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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.

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."

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."

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.

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 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,* *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).

[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,

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 rules relaxed for non-resident businesses, 31 October 2013

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The Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 was passed in July 2013. It introduces a new regime for the registration and claiming of GST input tax credits by non-residents who make no supplies but nevertheless incur GST on supplies received in this country.

Known as “Business-to-Business neutrality across borders”, the new regime allows non-residents who acquire goods or services in New Zealand as part of their overseas business activity to register with Inland Revenue and reclaim that GST. It comes into force on 1 April 2014. The regime is intended to be concessionary by permitting non-resident taxpayers to recover input tax that was not previously claimable. In this review of the regime by Mark Keating, senior lecturer in taxation, University of Auckland Business School, the author asks whether taxpayer concerns are completely answered in view of the additional compliance costs imposed and the number of fish-hooks.

The problem

The problem of non-resident businesses incurring and not recovering GST in New Zealand was never large. Treasury estimates quantify the likely sums involved at only $10m per year.[1] Nevertheless, the Government was sensitive to allegations that it was wrong from a policy perspective to refuse to refund GST incurred in New Zealand by non-resident business taxpayers — particularly when many of our trading partners have taken steps to provide refunds of GST incurred in foreign jurisdictions by New Zealand businesses.

The problem can be demonstrated in this example taken from Inland Revenue’s 2011 discussion document.[2]

A New Zealand flying school trains commercial pilots. Most of its clients are private students paying for their own education. As such, those students are private consumers who, regardless of their residency status, are properly charged with GST on that taxable supply. However, a few of the clients are employees of a foreign airline which has sent them to New Zealand for retraining or upskilling. Those students are not private consumers and the fees for those students are paid for by the airline. Accordingly, the fees charged by the flying school are incurred by the airline for staff training and therefore are acquired in the course of making its own taxable supplies.

Where the airline is making taxable supplies in New Zealand and is therefore registered for New Zealand GST, it will be entitled to claim an input tax credit under s 3A of the Goods and Services Tax Act 1985 (the Act). The problem arises when the overseas airline is not registered for New Zealand GST. In that instance there is no mechanism by which the overseas airline can recover the GST it pays on the pilot training fees. As a result, it is effectively treated like the other students as being a private consumer of those services. This is the wrong outcome from a GST policy perspective, which seeks to impose tax only on the final consumer by allowing businesses to recover any GST paid in respect of making their taxable supplies. However, as this business is not making supplies in New Zealand and is therefore not registered for GST, it is (wrongly) prevented from recovering any tax it pays on goods and services it acquires in New Zealand. The worry for the Government was that, while the amount of GST involved may be small, the structural problem creates a financial disincentive for non-resident businesses to purchase goods or services from New Zealand suppliers. And the amount of potential lost business was difficult to quantify.

The destination principle

The New Zealand GST Act (like all valued added tax (VAT) regimes) is premised on the "destination principle". That is, it is intended to tax private consumption within New Zealand. That principle has two elements: geography and identity.

Geography — GST will apply only to supplies consumed within New Zealand and not beyond. Supplies are not taxed at the point of production but at the point of final consumption. If that consumption occurs in New Zealand, then GST is payable. But if that consumption arises outside New Zealand, GST ought not to apply.

An increasing number of provisions in the GST are intended to give effect to this simple premise:

- exported goods and services are taxed at 0%, because zero-rating these supplies ensures consumption that occurs outside New Zealand does not attract GST,[3] but
- where those exported supplies are actually consumed in New Zealand by a person associated with the overseas party, rules introduced with retrospective effect in 1999 ensure that consumption cannot be zero-rated but instead becomes fully taxed[4]
- where New Zealand residents import goods,[5] and in some instances services, under the reverse charge mechanism, they are liable to pay GST based on their consumption in this country.

