Practitioner’s viewpoint: GST pitfalls for mortgagee sales, 01 July 2002

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By now all business and professional people with an interest in commercial lending should be aware of the recent decision in *Edgewater Motel Ltd* v *C of IR* (2002) 20 NZTC 17,713. Overturning long-standing practice and understanding, the High Court has ruled that mortgagees have priority over the Inland Revenue Department for the proceeds of a mortgagee sale. If there is a shortfall between the GST owing on the sale and the mortgagee's security, both the mortgagee and all subsequent mortgagees have first call on the money. The Department must instead pursue whatever payment it can recover from the defaulting debtor. In this article, **Mark Keating**, taxation law lecturer, Faculty of Commerce, University of Auckland, considers the implications of the Edgewater case and the wider effects of GST on creditors exercising a power of sale.

The *Edgewater* decision highlights the legal problems surrounding mortgagee sales. Regardless of whether or not the decision is correct, and almost all leading commentators have questioned its correctness, the case has drawn attention to the GST issues applicable to secured creditors who have, or are contemplating, exercising a power of sale. This article discusses the GST issues for secured creditors and concludes that, despite the advantages offered by their security as confirmed by the *Edgewater* decision, the process contains hidden perils that should not be ignored.

The Edgewater decision

The *Edgewater* decision focuses on the priority between mortgagees and the Commissioner where there is a shortfall between the secured debt and the proceeds from a forced sale. In this case the debtor company, Westwood, borrowed money from two creditors. The first lender, Belman, took a first mortgage security over land owned by Westwood, while the second lender, Edgewater, was granted a second mortgage.

Following persistent defaults under the loan agreements by Westwood, Belman stepped in to exercise its power of sale under the first mortgage. The proceeds of sale were sufficient to repay Belman's debt in full but the small surplus was sufficient only to pay either GST on the sale of the property or a partial repayment of the second mortgage held by Edgewater.

In line with previous understanding and practice, Belman paid the surplus to the Department as GST on the sale, in terms of s 17 *Goods and Services Tax Act* 1985. Edgewater sought summary judgment against the Department for repayment of the GST. At issue was the Department's right to recover GST on the sale in priority to Edgewater's registered mortgage.

The case revolved around which of two competing pieces of legislation should take priority. On the one hand, s 104 of the *Land Transfer Act* 1952 dictates that the proceeds of any mortgagee sale of land must be distributed in the following order:

- to pay for the reasonable costs of sale; and then
- to the first mortgagee; and then
- to any subsequent mortgagees; and finally
- to the debtor whose land was sold.

On the other hand, the *Goods and Services Tax Act* contains a number of provisions that specifically require the proceeds of any sale by creditors in satisfaction of debt to be subject to GST. First, s 5(2) of the *Goods and Services Tax Act* determines that a forced sale is deemed to be a taxable supply made in the course or furtherance of the debtor's taxable activity. Accordingly, unless certain narrow exceptions are met (discussed below), any mortgagee sale will attract GST. Secondly, s 17 of the *Goods and Services Tax Act* stipulates that a forced sale must be returned by the creditor who exercises the power of sale. The creditor must make a special return to the Department and pay GST on the sale.

Before *Edgewater*, it had universally been accepted that the liability for GST on a forced sale fell on the secured creditor who exercised the power of sale. In keeping with the transactional nature of GST, the obligation to pay tax on the sale was imposed on the supplier — in this case, the mortgagee.

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Adopting that practice, Belman filed the necessary special return under s 17 and paid the GST to the Department from the proceeds of sale. Unfortunately, by doing so, Belman reduced the surplus available to pay the second mortgagee, Edgewater.

After some interesting legal analysis that even the High Court admitted led to a "strained" interpretation, *Baragwanath* J ruled that the long-standing rules governing the distribution of proceeds from mortgagee sales should take precedence over the more recent requirements for mortgagees to account to the Department for GST. In effect, the court determined that all mortgagees should be paid out before the Department becomes entitled to recover GST from the sale proceeds. If there is a shortfall, the GST liability is that of the debtor whose property was sold rather than the creditor who made the sale.

