be excluded from the GST and financial arrangement rules – they would still be subject to other tax rules.

3.61 In particular, a crypto-asset is considered property for income tax purposes. When a person acquires crypto-assets for the purpose of disposal (selling or exchanging it) the proceeds made from selling it are subject to income tax (see section CB 4 of Income Tax Act). Disposal includes swapping one type of crypto-asset for another or exchanging a crypto-asset for New Zealand dollars or another fiat currency such as US dollars or Euro.

3.62 Investors who have a business of dealing in crypto-assets (see section CB 5 of the Income Tax Act 2007) will be subject to income tax each year under the trading stock rules.

Application date

3.63 It is proposed that the relevant law changes to exclude crypto-assets from the GST and financial arrangement rules should apply retrospectively from 1 January 2009, the date the first crypto-asset, bitcoin, was launched.

3.64 The proposed application date should ensure all New Zealand traders of crypto-assets are not subject to GST or the financial arrangement rules, regardless of when their purchases or disposals took place.

3.65 It should also mean the proposed new rules would generally align with current and previous tax positions where we understand most of the affected New Zealand taxpayers have generally not applied GST or the financial arrangement rules to determine their tax positions.

3.66 The application date for any changes to the capital raising deduction rules would be from 1 April 2017 as this was the date that the capital raising deduction rule took effect.

3.67 Submissions are sought on whether any variations or savings provisions to the proposed application dates should be provided. For example, a savings provision could be included to preserve tax positions taken based on the GST Act provisions or financial arrangement rules that applied prior to the new amendments.

Other tax issues with crypto-assets

3.68 Officials appreciate that some other aspects of the tax rules may also be difficult to apply to investments and transactions involving crypto-assets. While we welcome submissions identifying these issues, this issues paper only proposes excluding crypto-assets from the GST and financial arrangement rules.

3.69 Inland Revenue intends to continue to publish guidance such as answers to commonly asked questions in respect of how other tax rules may apply to crypto-assets.

Questions for submitters

- Should different types of crypto-assets have different GST treatments, or should a broad definition of crypto-asset be developed to exclude all types from GST?
- How should a crypto-asset be defined?
- How should GST be removed from supplies of crypto-assets? Should the same GST treatment apply to supplies to residents and non-residents?

CHAPTER 4

Apportionment and adjustment

4.1 The apportionment and adjustment rules apply when a GST-registered person uses or intends to use goods and services for both taxable and non-taxable purposes. For example, a contractor that acquires a car for both their contracting business and private travel will only be able to claim input tax credits for the intended taxable use of the car.

4.2 Following acquisition of an asset, the GST-registered person must annually compare the intended taxable use of an asset with the actual taxable use of an asset. If there is a difference the person must make an adjustment to either claim extra input tax credits or pay output tax to reflect the actual taxable use of the asset.

4.3 This chapter discusses a number of issues with the apportionment and adjustment rules and suggests some possible solutions. We would also like feedback on further ways in which the apportionment and adjustment rules could be simplified and improved.

Change of use wash-up calculation (non-land assets)

4.4 Section 21FB of the GST Act contains a wash-up calculation that requires a registered person to claim or pay the full input tax credits for an asset when they switch the use of that asset to one hundred percent taxable or non-taxable.

4.5 The rationale for the wash-up calculation is to reduce compliance costs for taxpayers by reducing the number of adjustments they need to perform.

4.6 Without the wash-up calculation the number of adjustments a taxpayer needs to make will depend on the type and value of the asset (see section 21G). For non-land assets a taxpayer must perform two adjustments for assets valued between $5,000 and $10,000, five adjustments for assets valued between $10,000 and $500,000 and ten adjustments for assets valued over $500,000. Alternatively, for non-land assets a taxpayer may choose the relevant number of adjustment periods based on the estimated useful life as determined by the tax depreciation rates determinations set by the Commissioner. For land there is no limit to the number of adjustments required.

4.7 For a change in use to one hundred percent taxable, the wash-up formula entitles a taxpayer to a full input tax deduction less any actual deduction already claimed for that asset. For a change in use to one hundred percent non-taxable, the wash-up formula requires a taxpayer to pay as output tax an amount equal to the actual deduction claimed for that asset. The terms "full input deduction" and "actual deduction" are defined by paragraphs 21FB(a) and (b) respectively.

4.8 In order for an asset to be subject to the wash-up rule its use must be changed to one hundred percent taxable or non-taxable and this total taxable or non-taxable use remain unchanged for an unbroken period of the remainder of the adjustment period in which the change in use occurred, and the entirety of the following adjustment period.

> **Example 1**
>
> On 1 April 2016 Fernanda, a GST-registered plumber, acquires a van for $34,500, intending to use it 50% for taxable and 50% for non-taxable purposes. As such, Fernanda claims $2,250 in input credits on acquisition.
>
> Halfway through her first adjustment period, Fernanda switches the taxable use of the van to 0%. Therefore, in Fernanda's first adjustment the actual taxable use of the van was only 25% and Fernanda must pay output tax of $1,125.
>
> If the taxable use of the van remains at 0% for all of the next adjustment period Fernanda must perform the wash-up calculation. As such, Fernanda will be required to return as output tax the remaining input credits she had claimed for the van ($1,125).

4.9 This section considers a number of issues with the change of use wash-up calculation for non-land assets. Issues with the wash-up calculation for land are discussed later in this chapter.

Issue 1: Wash-up adjustments are disproportionately large

4.10 For non-land assets the wash-up calculation results in adjustments that are disproportionately large. This is because the wash-up calculation does not take into account any business or private consumption of the asset that has occurred prior to the wash-up being performed. In addition, the wash-up calculation does not take into account any change in value of an asset that may have occurred.

4.11 For assets that have had a change in use to one hundred percent taxable, the wash-up requires the taxpayer to claim all the input tax (less any input tax already claimed) for the asset. The concern is that taxpayers can effectively use and "consume" an asset for private purposes over a period of years and then enjoy full input tax recovery upon a subsequent change to full taxable use. Therefore, the wash-up calculation does not tax the non-taxable usage prior to the change to full taxable use.

> **Example 2**
>
> Leigh, a GST-registered fisherman, purchases a boat for $1,150,000 (including GST) on 1 April 2017. Leigh uses the boat equally for both private use and his taxable fishing activities. As such Leigh can claim $75,000 as an input tax credit.
>
> On 1 April 2023 Leigh switches the use of his boat to being used solely for his taxable activity of fishing. At the end of his 7th adjustment period on 31 March 2024 Leigh performs an adjustment under section 21A and claims $10,714.29 of input tax credits.
>
> After the end of his 8th adjustment period on 31 March 2025 Leigh can perform the wash-up calculation under section 21FB and claim $64,285.71 of GST in input tax credits. This gives Leigh a total deduction of $150,000 despite 50% of the boat's use for the first six years Leigh owned it being non-taxable.
>
> If the wash-up rule did not exist Leigh would have instead only been able to claim the following input tax deductions after switching to 100% taxable use:

7th adjustment:	$10,714.29
8th adjustment:	$8,035.71
9th adjustment:	$6,250
Final adjustment:	$5,000
Total inputs claimed:	$105,000

This is because over the ten years in which adjustments were required only 70% of the use of the boat was taxable.

4.12 Conversely for assets that have had a change in use to one hundred percent non-taxable, the taxpayer is required to pay as output tax all the input tax they have claimed for the asset. As the wash-up calculation does not take into account prior taxable use, it therefore results in over-taxation of assets that are switched to one hundred percent non-taxable use.

Issue 2: Wash-up can only be used for changes of use to one hundred percent or zero percent taxable

4.13 Section 21FB only applies to a complete change of use to either one hundred percent taxable or one hundred percent non-taxable use. However, if a registered person permanently changes their use of an asset to something other than one hundred percent taxable or one hundred percent non-taxable, they are required to perform the full number of yearly adjustments as required under section 21G.

Example 3

On 1 April 2017 Claire, a GST-registered florist, purchases a van for $23,000 (including GST). Claire's use of this van is 75% taxable as she mainly uses it for her taxable activity but does also use it for private purposes. As such, Claire claims an input tax deduction of $2,250.

On 1 April 2019 Claire permanently switches the use of the van to 50% taxable. Claire will need to make yearly adjustments for the next three years to account for this change of use.

4.14 Discussions with business groups have indicated that allowing the wash-up to be performed after a permanent change in use to something other than one hundred taxable or non-taxable would reduce compliance costs.

Issue 3: Usual adjustment provisions not switched off following wash-up calculation

4.15 Section 21(2) of the GST Act provides an exception from the requirement to make an adjustment if one or more exceptions apply. However, there is no exception from the requirement to make an adjustment for goods and services that have been subject to the wash-up calculation under section 21FB.

4.16 As such, it appears that a registered person is required to continue to perform adjustments for goods and services that have had a complete change of use and have been subject to the wash-up under section 21FB.

4.17 We are proposing to introduce an exception to the requirement to perform adjustments when the wash-up has been performed.

Proposal: New wash-up formula

4.18 To address the first two issues above we propose changing the formula for the change in use wash-up calculation for non-land assets. The proposed new formula is:

$$\frac{\text{Time remaining} \times (\text{Full input tax deduction} \times \text{Current use - Actual deduction})}{\text{Total time}}$$

4.19 This formula would apply for both changes to 100% taxable use or 100% non-taxable use. It would also apply for any permanent change of use to something between 0% and 100% taxable.

4.20 Full input tax deduction and actual deduction would both have their current meanings.

4.21 Current use would be the percentage taxable use of the asset since the change of use.

4.22 Total time would be defined as the total amount of time from acquisition of the asset until the end of the last adjustment period that would be required under section 21G in the absence of the wash-up. Time remaining would be calculated by subtracting from total time the amount of time from acquisition of the asset until the end of the adjustment period in which the change of use occurred.

4.23 As with the existing formula, the proposed wash-up formula would apply if the use has been changed and remains unchanged for the remainder of the adjustment period in which the change of use occurred, and the adjustment period following the period in which the change of use occurred.

4.24 Under the proposed formula, the result under the wash-up is the same as if the person had instead used the standard change in use provisions for the remaining adjustment periods (ignoring the restrictions to performing adjustments under section 21(2)). This is illustrated in examples 4–6.

Example 4: Change to 100% non-taxable

On 1 April 2017 Caroline, a GST-registered electrician, purchases a van for $46,000 (including GST). Caroline's use of this van is seventy five percent taxable as she mainly uses it for her taxable activity but does also use it for private purposes. As such, Caroline claims an input tax deduction of $4,500.

On 1 April 2019 Caroline switches the use of the van to one hundred percent non-taxable as she has now purchased a new vehicle for use in her taxable activity.

At the end of her 3rd adjustment period on 31 March 2020 Caroline's actual taxable use of the asset was fifty percent so she is required to return $1,500 as output tax.

After the end of her 4th adjustment period Caroline is able to perform the wash-up calculation and return $1,200:

$$\frac{2 \text{ years} \times (\$6{,}000 \times 0\% - \$3{,}000)}{5 \text{ years}} = -\$1{,}200$$

This brings the total amount of inputs Caroline has claimed for the van to $1,800. This is equal to the amount of inputs she would have been able to claim under the standard change of use rules (ignoring the restrictions on performing adjustments under section 21(2)). This is because over the five years in which adjustments were required, 30% of the use of the van was taxable.

Example 5: Change to 50% taxable

On 1 January 2018 David bought a vintage car for $230,000 (including GST). David is initially not registered for GST. However, on 1 February 2019 he registers for GST and begins renting out the car for weddings and special events while still using it privately. David's taxable use of the car from this point forward is 50%.

Under section 21B David's first adjustment period will end on 31 March 2019. David calculates that his taxable use of the car for this adjustment period was 6.67 % (50% taxable use for two months and 0% taxable use for 13 months). As such he claims $2,000 in input tax.

After the end of his second adjustment period David is able to perform the wash-up calculation and claims an additional $9,904.76 of input tax:

$$\frac{48 \text{ months} \times (\$30{,}000 \times 50\% - \$2{,}000)}{63 \text{ months}} = \$9{,}904.76$$

This brings the total amount of inputs David has claimed for the car to $11,904.76. This is equal to the amount of inputs he would have been able to claim under the standard change of use rules.

Example 6: Change to 100% taxable

Consider example 2 with Leigh.

At the end of his 8th adjustment period on 31 March 2025 Leigh can perform the wash-up calculation. Under the proposed formula he can claim an additional $19,285.71 in input tax credits:

$$\frac{3 \text{ years} \times (\$150{,}000 \times 100\% - \$85{,}714.29)}{10 \text{ years}} = \$19{,}285.71$$

This gives Leigh a total deduction of $105,000, equal to his total deduction under the standard change in use rules.

4.25 We are seeking feedback on the proposal to amend the wash-up formula for non-land assets in the manner described above.

Zero-rated supplies of going concerns

4.26 Under section 11(1)(m) of the GST Act, the sale of a going concern from one registered person to another may be zero-rated if the supplier and the recipient agree.

4.27 Issues arise with this rule when the recipient of the going concern intends to use the supply for both taxable and private or exempt purposes. Zero-rating the supply of a going concern means that there is no input tax to apportion. As a result, any exempt or private use of the going concern is not correctly accounted for.

> **Example 7**
>
> Shanae has a mobile dog washing business. She enters into an agreement to sell the entire business, including the business's van to Gordon for $100,000 (plus GST if any). This $100,000 is made up of $50,000 for the van and $50,000 for all other assets.
>
> Shanae and Gordon agree to zero-rate the sale of the business as a going concern. Gordon estimates that the private use of the van will be 50%. However, as no GST has been paid Gordon does not need to account for this private use.
>
> Alternatively, Shanae and Gordon could have agreed to not zero-rate the supply as a going concern. Gordon would then have been required to pay Shanae $115,000 and Shanae would have had to return $15,000 in output tax. As Gordon will be using the vehicle for 50% private use, he can only claim an input tax deduction of $11,250.

4.28 In contrast, under the zero-rating of land rules any private or exempt use of zero-rated land is effectively taxed. Section 20(3J) requires the purchaser to determine the nominal amount of GST they would have incurred if the supply was standard rated and return as output tax the proportion of this nominal GST relating to private or exempt use.

4.29 We are proposing to introduce a similar provision to section 20(3J) that would apply to zero-rated supplies of going-concerns. In example 7, such a provision would have required Gordon to return $3,750 in GST if he and Shanae had agreed to zero-rate the sale of the business as a going concern.

Apportionment of land

4.30 Some apportionment and adjustment issues mainly affect land rather than other assets. This is because land is different from most other assets in that it tends to appreciate in value. Furthermore, it is common for land to be used for a mix of taxable and non-taxable purposes given it is often used privately or for the supply of accommodation in a dwelling.

4.31 Issues with the apportionment and adjustment rules for land are discussed in the next section.

Concurrent use of land

4.32 A special apportionment rule in section 21E of the GST Act applies where a GST-registered person is concurrently using the same piece of land with a dwelling for both a taxable (development) and non-taxable (supply of accommodation in a dwelling) purpose.

4.33 The rule applies in the adjustment periods prior to the sale of the property and adjusts the input credits that can be claimed on the property based on the ratio of taxable use to total use.

4.34 This rule was developed in response to issues raised by the Court of Appeal decision in *Lundy* (2005) 22 NZTC 19 at 637, which involved land being used concurrently for taxable (advertised for sale) and non-taxable (supply of accommodation in a dwelling) purposes. In that case a developer bought houses intending to develop and quickly sell them. The developer was initially unable to find buyers and so rented out the houses until they were able to find a buyer. As the developer was using the land concurrently for both taxable and exempt activities, they could not apportion their inputs based on time or space.

