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[¶17-501] Practitioner's viewpoint: Side effects and solutions for Compulsory Zero-Rating of land transactions for GST, 30 November 2017

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The compulsory zero-rating ("CZR") rules for land in the Goods and Services Tax Act 1985 came into effect on 1 April 2011. Despite the intended simplicity of their application and after more than six years the rules continue to cause problems for both vendors and purchasers. Inland Revenue has taken steps to publicise the intended operation of the regime and highlight its potential pitfalls but taxpayers continue to be caught out. This paper by Paul Smith, GST Partner at EY and Mark Keating, Senior Lecturer in Tax at the University of Auckland Business School considers a range of issues that continue to arise with respect to the CZR rules.

Unique nature of the CZR rules

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Prior to 2011 the GST Act treated the supply of land much the same as any other supply of goods.[1.] A registered person selling land generally paid output tax[2] and a registered person purchasing land claimed an input tax credit.[3] While there was nothing unusual in that GST treatment the quantum paid for land transactions created a fiscal risk to the Revenue. Inland Revenue was obliged to refund input tax to the purchaser of land regardless of whether the vendor accounted for output tax on that supply — even when those parties were associated, in what became known as “Phoenix schemes”.[4] This was described as “a structural imperfection under the GST regime.” [5]

The Commissioner addressed the problem in the discussion document, *GST: Accounting for land and other high-value assets*, released in November 2009. That document considered a range of possible fixes to prevent the revenue leakage but eventually it was resolved to treat all sales of land[6] between registered persons as zero-rated for GST purposes. Interestingly, while the focus was on preventing Phoenix schemes, the solution applied more widely to all land transactions or any transaction that includes the sale of land between registered persons regardless of the parties’ financial risk or compliance history.[7] The definition of “land” was itself expanded to ensure the CZR applied widely.[8] New rules were introduced to catch “commercial leases” to ensure that, while periodic payments of rent are still standard rated, assignments and surrenders of leases fall under the CZR rules.[9]

Section 11(1)(mb) requires zero-rating of all such transactions where two criteria are met:

- The transaction is between two GST-registered taxpayers, and
- The purchaser confirms it will use the land for the purposes of its taxable activity and not as a dwelling for itself or any associated person.

As a result, sales of land as second-hand goods and sales to consumers continue to enjoy the previous GST treatment.

Interpretation statement IS 17/08 states: “The CZR rules effectively streamline the GST cash flow for transactions involving land and, in so doing, are intended to protect the tax base from phoenix schemes.”[10]

The streamlining of GST cash flow for transactions involving land through the CZR rules is very apparent as it is no longer necessary to request GST offsets for land transactions between GST registered taxpayers. Previously, it had been common for the parties to separately agree that a purchaser’s input tax was to be offset by Inland Revenue against a vendor’s output tax liability.[11] The CZR rules make such off-set agreements unnecessary, although they are still occasionally used for significant transactions that do not have a land component, such as a sale of business assets.

Unfortunately, the CZR approach has yet to be extended to other transactions whereby the streamlining of GST is overdue. For example, the need for the streamlining of the administration of GST on imports of goods by GST registered persons has only recently been acknowledged through a review of the Customs & Excise Act 1996[12] . The extension of CZR for imports of goods made by GST-registered persons would be an effective way of achieving this streamlining.[13]

Documentation

To prevent disputes between parties over the GST treatment of transactions (as had been experienced by Inland Revenue when parties to the zero-rated sale of a “going concern” treated that transaction inconsistently[14]) the CZR rules for land took a unique approach:

- First, the zero-rating of land transaction is compulsory, and therefore the lack of any written agreement as to that treatment by the parties themselves does not affect the GST treatment (otherwise most compliant taxpayers would adopt the zero-rating treatment while Phoenix scheme participants would simply decline to do so, which would defeat the primary purpose of the new rules), and
- Second, the vendor is entitled to rely upon the written confirmation of the purchaser regarding its GST registration status and intended use of the property, even if that statement is accidentally or

intentionally incorrect.[15] This treatment is contrary to the "going concern" rules whereby the Act takes a substance approach and even mutual agreement between the parties will not displace the correct GST treatment if that transaction is not, in fact, the supply of a going concern.[16]

- Finally, provided the vendor obtains the purchaser's written confirmation, the liability for any error in the GST treatment passes to the purchaser.[17] Unlike all other types of zero-rated supplies, whereby the vendor remains responsible for ensuring the requirements for zero-rating are satisfied, and bears the risk if they are not, the GST liability for incorrectly zero-rated land transactions passes to the purchaser. In effect, the GST liability "follows the land" presumably on the assumption that the Commissioner will still have access to that asset to recover the outstanding GST.[18]

In that regard the CZR rules are unique in both applying a zero-rated treatment even when the substance of the transaction does not satisfy the statutory requirements and in passing the resulting GST liability to the purchaser. In a practical sense this means that the GST treatment may be determined by the confirmation provided by the purchaser rather than the reality of the transaction itself.

ADLS standard agreement for sale of land

Given the importance of the documentation, it made practical sense to incorporate that into the standard Sale and Purchase agreement itself. The standard Auckland District Law Society agreement ("ASP")[19] was therefore amended in 2012 to encompass the statutory requirements.[20] The effect of those changes was to incorporate the CZR rules and terminology from the GST Act into the parties' bargain.[21]

First, on the cover page the vendor is required to stipulate if it is (or is deemed to be)[22] GST-registered with respect to the land being sold.

Second, Schedule 2 requires the purchaser to stipulate (with respect to itself or any subsequent nominee) both:

- whether it is (or will be at the time of settlement) GST-registered and, if so
- whether the land being purchased will be used for the purpose of its taxable activity or as a domestic dwelling for the purchaser or an associated person.

Receipt of that written statement allows the vendor to be satisfied the land can be zero-rated, even if the vendor is aware that the statement is accidentally or deliberately incorrect.[23]

Third, cl 15 was inserted into the ASP to record the GST consequences for the parties upon settlement. This clause also provides for changes to either party's GST status prior to settlement and for nomination or assignment of the purchaser's rights under that agreement.

In particular, cl 15 requires the purchaser to notify the vendor of any nomination or change in particulars in Schedule 2 at least two working days before settlement. If that change alters the GST position, the agreement provides for an amended settlement statement, and a credit or debit note may be issued by vendor. Accordingly, the ASP provides for the possibility of changes to the GST treatment between contracting and settlement.

The obvious intention of those changes was to provide for all eventualities. As recognised by the High Court in *YL NZ Investment*:[24]

> "the intention of the [ADLS] agreement is clear. Those who prepared the agreement, knowing it was going to be used widely throughout New Zealand for any number of real estate transactions for a wide variety of properties, could not have made themselves clearer …."

However, while the ASP proves adequate for most land transactions, the operation of those clauses sometimes causes problems. As explained by one commentator in 2012:[25]

> "GST is a transaction-based, value added tax. The GST impost should be clear for every transaction from the outset. The lack of clarity at this crucial junction can cause considerable cost…. It may be

> that simplicity in this complex area is just too much to ask. However, the level of complexity and the number of fish hooks currently inherent in the legislation and the application of the ADLS clauses are excessive."

That commentator proposed a number of reforms both to the GST Act itself and the ASP to simplify and clarify the application of the CZR rules. None of those recommendations have been taken up and, as set out below, a number of significant problems remain.

Pricing

The ASP provides two alternative and mutually exclusive formulations of the contract price:

- "plus GST" (if any), or
- "inclusive of GST" (if any).

The "plus GST" price generally protects vendors; any GST imposed on the transaction may be added to the sale price thereby increasing the proceeds from which they can account for GST output tax.

The "inclusive of GST" price can benefit a purchaser because they cannot be asked to pay an additional amount towards the vendor's potential GST liability. This pricing will be especially beneficial if that purchaser is subsequently able to make a GST input tax claim based on that agreed price.

However, it must be noted that the reference to GST in the price does not determine that GST does (or does not) apply.[26] The parties cannot by contract agree to a GST treatment that is incorrect. For example, an agreement that a particular sale price is "GST inclusive" does not determine that GST is actually payable on that price. In the alternative, an agreement that the price is "zero-rated" will not mandate that treatment applies if the transaction should actually be standard-rated — and the vendor is generally not entitled to increase the sale price to recover that GST from the purchaser.[27] So the GST Act provides little relief to the parties when the agreed pricing is inconsistent with the actual GST treatment of the transaction.[28]

Unresolved issues

From the time the CZR rules came into effect, commentators feared they would cause new and unexpected issues. Explaining those rules in 2011 one commentator concluded:[29]

> Their significance can be gauged by the fact that all parties to land transactions that are within the GST net are affected by them and by their consequences for mortgagees and agents. Regarding the uncertainties, it is hoped that Inland Revenue guidelines will for the most part resolve them.

Unfortunately, the predicted uncertainties have become apparent and little guidance has been provided by Inland Revenue. Those unresolved issues, and some suggested solutions, are set out below.

Problem 1 — Change in GST treatment by purchaser

As the ASP provides for changes in GST status prior to settlement, it is possible that a GST registered purchaser who has completed Schedule 2 may advise that it has changed its mind and now plans to either not use the property for its taxable activity or plans to use it as a domestic dwelling. In effect, the purchaser has unilaterally changed the GST treatment of the transaction.

