



**GST BUSINESS-TO-BUSINESS NEUTRALITY
CONCERNS: DOMESTIC REVERSE CHARGE VERSUS
ZERO RATING PROVISIONS**

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TABLE OF CONTENTS

I.	ATTESTATION OF AUTHORSHIP	5
II.	ABSTRACT.....	6
III.	ACKNOWLEDGEMENTS.....	7
IV.	INTRODUCTION.....	8
	<i>A. How has the global shift to indirect taxes been happening?</i>	<i>10</i>
	1. <i>New regimes</i>	<i>10</i>
	2. <i>Higher rates</i>	<i>10</i>
	3. <i>Broadening the base.....</i>	<i>10</i>
	<i>B. Why has VAT become the tax of choice for so many governments?.....</i>	<i>10</i>
	1. <i>Fiscal stability and growth.....</i>	<i>11</i>
	2. <i>Simpler tax administration.....</i>	<i>11</i>
	3. <i>External influences.....</i>	<i>11</i>
	<i>C. Revenue from GST in New Zealand</i>	<i>12</i>
	<i>D. Global fears about VAT and GST models</i>	<i>13</i>
	<i>E. Fears about New Zealand's GST model.....</i>	<i>15</i>
V.	GST MODEL USED IN NEW ZEALAND	19
	<i>A. History of GST in New Zealand.....</i>	<i>19</i>
	<i>B. The New Zealand GST model – Credit-Invoice Mechanism</i>	<i>20</i>
	<i>C. Problems with Credit-Invoice Mechanism</i>	<i>21</i>
	1. <i>Risks to business.....</i>	<i>21</i>
	2. <i>Revenue risks for the Government</i>	<i>24</i>
	<i>D. Threats to business-to-business neutrality</i>	<i>24</i>
	1. <i>Phoenix entities</i>	<i>24</i>
	2. <i>Carousel fraud</i>	<i>27</i>
	3. <i>Timing mismatches.....</i>	<i>28</i>
	<i>E. The General Anti-Avoidance Provisions</i>	<i>29</i>
	1. <i>Ch'elle Properties</i>	<i>30</i>
	2. <i>Glenharrow Holdings</i>	<i>32</i>
	<i>F. Is the use of the general anti-avoidance provisions adequate to deal with the weaknesses of the GST model?</i>	<i>37</i>
VI.	DOMESTIC REVERSE CHARGE	40
	<i>A. Overview of DRC</i>	<i>40</i>
	<i>B. Objective of DRC.....</i>	<i>43</i>
	<i>C. Advantage of the DRC</i>	<i>43</i>
	<i>D. Scope of the DRC</i>	<i>44</i>
	<i>E. Other features of the DRC</i>	<i>45</i>
	1. <i>Time of supply rules</i>	<i>45</i>
	2. <i>DRC contract with more than one recipient</i>	<i>45</i>
	3. <i>Recipient – Deemed to be registered</i>	<i>46</i>
	4. <i>Post-sale adjustments.....</i>	<i>46</i>
	<i>F. Exceptions to the proposed DRC.....</i>	<i>47</i>

1. Progressively supplied goods and services	47
2. The DRC and sales in satisfaction of debt	48
G. Issues with the proposed DRC- The Stakeholders perspective	49
1. Land transactions	50
2. Going concerns	51
3. Compulsory nature of the DRC	52
4. Magnitude of DRC	53
5. Practical implications of the DRC	53
H. DRC - The UK Experience	54
1. DRC – The application	55
2. Supplies excluded from the DRC	57
3. Reasonable checks	57
4. Issues identified with the UK DRC	58
I. The proposed DRC - Australia	59
1. The existing law – going concern and farm land	60
J. Comparisons of the 3 DRC models	62
K. Summary	63
VII. THE ZERO-RATING PROVISION	64
A. Government’s arguments for not zero-rating	64
B. Key features of the zero-rating provisions	66
C. Determining zero-rating	67
1. Definition of “land”	68
2. Disclosure requirements	69
3. Supplier’s obligations	70
4. Record-keeping requirements	71
D. Consequences of incorrect GST treatment	72
1. Correction of GST treatment before settlement	72
2. Correction of GST treatment after settlement	73
E. Submissions received in respect of the zero-rating provisions	75
1. Periodic Supplies	75
2. Reducing vendor’s obligation	76
3. Determining the recipient’s intention	77
F. Issues with the zero-rating provision	78
1. Compliance costs	79
2. The purchaser’s statements	79
3. Potential for confusion	81
G. Summary	83
VIII. DOMESTIC REVERSE CHARGE V ZERO-RATING	84
A. DRC introduces new GST concept - creates uncertainty and complexities	86
B. GST rules – keeping it simple	90
C. Compliance Costs	93
D. Audit trail – unintended consequences	96
E. Audit intervention resources	98
F. The scope of the DRC	99
G. Timing of DRC - “The ship has sailed”	100
H. Political Viewpoint	102
IX. CONCLUSION	104

X.	BIBLIOGRAPHY	107
A.	<i>Books</i>	107
B.	<i>Articles</i>	107
C.	<i>Cases</i>	108
D.	<i>Websites.....</i>	108

I. ATTESTATION OF AUTHORSHIP

I hereby declare that this submission is my own work, and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma or a university or other institutions of higher learning

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Harish Singh

II. ABSTRACT

The importance of revenue from Goods and Services Tax (GST) and Value Added Tax (VAT) to governments worldwide cannot be understated. Worldwide, the company tax rates and personal tax rates in general have been falling while the GST and VAT rates have either remained the same or been on the rise. With the world economy slowing down, more governments are increasingly relying on the tax take from indirect taxes to fund their policies.

Evaluation of the GST and VAT systems are therefore very important to assist with keeping pace with the changing environment. As part of the recent tax reforms in New Zealand, the government identified some weaknesses with the GST model used in New Zealand. Consequently, the government issued two discussion documents identifying what these weaknesses were and what it considered were the solution to these issues.

This dissertation considers the weaknesses of the GST model that were identified by the government and discusses in detail what the government had identified as its preferred option of dealing with these weaknesses, the Domestic Reverse Charge mechanism.

The dissertation also focuses on the alternative that was proposed, the compulsory zero-rating provisions, which the government eventually legislated for to address these concerns. Finally, the dissertation will attempt to answer the question as to whether the government has made the right decision in legislating for the zero-rating provisions instead of the proposed DRC.

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IV. INTRODUCTION

"No government can exist without taxation. This money must necessarily be levied on the people; and the grand art consists of levying so as not to oppress." — Frederick the Great, 18th Century Prussian King.¹

If Frederick the Great was alive today, he would be impressed in the way Value Added Tax (VAT) and Goods and Services Tax (GST) has evolved worldwide since it was first introduced and its growing acceptance amongst people as a form of consumption tax.

According to the KPMG report on "Managing the global reform challenge", the rise of VAT (which will be used interchangeably with GST throughout this paper) over the last 50 years has been nothing short of remarkable.² From its beginnings in post-World War II France, over 140 countries around the globe now rely on a VAT-type tax as a significant source of government revenue.³ Even without the global downturn, indirect taxes such as VAT have been gradually extending their reach into the global economy to become an increasingly important element of government tax revenue.⁴

The growth of VAT was slow to start, with only a limited number of European and South American countries initially adopting VAT systems. However, in the last 20 years, approximately 100 countries globally have introduced VAT systems. VAT is now a key part of the tax system of all major developed economies (except the United States of America).⁵ As the table shows, VAT now accounts for approximately 19 percent of tax revenues for members of the Organisation for Economic Co-operation and Development (OECD).⁶

¹ < <http://www.rfcafe.com/miscellany/humor/tax-quotes.htm>, assessed 30 August 2010 >

² Driving Indirect Tax Performance- *Managing the global reform challenge* at <<http://www.kpmg.com>> last accessed 2 February 2011

³ Ibid, pg 4

⁴ Ibid, pg 2

⁵ Ibid, pg 5

⁶ See, OECD Consumption Tax Trends 2008

OECD VAT Trend as percentage of total taxation

	1965	1970	1975	1980	1985	1990	1995	2000	2005	2006
Australia								11.1	13.0	12.6
Austria			19.8	20.1	21.0	20.8	18.6	18.8	18.8	18.4
Belgium		11.1	16.3	17.0	15.8	16.5	15.3	16.2	15.9	16.4
Canada						6.9	8.4	9.3	10.1	9.2
Czech Republic							16.7	18.3	19.2	17.9
Denmark		18.8	17.3	22.3	20.2	18.3	19.3	19.3	19.7	20.8
Finland	18.5	19.0	15.6	17.3	18.3	19.3	17.4	17.4	19.8	19.9
France	20.1	25.5	23.1	20.9	19.7	18.4	17.1	16.5	16.6	16.3
Germany		17.1	14.6	16.6	15.8	16.6	17.4	18.4	18.0	17.6
Greece						24.6	22.0	21.2	21.6	22.7
Hungary							17.8	22.4	22.6	20.4
Iceland						28.4	29.9	28.5	27.3	27.2
Ireland			14.7	14.8	20.6	20.6	21.2	23.1	25.1	24.7
Italy			13.7	15.6	14.5	14.7	13.8	15.4	14.6	14.9
Japan						4.4	5.4	9.1	9.5	9.2
Korea				22.0	21.1	19.7	18.9	17.0	17.5	16.6
Luxembourg		10.6	12.1	10.5	11.1	11.8	12.2	13.3	15.8	15.6
Mexico				15.6	15.9	20.8	16.9	18.7	19.1	20.2
Netherlands		14.6	14.4	15.8	16.2	16.5	15.6	17.4	19.5	18.6
New Zealand						22.4	22.8	24.9	23.8	24.4
Norway		23.8	20.5	18.2	18.2	18.8	21.2	19.7	18.1	18.1
Poland							17.0	22.0	23.4	24.2
Portugal						19.6	22.5	23.4	25.1	24.6
Slovak Republic								20.5	25.0	25.4
Spain						15.7	15.8	17.8	17.6	17.4
Sweden		10.3	12.0	13.4	14.0	14.9	19.4	16.9	18.3	18.5
Switzerland							8.6	13.1	13.4	13.2
Turkey					22.3	18.3	24.3	24.2	21.8	22.2
United Kingdom			8.9	14.7	15.9	16.9	19.0	18.1	18.6	18.1
<i>Unweighted averages</i>										
OECD Europe	19.3	15.9	15.2	16.6	17.3	18.3	18.1	19.2	19.9	19.8
OECD America				15.6	15.9	13.9	12.7	14.0	14.6	14.7
OECD Pacific				22.0	21.1	15.5	15.7	15.5	16.0	15.8
OECD total	19.3	16.7	15.6	17.0	17.5	17.6	17.6	18.3	18.9	18.6

The global importance of VAT was confirmed in the Lucerne Communiqué issued in September 2009 following a meeting of tax policy officials from 25 OECD countries, the European Commission and 5 non-OECD countries, which stated:⁷

“We agree that VAT is likely to maintain its position and could become even more central as the world emerges from recession and countries seek to deal with their public debt imbalances.”

⁷Driving Indirect Tax Performance- *Managing the global reform challenge*, pg 5 at <<http://www.kpmg.com>>) last accessed 2 February 2011

A. How has the global shift to indirect taxes been happening?

According to the KPMG report, the global shift to indirect taxation from direct taxation has been happening over a number of years and in three different ways:⁸

1. New regimes

Firstly, more countries have been introducing VAT systems, either to replace historical sales taxes or as a new addition to their existing tax system.

2. Higher rates

Secondly, unlike corporate tax rates which have been falling globally, standard VAT rates have either remained constant, or as witnessed more recently have been going up.⁹ New Zealand is one such country where the GST rate increased from 12.5% to 15% effective from 1 October 2010.¹⁰

3. Broadening the base

Thirdly, and perhaps less visibly, the taxable base to which VAT has been applied and collected has been expanding. For example, the wholesale tax system that applied prior to GST being introduced in New Zealand only taxed approximately one-third of personal consumption (goods only).¹¹ GST on the other hand is a broad based tax that applies to both goods and services.¹²

B. Why has VAT become the tax of choice for so many governments?

The answer to the above question depends on the country and its experiences. However, Indirect Tax professionals from KPMG have concluded that there have been three main drivers for this tax's growing popularity:¹³

⁸ Ibid

⁹ Ibid

¹⁰ *GST Rate Increases* Budget 2010 Special Tax Report (Policy Advice Division of Inland Revenue, Wellington, 23 December 2010)

¹¹ GST in Retrospect and Prospect , pg 29

¹² Driving Indirect Tax Performance-*Managing the global reform* challenge, pg 11 at <<http://www.kpmg.com>> last accessed 2 February 2011

¹³ Ibid, pg 6

1. Fiscal stability and growth

Indirect taxes provide a more secure tax base for governments because indirect taxes which are charged on the consumption of goods and services, is significantly less mobile and less volatile than corporate profits or labour. While this may have been understood before, it has been truly appreciated in many jurisdictions in recent times due to the impact of the global financial crisis and resulting global recession on domestic tax revenue.¹⁴

In addition, because VAT is imposed on consumption rather than on savings, investments or business inputs, it is likely to have less negative influence on capital formation, investment decisions, and job creation than income-based taxes, thus encouraging fiscal growth.¹⁵

2. Simpler tax administration

Indirect taxes are generally payable as transactions occur, and thus produce a more real-time collection of tax, which is increasingly important for many tax authorities in a more challenging economic environment. There is a further widespread opinion that VAT, particularly a VAT system with limited reduced rates or exemptions, is more cost effective for tax authorities to administer than individual or corporate profits taxes.¹⁶

3. External influences

While governments may introduce VAT for domestic reasons, external influences such as the International Monetary Fund (IMF), the European Union (EU) and the OECD have also played a very strong role. Apart from their role in assisting governments to implement locally effective tax policies, the actions of organizations such as the IMF, EU and OECD are also partly designed to eliminate the economic distortions which can be caused by the lack of a globally, or even regionally, harmonized VAT system.¹⁷

¹⁴ Ibid

¹⁵ Ibid

¹⁶ Ibid

¹⁷ Ibid, pg 7

C. Revenue from GST in New Zealand

GST was first introduced in New Zealand in 1986¹⁸ and the government's reliance in recent years on the tax revenue from GST cannot be understated. The tax revenue from GST is increasing by the year and is set to increase further in the future. The New Zealand Crown Revenue statistics for the 2005/06 fiscal year shows that revenue from GST represented 19% of the total tax revenue for the fiscal year.¹⁹

In comparison, the GST revenue for the 2008/2009 fiscal year represented 21% of the government's total tax revenue for that fiscal year. Table 1 indicates that the revenue from GST stood at \$11.6 billion in the 2008/2009 fiscal year. This ranked as the government's 2nd highest income source from all taxes in the 2008/2009 fiscal year. The table also shows that GST was the only revenue which represented an increase from the previous fiscal year - 2007/2008 (\$0.4 billion).²⁰

Table 1

Crown Tax Revenue - \$ billion			
Tax Type	2008/09	\$ Change Since 2007/2008	% of total
Source Deductions	22.6	-0.8	41%
Other persons tax	2.8	-0.8	5%
Corporate Tax	9.8	-0.7	18%
GST	11.6	+0.4	21%
Other	7.9	-0.2	14%
<i>Total</i>	54.7	-2.1	100%

¹⁸ Alastair Mckenzie: *GST- A Practical Guide*, edition 8

¹⁹ <http://en.wikipedia.org/wiki/Taxation_in_New_Zealand> last accessed 15 November 2010

²⁰ *Monthly Economic Indicators* – New Zealand Treasury report (November, 2009)

The tax revenue from GST is expected to increase further as the GST rate was recently increased from 12.5% to 15%. According to the special report into the 2010 budget by the Policy Advice Division (PAD) of Inland Revenue, the increase in the GST rate was to compensate for the loss in revenue that was expected as a result of the switch in the tax mix from income tax to consumption tax.²¹

The special report by PAD also highlighted that New Zealand relies heavily on income taxes in order to fund expenditure; however, income taxes may be harmful for efficiency and growth. Taxes on consumption, such as GST, tend to be less harmful to growth as, unlike income taxes, they do not apply to savings and, therefore, do not discourage this activity. A switch from income tax towards GST can, therefore, boost incentives to save and encourage economic growth.²²

The company tax rate has been significantly reduced in recent years (33% to 30% effective from 1 April 2008) and was reduced further from 30% to 28% effective 1 April 2011.²³ Given that the government is continually facing pressure from the business sector to match the company tax rates of that in Australia, it is likely that the tax revenue from this source will decrease further if there are reductions made in the future.²⁴

Furthermore, the decrease in the personal tax rates effective from the 1 October 2010 means that reliance by the government on revenue from GST could be even greater moving forward.²⁵

D. Global fears about VAT and GST models

Given the growing importance of VAT to the government revenue bases around the world, periodic evaluation of the VAT system is therefore warranted. Evaluation of the VAT system will assist in keeping pace with the changing environment and ensure competitiveness, revenue-raising efficiency and overall effectiveness. Such evaluation is

²¹ *GST Rate Increases* Budget 2010 Special Tax Report (Policy Advice Division of Inland Revenue, Wellington, 23 December 2010)

²² Ibid

²³ < <http://www.ird.govt.nz/business-income-tax/did-you-know-ctr.html> > last accessed 20 March 2011

²⁴ < <http://www.wecc.org.nz/news-and-info/new-zealand-must-match-australias-business-tax-cut> > last accessed 2 February 2011

²⁵ < <http://www.ird.govt.nz/changes/income-tax/individuals/personal/> > last accessed 16 December 2010

also very important for the protection of the tax base as weaknesses can be identified and measures taken to remedy these weaknesses.²⁶

It is also important to understand what each of these reforms can bring, managing the resulting compliance challenges and capturing any new opportunities that can arise in order to achieve leading indirect tax management in 2011 and beyond. This was again confirmed in the Lucerne Communiqué where the tax policy officials stated:²⁷

“We encourage countries to modernise their VAT systems to keep pace with economic and technological changes. We recognise that their economic efficiency should be improved while recognising the political difficulties attached to any increases in taxes.”

