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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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Paul Smith

Mark Keating

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

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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."

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

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

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

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

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

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

Problem 3 — Nominee transactions

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Problem 4 — Time of supply

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

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

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

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

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

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

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

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

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

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

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

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

Problem 5 — Wrongly unregistered vendor

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

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

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

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

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

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

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

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

Problem 6 — Wrongly registered vendor

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

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

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

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

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

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

Problem 7 — Mortgagee sales

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

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

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> 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).

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

Footnotes

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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.

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Practitioner's viewpoint: Why would you be a trustee?, 29 October 2015

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Inland Revenue (IR) is increasingly adopting a strategy of aggressively pursuing trustees for unpaid tax. Reported cases reveal trustees facing personal liability for income tax and/or GST owing by their trusts, and litigation between co-trustees, or between trustees and their professional indemnity insurers, squabbling over who will ultimately pay this tax. This article by Mark Keating, Senior Lecturer in Tax at the University of Auckland Business School, examines the state of the law on trustee liability for tax. It examines the remedies available to IR to recover unpaid tax, and considers various strategies adopted by, or that may be available to, trustees to protect themselves against that potential liability.

So many trusts …

As part of its comprehensive review of the law relating to trusts, the New Zealand Law Commission commented on the appeal of trusts both for asset protection and for trading activities. Due to the lack of any central registry it was not possible to be definitive on the number of trusts but estimated:[1]

> There are at least 237,500 trusts, as this was the number of tax returns filed by trusts with Inland Revenue for the 2007–2008 tax year. This number increased from 145,900 in the 2000–2001 tax year. Based on the 2008 figure, the most cautious assessment is that there is one trust for every 18 people in New Zealand. Trusts are only required to file a tax return if they earn income during the financial year. However, they are not required to alert Inland Revenue (or any other agency) to their existence if they are not income-earning. Some commentators have estimated that the number of trusts may range up to 400,000.

As a result, the Law Commission concluded "that New Zealand has a high number of trusts per head of population relative to other countries".[2]

The definitions of "taxpayer" and "tax position" in s 3(1) Tax Administration Act 1994 (TAA) did not encompass family trusts that earned no income and only owned the family home. Such trusts were not required to, and often did not, register with IR. But a presumably unintended consequence of the newly enacted land rules requiring[3] all vendors and purchasers of residential land to provide their IRD number as part of the land conveyancing process is that trusts not previously registered with IR must now do so, under new s 24BA of the TAA. The Special Report issued by IR regarding the operation of the new reporting rules explains:[4]

Trusts — Where the property being transferred was or will be trust property, section 156A(2)(b)(i) and (ii) provides that the main home information exception will not be able to be used. This means that the trustees of a trust will need to provide the trust's IRD number (and foreign equivalent of an IRD number and country code, if applicable) when transferring trust property.

To relieve these newly registered trusts from the obligation to file a (presumably nil) annual tax return, new s 43B of the TAA (to be enacted by s 16 of the Taxation (Bright-line Test for Residential Land) Bill) establishes an exemption for "non-active trusts", similar to that in s 43A for non-active companies, to alleviate this unnecessary compliance cost.

Joint and several liability of trustees for tax

The tax benefits of trusts are well-known, but[5] the potential risks are less well-understood. Under both the rules of equity and the Trustee Act 1956, a trust is not a separate legal entity but instead is a collection of rights and obligations owing by the person/s acting as trustees for the beneficiaries' interest.[6] In this way trustees of a trust have personal liability for their actions (and possibly, for the actions of their co-trustees — discussed further below) similar to the liability shared by partners in a partnership.

Not surprisingly, tax law ensures this personal liability is sheeted home to trustees to the fullest extent. The definition of "trustee" in s YA 1 Income Tax Act 2007 expressly "includes all trustees, for the time being, of the trust".[7] Likewise, s HC 2(2) stipulates that "the trustees of a trust are treated in that capacity as if they were a notional single person, and are jointly and severally liable to satisfy the income tax liability of the notional single person". Even with respect to income allocated to beneficiaries, trustees retain personal liability as deemed agents for those beneficiaries under s HC 32(3) to ensure the full tax liability is satisfied.