The major reasoning behind the judgment appears to be that the Department is not a secured creditor and therefore its right to recover GST should remain subordinate to repayment of the mortgagees.

It is certainly true that the Department's priority for a GST debt, while superior to other unsecured creditors, is inferior to that of secured creditors. This leads to some anomalies. For example, if the debtor sold its own property to avoid an impending mortgagee sale, the mortgagee would have priority over the proceeds of sale ahead of the Department. If the proceeds of the sale were insufficient to pay the creditors, and the debtor was forced into insolvency, the mortgagees would retain priority. The Department would recover nothing. Looking at that result, *Baragwanath* J reasoned that the outcome ought to be the same regardless of who effected the sale. His Honour described the situation this way (at p 17,721):

> "So the Commissioner's argument for a different result in the case of mortgagee sale requires one to pause and consider whether the true construction of the Act is really to create a priority for the Commissioner ahead of the mortgagee in that but in no other case. Why should the relative priority of the mortgagees' and the Commissioner's debt turn on the fortuity of which method of enforcing the mortgagees' securities is adopted? Why in this context should there be a departure from the over-arching priority of s 104 that is implied [when the debtor sells its own property]?"

Whatever one's view of this approach, the decision overturns a fundamental plank of the *Goods and Services Tax Act* that the person making the supply is the person charged with tax. Justice *Baragwanath* appears to have misunderstood that GST is a tax on the supplier — even where the goods being sold under the mortgage are not the supplier's own.

Section 17 merely gives effect to that principle by imposing the GST liability on the creditor conducting the sale, a liability that is merely the consequence for the creditor of making the supply by way of realising its security. As vendor, it has the GST liability. At the time of sale, questions of priority simply do not arise — they only become relevant when that vendor cannot pay the GST liability.

If the debtor sells the property, it must account for GST. If it finds it cannot pay all its debts, the Department — along with all other creditors — must seek to recover what they can from the debtor. How much is recoverable, and in what priority, is determined by other legislation: in the case of individuals, by the *Insolvency Act* 1967 and, in the case of companies, by the *Receiverships Act* 1993.

If the creditor sells the property, it must account for GST by virtue of s 17. That creditor must therefore pay the full GST as a liability owed by it personally, regardless of whether there is a surplus on the sale. Because, presumably, the creditor is not insolvent, no questions of priority arise.

Justice *Baragwanath* acknowledged that the creditor does have this liability but "strained" (His Honour's own word) the interpretation of s 17 to find that this liability only had to be met when there were sufficient proceeds from the sale. In the event of a shortfall, the GST liability reverts back to the debtor.

With respect, this interpretation confuses two distinct concepts: the liability for GST of the vendor of the property, and the competing priorities of various creditors upon the insolvency of that vendor. While it is certainly to the Department's benefit to have the property sold by a solvent party, the extent of the recovery of GST owing by that vendor should not affect the question of which party is liable. Furthermore, it is worth noting that the decision was based firmly on what His Honour saw as the need to preserve the long-standing rules relating to the proceeds of mortgagee sales of land. As such, the extent to which the decision has any application to creditors who sell other types of property is uncertain.

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Given all the uncertainty this decision has generated, it is important that the Commissioner has appealed and a speedy decision is anticipated. However, whichever way the Court of Appeal decides, there are still a number of other issues that creditors should be aware of when exercising a power of sale. These matters form the subject of the remainder of this article.

GST on forced sales falls on debtor

As explained above, s 5(2) stipulates that the sale of property by a creditor in satisfaction of debt is deemed to be a taxable supply. There are two exceptions to that rule, whereby the sale by a creditor is not a taxable supply:

- where the creditor receives a statement in writing from the debtor that the sale would not be a taxable supply if it were made by the debtor itself; or
- where, having not received a written statement from the debtor, the creditor nevertheless determined “in relation to reasonable information held” that the sale by the debtor would not be a taxable supply.