“We encourage all countries to ensure that simplification of VAT without putting the fight against VAT fraud at risk is carried through in the years ahead. In particular, we encourage tax administrations to ensure that they provide business with certainty and clarity in the way that the tax is applied and that the compliance costs can be minimised.”²⁸

Further, in their statement at the summit meeting in L’Aquila on 8 – 10 July 2009 the Leaders of the G8 stated;

“In this difficult time, the protection of our tax base and the efforts to combat tax fraud and tax evasion are all the more important, especially given the extraordinary fiscal measures adopted to stabilise the world economy and the need to ensure that economic activity is conducted in a fair and transparent manner.”²⁹

Evaluation of the tax systems has resulted in some governments and businesses being unhappy with existing VAT systems. Whilst driven by a slow economy on the one hand and falling direct tax rates on the other, all around the world governments are reassessing their long-term tax policies, with the result that many are turning to indirect taxes, particularly VAT and GST, as a key part of their solution. Keeping pace with

²⁶ Driving Indirect Tax Performance- *Managing the global reform challenge* , pg 25

<<http://www.kpmg.com>> last accessed 2 February 2011

²⁷ < <http://www.oecd.org/dataoecd/19/12/43669264.pdf> > last accessed 10 March 2011

²⁸ Ibid

²⁹ Ibid

these changes and actively managing the new, emerging risks and opportunities has become a key objective for all global businesses and governments.³⁰

It has also been recently highlighted that the current VAT model has some fundamental weaknesses that need to be addressed globally. Given that VAT provides a more real time collection of tax, it is open to manipulation and provides a threat to the tax base.

E. Fears about New Zealand's GST model

Since its introduction in 1985, New Zealand's GST model has been internationally praised for its simplicity, its efficiency, and its transparency.³¹ Overall, the GST model in New Zealand works very well. However, over the passage of time, and with the growing complexity of the business environment in New Zealand, some parts of the GST model had been identified as a cause of concern for both taxpayers and the government alike. Consequently, the government released the following discussion documents to address the weaknesses of the GST model that had been identified:

- *Options for strengthening GST neutrality in business-to-business transactions* - June 2008 (DD 1).³²
- *GST: Accounting for land and other high-value assets* – November 2009 (DD 2).³³

DD 1, issued in June 2008, introduced what the government considered were the weaknesses of the GST model. In particular, GST created the unique situation whereby Inland Revenue (IR) regularly refunded GST-registered persons for excess input tax deductions. Another unique feature of the GST system as identified by DD 1 was that it allowed taxpayers to use different GST accounting basis and different taxable periods.

³⁰Driving Indirect Tax Performance- *Managing the global reform challenge*), pg 25 <<http://www.kpmg.com>> last accessed 2 February 2011

³¹ Hansard : Taxation (GST and Remedial Matters) Bill — First Reading (Volume: 665; Page: 13277) at <<http://www.parliament.nz>> last accessed 16 February 2011

³²Inland Revenue “Options for strengthening GST neutrality in business-to- business transactions” Discussion Document (Inland Revenue, Wellington, June 2008)

³³Inland Revenue “GST: Accounting for land and other high-value assets” Discussion Document (Inland Revenue, Wellington, November 2009)

Aggressive arrangements such as those used by *Ch'elle*,³⁴ demonstrated that the government's revenue base was at risk from business structures that were being designed to exploit these aspects of the GST system.³⁵

According to DD 1, the inevitable complexity and pace of litigation in this area suggested that there was a need to address the issues not only at an operational level but in terms of possible amendments to the Goods and Services Tax Act 1985 (GSTA).³⁶ Further, DD I also identified risks associated with "Phoenix fraud" and the emergence of "carousel" or "missing trader" fraud (which had a material effect on the revenue collection for some countries) are of real concern to the government. The government considered that in developing any legislative changes, these risks should also be taken into consideration.³⁷

DD 1 suggested a number of solutions to these concerns including the removal of the "going concern" rules, suspending the liability for GST on certain business-to-business supplies and the introduction of the compulsory DRC for transactions involving the following:

- Going concerns
- Land and
- High value assets with value greater than \$50 million.

These transactions were identified because they were considered to be the ones that posed a cash-flow risk to both GST-registered persons and the government. Submissions were invited on the merits of the options suggested in DD 1 and the government also welcomed submissions on alternative measures that met the objectives of enhancing business neutrality as it affected the application of GST in day-to-day business activities.

DD 2 was issued in November 2009 after drawing upon the analysis of DD1 and the submissions that were made. While the submissions made were in agreement with the

³⁴ *Ch'elle Properties (New Zealand) Limited v Commissioner of Inland Revenue* SC 46/2007 [2007] NZSC 73

³⁵ Inland Revenue "Options for strengthening GST neutrality in business-to-business transactions" Discussion Document (Inland Revenue, Wellington, June 2008), pg 3

³⁶ *Ibid*

³⁷ *Ibid*

government that some of the options mentioned in DD1 may have addressed the tax base risks, they were rejected as being either too broadly targeted or because of their potential negative effect on normal business operations.

According to DD 2, submissions on the officials' paper (DD 1) indicated a level of support for a DRC but there were concerns about the complexity of the rules necessary to support its application. Some submissions also suggested that the zero rating provisions should be considered as an alternative option to the DRC, arguing that zero-rating was more consistent with the current GST framework. DD 2 analysed the merits of the two options (DRC and zero rating provisions) and proposed introducing a DRC which would apply to land, going concerns and transactions with a GST-exclusive value exceeding \$50 million.

However, once submissions in respect of DD 2 were reviewed, it became a lot clearer to the government that most of the stakeholders did not agree with the government's preferred option of the DRC to deal with the business-to-business neutrality concerns and threats to the government revenue base. Instead, there was overwhelming support for the zero rating provision. Consequently, after a further consultation with some selected stakeholders, the government made a decision to extend the existing zero rating provisions to deal with issues in respect of the weaknesses of the GST model. This law came into effect from 1 April 2011.³⁸

The first part of this dissertation will consider the GST model currently used in New Zealand and the weaknesses of this model as identified in the discussion documents. The paper also considers why a change to the legislation is required despite litigation being available to the government as a means of dealing with the weaknesses of the GST model.

The second part discusses the DRC that was proposed including its strengths and weaknesses. Consideration is also given to issues that were identified by stakeholders' in respect of the proposed DRC. The author also considers the DRC model used in the United Kingdom and the DRC proposed for introduction in Australia to assist in understanding why the proposed DRC was rejected in New Zealand.

³⁸ Ibid

The third part of this paper discusses in detail the new zero rating provisions, why it was not the preferred choice of the government, issues identified with the zero rating provisions during the consultation stage and why the government changed its opinion on the zero rating provisions.

The final part of the dissertation applies a classic DRC versus zero rating provision argument. The author will consider whether the proposed DRC would have been a better means of solving the problems of the GST model used in New Zealand or whether the government has made the correct decision in extending the zero rating provision.

V. GST MODEL USED IN NEW ZEALAND

A. History of GST in New Zealand

The 1980's was a decade of worldwide tax reform, with the personal income tax system being revitalised along with greater reliance upon spending as a tax base. New Zealand was at the forefront of this reform, with the broadening of each tax base permitting lower tax rates and greater tax-revenue as well as a tax-mix switch, reducing the reliance upon personal income taxation revenue.³⁹

New Zealand's tax system was highly distorted with the top marginal rate of 66%. Among the objectives of the reform was the government's determination to remove all tax concessions and incentives and close loopholes. Company tax was to be aligned with the new top marginal rate for individuals at 33% in two stages and a new tax on goods and services was proposed.⁴⁰

The wholesales tax system that applied prior to the reforms only taxed approximately one-third of personal consumption (goods only), and applied at 18 different rates. There were also quite a few sales tax exemptions which applied. Many of these exemptions were granted on a one-off basis after lobbying by a particular interest group.⁴¹

The New Zealand tax system was in what can only be described as a mess, created by decades of ad hoc solutions and bad political compromises. It also did not help that New Zealand was faced with a number of serious economic problems. According to the Hon Sir Roger Douglas, there was general acceptance within the cabinet that:⁴²

- A switch from direct to more indirect taxes was necessary.
- Any new tax had to be simple to operate.
- The new tax needed to be broad based so the rate could be as low as possible.

³⁹GST in Retrospect and Prospect , pg 65

⁴⁰ Ibid, pg 29

⁴¹ Ibid

⁴² Ibid, pg 3

GST was the significant step in that direction for New Zealand. After the publication of the Government White Paper on GST, a consultative committee (“The Committee”) was set up.⁴³ The Committee was able to secure for the government the time it needed to sell the change to GST and it also helped create a bond of understanding between business and government. The Committee also read all the submissions that were made by interested parties and made recommendations that influenced the shape of the legislation put before the select committee of Parliament. Most of the recommendations made by the Committee were accepted.⁴⁴

B. The New Zealand GST model – Credit-Invoice Mechanism

When GST was first introduced in New Zealand, there was a determination at the very highest level of policy development to keep the GST system very simple and to avoid the mistakes and complexities of overseas VAT systems.⁴⁵ Those charged with developing the GST system in New Zealand were well aware of the British experience where just months after the introduction of VAT, about 400 pages of Customs and Excise notices were issued to explain how it worked.

GST in New Zealand is modelled on a “credit-invoice” mechanism.⁴⁶ One of the basic design principles of GST in New Zealand is that businesses should not be subject to the tax when producing goods and services. The “credit-invoice” model ensures that the legal incidence of the tax is removed on most business purchases.⁴⁷

The deduction of GST (by way of a refund or credit) prevents the tax from “cascading” as goods and services are supplied between businesses that are registered for GST. The terms “GST-neutral” and “business-to-business neutrality” describe the situation where GST paid by a business can be claimed against the GST payable on taxable supplies. A business is “neutral” about the purchase of goods and services if the GST paid does not become a permanent business cost.⁴⁸

⁴³ Ibid, pg 7

⁴⁴ Ibid

⁴⁵ Ibid, pg 3

⁴⁶ Inland Revenue “Options for strengthening GST neutrality in business-to-business transactions” Discussion Document (Inland Revenue, Wellington, June 2008), pg 1

⁴⁷ Ibid

⁴⁸ Ibid, pg 7

Under the credit-invoice model, a liability for GST arises every time goods and services are supplied by a GST-registered person in the course of a taxable activity. GST is also imposed on goods and services that are imported. Tax is therefore paid throughout the production and distribution chain, but because GST-registered persons are able to deduct GST paid, the tax is ultimately passed on to the final consumer. Therefore, unless the GST paid is connected with the supply of GST exempt goods or services, it does not directly tax the intermediate production of goods and services in New Zealand.

GST systems based on the credit invoice system create compliance costs. However, the government considered this as a trade-off against the benefit that came from the comprehensive application of GST to goods and services that are imported, produced and distributed in New Zealand.⁴⁹

C. Problems with Credit-Invoice Mechanism

According to DD 1, the operation of GST using the credit-invoice model is not without its problems, particularly for transactions involving the supply of significant assets, such as the sale of businesses, land, or other high-value assets.⁵⁰ These can create some major problems for both businesses and the government. The discussions below focus on what some of the problems associated with the operation of the credit-invoice mechanism as identified by DD 1 are.

1. Risks to business

Transactions that are not neutral to businesses can result in GST becoming a fixed burden on production. This can affect business margins, affect business decisions and alter perceptions about voluntary compliance. Non-neutral business-to-business transactions can also have wider economic implications if the tax has the potential to cascade. Some examples of these risks include:⁵¹

The carrying cost of GST

⁴⁹ Ibid , pg 1

⁵⁰ Ibid , pg 11

⁵¹ Ibid

The inability of businesses to immediately claim an input tax deduction in respect of supplies received from other GST registered entities can have relatively serious consequences on its cash flows. This cost is of great relevance to exporters whose supplies are zero rated for GST purposes (GST charged at 0%). These exports do not produce the usual offsetting cash flow benefits that arise by holding GST charged on supplies to customers until payment to IR is required.⁵²

Another cash flow issue arises when businesses registered for GST on an invoice or hybrid basis are required to account for GST to IR when payment for the supply has not yet been received. The GSTA attempts to deal with this cost by allowing taxpayers a variety of accounting basis and filing frequencies. Other rules like those applicable to the supply of “going concerns”, further help in trying to mitigate this carrying cost of GST. However, these measures may not always be enough to deal with these issues.⁵³

Another means for businesses to deal with this issue is to put a request in writing to IR for a GST offset whereby the GST liability incurred by a GST-registered supplier on a transaction is offset against the input tax deduction that would otherwise be available to the GST-registered recipient.⁵⁴

Potential for over taxation

A taxpayer is allowed a deduction of input tax credit when GST has been invoiced or paid, subject to the GST-registered person holding a valid tax invoice. According to DD 1, it is important that these deductions are dealt with promptly, particularly when they give rise to a refund, so that GST does not become a cost of production rather than a tax on consumption.⁵⁵

Input tax deduction can also arise from the purchase of second-hand goods or from change in use adjustments. In these instances, IR may scrutinise the transaction more closely given that these deductions do not arise from the payment of GST to another

⁵² Ibid

⁵³ Ibid

⁵⁴ Section 173M of the Tax Administration Act 1994

⁵⁵ Inland Revenue “Options for strengthening GST neutrality in business-to-business transactions” Discussion Document (Inland Revenue, Wellington, June 2008), pg 12

GST-registered person or to the New Zealand Customs Service and therefore do not immediately give rise to offsetting output tax.⁵⁶

Businesses can also face problems when the legal entitlement to input tax cannot be established but the cost of the purchase has been incurred. For example, when a nominee provides consideration for a supply of goods and services to the vendor, but the contract treats the named purchaser – rather than the nominee – as the recipient, uncertainty can arise over the entitlement to deduct input tax and this can possibly even result in over-taxation.⁵⁷

Supplies of going concerns

DD 1 also recognised that the rules around zero rating are uncertain and this has been well documented by case law. If this uncertainty is identified at the beginning, the parties may, seek an offset of the GST-registered recipient's input tax deduction against the output tax owed by the GST-registered supplier. However, this may not always be possible and if the uncertainty results in an error, it can be costly for businesses once potential penalties and /or interest is applied.⁵⁸

Company grouping rules

The GST grouping rules reduce compliance costs which arise as a result of transactions within a group. This is done by ensuring that intra-group supplies sourced completely from within a group's resources are not subject to GST unless the assets are used for private or exempt purposes. However, to elect into the grouping rules, entities have to meet requirements set out in the GSTA. Some entities cannot satisfy all these requirements and therefore cannot elect into the grouping rules. Consequently, GST risks may still exist for businesses when entering into group transactions.⁵⁹

⁵⁶ Ibid

⁵⁷ Ibid

⁵⁸ Ibid, pg 13

⁵⁹ Ibid

2. Revenue risks for the Government

GST presents a major risk to the government's tax base. This comes about because of the manner in which GST operates. The operation of GST requires the issue of refunds from input tax deductions that may not be offset by the payment of GST in some circumstances where that would be the expected outcome. This can occur for legitimate reasons and is a cost that the government is well aware of, for example in the case of liquidations that can be faced by any business.⁶⁰

However, there are situations when this offset does not occur due to deliberate actions taken by certain taxpayers – for example, if timing mismatches created by the choice of accounting basis and filing frequencies is exploited or if “phoenix” entities are used to create tax advantages.

D. Threats to business-to-business neutrality

The government is well aware of threats posed by the credit-invoice mechanism to the tax base. DD 1 identified the following threats as of the biggest concern to business-to-business neutrality and consequently a threat to the government revenue base.⁶¹

1. Phoenix entities

The phoenix is a legendary bird which is reputed to have died by fire and to have subsequently been re-born from its own ashes.⁶² The modern dictionary also recognises the term as meaning the following:

“tendency for a bankrupt business to start up again under a new identity”.

However, this statement fails to distinguish between the honest and responsible business failure which may result in a new or reconstituted business being established and the unscrupulous business practices which achieve the same result.⁶³

⁶⁰ Ibid

⁶¹ Ibid, pg 22

⁶² The Regulation of Phoenix Companies – (Report of The International Association of Insolvency Regulators, 29 October 2004) at <<http://www.insolvencyreg.org>> last accessed 19 October 2010

One of the main tax base risks identified in DD 1 was the use of “phoenix” type entities in fraud schemes. The use of “phoenix” entities can be problematic for the operation of GST because the purchase of assets from the failed entity by the “re-born” entity can give rise to an input tax entitlement without the corresponding payment of GST. When situations like this arise, it becomes a cost to the government.⁶⁴

The government recognises that situations like this can happen as a result of a genuine business failure. It considers such situations to be a trade-off for the wider benefits that come from the comprehensive application of GST. However, when entities become insolvent as a result of the deliberate actions of its owners and/or the entity’s assets are transferred to an associated entity, the result can defeat the objective of providing business neutrality.⁶⁵

The government has recently responded to some of the general problems created by phoenix entities by changing the laws governing the appointment of liquidators and introducing a framework of “voluntary administration” to assist creditors of financially troubled companies. However, these measures were not considered to be sufficient enough to deal with the government’s concern regarding the existing GST system and the opportunity it provides for these phoenix type entities.⁶⁶

Below is an illustration from DD 1 as to how these phoenix type entities operate.⁶⁷

⁶³ Ibid

⁶⁴ Inland Revenue “Options for strengthening GST neutrality in business-to-business transactions” Discussion Document (Inland Revenue, Wellington, June 2008), pg 22

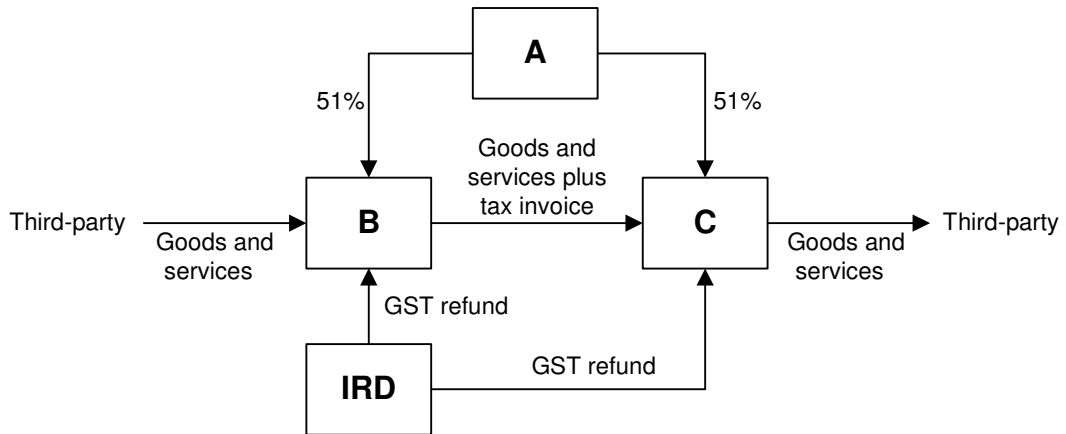
⁶⁵ Ibid

⁶⁶ Ibid

⁶⁷ Ibid

Figure 1:

Illustration of a possible “phoenix” arrangement



Notes:

- Company B claims an input tax deduction in the usual manner in connection with its purchases from third parties and supplies goods and services to Company C.
- Company C does not immediately pay Company B – who accounts for GST using the payments basis. Company C claims an input tax deduction on the basis of the tax invoice provided by Company B.
- Person A decides to wind up Company B leaving an unpaid tax debt.
- The transaction between companies B and C therefore creates an input tax deduction which is not met by a corresponding payment of GST from Company B.