For simplicity reasons, the determination of where consumption is generally deemed to take place depends upon the residence of the supplier. In particular, s 8(2) mandates that:

> For the purposes of this Act, goods and services shall be deemed to be supplied in New Zealand if the supplier is resident in New Zealand, and shall be deemed to be supplied outside New Zealand if the supplier is a non-resident.[6]

But giving effect to this simple premise has become increasingly complex as new and unforeseen examples of supply and consumption have arisen. Telecommunication technology has been given its own rules under the Voice Over Internet Protocols in ss 8(6) and 8A whereby charges for these services are determined either by the location from which the service is initiated or to which the service is charged (ie if the charge is billed to an address or account in New Zealand then, by default, that will be deemed to be proof the service was supplied in New Zealand).

But even for standard supplies, this simple rule was never going to be sufficient in all circumstances. Accordingly, s 8(2) was only ever a starting position that in some instances could be amended by agreement between the parties.[7]

However, this geographic principle is generally recognised by all countries and operates sufficiently well that the need for the equivalent of double tax agreements between countries allocating the right to impose consumption taxes on a supply simply does not arise for GST/VAT. As noted by Inland Revenue:[8]

> The GST system prevents the double taxation of goods and services that are traded between New Zealand and other countries through the "destination principle", which assigns the rights to tax the consumption of traded goods and services to the country in which those goods and services are destined to be consumed. This means that exports are zero-rated and imports are subject to GST, in the same way as domestically produced goods and services that are consumed in New Zealand.

Identity — As well as geographical boundaries, GST was intended to apply only to the final consumer and not traders who incur tax at each level of the supply chain. The entitlement of registered persons to claim input tax under s 3A of the Act is the primary mechanism to ensure traders are relieved from the ultimate liability for GST. As McKay J explained in *LR McLean and Co Ltd* v *C of IR*:[9]

> … [GST] is basically a consumer tax, with the incidence of the tax falling on the ultimate consumer of the goods and services. The obligation for payment of the tax is, however, placed upon those suppliers who are registered under the Act.

But those suppliers can then recover the GST they have paid, thereby passing that GST cost up the supply chain until it reaches the final consumer, who pays but cannot recover the GST. The result should be that supplies between businesses (B-2-B supplies) are GST neutral, with the same amount of GST being charged and recovered by both sides of the transaction.

An example of the identity boundary in operation is the apportionment rules in ss 21–21F, which ensure any non-business use of goods or services by traders is taxed appropriately by effectively treating them as the final consumer of those items. A specialist example of that rule is the provisions permitting the suppliers of financial services to zero-rate a portion of their services made to other GST-registered traders (and therefore recover a portion of the tax they pay on their own overheads) on the basis the recipients of those services should not be treated as a final consumer.

An extension (and arguable over-reach) of this destination principle is the imposition of GST on overseas tourists travelling in New Zealand. Unlike most countries, New Zealand offers no refunds of GST for tourists on goods purchased in New Zealand which they take with them (and therefore consume) when they return home. In fact, Inland Revenue has previously been vigilant to ensure such purchases by departing tourists are fully taxed in New Zealand.[10] Inland Revenue recognises this anomaly:

> An exception to the zero-rating of exports applies in practice to goods purchased in New Zealand by tourists. While there are schemes in place that enable removal of the tax impost in limited circumstances, tourists who take goods outside of New Zealand do not receive GST refunds as a matter of course. This is because the economic costs of doing so (mainly compliance and administration costs) outweigh the economic benefits. Tourists' purchasing behaviour has been assessed as unlikely to be altered by whether there is a general refund scheme or not.

The theory is that, as these tourists are final consumers, they are properly charged for GST at the point where they buy goods in New Zealand, even if they subsequently take the goods home with them.

Unfortunately for non-residents in New Zealand on business, the problem identified with the GST treatment of supplies made to them potentially offends against both aspects of the destination principle:

- it effectively imposes New Zealand GST when the ultimate consumer of the supply is overseas, and
- it imposes GST on a trader as if it were a final consumer by refusing any mechanism by which it may recover the GST incurred.