The position with respect to GST is more complicated because under s 57 of the Goods and Services Tax Act 1985 (GST Act), trusts are effectively treated as separate taxpayers. This means that the trust itself, and not the trustee/s, register and account for GST.[8] However, under s 51(3) each trustee "is jointly and severally liable with all other [trustees] for all tax payable by the body during the taxable periods or part of taxable periods as the case may be, the person is a [trustee], even if the person is no longer a [trustee]".

The wide-ranging operation of these provisions has been recognised in an unbroken string of cases. For instance, in *Macalister Todd Phillips Bodkins v AMP General Insurance Ltd*, the Supreme Court explained (at [42]):

> In imposing personal liability the tax statutes do no more than recognise the general principle that liabilities incurred by a trustee in relation to a trust are always the personal liabilities of the trustee. This is an aspect of the nature of a trust, which is not a person but an equitable obligation to deal with property for the benefit of beneficiaries. A creditor has a personal right to sue a trustee and to get judgment and make the trustee bankrupt.

Likewise, in *Selkirk* v *McIntyre* (2013) 26 NZTC ¶21-008, the High Court confirmed (at [14]):

> A trust is not a separate legal entity. Trust assets are held in the individual names of the trustees. The same applies to liabilities. Trustees will be personally liable to creditors, including the IRD.

Resignation as trustee?

Under s 57(3B) of the GST Act, a trustee is deemed to continue as trustee, and therefore to remain personally liable for any GST, even after they have actually resigned as trustee. To escape this ongoing liability the trustee must provide the Commissioner with "written notice" of his or her resignation.

The operation of this provision was tested in *Chester Trustee Services Ltd* v *CIR* (2002) 20 NZTC 17,725 when a trustee retired after a GST liability had been incurred but before IR commenced debt recovery action. The retired trustee asserted, and the High Court accepted, that all GST liability remained with the new trustee/s and did not follow the retiring trustee. This result meant that trustees could escape personal liability for GST accrued by the trust while under their control simply by resigning as trustee.

Understandably, the Court of Appeal in *CIR* v *Chester Trustee Services Ltd* (2002) 20 NZTC 17,925 overturned that impractical result. It ruled that trustees remained liable for any GST liability until the date they

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give IR written notice of their retirement, at which point any ongoing liability cease, but that they remained personally liable for all GST liabilities accrued during the period of their trusteeship. The corresponding effect of this interpretation appears to be that new trustees are personally liable only for GST the trust accrues after they are appointed and not for any historical GST owing by the trust.[9]

This understanding was confirmed in another context by the Court of Appeal decision in *CIR* v *Duncan* (2007) 23 NZTC 21,380 (CA). There, a bankrupt somehow remained as trustee of his family trust throughout his bankruptcy. That trust had previously claimed an input tax credit on the purchase of land and incurred a GST liability upon its eventual sale, which occurred after the bankruptcy period had passed. The trust had insufficient funds to pay the GST so the Commissioner pursued the former bankrupt personally. He defended the debt recovery proceedings on the grounds all his debts, including his contingent liability as trustee for the pending output tax, had been absolved during his bankruptcy. The Court of Appeal rejected this defence on the grounds that the GST liability arose only when the trust sold the land, which occurred after his bankruptcy was completed. As such, it represented a new liability for which he remained liable as trustee.

Interestingly, the Court itself commented that the bankrupt could have avoided that pending liability by the simple expediency of notifying IR of his resignation as a trustee any time prior to the trust's sale of the land. This, therefore, provides a clear warning to trustees who recognise a potential tax shortfall from the pending sale of an asset that they should immediately resign in order to avoid that inevitable liability.

That appears to be precisely what occurred in *Bank of New Zealand* v *Rowley and Skinner* (2012) 25 NZTC ¶20-150. There, two trustees simultaneously purported to resign immediately before claims could be filed against them by creditors. The High Court rejected those resignations as ineffective on two grounds: first the trust deed itself did not permit such resignation; second, that allowing trustees to resign en masse risked the failure of the trust for lack of a validly appointed trustee. Instead, the Court appointed two accountancy practitioners as receivers for the trust, to act with the powers of a liquidator, but indicated the purportedly retired trustees retained their personal liability.