The above illustration clearly shows the risk of loss of revenue faced by IR (and consequently the government). There is also no guarantee that Company C will return output tax on its supply to the third party given the history of its associates. Money could easily be transferred out of the company and the company is then liquidated, and once again the government suffers a loss of revenue.

2. Carousel fraud

DD 1 also highlighted that internationally, there have been high-profile instances where government revenues have been affected by fraud and aggressive structures designed to exploit the refunds that can arise from input tax deductions. These arrangements, commonly referred to as “carousel fraud”, are deliberately designed not to be neutral.⁶⁸

As reported in the European Union, carousel fraud works like this:

- An entity (entity A) based in, say Germany, supplies goods to entity B, which is based in the United Kingdom. Entity A zero-rates the supply as it is an export.
- As the supply is an intra-community transaction between European Union businesses, entity B is required to self-assess VAT using the relevant rate of VAT for that member state. Entity B would generally recognise an input tax deduction for self-assessed VAT in the same return period.
- Entity B on-sells the goods to entity C, which is based in the United Kingdom. Entity B charges VAT on the transaction and ceases operation as soon as the goods are sold. Entity B retains the VAT charged and does not file a return.
- Entity C claims a deduction for the VAT charged by entity B and exports the goods to entity A. The supply is zero-rated.
- These steps are then repeated.

According to the DD 1, it is difficult to see this happening in New Zealand; however, it is still technically possible for carousel fraud to occur. While this has not been a significant concern for the government to date, the possibility that it could occur had been taken into account in addressing the GST issues.⁶⁹

⁶⁸ Ibid

⁶⁹ Ibid , pg 24

3. Timing mismatches

The GSTA provides taxpayers with a choice of accounting basis and taxable periods. The accounting bases available in the GSTA determine how output tax and input tax should be attributed to a particular taxable period. Although the time of supply rules determine when GST-registered persons are required to recognise a liability for GST, the accounting basis adopted can alter the taxable period in which that liability needs to be disclosed to IR.⁷⁰

The three basis of accounting for GST allowed by the GSTA are:

- **The Invoice Basis:** The standard basis of accounting for GST is the invoice basis. Output tax is accounted for at the time of supply. Input tax deductions may be claimed on the basis of payment or invoice – subject to the deduction being supported by a valid tax invoice.⁷¹
- **The Payments Basis:** GST-registered persons may use the payments basis if they have annual taxable supplies of less than \$2 million or are a non-profit body. Output tax is accounted for to the extent that payment is received. Input tax deductions can be claimed to the extent to which payment has been made – subject to the deduction being supported by a valid tax invoice. IR has discretion to allow GST-registered persons who have a turnover of greater than \$2 million to account for GST using this basis after taking into account the nature, volume and value of the supplies made.⁷²
- **The Hybrid Basis:** GST-registered persons may choose to use the hybrid basis if they do not qualify to account for GST using the payments basis and do not want to use the invoice basis. No turnover limitations are imposed on who may account for GST using the hybrid basis. Output tax is accounted for in a similar

⁷⁰ Ibid , pg 29

⁷¹ Ibid , pg 30

⁷² Ibid , pg 31

manner as under the invoice basis. Input tax deductions are claimed in a manner similar to the payments basis.⁷³

DD 1 also addressed the consequences of these choices that are provided by the GSTA. As a result of these choices, there have been consequences to the revenue base, which have been well documented by the New Zealand courts, tax practitioners and the government.⁷⁴

“Timing mismatches” involve a GST-registered person who accounts for GST using the payments basis making a supply to a GST-registered person who accounts for GST using the invoice basis. The payment basis supplier provides the invoice basis purchaser with a tax invoice. The purchaser claims an input tax deduction following receipt of the tax invoice, but payment of GST is deferred. In some cases, payment may be deliberately deferred for a significant period of time or even indefinitely.⁷⁵

These timing mismatches provide opportunities for taxpayers to manipulate the GSTA to obtain GST refunds which in many situations they are not entitled to. Such arrangements are clearly inconsistent with the policy intent of the GSTA.

E. The General Anti-Avoidance Provisions

The general anti-avoidance provisions in the GSTA deem transactions to be void that have been entered into by taxpayers that exploit “timing mismatches” and the use of “phoenix entities” to create GST input tax entitlements.⁷⁶

Section 76 of the GSTA states that a tax avoidance arrangement entered into by a person is void against the Commissioner for tax purposes.⁷⁷ A tax avoidance arrangement is one that directly or indirectly has tax avoidance as its purpose or effect; or has tax avoidance as one of its purposes or effects, whether or not another purpose or

⁷³ Ibid

⁷⁴ Ibid, pg 29

⁷⁵ Ibid, pg 29

⁷⁶ See section 76 of Goods and Services Tax Act 1985

⁷⁷ Ibid

effect relates to ordinary business or family dealings, if purpose or effect is not merely incidental.⁷⁸

This raises the question as to why further legislation is required when the general anti-avoidance provision is available to the Commissioner of Inland Revenue (CIR) to deem such transactions void. The CIR has in recent years had major success in invoking section 76 of the GSTA (anti avoidance provisions) and this position has been confirmed by the Court as interpreters of legislation.

Two leading cases in the use of the anti-avoidance provisions in GST are discussed below to assist in understanding the lengths some taxpayers go to create a tax advantage and also answering the question posed above.

1. Ch'elle Properties

The risk associated with timing mismatches was highlighted by the series of cases involving *Ch'elle Properties (New Zealand) Limited v Commissioner of Inland Revenue*.⁷⁹ These cases concerned an arrangement that was designed to produce a refundable input tax deduction of \$9 million to the purchasing company (*Ch'elle*) but defer the liability to account for GST by the 114 separate companies supplying the land in question to *Ch'elle*.⁸⁰

The taxpayer had claimed GST input tax credits on a total of 117 property transactions. Payment to the vendor was by way of a small deposit with the remainder payable on settlement. The difference in registration types (payment and invoice) between the parties saw the taxpayer claiming an input credit on the entire purchase price whilst the vendor only paid output tax on the deposit paid. The Commissioner considered the arrangement was entered into for the tax advantages it could obtain and alleged tax avoidance under section 76 of the GSTA. The Taxation Review Authority (TRA), High Court (HC) and Court of Appeal (CA) all agreed with the Commissioner.⁸¹

⁷⁸ Ibid

⁷⁹ *Ch'elle Properties (New Zealand) Limited v Commissioner of Inland Revenue* [2007] NZSC 73 SC 46/2007

⁸⁰ Inland Revenue "Options for strengthening GST neutrality in business-to-business transactions" Discussion Document (Inland Revenue, Wellington, June 2008), pg 14

⁸¹ Ibid

Facts

In brief, the arrangement involved 114 shell companies formed by the promoter of the scheme, Mr Ashby, agreeing to buy 114 lots in a subdivision for \$70,000 each payable on 31 August 1999 and then reselling them to another shell company, *Ch'elle*, formed by an associate of Mr Ashby. The price payable by *Ch'elle* for each lot was about \$700,000. A deposit of \$30,000 was payable at a time when a GST tax refund was expected to have been received. The balance of the price was deferred for between 10 and 20 years, by which time each property was to be developed.⁸²

The use of 114 companies enabled the value of the taxable supplies by each company to be kept at less than \$1 million in the year in question and so each company could choose to account for GST upon receipt of payments. On the other hand, *Ch'elle* was to account on the usual invoice basis and could claim an immediate tax credit which plainly was to be the source of funding the amounts payable to the subdivider. The balance between inputs and outputs was by this means to be artificially distorted to the advantage of the promoter of the arrangement.⁸³

The TRA, HC and CA all considered the scheme constituted tax avoidance pursuant to section 76 of the GST Act. The HC and CA considered the test of avoidance under that section was an objective one and that while timing mismatches were provided for in the GSTA, these transactions exploited that provision and defeated the intent and purpose of the GSTA.⁸⁴

Supreme Court Decision

Ch'elle appealed the earlier verdicts of the Courts to the Supreme Court. The Supreme Court considered it unnecessary to express any view on the merits of *Ch'elle's* arguments that.⁸⁵

- The CA erred in finding it was unnecessary for the Commissioner to show an intention to defeat the intent and application of the Act and

⁸² *Ch'elle Properties (New Zealand) Limited v Commissioner of Inland Revenue* [2007] NZSC 73 SC 46/2007 at [2]

⁸³ *Ibid*, at [3]

⁸⁴ *Ibid*, at [1]

⁸⁵ *Ibid*, at [4]

- That an arrangement can defeat the intent and application of the act only if there is a tension between the commercial and juristic nature of the transactions, on the basis the TRA had made factual findings that *Ch'elle* did have an intention to defeat the intent and application of the Act.

The Supreme Court also considered *Ch'elle's* third ground of appeal that it did not gain a "tax advantage" equally as hopeless. The definition of that term included "any increase in the entitlement of any registered person to a refund of tax". *Ch'elle* clearly came within this definition.⁸⁶

2. *Glenharrow Holdings*

This case is considered to be the leading authority in tax avoidance for GST because the principles applied in the decision of *Ben Nevis*⁸⁷ were considered here. *Ben Nevis* is considered to be a leading authority in tax avoidance as this is the first case in which the Supreme Court had discussed the relationship between the general anti-avoidance rule and specific sections in the tax legislation.⁸⁸

The court concluded in *Ben Nevis* that Parliament's overall purpose is best served by giving appropriate effect to each and that neither should be regarded as overriding the other. The case considered whether, notwithstanding taxpayer compliance with specific provisions of the Act, the Commissioner may set a particular arrangement aside and reconstruct it because the arrangement constituted tax avoidance.

While the *Glenharrow* case did not specifically deal with the use of phoenix type entities or timing mismatches, it nevertheless shows the extent to which some taxpayers go to create a GST tax advantage.⁸⁹

⁸⁶ Ibid, at [5]

⁸⁷ *Ben Nevis Forestry Ventures Limited & Ors v CIR* [2009] 2 NZLR 289 (SC)

⁸⁸ < <http://www.ird.govt.nz/technical-tax/case-notes/2008/cn-20081219-supreme-court-trinity.html> > last accessed 11 December 2010

⁸⁹ < <http://www.ird.govt.nz/technical-tax/case-notes/2008/cn-20081219-section-76-general-anti-avoidance-provision.html> > last accessed 15 December 2010

Facts

In 1997 *Glenharrow Holdings Ltd* purchased a mining licence (which constitutes second-hand goods for the purposes of the Act) from Mr Michael Meates for \$45m. The licence then had some three years of its term to run and authorised the holder to mine for serpentinite and bowenite within a defined area on Mt Griffin in Westland. *Glenharrow*, which had a share capital of \$100, paid a deposit of \$80,000 which it had obtained from its shareholder, Mr Fahey. Then, when the licence was transferred to it, it gave Mr Meates a cheque for the rest of the price (\$44,920,000) drawn on its solicitor's trust account.⁹⁰

Mr Meates gave *Glenharrow* a cheque for the same amount drawn on his solicitor's trust account as an advance by way of loan and *Glenharrow* delivered to Mr Meates a mortgage over the mining licence, a general mortgage debenture over all its assets and a mortgage over its shares executed by Mr Fahey but, it was agreed, without personal liability. (It is common ground that the supplies made by way of the cheques were financial services which are tax exempt for GST purposes.) The loan was repayable without interest by three annual instalments.⁹¹

Glenharrow claimed from the Commissioner an input tax "refund" of the tax fraction (one-ninth) of \$44,920,000. (It was already been paid a refund in respect of the deposit.) The Commissioner resisted *Glenharrow's* claim, alleging in the first place that the arrangements between Mr Meates and *Glenharrow* were a sham. That defence failed in the High Court and had not been further pursued. But the Commissioner also argued that the arrangement constituted tax avoidance and had treated it as void under s 76 of the Act (as that section stood in 1997). The resulting reconstruction was largely upheld by the High Court, and almost completely by the Court of Appeal.⁹²

Before the licence expired *Glenharrow* was able to extract a limited quantity of stone and made further payments to Mr Meates totalling \$210,000. The Court of Appeal had held, and the Commissioner accepted, that *Glenharrow* was entitled to tax credits for these payments.⁹³

⁹⁰ *Glenharrow Holdings v CIR [2008] NZSC 116 SC 59/2007* at para [2]

⁹¹ *Ibid*

⁹² *Ibid*, at [3]

⁹³ *Ibid*, at [4]

High Court Decision

Chisholm J found that the transaction was not a sham and that the principal purpose for the purchase of the licence was for the making of taxable supplies. Notwithstanding that, Chisholm J held that section 76 did not require proof of a subjective intention and was directed at the effect or purpose of the arrangement. He noted that the definition of "tax advantage" in section 76 (4) of the GSTA included an increase in the entitlement of any registered person to a refund of tax.⁹⁴

Chisholm J then concluded that if the consideration for the licence was grossly inflated the input tax would also be grossly inflated. He found that the appropriate value for the mining licence was \$9.757 million. The Commissioner was ordered to credit *Glenharrow* with a GST input deduction for the GST on the \$9.757 million.⁹⁵

Court of Appeal Decision

Both parties appealed the High Court decision; however the Commissioner did not pursue the argument that the arrangement had been a sham.⁹⁶ *Glenharrow* appealed against the High Court finding of avoidance. The appellant claimed there could not be any tax advantage in terms of section 76 of the GSTA as the High Court found they had acquired the licence having paid \$45 million for the principal purpose of making taxable supplies.

The Commissioner cross-appealed against the valuation of the tax advantage allowed by the High Court. He argued that the concept of payment had been met in purely juristic terms, there was no definitive commitment to pay and that the economic burden intended by Parliament had not been suffered by *Glenharrow*.

The majority of the Court of Appeal found Chisholm J was not wrong to find tax avoidance on the basis of a grossly inflated value. The majority were satisfied that there had been a significant temporal mismatch and that the line had been crossed into tax avoidance. The tax advantage for *Glenharrow* was seen as an increased entitlement to a refund received without suffering the economic burden intended by the Act.⁹⁷

⁹⁴ Ibid, at [22]

⁹⁵ Ibid, at [25]

⁹⁶ Ibid, at [26]

⁹⁷ Ibid

Supreme Court Decision

The appeal from *Glenharrow* was dismissed. The Court accepted that before looking at the provisions of section 76 of GSTA, the position in relation to the sale of the licence was that the licence was a second-hand good. The deed of sale provided for a consideration of \$45 million in money and the open market value provisions of the GSTA did not apply to the agreement which was considered to be at "arms length".⁹⁸ They then considered the operation of section 76 of GSTA.⁹⁹

The Court confirmed that section 76 of the GSTA assumed that the arrangement under scrutiny was not a sham. The section 76 determination requires an assessment that goes beyond the technical legality of the constituent parts of the arrangement. The onus is on the taxpayer under section 149A(2)(b) of the Tax Administration Act (TAA) to show that the Commissioner could not have been properly satisfied that section 76 of GSTA applied in the circumstances.¹⁰⁰

There is a two-stage process before the Commissioner can carry out a section 76 reconstruction. Firstly there must be an arrangement entered into between at least two persons. Secondly the Commissioner must be properly satisfied that the arrangement was entered into between the two parties to defeat the intention or application of the Act or any provision of the Act. This does not mean that the Commissioner must be satisfied that the parties subjectively had that defeating purpose. A natural reading of section 76 of the GSTA, as it stood prior to 2000, was to require the Commissioner to be satisfied that an arrangement had been entered into so as to defeat the intent and application of the Act.¹⁰¹

The Commissioner was required to ask what the purpose of the arrangement was. This question in turn required examination of the effect of the arrangement. The Court followed the findings in *Newton v Commissioner of Taxation of the Commonwealth of Australia [1958] AC 450* in relation to the term "purpose or effect" where Lord Denning found that the word purpose did not mean "motive" but rather "the effect which was sought to achieve". The crucial distinction is that general anti avoidance rules are not

⁹⁸ Ibid, at [31]

⁹⁹ Ibid, at [33-39]

¹⁰⁰ Ibid, at [33]

¹⁰¹ Ibid, at [35]

aimed at the purpose of the parties but at the purpose of the arrangement. The Court also followed the findings of the Privy Council in *Ashton v Commissioner of Inland Revenue*, [1975] 2NZLR 717, where Viscount Dilhorne confirmed that, "if an arrangement has a particular purpose, then that will be its intended effect".¹⁰²

The Court found that any assessment would principally be a matter of inference from the arrangement and its effect. The intention of the Act would be defeated if an arrangement had been structured to enable the avoidance of output tax, or the obtaining of an input deduction in circumstances where that consequence was outside the purpose and contemplation of the relevant statutory provisions.