Scope of section 21E

4.35 The rule was developed under an assumption that the concurrent use of the land would only be for a short period of time (a few adjustment periods) prior to the sale.

4.36 However, the rule can also apply in situations in which there is a concurrent use of land for a long period. For example, the concurrent use of land rule may apply if a property developer rents out houses but has a well-developed plan to sell them in 20 years. In this situation it may be argued that they are passively using the land for taxable purposes as they are holding it for future sale at the same time as they are actively using the land for the non-taxable use of supplying accommodation in a dwelling.

4.37 Note that section 21E would not necessarily apply even if there is a well-developed plan to sell the land. Whether or not there is concurrent use would depend on all of the facts of an arrangement.

4.38 The concurrent use rule was not intended to apply to situations in which the only taxable use was passively holding the land for future sale. Instead it was targeted at situations similar to the Lundy case in which land was actively being advertised for sale or had some other active taxable use whilst simultaneously being used for non-taxable purposes.

4.39 We therefore propose limiting the application of section 21E to not apply in situations where the only taxable use of the land in an adjustment period is holding the land for its eventual sale or development. If the only taxable use of land in an adjustment period is holding the land for its eventual sale or development, then the taxable use of the land during that period would be zero percent.

4.40 We are seeking feedback on the appropriateness of this proposal to limit the scope of section 21E.

Concurrent use apportionment formula

4.41 In addition to the scope of the concurrent use rule being broader than intended, the apportionment formula in section 21E(3) appears to be overly generous.

4.42 The apportionment formula in subsection (3) compares the expected consideration for taxable supplies (approximated by the current market value of the property) with the total consideration, where total consideration is the current market value of the property plus any rental income (or imputed rent) that has been received since the registered person purchased the property. This ratio of taxable use to total use is then used to determine the percentage of GST input credits which can be claimed on the property and expenses associated with the property.

4.43 As the market value of the property will generally be significantly more than the rental income received, this formula often allows a high proportion of GST input credits to be claimed. This may provide a registered person with a concurrent use of land a time value of money advantage over someone with a fully-taxable use of the land (that is, a property developer renting out the land as commercial accommodation while advertising it for sale), or someone with a fully non-taxable use of the land (that is, a residential landlord).

4.44 In addition, the existing formula in subsection (3) does not appear to calculate either the extent to which the use of land is taxable, or the extent to which the land holder's purpose in using the land is taxable. As such, we consider that the apportionment formula in subsection (3) should be amended. Two options for amending the formula are discussed.

4.45 The first option would recognise that, as it is being entirely used for taxable purposes and entirely used for non-taxable purposes, the land is being equally used for both purposes. As such, the taxable use of the land for periods of concurrent use would be fifty percent. This option would appear to be consistent with a time and space apportionment approach.

Example 8: Fifty percent taxable use for concurrent use

Property Co acquires bare zero-rated land on 1 April 2020 for $1,000,000. They spend the next three years building houses on the land. As such, their use of the land for these three years is 100% taxable.

On 1 April 2023 Property Co begins renting out the houses as residential accommodation while advertising the houses for sale. Their taxable use of the land from 1 April 2023 on will be 50% as the land is being used concurrently.

On 31 March 2024 Property Co calculates that their taxable use of the land since acquisition was 87.5% (three years of 100% taxable use and one year of 50% taxable use). As such, they make an adjustment and return $18,750 (12.5% of the nominal GST component of the purchase price).

4.46 The second option would attempt to calculate taxable use based on the benefit the registered person receives in using the land concurrently. This would be achieved by comparing, over the period the land is used concurrently, the taxable benefit the owner receives from the land with the total benefit the owner receives from the land. This would be calculated using the formula:

$$\frac{\text{Consideration for taxable supply - Cost}}{\text{Total consideration for supply - Cost}}$$

4.47 Consideration for taxable supply and total consideration for supply would maintain their current meaning.

4.48 Cost would be the market value of the land at the time the land began to be used concurrently.

Example 9: Option 2 formula

Develop Co acquires land on 1 April 2020 for $1,150,000 (no GST). They intend to use the land entirely in their taxable activity of property development so claim a second-hand goods input tax deduction of $150,000.

Develop Co spends the next two years demolishing the house on the land and constructing an apartment building. As such, their use of the land for these two years is 100% taxable.

On 1 April 2022 Develop Co begins renting out the apartments as residential accommodation while advertising the building for sale. As such, from 1 April 2022 they are concurrently using the land. The market value of the land on this date is $2,300,000.

Over the next year Develop Co receives 200,000 in rental income and the market value of the land increases to $2,400,000. As such, their taxable use of the land for the last year is calculated as:

$$\frac{\$2,400,000 - \$2,300,000}{\$2,400,000 + \$200,000 - \$2,300,000} = 33\tfrac{1}{3}\%$$

On 31 March 2023 Develop Co. calculates that their taxable use of the land since acquisition was 77 7/9% (two years of 100% taxable use and one year of 33 1/3% taxable use). As such, they make an adjustment and return $33,333.33 of the input credits they had previously claimed for the land.

4.49 Note that under the second option the proposed formula would not work if the land depreciates in value over the period of concurrent use. In these situations, the taxable use of the land over the period of concurrent use would be zero percent.

4.50 We are seeking feedback on whether the apportionment formula in section 21E(3) should be amended, and if so which of the two options discussed above is more appropriate. We are also seeking feedback on whether there are other options for amending the formula in subsection (3) that would be more appropriate than the two options discussed above.

Transitional rules

4.51 There may be some registered persons that own land that section 21E currently applies to but under the proposal to limit the scope of the rule would no longer have a concurrent use of land. This may result in them being required to make large adjustments to return input tax claimed on the land as their taxable use of the land going forward would be zero percent. We are therefore seeking feedback on whether any transitional rules are necessary to limit the impact of the change on these registered persons.

4.52 Any transitional rule would only apply when the registered person's concurrent use of the land (as currently defined) began prior to 24 February 2020.

Disposal of land with a mix of taxable and non-taxable use

4.53 Section 21F applies when a registered person disposes of an asset which they have used for a mix of taxable and non-taxable uses and have therefore only claimed some of the GST they incurred when they acquired the asset.

4.54 Section 21F allows the registered person to claim as an adjustment the proportion of the output tax related to their non-taxable use. However, the amount of the adjustment is capped at the amount of GST paid by the registered person on acquisition of the asset.

4.55 For depreciating assets, the final adjustment under section 21F appears to achieve an appropriate result as the net GST returned on disposal of the asset will be equal to the taxable proportion of the asset's use. This is shown in example 10.

> **Example 10: Depreciating asset**
>
> Paul purchased a car for $115,000 and 50% of its use is taxable. As such he has claimed an input tax deduction for the car of $7,500.
>
> After a few years Paul sells the car for $46,000. He is required to return $6,000 as output tax but can claim an adjustment under section 21F of $3,000 as calculated below:
>
> $$\frac{3}{23} \times \$46,000 \times \left(1 - \frac{\$7,500}{\$155,000}\right) = \$3,000$$
>
> As such, the net GST Paul returns on disposal of the car is only $3,000 (50% of the $6,000 of output tax). This recognises that 50% of Paul's use of the car was non-taxable.

4.56 However, for land, which often appreciates in value, the final adjustment under section 21F will often produce an inappropriate outcome.

4.57 The amount of the adjustment under section 21F is capped at the unclaimed portion of the GST paid by the registered person on acquisition of the asset. This cap on the adjustment means that, despite any non-taxable use, all the appreciation in value of land is treated as being related to the land's taxable use.

4.58 Treating all the appreciation in value of land as relating to the taxable use of the land is appropriate in some circumstances. For example, a property developer may use land for some non-taxable purposes (that is, supplying accommodation in a dwelling) before they dispose of it. However, given their taxable activity is property development, the appreciation in the value of the land is likely to primarily relate to their taxable use of the land, rather than any non-taxable use. As such, capping the adjustment under section 21F to the unclaimed portion of the GST paid on acquisition of the land by the property developer is appropriate.

4.59 However, in other situations in which the use of land is both taxable and non-taxable, treating the entire appreciation in value of the land as relating to the taxable use does not appear to be appropriate. When the taxable use of the land does not include adding value to the land, such as having a home office or using a home or bach both privately and for providing short-term commercial accommodation, appreciation in the value of the land relates to both the taxable and non-taxable uses of the land. In these cases, the cap on the adjustment results in the disposal of the land being overtaxed. This is shown in example 11.

> **Example 11: Home office**
>
> Kelvin purchases a house for $1,150,000 (including GST). He lives in it as his main home, but also has a home office from which he runs his online business of selling biscuits. His taxable use of the house is 20% so he claims an input tax deduction for the house of $30,000.
>
> After a few years Kelvin sells the house for $1,265,000. He is required to return $165,000 as output tax but can claim an adjustment under section 21F of $120,000, being the remainder of the input tax he had not previously claimed.
>
> As such, the net GST Kelvin returns on disposal of the house is $45,000. This is 27.27% of the output tax on disposal even though Kelvin's taxable use of the house was only 20%.

4.60 We understand that because of the cap on the adjustment in section 21F, some registered persons that have some taxable use of their home or bach are attempting to structure in such a way as to keep their land out of the GST base.

Proposal: Removing cap on adjustment for non-developers

4.61 To address the issue discussed above we propose removing the cap on the adjustment in section 21F for land that is disposed of by someone other than a property developer.

4.62 This would be achieved by removing the cap on the adjustment in section 21F for land unless, in the absence of any other taxable supplies the land is used to make, the supply of the land would still be considered as being made in the course or furtherance of a taxable activity. Examples 12–14 demonstrate how this would work.

Example 12: Home office

Consider example 11 with Kelvin.

Kelvin's only taxable activity is his online business of selling biscuits. As such, in the absence of the use of his home for a home office for his online business, the sale of his home would not be considered as being made in the course or furtherance of a taxable activity. The cap in section 21F would therefore not apply to the disposal of Kelvin's home.

On disposal of his home Kelvin is required to return $165,000 as output tax but can claim an adjustment for $132,000, recognising his 80% non-taxable use of the home.

Example 13: Short-term commercial accommodation

Brian and Nita bought a bach in Whangamata for $690,000 that they mainly use privately. However, they also have a taxable use of the bach as they use it for supplying short-term commercial accommodation. Their taxable use of the bach is 40% so they only claim an input tax deduction of $36,000.

After a few years they sell the bach for $1,035,000 (including GST). As such they return output tax of $135,000.

In the absence of the supplies of short-term commercial accommodation Brian and Nita made from the bach, the supply of the bach would not be considered as being made in the course or furtherance of a taxable activity. The cap on adjustments in section 21F would therefore not apply to the disposal of the bach so Brian and Nita claim an adjustment of $81,000.

This recognises that 60% of their use of the bach was non-taxable.

Example 14: Property developer

House Co is a property developer that purchases a house for $2,300,000 that is currently rented out as residential accommodation. Six months later the tenancy ends and they begin renting out the house as short-term commercial accommodation while developing plans and obtaining consent for development work.

After six months of using the home for providing short-term commercial accommodation House Co begins the process of demolishing the house, subdividing the land and constructing five new houses on the land.

Two years after acquiring the land House Co sells the five new houses for a total price of $5,750,000 (including GST) and returns output tax of $750,000.

House Co has a taxable activity of property development and therefore, even in the absence of the supplies of short-term commercial accommodation they made with the land, the supply of the land would still be made in the course or furtherance of a taxable activity. As such, the cap on adjustments in section 21F would apply to the disposal of the land.

Over the period House Co owned the land their taxable use was seventy 75% so they had claimed an input tax deduction of $225,000. Their adjustment under section 21F would therefore be $75,000. This is the remainder of the input tax they had not previously claimed for the land.

4.63 In removing the cap on section 21F for land (except for property developers) we consider that section 5(18) would no longer be required. The proposal would have a broader impact than section 5(18) as section 5(18) only applies to disposals of dwellings and does not apply to disposals of commercial dwellings or other types of land. Furthermore, section 5(18) could apply to disposals by property developers and we consider this to be inappropriate as, for property developers, increases in the value of the land relate primarily to the taxable use.

4.64 We are seeking feedback on the proposal to remove the cap on adjustments in section 21F for disposals of land by someone other than a property developer.

4.65 At this stage we are not proposing to remove the cap on adjustments for any other appreciating assets. However, we are seeking feedback on whether there are any other situations where the cap on the adjustment should be removed when an asset appreciates in value.

Change of use wash-up calculation for land

4.66 As discussed above, the wash-up calculation in section 21FB applies when a registered person changes the use of an asset to one hundred percent taxable or one hundred percent non-taxable.

4.67 As there are no limits to the number of adjustment periods required for land under section 21G, the new formula for the change of use wash-up calculation proposed above would not apply for land. However, there are still some issues with the change of use wash-up calculation for land and these are discussed below.

4.68 For land, the wash-up calculation can result in adjustments that are disproportionately small. This is because the wash-up calculation is based on the cost of an asset rather than its market value and land tends to appreciate in value. This creates a concern that a taxpayer could reduce their output tax liability by switching the use of land to one hundred percent non-taxable and performing the wash-up prior to disposal.

4.69 Given the proposed changes to section 21F for non-property developers discussed above, the wash-up calculation in section 21FB may also result in a worse outcome for a person that changes their use of land to one hundred percent taxable, compared to if they had disposed and reacquired the land at its current market value.

4.70 As with non-land assets, the wash-up calculation in section 21FB can only currently be performed when the use of land has been changed to one hundred percent taxable or one hundred percent non-taxable. As such, a person who permanently changes the use of land to something between zero percent and one hundred percent taxable would need to perform yearly adjustments until they dispose of the land. This creates additional compliance costs.

Option 1: Deemed disposal and reacquisition

4.71 One option to address the issues discussed above would be for land to be treated as being disposed and reacquired at market value when the change of use wash-up is performed. For ease of compliance, the deemed disposal would be considered a standard rated supply.

4.72 This option could apply for both changes to one hundred percent taxable or non-taxable use and for permanent changes in use to something between zero percent and one hundred percent taxable use. Examples 15–17 illustrate how this would work.

Example 15: Change to one hundred percent taxable use

On 1 April 2020 Ben purchases a house for $1,150,000 (including GST) that he intends to use both privately as his main home and for supplying short-term commercial accommodation. His intended taxable use of the house is 20% so he claims an input tax deduction of $30,000.

On 1 January 2024 Ben switches the use of the house to one hundred percent taxable as he has purchased a new property to live in as his main home.

On 31 March 2024 Ben calculates that his taxable use of the land since acquisition has been 25% (3.75 years 20% and 0.25 years 100% taxable use) and performs an adjustment, claiming an additional $7,500 of input tax.

On 31 March 2025 Ben can perform the wash-up calculation. He is deemed to dispose of the property and reacquire it at its current market value of $1,285,000 (including GST). As such, he returns output tax of $165,000 but can claim this all back as an input tax deduction.

Ben also performs an adjustment under section 21F for his deemed disposal of the land. In the absence of the supplies of commercial accommodation he has made, the disposal would not be in the course or furtherance of a taxable activity. As such, the cap on the adjustment in section 21F does not apply and Ben claims an adjustment of $123,750. This is the net effect of performing the change of use wash-up adjustment.

Example 16: Change to zero percent taxable use

On 1 April 2020 Joanna purchases a house for $690,000 (including GST) that she intends to use both privately as her main home and for a home office that she uses in her taxable activity. Her intended taxable use of the house is 30% so she claims an input tax deduction of $27,000.

On 1 October 2023 Joanna switches the use of the house to 0% taxable.

On 31 March 2024 Joanna calculates that her taxable use of the land since acquisition has been 26.25% (3.5 years 30% and 0.5 years 0% taxable use) and performs an adjustment, returning $3,375 of input tax she had previously claimed.