How far will IR go in pursuing trustees?

The procedure for the recovery of taxes by IR are provided under s 156 of the TAA, which grants the District Court jurisdiction to hear and determine proceedings by the Commissioner for the recovery of tax.

After an apparently slow start,[10] from at least 2000 IR has adopted a policy of vigorously pursuing trustees personally for their trust's unpaid tax liability. For example in *Bhana* v *CIR* (2007) 23 NZTC 21,001, IR pursued a sole trustee into bankruptcy for unpaid *income* tax and GST. The trustee claimed he had no personal liability as the tax was owed by the trust — and IR should bring a claim against the trust's assets for recovery. Referring to the clear statutory extension of personal liability to trustees for unpaid taxes, the High Court rejected the taxpayer's arguments and adjudicated him bankrupt.

An interesting practical issue arose in *CIR* v *Newmarket Trustees Ltd* (2011) 25 NZTC ¶20-030. That case involved a trustee company established by a law firm. The trustee company was simultaneously the trustee of more than a hundred other trusts established for clients of the firm. Unfortunately, one of those trusts had been maladministered by its co-trustee and became insolvent, owing IR $300,000 in GST. IR commenced liquidation proceedings against the trustee company for payment of that unpaid tax.

The law firm applied to prevent that liquidation. It acknowledged that neither that trust nor the trustee company could pay the outstanding GST. However, it claimed that the trust's insolvency arose from the conduct of its co-trustee and not itself. Furthermore, it pointed to the adverse consequences, administrative costs and potential hardship that liquidation of the trustee company would impose on the hundred other trusts of which it was also trustee. In effect, it pleaded that IR should not punish all the other trusts for the actions of the single defaulting trust, and requested the court exercise its discretion under s 241(4) of the Companies Act 1993 against putting the trustee company into liquidation.

Balancing IR's right to recover the unpaid GST against the interests of the other trusts, the High Court set aside the application for liquidation. This decision effectively thwarted IR's ability to recover the unpaid GST from the trustee company

The Court of Appeal in *CIR* v *Newmarket Trustees Ltd* (2012) 25 NZTC ¶20-139 overturned that impractical result. It criticised the trustee company for the negligent supervision of its co-trustee and concluded that the

trustee company carried a degree of responsibility for the trust's insolvency. The Court rejected the moral hazard of excusing the defaulting law firm of the adverse consequences (for itself and its other clients) of its own negligence. It stated:[11]

> … Here, where there is no dispute that Newmarket was operated unsatisfactorily, the question is whether there was any good reason why a liquidation order should not have been made. … the fact that the liquidation of Newmarket would have practical consequences for Castle Brown's remaining trusts is not a reason in this case why the order should not be made because:
>
> > (a) responsibility for taking the steps necessary to replace Newmarket as trustee of the other trusts would rest on Castle Brown, not the other trusts;
> > (b) the costs involved in taking these steps would be met by Castle Brown, not the other trusts; and
> > (c) … there is no evidence that the other co-trustees and beneficiaries would agree to an insolvent Newmarket remaining as trustee of their trusts.

So the firm's trustee company was liquidated.

Liability of passive trustees?

An issue raised in both the *Chester Trustee Services* and *Newmarket* cases was the culpability of independent trustees for the actions (or inactions) of co-trustees. In particular, professional trustees often defer or even delegate day-to-day responsibility to co-trustees with a personal interest who naturally want a greater say in the running of the trust, often including tax compliance.

The courts have repeatedly confirmed inattention or delegation by professional trustees to a co-trustee is inexcusable. Far from being a mitigation factor, the courts have consistently held such "passive trustees" to be fully liable for the resulting tax liability on the grounds they have brought their fate upon themselves.

This issue was considered in detail in *Selkirk* v *McIntyre* (2013) 26 NZTC ¶21-008 (HC). That case examined the fall-out following IR's recovery of unpaid tax from a solicitor who acted as a co-trustee of a client's trust. The solicitor apparently delegated administration of the trust, including its tax compliance, to the client, who had allowed a substantial GST liability to remain unpaid.