But what was to be done to prevent this problem?

Options considered

In August 2011 Inland Revenue released its discussion document identifying the problem. The document explained:[11]

> New Zealand zero-rates some cross-border services and has a registration mechanism which refunds GST incurred by non-resident businesses in many instances. Nevertheless, it is essential that our domestic GST laws relating to services received by non-residents are fair and efficient, and do not impose undue economic costs on New Zealand. We refer to this objective as B2B neutrality.
>
> Such economic costs could arise if non-resident businesses are deterred from undertaking business with New Zealand because of the lack of GST neutrality in certain areas. Alternatively, New Zealand businesses could face additional constraints when undertaking business overseas because overseas jurisdictions perceive our rules in this area to be unfair.

The most problematic area is where the contractual recipient of the service is a non-resident but the physical supply of the service takes place in New Zealand. Inland Revenue was forced in 1999 to retrospectively impose enhanced rules to prevent the zero-rating of certain supplies (namely inbound tourism and certain educational supplies) which had exploited loopholes in the zero-rating rules to effectively zero-rate private consumption enjoyed in New Zealand by non-residents.[12] Those taxpayers applied the Court of Appeal's reasoning in *Wilson & Horton Ltd* v *C of IR*[13] that it was the residence of the contracting party and not the actual recipient of a supply that was determinative of whether a supply should be zero-rated. This thereby permitted:

- New Zealand tourism operators to contract on a zero-rated basis with non-resident tourism agencies to supply services to tourists visiting this country, or
- educational suppliers to contract on a zero-rated basis with non-resident parents for the education of their children in New Zealand.

Both arrangements breached the destination principle because they allowed for the consumption of the supplies in New Zealand by private consumers to escape GST. Accordingly, s 11A(2) was hastily enacted with retrospective effect to prevent zero-rating of supplies if:

> the performance of the services is, or it is reasonably foreseeable that the performance of the services … will be, received in New Zealand.

That provision was described by Inland Revenue as "as an essential base maintenance provision". However, even upon its introduction, it was recognised that this restriction ought not to apply if the recipient of the service does so in the course of making taxable supplies. However, that "fix" to protect the zero-rating rules had the unintended effect of catching supplies made in New Zealand to non-resident businesses which are not conducting taxable supplies (such as in the example provided of the overseas airline paying for pilot training in New Zealand). Because the actual recipients of that service are physically present in New Zealand the supply will be subject to GST, even though the contractual arrangements are with the non-resident airline. And because the airline does not conduct a taxable activity in New Zealand, it cannot claim that GST back as an input tax credit.

The discussion document explained:[14]

> The result is that New Zealand GST forms an irrecoverable cost to the non-resident business. Although an irrecoverable tax cost is not a problem if it is applied universally, it can create distortionary effects when it represents a real economic cost to a non-resident business and a resident business incurring the same cost would be able to claim the amount as an input tax deduction. In these circumstances, the cost of consuming services in New Zealand is higher for a non-resident solely on the basis of the GST treatment. All things being equal, this may have the effect of deterring a non-resident from consuming services in New Zealand altogether or limiting the market share that New Zealand businesses can realistically compete for.

Strangely, the Act has always allowed non-residents to voluntarily register for GST. Provided a person is conducting a taxable activity somewhere in the world, it technically meets the requirements for registration under s 51. However, simply being GST-registered does not give rise to an entitlement to claim input tax under s 3A. Instead, input tax can only be claimed for goods or services acquired for making taxable supplies in New Zealand. Likewise, the Commissioner can always take steps to de-register a taxpayer who fails to make taxable supplies in New Zealand (sometimes retrospectively).[15] As the discussion document notes dryly:[16]

> This limits somewhat the use of registration as a means for non-residents to obtain neutrality.

Accordingly, a new rule to remedy the problem was required.

The discussion document considered three possible solutions to the problem, each with their own benefits and detriments. These were:

- zero-rating certain supplies
- relaxing the restrictions on registration for non-resident businesses when claiming input tax, and
- a refund system for non-resident businesses.