On 31 March 2025 Joanna can perform the wash-up calculation. She is deemed to dispose of the land and reacquire it at its current market value of $920,000 (including GST). She therefore returns output tax of $120,000 but cannot claim any of this back as an input tax deduction.

Joanna also performs an adjustment under section 21F for her deemed disposal of the land. As she was not a property developer the cap in section 21F does not apply so Joanna claims an adjustment of $88,500 (73.75% of the output tax).

The net effect of performing the change of use wash-up adjustment is that Joanna must return $31,500.

Example 17: Change to twenty five percent taxable

On 1 October 2021 Graeme purchases a bach for $805,000 (including GST). He intends to use the bach equally for both private use and for making supplies of commercial accommodation. As such he claims an input tax deduction of $52,500.

On 1 January 2024 Graeme switches the taxable use of the bach to twenty five percent.

On 31 March 2024 Graeme calculates his taxable use of the bach since acquisition as 47.5% (2.25 years fifty percent and 0.25 years twenty five percent). As such he performs an adjustment and returns $2,625 of the input tax he had previously claimed.

On 31 March 2025 Graeme can perform the wash-up calculation. He is deemed to dispose of the bach for its current market value of $1,035,000 (including GST). He therefore returns output tax of $135,000 but can claim $33,750 of this back as an input tax deduction as his taxable use of the bach going forwards will be twenty five percent.

Graeme also performs an adjustment under section 21F for his deemed disposal of the land. As he is not a property developer the cap on section 21F does not apply. Graeme therefore claims an adjustment of $70,875 (52.75% of the output tax).

The net effect of performing the change of use wash-up adjustment is that Graeme must return $30,375.

4.73 One concern with this option is that it may impose compliance costs on registered persons in determining the market value of the land when they perform the wash-up calculation. However, the one-off compliance cost of determining the land's market value may be less than the compliance costs of performing continual yearly adjustments after a permanent change in use. There is also a risk that obtaining an estimate of the land's market-value could be open to manipulation.

4.74 We are seeking feedback on the appropriateness of this option to make the change in use wash-up for land a deemed disposal and reacquisition at market value.

Option 2: Updated formula

4.75 As an alternative, the existing wash-up adjustments for land could be maintained but the calculation amended to allow it to be used for permanent changes in use to something other than one hundred percent taxable or non-taxable. This would be achieved by replacing both of the current formulas with this formula:

Full input tax deduction × Current use - Actual deduction

4.76 Current use would be the percentage taxable use of the land since the change of use occurred.

4.77 This proposed formula would not address the concerns that the wash-up calculation for land can result in adjustments that are disproportionately small. However, to address the fiscal risk from someone reducing their output tax on disposal by performing the wash-up adjustment, a special adjustment rule would apply when land that has been subject to the wash-up after a permanent decrease in its taxable use is disposed of within five years of the permanent change of use occurring. This special rule would not apply when land is disposed of after the wash-up has been performed following a permanent increase in the land's taxable use.

4.78 This rule would require the actual taxable use of the land since acquisition to be calculated and an adjustment made to claim input tax in line with this percentage. The supply of the land would then be a taxable supply (even if the use of the land had changed to zero percent) and section 21F would apply to the disposal of the land. Examples 18–19 demonstrate how this would work.

Example 18: Change to zero percent taxable use

Consider example 16 with Joanna.

On 31 March 2025 Joanna performs the wash-up calculation and returns the $23,625 of input tax she had previously claimed.

On 30 September 2027 Joanna sells the house for $1,150,000. As this is within five years of the permanent change of use to 0% taxable use the supply of the house is treated as a taxable supply and Joanna must return output tax of $150,000.

Joanna calculates her actual taxable use of the land since acquisition as 14% (3.5 years 30% and four years 0% taxable use). As such, Joanna claims $12,600 in input tax for the land. She then claims an additional adjustment under section 21F of $129,000, being eighty six percent of the output tax.

Example 19: Change to twenty five percent taxable

Consider example 17 with Graeme.

On 31 March 2025 Graeme can perform the wash-up calculation and returns $23,625 of the input tax he had previously claimed:

$$\$105,000 \times 25\% - \$49,875 = \$23,625$$

Graeme sells the house on 1 January 2028 for $1,265,000 (including GST) and returns output tax of $165,000.

As the disposal is only four years after the permanent change in use to 25% taxable use, the special adjustment rule would apply. Graeme calculates his taxable use of the property since acquisition as 34% (2.25 years 50% and four years 25% taxable use). As such he claims an additional $9,450 input tax for the property.

He also claims an adjustment under section 21F of $108,900 (66% of the output tax).

4.79 The special adjustment rule would also apply if a person ceases being a registered person within five years of the permanent change of use occurring.

4.80 We are seeking feedback on the appropriateness of the proposed new formula under this option. We are also seeking feedback on the proposed special adjustment rule to address the fiscal risk from someone reducing their output tax by performing the wash-up after a permanent decrease in the taxable use of land.

Zero-rated land

4.81 If either the existing wash-up calculation is maintained or the proposed calculation under option 2 is adopted a minor amendment would need to be made to the definition of "actual deduction".

4.82 For the purposes of the wash-up calculation, "actual deduction" is defined in section 21FB(3)(b) as the "amount of deduction already claimed, taking into account adjustments made up to the end of the adjustment period referred to in subsection 1(c)(ii)". This definition does not take into account any nominal deduction received for zero-rated land. In contrast, the definition of "full input tax deduction" does include the nominal GST component chargeable under section 20(3J)(a)(i).

4.83 We propose to update the definition of "actual deduction" to include a nominal deduction for the proportion of the nominal GST component not returned as output tax on acquisition of zero-rated land.

Other ways to simplify the apportionment and adjustment rules

4.84 We have also heard from many stakeholders that the apportionment rules can be complex and difficult to apply. As such, we are considering ways in which the apportionment and adjustment rules could be simplified.

4.85 Some possible ways in which the rules could be simplified are discussed below. We are interested in feedback on whether these ideas have merit and are worth exploring further. We also welcome submissions on any other ways the apportionment and adjustment rules could be simplified.

Understanding which rule is applicable

4.86 We understand that it may not always be easy for a registered person to determine which particular apportionment or adjustment rule applies to them. To assist in navigating these rules a signposting provision could be added at the beginning of the apportionment and adjustment section of the GST Act.

4.87 Alternatively, Inland Revenue could provide additional guidance material to assist taxpayers and their agents navigate the apportionment and adjustment rules.

De minimis thresholds for minor taxable use

4.88 The sale of an asset that has been used in a person's taxable activity will generally be a taxable supply. This means that very minor taxable use of a good or service can make the eventual disposal of that asset a taxable supply.

4.89 A threshold for minor taxable use of an asset could be established, for example ten percent. If the taxable use of the asset is below this threshold and no input tax deductions have been claimed in relation to the asset, the disposal of the asset would not be considered as being made in the course or furtherance of a taxable activity.

4.90 A *de minimis* threshold for minor taxable use would mean that, when the taxable use of an asset is below this threshold a registered person could choose not to claim any input tax and would therefore not be required to perform any adjustments.

Accuracy of apportionment and adjustments

4.91 The current apportionment and adjustment rules require precise calculations of the taxable use of a good or service. However, the rules could instead require the taxable use of an asset be calculated to a certain level of accuracy, for example the nearest five percent.

4.92 This would mean that if the intended taxable use of an asset was 50%, but it is determined that during the first adjustment period the actual taxable use was 52% or 49% no adjustment would be required. Conversely, if the actual taxable use was 53% the taxable use of the asset would be considered 55% and an adjustment would be required.

4.93 We note that for high-value assets it is more important for apportionment to be accurate. Therefore, it may only be appropriate to allow taxable use to be calculated to a certain level of accuracy for assets acquired for less than a particular amount.

4.94 There are also some thresholds under which adjustments are not required. For example, adjustments are not required for goods and services under $5,000 (excluding GST), or if the difference between the percentage intended use and percentage actual use is less than 10 percentage points and the amount of the adjustment does not exceed $1,000. These thresholds could be amended to reduce the instances of adjustments being required.

Questions for submitters

- Do you support the proposed new wash-up calculation for non-land assets that have had a permanent change in use?
- Do you support the proposal to limit the application of section 21E so it does not apply in situations where the only taxable use of the land in an adjustment period is holding the land for its eventual sale or development?
- Should the apportionment formula in section 21E be amended and if so which of the two proposed formulae is more appropriate?
- Would any transitional rules be necessary if the scope of section 21E was limited?
- For disposals of land that has had a mix of taxable and non-taxable use, do you support the proposal to remove the cap on the final adjustment for non-developers?
- Should the wash-up calculation for land that has had a permanent change of use be amended and if so which of the two proposed options do you support?
- How can the apportionment and adjustment rules be amended more generally to make them simpler and easier to apply?

CHAPTER 5

Domestic legs of the international transport of goods

Background

5.1 The GST Act zero-rates services provided to transport goods to and from New Zealand. Furthermore, in certain circumstances, the transport of goods within New Zealand as part of the international transport of goods may also be zero-rated. This is because exported goods are zero-rated, and the value of transport services is already included in the cost of imported goods which are subject to 15% GST.

5.2 However, the rules around when domestic transport services that form part of the international transport of goods may be zero-rated do not align with common commercial practices. It is now common commercial practice for an international courier contracted to supply the international transport of goods to or from New Zealand (the primary transport supplier) to subcontract to a New Zealand-based courier company to supply the domestic transport services – instead of establishing their own courier company in New Zealand to carry out the domestic portion of the courier service.

5.3 For the domestic transport services to be zero-rated, the requirement that the primary transport supplier must also supply the domestic portion of the international transport of goods for the domestic transport services is applied strictly. That means that if a New Zealand-based courier is subcontracted by the international transporter to provide domestic transport services as part of the international transport of goods service, the New Zealand-based courier must charge GST on this supply, even if they are associated with, or a wholly owned subsidiary of, the international transport supplier.

> **Example 20**
>
> Jason's Amazing Shipping Experience (JASE), an international courier company, has a New Zealand-based subsidiary called Kim Couriers.
>
> JASE is hired to transport goods from Sydney to Greymouth. JASE delivers the goods from Sydney to Christchurch and contracts Kim Couriers to deliver the goods from Christchurch to Greymouth.
>
> Despite being associated JASE and Kim Couriers are considered to be different suppliers. Therefore, the domestic transportation services supplied by Kim Couriers to JASE should be subject to GST at the standard rate.

Issues

Non-compliance

5.4 The current rules have led to significant non-compliance within the goods transportation industry. Officials understand that many goods transporters are incorrectly zero-rating their domestic services, even though they do not qualify under the GST rules.

5.5 Much of this non-compliance is due to a lack of understanding of the requirement that for the domestic transportation leg to be zero-rated it must be supplied by the exact same supplier as the international transportation. We understand that some couriers erroneously consider the same supplier requirement to be met if an associated or sub-contracted courier supplies the domestic transportation services.

5.6 We also understand that there can be significant commercial pressure for suppliers of domestic transport services to erroneously zero-rate their supply, especially when the recipient of the supply of the domestic transport service is not registered for GST. Naturally, the current rules create a bias towards the international transport supplier of the international transport services also supplying the domestic transport services. This can lead to commercial pressure on domestic courier companies to zero-rate their supplies of domestic transportation services provided as part of the international transport of goods.

Tax cascades

5.7 The current rules may create tax cascades when a business that is not registered for GST (such as an offshore courier company) is charged GST by a domestic courier undertaking the domestic leg of the transportation. Any GST charged to a non-registered business by a supplier of the domestic leg of the international transport of goods cannot be refunded by Inland Revenue. Consequently, this GST will become embedded in the price charged for the international transport of the goods and ultimately will become embedded in the price of the goods.

Example 21

Brett's Golf Emporium, a GST-registered golf store from Hamilton, purchases a large order of golf clubs from Luecker Golfing Supplies, a golf equipment manufacturer based in Chicago.

Brett's Golf Emporium hires JASE, an international courier company that is not registered for GST, to transport the golf clubs from Chicago to Hamilton. JASE subcontracts the domestic leg of the transportation to Kim Couriers, JASE's New Zealand subsidiary.

Kim Couriers is registered for GST so charges JASE $115 (including GST) for its supply of domestic transport services. As JASE is not registered for GST, they are unable to recover the $15 GST charged to them by Kim Couriers. The total price charged by JASE to Brett's Golf Emporium is $215. This price includes the $15 of GST charged to JASE by Kim Couriers.

Despite Brett's Golf Emporium being registered for GST they are unable to reclaim this $15 of GST that is embedded in the price of the international transport of the golf clubs. This unrecoverable GST will therefore become embedded in the price of the golf clubs sold by Brett's Golf Emporium.

5.8 Tax cascades (where a business absorbs the GST cost that is otherwise irrecoverable and passes this additional cost on to its customers as part of the sales price) can be avoided if non-resident businesses chose to register for GST in New Zealand either under section 51 if they have a taxable activity in New Zealand or section 54B if they do not make taxable supplies in New Zealand but do incur GST.

Services provided to international postal agencies

5.9 Section 11A(1)(g) of the GST Act zero-rates services supplied to overseas postal organisations for delivery in New Zealand of postal articles mailed from outside New Zealand, regardless of whether parts of the service are provided by the same transport provider. This difference in GST treatment between courier-delivered packages and postal-delivered packages has unintentionally favoured postal-delivered businesses.

Possible solution

5.10 We propose allowing domestic transport services supplied to the primary transport supplier contracted to transport goods to or from New Zealand to be zero-rated if the primary transport supplier is a non-resident. This is similar to the approach taken in Australia and Singapore.

> **Example 22: Non-resident courier subcontracts a domestic courier**
>
> JASE, a non-resident courier company, is contracted to transport goods from Mumbai to Hamilton. JASE transports the goods to Auckland and subcontracts Kim Couriers to provide domestic transport services between Auckland and Hamilton.
>
> Under the current rules Kim Couriers must charge GST on its supply to JASE.
>
> Under the proposed rules Kim Couriers can zero-rate its supply of domestic transport services as they are part of the international transport of goods and are supplied to the primary transport supplier who is a non-resident.

> **Example 23: Resident courier subcontracts a domestic courier**
>
> Laura's Logistics, a resident courier company, is contracted to transport goods from Stewart Island to New York City. Laura's Logistics subcontracts Pilko's Post, a domestic courier company based in Stewart Island, to transport the goods from Stewart Island to Bluff. Laura's Logistics then transports the goods from Bluff to New York City.
>
> Despite Laura's Logistics being the primary transport suppliers, Pilko's Post would still need to charge GST on its supply to Laura's Logistics under the proposed rules. This is because Laura's Logistics is a resident courier company.

Why should domestic transport services only be zero-rated if supplied to a non-resident?

5.11 The rationale for only allowing zero-rating of domestic transport services supplied to the primary transport supplier if the international transport supplier is a non-resident is that non-residents are much less likely to be registered for GST. The commercial pressure to zero-rate the domestic transport services and potential for tax cascades from standard rating domestic transport services only arise when the recipient of these services is not registered for GST.

5.12 In addition, only allowing zero-rating when the international transport supplier is non-resident means the supplier of domestic transport services only needs to determine if their supply is part of the international transport of goods if supplied to a non-resident.

5.13 However, we are interested in receiving feedback on whether it would be better to zero-rate all domestic transport services supplied to the primary transport supplier contracted to transport goods to or from New Zealand regardless of the residency of the primary transport supplier. This approach may be simpler for domestic transport providers because rather than determining the residency of the international transport provider, they would need to identify whether the goods delivery service they are undertaking is related to an international transport service.