For example, a GST-registered vendor sells land to a GST-registered purchaser. The transaction must be zero-rated and therefore the $500,000 sale price will be the GST-exclusive amount, with the vendor not liable to return output tax and the purchaser unable to claim input tax. However, prior to settlement the GST-registered purchaser changes its intended use so that the CZR rules can no longer apply. Depending on whether the price has been plus GST or GST-inclusive, the vendor may have to return unexpected output tax out of its sale proceeds — and the purchaser may eventually claim an equivalent input tax credit under s 21G if in future it again changes its mind to apply that property to its taxable activity.

Solution 1 — This problem can be overcome if the correct pricing is chosen by the parties under the ASP. If the parties contract on a "plus GST (if any)" basis, then any change in the purchaser's GST status will result in an increase in the GST price to ensure the vendor is not out of pocket.

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Solution 2 — Unfortunately the use of "inclusive of GST (if any)" in the pricing of what are prima facie CZR transactions is common.[30] Given the obvious potential for purchasers to seek to gain an effective 15% reduction in the purchase price, the authors are aware of instances where unscrupulous purchasers have taken advantage of unwitting vendors to "change their mind" prior to settlement only to immediately "change it back again" after settlement in order to claim an input tax credit on what would otherwise have been a zero-rated sale. While Inland Revenue has commonly refused to become involved in such disputes and simply expected the parties to comply with the pricing stipulated in their agreements, presumably this practice should cause the Commissioner concern as it would return that transaction to the standard GST treatment that applied prior to the introduction of the CZR rules.

Problem 2 — "C" is for compulsory

A related problem has arisen when the parties (sometimes associated persons or related parties) simply have not adequately completed the necessary documentation required under the CZR regime. In those instances there appeared to be initial confusion within Inland Revenue as to the correct treatment. For instance, if the purchaser has provided none of the necessary written statements regarding its GST status or intent regarding the property in Schedule 2 of the ASP (but in fact is GST-registered and intends the property for a taxable use), is the transaction zero-rated? Or should the vendor be subject to output tax?

The authors are aware of Inland Revenue investigators taking the position that the absence of the correct documentation altered the GST treatment and therefore the standard pre-2011 GST treatment applies. Inland Revenue proposed to not apply the CZR rules but instead impose output tax on the vendor — which presumably would have given rise to an entitlement to input tax by the purchaser.

That approach cannot be correct. The very "compulsory" nature of the CZR rules was intended to prevent land transactions (particularly between associated persons) from giving rise to output liability and input claims, to prevent Phoenix schemes. The opening words of s 11(1) provide that a supply coming with the situations described in that subsection "*must* be charged at the rate of zero per cent". The wording is in a mandatory form.

If the CZR regime could be circumvented by the simple expediency of a purchaser (possibly falsely) asserting that its purpose for that property was not a taxable use, then the door would be ajar for parties to knowingly ensure their documentation failed to satisfy the CZR requirements and thereby return to the standard pre-2011 GST treatment, with all its fiscal risk for the Commissioner.

Solution — The solution to this problem lies solely with the Commissioner. Unfortunately, the policy issued at the time the CZR rules came into effect advised vendors in doubt to standard-rate transactions:[31]

> If the purchaser either refuses or for any other reason has not provided a written statement regarding their GST registration status and intentions in respect of land, the supplier should standard-rate the transaction ….

The Commissioner's interpretation statement on the operation of the CZR rules,[32] referred to above, does little to resolve the confusion. While that policy sets out in detail how errors in the correct GST treatment should be resolved, it repeatedly advises vendors to standard rate a land transaction in the absence of the necessary purchaser declarations. For instance:[33]

> "A vendor should consider standard-rating a supply involving land if the purchaser fails to notify them about their GST-registration status and their intentions for the land, unless the vendor is confident at settlement the CZR rules will apply to the supply. … Of course, in so doing, there is a risk a vendor may wrongly decide to standard-rate the supply and corrections will be needed."

Later it concludes more firmly:[34]

> "If the purchaser refuses to or does not provide the required information about their GST-registration status and their intention for the goods acquired (including land), it is recommended the vendor standard-rates the transaction."

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Based on the experience of the authors, this is clearly the approach most likely to be adopted by investigators of Inland Revenue. Strangely, many investigators seem reluctant to actively enforce the purchaser's GST obligations for GST on the purchase of land that was wrongly zero-rated. .[35] However, as the information disclosure requirements in s 78F apply to both GST-registered taxpayers and taxpayers who are not registered for GST, this is unlikely to be an easy task for Inland Revenue. It should also be noted that deliberate non-compliance or making false statements under s 78F may potentially expose purchasers to both shortfall penalties[36] and criminal penalties[37] .

Despite the above, the interpretation statement confirms that the application of the CZR rules "is an objective test"[38] and therefore not simply dependent upon the written statements made by the purchaser (or absence thereof).[39] Rather, the written statement merely provides comfort for the vendor (by passing any potential GST liability on to the purchaser)[40] but is not a prerequisite for the CZR rules to apply; and a supply that factually meets the statutory criteria should not become standard-rated simply by the parties innocently or deliberately failing to complete the necessary documentation. On that basis the Commissioner's recommendation that vendors standard-rate the transaction appears questionable.

That conclusion is supported by the Court of Appeal in *Y& P NZ Ltd v Wang*. In that instance the purchaser had declared in Schedule 2 that it was not GST-registered and therefore the parties treated the transaction as standard-rated. Immediately prior to settlement the purchaser's solicitors revealed that their client had changed its GST status and therefore required the transaction to be zero-rated. The vendor refused to accept that change (due to a lack of adequate notice) and insisted upon continuing to treat the transaction as standard-rated.

In the subsequent dispute the Court of Appeal noted:[41]

> "The Attorney-General, who was joined to this appeal as intervener, supports the appellant's submission that the requirement for notice of the s 78(2) matters cannot be waived. He submits s 78F exists primarily for the benefit of the tax base and to enable the efficient functioning of the GST system. As such, its requirements cannot be waived by a vendor. He also submits that s 11(1)(mb) has mandatory effect. Regardless of what the vendor knows at settlement, GST is zero-rated if the criteria in s 11(1)(mb) are met. Where the wrong rate of GST is applied at settlement, there are provisions to correct the position. … we consider there is force in the Attorney-General's submission that the provision is for the benefit of the tax base and not for the sole benefit of the vendor."

This reasoning confirms that it is the GST status of the parties that determines the correct GST treatment and not the documentation (or lack thereof) or formal notice requirements for any change of that status stipulated in their agreement. This raises the possibility that if a purchaser has actually changed its status then the GST treatment must change accordingly — even if inadequate notice of that change is given to the vendor or it is entirely unaware of that change.

Problem 3 — Nominee transactions

Another common difficulty faced by vendors is the ability of purchasers to nominate an alternative buyer under the agreement. Again, such a nomination causes difficulties when the original purchaser and the nominee have a different GST status or different intended use for the property.

As with the example above for Problem 1, if the GST-registered parties agree the price is to be "GST-inclusive (if any)" but the purchaser then nominates an unregistered person to take over the contract, the CZR rules can no longer apply. The vendor must then return unexpected output tax from its sale proceeds — and presumably the purchaser may eventually claim an equivalent input tax credit under s 21G if in future it again changes its mind to apply that property to its taxable activity. Crucially, IS 17/08 confirms that:[42]

> "A vendor cannot rely on a purchaser's statement where a nomination occurred, unless the purchaser's statement is about the nominee's position. Ultimately, it is the GST-registration status and intentions of the recipient of the supply that must be communicated in writing to the vendor before or at settlement."

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Again, the risk of nomination creates the opportunity for unscrupulous purchasers to take advantage of unwitting vendors by nominating an unregistered purchaser, only for that entity to immediately commence its taxable activity after settlement in order to claim an input tax credit on what would otherwise have been a zero-rated sale. The Documents and Precedents Committee of the ADLS has warned practitioners a number of times to watch out for instances where purchasers have either changed their status prior to settlement from being registered to unregistered for GST purposes or have nominated an unregistered entity.[43]

Solution 1 — The vendor should always ensure the nomination satisfies the requirements under the agreement. The ASP recognises and permits the purchaser to nominate another buyer — and that the nominated person's GST status need not be the same as the original purchaser, and therefore may alter that zero-rated GST treatment, as provided in Clause 15.5.

However, cl 15.5 also stipulates the time-period within which the purchaser must advise the vendor of any such nomination that *"altered particulars and of any other relevant particulars in Schedule 2"*. That clause provides that the purchaser *"shall notify"* any such alteration of the GST treatment provided in Schedule 2 *"as soon as practicable and in any event no later than two working days before settlement."*

That time limit is stipulated so the vendor can know the correct GST treatment at least two days prior to settlement when preparing the required GST invoice and other settlement documents. It sensibly prevents last-minute changes of GST treatment that would require those documents to be redrafted. The time limit in cl 15.5 is presumably included for the benefit of the vendor, not the purchaser.

Accordingly, vendors should ensure the purchaser does, in fact, comply with the requirement for two working days notice as an absolute minimum.[44] Problems arose in *Y&P NZ Ltd v Wang* when the vendor appeared to have waived the notice period. There the vendor's solicitor's issued settlement statements to the purchaser on the basis it was not GST-registered so the transaction was standard-rated, based on the information contained in Schedule 2. However, the day before settlement the purchaser advised the vendor of a change in GST status such that the transaction should now be zero-rated. The vendor's solicitors amended and re-issued the settlement statements accordingly — but then refused to complete settlement on the basis it had not received sufficient notice of that change as required under the ASP.