In considering those options the discussion document stresses that it must always be "*mindful of the need to balance neutrality and protect the tax base*".[17] In that regard, the document refuses to reconsider a number of other concerns commonly raised regarding cross-border supplies between businesses and consumers, such as:

- the desirability of a refund scheme for tourists on goods they take with them when they leave the country, and

- the $60 minimum duty threshold on goods imported into New Zealand (meaning that goods of up to NZ$400 value can generally be imported without GST being imposed).

Instead the discussion document focused narrowly upon the GST treatment of non-resident businesses. It advised:[18]

> If a change is to be made, the challenge is to strike the right balance between addressing some lack of neutrality between resident and non-resident businesses and ensuring that GST is not easily avoided in New Zealand. … We consider that, if a solution that is workable for both government and taxpayers can be found, it may increase the attractiveness of New Zealand for non-resident businesses that consume services away from their main place of operation. This may result in a greater number of non-residents choosing to consume services in New Zealand, to the benefit of the New Zealand economy more generally.

Option 1 — zero-rating

Under this option certain types of supplies commonly purchased by non-resident businesses would henceforth be zero-rated when made to non-residents. Presumably Inland Revenue would canvas taxpayers and invite them to suggest what specific types or categories of supplies should be included (presumably starting with aviation training services). The result would be that any supply of that kind made to any non-resident would be zero-rated.

This option had the benefit of fitting easily within the present structure of the Act, under which a range of specific supplies are already zero-rated under ss 11 and 11A. Accordingly that concept is well understood by taxpayers and would be easy to implement.

Unfortunately this option had a number of drawbacks, both for Inland Revenue and suppliers. For Inland Revenue, zero-rating particular supplies would have had the effect of removing GST for all recipients, whether they are a business or private consumer. Using the pilot training example, zero-rating that supply would have relieved GST for both the overseas airline and non-resident private consumers (for whom GST is properly imposed). Accordingly, zero-rating would be a blunt instrument to address the narrow problem of business-to-business neutrality.

For taxpayers, the requirement to verify the residency status of all recipients to determine whether they qualify for zero-rating would have imposed both significant compliance costs and potential uncertainty.

What if the recipients deliberately or unwittingly provide inaccurate residency details? Could the supplier nevertheless rely upon that inaccurate information (as can the vendor of land under the compulsory zero-rating of land rules, in s 78F) or must it make its own enquiries (as must a mortgagee when determining the correct GST treatment of a mortgagee sale, in s 5(2))? Not surprisingly, the discussion document assumed that responsibility for verifying the recipient's residency status (and therefore liability for GST if that proved to be inaccurate) should fall upon the supplier:[19]

> The GST Act would make the supplier in such cases liable for output tax not charged on the relevant supply. This would increase costs for New Zealand suppliers, forcing them into rigorous checks to determine whether the supply should be zero-rated and being financially penalised if they get it wrong. Risk-averse suppliers may resort to standard-rating all supplies, thereby defeating the objective of any revised rules.

Despite these potential difficulties, a number of taxpayer groups and advisers supported this option as the best means to address the problem. However, given the potential loss of revenue and difficulty with enforcement that would result, this option was always unlikely to be acceptable to Inland Revenue.

Option 2 — enhanced registration

As noted above, while non-residents could always register for New Zealand GST, the ability to claim input tax was restricted. An enhanced registration option would continue to allow non-residents to register for GST but provide for more generous rules around claiming input tax.

This option would be similar to the rules that operate in Australia whereby, generally speaking, a registered person is entitled to an input tax credit for GST incurred to the extent that the acquisition is made in the carrying on of an enterprise ("enterprise" being a broadly similar concept to "taxable activity").[20] There is no requirement for that acquisition to relate to supplies made in Australia. Therefore, non-residents that acquire goods or services, but who make few or no supplies in Australia, may still claim back the GST paid (ie obtain a refund), with the result that the GST cost of their Australian activities is not an economic burden on the business.