Domestic transport services supplied as part of the international transport of goods

5.14 Consistent with the existing policy intent, we are proposing that if the international transport supplier is contracted to deliver goods from point A outside New Zealand to point B in New Zealand then they can zero-rate their entire supply. Any domestic transport services contractually supplied to the international primary transport supplier between point A and point B can therefore also be zero-rated if the international transport supplier is non-resident.

5.15 Likewise, if the international transport supplier is contracted to deliver goods from point B in New Zealand to point A outside New Zealand then they can zero-rate this entire supply. Any domestic transport services contractually supplied to the international transport supplier between point B and point A can therefore also be zero-rated if the primary transport supplier is non-resident.

5.16 However, we are interested in feedback on whether we need a more prescriptive definition of what constitutes the international transport of goods. For example, Australia has specific rules to determine when domestic transport services have been supplied as part of the international transport of goods.

5.17 In Australia, the transport of imported goods may be zero-rated up to the place of consignment. This is generally where the goods are to be delivered under the international transport supplier's contract for international transport services. Any domestic transport services supplied to the international transport supplier until the goods reach the place of consignment can therefore be zero-rated if the international transport supplier is a non-resident.

5.18 Likewise, for the international transport of exported goods Australia allows zero-rating from the final place of collection prior to containerisation. This is the location that the goods will be collected under the international transport supplier's contract of service before the goods are placed into shipping containers. Any domestic transport services provided to the international transport supplier from the final place of collection prior to containerisation can therefore be zero-rated if the international transport supplier is a non-resident.

Questions for submitters

- Other than subcontracting arrangements, are there any other commercial practices that should be considered?
- Should any amendment to the rule be based on whether the international transport provider is a non-resident, or alternatively, zero-rate all domestic transport services where they relate to an international transport service?
- Should any amendment include a prescriptive definition of when domestic transport services have been supplied as part of the international transport of goods?

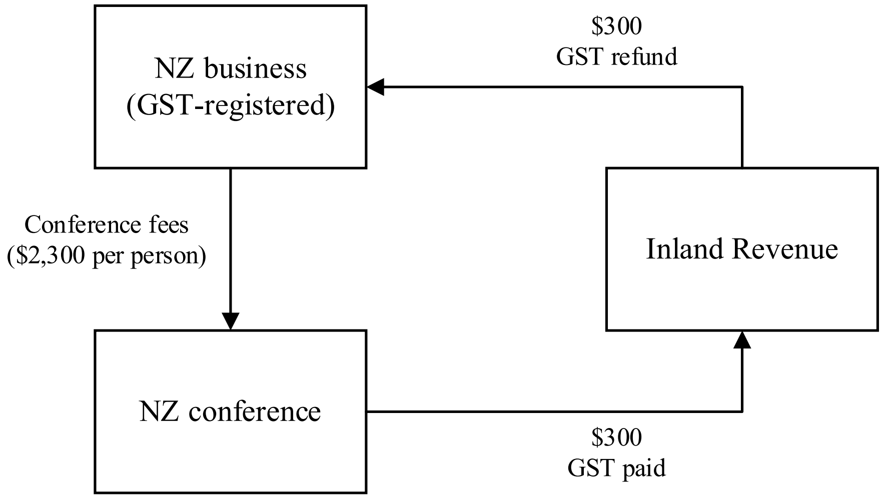
CHAPTER 6

Business conferences and staff training

6.1 GST is designed to be a broad-based low rate tax on consumption of goods and services in New Zealand. When GST has been incurred by businesses making taxable supplies, then the business should be able to recover the GST paid on their business expenses, in a cost-effective way. This includes situations where a business sends their staff to a New Zealand conference or training course.

6.2 A business that is registered for GST can claim GST input credits in relation to the GST it pays for its employees to attend a New Zealand conference (see figure 1).

Figure 1: Claiming GST for a New Zealand conference



Impractical for offshore businesses to claim back GST on conferences and staff training

6.3 However, most offshore business will not be registered for GST in New Zealand so are unable to claim GST input credits in relation to GST on conference or training fees.

6.4 Although it is possible for such offshore businesses to register for GST (under section 54B of the GST Act) in order to claim refunds, in practice the process of registering for GST solely to claim small, irregular GST refunds can impose an undue compliance on offshore businesses (when their only New Zealand expenses are a one-off or occasional expense of attending a conference).

6.5 For some conferences, a large number of offshore businesses may attend and each of these businesses would need to register for GST and file a GST return if they wished to claim a GST refund. This means the current rules are not a practical way for offshore businesses to recover their GST costs when they attend New Zealand conferences.

6.6 To mitigate these practical difficulties, Australia and Singapore have made conferences, staff training, and other services provided to offshore businesses "GST-free" or zero-rated for GST (GST applies at 0%).

6.7 The New Zealand conference industry faces a disadvantage in respect of attracting international conferences compared to Australia and other locations such as Singapore which do not charge GST on business conferences or staff training. In contrast, the European Union countries apply VAT/GST at full rates on conference services provided to offshore businesses.

Zero-rating GST on conferences and staff training supplied to non-resident businesses

6.8 To address this issue, officials are proposing to zero-rate GST on conferences, conventions and staff training supplied in New Zealand to non-resident businesses.

6.9 Zero-rating GST for conference services provided to offshore businesses would make it relatively more attractive to host large international conferences in New Zealand.

6.10 The proposal could increase the competitiveness of New Zealand training providers that provide staff training courses. We are interested in any market data available on the current size of this market.

Design issues

6.11 In order to implement a clear and robust zero-rating rule, a number of design issues would need to be worked through with the affected conference organisers, business training providers and tax advisors.

6.12 The two main design issues are the definition of a non-resident business and the definition of the qualifying conference or staff training services.

Non-resident business

6.13 The rationale for the proposed zero-rating rule is to ensure GST does not impose unrecoverable costs on businesses. Therefore, zero-rating should only apply when the service is supplied to a non-resident business.

6.14 In many cases, training and education services will be received by students in a personal capacity (as opposed to a business buying training for its staff). In such circumstances the training represents final consumption in New Zealand rather than a business input, so it should continue to be standard-rated (subject to 15% GST).

6.15 For the purposes of the proposed zero-rating rule a non-resident business could be defined using the existing criterion in section 54B. That criterion refers to a non-resident who is not registered for GST under section 51 and is registered for a consumption tax (GST or VAT) in a country or territory in which they are resident (or is resident in a country or territory without a consumption tax and would have at least $60,000 of taxable supplies if they were resident in New Zealand). In addition, the zero-rating rule would also not apply to non-resident businesses which were already registered for GST under section 54B as these businesses are already able to claim input credits in respect of New Zealand GST costs.

6.16 A key difference between the existing rules in section 54B and a proposed zero-rating rule for conferences, would be that the New Zealand supplier would need to obtain sufficient information to be able to determine both the residency and business status of the conference attendee.

Services which qualify for the zero-rating provision

6.17 Singapore's GST rules zero-rate exhibitions, conventions, staff training or retraining for business or employment.

6.18 Singapore's rules also zero-rate services which are supplementary to providing the exhibition, convention or staff training (such as organising these events), but specifically exclude "services related to entertainment and accommodation" (such services are subject to the standard rate of GST).

6.19 Officials consider Singapore's rules provide a clear boundary between business conferences and staff training and private consumption of tourism activities and that similar zero-rating rules could be used in New Zealand.

6.20 It is proposed that the service would have to relate to a business conference or staff training and there would be specific exclusions for accommodation or entertainment. So, for example, conference fees would be zero-rated but hotels and tourism experiences would continue to be standard-rated (subject to 15% GST).

6.21 However, we note that it is industry practice to "bundle" accommodation and other services (such as hospitality) into a conference or convention attendance fee. There could be a greater incentive to bundle other services (such as entertainment) into a conference package, to subject all of the services to zero-rate.

6.22 Officials are keen to receive submissions on the types of services that are typically bundled into a conference or convention fee, to assist officials with the policy development of this proposal.

6.23 Accordingly, most parts of "incentive tours" that businesses use to reward employees with tourism experiences would remain standard-rated. This is consistent with the fact that similar incentives provided to New Zealand employees as rewards for their work would be liable for fringe benefit tax and subject to GST as they represent private consumption.

6.24 It is therefore proposed that the zero-rating would only apply if a non-resident business uses the service for the purpose of carrying on a taxable activity. This should ensure that training provided to an individual in a personal capacity would not qualify for zero-rating.

Questions for submitters

- What are the costs, benefits and risks from the proposal to zero-rate GST on business conferences and staff training supplied to non-resident businesses? What data is available to assist with estimating these costs and benefits?

- How should a non-resident business be defined and identified by the relevant suppliers?

- What type of conference and training services should qualify for the proposed zero-rating? How should these be defined to provide certainty and reduce the risk of private consumption such as tourism activities becoming zero-rated?

CHAPTER 7

Managed funds

7.1 This chapter discusses policy options for changing the GST treatment of manager and investment manager services supplied to managed funds.

There are differing GST treatments for management services supplied to managed funds

7.2 The current GST treatment of different types of management services supplied to managed funds is complex and inconsistent.

7.3 Consider for example, a KiwiSaver scheme that invests into many underlying funds that specialise in different investments such as United States shares or New Zealand fixed interest. Each of these funds has a manager and investment managers. The KiwiSaver scheme will buy services from a KiwiSaver manager, and for each underlying fund they invest into they will be charged for services provided by managers and investment managers.

7.4 There is a specific GST exemption for the "management of a retirement scheme", which would apply to the management services provided by the KiwiSaver manager. However, this exemption does not apply when a retirement scheme invests into a general wholesale fund as the managers and investment managers will be providing their services to the wholesale fund rather than the retirement scheme.

7.5 For services provided to wholesale funds there are a range of differing GST practices:

- Some managers and investment managers apply 15% GST to all of their services (as in their view their services are providing "advice" or other types of services that are subject to 15% GST).
- Others treat ten percent of their services as being subject to 15% GST and the remaining ninety percent as exempt from GST (because they consider their services are mostly "arranging" the buying and selling of investment products and so should qualify for the GST exemption for financial services).

7.6 Inland Revenue analysed the existing law and publicly consulted on two draft questions we've been asked outlining the Commissioner's considered views on how the current GST Act would apply to unit trust managers and investment managers.[2] The draft views concluded that:

- Unit trust manager fees are exempt from GST as the unit trust manager is considered to be arranging financial services.
- Investment manager fees are subject to 15% GST in the typical case where the unit trust manager is not required to accept decisions made by an

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[2] PUB00277aa: Goods and Services Tax – GST treatment of fees payable to manager of a unit trust
PUB00277bb: Goods and Services Tax – GST treatment of outsourced services in relation to a unit trust

investment manager and the investment manager does not have authority to give instructions to the trustee (who holds the assets of the unit trust). In these cases, the investment manager is considered to be providing advice (which is subject to 15% GST), rather than arranging a financial service (which would qualify as an exempt financial service).

- Other outsourced services such as administrative or registry services will typically be subject to 15% GST as they are not financial services.

7.7 Because different types of manager and investment manager services can have complex and differing GST treatments, the current GST rules can distort competition by favouring certain types of managed funds, business structures, or judgements for how the supplier may choose to interpret the GST rules (for example, where one interpretation or position may provide them more favourable outcome than an alternative position).

7.8 The current GST rules can also add costs to managed funds products. These costs include compliance costs of identifying and working out the GST treatment of different types of management services and unrecoverable GST costs to the extent to which a provider of exempt financial services is charged GST on their inputs of non-financial services.

7.9 For these reasons, officials propose developing some special rules for determining the GST treatment of manager and investment manager services. The appropriate GST treatment of these services is not obvious as it depends on the policy objectives of the reform.

Policy objectives when considering GST treatment of services supplied to managed funds

Limiting the GST exemption for financial services

7.10 GST is a broad-based tax with few exemptions. The GST exemption for financial services means these services are undertaxed compared to other services which creates biases (discussed in the next section) and requires increased taxation on other activities to generate the same amount of Government revenue. From a GST policy perspective, the financial services definition should be as limited as necessary.

7.11 The main reason for the proposed GST exemption for financial services is valuation difficulties. These valuation difficulties arise because some financial services involve a mixture of a savings product and a service. These valuation issues do not arise for managers and investment managers as they charge a separate fee for their services (rather than a fee for a bundled mix of services and investment products).

Minimising any significant biases that GST may create

7.12 It is important to ensure that GST treatment of various managed fund fees does not provide a significant competitive advantage for certain types of savings products, managed funds, business structures or larger funds which may be better able to reduce or recover some of their GST costs.

7.13 For example, because the GST rules currently provide an exemption for "management of a retirement scheme", there could be a bias for managed funds to invest into specialist retirement funds, rather than more general funds. This may encourage inefficient arrangements. More generally, the retirement scheme exemptions were introduced in 1985 to ensure that the GST exemption for life insurance did not encourage life insurance to be the preferred long-term savings product compared to retirement schemes. Commercial developments with how life insurance products are used, and how retirement funds invest into and are close substitutes for other types of managed funds mean there is no longer a good policy rationale for having different GST rules apply depending on whether the management service is provided to a retirement scheme, compared to another type of managed fund.

7.14 GST exemptions also create a bias for exempt service providers to provide services in-house as they face unrecoverable GST costs from outsourcing. This bias is undesirable given that outsourcing may be more commercially efficient or more consistent with financial market regulations.

Providing certainty of GST treatment

7.15 To minimise compliance costs, potential errors or competitive biases it will be important to develop a clear definition of the manager and investment manager services which qualify for a particular GST treatment.

Minimising adjustment costs compared to current commercial practices

7.16 Transitional and compliance costs could be reduced by aligning with existing commercial practices. The difficulty is there are a range of current practices.

GST treatment of managed funds in other countries

7.17 Looking at the rules in other countries, there are different ways that other GST and VAT systems treat managed funds and investment management services.

Australia and Singapore

7.18 Both Australia and Singapore's GST rules apply GST at standard rates to all services provided to managed funds. However, both these countries then allow the funds to claim back most of the GST costs of their inputs through a reduced input tax credit mechanism. In Australia reduced input tax credits are available for seventy five percent of the GST costs except for trustee fees where only fifty five percent of the GST cost can be deducted. In Singapore a GST remittance is allowed for qualifying funds – the percentage varies each year but is about ninety percent of the GST charged to the fund.

7.19 The rationale for providing a reduced input tax credit is to reduce the bias to perform the relevant services in-house (as there are GST costs from outsourcing but none from the insourcing). Conceptually, the reduced input tax credit should be set so it is equal to the percentage of the outsourced service provider's fee that comprises their own wages and profits (as opposed to third party costs). In practice, determining the appropriate percentage is not obvious.

European Union countries

7.20 A European Union VAT directive requires European Union member states to exempt the "management of special investment funds as defined by member states". European Union countries exempt management services provided to funds on the basis that the VAT system should not impose additional VAT costs from investing through managed funds, compared to investing in the underlying shares or bonds directly.

Policy options for how GST could apply to manager and investment manager services

7.21 Officials propose amending the GST Act definition of "financial services" to provide a more certain and consistent GST treatment for manager and investment manager services supplied to managed funds.

7.22 Three main options for changing the law are discussed below. We welcome submissions on these or other potential policy options. If the law is changed, Inland Revenue will not finalise or implement its view of the current law (which is currently in draft).

Making all management services supplied by investment managers and other fund managers taxable supplies

7.23 This option would involve excluding services provided by fund managers and investment managers from the GST Act definition of financial services.

7.24 This would be consistent with the rationale that the financial services exemption should generally be limited to cases where there are valuation issues. This is not the case for fund managers and investment managers as they usually charge a separate fee for their services (rather than a margin or a bundled combination of services and investment products).

7.25 Applying GST to all services provided by fund managers and investment managers could reduce insourcing biases and simplify GST compliance as they would be able to claim input credits for GST charged on their external costs.