The exceptions are intended to ensure equal GST treatment regardless of whether the goods are sold by the owner or by a creditor exercising a power of sale. Private assets that would not attract GST if sold by the debtor should not attract GST when sold by the creditor; assets used in a taxable activity would attract GST if sold by the debtor, so they should also attract GST when sold by the creditor. The exceptions therefore preserve the distinction between taxable and non-taxable supplies found elsewhere in the Act. The exceptions are both necessary and fair but problems arise when a creditor attempts to rely upon them.

In order to rely upon the first exception, the creditor requires a debtor to provide a written statement that the sale is not subject to GST. A defaulting debtor is unlikely to harbour much goodwill towards a creditor exercising a forced sale of the debtor's property. This is unfortunate because it is in the debtor's interest to provide a written statement where the sale is not a taxable supply. This ensures that the full proceeds of sale are applied to the outstanding debt (and any surplus paid to the debtor) rather than being applied to pay GST owing on the sale. However, examples of such written statements actually being obtained are rare. Accordingly, reliance on the second exception is much more common.

In order to rely upon the second exception, the creditor must be able to point to reasonable information held by it (presumably at the time of sale) indicating that the sale was not a taxable supply. What information is reasonable depends upon the circumstances, and might relate to the nature of the asset being sold or the identity of the debtor. For example, the sale of an asset generally recognised to be private in nature, such as residential housing or personal jewellery, may make it reasonable for a debtor to assume the sale will be non-taxable. Likewise, the sale of assets owned by an individual whom the creditor knows receives only salary or wages may make it reasonable to conclude that the sale will not attract GST. But the reasonableness of the assumption alone may not be sufficient.

Almost overlooked is the requirement that this second exception can only be relied upon if the creditor “has been unable to obtain the written statement” from the debtor. The Department has interpreted this as imposing a requirement that the creditor has actually attempted and failed to obtain that written statement. As a result, the Department considers that, unless the creditor has actively sought to obtain a written statement from the debtor, it cannot rely upon the exception. The difficulty with this interpretation is shown in the following example.

Example

The lender was a private financial institution commonly loaning money for business purposes but requiring a mortgage over the borrower's residential house as security. After a debtor had repeatedly defaulted on his loan obligations, the creditor gave notice of its intention to exercise its power of sale over the debtor's home. The debtor threatened litigation against the creditor to prevent the sale and correspondence was entered into between the parties' solicitors.

Eventually the debtor abandoned its defence and the creditor effected a mortgagee sale. The proceeds of sale left a small shortfall outstanding on the loan but the debtor was considered by the creditor as “not worth powder and shot”.

Throughout the sale process, it was understood by the creditor that GST was not payable on the sale. In fact, unknown to the creditor, the debtor had claimed a secondhand input tax credit on the purchase of the home on the basis of diversifying his taxable activity into “property development”. Accordingly, the sale of the property was subject to a GST liability of which the creditor was unaware.

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Despite the correspondence between the parties' solicitors, the creditor had never actually requested a written statement from the debtor regarding the GST treatment of the sale. In contrast to many large financial institutions which include such a request as standard in notices sent to a debtor, this creditor had never made any request for confirmation of the property's GST status. Instead, it had simply assumed the sale did not attract GST based on the "reasonable information" that the property was a private residence and thereby normally an exempt supply under s 14(1).

While this assumption might have been reasonable in the circumstances, the Department's narrow interpretation of this exception to s 5(2) meant that, contrary to its own expectations, the creditor was pursued for the outstanding GST. The creditor argued that, given the obvious hostility from the debtor during the sale process, there was no likelihood of it providing the written statement even if one had been requested. Furthermore, given the normally non-taxable nature of this kind of sale, the creditor considered requesting a written statement unnecessary.