Under this option a non-resident business would be required to complete and file GST returns in the same way as any other registered person, claiming input tax credits on goods or services received in New Zealand, without needing to establish they related to the making of supplies in this country.

The biggest problem with this option is the increased compliance costs imposed on non-residents in registering and completing the GST returns necessary to claim back their GST — especially compared with the zero-rated option whereby GST is simply not charged at all and therefore imposes nil compliance costs on non-residents. In particular, Inland Revenue's discussion document recognised:[21]

> risk-averse non-residents may be unfamiliar with, and less trusting of the system and may consider it necessary to engage a New Zealand advisor to help with ongoing filing requirements.

If these concerns proved too much, non-residents would not risk or bother to register, thereby defeating the whole purpose of the enhanced registration option.

Option 3 — direct refund

This is the option applied in the European Union whereby any non-resident who incurs GST on goods or services acquired within the Union may apply for a refund of that tax. No prior registration is required and claims can be made at any time, thereby reducing compliance costs. This type of direct refund scheme is the easiest to understand and likely to be most familiar to non-residents.

Unfortunately, as the EU has discovered, this option is also most likely to give rise to fraudulent refund claims. Likewise, the lack of prior registration by the taxpayer means Inland Revenue has no existing knowledge of the non-resident claimant, making the system more complex to administer and the conduct of audits more difficult. These problems are explained in the discussion document:[22]

> The administration costs of this option are likely to be high for Inland Revenue. New forms would be needed, and staff hired or retrained to ensure applications were processed and monitored appropriately and refunds issued in a timely manner. More significantly, a refund system may require new IT systems to be developed. Such developments could be seen as being counter to Inland Revenue's programme of streamlining customer interactions and IT systems.

Outcome

Not surprisingly, Inland Revenue chose to follow Australia and adopt the enhanced registration system:[23]

> We consider that an enhanced registration system would provide the best balance between achieving B2B neutrality and protecting the revenue base. Although the refund model appears to have the advantage of accessibility and simplicity, it is also the option that would be likely to impose the highest administration costs on New Zealand and may be the most susceptible to abuse. A full zero-rating approach could give rise to substantial compliance costs for suppliers and would also be prone to greater legislative uncertainty.

That preferred regime comes into force on 1 April 2014. However, while the regime is intended to assist taxpayers, the devil in the detail has left some advisers to wonder whether it will provide the benefits claimed.

Who may register?

A non-resident will be able to register in New Zealand only if they are registered under a comparable VAT, GST or sales tax regime in their home jurisdiction where their main taxable activity is based. Proof of that registration from the tax authority in that jurisdiction will be required.

As part of the registration process, the non-resident business must:[24]

- certify it is currently carrying on a taxable activity in that jurisdiction and will continue to do so during the present GST period. This requirement would allow Inland Revenue to refuse to register a special purpose vehicle set up temporarily solely for the purpose of obtaining a refund in New Zealand
- confirm it makes sufficient taxable supplies such that, if they were made in New Zealand, it would be required to register for GST. This requirement would ensure that only businesses that were relatively well-established, with a turnover of more than $60,000,[25] could register.

A condition of registration is that the non-resident must immediately advise Inland Revenue if it has ceased its taxable activity or if its worldwide turnover falls below the registration threshold.

All non-residents will be registered under the regime on a payments basis.[26]

A minimum threshold of $500 of GST refund has been imposed for the first return period to reduce the number of small value claimants registering under the system. Inland Revenue considers that only larger taxpayers making regular sizeable claims should remain within the regime. Lesser or irregular claims merely add to compliance costs for all parties without providing sufficient benefit and are therefore discouraged.

Taxpayers cannot retrospectively claim input tax incurred prior to their registration. This encourages taxpayers who are considering receiving New Zealand supplies to immediately register under the regime or risk being unable to reclaim that GST.