Both the High Court[45] and Court of Appeal[46] accepted the purchaser's allegation that it was arguable the vendor had waived the two-day notice requirement by issuing the revised settlement statements and therefore could not now refuse to accept notice of the purchaser's changed GST status.

Despite that decision, the authors are aware of at least one instance in which an unwitting vendor was "saved" by the purchaser's nomination being received too late to be effective under that agreement. It is therefore crucial that vendors strictly enforce (and do not waive) the notice requirements under the agreement.

Solution 2 — Again, this problem can be solved by the vendor ensuring the price is recorded as "plus GST (if any)" rather than "inclusive of GST" (discussed above). But we also recommend the ASP be amended to explicitly prevent the purchaser from unilaterally changing its declared GST status (whether because of changes to its particulars in Schedule 2 or resulting from a nomination). The agreement should require that the purchaser or any nominee maintain the original GST treatment of the transaction as recorded in the agreement as it was first signed. In the absence of any amendment to the ASP, we recommend the parties include a special condition to that effect.

Solution 3 — The vendor may need to involve Inland Revenue. In many of these instances the unregistered status of the purchaser is, at best, temporary and may be illusory. The land being sold may be such that any purchaser is bound to be GST-registered because the turnover arising from the land would exceed the mandatory registration threshold.[47] While some properties possibly have a non-taxable use, others are clearly for a taxable purpose. Anything done by the purchaser to commence that taxable activity (presumably including purchase of the land) may therefore be included within that taxable activity.[48] In those circumstances, the purchaser may be liable to be registered for GST (and therefore the CZR rules would apply to that transaction) regardless of any contrary statements by the purchaser at the time of settlement.

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Inland Revenue recognize this potential in interpretation statement IS 17/08:[49]

> "… a purchaser's circumstances might change and they fail to notify the vendor of the change before settlement, or a purchaser might enter into an agreement on the basis they will not be GST-registered, but it transpires that, in fact, they will be or should have been GST-registered at or before the settlement date. Sometimes, the Commissioner will back-date a person's GST registration."

While this solution is dependent upon the assistance of Inland Revenue, in the authors' experience any claim for input tax by a purchaser of land normally generates a risk review or an audit and the correct GST status of that transaction is therefore subject to scrutiny.[50] Given the obvious financial risk faced by Inland Revenue from standard-rated transactions, it has an inherent bias in favour of CZR treatment. As a result, it is not uncommon for Inland Revenue to apply the involuntary registration provision[51] to the parties to land transactions to ensure the correct CZR treatment.[52]

Problem 4 — Time of supply

The standard time of supply rules in s 9 continue to apply to the sale of land, including transactions subject to the CZR rules. Accordingly, where that transaction occurs across different GST periods, the GST-registered vendor is required to determine the GST treatment of the transaction as at the time of supply (often upon receipt of the deposit). That vendor must therefore either return output tax on that transaction or not depending upon the information provided by the purchaser in Schedule 2 of the agreement.

Unfortunately, the GST treatment of that transaction under the CZR rules is not determined until the time of settlement.[53] As one commentator notes:[54]

> "It is important to test the GST position at time of supply **and** again at settlement in relation to CZR transactions. This area represents an area of commercial risk and gives rise to a state of CZR flux."
>
> [original emphasis]

The ASP contemplates that GST treatment may change during that period. As one commentator has noted:[55]

> "There is no explanation as to why … s 11(8B) should be subject to the time of supply provisions."

This inconsistency between the standard time of supply rules and the CZR requirements obviously raises the possibility that the GST treatment of that transaction originally returned by the taxpayer on one basis subsequently changes by the time of settlement. That previous return is now incorrect, thereby potentially giving rise to a GST shortfall, with the consequent imposition of use of money interest on any underpayment by the vendor or improper input tax refund issued to the purchaser. Given that uncertainty, the authors are aware of instances when Inland Revenue appears to deliberately withhold the issue of a claimed refund pending correct application of the CZR rules.[56] This practice is implicitly acknowledged by the Commissioner in IS 17/08 which confirms that:[57]

> "Payment of any resulting refund may be withheld pending any review of the transaction by Inland Revenue."

The many problems caused by this timing inconsistency are recognized and explained in IS 17/08[58] — but few practical solutions are offered, other than the necessity for the parties to invoke the credit and debit note provisions to retrospectively remedy any error in previous returns.[59]

From a practical perspective, the problems are exacerbated in situations where the vendor is registered for GST and files returns on a monthly basis.[60] Such a vendor may have sold multiple lots over prior taxable periods, each with a different time of supply or settlement date. The possibility that the GST registration status of each of those purchasers may change at any time prior to settlement causes needless uncertainty.

Given Inland Revenue actively monitors the transfer of land,[61] the authors recognize the practical difficulty that property developers experience in responding to queries by Inland Revenue regarding their GST compliance for the sale of land both at the time of supply and upon settlement.

Solution — the most obvious solution would be to make the time of supply rules for land apply at the time of settlement, bringing them into line with the CZR rules. This change would ensure the necessary documentation (and any subsequent notification of a change in GST treatment) is determined at settlement, as required under both the ASP and the CZR rules. That change would ensure the correct tax treatment of the transaction is included in that single GST period without the need for the parties (and Inland Revenue) to correct that treatment by way of subsequent debit or credit notes.

An alternative solution would be to extend the GST return filing period for all taxpayers who deal in land. Currently, a GST-registered taxpayer may file GST returns on a monthly, two-monthly, quarterly[62] or six-monthly basis depending on the taxpayer's circumstances. A longer GST return period for such taxpayers to reflect the standard delay between agreement and settlement (eg two-monthly or quarterly) may assist in addressing the inconsistency highlighted above.

Problem 5 — Wrongly unregistered vendor

Obviously, the CZR rules are premised on the assumption the vendor is GST-registered; sales of land by unregistered persons are outside the scope of the Act. The front page of the ASP therefore requires the vendor to declare their GST registration status with respect to that land.[63] If the vendor declares it is not GST-registered, then the transaction will be treated as a private sale, and the GST-registered purchaser may claim a second-hand goods input tax credit.[64] But the purchaser's input tax credit is reliant upon the correctness of the vendor's declaration. If that declaration is incorrect (and the vendor either is GST-registered with respect to that land or is not but should have been), then the transaction will be subject to the CZR rules — and the purchaser will not be entitled to its input tax credit.

An example of this problem arose in *YL NZ Investment Ltd v Ling*[65]. There the vendor declared it was not registered for GST and the purchaser therefore claimed an input tax credit for the purchase. Following an investigation Inland Revenue concluded that the vendor should have been GST-registered and backdated her registration to a date before the transaction so that the CZR rules applied. Unfortunately, the consequences were that the unwitting purchaser was denied its input tax credit — and therefore sued the vendor for breach of its warranty.

The High Court ruled in favour of the purchaser and awarded damages reflecting the quantum of the expected GST input tax credit plus the adviser fees for dealings with Inland Revenue to correct the GST treatment. The Court rejected the vendor's argument that its declaration was technically correct regarding its actual GST status when made. The High Court explained:[66]

> "When entering into the agreement, the purchaser needs to know the GST implications of the transaction. It is no good for the purchaser to be told that the vendor is not registered if in fact the transaction turns out to be compulsory zero-rated because the Inland Revenue determines that the vendor was carrying on taxable activities in respect of the property the subject of the supply so as to bring her within the GST Act."

That decision is based partly on the inability of purchasers to accurately determine the GST status of a vendor and the ASP requirement that vendors declare their correct GST status, otherwise "it is hard to see how the purchaser could avoid the risk".[67] Somewhat unhelpfully, Inland Revenue has taken the approach that its secrecy obligations[68] prevent it from disclosing information about the GST registration status of counterparties or details of any investigation that concludes a vendor should have been registered and therefore a purchaser cannot claim input tax on the purchase.

Given the Commissioner's Interpretation statement IS 17/08 is largely devoted to correcting mistakes in the GST treatment of land transactions, it is disappointing that Inland Revenue refuses to cooperate with parties by providing accurate and timely information to ensure the GST treatment of their land transactions is correct in the first instance. Presumably, the general exception within the secrecy rules permitting disclosure of information *"for the purpose of carrying into effect the Revenue Acts"* would permit such disclosure.[69]

Solution — While the result in *YL NZ Investment* is helpful, it still exposes purchasers to expensive litigation and the possible insolvency of the vendor. As a practical solution, the authors recommend that if purchasers

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of land suspect that their transaction *might* be subject to GST at the standard rate, they should take steps to protect themselves against the risk the vendor is mistaken regarding its proper GST status. For instance, purchasers may require 15% of the purchase price be retained separately by the vendor's solicitor pending release of their input tax claim by Inland Revenue, and for the return of those funds if that input tax is refused due to an error in the vendor's GST declaration. This requirement will be only a temporary inconvenience for a vendor confident in its GST status — but create an effective self-help remedy for a purchaser against any mistake by a vendor regarding that status.

