Practitioner’s viewpoint: Calculating GST adjustments — the way forward?, 01 April 2006

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The Court of Appeal has directed a new method for calculating GST adjustments. In *C of IR v Lundy Family Trust and Behemoth Corp Ltd* (2005) 22 NZTC 19,637 it handed down what it obviously intends to be the definitive statement on the requirement for, and calculation of, GST adjustments. **Mark Keating**, taxation law lecturer, Faculty of Commerce, University of Auckland, considers the implications of this case.

The Lundy decision

The *Lundy* decision, which will affect all taxpayers who make adjustments, applies somewhat arbitrary rules that have the effect of reducing the amount of GST adjustments for the mixed taxable and non-taxable use of property. It also opens the way for the Inland Revenue Department to refund output tax adjustments previously accounted for by taxpayers.

The decision in *Lundy* comes as the culmination of a long line of uncertain and often contradictory lower court decisions. The earlier cases applied differing methods for calculating the output tax payable for changes in the use to which taxable assets were applied. But *Glazebrook* J, delivering the unanimous Court of Appeal judgment, has laid down clear guidelines on when adjustments are required and how they should be calculated.

The judgment examines the GST adjustment provisions in former s 21 of the *Goods and Services Tax Act* 1985. That section was substantially restructured, largely with application from 10 October 2000 — see ss 21 and 21A–21H. Despite these changes, the decision has continuing application as it contains clear principles for when and how adjustments are to be made. In setting out the rules to be followed when making GST adjustments, the court adopts a somewhat unusual method of requiring the depreciation of land when calculating the non-taxable use of property. It also dictates that the calculation of adjustments must be the same for both input and output tax, and stipulates that all period-by-period adjustments should be refunded by the Commissioner when the goods are again applied to their full taxable use.

The facts

The *Lundy* case involved a dispute over the amount of output tax adjustment a GST registered developer was required to make when it rented to private tenants the properties it had acquired as part of its taxable activity. While the trust acknowledged that adjustments were required to account for this exempt use of properties that formed part of its taxable activity (for which GST input tax had earlier been claimed in full), the trust had calculated those adjustments based only on the costs directly related to the rental activity. It declined to make adjustments for any of the holding costs, such as rates, insurance and mortgage interest.

As a result, the adjustment was calculated only on the depreciation of the building and any repairs and maintenance occasioned by the rental activity. No adjustment was made for either the capital value of the properties or the ongoing expenses associated with them.

The Commissioner opposed that method of calculating the output tax adjustment. Contrary to the policy in *Tax Information Bulletin* ¶58-102 Vol 5, No 8, January 1994, stipulating that depreciation was the correct method for making such an adjustment, the Commissioner argued that all outgoings on the properties had to be accounted for. The Commissioner reasoned that, as the properties had been fully applied to the rental activity pending sale, all the holding costs should be fully adjusted for GST purposes.

A secondary issue involved the question of whether, having made the adjustments (however calculated), the taxpayer was subsequently entitled to a credit for that output tax against the GST payable when the principal purpose was fulfilled and the properties were eventually sold.

The Court of Appeal

Judge *Willy* in the Taxation Review Authority ruled in favour of the taxpayer and the Commissioner appealed: see *Case* W28 (2003) 21 NZTC 11,289.

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In the High Court ((2004) 21 NZTC 18,595) *Chisholm* J again found for the trust, ruling that it had to make adjustments only on the extra costs associated with the rental activity. His Honour also found that any output adjustments paid by the trust during the period of its rental activity could be credited back to reduce the amount of output tax payable upon the eventual sale of the property.

The Commissioner appealed that decision. In summing up the arguments before it the Court of Appeal stated:

> "Both parties agree that the properties were applied for a purpose that was not taxable when they were let and that a sec 21(1) adjustment was required. The issue is as to the amount and nature of that adjustment."

When delivering the unanimous Court of Appeal judgment, *Glazebrook* J summarised the law regarding GST adjustments.

First, her Honour affirmed the High Court decisions in *C of IR v Morris* (1998) 18 NZTC 13,385 and *C of IR v Carswell Investments Ltd* (2001) 20 NZTC 17,149. These cases required taxpayers to make GST adjustments when the assets of their taxable activity were applied to any non-taxable use. In endorsing these decisions, the Court of Appeal unequivocally recognised that GST adjustments are required even when the taxpayer maintains the principal purpose for which the input tax on that asset was originally claimed under s 3A.

When discussing these decisions, *Glazebrook* J recognised that, even if the taxpayer's principal purpose has not changed, the subsidiary purpose to which that asset is being put warrants an adjustment under s 21.