7.26 However, because the services that funds provide to investors would still be exempt from GST, applying GST to the manager's fees charged to funds would impose an unrecoverable GST cost on funds. These GST costs are likely to lead to higher fees and reduced after-tax returns for retail investors.

7.27 Also, if the existing GST exemption for managers of a retirement scheme was retained, there would be inconsistent GST treatment as managers of retirement schemes would have no GST on their fees whereas other types of fund managers would have 15% GST on their fees. This could create biases for investing through retirement funds rather than other types of managed funds and for retirement schemes to be structured so that they receive manager services directly, rather than indirectly through investing in non-retirement funds.

Exempting all management services supplied by investment managers and other fund managers

7.28 This option would broaden the GST Act definition of financial services to include fund management. This would involve expanding the existing exemption for managers of a retirement scheme, so it also applies to managers who provide management services to other types of funds.

7.29 A more general exemption for fund managers and investment managers may be justified on the basis that the financial services exemption already extends to some services which are close substitutes for another type of exempt financial service in order to reduce tax distortions on business or investment decisions. For example, because services provided by a manager of a retirement scheme are specifically exempt from GST, a managed fund may prefer to purchase those services as opposed to services provided by an investment manager, unless investment management services are also exempt.

7.30 On the other hand, a broader financial services exemption that includes all fund manager and investment manager fees would narrow the GST base and lead to greater amounts of financial services being only partially subject to GST (on their taxable inputs), compared to other services (such as financial advice) which are subject to 15% GST.

7.31 This creates a bias because an individual investor seeking financial advice would be charged GST for that advice but a managed fund purchasing investment management services (which may include investment advice) would not be charged GST. However, this bias is unlikely to be significant enough to affect decisions about whether to invest into a managed fund or invest directly into shares or bonds.

7.32 Similarly, Discretionary Investment Management Services (DIMS) services may be disadvantaged if they are required to charge GST on their services and managed funds are not.

7.33 An exemption would impose GST costs for managers and investment managers to the extent to which they purchase inputs such as renting office space, hiring contractors, or procuring data, external advice, administrative services or computer services.

7.34 Depending on how the relevant services are defined an exemption could create boundary issues in determining whether a service was a management service or another type of service. For example, there could be incentives to bundle or reclassify some other types of services as being management services to further reduce GST costs for managed funds.

7.35 Providing an exemption for management services would also lead to policy arguments that other types of services provided to managed funds should also be made exempt from GST in order to further reduce GST costs for managed funds. See paragraphs from 7.58 onward for a further discussion about the GST treatment of other types of services provided to managed funds.

7.36 It would be important to develop a robust and certain definition of the services which qualify for any fund management exemption. European Union case law has found that the "management" of an investment fund has a broad meaning for

European Union VAT purposes and can include administrative services and advice. In contrast, New Zealand has made policy decisions that administrative services and advice should be subject to 15% GST and should not qualify as exempt financial services.

Legislate that managers and investment managers are deemed to have a certain percentage of taxable (subject to GST at 15%) and exempt supplies

7.37 This approach could be used to partly tax the relevant services. It could provide certainty and consistency which may reduce competitive distortions.

7.38 Depending on the percentage used, it could also potentially align with some existing industry practices (ninety percent exempt, ten percent taxable), although this would represent a major change for other managers who are currently treating their supplies as taxable supplies.

7.39 One of the issues with this approach is that it is not obvious what the appropriate percentage should be. Any legislated percentage could either overcompensate or undercompensate relative to the true nature of the manager's services unless it was supported by evidence. We are interested in submissions on what percentage could be considered a reasonable approximation of the taxable services provided by managers and investment managers.

7.40 As with an exemption option, a partial exemption option would also mean there was less GST charged on these services compared to other types of services which are subject to GST at 15%.

7.41 This option would also be inconsistent with the fact that the GST Act does not usually apportion output tax on supplies. (The main exception to this is section 10(6) which deems sixty percent of domestic goods and services provided in a commercial dwelling to be taxable supplies if the occupant stays for more than four weeks.)

7.42 If the manager is providing multiple types of services to the fund, a better approach could be to apply the analysis for determining if there is a single or multiple supply as discussed in the Inland Revenue *Interpretation Statement IS 18/04 (Goods and services tax – single supply or multiple supplies)*. Applying this analysis would typically conclude that a service is a single supply if it had a dominant element and the other elements were reasonably incidental. This option of deeming a certain percentage of the supply to be taxable would therefore represent a significant departure from this approach.

Zero-rating or a reduced input tax credit mechanism

7.43 Compared to an exemption, zero-rating would further reduce the GST costs associated with providing management services to funds, as the managers and investment managers would still be able to claim back the GST costs of their own inputs.

7.44 A reduced input tax credit mechanism for the managers and investment managers would allow partial recovery of the GST costs on the inputs.

7.45 Both options give rise to many of the same disadvantages of the exemption or partial exemption options discussed above – such as the need to carefully define manager and investment manager services to provide certainty as to what services qualify for the special GST treatment.

7.46 However, compared to the other policy options, zero-rating or a reduced input tax mechanism would mean the manager and investment manager services would be substantially undertaxed (compared to both other services and to GST-exempt financial services). It would also create a much more significant precedent. Furthermore, compared to current practices it would have a high fiscal cost for the Government.

7.47 While both Australia and Singapore provide reduced input tax credits for managed funds, these countries also have a narrower definition of financial services than New Zealand that excludes services of "arranging" a financial product. Accordingly, the services provided by managers and investment managers are subject to GST in these countries.

7.48 In Australia, reduced input tax credits are available to all financial service providers, not just managed funds. The policy rationale for providing reduced input tax credits is to reduce the bias that an exemption creates to provide inputs in-house rather than outsource these to other providers. It may also be hard to justify why reduced input credits should only be provided for managed funds or managers of managed funds (which for commercial and regulatory reasons often need to outsource certain services regardless of the GST cost) compared to other financial service providers (where GST may create a bigger bias against outsourcing).

7.49 Even if the GST treatment of manager and investment manager fees generates a significant problem by discouraging outsourcing, it is not obvious what percentage of GST should be recoverable under the reduced input tax credit. Conceptually, it should be the percentage of the outsourced service providers' fees that comprises their profit and staff wages, but in practice this can differ across service providers and will be difficult to reduce into a single percentage.

7.50 For these reasons, officials consider the case for introducing reduced input tax credits would be more appropriately considered as part of a more fundamental review of the financial services definition that considered the full range of financial services, not just manager and investment manager services. Reduced input tax credits are a logical alternative option to providing an exemption for the service of "arranging" a financial product.

7.51 Providing zero-rating or reduced input tax credits would further reduce the partial GST on non-financial services that retail investors benefit from as a result of investing through managed funds. This would make receiving these services through managed funds further advantaged compared to other services, such as individual investors buying their own research or financial advice which would be subject to 15% GST.

7.52 Finally, either a new zero-rating rule or a reduced input tax credit mechanism would have a significant fiscal cost compared to the current rules where GST partially applies to managed funds. For example, zero-rating would effectively allow GST to be removed on all administrative services provided to managed funds as these would be purchased by a manager who makes zero-rated supplies and is able to claim input credits for these GST costs.

Application date

7.53 It is proposed that the potential law change could apply prospectively but with grandparenting of existing contracts for a period (for example, three years) to ease adjustment costs and to enable new contracts to be negotiated.

Defining the relevant management and investment management services

7.54 The changes would apply to both management services by a manager and investment services by an investment manager that were provided directly or indirectly to a managed investment scheme or a foreign equivalent.

7.55 The terms "manager", "investment manager" and "managed investment scheme" could be defined by referencing the existing definitions of these terms in section 6(1) and section 9 of the Financial Markets Conduct Act 2013.

> **Relevant definitions from Financial Markets Conduct Act 2013**
>
> **investment manager means**, in relation to a managed investment scheme, a person to whom a manager of the scheme has contracted the investment of some or all of the scheme property.
>
> **manager** means,—
>
> (a) in relation to a registered scheme (other than a restricted scheme), the person designated or appointed as the manager of the scheme:
>
> (b) in relation to a restricted scheme, the persons designated or appointed as trustees of the scheme or, if only 1 person is designated or appointed as a trustee of the scheme, that person:
>
> (c) in relation to a managed investment scheme if there is no person to whom paragraph (a) or (b) applies or if it is not a registered scheme, a person occupying the position of, and carrying out any of the functions of, the manager set out in section 142:
>
> **142 Management and administration functions of manager**
>
> (1) The manager of a registered scheme is responsible for performing the following functions:
>
> (a) offering the managed investment products; and
>
> (b) issuing the managed investment products; and
>
> (c) managing the scheme property and investments; and
>
> (d) administering the scheme.

> **managed investment scheme** means a scheme to which each of the following applies:
>
> (a) the purpose or effect of the scheme is to enable persons taking part in the scheme to contribute money, or to have money contributed on their behalf, to the scheme as consideration to acquire interests in the scheme; and
>
> (b) those interests are rights to participate in, or receive, financial benefits produced principally by the efforts of another person under the scheme (whether those rights are actual, prospective, or contingent, and whether they are enforceable or not); and
>
> (c) the holders of those interests do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions).

7.56 "Foreign equivalents" would include Australian Managed Investment Trusts (AMITs) and other entities subject to the AMIT regulatory regime as well as other foreign funds that are comparable to the relevant New Zealand funds.

7.57 The proposed changes would also apply to "out of fund" fees. Out of fund fees are charged in cases where a fund invests into a second wholesale fund that is managed by another manager, but the management fee of that other manager is invoiced directly to the manager of the first fund. This practice occurs to ensure that there is no duplication of investment management fees.

Other outsourced services which are not management services

7.58 Officials do not propose changing the GST treatment of other services provided to managed funds such as accounting, administrative or registry services. These outsourced services are generally subject to GST (taxable supplies) unless they are themselves exempt financial services.

7.59 We consider it is sensible to draw a distinction between providing management services to a fund and providing other types of services.

7.60 Providing a special GST treatment such as an exemption for administrative services provided to managed funds would create a precedent and make it difficult to justify continuing to apply 15% GST to administrative services provided to other financial service providers such as banks or life insurers.

7.61 There is already an existing precedent for exempting the "management" of a retirement scheme. In addition, under the current GST rules three similar types of fund management services (management of a retirement scheme, managers of managed investment schemes and investment managers) can have three different GST treatments which creates more significant uncertainty and biases on how these services are arranged or priced.

7.62 The same uncertainties and inconsistent GST treatments should be much less likely to arise for administrative services as there is a clearer position that such services are taxable in the typical cases where they are outsourced (as opposed to being incidental services supplied as part of a much larger, single supply of an exempt financial service).

7.63 The legislative position whereby GST applies to such outsourced administrative inputs was established in 1987 through the decision in *Databank Systems Ltd v CIR* (1987) 9 NZTC 6,213 which found that Databank was providing computing services to banks rather than financial services. As a result of the *Databank* proceedings, a clarifying amendment was also made to explicitly exclude "general accounting and record-keeping" services from the definition of financial services.

Questions for submitters

- What are the pros, cons or practical issues associated with each of the policy options? How well would they achieve the policy objectives?
- What types of manger and investment manager services should the proposed policy or law change apply to? What is the clearest way to define the relevant services?
- If the law was changed, what transitional issues could arise and what measures could be implemented to enable a smooth transition to the new law?

CHAPTER 8

Insurance pay-outs to third parties

8.1 The GST rules require GST-registered recipients of an insurance pay-out to return GST on these pay-outs. When a GST-registered recipient of an insurance pay-out is a third party to the insurance contract, they may not be aware they are receiving a payment which is covered by insurance. As a consequence, they may fail to comply with the rules or may be under-compensated as they did not expect to have to return GST on the payment.

8.2 This chapter discusses some potential options for mitigating this issue.

Current GST rules for insurance

8.3 The GST Act includes special rules for applying GST to general (non-life) insurance. Insurers pay GST output tax on premiums they receive and claim GST input credits on the total amount of their pay-outs.

8.4 If the insured party is a GST-registered person who is insuring their taxable activity they can claim deductions for GST input credits in relation to the GST that is charged on their insurance premiums.

8.5 Section 5(13) of the GST Act requires GST to be returned on insurance pay-outs received by GST-registered persons to the extent that it relates to a loss incurred in the course and furtherance of the person's taxable activity (for example, their business, rather than a private use). It does this by deeming the GST-registered person to have made a taxable supply to an insurer when they receive a payment under a contract of insurance, "whether or not they are a party to the insurance contract".

8.6 This means that even if the recipient of the insurance pay-out is a third party to the insurance policy, they will still be required to return GST output tax if they are a GST-registered person and the loss is incurred in the course and furtherance of their taxable activity (such as an asset used for their business).

8.7 This deeming rule is not intuitive, as the GST-registered person has not made a sale or supplied any actual goods or services to the insurer. Also, GST does not generally apply to compensation payments. So, if the third party had received a compensation payment that was not covered by insurance, GST would not apply to the payment.

8.8 Problems can arise when the insurance pay-out is made to a third party, rather than the insured person.

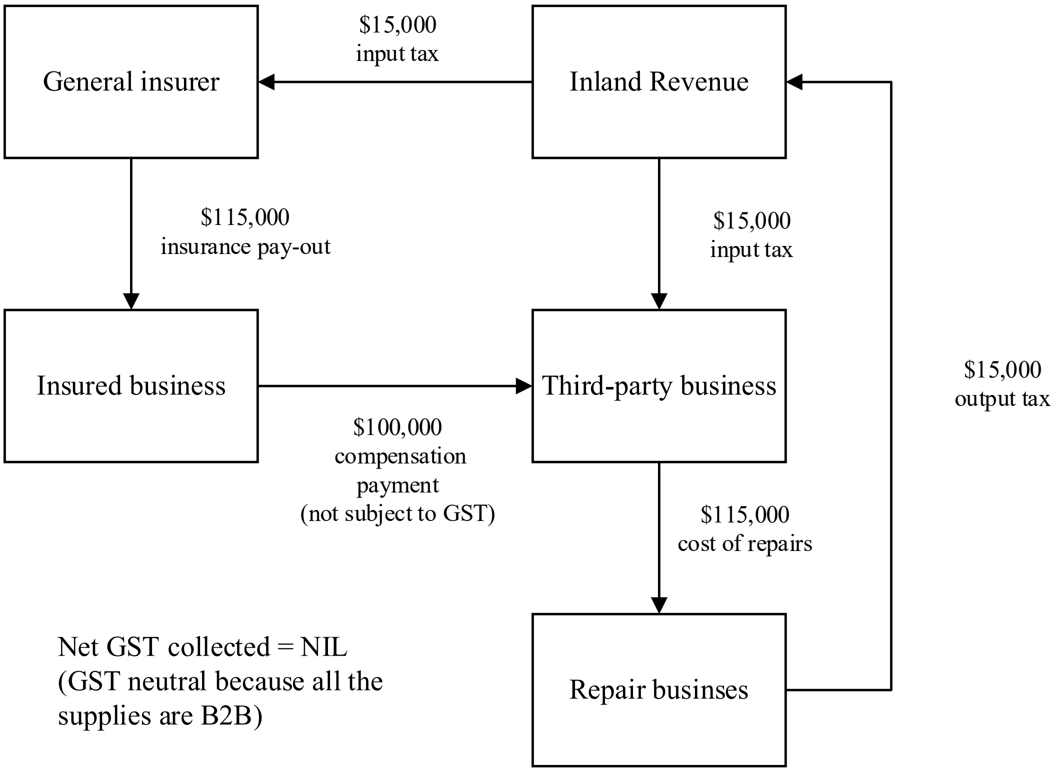
Intended operation of rules when insurance pay-out is to a GST-registered third party

8.9 A typical scenario involves:

- an insured party causes loss to a third party (for example, vehicle or property damage, professional liability, and so on);
- the insurer assists the insured party to reach a settlement agreement between the insured party and the third party which specifies a sum to be received by the third party.