Problem 6 — Wrongly registered vendor

An alternative problem arises when a vendor mistakenly declares its GST-registered status on the ASP and the transaction is therefore (wrongly) zero-rated. This may occur if the Commissioner exercises her power to retrospectively cancel the vendor's GST registration.[70] In that instance the vendor becomes liable to pay output tax on the value of that land at the (retrospective) date of its de-registration.[71] The land transaction should have been treated as a private sale with the purchaser entitled to claim a second-hand goods input tax credit for the purchase.

That problem arose in *Jackson Surridge Property Group Ltd v Eastern Star Group Ltd*[72] where the parties entered into an agreement to sell land valued at $1m, inclusive of GST. The parties then obtained accounting advice and identified that, as they were both GST-registered, the transaction was subject to the CZR rules. Accordingly, they amended the sale price to $870,000 plus GST.

Before the transaction settled the Commissioner retrospectively de-registered the vendor, with the result that it was obliged to pay GST output tax of $130,000. The vendor could not recover that liability by increasing the purchase price since it was now not GST-registered and the "plus GST (if any)" pricing did not technically apply.

The vendor claimed the price should be altered under the Contractual Mistakes Act 1977 on the grounds either both parties were mutually mistaken over the GST treatment and/or that the vendor was mistaken and the purchaser was aware of that mistake. The High Court rejected that claim and ordered the vendor to complete the sale at the agreed price of $870,000. It concluded the financial loss arose from its own GST dealings with Inland Revenue and not due to any fault or advantage obtained by the purchaser. The Court concluded that, as the vendor had correctly declared its GST status at the time the agreement was entered into, any subsequent change could not be taken into account under the Contractual Mistakes Act.

This decision sits uneasily with the subsequent result in *YL NZ Investment* whereby the parties are expected to declare not only their current registration status but the correct position, and subsequent changes will amount to a breach of warranty under the agreement. Obviously, that argument was not available to the vendor in *Jackson Surridge* as it was in breach of its own warranty and was the architect of its own misfortune. But it is unsatisfactory that the vendor unwittingly suffered a significant loss (and the fortunate purchaser an unwitting benefit) because of difficulties with the CZR rules.

Solution — Again we suggest the ASP be amended to ensure the CZR rules apply only when both parties are properly registered. If the parties are mistaken about that crucial status and therefore the transaction properly has a different GST treatment to that agreed by the parties, then the price should automatically be adjusted to reflect the correct GST treatment.

Problem 7 — Mortgagee sales

The CZR rules cause unique problems when land is sold by a secured creditor using its power of sale.[73] The CZR rules require that the supply of land must be *"a supply made by a registered person"* — but does that refer to the lender (who may not be GST-registered) or the borrower (who is GST-registered)?

It is generally accepted that the CZR rules refer to the GST status of the borrower and not the lender. This is because s 5(2) stipulates that the mortgagee sale is deemed to have been made by the lender in the course of the borrower's GST-registered activity, even though the resulting GST liability falls on the lender.[74] Inland Revenue explains:[75]

> If a supply of land is made by a lender to whom section 5(2) applies, the purchaser must provide the information required by section 78F to the lender rather than the borrower, for example, the mortgagee under a mortgagee sale.

However, even accepting the application of the CZR rules when the borrower is GST registered, the conduct of the mortgagee sale may itself cause difficulty. A sale by the lender to a registered person will be zero-rated while the sale to a consumer will not. However, the majority of mortgagee sales of dwellings are conducted by auction, with the sale price stipulated to be "inclusive of GST (if any)". This means for a property that may have both taxable and non-taxable use, bidders are not competing on an equal footing — and the actual GST treatment of the transaction with the highest bidder will not become known until after the hammer has fallen.

This risk exists to a lesser extent in relation to mortgagee sales of commercial properties with the sale price typically stipulated to be "plus GST (if any)". Also, there is a greater proportion of sales made by a tender process rather than by auction.

Solution — Sadly IS 17/08 gives no guidance at all regarding mortgagee sales. Accordingly, we recommend excluding mortgagee sales of dwellings from the scope of the CZR rules. The fiscal risk of the CZR rules was of vendors not accounting for output tax; but that risk does not exist for mortgagee sales whereby the creditor assumes direct liability for GST output tax on the sale.[76] Absent that fiscal risk, and given the practical difficulties it caused, there is no justification for including mortgagee sales of dwellings within the CZR rules. Given the greater certainty regarding the use of commercial properties (including commercial dwellings) these mortgagee sales should remain within the scope of the CZR rules).

Problem 8 — Unscrupulous vendor and naïve purchaser

Section 78F permits a vendor to rely upon the written declaration of the purchaser regarding its GST status and intended use of the property. The vendor is therefore not responsible for any errors or omissions in that declaration affecting the GST treatment; instead the resulting GST liability passes to the purchaser.[77] Inland Revenue confirms no duty is imposed on the vendor to determine the accuracy of the purchaser's declaration:[78]

> In some circumstances, the vendor may believe that the information provided by the purchaser is not accurate. In these situations, the legislation provides flexibility for the vendor to adopt the GST treatment that they consider to be correct. For example, if, in contrast to the purchaser's claims the vendor is aware that the purchaser will use the property in question as their principal place of residence, they may but are not obliged to choose to standard-rate the supply. [But …] Once a written statement is provided, the supplier is not required to make any further enquiries regarding the purchaser's circumstances.

Prima facie that treatment is reasonable as it provides comfort to vendors and passes the potential GST liability to the errant purchaser. It is normally appropriate that the defaulting party bears the GST risk. Furthermore, that purchaser will have enjoyed the benefit of a reduced price that does not have a GST component added.

However, the authors are aware of instances where unscrupulous vendors exploit this protection to deliberately pass the potential GST liability to unwitting private consumers who do not understand the GST implications of completing Schedule 2. Such purchasers are advised that providing their IRD number is a standard requirement to complete the ASP, particularly since tax information is now required of all purchasers. Many purchasers are also persuaded to acknowledge they plan to establish a "home office" to superficially satisfy the other requirement for CZR to apply. For example, a naive purchaser may be offered a small discount in return for agreeing to complete Schedule 2 — not realising that by doing so they will assume the full GST liability.

Solution — Obviously *caveat emptor* applies and purchasers should seek independent advice. In reality many do not and are thereby caught out by the unique CZR rules for land. To protect taxpayers from unscrupulous vendors we suggest limits on the application of s 78F similar to those imposed on lenders with respect to returning GST on mortgagee sales under s 5(2). That section allows creditors to *"determine,*

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in relation to any reasonable information held" whether the debtor was GST registered with respect to the secured asset. Factors such as the nature of the asset, information known about the debtor and other relevant details must be weighed to ensure the correct GST treatment of mortgagee sales on the best understanding available.[79]

We recommend a similar requirement be imposed on vendors to ensure they may not rely solely upon the deeming effect of s 78F regarding the sale to naïve or unwitting purchasers of what are obviously domestic dwellings. Alternatively, the ASP could be amended to require the contract price be stipulated in both the GST-inclusive and -exclusive formulation, and require that purchasers who complete Schedule 2 are liable only for the GST-exclusive price (with the GST amount clearly stated as being payable to the Inland Revenue if that zero-rating is found to be incorrect).

Problem 9 — Mixed use land

A long-standing problem with the GST treatment of land is its possible mixed use. Even prior to the introduction of the CZR rules the GST treatment of land used partly for business and partly for non-taxable or residential use created difficulties.[80] As a result, various statutory amendments were required to separate the elements of the supply to differentiate the taxable and non-taxable portions.[81] The outcome was that the (generally) non-taxable supply of a domestic residence was deemed to be separate from the remaining taxable supply.

But those existing rules focus upon the nature of what is being supplied by the vendor to determine its output tax liability (ie how much of that supply of land is subject to output tax and how should it be apportioned).

By contrast, the CZR rules focus upon the use to which the purchaser intends to apply the land, and passes the output tax liability to the purchaser for any portion of the land it does not use for making taxable supplies.[82] However, the interface between the vendor's and purchaser's obligations with respect to the sale of mixed use land is complex. Clauses 15.6 and 15.7 of the ASP now provide for the apportionment of the single supply between its different elements. Unfortunately this necessitates a different GST treatment of each element, which can cause difficulties over the pricing agreed between the parties (some parts of the supply may be plus GST while others are inclusive of GST). This results in increased complexity whereby a single transaction may give rise to both CZR and taxable treatment for both the vendor and purchaser. It can also give rise to significant uncertainty as to whether a second-hand goods input tax credit is available for the non-taxable component of a single supply of land that will be used by the purchaser in making taxable supplies.

Solution — given that the different elements of the mixed supply of land may be treated differently, the parties should allocate their agreed purchase price between the respective parts of that supply. In the event of any uncertainty, vendors are only protected if they ensure all elements of the transaction are priced as "plus GST (if any)". While the traditional problems with the GST treatment of mixed-use land remain, unfortunately the enactment of the CZR rules have simply added a new layer of complexity.

Conclusion

While the CZR rules have solved the fiscal risk to Inland Revenue posed by Phoenix schemes, that solution has largely been achieved by passing the risks to the contracting parties. None of the problems identified above existed under the previous standard-rated GST treatment. It is the attempt to treat some land transactions (but not others) as zero-rated that has created a difficult boundary issue for taxpayers to navigate.