The Court examined the history behind the GSTA and the need for avoidance legislation. It determined that GST was a type of "value added tax" intended to be broad based, efficient and neutral. The Court concluded that registered persons producing taxable supplies effectively operated as tax collectors on behalf of the Government and as such were not themselves subject of the GST's economic incidence. By the same token it was recognised that registered persons should not obtain unacceptable windfall gains from the regime. They found that reading the Act as a whole it was clear that the legislature anticipated that for a trader in goods and services there would over time usually be some balancing out or netting off of the GST components of sales and purchases.¹⁰³

The Court recognised that there was potential for registered taxpayers to create distortions at the boundary between themselves and unregistered persons. It said that the same could occur where transactions were between those registered on a payments basis and those registered on an invoice basis. The Court confirmed that the general anti-avoidance provision was available to stop or counteract both these distortions.¹⁰⁴

The Court concluded that it did not need to form a view on whether or not the price paid for the licence was the market value. However, it did rule that even though there was stone to be extracted while the licence was running the arrangement still had a very artificial element. The Court noted that an objective observer could have said that *Glenharrow* would never have been able to mine enough stone during the term of the

¹⁰² Ibid, at [37]

¹⁰³ Ibid, at [40-49]

¹⁰⁴ Ibid

licence to generate sufficient sales to pay for the licence. There was no issue that *Glenharrow* undertook liability for the \$44.920 million funded by vendor finance. However *Glenharrow* was a shell company with a share capital of just \$100. Michael Meates was unregistered and there was no GST impost on the other side of the transaction.¹⁰⁵

The Court found that the effect of the structure was to produce a GST refund totally disproportionate to the economic burden undertaken by *Glenharrow*. They concluded that the end in view was a distortion which very plainly defeated the intent and application of the Act.¹⁰⁶

Impact of decision

This decision confirms that where transactions are not a "sham", the Commissioner is still entitled to consider the tax consequences of the transactions under section 76 of the GSTA. The court has confirmed that section 76 is a general anti-avoidance provision and therefore every avoidance issue will need to be assessed objectively on its merits on a case-by-case basis.¹⁰⁷

F. Is the use of the general anti-avoidance provisions adequate to deal with the weaknesses of the GST model?

The cases discussed above demonstrate the success the CIR has had in recent years in the fight against the use of "phoenix" type structures and the use of timing mismatches. It also confirms that the CIR has a very powerful tool to combat such fraudulent activities, the general anti-avoidance provisions. These cases also demonstrate the lengths certain taxpayers go to in order to exploit the GSTA. It is therefore heartening for those taxpayers that are compliant to know that those that trying to obtain an unfair tax advantage is being dealt with appropriately by the CIR.

¹⁰⁵ Ibid, at [50-54]

¹⁰⁶ Ibid, at [55]

¹⁰⁷ < <http://www.ird.govt.nz/technical-tax/case-notes/2008/cn-20081219-section-76-general-anti-avoidance-provision.html> > last accessed 15 December 2010

However, questions remain, about the long term desirability of using the general anti-provision for this purpose and whether policy changes that would have more certain application are required to deal with timing mismatches and phoenix type entities.¹⁰⁸

Several tax commentators have noted that the outcomes created by general anti-avoidance provisions have the potential to create uncertainty, i.e. there is a feeling among tax practitioners that even the Courts as interpreters of the legislation can get it wrong. This creates uncertainty and this in their view is unhelpful in promoting voluntary compliance.¹⁰⁹

The use of the general anti-avoidance provisions can also be costly and time consuming, both for the taxpayers and the CIR. While the CIR has had some success in invoking section 76 of the GST Act, this does not necessarily guarantee the same success in the future. The Court's will not always agree with the CIR's interpretation of whether a transaction is a tax avoidance arrangement under section 76 of the GSTA.

The recent decision of *Thompson v Commissioner of Inland Revenue*¹¹⁰ highlights this point. The Courts were not impressed by the CIR's use of the anti-avoidance provisions. In the disputes documents, the CIR had raised as an alternative argument that the steps and transactions that Mr Thompson took amounted to an arrangement that infringed section 76 of the GSTA. The Court went out of their way to say:¹¹¹

"we record that we were not impressed by the Commissioner's argument on this topic, which was clearly no more than a backup argument to the (successful) arguments, based on the black letter requirements of the relevant legislation."

This indicates that despite explicit steps being taken to gain a tax advantage, the Court was unimpressed with the suggestion that those steps should be stigmatised as constituting tax avoidance. While there was nothing artificial or contrived about the transactions, there was an explicit pursuit of tax advantages.¹¹²

¹⁰⁸ Inland Revenue "GST: Accounting for land and other high-value assets" Discussion Document (Inland Revenue, Wellington, November 2009), pg 6

¹⁰⁹ Joanne Dunne "Recent anti-avoidance cases in New Zealand", pg 4 *Taxation in Australia Volume 44 number 11*. June 2010 at < <http://www.minterellison.com> > last accessed 17 January 2011

¹¹⁰ *Thompson v Commissioner of Inland Revenue* [2011] NZCA 132

¹¹¹ *Ibid*, at [66]

¹¹² James Coleman "GST Deregistration- Planning Essential" *Taxation Today*, Vol. 39, April 2011, 29-31 at < <http://library.nzica.com> > last accessed 15 May 2011

It would seem therefore that it is artifice and contrivance that remain the key determinant of avoidance, not explicit pursuit of tax benefits. In the author's view, the line between what is considered to be a tax benefit and a tax avoidance arrangement is very narrow and the Court's as interpreters of legislation will not always agree with the CIR's interpretation.¹¹³

Another issue with the use of the anti avoidance provisions in the author's view is that it can only be applied if IR becomes aware of such transaction. Unless the transaction comes under the scrutiny of IR, it is unlikely that the existence of a tax avoidance arrangement will be uncovered. With the limited resources available to IR, it would be reasonable to assume that certain arrangements may never be scrutinised by IR.

For these reasons, legislative intervention is often needed when government is faced with risks that threaten the tax base. Consequently, the government considered that in this instance, a change in legislation was required to deal with the risks associated with the increase in the use of "phoenix" type entities and the exploitation of timing mismatches.

The following chapter focuses on what the government initially considered as its preferred option of dealing with the business-to-business neutrality concerns and the risk to the revenue base, the DRC.

¹¹³ Ibid

VI. DOMESTIC REVERSE CHARGE

As discussed earlier, the use of the credit-invoice mechanism in GST provides serious challenges and the government had been concerned that business-to-business neutrality was not always occurring as it should, especially with transactions involving land and high-value assets.

To deal with such concerns, the use of the general anti-avoidance provision and prosecution action has been available to IR. However, these were considered an expensive exercise for all parties concerned and as discussed previously, the outcomes were not necessarily consistent with good policy. The government considered that legislation was the best way to deal with such issues.¹¹⁴

The government considered the DRC to be the best option at the time DD 1 and DD 2 were issued to deal with the business-to-business neutrality concerns and the risk to the tax revenue base.

A. Overview of DRC

According to DD 2, the proposed DRC was designed to work by:¹¹⁵

- Shifting the obligation to charge GST from the GST-registered supplier to the GST-registered recipient.
- The DRC required the recipient of the goods and services, who had to be registered for GST at the time of supply, to self-assess GST on the purchase and deduct, if entitled to do so, input tax in the same taxable period (if the goods and services were acquired for the purpose of making taxable supplies).
- The DRC would apply irrespective of whether either GST-registered person made predominantly exempt supplies. If the goods were acquired for mixed use (taxable and non-taxable), then the change-in-use adjustment rules or the apportionment rules would need to be applied.

¹¹⁴ Inland Revenue “GST: Accounting for land and other high-value assets” Discussion Document (Inland Revenue, Wellington, November 2009), pg 6

¹¹⁵ Ibid, pg 7

- Supplies to unregistered persons would have continued to be subject to normal GST rules (subject to GST at the standard rate).
- To ensure that the supplier would still be entitled to input tax deductions, all supplies made by the supplier would be treated as “taxable supplies” of goods and services. Transactions to which the proposed DRC applied would have been expressed as “exclusive of GST”.
- The agreement for sale and purchase (S&P) was to be the main document to support suppliers’ and recipients’ obligations under the DRC. It was expected that some of the details that the S&P would need to contain included the core details about the supplier and the recipient, their respective GST registration numbers, their respective names and addresses, and details about the transaction, including its value (excluding GST).
- In the event that the recipient did not account for GST, IR would not have any powers to force the supplier to account for the GST owing on the transaction. However, if the supplier had not complied with and retained the prescribed information as outlined above, then the supplier could be held accountable for the GST owed to the IR.¹¹⁶

The diagram below shows how the current GST model works (in the absence of the proposed of the DRC).¹¹⁷ The vendor would supply land to the purchaser which would include GST. The vendor would in normal circumstances be required to return GST to the IR. The purchaser on the other hand would be entitled to an input tax credit and therefore a refund from the IR.

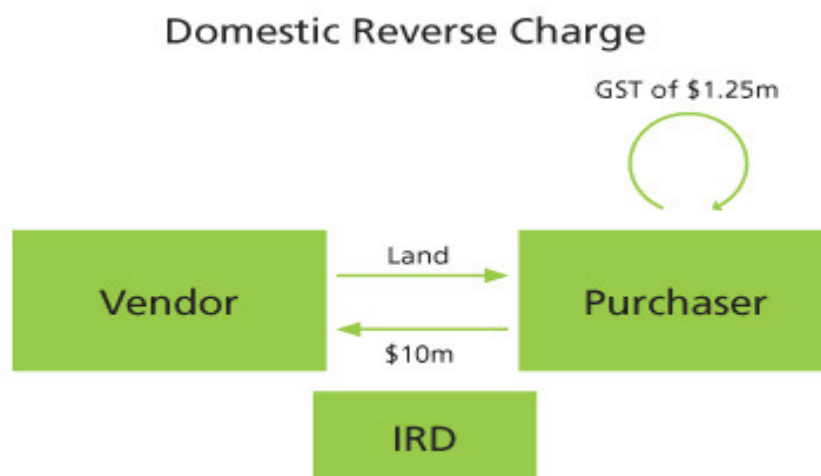
¹¹⁶ Ibid

¹¹⁷ Jeanne Du Buisson and Allan Bullock “Major changes on the horizon” *Tax Alert – November/December 2009* at < <http://www.deloitte.com> > last accessed 18 August 2010



The diagram above clearly illustrates the risk faced by IR in the event the vendor was unable to meet its obligation. IR would be out of pocket in the vicinity of \$1.25 million as the inability of the vendor to meet its tax obligation would have no impact on the purchaser's ability to claim an input tax deduction for the same amount. Consequently, this results in a loss of revenue to the government.

The diagram that follows below demonstrates how the proposed DRC was designed to work.¹¹⁸ It was expected that the proposed DRC would remove the risk faced by IR and consequently the government as there was no longer an obligation for IR to refund any GST in respect of the supply.¹¹⁹ The obligation is shifted to the recipient of the supply, being the purchaser who would, in the taxable period the supply took place; self-assess for output tax and then also claim a deduction for input tax.



¹¹⁸ Ibid

¹¹⁹ Ibid

B. Objective of DRC

The main objectives of the proposed DRC according to DD 2 released in November 2009 were:¹²⁰

- To remove the cash flow concerns for the parties to an affected transaction for the period between which the tax was paid and the input tax deduction was allowed. (This is because the recipient would be able to offset the GST payable and the input tax deduction in the same taxable period as shown in the diagram above).
- Reduce the risk that the supplier faced an unexpected GST liability in the event that a transaction was incorrectly zero-rated, as could occur if a registered person sold a zero-rated going concern to an unregistered person that they believed was registered.
- Limit the involvement of the supplier if the contract was varied, cancelled or otherwise did not proceed.
- Reduce the revenue risk to the government arising from a genuine or structured business failure. The recipient, having acquired the goods and services in all likelihood for an ongoing taxable activity, would be less likely than the supplier to exit the GST system.¹²¹

C. Advantage of the DRC

DD 2 listed the following as the advantages of the proposed DRC:¹²²

- GST neutrality could be achieved in a manner consistent with the credit-invoice method.

¹²⁰Inland Revenue “GST: Accounting for land and other high-value assets” Discussion Document (Inland Revenue, Wellington, November 2009) , pg 6

¹²¹ Ibid

¹²² Ibid

- It was thought that businesses would benefit from a more certain rule and the carrying cost of GST would be reduced.
- It was also considered that the risk to the IR that GST would not be paid after refunding an input tax deduction on a transaction to taxpayers would also be reduced.

D. Scope of the DRC

DD 2 also identified that the DRC would apply to the following group of transactions in the following way:¹²³

- **Land:** The DRC would have applied to all transactions involving the supply of land, including a freehold interest or an option to acquire land. It was also proposed that, in circumstances when a bundle of goods and services was supplied and land and building was the predominant feature of the supply, the DRC would apply to the entire contract.
- **Going concerns:** It was also expected that the DRC would have applied to the supply of a taxable activity or part thereof that is a “going concern”. Consideration was also given to repealing the zero-rating rules applicable to the supply of going concerns. While the question of what constitutes a “going concern” would remain open to interpretation in some cases, the requirement that the taxable activity must be carried on until the time of transfer to the recipient, and the inherent difficulties that this sometimes causes, would have been removed.
- **Other high-value assets:** the DRC would also have applied to supplies of goods and services with a value of \$50 million or more, excluding GST. This limits the extension of the DRC in other cases to infrequently occurring transactions that could, if the GST treatment is not neutral, create significant tax risks for businesses and a revenue loss to the government.¹²⁴

¹²³ Ibid, pg 7

¹²⁴ Ibid, pg 8

E. Other features of the DRC

Some of the other features of the DRC as identified by DD 2 were:

1. Time of supply rules

Section 9 of the GSTA states that the time of supply is triggered at the earlier of the issue of an invoice or when payment is received for the supply of goods and services.¹²⁵

As mentioned in earlier discussions, the time of supply rules determine when GST-registered persons are required to recognise a liability for GST

DD 2 recognised that the time of supply rules could create some problems for the recipient (the purchaser), for example, the supplier might create an obligation to return GST without the recipient's knowledge. If this resulted in GST not being returned in the correct taxable period, the recipient could be subject to shortfall penalties and use-of-money interest.¹²⁶

Therefore, to prevent such issues from arising, it was also proposed that, when the DRC applied, the time of supply would be the date when payment for the supply was required to be made to the supplier. The time of supply would be triggered when the supplier required full payment to settle the contract, not payment by a deposit.

It was also considered that the definition of "payment" would not be limited to the transfer of cash and would also include other situations when contractual obligations were discharged, such as with a vendor mortgage.¹²⁷

2. DRC contract with more than one recipient

DD 2 also considered which party the DRC would apply to when nominee transactions and other transactions involving more than two parties occurred.¹²⁸ It was proposed that, for the purpose of the DRC, the liability for GST would be on the party named in the contract as being the recipient of the goods or services. If the contract provided for

¹²⁵ See Section 8 of Good and Services Tax Act 1985

¹²⁶ Inland Revenue "GST: Accounting for land and other high-value assets" Discussion Document (Inland Revenue, Wellington, November 2009), pg 8

¹²⁷ Ibid

¹²⁸ Ibid, pg 9

two or more recipients, the DRC obligation would fall on the recipient that physically received the goods and services or had ownership or entitlement to them.¹²⁹

3. Recipient – Deemed to be registered

It was also proposed that the GST registration rules would be amended to treat any recipient that purports to be registered for GST as registered on the day the supply is treated as made under the DRC. While the recipient would still have an obligation to self-assess and return GST, no input tax deduction would have been allowed unless they were able to establish a taxable activity and that the purchase was used for making taxable supplies.

It was also proposed that recipients that did not return the GST would also have been subject to use-of-money interest and shortfall penalties in these circumstances. It was also proposed that additional anti-avoidance provisions might have been required.¹³⁰

4. Post-sale adjustments

It was also proposed in DD 2 that subsequent changes to a supply that was subject to the DRC would not have altered its operation. In all cases when there was an adjustment to the price of the goods and services supplied, the supplier would remain responsible for issuing a debit or credit note. The recipient would be required to reflect the GST consequences of the change in the taxable period in which the debit or credit note was received.

For example, if intellectual property was sold for an agreed price of \$58 million and it was later agreed that the price should be adjusted down to \$42 million, the transaction would remain subject to the DRC. The supplier would provide a credit note to reflect the \$16 million adjustment to the value and the recipient would reflect the GST effects of the adjustment in the taxable period in which the credit note was received.¹³¹

¹²⁹ Ibid

¹³⁰ Ibid

¹³¹ Ibid

If the reverse situation occurred – for example, the initial price for intellectual property, such as a trademark, was \$48 million but was later adjusted upwards to \$53 million – the DRC rules would not retrospectively apply to the transaction.

Another situation involving adjustment was when views about the nature of the supply changed. For example, assets supplied as a going concern would have been taxed under the DRC. If it was later determined that the supply was not of a going concern, the GST treatment of the transaction would not need to be retrospectively altered.

It was also proposed that an amendment to section 78E of the GSTA would be required to address situations when the DRC should have applied but was not considered at the time the contract was entered into.¹³²

F. Exceptions to the proposed DRC

DD 2 also identified exceptions to the application of the DRC.¹³³

1. Progressively supplied goods and services

It was considered that an exception to the compulsory application of the DRC would apply when the contract provided for successive payments over a number of taxable periods. The discussion document provided two reasons for excluding periodic payments from the scope of the DRC:¹³⁴

- GST-registered persons whose businesses did not principally involve making taxable supplies could face large GST liabilities without the ability to fully offset the payment with a matching input tax deduction. This would happen due to the DRC requiring the payment of GST at an earlier time than would occur under the current rules. The periodic consumption of the relevant goods and services as contemplated by the contract would not be properly recognised by the GSTA in this case.

¹³² Ibid

¹³³ Ibid, pg 10

¹³⁴ Ibid

- In situations when the contract made provisions for periodic payments, the revenue risk was perceived by the government to be lower. It was less likely that the transaction would be one-sided as there is an intention between the supplier and the recipient to maintain an on-going relationship over the contract period.

Changes were therefore proposed that would switch off the DRC and allowed goods and services to be treated as progressively and periodically supplied when the contract provided that payment was to be made in instalments. Supplies covered by the exception would continue to be taxed under the ordinary GST rules. The exception would not apply to progressive supplies made between associated persons which are the subject of a separate “time of supply” rule.¹³⁵

2. The DRC and sales in satisfaction of debt

It was proposed that the DRC would not apply to taxable supplies made when goods are sold in satisfaction of a debt under section 5(2) of the GSTA. The rules dealing with sales in satisfaction of debt shift the obligation to account for GST on a mortgagee sale from the mortgagor to the mortgagee. The rules ensure that goods owned by registered persons cannot exit the GST base without GST being accounted for.¹³⁶

The rules apply independently from the rest of the GSTA. Persons selling goods to repay a debt are required to complete a special GST return.¹³⁷ These sales are unable to be zero-rated as “going concerns”.