IR elected to pursue recovery solely from the solicitor, who then sought recovery from the client.

The case raised a number of interesting issues:

- whether trustees have an automatic right of equal recovery from co-trustees, and
- whether an independent trustee should be entitled to be fully indemnified by an interested co-trustee.

The solicitor's claim was based on the assumption that the client was responsible for the trust's GST problems while he had been blameless, therefore he should be entitled to full reimbursement.

The High Court rejected this approach. After reviewing the relevant case law on the proper liability of so-called passive trustees,[12] the court concluded:[13]

> Passive trustees have been seeking relief from the courts, on the basis of their lesser culpability, since the earliest days of the development of contribution and indemnification as equitable remedies. … A "passive" trustee is not entitled to simply delegate their responsibilities to the "active" trustee. In this case the Trust deed required that the trustees act unanimously (as is the norm). The names of both trustees were presumably recorded as the legal owners on the various properties which formed part of the Trust assets. … Equity simply does not recognise the concept of an "active" trustee or a "passive" trustee. All trustees are accountable to the beneficiaries of the trust and must account to them for its proper administration.

As a result, the court ordered only that the co-trustee pay his share of the tax and no more.

This approach applies equally to independent non-professional trustees. For instance in *Rowmata Holdings Limited (in liq)* v *Hildred* (2013) 26 NZTC ¶21-039, the High Court confirmed that a friendly neighbour who agreed to act as an unpaid co-trustee of a family trust, and who acquiesced in the administration of the

trust by his co-trustees, was equally liable for all taxes owing by the trust. The Court noted the trust deed required unanimous trustee consent and the neighbour had repeatedly agreed with or ratified the actions of his co-trustees and thereby had assumed equal personal liability. The court's treatment of passive trustees is therefore no different than that of "sleeping directors" under company law.[14]

Breaches of trust by co-trustee?

"Passive trustees" who fail in their duties by acquiescing to the wishes of their fellow trustees can have no excuses. But what about diligent trustees who face a tax liability resulting from the unilateral action or breach of trust by a co-trustee?

As most trust deeds require unanimous agreement of all trustees, unilateral action by trustees constitute a breach of trust, unless ratified by their co-trustees. But if the independent trustee is either unaware or refuses to sanction that conduct, what is their liability for the tax consequences?

The Income Tax Act is silent on the matter. The GST Act generally deems all actions undertaken by one trustee to be authorised by all trustees "unless the contrary is proved".[15] The statutes therefore presume, and in the author's experience IR assumes, that tax liabilities resulting from any breach of trust remain the joint responsibility of all trustees, who must subsequently dispute that liability between themselves.

The correctness of that view is unproven. It may equally be argued that any tax liabilities arising from an unauthorised act or breach of trust attaches only to that trustee and not to any co-trustees, especially if the breach "is proved".

Under general law, a trust is only liable for the lawful and authorised actions of its trustee/s. Likewise, co-trustees are jointly and severally liable only for the authorised and lawful acts of co-trustees.[16] As part of its review of our trust laws the Law Commission considered the liability of co-trustees in a number of contexts:[17]

> Unsecured creditors of a trustee do not have a direct claim against the trust assets, unlike secured creditors who have a claim through their security. It is the trustee that is personally liable for debts properly incurred in the administration of the trust. Therefore the primary claim for creditors is against the trustee personally, not the trust assets.

The converse of that position is that the trust, and therefore the other trustees, is not liable to third parties for unauthorised actions or breach of trust by co-trustees. Such third parties may include IR.

As explained, the most common breach of trust is the failure by co-trustees to act unanimously. Such unilateral behaviour is always unauthorised and therefore cannot bind the trust.[18]

A recent example of this principle is *Thorpe* v *Hannam* (2010) 3 NZTR ¶20-014. That case concerned a trust's planned sale of a residential property. Decisions about the property's sale were made by only one trustee. Even though the co-trustees acquiesced to that sale (by signing the agreement), that did not constitute the unanimous agreement required under the trust deed. Accordingly, that sale could not be enforced against the trust.[19] But had that sale proceeded and a tax liability resulted, could the other trustees also have escaped personal liability on those grounds?