Secondly, adjustments are required "to the extent that" the taxable assets are applied to a non-taxable purpose. This wording (which appears in both the former and current input and output adjustment provisions) envisages assets being applied completely or partially to the non-taxable purpose, and output tax adjustments must be calculated accordingly.

periodic vs one-off adjustments

Both the current and former adjustment provisions allow for either periodic or one-off adjustments. When faced with this uncertainty, her Honour directed that there are some situations where a one-off adjustment is more suitable, such as where there is a total change in use in the whole or part of the goods or services. Examples include:

- where part of a business premises is converted into living quarters — in which case there would be a deemed supply of that part of the property; or
- for a home office, where the premises are used for some of the day as private residence and for the rest of the day as business premises.

By contrast, the court felt there were other situations where period-by-period adjustments would be more suitable, such as when the non-taxable use was variable or temporary or coincided with a continued taxable use.

Here, *Glazebrook* J recognised that the trust's properties were simultaneously used for both taxable and non-taxable purposes. Although the properties were fully tenanted, they were also fully available for sale as part of the trust's taxable activity of development. Because of that simultaneous mixed use, the court ruled that the trust's properties could properly be subject to period-by-period adjustments.

calculation of adjustments

As the rental activity (and therefore the requirements to make adjustments) was potentially open-ended, it was theoretically possible that adjustments made period-by-period could accumulate over time to more than the original GST portion paid on the purchase of the properties. However, her Honour rejected that possibility, stating that "any period adjustments cannot exceed the costs (or lower market value)".

No ceiling on output tax adjustment is contained in the legislation, and the reasoning relied upon by *Glazebrook* J for that conclusion is not provided in the judgment. Instead, the reasoning appears to have been based upon a general analysis of the role adjustment provisions play in the scheme of the *Goods and Services Tax Act*.

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The decision presumes that input tax is properly claimed or not claimed under s 3A at the time of purchase based on the taxpayer's principal purpose. The adjustment provisions simply claw back or allow GST where the goods or services are used in a way that is inconsistent with the original purpose. On that reasoning, any claw-back or allowance should not be allowed to exceed the original GST amount.

Her Honour agreed with the Commissioner that the entire properties were the "goods" that were required to be adjusted in this case, and that they had been fully supplied by the trust in an exempt activity. Under both the old and new provisions, the adjustment must then be valued at the lesser of either:

- the cost of the goods or services being used; or
- the open market value of the supply.

Given those alternatives, the Court of Appeal made an interesting choice.

First, it found that "the cost of the goods" was the price of the properties themselves, not the cost of making the rental supply. This sum included the original purchase price (including GST) and any improvements to them — a substantial sum.

Secondly, the value of the supply was recognised as the residential rent charged by the trust to its tenants. The rental was obviously the lesser sum and therefore would logically have been the amount upon which the adjustment was calculated (as in the *Morris* case: see *Case* U13 (1999) 19 NZTC 9,147).

However, *Glazebrook* J refused to adopt this valuation method because "that would have the effect of a GST charge on what is an exempt supply, which would not accord with the scheme of the legislation". Accordingly, despite the clear wording of the section, Her Honour attempted to find some other method for calculating the adjustment.

Having rejected the value of the rent, the court returned to the cost of the property and postulated that "the issue is what the 'cost' of the property means" in terms of the tenanting of residential property. Again, it found that the cost was the acquisition cost of the property, but nevertheless found that it was the holding costs that required adjustment. This cost was made up of both depreciation and the ongoing expenses associated with the property in each period.

Because the legislation contained no rules as to how the adjustment should be allocated to each period, the court accepted that "any reasonable method appears to be allowed by the statute".

As a result, the court accepted the Commissioner's submission that depreciation was a suitable method of apportioning the cost of the buildings. However, in a somewhat unorthodox move the court also went on to "accept the Commissioner's submission that the cost of the land should similarly be apportioned and agree that applying the depreciation rate to the land is a suitable methodology for this exercise".

Although land is expressly excluded from depreciation under income tax legislation on the basis that it does not generally decline in value with use, the court ruled that the exempt use of the property included use of the land, and therefore depreciation should be applied to both the land and building when calculating the value of the adjustments. This conclusion was reached because "both the land and the buildings [were] applied to the residential letting and the buildings [were] effectively no more used up in that process than the land [was]".

Having reached this decision, the court then had to determine to what extent the property was used for the non-taxable rental purpose. Instead of adopting the Commissioner's submission that the property was fully tenanted and therefore used only for the rental activity, the court found that the property continued to be available for sale and therefore was simultaneously applied to both the taxable and non-taxable purpose throughout. Consequently, the court directed a 50% apportionment of the full depreciation cost as "a somewhat rough and ready" means of recognising the continued dual use.