Getting the GST treatment wrong can be expensive for GST-registered taxpayers. First, mistakes may expose taxpayers to shortfall penalties. Given the quantum of GST involved in major land transactions, taxpayers should not assume Inland Revenue will restrict itself to the lower categories of penalties (ie tax shortfall penalties for "not taking reasonable care"). Sometimes Inland Revenue may conclude the defaulting party has been guilty of "gross carelessness"[83] or worse.

Perhaps a better overall solution would be to treat all land transactions as zero-rated (thereby also removing the entitlement to input tax for second-hand purchasers and output tax liability for sales to consumers).

This would again ensure a consistent GST treatment that will apply in all circumstances. Instead, Inland Revenue's response in most instances is simply caveat emptor and recommending the parties obtain independent advice. If that advice is wrong, then it considers taxpayers should seek redress from the adviser. If advice is not taken, then the taxpayer has no one else to blame. But the extension of the CZR rules intended to prevent Phoenix schemes so as to catch all registered taxpayers has drawn honest and unwitting vendors and purchasers into its net, and now individual taxpayers are paying the price.

Footnotes

1. For an explanation to the background and scope of the then-newly enacted CZR regime, see P Speakman, "The Compulsory Zero-rating (CZR) rules", *CCH New Zealand Tax Planning Report*, 24 August 2011.
2. Output tax was payable under s 8(1) unless that sale was treated as part of the sale of a going concern under s 11(1)(m).
3. Either under s 3A(1) if purchased from another registered person or under s 3A(2) if it constituted a purchase of second-hand goods from an unregistered supplier.
4. See TIB, Vol 23, No 1, Feb 2011, at p 30.
5. *YL NZ Investment Ltd v Ling* (2017) 28 NZTC ¶23-026, citing "GST in New Zealand" 2017, Thomson Reuters, at 26.1.
6. If the sale of land includes the supply of services then s 5(24) deems those services to be a supply of goods subject to the CZR rules. See Inland Revenue "Questions we've been asked QB 12/07: Goods and services tax — treatment of transitional services supplied as part of the sale of a business (that includes the supply of land)"; TIB Vol 24, No 6, July 2012 at p 65 that holds "transitional services" supplied as part of that transaction involving land should also fall under the CZR rules.
7. See the Taxation (GST and Remedial Matters) Bill 2010 (182-2), p 2.
8. See the inclusion of "commercial leases", a "licence to occupy" and a share within a "flat-owning or office-owning company" within the definition of "land" in s 2(1). Only a mortgage or the lease of a dwelling are excluded.
9. See s 11(8D).
10. Interpretation statement: IS 17/08, Goods and services tax — compulsory zero-rating of land rules (general application), 15 September 2017 at [10] (see *Tax Information Bulletin* Vol 29 No 10, November 2017 at 17).
11. Such requests for a GST offset were typically made by reference to s 173M of the Tax Administration Act 1994.
12. See Customs & Excise Act 1996 Review, Summary of Submissions, March 2015, p 84.
13. Acknowledging that imports by private consumers would need to be excluded from the scope of a CZR regime for imported goods, just as they are from the current CZR rules for land.
14. Under s 11(1)(m); see examples where the parties adopted inconsistent GST treatment of a transaction, which was eventually resolved from 2000 by the requirement that the parties recorded their agreement to the GST treatment in writing.
15. See s 78F Good & Services Tax Act 1985.
16. See *Fatac Ltd (in liq) v CIR* (2002) 20 NZTC 17,902, [2002] 3 NZLR 648 (CA) and *Starrenberg v Mortre Holdings Ltd* (2004) 21 NZTC 18,696, (2004) NZCPR 193 (CA).
17. See s 5(23) and 51B(4)–(6).
18. See s 78E Goods and Services Tax Act 1985 which provides limited relief to vendors who incorrectly zero-rate a going concern, but only where the relevant contract does not contemplate that consequence.
19. Auckland District Law Society Inc "Agreement for Sale and Purchase of Real Estate" (9th Edition); see also schedule 3 to the Auckland District Law Society Inc "Agreement for Sale and Purchase of a Business" (2008).

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20 For a fuller discussion of those changes see *S van Schalkwyk*, “GST zero-rating of land — a critical evaluation of the law and the ADLS standard agreement GST clauses”, *CCH New Zealand Tax Planning Report* 20 November 2012.

21 See *YL NZ Investment Ltd* v *Ling*, above n 5.

22 See the outcome in *YL NZ Investment Ltd* v *Ling*, above n 5.

23 See s 78F Goods and Services Tax Act 1985.

24 *YL NZ Investment Ltd* v *Ling*, above n 5 at [32].

25 See *S van Schalkwyk*, above n 20.

26 See *Newman* v *CIR* (1994) 16 NZTC 11,229 (HC).

27 See *Chesham Investment Ltd* v *Robertson* (1992) 14 NZTC 9,105 (HC).

28 There is no equivalent, for the mistaken zero-rating of land transactions, to the limited relief provided with respect to mistaken zero-rating of “going concerns” in s 78E Goods & Services Tax Act 1985.

29 For an explanation to the background and scope of the then-newly enacted CZR regime, see P Speakman, *“The Compulsory Zero-rating (CZR) rules”*, *CCH New Zealand Tax Planning Report*, 24 August 2011.

30 For example see *Wyatt* v *Real Estate Agents Authority* (2012) 25 NZTC ¶20-152 (HC) where the vendor of land’s claim against the real estate agent for using the “GST inclusive” pricing formulation failed. The previously unregistered vendor had been indifferent to the pricing clause but could not recover the additional GST when it was subsequently registered for GST by the Commissioner with respect to that sale.

31 See TIB Vol 23, No 1, Feb 2011, at p 30.

32 Interpretation Statement IS 17/08 “Goods and services tax — compulsory zero-rating of land rules (general application)”, above n 10.

33 IS 17/X08, above n 10, at [23].

34 IS 17/08, above n 10, at [59].

35 Under ss 78F and 5(23) Goods & Services Tax Act 1985.

36 For example, the penalty for failing to take reasonable care under s 141A Tax Administration Act 1994.

37 For example, s 143(1)(b) Tax Administration Act 1994.

38 S 17/08, above n 10, at [55].

39 See Inland Revenue “Large Enterprises Update — Number 18”, February 2012.

40 Under s 5(23), pursuant to s 78E.

41 *Y&P NZ Ltd* v *Wang* (2017) 28 NZTC ¶23-021 at [22] and [25].

42 IS 17/08, above n 10, at [24].

43 See ADLS *Law News* Issue 30, 27 June 2014.

44 Note cl 1.3(5) expressly excludes the day of notification from the calculation of the required notice period.

45 *Wang v Y&P NZ Ltd* (2016) 28 NZTC ¶23-004 (HC).

46 *Y&P NZ Ltd v Wang* (2017) 28 NZTC ¶23-021 (CA).

47 Presently $60,000 in any 12-month period, under s 51 Goods & Services Tax Act 1985.

48 Under s 6(2) Goods & Services Tax Act 1985.

49 See IS 17/08, above n 10, at [62].

50 As explained in IS 17/08, at [71] which explains that “What happens if the supply was incorrectly standard-rated”. It also advises [at 77] that “Depending upon the circumstances giving rise to the error the purchaser may be liable for shortfall penalties.”

51 See s 51(4) Goods & Services Tax Act 1985.

52 For example, see *YLNZ Investment Ltd* v *Ling*, above n 5 where Inland Revenue compulsorily registered for GST a taxpayer who purchased and quickly on-sold a large block of development land,

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thereby ensuring that at least the on-sale transaction was subject to the CZR rules. See also *Jackson Surridge Property Group Ltd* v *Eastern Star Group Ltd* (2015) 27 NZTC ¶22-019 where the GST registration of the vendor was retrospectively cancelled between the date of the zero-rated transaction and the date of settlement.

53 Under s 11(8B) Goods & Services Tax Act 1985.

54 E Trombitas, "GST and Land Transactions", NZJTLP Vol 23, No 1, March 2007.

55 GST in New Zealand, 2017, Thomson Reuters, at 15.6.5.

56 Inland Revenue has 15 working days within which to release the GST refund, pursuant to s 46(1) Goods & Services Tax Act 1985, unless *"the Commissioner is not satisfied with a return made by a registered person"* in which case it may withhold the refunding pending any request for additional information or investigation.

57 IS 17/08, above n 10, at [71].

58 IS 17/08, above n 10, at [63]–[83].

59 Under s 25 Goods & Services Tax Act 1985.

60 Under s 15(4) Goods & Services Tax Act 1985.

61 See www.linz.govt.nz.

62 Currently limited to non-resident suppliers of remote services.

63 This question was included in 9th edition of the ASP from November 2013.

64 Pursuant to s 3A(2) Goods & Services Tax Act 1985.

65 *YL NZ Investment Ltd* v *Ling*, above n 5.

66 *YL NZ Investment Ltd* , above n 5, at [31]–[32].

67 *YL NZ Investment*, at [33].

68 Under s 81 Tax Administration Act 1994.

69 See M Keating, "Can you keep a secret? The obligation of secrecy and right to disclose taxpayer information", ATR Vol 38, No 3, 2009.

70 Presumably on the grounds they are not properly conducting a taxable activity under s 51 Goods & Services Tax Act 1985.

71 Under s 5(3) Goods & Services Tax Act 1985.

72 *Jackson Surridge Property Group Ltd* v *Eastern Star Group Ltd* (2015) 27 NZTC ¶22-019.