Strong support for this argument is found in *Rodney Aero Club Inc* v *Moore* [1998] 2 NZLR 192. That case involved a dispute over the renewal of a licence to an aero club by two trustees over the opposition of another. After a lengthy discussion of the requirement for all trustees to act unanimously in order to bind the trust, the High Court concluded the license entered into by the two trustees was invalid and could not be enforced. Furthermore, the aero club's remedy lay only against the trustees who had acted unilaterally and without authority, and not against either the trust itself or the trustee who opposed the licence.

This approach is further supported by s 38 of the Trustee Act 1956 which mandates that, while co-trustees are jointly and severally liable in normal circumstances, a trustee is only liable for a personal breach of trust and not those of a co-trustee.[20] Finally, the rules of agency stipulate that trustees are not agents for, and therefore cannot bind, each other or the trust in liability to a third party without proper authority unless in

some way the trust "cloaked him with its authority".[21] Any representations of apparent authority for a trustee must be made by the authorised trustees and not the unauthorised trustee.[22]

Obviously, the common law position that only the defaulting trustee is liable for the consequences (including possible tax liability) while neither the trust itself nor the co-trustees can be held liable would significantly limit IR's ability to recover that tax. Instead IR takes the approach that co-trustees cannot avoid liability for a trust's tax even if that liability arose from a breach of trust. It maintains that any breach of trust is irrelevant and the trust (and therefore the co-trustees) remain personally liable — with only the right to seek equal contribution or indemnity from the defaulting trustee.[23]

Partial support for this harsh stance is found in *Case* 5/2013 (2013) 26 NZTC ¶2-004. That case concerned whether all trustees had the required purpose or intention of sale regarding land under s CB 6 of the Income Tax Act. However, the TRA went beyond that narrow point and explained:[24]

> In any case, I consider that it would be an extraordinary outcome if a trust can simply ignore the unanimous trustee decision requirement in its day to day operation and then be able to take advantage of that requirement when considering its tax obligations. In the present situation I am of the view that Ms X cannot plead her own ignorance of her co-trustees' intentions when she has simply maintained a passive role and permitted Mr and Mrs B to effectively run the Trust particularly knowing as she did, that Mrs B did not understand her responsibilities as a trustee and saw Ms X as simply having a rubber stamping role.

Importantly, that case involved no allegation of breach of trust; merely that the "passive trustee" failed to exercise her duties properly. It is clear from the judgment that this passive trustee was entirely aware of all decisions taken by her fellow trustees and simply acquiesced or adopted them. No deceit or breach of trust was identified. The TRA's statements therefore may not apply if a lack of authority or breach of trust is established.

Interestingly, the TRA in *Case* 5/2013 referred repeatedly by analogy to the judgment in *CIR* v *Boanas* (2008) 23 NZTC 22,046 (HC). That case concerned whether all partners were bound by the tax consequences of a land transaction undertaken by a partnership even if they voted against it. The High Court ruled they were. Significantly, even when reaching that decision the Court recognised that an exception may arise upon a breach of fiduciary duty:[25]

> I consider that the Commissioner's approach to ascertainment of purpose or intention [of the partnership] is correct, at least in circumstances such as the present. … Individuals could not be at a tangent to what the partnership rationale was, except in the most unusual of circumstances that might arguably amount to a breach of fiduciary obligations to the remaining partners. Whilst I would not exclude the theoretical prospect of an individual partner being able to establish purposes and intentions different to that of his or her partners at the time, that would be a very limited exception. It would be for such a partner to reconstruct the circumstances of that difference.

This decision recognises the possibility that a tax liability resulting from a breach of duty may be an exception and, if established, that liability would not extend to individual partners innocent of that breach. Presumably that liability would fall only on the defaulting partners. The TRA in *Case* 5/2013 does not refer to or explain that exception in its own brief consideration of the tax consequences of a breach of trust. This question therefore remains open for reconsideration in an appropriate case.

Professional indemnity insurance?