Group registration

A common approach to alleviating the problem previously faced by non-residents was for them to group register for GST with their New Zealand-resident associated companies under s 55 of the Act. This allowed supplies received by the non-resident to be deemed to have been received by the representative group member, thereby permitting greater input tax claims.

Initially, implementation of the enhanced registration regime would have applied to all non-residents, who would henceforth have been precluded from being group registered with New Zealand residents. This would have had the effect of forcing non-resident taxpayers which were formerly the members of GST-registered groups to register in their own capacity under the new rules. Inland Revenue initially proposed this approach because it would:

> allow Inland Revenue to accurately assess the level of refunds paid to non-residents. If cross-border groups were allowed, when a representative member filed a GST return on behalf of the group, it would be possible for what are effectively GST refunds to non-residents to be “masked” by the activities of a broader group that included New Zealand residents. Grouping with a New Zealand resident could also be used by non-residents as a method of accounting for GST on an invoice basis — a basis that is more susceptible to fraud because GST refunds are provided on invoices issued, rather than cash paid.[27]

Despite that justification, Inland Revenue’s proposed approach proved extremely unpopular with both taxpayers and their advisers, especially as the entire regime was intended to be concessionary to these non-resident businesses. Accordingly, Inland Revenue was persuaded to adopt more relaxed group registration rules that “*will allow for the formation of cross-border groups but still provide an adequate degree of protection to the revenue base*”.[28]

The solution was to continue to permit non-residents that directly make some taxable supplies in New Zealand to either group register with residents or voluntarily register under the standard GST registration regime.[29] Non-residents who do not make taxable supplies in this country cannot group register with New Zealand residents but are obliged to register under the enhanced registration regime.[30]

This compromise ensured most existing GST groups that included a non-resident will not be broken up. However, those non-residents that continue or choose to group register with a New Zealand resident would have to show that any input deductions claimed by that group were linked to taxable supplies made in New Zealand (rather than their worldwide business) in order to qualify for a refund. By contrast, non-residents that do not make any taxable supplies in New Zealand cannot group register with resident companies but can still claim GST refunds under the enhanced registration regime in respect of their worldwide supplies.

Apportionment of GST claim?

As with New Zealand residents,[31] non-residents claiming GST refunds under the enhanced registration regime are entitled to input tax only to the extent of their own taxable supplies. This ensures that non-residents who are engaged in financial or other exempt activities cannot obtain input tax refunds that would not be available to resident taxpayers engaged in those same activities.

This calculation is made according to the turnover from the non-resident's worldwide taxable activity to determine the proportion of any input tax entitlement. Given the broad base of New Zealand's GST system, this requirement should not affect most taxpayers, who will be entitled to claim near full input tax. For those within the financial services sector, increased compliance costs will be imposed to calculate the proportion of worldwide taxable and exempt financial supplies, which will then determine the proportion of input tax that can be claimed. However, as for existing resident financial services providers, non-residents can also make arrangements with the Commissioner under s 20(3E) of the Act to agree on the proportion of financial and taxable supplies being made as a method of lowering their compliance costs. In adopting this approach, Inland Revenue rejected taxpayer proposals to calculate the proportion of input tax to be claimed solely by reference to the use made by the non-resident of its New Zealand supplies. Such an approach would likely have favoured non-resident financial providers over resident providers and therefore, officials concluded, would defeat the purpose of the rules.

Filing returns

Non-residents must file a GST return for each period whether or not they have actually incurred New Zealand GST during that period. In effect, such taxpayers will be obliged to file nil returns for those GST periods. However, despite the unfortunate compliance costs for both the taxpayer and Inland Revenue, the filing of these nil returns is mandatory. The failure to file three GST returns in a row will result in the taxpayer's de-registration from the regime — coupled with a mandatory "stand-down period" under which they cannot re-register for a further five years.[32] Taxpayers and their advisers strongly opposed the length of this stand-down period but their arguments went unheeded.