73 Under s 5(2) Goods & Services Tax Act 1985.

74 Who is required to file a special return under s 17 Goods & Services Tax Act 1985.

75 TIB Vol 23, No 1, February 2011 at p 30.

76 See *Edgewater Motel Ltd v CIR* (2004) 21 NZTC 18,664 (PC) and *Simpson and Downes v CIR* (2011) 25 NZTC ¶20-047.

77 Under s 5(23).

78 TIB Vol 23, No 1, February 2011, at p 30.

79 See TIB Vol 1, No 8, February 1990, at p 30.

80 For example, see *CIR v Smith City Group Ltd* (1992) 14 NZTC 9,140 (HC) and *CIR v Coveney* (1995) 17 NZTC 12,193 (CA).

81 See s 5(15)–(19) Goods and Services Tax Act 1985.

82 By virtue of s 5(23) and s 20(3J) Goods and Services Tax Act 1985.

83 Under s 141C Tax Administration Act 1994. Disappointingly, IS 17/08 does not address the potential application of shortfall penalties arising from errors in the application of the CZR rules.

Practitioner's viewpoint: GST reform — practical implications and problems, 20 December 2010

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After a decade of relative stability, the GST regime has suddenly undergone drastic reform. On 1 October 2010 the rate of GST increased from 12.5% to 15%. That single change, and the time of supply and anti-avoidance rules imposed to regulate it, posed major implications for taxpayers. But before the dust from that increase has even settled, the Government has made major reforms to the GST regime. The most significant of these changes require zero-rating of business-to-business land transactions, replace the principal purpose test for input tax with an apportionment test and alter the GST adjustment rules.

In this article, Mark Keating, senior lecturer in taxation at the University of Auckland Business School, examines the reasoning behind these fundamental changes to the GST regime and considers their implications for taxpayers. The author concludes that, while the reforms are generally warranted and should simplify what were previously complex areas, they have created new areas of uncertainty for taxpayers that are likely to cause problems as the new regime takes effect.

Legislative history

The GST amendments made by the Taxation (GST and Remedial Matters) Act 2010:

- Classify all business-to-business transactions involving land as zero-rated supplies, thereby removing the entitlement of purchasers to claim input tax credits on these assets. Originally proposed as a measure to prevent the operation of phoenix companies, this change will have wide-ranging implications for all taxpayers.
- Do away with the principal purpose test for GST input tax, replacing it with an apportionment test, under which taxpayers can claim the proportion of input tax on any purchase that reflects the degree to which the goods or services will be used for making taxable supplies.
- Amend the adjustment provisions (which were premised on the all-or-nothing claim to input tax under the now-defunct principal purpose test) and replace them with a further apportionment standard, whereby any subsequent change in use of an asset by more than 10% or $1,000 will require or allow for an additional adjustment.

These reforms were first proposed in the Inland Revenue Department (IRD) discussion document, *GST: accounting for land and other high-value assets*, released in November 2009.[1] The reforms were incorporated into the Taxation (GST and Remedial Measures) Bill 2010 (182-2) (the Bill) which was reported back to the Finance and Expenditure Select Committee on 15 November 2010, and passed by Parliament under urgency on 10 December 2010. The Taxation (GST and Remedial Measures) Act 2010 (the Act) comes into effect on 1 April 2011.

Zero-rating of land transactions

Perhaps the headline-grabbing aspect of the reform is the zero-rating of land transactions between registered persons. The original discussion document explained that the amendment was devised as a base maintenance measure to foil phoenix companies. The commentary to the Bill explained the rationale for the proposed change:[2]

The GST legislation is being amended to require GST-registered vendors to charge, subject to certain conditions, GST at the rate of 0% on any supply to a registered person involving land or in which land is a component. This measure is intended to prevent "phoenix" fraud schemes that involve Inland Revenue refunding GST to the purchaser with no corresponding payment being made by the vendor because the supplying company deliberately winds up before making payment.

The decision to impose zero-rating on land transactions was chosen in preference to other possible solutions to the phoenix company problem, including:

- excluding land from the GST base all together
- providing GST refunds in the form of input credits (rather than cash refunds) as generally applies in Australia, or
- the IRD taking some form of security or priority creditor status over all land upon which input tax was claimed.

Instead, the Act provides that most sales of land (including those where the land is only part of the property being transferred) must be zero-rated for GST under new s 11(1)(mb) of the Goods and Services Tax Act 1985 (the GST Act). This amendment will ensure purchasers will generally be unable to claim an input tax credit on the supply and therefore there will be no loss to the IRD.

Under the reform, in order to ensure the supply of land is properly zero-rated, the purchaser must warrant it is both registered for GST and intends to (and actually will) apply that land for the purpose of making taxable supplies. These requirements obviously pose the difficulty of how transactions should be treated if the purchaser provides false or inaccurate information regarding its GST registration status or purpose.

New s 78F of the Act imposes obligations on vendors to obtain a written declaration from a purchaser regarding the latter's status and confirming that the land will be used for making taxable supplies. If the purchaser provided incorrect or false information so that the sale ought not to have been zero-rated, the original proposal imposed output tax liability equally on both the vendor and purchaser (ie both were equally liable for the resulting output tax). However, the Select Committee felt this joint liability was too harsh on vendors who had relied upon the assurances of a purchaser, so in those circumstances the revised Act imposes output tax liability on the purchaser alone. Provided the vendor has obtained the purchaser's declaration, it is entitled to rely upon it — and any inaccuracies in that declaration impose an immediate liability for output tax on the purchaser for the value of the land supplied, under new s 20(3I). As a result, disputes arising between taxpayers over the liability for GST imposed when the zero-rating of a transaction fails, such as *Starrenburg* v *Mortre Holdings Ltd* (2004) 21 NZTC 18,696 (CA) and more recently *Cockburn* v *CS Development No 2 Ltd* [2010] NZSC 139, will no longer arise in relation to land.

The original Bill also included a wide definition of land to ensure taxpayers did not seek to structure their transactions to avoid the new zero-rating rules. In particular, there was concern that taxpayers would attempt to sell a long-term lease over land rather than the land itself, just to ensure zero-rating did not apply. However, such a wide definition of land would have had an unanticipated effect on all long-term leases of commercial land (in effect, providing zero-rated treatment for most commercial leases). Instead the revised Bill limits the definition of land for zero-rating purposes to short-term leases and shares in flat-owning companies. The current treatment of most commercial leases as standard rated transactions will therefore continue to apply.

Significantly, the new zero-rating provisions will not apply where:

- the land is purchased by a registered person other than for making taxable supplies (either for private purposes or for making exempt supplies), or
- the land is supplied to a private consumer.

In both instances, the transaction will still be standard rated (ie charged with GST at 15%). Nor does the zero-rating apply to the purchase of land as second-hand goods by registered persons. Accordingly, while the reforms will limit the opportunity for phoenix transactions, they will not entirely eliminate them.

It is obvious that the new zero-rating rules apply much more widely than was necessary simply to address the instances of phoenix companies. Instead, all taxpayers (regardless of their tax compliance history) will be obliged to treat most land sales as zero-rated after 1 April 2011. The reforms will therefore have the

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effect of preventing purchasers of land from obtaining and relying upon input tax credits to part-finance their purchase.

The Act also extends the zero-rating requirements to sales of land by mortgagees. Under the GST Act, mortgagees who hold security over land owned by registered persons are liable to the IRD for the full amount of GST output tax on mortgagee sales.[3] By contrast, where the sale was effected by the registered person themselves (even in constrained circumstances and simply to prevent a mortgagee sale), the (often impecunious) vendor remains liable to the IRD for the GST output tax.[4] This different GST treatment created an incentive for mortgagees to facilitate or force a sale by the defaulting borrower in what amounted to a mortgagee sale in all but name, and therefore gave rise to GST avoidance opportunities.[5]

To prevent this loss to the IRD the Act extends the zero-rating treatment of land transactions to mortgagee sales. As with ordinary sales under the new regime, the purchaser at a mortgagee sale that is subject to GST is obliged to provide details of it's own registration status and a statement regarding the use to which that land will be put. If the purchaser is GST-registered and the land will be applied to a taxable activity, that mortgagee sale will be zero-rated. Only where the sale was made to a consumer or registered person for their private/exempt purposes do the current rules (and the current inconsistent GST treatment) continue to apply and that sale must be standard-rated.

In practice it is likely that the mortgagee sale of most land subject to GST will be to a registered person for use in a taxable activity. The effect will be that there is no longer any GST payable upon most mortgagee sales, therefore depriving the lender of the additional proceeds of sale to satisfy its security.

Nominee transactions

There has long been uncertainty regarding the GST treatment of transactions involving nominees. The assignment of a contract or nomination of an alternative purchaser particularly raised concerns over the eventual purchaser's entitlement to input tax and the details required on the accompanying tax invoice.[6] It was unclear whether the eventual sale under that assignment or nomination involved a single or two-step supply. No cases had adequately addressed the problem and there was no applicable IRD policy.

In response to that vacuum, the Act provides a number of new rules applying an "economic reality" test to nominee transactions (new s 60B). It effectively provides that the person who actually or eventually pays for goods is recognised as the true purchaser, not simply the purchaser named in the relevant sales agreement or tax invoice. This approach also dictates that nominee transactions constitute a single supply from the vendor to the nominee/payer and not a triangular or back-to-back supply via the nominator. While obviously a welcome clarification of the law, the introduction of a purely economic substance test into the GST Act is a novel approach by placing greater importance on the source and flow of funds than upon the actual contractual documentation agreed by the parties.