The government considered that sellers of goods to which section 5(2) of the GSTA¹³⁸ applied should not be able to use the DRC because it would confuse the differing purposes of the two sets of rules. The DRC requires that both the supplier and the recipient are registered for GST and is therefore limited to business-to-business transactions. On the other hand, section 5(2) of the GSTA is concerned with whether a

¹³⁵ Ibid

¹³⁶ Ibid

¹³⁷ See section 17 of GSTA – *Special Returns*

¹³⁸ Section 5(2) of GSTA - Sale in satisfaction of debt

supply of the goods would be a taxable supply if sold by the borrower. The rules do not require the seller to be registered for GST.¹³⁹

G. Issues with the proposed DRC- The Stakeholders perspective

Given the comprehensive nature of the proposed DRC and its obvious advantages, the question has to be asked as to why the DRC was not the preferred choice of the stakeholders. The author is of the view that the discussion documents issued by the government did a good job of explaining how the proposed DRC was meant to work. A review of the various articles and submissions made in respect of the DRC is therefore warranted to gain an understanding of why it was rejected in favour of the zero-rating provisions by the stakeholders.

The articles written on the topic by leading accounting and law practitioners in New Zealand were in many aspects were very similar in their thoughts about what they perceived were the advantages and disadvantages of the DRC. In general, most agreed that the proposed DRC represented a fundamental change to how GST ordinarily works as it shifted the obligation to account for GST from the supplier to the recipient.¹⁴⁰ Under the proposed DRC, it was the recipient that stepped into the shoes of the supplier and accounted for the output tax on the transaction. The recipient then recovered the GST on the transaction in accordance with their normal GST recovery entitlement.

Advantages of the proposed DRC

Some of the advantages of the DRC as identified by the various articles included the following:¹⁴¹

- Cash flow costs - the advantage of the DRC for businesses entering into high-value transactions is that it would eliminate any potential GST cash flow cost.

¹³⁹ Inland Revenue "GST: Accounting for land and other high-value assets" Discussion Document (Inland Revenue, Wellington, November 2009), pg 10

¹⁴⁰ "Welcome to this GST Alert" *Ernst & Young GST Alert* –November 2009 at <<http://www.ey.com/NZ>> last accessed 12 September 2010

¹⁴¹ Sybrand van Schalkwyk "Is GST Domestic Reverse Charge a Good Idea?" at <<http://www.parryfield.com>> last accessed 15 November 2010

- It would also remove the potential uncertainty associated with zero-rated going concern transactions.
- It would protect IR against a distressed vendor being unable to account for the GST. It would also deal with situations in which the purchaser has received the GST refund but the vendor has not accounted for GST.

In general, the introduction of the proposed DRC was seen as an attractive proposition in the first instance. The New Zealand Institute of Chartered Accountants (NZICA) was also in agreement that the DRC should remove some of the complexities for taxpayers in relation to the existing going concern rules and allow simpler compliance with GST cash flow requirements.¹⁴² Further, DRC was consistent with the separately proposed input tax apportionment rules.¹⁴³

However, most stakeholders were also in agreement that while there were some advantages in introducing the proposed DRC, there were also several issues with the proposed DRC which in their view outweighed these advantages. For these reasons, they could not support the implementation of the DRC.

The following issues were identified in the articles that either needed further clarification or needed to be resolved:

1. Land transactions

Pricewaterhouse Coppers (PWC) was concerned that difficulties could arise where land was supplied with other goods and services under the same agreement and the business was not being sold as a going concern. The discussion document suggested that the DRC would also apply to the other goods and services supplied under the agreement if the land and buildings are the “predominant feature of the supply”.¹⁴⁴

¹⁴² See Submission on “*GST: Accounting for land and other high-value assets*”, pg 2 at <<http://www.nzica.com>> last accessed 12 March 2011

¹⁴³ Ibid

¹⁴⁴ See “Radical GST changes ahead” *Tax Tips November 2009* at <http://www.pwc.com/en_NZ> last accessed 12 December 2010

It was perceived that the application of two sets of GST rules to the same transaction could add complexity to many transactions and could create pricing and invoicing difficulties.¹⁴⁵

NZICA also had concerns about this issue and picked up on this in their submission. It was their view that if the DRC was introduced, it should apply to all transactions involving land including land sold with other assets. They were concerned about how the transaction should be treated when a sale was a mixed supply consisting of both land and other assets.

Under what was initially proposed, there was some possibility that there would be some “transfer pricing” between the land and the other assets. Accordingly, to combat this scenario, where there was a joint or mixed supply, the DRC should apply to both the land and the other assets or services that comprise the supply.¹⁴⁶

2. Going concerns

According to PWC, a lingering question has been whether or not a transaction can qualify as a transfer of a going concern. Suppliers that decide to zero-rate a transaction under the existing provisions currently face the risk of having to pay GST, late payment penalties and interest if, at a later point, it turns out that the supply should not have been zero-rated.¹⁴⁷

While there was agreement that the proposed change will provide certainty that a going concern was subject to the reverse charge, it did not address concerns around the definition of “going concern”.¹⁴⁸ Given going concern questions have generated more GST court cases than any other issue in New Zealand in respect of GST, the proposed DRC approach for going concerns in the view of some seemed to be a step backward from a practical perspective.¹⁴⁹

¹⁴⁵ Ibid

¹⁴⁶ See Submission on “*GST: Accounting for land and other high-value assets*”, pg 3 at <<http://www.nzica.com>> last accessed 12 March 2011

¹⁴⁷ See “Radical GST changes ahead” *Tax Tips November 2009* at <http://www.pwc.com/en_NZ> last accessed 12 December 2010

¹⁴⁸ Ibid

¹⁴⁹ Ibid

Deloitte, a leading accounting firm, also commented on this issue in their article on the proposed DRC. By removing the requirement for the parties to agree in writing that there was a transfer of a going concern, they were concerned that this was arguably going back to the bad old days of having uncertainty as to the GST treatment of significant transactions, something that should be avoided.¹⁵⁰

Further, as the DRC rules still required parties to determine whether their transaction met the "going concern" test, there was concern that there may still be transactions relating to land where it was unclear whether the new regime applied. The \$50m threshold appeared to be reasonably clear but it was possible in transactions involving multiple contracts and multiple parties it would not always be clear whether the new regime applied. Getting this wrong could have major impact on some businesses later when it was found that the transaction should not have been subject to the going concern rules.¹⁵¹

NZICA also had similar concerns about the proposed DRC's application to going concerns. It was their view that this was in effect a return to the old style rules for going concerns, where there was no requirement for the agreement to be in writing. It would be a step backwards and would introduce significant commercial uncertainty into many commercial transactions. There were significant numbers of historic cases which show in practice the difficulties in actually determining if a transaction does qualify as a going concern.¹⁵²

Further, many large transactions that could potentially be treated as going concerns, were not being treated as such just to avoid the uncertainty it created. Instead the parties were not agreeing in writing, and treating the transaction as a GST offset. NZICA were not supportive of the introduction of a compulsory DRC for transfers of going concerns (of non-land transactions) where there were no agreements between the parties to the transaction.¹⁵³

3. Compulsory nature of the DRC

¹⁵⁰ Jeanne Du Buisson and Allan Bullock "Major changes on the horizon" *Tax Alert* – November/December 2009 at <<http://www.deloitte.com>>

¹⁵¹ Ibid

¹⁵² See Submission on "GST: Accounting for land and other high-value assets", pg 4 at <<http://www.nzica.com>>

¹⁵³ Ibid

Deloitte were in favour of the introduction of the DRC on a voluntary basis as a simplified and cheaper alternative to the current practice of using GST offsets for high value asset transfers between GST registered entities.¹⁵⁴

4. Magnitude of DRC

PWC was also concerned that the proposed DRC of this magnitude was untested and as a result, some of the following issues could arise:¹⁵⁵

- pricing - the proposed DRC rules anticipated a GST-exclusive price but market forces may resist this; and
- systems – adapting GST accounting systems to deal with both DRC transactions and non-DRC transactions. This would add to the compliance costs for businesses, something which the government has always maintained it was trying to reduce

5. Practical implications of the DRC

PWC were also concerned that the introduction of the DRC would bring about some practical implications and these were:¹⁵⁶

- GST clauses of the Auckland District Law Society (ADLS) contracts would have to be re-written, and re-interpreted to ensure that the parties' GST position was protected.
- The time of supply rules will become more complex as special rules would be needed to ensure GST is accounted for correctly.
- In addition, the mortgagee sale provisions would be excluded from the application of the DRC.

¹⁵⁴ Jeanne Du Buisson and Allan Bullock "Major changes on the horizon" *Tax Alert – November/December 2009* at < <http://www.deloitte.com>>

¹⁵⁵ See "Radical GST changes ahead" *Tax Tips November 2009* at < http://www.pwc.com/en_NZ>

¹⁵⁶ Ibid

- New provisions would apply for debit and credit note purposes.

The various articles and submissions identified several areas of concern with the proposed DRC. However, the author is of the view that whenever there is any new legislation is proposed, there is naturally going to be some concerns about it. The discussion documents requested feedback and those affected stakeholders obliged with their views on the topic.

With respect, this not does necessarily mean that the feedback provided by the various stakeholders is necessarily correct. It is only human nature for people to have some bias in their views and while the author is not implying this was the case, there is no reason why the articles could not have had such bias. The articles written and the submissions made were by parties that would be most affected by the new legislation and it is quite possible that this played a strong part in how they viewed the new legislation.

However, the government would have been well aware of this when they requested the feedback in respect of the proposed DRC. The articles written and the submissions made were by highly respected professionals who are bound by the standards set by their profession. The acceptance by the government of some of their views and suggestions made suggests that this was clearly not the case (bias in the submissions and articles) and perhaps there was something fundamentally wrong with the proposed DRC itself for it to be so overwhelmingly rejected.

A review of the DRC used in the United Kingdom since 2007 and the proposed DRC in Australia could perhaps help in understanding the flaws of the DRC that was proposed in New Zealand.

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H. DRC - The UK Experience

Cross-border transactions within the EU have, since 1992, been zero-rated for VAT. Importers of goods are therefore able to receive goods without paying VAT, but charge VAT on their resale. If the VAT they receive is not then remitted to the revenue authority, they commit a crime; this is Missing Trader Fraud. If the goods can be

repeatedly exported and re-imported then this criminal practice can be repeated, giving the activity its more common name, Carousel Fraud.¹⁵⁷

This is not a fraud against the institutions of the EU, nor does it occur because of any mismanagement by them. Instead it is the fiscal authorities of the Member States that are being defrauded, due to the rules that they have chosen to implement for the taxation of intra-Community trade.

Attempts to undertake this fraud had risen considerably, largely due to the proliferation of high value & low weight goods, such as mobile phones, and substantial losses up to £4.75 billion for the 2005/06 fiscal year were estimated to have occurred in the UK alone.¹⁵⁸

DRC came into effect in the UK from 1 June 2007. The limited reverse charge accounting system was introduced to sectors most commonly used by the criminals exploiting the loophole in the tax system. The specified goods to which the DRC applies are:

- mobile telephones and
- computer chips.

Under the reverse charge accounting mechanism, it was the responsibility of the customer, rather than the supplier, to account for VAT on supplies of the specified goods to the tax department. From 1 November 2010, the scope of the DRC was increased to include carbon emission trading as part of Her Majesty's Revenue and Custom's (HMRC) plan to combat Missing Trader Intra-Community (MTIC).¹⁵⁹

1. DRC – The application

UK supplies

¹⁵⁷ See VAT Information Sheet 06/07 "VAT: Reverse Charge for purchases and sales of mobile phones and computer chips" April 2007 at <<http://customs.hmrc.gov.uk>> last accessed 1 October 2010

¹⁵⁸ Ibid

¹⁵⁹ UK Budget 2010: "Summary of VAT Specific Changes" at <<http://www.meridianglobalservices.com>> last accessed 23 March 2011

The reverse charge applies only to supplies of specified goods within the UK made by one VAT-registered business to another. The rules and procedures for sales to non-business customers, dispatches of goods to persons in another member State and for exports outside the EU were unaffected by the introduction of the reverse charge.¹⁶⁰

£5,000 de minimis rule

The reverse charge does not apply to supplies with a VAT-exclusive value below £5,000. This figure is calculated on an invoice basis, that is, the reverse charge applies if the total value of all the specified goods shown on an invoice is £5,000 or more. In that event, the reverse charge applies to the total value of the specified goods on that invoice.¹⁶¹

If supplies of any other goods or services are shown on the same invoice as reverse charge goods, the reverse charge does not apply to the other supplies. If an itemised invoice relates to a single supply, for example a computer, which is not subject to the reverse charge, VAT is charged as normal on the supply, even if some of the itemised components are reverse charge goods.

Where VAT is due on a value reduced by an unconditional discount - for example, a prompt payment discount - then the discounted value is used to establish the value for the purpose of applying the de minimis rules. However, where there are contingent discounts or delayed reductions in price, the full value shown on the invoice are used.¹⁶²

Sales to businesses

The reverse charge only applies to supplies where the customer is registered or liable to be registered for UK VAT, and is buying the goods for a business purpose. Suppliers selling goods under the reverse charge procedure therefore need to obtain their customers' VAT registration number and satisfy themselves, as far as possible, that the number is genuine and the condition is met.¹⁶³

¹⁶⁰ See "VAT: Reverse Charge for purchases and sales of mobile phones and computer chips" at < <http://customs.hmrc.gov.uk> > last accessed 11 April 2011

¹⁶¹ Ibid

¹⁶² Ibid

¹⁶³ Ibid

2. Supplies excluded from the DRC

Supplies of specified goods in the following circumstances are always excluded from domestic reverse charge accounting:

- supplies of specified goods to customers for non-business use
- supplies of specified goods for which the seller chooses to use
- the second-hand margin scheme - and
- specified goods which a business gives away for no consideration - these are deemed supplies on which the supplier is required to account for VAT.¹⁶⁴

3. Reasonable checks

The supplier in a DRC transaction is required to carry out a reasonable check. Section 8 of the VAT Act explains that a supplier will not be held liable for incorrect application of the reverse charge where they have taken reasonable steps to establish the VAT status of their customer. What is reasonable in any case will depend on norms in the sector and the type of relationship the supplier has with the customer. The following are indicators to assist in deciding how far one should go before accepting a customer's representations. It is not as an exhaustive or definitive list:¹⁶⁵

- Do commercial checks on creditworthiness and customer status which are good commercial practice for the sector suggest any reason to doubt the customer's representations?
- Is the VAT registration number genuine and does it belong to the person who is quoting it? Suppliers can use the checking facility provided by the National Advice Service. Large businesses may contact their Client Relationship Manager for advice.
- Is this a new customer or a well-established business known to the supplier? In general, however, there is no need for the supplier to carry out special

¹⁶⁴ Ibid

¹⁶⁵ Ibid

verification of VAT registration numbers of existing customers with whom they have an established trading relationship.

- Is there any indication in the pattern of orders that the customer is attempting to manipulate the £5,000 *de minimis*?
- Has the supplier any grounds to doubt the bona fides of the customer?

It was recommended that the supplier should keep evidence of the checks that they had performed, so that they could produce it to HMRC if subsequently required.¹⁶⁶

4. Issues identified with the UK DRC

During the implementation of the DRC in UK, submissions identified the following as weaknesses of the DRC:

- Systems: There were major concerns before the DRC came in place of the impact it would have on the systems used by businesses to process VAT transactions. The system would have to distinguish between specified goods (mobile phones and computer chips) and non-specified goods.¹⁶⁷
- Furthermore, the system would also be required to identify the *de minimis* amount.
- The *de minimis* limit itself caused some debate with manufacturers and retailers alike. The manufacturers had requested that the *de minimis* limit be made optional so that all their transactions could be treated as in the regime. This would avoid systems issues for the manufacturers.
- The retailers felt that the *de minimis* limit was not high enough. They had concerns that HMRC would expect them to track subsequent transactions made

¹⁶⁶ Ibid

¹⁶⁷ See TAX REP – “VAT Optional Reverse Charge Mechanism” submission on 15 October 2007 (Tax Faculty of the Institute of Chartered Accountants in England and Wales) at < <http://www.icaew.com>> last accessed 14 February 2011

by a single customer in one day in order to apply, or not apply the *de minimis* limit. There were also questions asked around whether the *de minimis* limit applied to the total transaction value of goods falling within and outside the regime, or just goods falling within the regime.

- The general consensus was that the *de minimis* limit should be scrapped but retailers should be able to charge VAT on all their supplies in the normal way.

As with the proposed DRC in New Zealand, there were also some concerns raised before DRC was implemented in the UK. However, it was very interesting to note that the experience in UK showed that some people thought that even though DRC would eradicate VAT fraud in the sector it was applied to, it was likely the fraud would spread to other sectors.¹⁶⁸

I. The proposed DRC - Australia

As part of the 2009 Australian Budget, Treasury issued a discussion paper proposing a number of changes to the operation of the GST regime. It was proposed that from 1 July 2010, the 'GST-free' treatment of going concerns and farm sales would be replaced with a 'reverse charge' mechanism where, instead of the sale being treated as GST-free, the purchaser would agree to pay the GST on behalf of the vendor. However, the date of the proposed implementation has now been pushed out to 1 July 2011.¹⁶⁹

It was proposed that the net effect would be similar to the current treatment in that the purchaser will not 'pay' GST to the vendor, but will pay it to the ATO directly (and offset any input tax credit available for that GST at the same time). As such, where a purchaser is in a fully creditable position, the GST and credit should net off, with no net payment to the ATO.