This harsh rule is intended to ensure only taxpayers regularly receiving goods or services in New Zealand should remain within the system in order to reduce Inland Revenue's administration costs.[33] Presumably Inland Revenue would rather process nil returns each period than allow taxpayers to "disappear" from the system until the next time they have a refund to claim.

When will the GST refund be released?

After a return claiming a refund of input tax has been filed, Inland Revenue has a 90-day period to conduct preliminary enquiries and decide whether a broader investigation is warranted or the refund will be released.[34] Inland Revenue insisted on a three-month time frame to recognise the inherent difficulties associated with obtaining information from offshore, especially where language difficulties may arise.[35] This time frame compares with the standard 15 days provided under s 46(1) for Inland Revenue to commence an audit or be obliged to release a GST refund.[36]

Inland Revenue rejected taxpayer proposals to reduce refund times to 60 days because of "*an increased fraud risk associated with providing refunds to non-residents. This risk exists because, unlike residents, Inland Revenue has limited ability to accurately track down and recover money from non-residents when a refund is released in error*".[37]

Conclusion

The enhanced registration regime is a welcome option for non-resident businesses that incur New Zealand GST that would otherwise be irrecoverable. However, the complexity of the registration system and the ongoing requirement to file GST returns each period, even when no GST is being claimed, will unnecessarily add to taxpayers' compliance costs. The harsh stand-down period imposed on taxpayers who fail to file those returns seems unwarranted. Nevertheless, enactment of this regime brings New Zealand into line with most other countries and enhances the destination principle upon which our GST system is based.

Footnotes

[1] This estimate takes into account the fact that non-residents with significant business interests in New Zealand will invariably have already established New Zealand subsidiaries and/or GST groups to ensure their eligibility for refunds of GST incurred.

[2] Policy Advice Division of Inland Revenue *GST: Business-to-business neutrality across borders — GST on cross-border supplies between businesses* (August 2011).

[3] Sections 11 and 11A of the Act.

[4] Section 11A(2) of the Act.

[5] Section 12 of the Act.

[6] For consistency purposes, the Act adopts the tax residency tests under the Income Tax Act 2007; see the definition of "resident" in s 2(1).

[7] See s 8(3) and 8(4) where New Zealand-resident taxpayers can agree in writing with overseas suppliers where a particular supply is deemed to take place.

[8] See the discussion document (fn 2) at para 1.5.

[9] (1994) 16 NZTC 11,211 (CA) at 11,215.

[10] See *Case* P55 (1992) 14 NZTC 4,382.

[11] See the discussion document (fn 2) at para 1.8.

[12] See s 11A(2) of the Act.

[13] *Wilson & Horton Ltd* v *C of IR* (1995) 17 NZTC 12,325.

[14] At para 2.12.

[15] See s 52, *Lopas* v *C of IR* (2006) 22 NZTC 20,010 (SC) and *C of IR* v *Thomson* (2007) 23 NZTC 21,375 (HC).

[16] At para 2.14.

[17] At para 1.10.

[18] At paras 2.19 and 2.22.

[19] At para 3.9.

[20] See A New Tax System (Goods and Services Tax) Act 1999, Div 11.

[21] At para 3.13.

[22] At para 3.18.

[23] At para 3.19.

[24] New s 54B of the Act.

[25] See s 51(1) of the Act.

[26] New s 19(1B) of the Act.

[27] Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill: Officials' Report to the Finance and Expenditure Committee on submissions on the Bill (March 2013) at 103.

[28] See Officials' Report, fn 25, at 103.

[29] See new s 54B of the Act.

[30] See new s 55(1B) of the Act.

[31] See s 20(3C) of the Act.

[32] New s 54C of the Act.

[33] The indicative administration costs over the five-year forecast period are $1.320m.

[34] See new s 46(1B) of the Act.

[35] New s 48(1B) of the Act.

[36] See *Contract Pacific Ltd* v *C of IR* (2010) 24 NZTC 24,095.

[37] See Officials' Report, fn 24, at 108.