Reform of the principal purpose test

Since the GST regime came into effect the entitlement to claim input tax, and the subsequent need to make adjustments of both input and output tax, has caused difficulties. Until the enactment of the reforms under discussion, the GST Act took an all-or-nothing approach to input and output tax. This was explained by the Court of Appeal in *C of IR v Coveney*:[7]

> … the yardstick then applicable in each case is whether or not the subject matter of the supply was "acquired for the principal purpose of making taxable supplies". If the principal purpose test is satisfied, the full amount is the applicable input tax.

This approach was confirmed by the IRD,[8] which rejected a taxpayer's right to a partial claim or apportionment of input tax:

> Whether GST is deductible as input tax is an all-or-nothing test: either GST is fully deductible as input tax or it is not deductible at all. There can be no partial deduction as input tax.

While this presumption was generally sufficient, it did not take account of supplies that were acquired for a mix of taxable and non-taxable purposes, or where that purpose subsequently changed. In those instances

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the presumption did not hold. Registered taxpayers making or receiving mixed supplies were obliged to make subsequent and often ongoing adjustments to account for the changed use of those goods or services.

Taxpayers often had difficulties in determining the principal purpose for particular goods or services when deciding whether to claim an input tax credit under s 3A of the GST Act. This lack of clarity caused numerous disputes — no other aspect of GST was so commonly litigated as the taxpayer's principal purpose.

Unfortunately there was no clear method for ascertaining a taxpayer's principal purpose in all circumstances and both the IRD and the courts used inconsistent tests in different cases. If hard cases make bad law, then idiosyncratic cases made for confusing law. A number of questions regarding the operation of the principal purpose test were never adequately resolved:

- whether the test was subject or objective (or some hybrid)
- whether it was based on the taxpayer's immediate or long-term purpose, and
- whether purpose could be proved by the actual use to which goods or services were put or could be demonstrated by the resulting turnover generated from their use by the taxpayer.

When the GST Act was last substantially reformed in 2000, the IRD recognised the New Zealand principal purpose test (and requirement for subsequent adjustments) operated differently from that in comparable jurisdictions such as the UK, Canada and Australia. It explained the GST regime in those countries:

> … provides that if goods and services are used partly for a taxable purpose and partly for a non-taxable purpose, input tax credits are apportioned. If a registered person's intentions regarding the use of goods or services change within six years of the original acquisition, an adjustment is made.

The IRD then acknowledged that:

> The adjustment approach used in New Zealand is difficult to apply in some circumstances and has resulted in considerable litigation. The apportionment approach may appear to be a simpler and more accurate approach to the calculation of input tax.

A full decade later the reforms now bring New Zealand into line with those comparable countries by abandoning the principal purpose test for input tax in s 3A. Beginning on 1 April 2011 taxpayers will apply a proportionate approach under which they are permitted an input tax credit to the extent they "actually use" the goods or services in making taxable supplies. If a registered person purchases items for both business and personal use, they can claim an input tax credit to the extent of the expected business use, not according to whatever their principal purpose may have been.

Example:

The effect of this change can be demonstrated using two variations of a simple example. A courier driver purchases a new van for use:

- in the first instance, 60% in the business, or
- in the second instance, 40% in the business.

Applying the former principal purpose test, in the first instance the courier would be entitled to claim a full 100% input tax credit at the time of purchase. The courier would then be obliged to make indefinite ongoing output tax adjustments in each GST period to account for the 40% non-business use. By contrast, in the second instance, the courier would be unable to claim any input tax credit for the van at the time of purchase, as the principal purpose test is not satisfied, but the courier would be entitled to claim ongoing input tax adjustments for the 40% business use.

Under the new input tax test, the courier will simply be entitled to claim the applicable percentage of the purchase price to reflect the actual use for the van, and will not generally be required to make any further adjustments (subject to significant changes in the percentage of actual use of the van by the courier, discussed below).

While this reform seems positive it may have unintended consequences. If the entitlement to input tax is determined primarily on the actual use of goods and services, a number of earlier decisions in favour of the Commissioner would be unwittingly reversed. For example, in both *C of IR* v *BNZ Investment Advisory Services Ltd*[9] and *Norfolk Apartments Ltd* v *C of IR*[10] the taxpayers unsuccessfully claimed an input tax deduction by pointing to their actual use of the supplies. Relying upon the turnover test, the Court in both cases rejected the taxpayers' arguments based on that actual use on the grounds that such use did not reflect the economic reality of the taxpayers' respective positions (ie the actual use was a form of "loss

leader" to attract clients to each taxpayer's more profitable exempt activity). In these cases no input tax credit was available to the taxpayers. The courts found that, despite the actual use of those goods and services in making taxable supplies, that use was not the taxpayers' principal purpose.

Because the entitlement to input tax will now be determined according to the "actual use" of the supplies, this reform may inadvertently have altered the outcome of those cases. As both taxpayers were able to demonstrate the majority of their supplies had actually (if uneconomically) been used for their taxable purposes, they would apparently become entitled to an input tax credit under the redrafted test for input tax. This reform may inadvertently have created a potential windfall for such taxpayers.

Adjustments

The practical consequence of the former principal purpose test was the requirement for GST adjustments when there was a subsequent change in the use of goods or services or when they were simultaneously applied for a mixed use. These adjustments were difficult to apply and imposed significant ongoing compliance costs for many taxpayers. Again, the requirement for and calculation of such adjustment was repeatedly litigated. The adjustment provisions (ss 21–21F at the time of writing) were reformed in 2000 in an attempt to streamline this process but proved generally unsuccessful.[11]

The reform of the principal purpose test for input tax therefore requires a corresponding change in the adjustment provisions, explained by the IRD as follows:[12]

> The current GST treatment of goods or services applied for dual purposes is to allow or deny an input tax credit depending on the principal purpose for which goods or services are acquired, and deem any application to the non-principal purpose to be a supply (the adjustment approach). An alternative approach (the apportionment approach) would be to provide that any non-taxable use is reflected in an apportionment of the initial input tax credit at the time of supply on the basis of the intended continuing use of the goods or services for each activity.

Under new s 21F, mixed or non-taxable use of goods or services is taken into account by the extent of input tax claimed at the time of purchase so there is no requirement for ongoing adjustments. Instead, taxpayers are obliged to make adjustments only when the actual use of those goods or services differs from their originally estimated use.

Under the new rules taxpayers must make a subsequent adjustment to the input tax originally claimed when the actual use of goods or services has increased or decreased by more than 10%. That actual use is measured annually and the ongoing requirement for such reviews depends on the cost of the goods or services being adjusted — the higher the original value of the asset, the more adjustment reviews are required, as follows:

- less than $5,000 = no review required in most circumstances
- $5,000–$10,000 = two adjustment reviews
- $10,000–$500,000 = five adjustment reviews
- greater than $500,000 = 10 adjustment reviews.

After making the required number of adjustment reviews any subsequent change in use is ignored. However, land will be subject to perpetual annual adjustment reviews regardless of its value.

Fortunately the new regime applies a pragmatic de minimis exemption for any changes in use of less than 10% or where the amount of that adjustment would be less than $1,000: new s 21. The proposed rules also maintain the existing exclusion for taxpayers who make mixed supplies whereby the non-taxable or exempt use is less than both $90,000 and 5% of their total annual turnover.

Special rule for domestic rental of commercial or development land

The most common adjustment cases concerned development land rented out pending sale. Under this scenario the land was simultaneously applied in full to both the taxable activity of sale and the exempt rental activity. An apportionment based only on the floor area used for each purpose was therefore unsatisfactory.

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Instead, the Act includes a specific adjustment rule (new s 21D) for the domestic rental of commercial or development land. This rule does not require taxpayers to calculate their mixed use or make period adjustments. Rather, an adjustment is necessary only when that land is eventually sold. The new rule requires the taxpayer to calculate all supplies generated from the land (ie the sale price plus all rental income derived) and thereby establish the percentage of taxable and non-taxable use. At the time of sale the taxpayer must then make a single adjustment to return that percentage of the original input tax credit reflecting the non-taxable use of the land. This ensures the taxpayer retrospectively accounts for the rental use of that land during the full period of ownership.

Example:

The taxpayer purchases land for $100,000 and spends $100,000 developing the property for sale. At the time of purchase the taxpayer claims a full 100% input tax on its $200,000 costs, being $30,000. The taxpayer is unable to sell the completed property so rents the finished house for one year at $15,000 before eventually selling it for $250,000.

Under the current adjustment rules the taxpayer would be obliged to make an ongoing adjustment to reflect the cost of making the exempt rental supplies or the value of that rental (whichever is less). The calculation of that adjustment was acknowledged by the IRD to often be "complex and confusing".[13] By contrast, under the new rules the total consideration generated from the property would be $265,000 (ie the $250,000 sale price plus the $15,000 rental income). The proportion of taxable supplies from that property was only 94.3% — not the full 100% estimated by the taxpayer at the time it originally claimed a full input tax credit. Accordingly, at the time of sale the taxpayer must make an adjustment by returning 5.7% of the original input tax, being $11,400. Significantly, the longer the property is applied to its rental purpose the lower the percentage of taxable use and therefore the greater the adjustment required at the time of sale.