Similar to the existing going concern and farmland tests, it was proposed that the reverse charge mechanism would only apply where:

¹⁶⁸ Ibid

¹⁶⁹ See Alert – “Reverse-charge mechanism' replaces GST-free treatment of going concern and farm sales in 2009 Budget” (20 May, 2009) at < <http://www.minterellison.com>> last accessed 11 October 2010

- there was an agreement between the parties to apply the reverse charge mechanism; and
- certain qualifying criteria were satisfied.¹⁷⁰

1. The existing law – going concern and farm land

The going concern GST exemption in Australia allows the sale of the assets of an enterprise to be sold as GST-free where certain requirements are met. Similarly, under the farm land GST exemption, the sale of farm land is GST-free where certain requirements are met, including that the purchaser intends to carry on a farming business on the land.¹⁷¹ The going concern exemption is used by businesses across various industries for the sale of their enterprises, including for the sale of tenanted commercial property and property development enterprises in relation to new residential property (recent legislative amendments were made to the margin scheme that impact on these latter arrangements).¹⁷²

The going concern and farm land exemptions are primarily used for the cash flow benefit and, particularly in the property sector, because they reduce the stamp duty payable on the sale of land / assets by the purchaser (since stamp duty is calculated on the GST-inclusive purchase price). However, there have been a number of practical problems with the going concern provisions:¹⁷³

- The provisions are highly technical with the consequence that many transactions considered to be commercial going concerns by the parties do not meet the technical requirements. An example is where the purchaser already has its own premises and therefore the vendor does not transfer or assign the business premises to the purchaser. This would normally preclude the transaction from being a GST going concern. Where the vendor incorrectly classifies a taxable

¹⁷⁰ Ibid

¹⁷¹ Jonathan Ackerman “Australian GST Update- Bye Bye Going Concern?” 19 June 2009 at <<http://www.mondaq.com>> last accessed 2 December 2010

¹⁷² Ibid

¹⁷³ Ibid

transaction as a GST-free going concern, it will normally have a significant GST exposure, including interest and penalties.¹⁷⁴

- The benefits of a going concern are primarily benefits for the purchaser, not the vendor. However, the vendor ordinarily bears the risk that the transaction will be incorrectly classified as a GST-free going concern. The lack of alignment concerning GST risk and benefit often leads to disputes between the parties.¹⁷⁵
- The GST law contains complex adjustment provisions that apply to some going concern transactions. These provisions are not well understood by taxpayers and are often ignored, once again leading to significant GST exposures, including interest and penalties.¹⁷⁶

The Board of Taxation concluded that the present going concern and farm land provisions were too narrow and uncertain in their application. As a result, the Board proposed to replace it with a reverse charge mechanism. Under this proposal the parties could specifically agree in writing that the GST on a supply of a going concern or farm land be subject to the reverse charge mechanisms.

The implementation of the reverse charge mechanism by the parties would mean that:

- the recipient of a supply was responsible for remitting GST that would otherwise be remitted by the supplier.
- The supply will consist of taxable supplies for a GST exclusive price. However, where the recipient has made a creditable acquisition, that is they are a recipient of a supply of a going concern or farm land, they will be entitled to claim input tax credits for that acquisition. Thus at the time of acquisition the recipient will be liable to remit the GST, but will also be eligible to claim input tax credits to the extent it has made a creditable acquisition.

¹⁷⁴ Ibid

¹⁷⁵ Ibid

¹⁷⁶ Ibid

- The reverse charge only applied to the extent that a supply was a taxable supply. The two amounts, generally, would offset one another, whilst maintaining the normal GST revenue result.¹⁷⁷

J. Comparisons of the 3 DRC models

Not surprisingly, all three DRC models work in a similar manner by shifting the obligation to return GST on the recipient of the supply instead of the vendor. In doing so, the proposed DRC reduces the risk to the government's tax base and also reduces cash flow costs for businesses.

The DRC model in the UK and the proposed DRC in New Zealand are compulsory in nature while it appears that the DRC proposed in Australia is voluntary as taxpayers are required to have an agreement in writing for the DRC to apply in Australia. Therefore, if there is no agreement in writing, the proposed DRC would not apply in Australia.

Another notable difference between the three models is that while the proposed DRC in Australia was introduced to deal with the complexities of the going concern and farmland provisions, the DRC in the UK and the DRC proposed in New Zealand were to deal with GST fraud. Naturally, this raises the question as to which of the options was the DRC better suited to, dealing with GST complexities or GST fraud?

Perhaps the most interesting aspect of the three models is that while the DRC models in the UK and Australia are limited in their scope, (they apply to specific sectors only), the DRC that was proposed in New Zealand was broad in comparison, that is, it would have applied to all land transactions, going concerns and sales of high value assets.

It is also interesting to note that the Australian government has also delayed the implementation of the proposed DRC to July 2011. Whether the decision by the New Zealand Government not to proceed with the proposed DRC has had any impact on its decision is unknown, however, it would come as no surprise if this was the case as the Australian GST model is to a large extent modelled on New Zealand's GST system.

¹⁷⁷ Ibid

K. Summary

The discussions in this chapter identified issues with the proposed DRC that were of concern to various stakeholders. However, before the author can conclude that these reasons were enough to justify that the proposed DRC was not the answer to the business-to-business neutrality concerns, a review of the compulsory zero-rating provision is necessary. The following chapter looks at what the government has legislated for effective 1 April 2011 to deal with the concerns of the GST system, the zero-rating provisions.

VII. THE ZERO-RATING PROVISION

A special report into the changes to the GST rules was released by the Policy Advice Division (PAD) of Inland Revenue on 23 December 2010. The PAD report stated that from 1 April 2011, all land transactions between GST-registered parties would be subject to GST at 0% (with very limited exceptions) if certain conditions are met at the time of settlement.¹⁷⁸ However, if one was to read into the government's intention at the time the two discussion documents were released, the compulsory zero-rating provision would have been the least expected outcome.

The zero-rating provision was considered in brief by the government as an alternative to its preferred option, the proposed DRC. While the initial submissions received by the government in response to DD 1 were in favour of the zero-rating provision, the government argued against the zero-rating provision in DD 2 as being the best option for dealing with the GST issues.

A. Government's arguments for not zero-rating

DD 2 listed the following reasons as to why the zero-rating provision was not the government's preferred option:¹⁷⁹

- Zero-rating had the effect of deferring the immediate collection of GST on a supply of goods and services. This deferral in its view could be a problem for IR if there were a significant number of instances when, at a later point, it turned out that the supply should not have been zero-rated. For example, the goods and services may have been provided to a final consumer, but the supplier had since deregistered or no longer existed. In these situations, IR could not seek payment from the recipient. However, under the proposed DRC, IR could seek payment from the recipient and address this concern; hence the DRC being government's preferred option.

¹⁷⁸ *Changes to the GST rules* Special Report (Policy Advice Division of Inland Revenue, Wellington, 23 December 2010) at < <http://taxpolicy.ird.govt.nz>>

¹⁷⁹ Inland Revenue "GST: Accounting for land and other high-value assets" Discussion Document (Inland Revenue, Wellington, November 2009), pg 11

- In other situations, the supplier may agree to a GST-inclusive price for a supply of goods and services on the understanding that the supply was zero-rated. In these situations, Inland Revenue may become involved in a dispute with either or both parties if the correct treatment becomes unclear and the recipient had claimed an input tax deduction but the supplier had not paid GST because of the earlier understanding.

For these reasons, the government considered that business-to-business neutrality was best achieved using rules that shifted the obligation to charge and return GST onto the recipient, as in the proposed DRC.¹⁸⁰

However, the support in the submissions for the zero-rating provision as the better alternative could not be ignored by the government. The submissions gave the following as some of the reasons why the zero-rating provision was a better option than the DRC:

181

- It was widely understood by GST-registered persons;
- it effectively resulted in a zero-liability for GST and preserved the supplier's right to deduct input tax; and
- it was consistent with the general operation of GST and would have required less legislative change.

Consequently, the government took a final consultation on the two options (proposed DRC and zero-rating provision) to ensure that the chosen option would be the most suited for the intended purpose. On 1 April 2010, a consultation paper (T2010/486; PAD2010/57) was released by the government seeking clarification on what was the most desirable option.¹⁸² According to the paper, the submissions had not shown a clear preference towards either of those measures (DRC or zero-rating); therefore, a further

¹⁸⁰Ibid, pg 12

¹⁸¹ Ibid, pg 11

¹⁸²*GST: Accounting for land and other high value assets* Tax Policy report (Policy Advice Division of Inland Revenue, Wellington, 1 April 2010) at < <http://www.treasury.govt.nz>>

consultation was desirable to ensure that the chosen mechanism provided the best balance of simplicity and revenue robustness.

The consultation was conducted by means of a short consultation note summarising more clearly the main advantages and disadvantages of the two approaches. These were sent to selected parties that had made submissions in respect of the issues concerned. Once the final feedback was received by the government, most submitters expressed a preference for the zero-rating provision over the DRC.¹⁸³ Consequently, the policy makers agreed that the zero-rating provision was a more suitable mechanism for addressing the GST issues in question and the new rules came into effect from 1 April 2011.

Under the zero-rating provision, the accounting obligations of the parties in most situations remain virtually unchanged from the previous legislation.¹⁸⁴ The key features of the zero-rating provisions are discussed in detail below.

B. Key features of the zero-rating provisions

The special report by PAD provided early information about the changes to the GST rules relating to land transactions. From 1 April 2001, any supply to a registered person involving land, or in which land is a component by GST-registered vendors has been subject to GST at the rate of 0%.¹⁸⁵

According to the report by PAD, the following were other features of the new rules:¹⁸⁶

- a definition of “land” which largely follows the definition used for income tax purposes but which excludes most commercial leases;
- an obligation for the purchaser to advise of their registration status and intentions in respect of the land; and

¹⁸³ *Changes to the GST rules* Special Report (Policy Advice Division of Inland Revenue, Wellington, 23 December 2010) at < <http://taxpolicy.ird.govt.nz>>

¹⁸⁴ *Ibid*, pg1

¹⁸⁵ *Ibid*

¹⁸⁶ *Ibid*

- special rules to deal with situations when a supply is either incorrectly zero-rated or incorrectly standard-rated.
- For transactions entered into before 1 April 2011 but for which the time of supply is on or after that date, the supplier has the option of treating the transaction as being governed by either the current GST rules or the new rules - section 11(1)(8C) of the Goods and Services Tax Act (GSTA).¹⁸⁷

C. Determining zero-rating

The report confirmed that a newly added section 11(1)(mb) of the GSTA provides that a GST-registered person must zero-rate a supply if the supply wholly or partly consists of land, and:

- is made to another registered person; and
- the recipient acquires the goods with the intention of using them for making taxable supplies; and
- the supply is not a supply of land intended to be used as a principal place of residence of the recipient of the supply or a person associated with them under section 2A(1)(c) of GSTA (that is, their relative).¹⁸⁸

To be a zero-rated supply, the above conditions for zero-rating must be satisfied at the time of settlement of the transaction (new section 11(8B) of the GSTA). If any of these conditions are not satisfied at the time of settlement, the supply will be taxed at the standard rate of 15%. If land is supplied as part of a larger supply, the whole supply is zero-rated. For example, if land is supplied as part of a business being sold as a going concern, under the new rules the supply of the going concern is zero-rated in its entirety.

189

¹⁸⁷ Ibid , pg 2

¹⁸⁸ Ibid

¹⁸⁹ Ibid

The special report also detailed how services included with the supply of land would be treated for zero-rating purposes. To ensure that the zero-rating rules applied to services supplied as part of a transaction that included land, new section 5(24) of the GSTA would treat these services as a supply of goods. The requirement that the recipient must intend to use the goods for making taxable supplies may be satisfied even if the recipient does not intend to use the goods wholly for making taxable supplies.

Therefore the supply may be zero-rated in its entirety even if the recipient intends to use the goods partly for making non-taxable supplies. It should be noted, however, that in these circumstances the purchaser will be liable to account for the output tax on the non-taxable use of the goods under new section 20(3I) of the GSTA.¹⁹⁰

The special report also explained that the zero-rating rules did not apply to supplies of land intended to be used as a principal place of residence of the recipient of the supply or a relative of the recipient (section 11(1)(mb)(ii) of the GSTA). If a “principal place of residence” is included in a larger supply of real property, amended section 5(15) of the GSTA requires the supplier to treat the supply of the residence as a separate supply from the supply of any other real property included in the supply. These provisions clarify that a supply of the principal place of residence is not subject to the zero-rating rules. This is intended to prevent registered persons, such as sole traders, from using their GST-registered status to zero-rate the purchase of their family home.¹⁹¹

1. Definition of “land”

The special report by PAD also provided a definition of “land”. A supply will only be zero-rated under section 11(1)(mb) of the GSTA if it is a supply of land. A new definition of “land” in section 2(1) of the GSTA includes an estate or interest in land, a right that gives rise to an interest in land and an option to acquire land or an estate or interest in land.¹⁹²

“Land” includes the ground within the territory of New Zealand, whether below or above the water and things of a permanent nature situated on the ground, such as

¹⁹⁰ Ibid

¹⁹¹ Ibid , pg 3

¹⁹² Ibid

buildings or any other structures that become a fixture and thus part of the land. “Land” does not simply mean the physical ground, but the nature of the right involved in the ownership of land.

Leases are excluded from the definition of land provided that they are leases of dwellings or they are commercial leases for which:

- the supply is made periodically; and
- 25% or less of the total consideration specified in the agreement, in addition to any regular payments is paid or payable under the agreement in advance of or contemporaneously with the supply being made.¹⁹³

The exclusion will ensure that commercial leases that do not require high one-off payments and which are unlikely to be used for phoenix fraud purposes are not caught by the new rules. The definition also expressly excludes mortgages. “Land” also includes a right or an option to acquire land or an estate or interest in land.

Lastly, the new definition includes a share in the share capital of a flat-owning or office owning company, as defined in section 121A of the Land Transfer Act 1952. The aim of this is to prevent such structures being used for fraudulent purposes.¹⁹⁴

2. Disclosure requirements

According to the special report, a new section 78F had also been added to the GSTA to provide assistance to the supplier in identifying information that is required in order to apply the correct GST treatment in respect of the supply of land which was to be zero-rated. Thus, if a supply wholly or partly consists of land, section 78F(2) requires that the purchaser provide, at or before settlement, a written statement to the supplier that at the date of settlement:¹⁹⁵

- they are, or expect to be, a registered person; and

¹⁹³ Ibid

¹⁹⁴ Ibid, pg 4

¹⁹⁵ Ibid

- they are acquiring the goods with the intention of using them for making taxable supplies; and
- they do not intend to use the land as a principal place of residence for them or a person associated with them under section 2A(1)(c) of the GSTA (their relative).

This information must be provided to the supplier in writing. It was expected that the requirements of this section could be incorporated into standard sale and purchase agreements. Since the tests in section 11(1)(mb) of the GSTA must be satisfied on settlement for the zero-rating rules to apply, the information provided by the purchaser may be provided on a prospective basis, that is, on the basis of the best prediction of the recipient's circumstances at the time of settlement. For example, if a purchaser was not registered for GST but intended to register before settlement, they could indicate on their statement that they expected to be registered for GST.

Furthermore, if the purchaser entering into the contract with the supplier did not intend to receive the land themselves but nominated or intends to nominate a third party to receive the supply, the purchaser may make representations on behalf of the nominated person (section 78F(5) of the GSTA).

If a supply of land is made by a lender to whom section 5(2) of the GSTA applies, the purchaser must provide the information required by section 78F of the GSTA to the lender rather than the borrower – for example, the mortgagee under a mortgagee sale.¹⁹⁶

3. Supplier's obligations

The special report also explained what the supplier's obligations in respect of the zero-rating provisions were. Once the supplier receives a written statement from the purchaser, the supplier may rely on the statement to either standard-rate or zero-rate the supply (section 78F(3) of GSTA). If the statement indicates that the conditions in

¹⁹⁶ Ibid

section 11(1)(mb) of the GSTA are or will be met, the supplier may zero-rate the supply.¹⁹⁷

However, if the statement indicates otherwise, the supplier may standard-rate the supply. There will be some circumstances where 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. In a commercial transaction it is reasonable to assume that the vendor is unlikely to adopt a GST treatment different from the one indicated by the purchaser's representation without first consulting the purchaser.

Once a written statement is provided, the supplier is not required to make any further enquiries regarding the purchaser's circumstances. 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.¹⁹⁸

4. Record-keeping requirements

The report by the Policy Advice Division of IR also provided information on the supplier's obligation in respect of the record-keeping requirements. If a supply is zero-rated under section 11(1)(mb), new section 75(3B) requires the supplier to maintain sufficient records to enable the following particulars in relation to the supply to be ascertained:¹⁹⁹

- the name and address of the recipient; and
- the registration number of the recipient; and

¹⁹⁷ Ibid, pg 5

¹⁹⁸ Ibid

¹⁹⁹ Ibid

- a description of the land; and
- the consideration for the supply.

D. Consequences of incorrect GST treatment

The special report also explained the consequences of incorrect GST treatment of the land transactions. It was envisaged that in some situations, the GST treatment of the transaction elected by the supplier may be found to be incorrect. The consequences of this will depend on whether the mistake is discovered before or after settlement.²⁰⁰

1. Correction of GST treatment before settlement

For a supply to be zero-rated, the conditions for zero-rating in section 11(1)(mb) must be satisfied at the time of settlement. Since the time of supply may occur before a transaction is settled, the supplier will need to determine whether the supply should be standard-rated or zero-rated at that earlier time. As discussed earlier, this determination will usually be made on the basis of the written statement provided by the purchaser.²⁰¹

Before settlement the parties may become aware that the GST treatment applied to the transaction was not correct. For example, on signing the sale and purchase agreement the purchaser may have informed the supplier that they will be registered at the time of settlement. The supplier zero rates the transaction as a result. Before settlement, the purchaser may decide to nominate a third person to settle the transaction. The nominated person indicates that they will not be registered at the time of settlement.