8.10 If the insurer makes a payment to an GST-registered insured party who caused the loss in the course and furtherance of their taxable activity, the insured party is liable to return GST under section 5(13) on the payment, and typically the amount of the pay-out would be grossed up to account for this. The insured party then pays the funds to the third party under the settlement agreement and because that payment is a compensation payment it is typically not subject to GST. This is illustrated in figure 2.

Figure 2: Pay-out to a GST-registered insured party

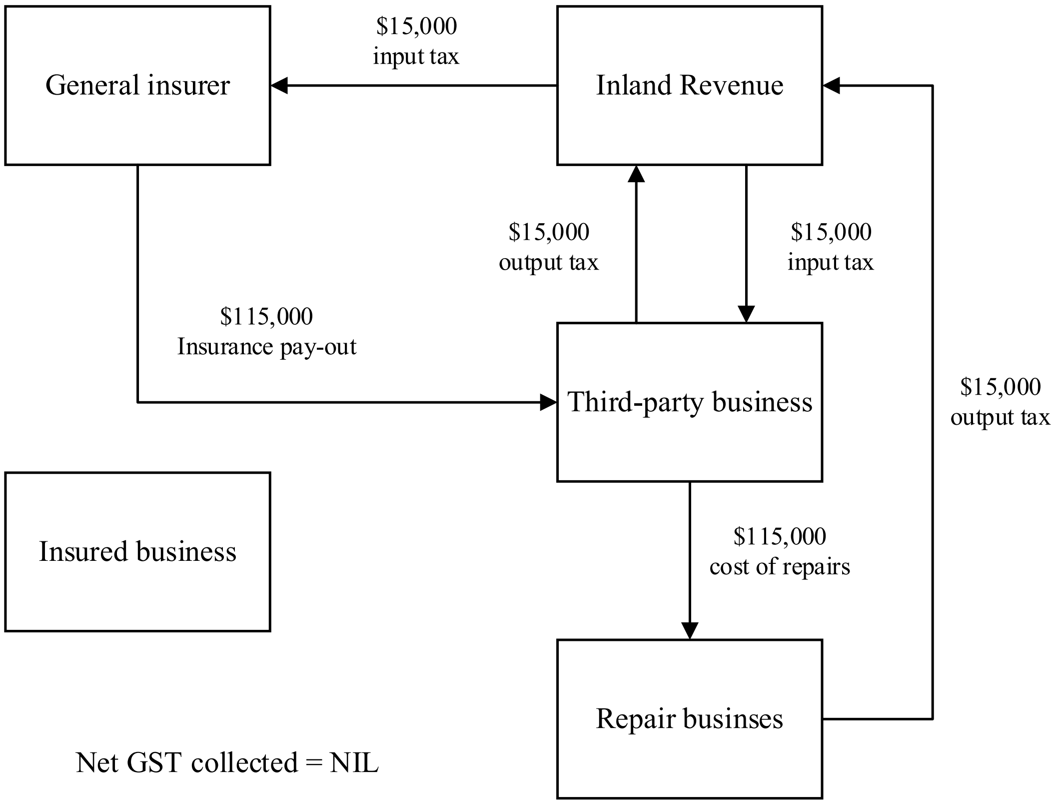


8.11 However, we understand that insurers will usually direct the payment to the third party, rather than the insured party in cases where the insurance policy is covering a loss to the third party.

8.12 The insurer can claim an input tax deduction in relation to the insurance pay-out regardless of whether it pays the insured party or the third party. However, the third party may be unaware of the nature of the payment.

8.13 If the third party knows the settlement payment is an insurance pay-out and correctly applies section 5(13) of the GST Act, they would return GST output tax on the payment. This is illustrated figure 3 which provides the same overall GST outcomes as figure 2.

Figure 3: Pay-out to third party who correctly returns GST on the payment

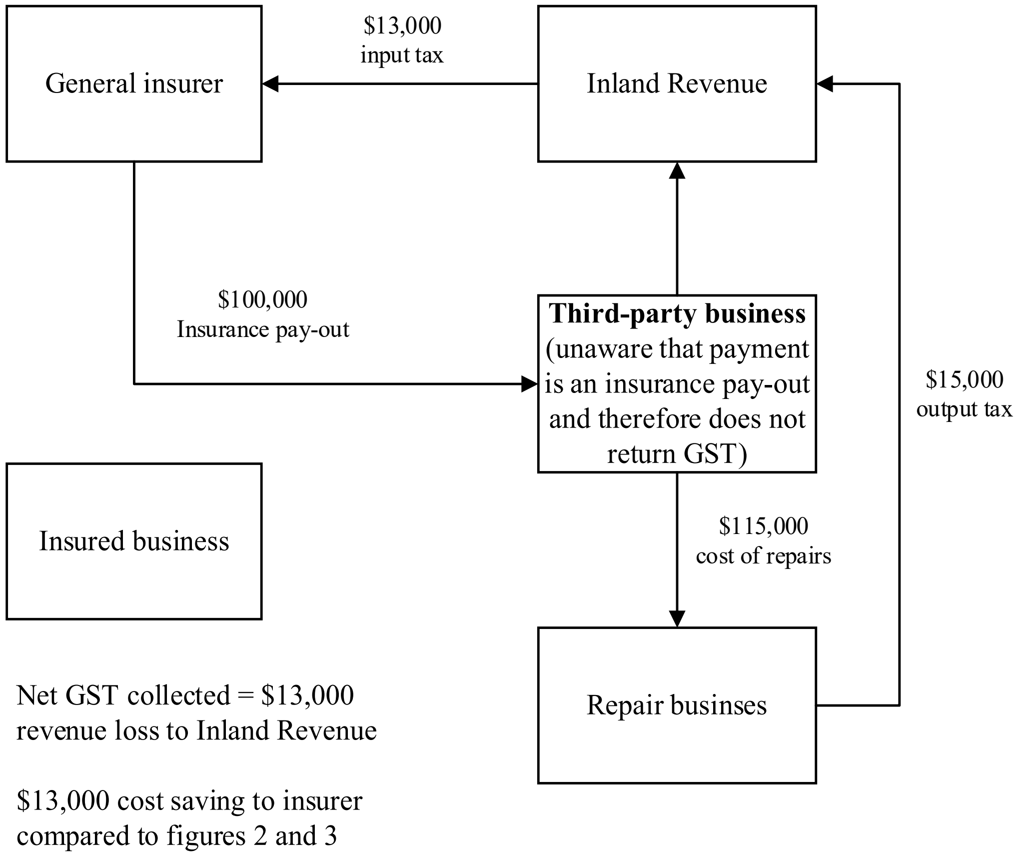


Problems occur when a GST-registered third-party is unaware of source of the payment

8.14 A GST-registered third party may often not know whether the source of the funds is from the insured party or an insurer, as the payment will usually be disbursed from a solicitor's trust account. The problem is exacerbated by the fact that an insurer may conceal its involvement in the dispute to lower the third party's expectations of a sizeable settlement. The insurer will benefit where the third party is unaware of the insurer's involvement and does not require the settlement to be grossed up for GST. This is because the third party may incorrectly assume they are receiving a compensation payment which is not subject to GST and therefore not return any GST on the payment.

8.15 The scenario where the third party does not know they are receiving an insurance payment is illustrated in figure 4, which results in a revenue loss to Inland Revenue and corresponding cost saving to the insurer compared to figures 2 and 3.

Figure 4: Pay-out to third-party who does not know the pay-out is covered by insurance



Scale of the problem

8.16 Officials do not have enough information to quantify the magnitude of these issues.

8.17 However, the potential fiscal risk is high given the commercial incentives to negotiate a lower settlement amount. For example, reaching agreement on a settlement amount of $10 million, rather than needing to gross that amount up to a $11.5 million (to offset the GST that is required to be paid by the recipient), could represent a $1.3 million cost saving for the insurer.

8.18 Inland Revenue has dealt with an increasing number of disputes involving section 5(13). Several tax and legal advisors have also raised concerns with us that GST may not be properly considered in negotiated settlements with third parties, leaving the third party undercompensated or at risk of an unexpected GST liability.

8.19 We are interested in submitters' views about the scale of the problem described above and their experiences with trying to apply the existing requirements.

8.20 In particular, is it obvious when a payment is an insurance payment (subject to GST) or a compensation payment (not subject to GST)? Are the legal advisors that deal with claims or settlements involving insurance generally aware of the existing requirements of section 5(13) of the GST Act? Do they take care to ensure the agreed amount is grossed up to include GST and that GST-registered recipients of insurance payment correctly return output tax as required by section 5(13)?

Policy options for improving certainty and compliance with GST on insurance pay-outs

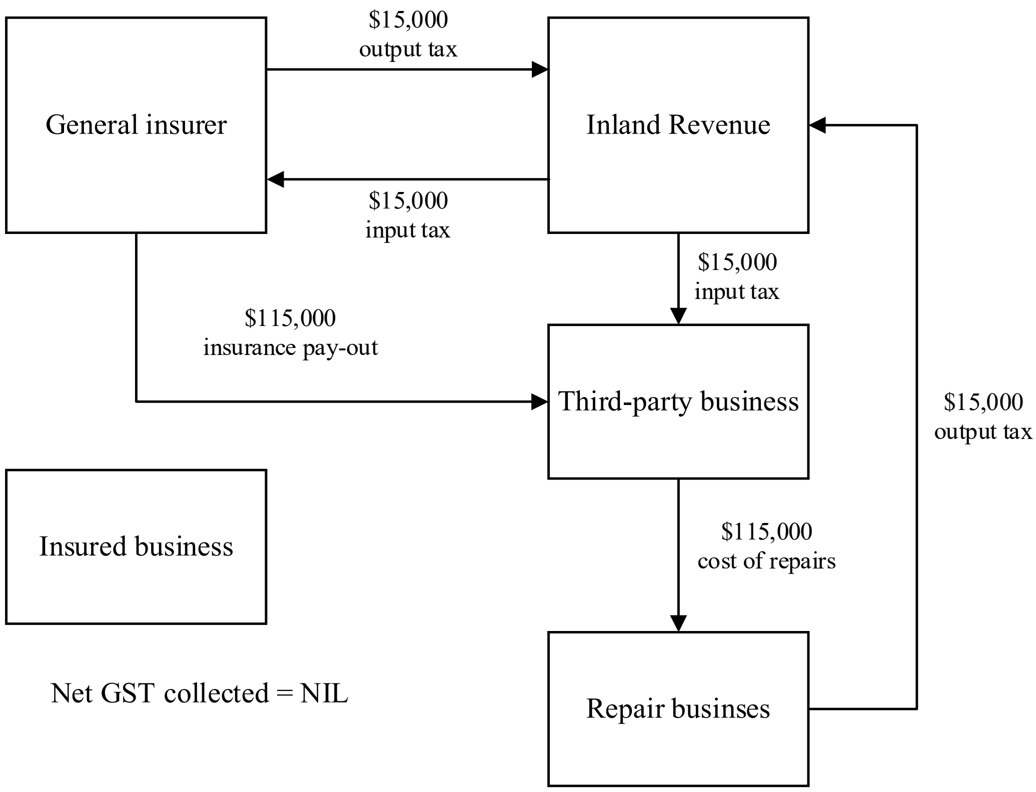
8.21 We have identified three main options for mitigating this issue and providing more certainty for third parties who are negotiating such settlements.

Making the insurer responsible for the GST obligations

8.22 We consider the most effective way to address the problem would be to make the insurer (rather than the person receiving the pay-out) responsible for the GST obligations.

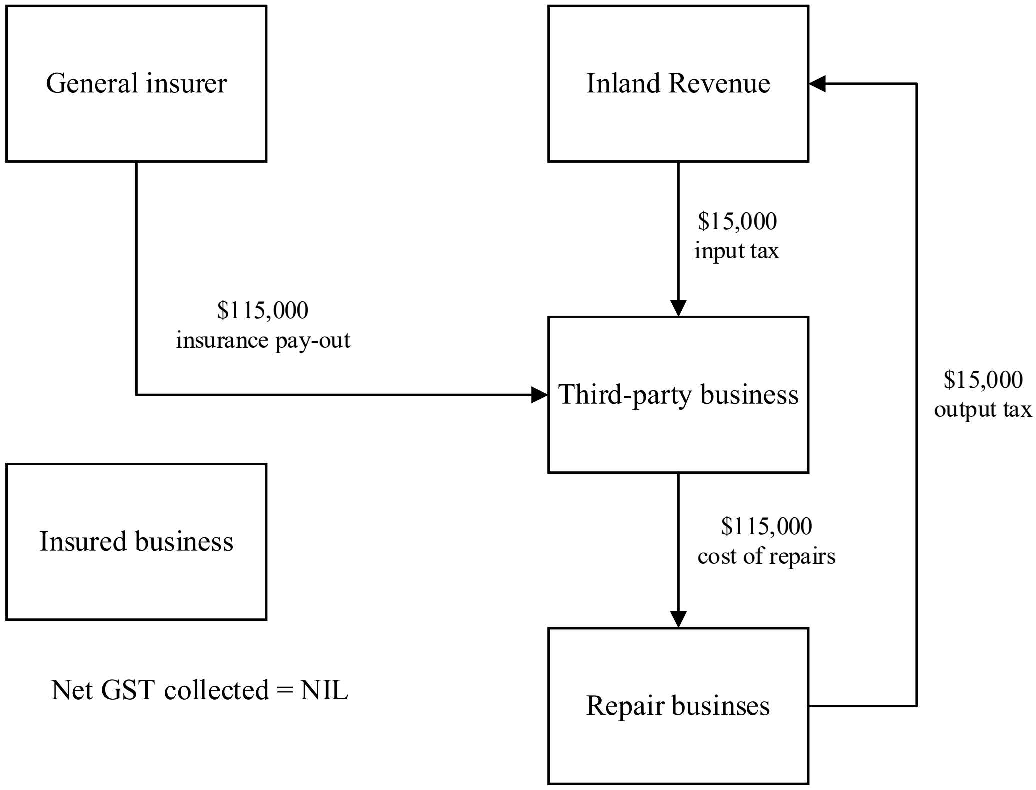
8.23 This could be achieved by amending section 5(13) so it operates as a reverse charge on the insurer. This would mean that the insurer, rather than the third party, would be deemed to make a taxable supply and required to pay the GST when the requirements of section 5(13) apply. This is illustrated in figure 5.

Figure 5: Pay-out to third party with a reverse charge on insurer



8.24 Alternatively, section 20(3)(d) could be amended to deny the insurer an input tax deduction for insurance pay-outs where the current section 5(13) applies to the payment (that is, the payment is to a GST-registered person and relates to a loss incurred in the course and furtherance of that person's taxable activity). Under this approach, a consequential amendment would be made to repeal section 5(13) so there would no longer be any GST output tax on the recipients of insurance payments.

Figure 6: Pay-out to third party with no input credit for insurer



8.25 Limiting the input deduction under section 20(3)(d) would appear to be simpler than a reverse charge but we invite submissions on which type of amendment would be less costly for insurers to implement.

8.26 Either of the proposed amendments would require the insurer to determine whether the person receiving the pay-out is GST-registered and whether the insurance pay-out relates to a loss incurred in the course or furtherance of their taxable activity (as opposed to a private or exempt activity).

8.27 This would increase compliance costs for insurers as they would need to request information about the recipient's GST status, and they would need to implement new systems to treat pay-outs differently depending on the GST status of the recipient.

8.28 In cases where a damaged asset is partly used for a taxable and non-taxable activity (such as a residential home with a home office, or a work vehicle with private use) it would also be necessary to determine to what extent the insurance payment relates to a taxable asset. In such cases it could be difficult for the insurer to obtain information from the recipient of the pay-out to correctly account for GST on payment.