It cannot be a coincidence that so many of the cases involve legal practitioners acting as trustees, either personally or through their firm's trustee company. But is that liability for a trust's unpaid tax recoverable under the firm's professional indemnity coverage?

In *AMP General Insurance Ltd* v *Macalister Todd Phillips Bodkins* (2007) 23 NZTC 21,086, a partner in a law firm acted as co-trustee of a client's trust. His co-trustee failed to pay GST owing on the sale of land so the partner was obliged to pay, and then claimed recovery from the law firm's insurer under its professional indemnity policy.

The firm conceded that the partner did not appreciate his own potential tax liability as co-trustee for the trust's property development activity and never sought appropriate advice. As a result, he inadequately supervised his co-trustee until after the GST liability had crystallised, by which time the trust had insufficient funds to pay the tax.

The insurer disputed liability on a number of grounds and the case eventually reached the Supreme Court, which ruled:

- The partner's failure to recognise his potential personal tax liability as co-trustee, and therefore failure to adequately supervise his co-trustee or properly participate in the administration of the trust was negligent. His stance as a "passive trustee" was heavily criticised; therefore
- That negligence fell under the firm's professional indemnity insurance policy; however
- The partner's loss arose from the trust's inability to pay GST from its own assets, not directly from his own negligence (which would not have mattered if the trust had sufficient funds to pay its own tax).

As a result, the insurer was liable to reimburse the firm only for the value of funds held by the trust that should have been used to pay its GST (but which the partner inadvertently allowed his co-trustee to utilise) and not for the full tax liability. That decision clearly has wide application to limit the recovery of professional trustees under similar policies.

Use of corporate trustees?

The Law Commission noted an increasing number of trusts with corporate trustees instead of natural persons. Perhaps this development is a rational response to the dire tax consequences faced by trustees, which makes the protection offered by limited liability companies desirable.

Faced with corporate trustees, IR is increasingly resorting to remedies under the Companies Act to pursue their directors personally for unpaid taxes. For instance in *Goatlands Ltd (in liq)* v *Borrell* (2007) 23 NZTC 21,107, the company received a GST refund in respect of the planned purchase of a property. The directors immediately used part of the GST refund to pay the deposit to the vendors and spent the rest. This left the company unable to repay the GST to IR when it was unable to complete the purchase.

The directors were reliant upon the sale of other assets to fund the planned purchase, or refund the GST if that purchase did not proceed. When the company was unable to complete the purchase liquidators were appointed, who then set about pursuing the directors for breach of their duties (references are to the Companies Act):

- Under s 135, for causing or allowing the company to carry on business in a manner likely to create a substantial risk of loss to its creditors, most notably IR; and/or
- Under s 136, for allowing the company to incur a contingent obligation to repay the GST in circumstances where they did not believe on reasonable grounds that it could do so.

The High Court upheld the liquidators claim on both grounds and imposed personal liability on the directors for the company's unpaid GST. A similar situation arose in *Rowmata Holdings Ltd (in liq)* v *Hildred* (2013) 26 NZTC ¶21-039 where GST claimed on the purchase of land by a company nominated by two mirror trusts was unable to be repaid when that transaction failed. All trustees, including the independent trustee, were held personally liable to repay that GST.

In a further blow to the use of corporate trustees, the Law Commission has now proposed changes to the Companies Act to extend personal liability for trust debts (presumably including tax debts) to the directors of trustee companies.[26] This recommendation, based on s 197 of the Corporations Act 2001 (Cth), would significantly impact professional trustees who have increasingly attempted to shelter behind the use of corporate trustees to limit their potential liability.

Conclusion

Trusts are a commonplace structure in New Zealand for protection of assets and trading activities. However, when trusts fail IR is becoming increasingly aggressive in pursuing any unpaid tax from trustees personally; and the courts appear to welcome that tougher approach. The recommendation to extend personal liability to

directors of trustee companies will leave few protections for professional trustees. Unless they are prepared to both take an active and equal role in administering their trusts (which clients may neither welcome nor wish to pay for), and accept the personal liability that may result, it may be wiser for professionals to leave the administration of trusts to the amateurs.