Conversely, the parties may become aware of circumstances that indicate that a transaction should be zero-rated rather than standard-rated. In both cases, since the crystallisation of the correct GST treatment in respect of the supply occurs at the time of settlement, the new zero-rating rules do not impose any obligations on the parties to change the initial GST treatment of the supply before settlement.²⁰²

²⁰⁰ Ibid

²⁰¹ Ibid

²⁰² Ibid ,pg 6

Nevertheless, the parties may voluntarily agree to correct the GST treatment to avoid the consequence of being incorrect, as outlined below. If GST has already been accounted for to IR by the supplier, the correction may be done under section 25 of the GSTA, which allows the supplier to issue a credit note to adjust the tax payable by the supplier. Thus, if a supply was standard-rated when it should have been zero-rated, the supplier will be able to deduct the GST already paid to IR and the purchaser will be required to account for the amount of any deduction incorrectly claimed in respect of the supply.

Alternatively, if a supply was zero-rated when it should have been standard-rated, the supplier would be required to account for the GST. Generally the purchaser will not be able to claim a deduction in respect of the supply since if they are registered for GST and intend to use the goods in making taxable supplies (requirements for obtaining a deduction), standard-rating is unlikely to be the correct treatment.

Section 25 of GSTA has been amended by the Taxation (GST and Remedial Matters) Act to explicitly allow suppliers to issue debit and credit notes in the context of the zero-rating rules.²⁰³

2. Correction of GST treatment after settlement

The special report also provided information about situations where the correct GST treatment may be unknown until after the transaction has been settled. The consequences of incorrectly standard-rating or incorrectly zero-rating the supply are set out below.²⁰⁴

Supply incorrectly standard-rated

When a supply that should have been zero-rated is incorrectly standard-rated and the GST has been accounted for to IR, the supplier will be required to use the credit note mechanism in section 25 of the GSTA to deduct the GST paid in respect of the supply.

²⁰³ Ibid

²⁰⁴ Ibid, pg 7

The purchaser would then be required to account for output tax in relation to any amount of input tax that they have incorrectly claimed in respect of the supply.²⁰⁵

Supply incorrectly zero-rated

When at any time after a transaction is settled it is found that the supply should have been standard-rated rather than zero-rated, new section 5(23) of the GSTA will treat the purchaser, at the date of settlement, as making a supply of the goods in question at the standard rate. The value of the supply under section 5(23) will be equal to the amount of the consideration for the original supply.²⁰⁶

Since the supply is treated as being made at the date of settlement of the underlying supply, the purchaser may be subject to use-of-money interest with any applicable penalties calculated from that date. If the purchaser who is required to account for tax under section 5(23) is not registered for GST, they will be treated as registered from the date of the supply under section 5(23) and must apply to be GST-registered (new section 51B(4) of the GSTA). If the purchaser fails to apply for registration, the Commissioner of Inland Revenue will be able to force their registration.²⁰⁷

New section 20(4B) of the GSTA denies a deduction to the person who is treated under section 5(23) as a supplier of goods. However, the person may be able to claim a deduction for the supply at a later date if they register for GST and use the relevant goods for making taxable supplies.²⁰⁸

Once GST is accounted for, the purchaser may request that the Commissioner cancels their registration (new section 51B(5) of the GSTA). Under section 5(3) of the GSTA a person cancelling their registration must ordinarily account for the output tax on any goods and services forming part of the assets of a taxable activity carried on by the person. This rule could result in unfair and unintended consequences if it applied to deregistration of a person who was required to register under section 51B(4) of the GSTA. Therefore, new section 51B(6) of the GSTA renders section 5(3) inapplicable if:

²⁰⁵ Ibid

²⁰⁶ Ibid, pg 8

²⁰⁷ Ibid

²⁰⁸ Ibid

- the person seeks cancellation of their registration by the end of the taxable period in which they have accounted for the output tax under section 5(23) of the GSTA; or
- the Commissioner agrees that section 5(3) of the GSTA should not apply.²⁰⁹

E. Submissions received in respect of the zero-rating provision

The government received several submissions in respect of the zero-rating provisions in their Taxation (GST and Remedial Matters) Bill before it settled on the shape of the legislation as it stands today and discussed in detail above. Some of the key features of the submissions that the government took into consideration included:²¹⁰

1. Periodic Supplies

The submission by PWC questioned the intention of the inclusion of periodic supplies of land such as commercial leases in the zero-rating provision. If periodic supplies of land were intended to be caught, PWC submitted that the following matters should be considered further:²¹¹

- Is the policy reason for introducing the new zero-rating of land provisions furthered by including periodic supplies in the ambit of the compulsory zero rating?
- Would a partially GST exempt lessee be required to make an adjustment each month when the rental payment is made?

Unless there was an ability to make less frequent (e.g. annual) adjustments, there was likely to be a compliance burden on lessees who were making exempt or partially exempt supplies.

²⁰⁹ Ibid

²¹⁰ “*GST: Zero rating of land*” Report (Policy Advice Division of Inland Revenue) at <<http://taxpolicy.ird.govt.nz/publications>>

²¹¹ Evidence/Submission *Taxation (GST and Remedial Matters) Bill – PricewaterhouseCoopers* at <<http://www.parliament.nz>>

However, if periodic supplies were excluded from the zero-rating provision, then PWC acknowledged that certain one off payments in relation to lease transactions would need to be covered by the zero-rating rules to prevent abuse of the GST system.²¹²

This issue was also addressed by another Big Four accounting firm KPMG in their submission. KPMG was of the opinion that the CZR should not apply to successive supplies of a commercial dwelling subject to a lease. The definition of “land” should be narrowed to exclude such transactions.²¹³

The Corporate Taxpayers Group (CTG) also commented on the inclusion of commercial lease in the zero-rating provision and acknowledged that the definition of “land” was too wide.²¹⁴

2. Reducing vendor’s obligation

The legislation as it was drafted at the time submissions were made did not provide commercial certainty as to the GST treatment applying at the time of a transaction. The proposed obligation on suppliers in section 78F of the GSTA was considered to be too onerous, particularly the obligation to confirm the intentions of the purchaser.

In their submission, one of New Zealand’s leading law firms, Russell McVeagh in commenting on the supplier’s obligation to gather records stated that the zero-rating rules must spell out unambiguously what a supplier must do in order to shift the statutory GST liability to the recipient.²¹⁵ In their view, it was not clear from the new section 78F(2) of the GSTA:²¹⁶

- What “GST registration details” the supplier was required to obtain e.g. GST registration number only and if so, legislation should use the defined term

²¹² Ibid

²¹³ Evidence/Submission *Taxation (GST and Remedial Matters) Bill – KPMG* at <<http://www.parliament.nz>>

²¹⁴ Evidence/Submission *Taxation (GST and Remedial Matters) Bill – Corporate Taxpayers Group* at <<http://www.parliament.nz>>

²¹⁵ Ibid

²¹⁶ Evidence/Submission *Taxation (GST and Remedial Matters) Bill – Russell McVeagh* at <<http://www.parliament.nz>>

registration number. Did the supplier also have an obligation to obtain details on whether the recipient was registered on an invoice or payments basis and so on?

- What type of evidence of GST registration should be acceptable?

Another Big Four accounting firm Deloitte also commented on this issue in their submission and commented that the legislation as it was drafted at the time could be interpreted as a broad obligation extending beyond the obligation to obtain the GST registration number only.²¹⁷ Further clarification was required on this matter so that guidance could be provided to the supplier.

The policy advisers agreed with the submissions and recommended an alternative approach that did not require an examination of whether the vendor had made sufficient enquires to obtain the information.²¹⁸

3. Determining the recipient's intention

A very interesting point raised by PWC in its submission was that consideration should have been given to updating IR's systems and processes to allow suppliers to validate the recipient's GST registration status. PWC noted that some overseas jurisdictions, like the UK, allow for this checking facility.²¹⁹ This however was rejected on the basis of the secrecy provisions by the government.

PWC also sought clarification as to when the intention of the recipient to use the land to make taxable supplies was to be measured (new section 11(1)(mb) of the GSTA). Under proposed section 11(1)(mb) of the GSTA, a supply of land would be zero-rated if the supply is made to a registered person having the *intention* of using the land to make taxable supplies (and not intending to use the land as a principal place of residence). In their view, the wording was unclear on whether the recipient's intention is required to be tested immediately or in the future (depending on what the ultimate intention is).²²⁰

²¹⁷ Evidence/Submission *Taxation (GST and Remedial Matters) Bill* – Deloitte at <<http://www.parliament.nz>>

²¹⁸ “*GST: Zero rating of land*” Report (Policy Advice Division of Inland Revenue) at <<http://taxpolicy.ird.govt.nz/publications>>

²¹⁹ Evidence/Submission *Taxation (GST and Remedial Matters) Bill* – PricewaterhouseCoopers at <<http://www.parliament.nz>>

²²⁰ Ibid

KPMG agreed with the requirement that the vendor obtain the purchaser's GST registration as a pre-condition for zero-rating the transaction, however considered it unnecessary and unreasonable for the vendor to confirm the intention of the purchaser of the land.²²¹ KPMG submitted that the vendor's obligation should be limited to obtaining the purchaser's registration details only as it imposes additional compliance costs on the vendor. This submission was also rejected as it was not considered that this obligation will greatly increase their compliance costs.

F. Issues with the zero-rating provision

In implementing the new zero-rating provision, it appears that the government took into account some of the suggestions made in the various submissions.²²² Some of the main features of the new legislation that can be directly linked to these submissions include:

- The definition of land excluding leases where supply is made periodically.
- Section 75(3B) clarifying the record keeping requirement of the supplier.
- Section 78F requires the recipient of the supply to make certain disclosures to the supplier. Once this disclosure is made in writing, no further enquiry is required of the supplier.
- Another feature of the submissions that has not been mentioned above but has become a feature of the legislation is that the representation made by the recipient of the supply of their GST registration should also be allowed on a prospective basis.²²³

While most submissions preferred the zero-rating provision over the DRC, it is the author's view that the zero-rating provision is not without its problems either.

²²¹ Evidence/Submission *Taxation (GST and Remedial Matters) Bill – KPMG* at <<http://www.parliament.nz>>

²²² “*GST: Zero rating of land*” Report (Policy Advice Division of Inland Revenue) at <<http://taxpolicy.ird.govt.nz/publications>>

²²³ *Ibid*

1. Compliance costs

One of the concerns raised in the submissions was that the supplier would be burdened with compliance costs. The author agrees that the supplier will be burdened with extra costs in ensuring that the correct data about the transaction is maintained. Such measures are important for the supplier because it will ensure that IR cannot compel the supplier to return output tax if the supply is incorrectly zero-rated.

The author is also of the view that both the suppliers and recipients would require expert advice to ensure that there is no future liability in case of any commercial disputes. This will also increase compliance costs for both parties concerned.

2. The purchaser's statements

The GST tax treatment of these transactions is now determined based primarily on the purchaser's intentions at settlement. The purchaser is required to provide a statement in writing to the vendor where the zero-rating provision applied. Once a written statement is received from the recipient, the supplier is not required to make any further queries about the purchaser's obligation and can zero-rate the supply.

If a land transaction is incorrectly zero-rated, the new law will treat the purchaser as having supplied the land and in doing so will have to account for the GST at the standard rate of 15%. The purchaser may then be subject to interest and penalties. The onus, therefore, falls on the purchaser to ensure that all statements made to support the zero-rating treatment are correct to avoid being caught by an unexpected GST bill.

The author is of the view that the supplier should have been able to, at the very minimum, verify the GST registration status of the recipient. By checking the GST registration, the suppliers not only protect themselves from any future liability, but the recipient is also protected especially in circumstances where the recipient has genuinely made an error in their statements. This would give the recipient an opportunity to correct such errors and ensure they are not stuck with an unexpected bill later.

This is an area of the law which, in the author's view, can also be manipulated. The majority of taxpayers are compliant and are unlikely to make false representations about

their GST status or exploit any opportunities that may arise due to any weaknesses found in the GST system. However, one cannot be certain that taxpayers would not be tempted should an opportunity exist.

Where such an opportunity exists, there is nothing stopping a recipient from purchasing land and making false representations about their intention and their GST registration status. The land is then on-sold by the recipient to an unregistered party inclusive of GST and the recipient does not account for output tax on the sale to IR. The GST portion of transactions involving land can be substantial and in the author's view big enough to entice some taxpayers to obtain such benefits for their personal gains.

For such fraudulent transactions to be uncovered, it would have to be scrutinised by IR. It is a well known fact that the voluntary compliance model puts the onus on the taxpayers to get their tax affairs correct and IR would only randomly select some of these taxpayers for audit. As discussed earlier, there is a strong possibility that some of these transactions could go undetected as it would never be scrutinised by IR.

Even if the transaction is scrutinised, the author can envisage the IR having to use a lot of resources in order to uncover this web of deceit and to ensure the integrity of the tax system is maintained. This would be largely be as a result of the incorrect information retained by the supplier about the recipient and consequently IR would:

- Have issues identifying who the actual recipient is as the IR would unlikely have information on their systems about unregistered parties.
- In such circumstances, contact details of the recipient provided to the supplier is also likely to be incorrect.
- This would make recovery of any output tax from the recipient impossible.
- In circumstances where the recipient is identified, IR may not be able to recover the debt and prosecution would be the only option available to IR.

While the opportunity to exploit this area of the new law is limited, it nevertheless exists and in the author's view should perhaps have been seriously considered by the government despite the secrecy provisions. The government rejected this submission made by PWC; however, confirming an IRD number that has been supplied by the recipient with a "yes or no" answer would in the author's view not have breached any secrecy provisions.

In checking the recipient's registration status, the supplier reduces the risk of the recipient manipulating their GST status by making false representations for their personal benefit. It also provides supplier's certainty that they would not be liable for any GST in the future.

The author is of the view that this issue could have been addressed now so that the risk this issue poses does not become a major tax base risk later.

3. Potential for confusion

The author is of the view that there are some aspects of the zero-rating provision that has the potential to create some confusion.

When is the zero-rating provision assessed?

Taxpayers are used to the GST assessment of the transaction being made as at the time of supply. Under the CZR it will be assessed again at the settlement date. It will be extremely important to consider any changes in the intervening period carefully to determine that GST is properly dealt with. The addendum that has been prepared by ADLS for use for the standard agreement for sale and purchase is simply a base line document. It is not intended to cover all circumstances.

Is the zero-rating provision mandatory?

The legislation is worded that the supplier may zero-rate the transaction once a written statement is received from the recipient. This could cause some confusion and could result in some suppliers to believe that the zero-rating provision is not compulsory.

Apportionment for non-taxable use

Goods and services subject to zero-rating would be supplied on a GST inclusive basis and charged GST at 0%. As discussed earlier, the supply can be zero-rated in its entirety even if the recipient intended to use the goods partly for making non-taxable supplies. In these circumstances, the recipient will be required to account for output tax on the non-taxable use of the goods. The recipient would need to identify what the GST component would be if the standard rate of GST applied. This has the potential of causing some confusion as the apportionment rules is an area of GST which has been problematic.

Unresolved issue

An area of the zero-rating provision that requires further clarification is whether a sale of a “right of refusal” together with fixtures (being tenant improvements including building permanently attached to land) constitutes a sale of land for GST purposes.

The sale of the right of first refusal (in the event the landlord chooses to sell the property) in the author’s view would not constitute land for GST purposes. However, the fixtures are considered land and where a single supply consists of multiple elements including land, the entire supply may qualify for zero-rating.

However, while fixtures are treated as forming part of the land to which they are attached, this is generally in relation to matters that affect both the land and the fixtures. It is not clear whether this treatment would extend to a supply of the fixtures where the land itself is not included in that supply.

There is also the question of whether the improvements can be legally classified as the property of the lessee. Therefore, if a situation arose whereby a tenant occupying land on which they have created certain fixtures (improvements) proposes to sell that “right of first refusal” together with the fixtures, the question of how the transaction should be treated for GST purposes. In the author’s view, there could be an argument that there are two interpretations to this (zero-rated or standard rated) and this matter should perhaps have been clarified in the definition of “land”.

G. Summary

The author is of the view that the zero-rating provision is not without its issues either as discussed above and raises the question as to why it was overwhelmingly preferred by the stakeholders instead of the proposed DRC. It also raises the question as to whether the government has made an error in relying so much on the views expressed by the various stakeholders and introducing the zero-rating provision instead of its preferred option, the proposed DRC.

The next chapter focuses on whether the proposed DRC was the “nirvana” to the business-to-business neutrality concerns and whether the government has made an error in legislating for the zero-rating provisions.

VIII. DOMESTIC REVERSE CHARGE V ZERO-RATING

According to the paper written by Ine Lejeune of PWC Belgium called ‘The EU VAT Experience’, when designing a best practice VAT model, a balance must be found amongst the objectives of the three stakeholders concerned: the government, businesses and the citizens.²²⁴ The paper explains that the government’s aim is to increase its budget by maximising tax revenue and therefore allowing it to invest in the country (infrastructure, healthcare, education, etc) and to attract and retain businesses while creating new jobs and securing existing ones.²²⁵

Businesses act as unpaid tax collectors in a GST system and must be able to compete globally and deliver a sustainable profit to its shareholders without the risk of violating the GST rules. Citizens, as the final consumers, are looking for a fair tax that is not regressive or inflationary. Citizens also expect the revenue to be invested by the government to provide long-term benefits such as jobs.²²⁶ The author is of the view that the introduction of any new legislation must also take into account the impact on all stakeholders so as to ensure that none of the stakeholders are disadvantaged at the expense of another.

The author agrees that the proposed DRC would have removed cash flow concerns from parties involved in the transactions for the period between which the tax was paid and the input tax deduction was allowed. Further, the DRC would significantly reduce the risk to IR that GST would not be paid after refunding an input tax deduction on a transaction to taxpayers.

In cases where the DRC clearly applied, it was considered to be better than the zero-rating provision because it reduced the potential for commercial disputes between the vendor and purchaser as it clarified whether a sum was either GST inclusive or exclusive (for example transactions involving going concerns where the rules have not been as clear as they could be).²²⁷ Transactions subject to DRC would have been exclusive of GST and any subsequent disputes that can happen with zero-rating

²²⁴ Ine Lejeune “*The EU VAT Experience: What are the lessons learnt?*” at <<http://www.taxanalysts>>

²²⁵ Ibid

²²⁶ Ibid

²²⁷ Submission on “*GST: Accounting for land and other high-value assets*” 18 December 2009 at <<http://www.nzica.com>>

transactions, especially in instances where transactions come under the scrutiny of IR and a dispute arises as to whether the transaction was correctly zero-rated is eliminated.²²⁸

Further, according to NZICA,²²⁹ the proposed DRC would also have been consistent with the input tax apportionment rules which were separately proposed as part of the government's tax reforms. Therefore, there could be a potential argument that by not implementing the DRC, the government has missed an opportunity to deal with the business-to-business neutrality concerns if the risk to the revenue base was as significant as the government has stated it to be.