Problems?

While the abandonment of the principal purpose test and new adjustment rules are undoubtedly an improvement, they do create a new set of potential problems.

Because the reforms do not amend the current liability for output tax under s 8(1) of the GST Act, the existing cases on the wide scope of that provision continue to apply. These cases demonstrate that taxpayers are liable for output tax on all supplies made "in the course or furtherance" of any taxable activity they conduct. There is also no basis in s 8 to apportion output tax for the sale assets that had a mixed use. As noted in *Case* K 55:[14]

> Section 8 does not provide for any apportionment of the supply being in the course or furtherance of a taxable activity and being for any other purpose or object, by such words as "to the extent of" or "so far as"; such phrases, or phrases of that nature being commonly found when apportionment is intended in the legislation.

Many subsequent cases adopted this wide approach: see *Case* M 129[15] , *Hibell v C of IR*[16] , *Case* R 38[17] and *Case* U 34[18] . Apart from the narrow instances where the legislation itself provides for apportionment,[19] any sale made as part of a taxable activity will be fully taxed regardless of any private or exempt aspect. Even if there were some non-taxable element to the supply, s 8(1) may still apply to tax all consideration received.

At the time of writing, the GST Act dealt with mixed supplies as follows:

- if an input tax credit was claimed under the principal purpose test, the ultimate supply of those goods and services was subject to tax
- if input tax was not claimed, the ultimate supply was tax free.

This approach ignores any ongoing adjustments made by the taxpayer to account for their non-principal use, unless there was a total change-in-use adjustment (which is effectively treated as a substitute for the principal purpose test and reclassified those goods or services accordingly). IRD policy clearly considers the taxpayer's liability for output tax was unaffected by any adjustments:[20]

> The GST on the subsequent supply depends only on whether the registered person initially acquired the goods for the principal purpose of making taxable supplies. If the goods were so acquired, and the registered person claimed a GST input tax deduction, the subsequent supply will be subject to GST,

regardless of any section 21 adjustments. If the goods were not acquired for the principal purpose of making taxable supplies, and no input tax deduction was claimed, the subsequent supply will not be subject to GST, again regardless of any section 21 adjustments.

While that approach effectively matched the all-or-nothing approach under the input tax principal purpose test, it remains uncertain how the sale of assets partly used in making taxable supplies should be treated under the new apportionment regime for input tax. In particular, what proportion of taxable use of goods or services will bring their eventual sale within the scope of s 8?

Using the example of the courier business (above):

- where the van was used 60% for business, presumably its eventual sale would be subject to GST output tax, but
- where the van was used only 40% for business, it is uncertain whether its eventual sale would attract GST output tax. Such a sale would not have attracted GST under the current regime.

The Act gives no guidance as to what proportion of business use attracts output tax but it cannot be presumed that the sale of assets with less than 50% business use would automatically fall outside s 8. At its most extreme, would the claiming of an input tax credit of 10% for the cost of a house and household expenses on the grounds the taxpayer maintains a home office mean the eventual sale of the house became subject to GST output tax? Neither the discussion document nor the commentary to the Taxation (GST and Remedial Matters) Bill offer any assistance and the Act provides no mechanism for answering such questions. Presumably taxpayers will have to look to the IRD for guidance.

Most other jurisdictions, including Australia, resolve this problem by stipulating output tax is payable in the same proportion to input tax. In effect the taxpayer is liable to account for output tax to the extent it has claimed input tax on that supply (either at the time of purchase or in subsequent adjustments). The courier driver would therefore be liable for output tax only in accordance with its taxable use (either 40% or 60%) rather than the full sale price. Unfortunately, that kind of apportionment is expressly prohibited under the GST Act and IRD policy does not offer any assistance.

Instead, the Act expressly provides that full output tax liability will sometimes be imposed on taxpayers who have claimed only a portion of the available input tax. To ameliorate the harsh effects of this result, the Act includes a new adjustment provision, s 21E, which expressly provides for taxpayers in those circumstances to claim the rest of any unclaimed input tax at the time of sale. In effect, as taxpayers are liable for 100% of the output tax on that supply, they may belatedly claim any outstanding input tax as a final adjustment. Unfortunately this new adjustment provision produces some perverse (and presumably unintended) outcomes, which have the effect of imposing GST on any increase or decrease in both the taxable and non-taxable portion of a supply.

Example: appreciating asset

The taxpayer purchased land for $100,000 for mixed (60% taxable and 40% non-taxable) use. Under the new apportionment test, the taxpayer claimed a 60% input tax credit at the time of purchase to reflect the expected taxable use of that land. After two years the taxpayer sells that land to a private buyer for $150,000 (note, if the sale was to a registered person for use in its taxable activity, the sale would fall under the new zero-rating provisions). At the time of sale the taxpayer would be required to:

- return output tax on the full $150,000 sale price, and
- claim an input tax credit for the remaining $40,000 not originally claimed.

The taxpayer would therefore be liable for tax on the whole $50,000 profit (GST of $7,500) not merely on the 60% that was used for taxable purposes (GST of $4,500). In effect, GST is imposed on the full appreciation of the asset despite its mixed use. It can only be assumed this approach was adopted because it favours the IRD by increasing the GST liability on the sale of appreciating assets. However, in what may be an entirely unanticipated consequence, the reverse applies for depreciating assets.

Example: depreciating asset

Using the courier driver example again, the taxpayer purchases a van for $40,000 for 60% taxable use and therefore claimed the corresponding 60% input tax credit (GST of $24,000). After five years the taxpayer sells the van for its then book value of $5,000. At the time of sale the taxpayer would be required to:

- return output tax on the $5,000 sale price, and
- claim an input tax credit for the remaining $16,000 not originally claimed.

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Under this system the taxpayer would be entitled to a GST refund representing the loss in value of the 40% non-taxable proportion of the depreciating asset. This would result in a net GST refund significantly larger than would be available under the output apportionment method.

Conclusion

The GST reforms enacted are generally welcome and will undoubtedly simplify the GST regime and reduce compliance costs for most taxpayers. However, the new zero-rating rules will undoubtedly impact upon purchasers who relied upon input tax refunds to assist with financing the purchase of land and mortgagees who looked to the additional GST proceeds of sale to satisfy their security. Likewise, the new input tax/ adjustment provisions will take some time to become established and pose a range of new and possibly unexpected problems for taxpayers. It is a pity that none of these problems were adequately addressed during the passage of the Act. Instead, it now falls on the IRD to provide adequate and timely guidance on how it intends to apply the new rules. As it currently stands, the introduction of these far-reaching reforms will generate a range of practical and interpretation problems for both taxpayers and the IRD.

Footnotes

1 See the excellent explanation of the proposed reforms by Campbell Rose and David Snelling in "GST discussion document: bouquets and brickbats", CCH, *New Zealand Tax Planning Report*, No 6, December 2009.

2 Commentary on the Taxation (GST and Remedial Matters) Bill, August 2010, p 3.

3 *Edgewater Motel Ltd* v *C of IR* (2002) 20 NZTC 17,713 (HC).

4 *Christchurch Readymix Concrete Ltd* v *Rob Mitchell Builder Ltd (in liq)* (2003) 21 NZTC 18,033 (HC).

5 See Mark Keating, "GST pitfalls for mortgagee sales", CCH, *New Zealand Tax Planning Report*, No 3, July 2002.

6 For example, see *Eastern Bays Builders Ltd and Eastland Construction Ltd* v *C of IR* (1989) 11 NZTC 6,014 (HC), *C of IR* v *Capital Enterprises Ltd* (2002) 20 NZTC 17,511 (HC) and *Southbourne Investments Ltd* v *Greenmount Manufacturing Ltd (No 2)* (2007) 23 NZTC 21,514 (SC).

7 (1995) 17 NZTC 12,193 at 12,196.

8 *Tax Information Bulletin* ¶810-108 Vol 8, No 10, December 1996 at p 7.

9 (1994) 16 NZTC 11,111 (HC).

10 (1995) 17 NZTC 12,212 (CA).

11 See the criticism of the operation of the adjustment provisions in *C of IR* v *Morris* (1997) 18 NZTC 13,385 (HC), *C of IR* v *Carswell Investments Ltd* (2001) 20 NZTC 17,149 (HC) and *C of IR* v *Lundy Family Trust and Behemoth Corporation Ltd* (2006) 22 NZTC 19,738 (CA), discussed in Mark Keating, "Calculating GST adjustments — the way forward?", CCH, *New Zealand Tax Planning Report*, No 2, April 2006, pp 9–13.

12 *GST: a review*, IRD discussion document, March 1999 at para 4.7.

13 *GST: accounting for land and other high-value assets*, IRD discussion document, November 2009 at para 7.1.

14 (1988) 10 NZTC 453 (TRA).

15 (1990) 12 NZTC 2,839 (TRA).

16 (1991) 13 NZTC 8,195 (HC).

17 (1994) 16 NZTC 6,212 (TRA).

18 (2000) 19 NZTC 9,320 (TRA).

19 See s 5(14) which provides for the apportionment of taxable and zero-rated supplies, s 5(15) which provides for the apportionment of a dwelling from the remaining land making up a single supply, and s 10(18) which apportions the value of taxable and non-taxable components within a supply.

20 *Tax Information Bulletin* ¶611-102 Vol 6, No 11, April 1995.

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