Reasonable as the assumptions made in the example are, the Department may be correct that, strictly speaking, the requirements of s 5(2) must be complied with. Whatever the merits of the particular case, the failure even to request a statement is unwise and potentially costly. To avoid stress and expense in this kind of dispute, it is advisable that creditors at least seek a written statement from the debtor prior to relying upon the second exemption.

all creditors' sales a taxable supply

While the above example relates to the sale of what was, in fact, a taxable asset, the creditor would have been in no better position had the sale of the house never been subject to GST. Whatever the true GST status of the property, s 5(2) deems any sale by a creditor to be a taxable supply — regardless of whether or not that sale would be subject to GST in ordinary circumstances. The effect of the section is that, unless one of the two exceptions applies, assets that would not normally attract GST if sold by the debtor become liable for GST when sold by a creditor.

As the above example demonstrates, the Department argues that the second exception (based on "reasonable information") can only be relied upon after a creditor has tried and failed to obtain a debtor's written statement that the sale is not subject to GST. If the creditor doesn't even attempt to obtain this statement, the pre-requisite to the exception has not been satisfied and the exception itself is therefore not available. As a result, even the sale by a creditor of clearly non-taxable assets may become subject to GST, thereby limiting the amount of money from the sale available to the creditor.

Sale by debtor

There are obviously hidden risks in the exercise of any power of sale. The *Edgewater* decision aside, the creditor assumes a GST liability that may reduce the amount of any recovery. As explained above, there is the risk that sales which are (or are thought to be) non-taxable supplies can nevertheless attract GST. As a result, it is tempting for a creditor to arrange for the sale to be conducted by the debtor, thereby avoiding all the potential difficulties.

Unfortunately, a creditor must ensure that its attempts to arrange such a sale, and its motives for doing so, are not so blatant as to draw the attention of the Department. Another example highlights the fine line between:

- a creditor allowing the debtor to effect its own sale so as to maximise the proceeds out of which it will have to satisfy any security; and
- a creditor engineering or coercing a debtor into making a sale so that the debtor alone bears the GST liability, which will be subordinate to the creditor's security.

Example

A creditor had advanced money in return for security over industrial machinery. The debtor defaulted on the loan and the creditor seized the machinery pending sale. However, after appraising the value of the goods, the creditor considered there was unlikely to be sufficient proceeds of sale to satisfy the full debt — and the additional GST liability imposed on it by s 17 would only further reduce the level of recovery. Furthermore, there was no prospect of recovering any shortfall from the debtor which was almost insolvent.

Following advice from its accountant, the creditor returned the machinery to the debtor on condition it would be immediately sold in a manner stipulated by the creditor and that the full proceeds of sale would be applied to repayment of the debt. The property was duly sold by the debtor under the close supervision of the creditor who received the full proceeds of sale. The debtor duly returned the

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sale but was unable to pay the outstanding GST. However, the debtor was a most willing witness in the Department's case against the creditor.

Correspondence between the parties made it clear that the creditor's motives in returning the property for sale by the debtor were directed at maximising its recovery by avoiding the GST liability imposed under s 17. The creditor had effectively promised not to pursue any shortfall on the proceeds of sale provided the debtor sold the machinery and bore the resulting GST liability.

Not surprisingly, the Department considered the creditor was party to a tax avoidance arrangement and invoked the general anti-avoidance provision in s 76 of the *Goods and Services Tax Act*. If the Department is correct, it could impose the tax liability back on the creditor and seek a substantial shortfall penalty.

Any creditor that finds his or her self in a similar situation should bear in mind that, whatever the GST liability owing on a mortgagee sale, disgruntled debtors do not make the best corroborating witnesses, and a shortfall penalty for tax avoidance might have a greater adverse impact on the level of any recovery.

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