With regard to the periodic costs such as rates, insurance and interest, the court felt they were "conceptually quite separate from the acquisition cost of the properties". Therefore, each expense had to be examined individually to determine whether or not it was incurred for the principal purpose of making taxable supplies. If it was acquired for that purpose, no adjustment was required at all. If it was not, such as the fees paid by the trust to a letting agency, no input tax credit was available at all.

The difficulty arose where an expense related to a mixed use, such as rates, insurance and mortgage payments, as these expenses had to be adjusted.

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Again, as the court found that the trust's principal purpose of sale had not altered, the property continued to be used fully for both taxable and non-taxable purposes. As a result, the court felt that the majority of these expenses could be claimed for input tax and only a small adjustment was required.

As with the depreciation of the buildings and land, the court initially considered a 50/50 apportionment, but rejected this in favour of a 75/25 apportionment "to recognise that the principal purpose remained the sale of the properties and that these costs would have been incurred whether or not the properties were let".

Refund of adjustments

On the second issue, the court found that the adjustments made during the rental period should be added back by the trust when the properties were finally sold. The scheme of the adjustment provisions was to reverse out earlier input tax deductions taken by the taxpayer while its goods were being used for some non-taxable purpose. During that non-taxable use, the input tax claim should not be available and the taxpayer was obliged to make an adjustment accordingly.

However, when the goods were once again used for the taxable purpose, the court felt that it was only proper that the Act "restores the input tax deduction when the goods and services are applied again to the taxable purpose".

This result holds out the prospect that taxpayers who have previously made output adjustments on a period-by-period basis (however calculated) may be entitled to a refund of the GST paid. All previous output tax adjustments should be added back when the property is again applied to the taxable use, usually when it is sold. Possibly years worth of output adjustments may therefore have to be refunded to taxpayers by the Department. At this time, no one is able to say how much revenue could be at stake.

Decision still relevant

Although the GST adjustment provisions were amended in October 2000, the central issues decided by the Court of Appeal are still relevant. The current legislation still requires adjustments to be made to the extent that the use of assets changes. In most cases it is left to the taxpayer to choose when those adjustments should be made: whether period-by-period, annually or one-off. The provisions valuing those adjustments also remain unaltered, requiring the adjustment to be made at the lesser of cost or open market value.

The Court of Appeal *Lundy* decision provides useful guidance to how the current provisions should be interpreted.

First, the court determined that the same method is required for calculating both input and output adjustments. The court stated:

> "Subsections 21(1) and 21(5) are effectively mirror provisions. Conceptually, sec 21(1) can be seen as a mechanism for ensuring the claw back of unwarranted input tax credits where they are no longer related to a taxable activity, while sec 21(5) is the mechanism to ensure that proper input tax credits are available when they are related to a taxable activity."

That sentiment would apply equally to the current ss 21 (output tax) and 21E (input tax).

Secondly, the provisions under which that adjustment is calculated remain identical: s 10(8) (output tax) and s 21F (input tax). As a result, the calculation method recommended by the Court of Appeal would be applicable. A 50/50 apportionment of depreciation on both land and buildings and a 75/25 apportionment of other holding costs must therefore be undertaken.

Given those two aspects of the decision, it now appears a separate depreciation calculation is required by all taxpayers who apply properties for a mixed use. While taxpayers formerly used their income tax accounts for this purpose, a new calculation (to include both the building(s) and the land) will be necessary.

Property developers and builders who rent out properties pending their sale must therefore calculate the output tax adjustment based on 50% of the enhanced depreciation of land and buildings and 25% of the ongoing expenses.

Similarly, taxpayers who make input tax adjustments for the portion of their home office can no longer simply rely upon their income tax calculations. Instead, a revised calculation must be undertaken to identify the deprecation amount for both land and buildings and to isolate only 25% of all ongoing expenses.

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Presumably the decision will also affect the calculation of adjustments for other mixed-use assets, such as motor vehicles. The private use of business vehicles should also be adjusted to take account of 50% of their depreciation and 25% of their ongoing expenses such as repairs, licensing and warrant of fitness. When a business vehicle is eventually sold by a taxpayer, a credit for all previous adjustments could be claimed to offset the output tax owing on that sale.

The effect of the *Lundy* decision is that the amount of both input and output tax adjustments will be reduced, and any output tax paid may be credited back by taxpayers when the goods are finally sold. However, after almost 20 years, the decision finally provides some certain, if somewhat arbitrary, guidelines in the area of GST adjustments.

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