8.29 One possible solution to this issue could be to require the insurer to account for the full amount of GST output tax (or not claim any input tax credit) when an insurance payment is made to a GST-registered person (regardless of the extent to which the payment was connected to the registered person's taxable activity). A corresponding amendment could be introduced to allow a GST-registered person who receives that payment to be able to claim a new type of GST deduction under section 20(3) to the extent to which the insurance payment was made in respect of an asset that was not used by the registered person to make taxable supplies (for example, a private or exempt use).

8.30 We note that non-resident suppliers of remote services (which includes general insurance) are already required to determine if they are supplying services to a GST-registered person as part of that person's taxable activity (see section 8(4D)). In that case the Commissioner can agree that a supplier can use an alternative method for determining if they are making supplies to a GST-registered person. This type of approach could be used to assist insurers if they were required to determine whether they were making a pay-out to a GST-registered person.

8.31 Australia's GST rules for general insurance require insurers to distinguish between pay-outs in relation to insurance contracts with GST-registered persons and contracts with unregistered persons. Under Australia's rules the insurer is only entitled to a GST deduction (called a decreasing adjustment) in cases where the insured party did not claim a GST deduction in respect of the premiums paid on that insurance contract. We would be interested in submitters' views about any compliance costs that this differing GST treatment of insurance claims creates for Australian insurers.

8.32 Making the insurer responsible for GST could reduce compliance costs on other GST-registered businesses as they would no longer have to return GST on insurance pay-outs, and they could treat insurance pay-outs the same as compensation payments (which are not subject to GST).

8.33 In addition, as discussed above the insurer will know the settlement payment is an insurance payment, whereas a GST-registered third party is often unaware of the nature of the payment. Even if they knew the payment is insurance, they may not be aware of the GST rules (in section 5(13) of the GST Act) which require them to return GST on insurance payments.

8.34 Officials are concerned that this option would impose high compliance costs and systems changes on insurers and welcome submissions explaining these costs. Officials are also interested in working with insurers, legal and tax advisors and affected businesses to develop some alternative options to address the problem. Two of these alternatives are discussed.

8.35 However, if these alternatives are not effective at improving GST compliance and Inland Revenue continues to observe and receive feedback that the commercial incentives to not disclose insurance make complying with GST too difficult, it may become necessary to shift GST obligations onto the insurer if this is the only way to effectively address the fiscal risk and fairness concerns.

Requiring disclosure that the payment is covered by insurance

8.36 An alternative option would be to require the insurer to disclose in writing to the third party that the amount of their settlement payment is covered by insurance and that if they are registered for GST, they may be required to return GST on that amount under section 5(13).

8.37 This information would allow the third party to be aware of their GST obligations and consider if the amount of the settlement is sufficient (or if it needs to be grossed up to account for GST).

8.38 The timing of the disclosure would need to be considered. In order to be fair to the third party, they would need to know about the GST implications prior to agreeing to the settlement. However, such a disclosure requirement may lead to the agreed settlement amount being significantly higher in those cases where it is covered by insurance. This could have a flow-on effect in increasing the costs for businesses in obtaining public or professional indemnity insurance to cover the risk of potential damages to other GST-registered persons.

8.39 Another consideration is the consequences for the insurer if they fail to disclose the information. One potential consequence would be to shift the GST liability to the insurer (as opposed to the GST-registered person) but this may create uncertainty and disputes about who is liable for the GST. Another possibility would be a separate standalone penalty on insurers who fail to disclose the information, but it may be difficult to set this penalty at the right amount to promote compliance (considering the potential cost savings from non-compliance will vary depending on the amount of the payment).

8.40 Information disclosure requirements could also lead to confusion. For example, a large number of insurance recipients are not registered for GST, but may become prompted by an information disclosure to consider whether or not GST obligations apply to them. This may lead to increased contacts and questions to insurers, advisors or Inland Revenue. One way to mitigate this could be to target the information disclosure requirement so it only applies to those insurance products where the problem is most likely to arise such as commercial property or professional liability insurance.

No law change, but provide education and guidance

8.41 The least disruptive option would be to retain the current insurance rules but provide education and guidance for advisors and GST-registered businesses.

8.42 If third party claimants were aware of the potential GST risk they could ask for advice as to who is paying the settlement amount, or the source of the settlement amount, and ask for either a GST gross-up and/or a GST indemnity.

8.43 For example, when negotiating settlement agreements, a third party could include a warranty that the payment they are receiving is not a payment of insurance or require the settlement amount be "plus GST, if any". Under such an agreement, the third party would be able to require the payment to be grossed up by the insured party in those cases where they discover they must return output tax on an insurance payment under section 5(13) of the GST.

8.44 However, in our view, this option is unlikely to be effective. It relies on the third party (or more likely their tax and legal advisors) being both:

- aware and sufficiently concerned about the GST risk; and
- being able to obtain information that the insured party (or their insurer) has commercial incentives to not provide (in order to lower the third party's expectations about the amount of an acceptable settlement).

8.45 Also, just because the settlement agreement includes a "plus GST if any" clause or a GST indemnity it does not mean that the recipient will return GST on insurance payments as they may mistakenly believe that the payment is not subject to GST.

If the recipient of an insurance payment fails to return GST, they could be liable for penalties and interest if the error is subsequently identified. The third party could also be exposed in cases where the insured party goes out of business.

8.46 It could be difficult to adequately alert the potentially affected parties (or their advisors) of the issue, particularly as negotiating a large insurance settlement will be an unlikely or rare event for most GST-registered persons.

Application date

8.47 Any law change would apply prospectively from a future date after the date the relevant legislation was enacted (which could be in 2021).

8.48 We invite submissions on how much lead time submitters consider could be necessary (for example, following enactment of any new legislation) for the affected parties to prepare their systems in order to comply with the potential legislative options discussed above.

8.49 We also invite submissions on potential compliance costs and systems impacts of the policy options described above and if there are ways to design the proposed rules to mitigate some of these impacts.

Questions for submitters

- When a damaged third-party receives an insurance or compensation payment is it difficult for them to determine whether or not the payment comes from an insurer?
- In what situations does the problem occur and what information is available to assess the potential scale of the problem?
- What are the costs, benefits and practical issues associated with the policy options? How much lead time would insurers or other affected parties need to implement these options?

CHAPTER 9

Compulsory zero-rating of land

9.1 The GST Act requires a supply that wholly or partly consists of land to be zero-rated if the supply:

- is made by a registered person to another registered person who acquires the supply with the intention of using the goods and services for making taxable supplies; and
- is not a supply of land intended to be used as a principal place of residence of the recipient of the supply or a person connected with them by blood relationship, marriage, civil union, de facto relationship or adoption.

9.2 This chapter consults on several suggested technical amendments to address situations where the current compulsory zero-rating of land rules appear to produce flawed outcomes or the timing of when the relevant provision applies could be improved. These scenarios include:

- Clarifying the relationship between sections 5(23) and 78F where land is incorrectly treated as zero-rated.
- Non-taxable supplies of land that have been incorrectly treated as zero-rated.
- The date that the deemed supply under section 5(23) should occur on.
- The taxable period for the adjustment when a second-hand goods deduction has been incorrectly claimed by purchaser of zero-rated land.
- The date of output tax adjustment under section 20(3J) which applies when a person acquires zero-rated land that they intend to use for both taxable and non-taxable purposes.

Relationship between sections 5(23) and 78F when land is incorrectly treated as zero-rated

9.3 Where the land zero-rating rules are incorrectly applied to treat a supply as zero-rated, the purchaser of the land is required to return GST on the supply under section 5(23). Section 5(23) provides that if a supply of land is incorrectly zero-rated and this fact is discovered after the date on which the transaction was settled, the recipient of the supply is treated as though they were a supplier making the supply of land on the date of settlement.

9.4 Section 78F requires the recipient of the land to notify the supplier whether at the date of settlement they will be a GST-registered person and are acquiring the land with an intention to make taxable supplies and do not intend to use the land as a principal place of residence for themselves or an associated person.

9.5 It is not clear how section 5(23) interacts with the requirement in section 78F for the recipient of the land to provide information to the supplier.

Suggested solution

9.6 We propose making an amendment to clarify that section 5(23) applies to place the output tax liability on the purchaser, in cases where a vendor incorrectly zero-rates land (as a matter of fact), regardless of the information that was provided (or not provided) by the recipient of the land under the section 78F disclosure requirement.

9.7 The policy concern that the business-to-business zero-rating of land rules were trying to address was phoenix fraud by the vendor. The GST liability should be placed on the purchaser whenever a supply of land was incorrectly zero-rated because that still enables Inland Revenue to recover the unpaid GST if the vendor ceases to operate, as the purchaser has a valuable asset (land) and is likely to continue their taxable activity. This approach is also consistent with the original policy proposal for addressing phoenix fraud which was to introduce a reverse charge mechanism on the purchaser (this was later changed to a zero-rating mechanism in response to submissions).

9.8 The proposed amendment would provide certainty that the purchaser is always liable for any GST output tax liability. However, we acknowledge that the proposed approach places a lot of risk on the purchaser.

9.9 In particular, it could lead to unfair outcomes in some cases where a vendor has unilaterally and incorrectly zero-rated the supply contrary to the purchaser's section 78F information disclosure, either by mistake or by a deliberate act to shift the output tax liability onto the recipient of the land. This may occur because the vendor is "trying to get it right" and thinks that the recipient's statement is either wrong or is likely to change. It also includes the situation where the vendor simply ignores the recipient's statement (despite the statement being correct).

9.10 We note that these issues can be resolved through the contracts between the parties. For example, if the contract price is expressed as "plus GST (if any)" the vendor will have nothing to gain from zero-rating the supply, so any incorrect zero-rating will be because they have simply made a mistake. With a plus GST (if any) contract price, the purchaser will have agreed to assume contractual liability to pay an additional amount for any GST. Therefore, if section 5(23) applies, the purchaser will pay the GST to Inland Revenue but will also be eligible for an input tax credit to claim back this additional GST.

Non-taxable supply incorrectly treated as zero-rated

9.11 Section 5(23) will achieve the correct result in circumstances where a supply of land has been incorrectly zero-rated as a result of the registration status of the purchaser (that is, the purchaser is not registered for GST or does not acquire the goods and services for the purpose of making taxable supplies). However, an anomalous result arises where a supply is incorrectly treated as zero-rated owing to the vendor's registration status or by way of oversight as a result of the vendor carrying on both taxable and non-taxable activities. This anomaly is illustrated in example 24.

Example 24: Property sold was held in trust unrelated to trust's taxable activity

The M Trust carries on a taxable activity and is GST-registered, but also has property holdings unrelated to the taxable activity which relate to residential accommodation for the beneficiaries.

The property is sold for $1 million plus GST if any to Chris who acquires the land to make taxable supplies. Chris does not intend to use the land as a principal place of residence for himself or any person associated with him under section 2A(1)(c) and is not associated with any of the trustees of the M Trust.

Matthew, the trustee of M Trust treats the supply of the land as zero-rated. It is discovered after settlement of the transaction that this is an error.

Section 5(23) applies to treat Chris as making a supply of the land in the course or furtherance of a taxable activity for $1 million. Chris is therefore required to account to Inland Revenue for output tax of $150,000. As Chris is acquiring the land for the purposes of making taxable supplies, he will be able to claim $150,000 as input tax, meaning that the net cost of the land to him is $1 million.

However, the supply should not have been subject to GST at all in the first place. Instead, Chris should have been entitled to a second-hand goods input tax deduction of $130,434.78 (assuming that Chris is not associated with Matthew or any of the other trustees of the M Trust under section 2A(1)). This would have made the net cost of the land to Chris $869,565.22.

This position cannot be rectified by re-characterising the transaction correctly. This is because if it is found after settlement that the supply was incorrectly zero-rated, the transaction is not re-characterised; instead, section 5(23) applies to deem a taxable supply made by Chris.

9.12 This issue may also arise when the Commissioner of Inland Revenue cancels the vendor's registration (after the date of settlement) with retrospective effect to the date of settlement or earlier. In these instances, the transaction may be incorrectly treated by the vendor as zero-rated on the date of settlement (this treatment being incorrect as a consequence of the retrospective deregistration, as the retrospective deregistration would mean the vendor was not a "registered person" on the date of settlement).

Suggested solution

9.13 An amendment could be made so that, where it is discovered after the date of settlement that section 11(1)(mb) was incorrectly applied by the vendor and the relevant supply is in fact not a taxable supply, section 5(23) does not apply and the original supply is instead re-characterised to be a non-taxable supply.

Date of deemed supply under section 5(23)

9.14 As mentioned above, section 5(23) treats the purchaser as making a taxable supply on the date of settlement. This means the resulting output tax is attributed to the taxable period in which the original supply was made. This can be contrasted with the credit and debit note provisions in section 25, where the liability to pay output tax does not arise until the parties have become aware of the need to adjust the output tax returned and input tax claimed.

9.15 Where the purchaser is acquiring the goods and services for the purpose of making taxable supplies, there is no rule deeming the input tax deduction to also arise in the period in which settlement occurred. The practical effect of this is that the recipient of the supply is required to issue themselves with a tax invoice in respect of the supply they are deemed to make under section 5(23), and then claim an input tax deduction in a later period. The timing difference means that in the period in which settlement occurs, the recipient will have underpaid GST, even though the net effect of the transaction is GST-neutral.

Suggested solution

9.16 An amendment could be made so that the recipient of the incorrectly zero-rated supply is treated as making a supply on the date that it becomes apparent that the original supply was incorrectly treated as zero-rated.

Taxable period for adjustment when a second-hand goods deduction has been incorrectly claimed by purchaser of zero-rated land

9.17 Section 25AB of the GST Act is designed to ensure that the rules dealing with changes in the consideration for a supply of second-hand goods apply correctly to deductions claimed by a GST-registered purchaser of second-hand goods.

9.18 When the terms of a contract for the supply of goods or services are varied (for example, by a discount being subsequently offered), the supplier may be required to issue a debit or credit note to the recipient if the supply is taxable. This triggers obligations on both the GST-registered supplier and a GST-registered purchaser to correct their tax position.

9.19 This requirement did not work well when a supply of second-hand goods was not a taxable supply. Although a second-hand goods deduction was available for a GST-registered purchaser (to the extent that they used the goods for making taxable supplies), the debit and credit note rules did not clearly apply to correct the purchaser's GST position where the consideration for the goods changed.

9.20 Section 25AB applies to a supply of second-hand goods to a registered person when the GST-registered purchaser claimed a second-hand goods deduction, and the amount of the claimed deduction exceeds the correct amount as a result of one of the following events:

- the supply has been cancelled;
- the nature of the supply has been fundamentally varied or altered;
- the previously agreed price of the goods changes, whether through the offer of a discount or by other means;
- the goods (or part of those goods) supplied have been returned to the supplier; or
- the compulsory zero-rating of land rules were incorrectly applied to the supply, so that the supply was not treated as zero-rated when it should have been.

9.21 In these circumstances, section 25AB requires the purchaser of the goods to return the excess amount of the deduction claimed as output tax for the taxable period in which one of the events referred to above occurred.

9.22 Requiring the adjustment to be made in the taxable period in which the event occurred should lead to the correct result where the relevant event is the cancellation of a supply, decrease in the amount of consideration for a supply or the return of goods or services. In these cases, the purchaser should be aware of the occurrence of the relevant event when it happens.