Footnotes

1 *Some issues with the use of trusts in New Zealand; Review of the law of trusts, second issues paper*, New Zealand Law Commission, December 2010, at 2.1.

2 Ibid, at 2.1.

3 See Taxation (Land Information and Offshore Persons Information) Act 2015.

4 See Special Report on "New Information Requirements to Improve Tax Compliance in the Property Investment Sector", September 2015, p 9, at www.taxpolicy.ird.govt.nz/sites/default/files/2015-sr-property-information-requirements.pdf.

5 For example, see the discussion by J Bassett, "Trusts to own family wealth", CCH, *New Zealand Tax Planning Report*, No 1, February 2012 at 1.

6 See *AMP General Insurance Ltd* v *Macalister Todd Phillips Bodkins* (2007) 23 NZTC 21,086 (SC) at [42].

7 That liability applies only with respect of their actions as trustees and not in their personal capacity which remains separate: see *Case* L72 (1989) 11 NZTC 1,419. However, this line between personal and trustee capacities can become blurred. For example, when a requisition notice demanding the recovery of tax under s 157 of the TAA was issued to a solicitor in his personal capacity, it was held to also encompass any payment made by him to the defaulting taxpayer, including distributions made by him as trustee of that taxpayer's family trust: see *King* v *Leary* (1988) 10 NZTC 5,067 (HC).

8 The trustee/s individual (or collectively) cannot themselves register for GST: see *Case* S61 (1996) 17 NZTC 7,387. Likewise, all supplies to or from the trust must be returned by the trust itself: see *Case* S84 (1996) 17 NZTC 7,526.

9 See *CIR* v *Sabre Investment Trust* (2006) 22 NZTC 19,941 where the High Court accepted that a replacement corporate trustee was liable only for GST that accrued after its appointment. See also *Case* 5/2013 (2013) 26 NZTC ¶2-004 where the Taxation Review Authority (TRA) expressly ruled that the replacement corporate trustee was liable only for income tax, GST and shortfall penalties arising in periods after its appointment.

10 There are no reported decisions involving debt collection action taken by IR against trustees personally for unpaid tax by trusts prior to 2000.

11 CA, at [61]–[62].

12 The leading New Zealand case is *Re Mulligan* [1998] 1 NZLR 481.

13 At [41]–[45].

14 See *Mason and Meltzer as Liquidators of Global Print Strategies Ltd (in liq)* v *Lewis* (2006) 9 NZCLC 264,024 where the Court of Appeal warned "the days of sleeping directors with merely an investment interest are long gone".

15 For example, s 51(7) of the GST Act provides that registration of a trust by a trustee "shall for all purposes be deemed to have been made by hat person or by that person's authority, unless the contrary is proved".

16 See The Duties, Office and Powers of a Trustee: Law Commission Review of the Law of Trusts, Fourth Issues Paper, June 2011, at 1.66: see www.lawcom.govt.nz/sites/default/files/projectAvailableFormats/NZLC%20IP26.pdf.

17 Law Commission Work Paper 5 at 7.1.

18 See *Niak* v *Davidson* (2001) 1 NZTR ¶11-003 (CA) and *Hansen* v *Young* (2003) 1 NZTR ¶13-013.

19 See also *Dever* v *Knobloch* (2009) 2 NZTR ¶19-042.

20 See the recent application of this section in *Huber* v *Richter* (2006) 2 NZTR ¶16-018.

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21 See *Freeman & Lockyer* v *Buckhurst Park Properties Ltd* [1964] 1 All ER 630 (CA).

22 See *Savill* v *Chase Holdings Ltd* [1989] 1 NZLR 257.

23 See cases on the right of participation and indemnity such as *Westpac Banking Corp* v *Savin* [1985] 2 NZLR 41 and *Marlborough District Council* v *Altimarloch Joint Venture Ltd* [2012] 2 NZLR 726.

24 At [84]–[85].

25 See *CIR* v *Boanas* (2008) 23 NZTC 22,046 at [68].

26 See Review of the Law of Trusts: Preferred Approach — Issues Paper 31, Ch 8, at p 34.

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