9.23 A problem with this requirement however arises in the following scenario:

- A person supplies land to a GST-registered purchaser who intends to use the land for making taxable supplies. The purchaser will not use the land as a principal place of residence for themselves or for a natural person associated with them under section 2A(1)(c).
- The vendor is not registered for GST at the date of settlement, but as at that date, has a liability to register for GST. Therefore, in terms of the definition of "registered person" in section 2(1) of the GST Act, the vendor is a "registered person" at the date of settlement. The conditions for zero-rating are therefore met, but the purchaser would not know this at the time of settlement.
- Based on the vendor's representation that they are not GST-registered, the purchaser claims a second-hand goods credit for the acquisition of the land. This means the purchaser underpays the amount of GST they are liable to return for that period.
- The Commissioner discovers that the vendor should have been registered and registers the vendor, back dated to before the date of settlement.
- Section 25AB therefore requires the purchaser to make an output tax adjustment for underpaid GST (equal to the amount of the second-hand goods deduction claimed on the acquisition of the land).

9.24 The issue is that section 25AB(2) requires the adjustment to be made for the taxable period in which the relevant "event" occurred (which in this case is the incorrect application of the land zero-rating rules to the treatment of the supply, so that it was not zero-rated when it should have been). This would lead to the purchaser incurring debit interest for the excess deduction claimed.

9.25 While in some cases the purchaser may be able to recover these interest costs (along with the amount of the denied second-hand goods deduction) from the vendor, this is not an ideal policy outcome. This result would be particularly problematic in cases where the GST return for the taxable period in which the supply was made was time-barred, resulting in a revenue loss to the Crown.

Suggested solution

9.26 The requirement that the GST-registered purchaser make an output tax adjustment for the taxable period in which the event occurred could be replaced with a requirement that the adjustment be made for the taxable period in which it became apparent that the amount of input tax deducted was incorrect.

Date of output tax adjustment under section 20(3J)

9.27 If a person acquires zero-rated land that they intend to use for both taxable and non-taxable purposes they must calculate and return the portion of the nominal GST component relating to non-taxable use as output tax. Section 20(3J) requires the recipient of the zero-rated land to calculate and return the output tax for the non-taxable use of the land on "acquisition".

9.28 It is not clear when acquisition of the land occurs for the purposes of section 20(3J). For instance, acquisition may be viewed as occurring at the time of supply, settlement, unconditional contract or at some other time. Section 20(3J) should therefore be clarified to make it clear exactly when the recipient must calculate and return output tax for the portion of the nominal GST component that relates to non-taxable use.

Suggested solution

9.29 Time of supply seems to be an appropriate time in which the recipient should have to return the output tax. If the land was not zero-rated, the supplier would have to return output tax for the taxable period in which the time of supply occurred (assuming they use the invoice or hybrid accounting basis). Therefore, using time of supply as the trigger for when an output tax adjustment is required to be made under section 20(3J) would ensure that output tax is returned at the same time, regardless of whether the land is zero-rated or not.

9.30 Officials suggest that this amendment should apply for supplies made on or after 1 April 2011, being the date that the compulsory zero-rating of land provisions came into force, but submissions are invited on whether application from the date of enactment may be more appropriate.

Questions for submitters

- What are your views on these issues and the suggested solutions?
- Are there other policy or practical issues with the compulsory zero-rating of land rules which officials should consider?

CHAPTER 10

Technical and remedial issues

10.1 This chapter seeks feedback on several proposals which involve more minor or technical changes to the GST Act. These proposals relate to:

- GST grouping rules;
- input credits on goods not physically received yet at the time GST return is filed;
- second-hand goods input tax credits on supplies between associated persons;
- providing more flexibility for the Commissioner to approve the end date of a taxable period;
- members of non-statutory boards; and
- challenge rights in relation to a decision of the Commissioner to re-open time-barred GST returns.

10.2 We also welcome submissions with suggestions for other technical amendments or remedial matters which could improve or correct the operation of provisions in the GST Act.

GST grouping rules

10.3 The GST grouping rules are intended to reduce distortions that might arise between a single entity, a branch structure and a group structure. For example, by disregarding intra-group taxable supplies, a group of companies is treated in the same way as a single company that might make taxable supplies between different departments or branches. In the case of a single company, the supply would be a "self-supply" and disregarded. The grouping rules ensure that in the case of a group of companies, the supply may similarly be disregarded.

10.4 The GST grouping rules are also intended to reduce compliance costs. For example, the representative member is responsible for filing a single consolidated GST return on behalf of all members in the GST group, which reduces compliance costs for group members who do not all need to file separate GST returns. Also, by disregarding supplies between group members for GST purposes, the cost of accounting for these intra-group supplies is reduced.

Clarify how the GST grouping rules relate to the other provisions in the GST Act

10.5 There is currently no legislative guidance on how the grouping rules should interact with the other parts of the GST Act. We note that there are two different interpretations – the first interpretation (the narrow interpretation) is that other provisions are applied before the grouping rules. Under the second interpretation (the wide interpretation), the grouping rules are applied before other provisions.

Applying other provisions first (the narrow interpretation)

10.6 Under this approach, by deeming the representative member to make a group member's supply, the supply is still treated as "made" by the group member and simply attributed to the representative member.

Applying the grouping rules first (the wide interpretation)

10.7 By deeming the representative member to make a group member's supply, the supply is treated as "made" by the representative member.

Comment

10.8 These two possible interpretations and some examples of where they produce differing outcomes are further explained in *IRRUIP 13 Consequences of GST Group Registration* issues paper which was released in April 2019.

10.9 In most cases, it does not matter which interpretation is applied. The outcome and analysis are the same under both interpretations.

10.10 In some cases, the wide interpretation provides an outcome that is more consistent with the purpose of the grouping rules. For example, the wide interpretation is more likely to reduce distortions that might arise between a New Zealand resident single entity, a New Zealand resident entity with an offshore branch, and a group structure with a New Zealand-resident representative member.

10.11 Another case where the wide interpretation helps achieve the policy intent is where a holding company group member is used to raise capital on behalf of another group member which is the operating company. In this case the holding company may only make exempt supplies of financial services, so under the narrow view could be unable to claim input tax deductions for capital raising costs. This is because the taxable supplies of the operating company group member would not be considered when determining if section 20H[3] can be applied by the holding company. Under the wider view, the taxable supplies made by the operating company would be considered, which is consistent with the policy intent of the capital raising deduction rules.

Suggested solution

10.12 We consider it would be useful to add a provision to clarify how the GST grouping rules should be applied in relation to the other provisions in the Act.

10.13 Specifically, the new provision could clarify that the GST grouping rules in section 55(7) should be applied prior to the application of other provisions in the Act. This would be consistent with the wide interpretation that is described in *IRRUIP 13 Consequences of GST Group Registration*.

[3] The provision of the GST Act which contains the rules for the treatment of GST incurred in making financial services for raising funds.

Allow the representative member to issue invoices on behalf of all group members

10.14 A practical issue that arises from the wide interpretation is whether there is an ability for the representative member to issue tax invoices on behalf of other group members. This is because section 55(7)(h) states that grouping does not affect a registered person's obligations under section 24. Section 24 requires a registered person to issue tax invoices.

10.15 Requiring each individual group member to issue their own tax invoices in cases where their supplies are deemed to be made by the representative group member would reduce some of the benefits that GST grouping has in reducing compliance costs by allowing GST accounting to be consolidated within the representative member.

Suggested solution

10.16 Officials consider an amendment to allow the representative member to be able to issue a tax invoice on behalf of all members, regardless of whether or not those members are registered or unregistered would be appropriate.

Input tax credits on goods not physically received yet at the time the GST return is filed

10.17 Section 20(3C) provides that where goods are acquired by a registered person, an input tax deduction is allowed to the extent to which the goods are "used for, or are available for use in" making taxable supplies.

10.18 The issue is whether goods are "available for use" if the registered person has not yet physically acquired those goods by the time they file their GST return. For example, they may have paid for or received an invoice for purchase of the goods, but the goods may not have been delivered to them yet.

10.19 Section 20(3C) was introduced in 2010. The previous rule required the registered person to consider the "principal purpose" of the goods.

10.20 This suggests that from a policy perspective section 20(3C) is intended to limit the deduction to the extent to which the goods will be used to make taxable supplies (as opposed to a non-taxable use such as private use or exempt supplies).

Suggested solution

10.21 It was not intended to exclude input tax credits in cases where the person has not yet obtained physical possession of the goods. Therefore, it is proposed that section 20(3C) be amended to clarify that the requirement is met to the extent to which the goods are "used for, or are expected to be used for, or are available for use in," making taxable supplies.

10.22 We consider this would be a remedial amendment which should apply retrospectively from 1 April 2011, as this is the date from which section 20(3C) first applied.

Second-hand goods input tax credits on supplies between associated persons

10.23 Section 3A(3)(a) of the GST Act limits a second-hand goods input tax credit on supplies between associated persons to the lesser of:

(i) the tax included in the original cost of the goods to the supplier; and

(ii) the tax fraction of the purchase price; and

(iii) the tax fraction of the open market value of the supply.

10.24 In many cases the supplier may have purchased an asset for which they were not charged any GST (although GST costs can be embedded in the cost of the asset). As example 25 illustrates this can lead to section 3A(3)(a)(i) denying the ability to claim any second-hand goods input tax credit:

> **Example 25: No ability to claim a second-hand goods input credit for an associated supply**
>
> A developer sells a property to Sam for $1.15 million, including $150,000 of GST.
>
> Sam is not registered for GST (or, if registered does not use the property to make taxable supplies). Two months later Sam sells the property for $1.15 million to John. As this sale is not subject to GST, there is no GST included in the sale price to John.
>
> John lives in the property for five years and then sells the property for $1.5 million to his sister, Jasmine who will re-develop the property to use it as the premises for her business of making taxable supplies.
>
> Currently, section 3A(3)(a)(i) would limit the second-hand goods input tax credit to the GST included in the original cost to John, which was zero – therefore Jasmine is unable to claim any second-hand goods input tax credit.
>
> The correct policy result is that Jasmine should be able to claim a second-hand goods input credit based on the tax fraction (3/23rds) of the original cost to John which would be a $150,000 second-hand goods input credit.

Suggested solution

10.25 Officials consider it would be appropriate for an amendment to section 3A(3)(a)(i) so that the second-hand goods input tax credit is limited to the tax fraction (3/23rds) of the original cost of the goods to the supplier. We consider this amendment should apply prospectively from the date of enactment.

Providing more flexibility for the Commissioner to approve the end date of a taxable period

10.26 A taxable period generally ends on the last day of a month, but under section 15E(2) a registered person may apply to the Commissioner for approval to have a taxable period ending on a different day, so long as that day is not more than seven days before or after the last day of the month.

10.27 Many businesses like to use a "4-4-5" accounting period[4] which in some cases could end on a date in the month that is outside the seven days before or after the

[4] The 4-4-5 accounting period divides a year into four quarters of 13 weeks grouped into two four-week periods and one five-week period. Its advantage over a regular monthly calendar is that the end date of the period is always the same day of the week, which is useful for shift or manufacturing planning.

last day of the month. In these situations the Commissioner cannot approve a different taxable period end date under section 15E(2). Therefore, the taxable periods for these businesses' GST returns may not align with their accounting periods which increases their compliance costs.

Suggested solution

10.28 Officials propose removing the requirement in section 15E(2) that the approved date must be within seven days before or after the last day of the month. This would allow the Commissioner to approve a taxable period end date for a broader range of dates, and could better cater for "4-4-5" accounting periods.

Members of non-statutory boards

10.29 Section 6(3) of the GST Act excludes several activities from being taxable activities. Examples of exclusions from the meaning of "taxable activity" include those for employees, directors, Members of Parliament and members of local authorities and statutory bodies. The rationale for these exclusions is to minimise compliance and administration costs as the contracts for these positions would be (at least predominantly) business-to-business, there would be compliance and administration costs for very little revenue if such persons were required to register for GST.

10.30 The issue is that the scope of the exclusion for board members in section 6(3)(c)(iii) appears to be narrower than was intended.

10.31 Section 6(3)(c)(iii) excludes from the meaning of "taxable activity" any engagement, occupation, or employment as a Chairman or member of any local authority or any statutory board, council, committee or other body.

10.32 The question is whether this exclusion is limited to members of statutory boards and other statutory bodies, or whether it equally applies to members of non-statutory bodies. The current view being applied by Inland Revenue is that section 6(3)(c)(iii) only applies to members of statutory bodies. Therefore, members of non-statutory boards are treated differently to members of statutory boards despite the well-documented policy intention to exclude board members more generally from having a taxable activity.

Suggested solution

10.33 The exclusion for members of statutory boards and other statutory bodies could be widened so that it clearly applies to members of non-statutory boards.

Challenge rights in relation to a decision of the Commissioner to reopen time-barred GST return

10.34 Section 108A of the Tax Administration Act 1994 prohibits the Commissioner from amending a GST assessment to increase the amount assessed if four years have passed from the end of the taxable period in which the return was filed. The Commissioner may however amend a GST assessment at any time if the Commissioner considers the person knowingly or fraudulently failed to disclose all of the material facts that are necessary for determining the amount of GST payable for a taxable period.

10.35 Section 138E(1)(e) of the Tax Administration Act sets out that a right of challenge against a decision made by the Commissioner under section 108A to reassess a time-barred GST assessment is not conferred under Part 8A. However, taxpayers do have the right to challenge a decision made by the Commissioner under section 108 to reopen a time-barred income tax assessment. The consequence of this is that a Commissioner-initiated reassessment for income tax is a "disputable decision", whereas her decision to reopen for GST is not. A decision by the Commissioner to reopen a time-barred GST assessment can therefore only be challenged by way of judicial review on very limited grounds.

10.36 The reasons for section 108 being a disputable decision arose from the decision in *Maxwell v Commissioner of Inland Revenue* [1962] NZLR 683. In Maxwell, the Court of Appeal ruled that under the law as it was then, the decision could not be challenged on the grounds it was incorrect but opined that this was an unsatisfactory state of affairs. Shortly afterwards, the relevant legislation was amended to provide that this type of decision was the then-equivalent of a disputable decision.

10.37 Until very recently Inland Revenue's view had been that an income tax reassessment under section 108 could only be challenged on essentially judicial review grounds (such as where the Commissioner did not truly hold the requisite opinion, the Commissioner took the wrong grounds into consideration, or the Commissioner misdirected herself as to the relevant law). Under this view, the taxpayer could not challenge whether the returns were in fact fraudulent, wilfully misleading or omitted income. On this basis the difference between a challenge to an income tax reassessment compared with a GST reassessment was simply a technical one as to what form of proceedings (Part 8A challenge or judicial review) would be used to advance the challenge, rather than the grounds on which the challenge could be made.

10.38 However, two cases *Edwards v Commissioner of Inland Revenue* [2016] NZHC 1795 and *Great North Motor Company Limited v Commissioner of Inland Revenue* [2017] NZCA 328 have made it clear that a taxpayer may challenge an income tax assessment on the basis that it was time barred and the Commissioner was not permitted to make a reassessment under section 108. In these cases, the Court must review from the beginning whether the return in question was in fact fraudulent, wilfully misleading or omitted income. As noted in the decisions, this outcome is consistent with the scheme of the challenge provisions in the Tax Administration Act and with the Commissioner's role in the section 108 decision.

10.39 The consequence of this is that there are two very different approaches to challenging a time bar for income tax as opposed to GST. There is no reason why a taxpayer should have much more limited scope to challenge a decision by the Commissioner under section 108A to reopen a GST return based on the Commissioner's opinion that the taxpayer has, for instance, fraudulently failed to disclose necessary matters in the return.

Suggested solution

10.40 Section 108A could be removed from the excluded provisions listed in section 138E(1)(e) of the Tax Administration Act to ensure that challenges to both time bar provisions (sections 108 and 108A) can be made on the same grounds.

Questions for submitters

- What are your views on these issues and the suggested solutions?
- Are there other technical or remedial issues with the GST legislation that officials should consider?