Significantly though, given the advantages of the proposed DRC, it received little support in the submissions received by the government. The author submits that there are a number of reasons for this. Firstly, despite the proposed DRC being marketed as being advantageous for all stakeholders, there was possibly the perception amongst the stakeholders that it would be the government that would benefit the most from the proposed DRC. While there is no doubt that the proposed DRC would have been beneficial to other stakeholders, on balance, this benefit in the author's view is not as significant as the benefit it provides to the government.

Further, while most submissions agreed in general with the need to address fraudulent transactions, they were unaware as to the extent of this problem. The government did not provide enough analysis on the extent of the problem and risk to the tax base to support the introduction of the DRC. For these reasons, they could not support the introduction of the proposed DRC.

The author agrees with NZICA that the level of analysis in the discussion documents did not delve deep enough in respect of the risks associated with the use of phoenix type entities, and timing mismatches.²³⁰ In other words, the government was not able to quantify the extent of the problem and provide data to the stakeholders to be able to convince them that the fraudulent activities of a minority of taxpayers warranted such a fundamental change to the majority.

²²⁸ Ibid

²²⁹ Ibid

²³⁰ Ibid

Whether the government would have received any extra support by providing the stakeholders with extra information about the phoenix problems is in the author's view debatable. Even if the government did get more support for the proposed DRC, it is unlikely that the extra support would have been enough to justify the introduction of a concept which, in the author's view, had so many flaws.

Perhaps more importantly, the extended zero-rating provision also works in a similar manner to insulate the IR against the possibility that after having paid an input tax credit, it will not be able to recover output tax. This immediately raises the question as to why introduce something new when the use of an existing legislation would produce a similar result for the government (without burdening other stakeholders with compliance costs).

The author has found it difficult to understand why the government even considered the DRC as an option in the first place and invested the resources it did given that the same tax base protection could have been achieved with the zero-rating provision. The proposed DRC was never going to be the "nirvana" that was going to solve the business-to-business neutrality issues. The discussion below focuses on other aspects of the proposed DRC that adds to the author's argument that the extended zero-rating provision was the better option.

A. DRC introduces new GST concept - creates uncertainty and complexities

In general, most stakeholders highlighted that the DRC would introduce a new form of transaction that would add to the complexity of the GSTA. The concept of reverse charge is not new, section 8(4B) of the GSTA²³¹ deems a supply to have been made by the recipient of imported services when certain conditions are met.

According to section 8(4B) of the GSTA, if the services acquired by the recipient is taxable if it were acquired in New Zealand, then the importer of the services has to self-assess on the value of the supply received and make output tax adjustments in their GST returns filed with IR. In instances where the recipient is not GST registered and the GST

²³¹ Goods and Services Tax Act 1985

registration threshold is breached, the importer of the services is deemed to be registered and must also return output tax in respect of the supply received.

However, given that the reverse charge rules are rarely applied in practice and its awareness amongst those people affected not likely to be great, the author agrees that the compulsory nature of the DRC would have introduced a new form of transaction for the majority of people in the GST net.

It is the “settling in” period when the legislation is in its infancy that has the potential to create taxpayer uncertainty and confusion. This increases taxpayer anxiety and also has the potential to make a piece of legislation appear more complex than it really is.

The confusion and uncertainty would in the author’s view arise from the fact that despite the goods and services subject to a DRC being supplied “exclusive” of GST; the supplier would still be entitled to an input credit in respect of that supply. In general, sales that are made exclusive of GST fall outside the GST net and these include supplies which are exempt from GST (e.g. financial services, supplies of residential accommodation etc).

Taxpayers are not entitled to an input tax deduction for expenses incurred while making exempt supplies. A taxpayer is only entitled to an input tax credit if the good or service has been acquired for the principal purpose of making taxable supplies (this has been changed recently as well but is not the focus of this paper).

While this concept of having the right to an input tax deduction while making GST “exclusive” supplies would only apply to transactions involving DRC, it is the author’s view that this concept had the potential to create confusion involving non-DRC transactions.

The author is of the view that taxpayers who are responsible for the preparation of their own GST returns without the assistance of tax agents and in general have very little experience with GST would have presented the greatest risk to the revenue base by claiming input tax deductions in respect of non-DRC transactions (in particular those that are exempt and exclusive of GST).

As 96% of the businesses in New Zealand are small to medium in size,²³² it is expected that a large number of these businesses would have staff (including owners) responsible for preparing the GST returns. In some circumstances, these staff would have very limited experience with GST. Consequently, it is possible that a taxpayer subject to a DRC transaction could apply the same logic in a subsequent transaction that was genuinely “exclusive of GST” (e.g. exempt supplies) to claim an input tax deduction in respect of that supply. In other words, the taxpayer could potentially claim an input tax deduction they were not legally entitled to.

The proposed DRC also had the potential to create opportunities for those very taxpayers that the proposed DRC legislation was designed to stop. It is the author’s view that this confusion and uncertainty could have provided the means for some taxpayers to fraudulently claim input tax credit in respect of supplies that were exclusive of GST but not subject to the DRC. The author is of the view that in these circumstances, certain taxpayers would be willing to take the risk that their tax position would not be scrutinised by IR.

The New Zealand tax system is based on a voluntary compliance model and the government has an expectation that most taxpayers are compliant in meeting their tax obligations. However, a review of their tax affairs on a regular basis by IR is required to provide government with confidence that this compliance model is working and the risks associated with such a tax model is within expectation. When this review by IR occurs, one cannot be certain. Potentially, it could happen immediately after a taxpayer has entered into the transaction or several years after. These taxpayers are willing to take the risk that it is the later that will apply in their circumstances.

However, where this risk does not pay off and the taxpayer’s position is scrutinised by IR, unless the taxpayer is known to be non-compliant by IR or to have previously made similar input tax claims in respect of non – DRC transactions, the taxpayers could potentially use the confusing nature of the DRC rules as a means to justify their actions. It would be very difficult for IR to suggest otherwise despite the fact that the taxpayer was well aware of how the proposed DRC actually worked.

²³² Inland Revenue “Reducing tax compliance for small to medium enterprises” Discussion Document (Inland Revenue, Wellington, December 2007), pg 2

Further, if the time lapsed since these transactions took place and when the transaction is actually scrutinised by the IR is substantial (more than 4 years), unless the IR had evidence to determine that these transactions were fraudulent, time bar rules could prevent the money from ever being recovered from these taxpayers.²³³ There could also be instances where businesses may no longer be in existence, people have moved abroad or are deceased by time the errors are discovered. This could result in substantial revenue loss for the government.

The author is also of the view that in circumstances where taxpayers are still in business and such errors (genuine and fraudulent) are discovered by IR through its audit intervention, it could potentially create a further dilemma for the IR. Whenever tax shortfalls are assessed by IR, consideration has to be given to tax shortfall penalties as well.²³⁴ Where the IR has evidence that proves beyond reasonable doubt that a taxpayer has fraudulently claimed deductions for input tax credit, then the appropriate level of shortfall penalty can be justified.

However, this issue becomes contentious where there is a strong indication that the taxpayer has manipulated the DRC rules to create the GST input tax credit; however, there is not enough evidence to prove that this was the case. To ensure that the integrity of the tax system is maintained, IR would, in the author's view, have to impose the same level of shortfall penalty as it would in situations where the input tax deductions were genuinely claimed in error. This hardly seems fair given the circumstances in which these errors occurred.

The introduction of the DRC would also have resulted in the change in the time of supply rules. It was proposed that time of supply would occur when payment was required. In general, the time of supply is triggered at the earlier of the issue of an invoice or receipt of payment. However, time of supply rules for transactions subject to DRC would not occur until full payment was required to be made to the supplier (deposit would not trigger time of supply). Again, this departure from the general GST rules would have had the prospect of causing confusion and open for manipulation by those taxpayers determined to exploit the GST system.

²³³ Section 108A of the Tax Administration Act 1994 – *Time Bar for Amending GST Assessment*

²³⁴ Section 141 of the Tax Administration Act 1995 – *Tax Shortfalls*

The proposed DRC could perhaps have been introduced on a voluntary basis as opposed to being compulsory. Some submissions preferred for the DRC to be on a voluntary basis and for taxpayers to elect into the DRC as proposed in Australia. This would have given the taxpayers in New Zealand some time to get acquainted with this new concept and be better prepared for it if or when the DRC was made compulsory.

The zero-rating provision on the other hand has been used in New Zealand for over twenty years and has gone through a period where there was tax and commercial uncertainty about its application.²³⁵ Despite this pain and cost, it is now a well understood and generally accepted aspect of the GST legislation.

While the zero-rating provision also has the potential to create confusion amongst taxpayers as discussed in the previous chapter, the author is of the view that it still provides a level of certainty that the proposed DRC would not have been able to. The zero-rating provision does not introduce a new form of transaction like the proposed DRC does.

It is the author's view that to deal with the business-to-business neutrality issues, a set of rules that provides certainty is required. In this case, as the zero rating provision has been in use for a longer period and been through its period of confusion and uncertainty, it provides taxpayers a level confidence in its operation that the DRC would not have.

B. GST rules – keeping it simple

The New Zealand GST system is revered around the world because it is a simple and a well understood model. While several GST models around the world such as the UK have had their fair share of issues, for the large part the GST model used in New Zealand has been void of any major issues since its implementation.

As discussed earlier, there was a determination at the very highest level of policy development to keep the GST system very simple and to avoid the mistakes and complexities of overseas VAT systems. The earlier discussion highlighted how the introduction of the proposed DRC could have created uncertainties and added to the

²³⁵ Submission on “*GST: Accounting for land and other high-value assets*”, pg 6 at <<http://www.nzica.com>>

complexities of the GSTA. Increasing the complexity of the GSTA would clearly not be in line with what policy developers have tried to achieve from when the GST model was initially developed.

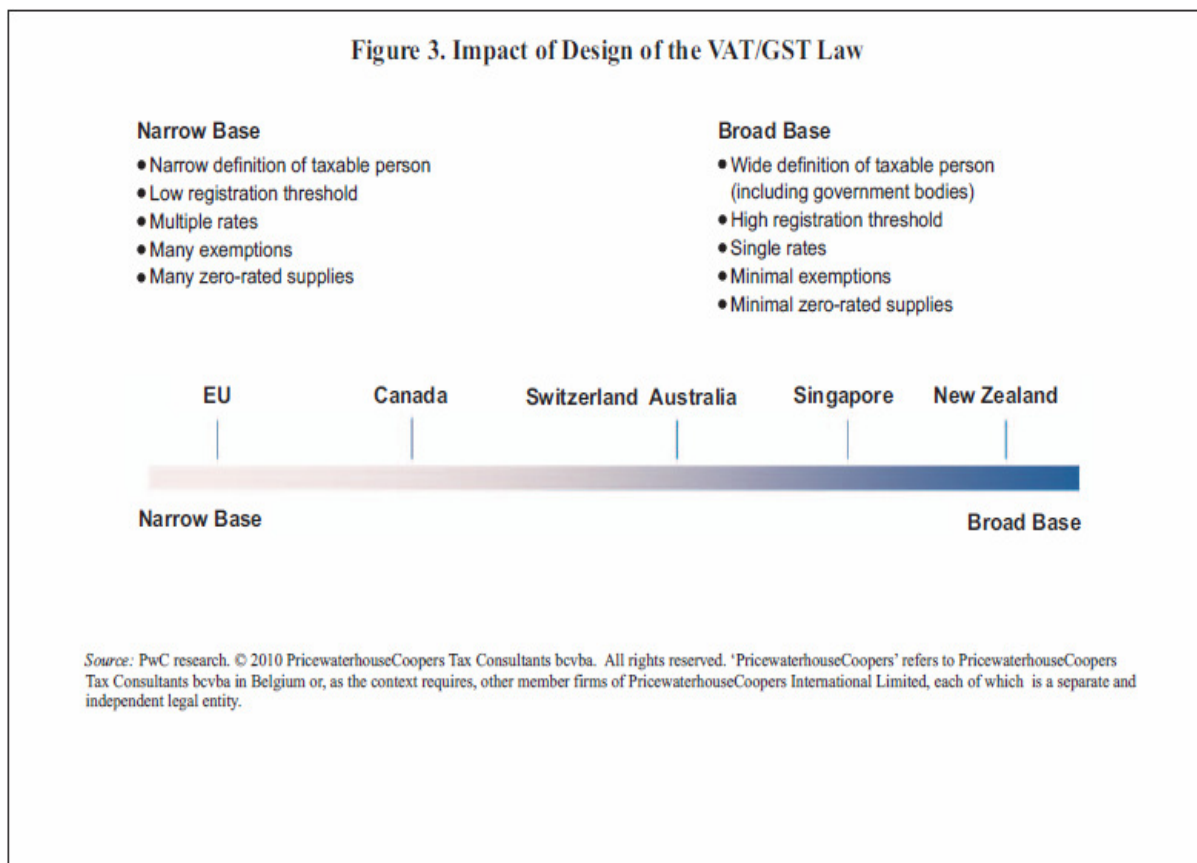
The IMF has also recommended some best practices to be used in VAT design, and these are as follows:²³⁶

- a single rate rather than multiple rates;
- a single, relatively high threshold regarding turnover;
- a broad base with minimal exemptions to avoid distortion of purchase (input) decisions and to provide transparency;
- use of the destination principle whereby exports are zero-rated and imports are taxed;
- use of the invoice-credit method whereby output VAT remitted is reduced by input VAT paid on purchases and imports; and
- the timely provision of input credits for the purchase of capital goods.

The diagram below represents research done by PWC on the impact of the design of the VAT/GST Law and PWC's view on how various countries stack up on this best practice model.²³⁷

²³⁶ Ine Lejeune "*The EU VAT Experience: What are the lessons learnt?*" pg 267 at <<http://www.taxanalysts.com>> last accessed 15 March 2011

²³⁷ Ibid, pg 281



According to the research, the GST model used in New Zealand is ranked as the best and its features are the closest to what PwC views are the features of a best practice GST model. It is the author's view that by complicating the GSTA through the introduction of the DRC, New Zealand's GST model would have moved further away from what is considered to be the best practice model.

While the policy designers should be applauded for this achievement, in the author's view, it brings up a very intriguing question, that is, whether keeping things simple is going to be appropriate at all times? There might come a time in the future when difficult measures might have to be taken and decisions made that require the use of complex legislation to deal with problems created by the GST model. While there is no doubt keeping things simple has worked for New Zealand, there might come a time in the future where use of complex legislation like the DRC might be required to deal with issues like "phoenix entities" and carousel fraud or timing mismatches, especially if these issues keep evolving.

However, in this instance, an alternative approach like the zero-rating provision which has been part of the GSTA for over 20 years is available so policy makers have been

spared from making such a tough decision. Even though there are aspects of the zero rating legislation that has the potential to cause uncertainties which in turn could complicate matters, it is the author's view that this is minor in comparison to the confusion and complexities that the proposed DRC would have created.

C. Compliance Costs

Inland Revenue's compliance strategy is based on voluntary compliance.²³⁸ IR begins by trying to make it easy for people to comply, by informing taxpayers of their obligations, and providing a mix of services to support payment. When a taxpayer does not meet their tax obligations, IR can encourage and enforce compliance by a range of measures.

Compliance with tax laws can entail significant time and costs for many businesses. Compliance costs can arise because of the variety of tax compliance activities involved (for example, performing tax calculations, seeking advice, record-keeping, filing returns and making tax payments) and the complexity of tax law and administrative procedures.²³⁹

In general, most submissions agreed that the introduction of the proposed DRC would add to compliance costs. The proposed DRC would have required a change to most GST systems so that transactions that would be subject to DRC and those that were not could be identified and processed accordingly for GST purposes. Transactions subject to DRC would be exclusive of GST, however, any expenses incurred in respect of that supply would be deductible. GST systems would have to be designed to recognise this as well and also separate those transactions that were legitimately exclusive of GST (e.g. exempt supplies).

Furthermore, under the proposed DRC, the supplier was also required to keep a record of the prescribed information to ensure that they were not penalised in the future in the event it was later found that the supply should not have been subject to the DRC. This

²³⁸ <http://www.ird.govt.nz/aboutir/reports/soi/soi-2009-2012/soi-2009-part3-strategic-overview/soi-2009-part3-compliance.html>

²³⁹ Inland Revenue "Reducing tax compliance for small to medium enterprises" Discussion Document (Inland Revenue, Wellington, December 2007), pg 1

would no doubt have required further changes to the GST system or at the very least minimal change to the system to ensure compliance requirements were being met. These changes would have required an outlay of funds by those affected and in some cases, major changes might have been required to the GST systems which could have required substantial capital outlay.

The timing of the proposed DRC would also have put extra burden on the affected taxpayers. The collapse of the global financial markets has resulted in the world economy slowing down and the flow on effect has had some dire consequences for businesses.

The introduction of the proposed DRC would have put further pressures on these businesses that it could ill-afford due to the economic climate. Given that 96% of the businesses in New Zealand are small to medium in size,²⁴⁰ this had the potential to have a disastrous impact on those businesses that were already in financial distress. The extra funding required to meet the compliance obligations might not have been within the means of some these businesses and extra funding from banks might not have been an option for some either.

In 2007, the government released a discussion document titled 'Reducing tax compliance costs for small and medium-sized businesses'.²⁴¹ The discussion document highlighted that the 2006 Business Tax Review noted that reducing tax compliance costs can help boost productivity and competitiveness as it would allow more resources to be applied to core business activities.²⁴² The introduction of the proposed DRC would have increased compliance costs at a time businesses needed to be as competitive and productive as they could be.

Perhaps more importantly for the government, implementing new legislation that would increase compliance costs so soon after releasing a discussion document seeking measures to reduce compliance costs would not have been a good policy decision. Further, if the proposed DRC would have been legislated, it is the author's view that the citizens of New Zealand would also have been burdened with these costs as businesses

²⁴⁰ Ibid, pg 2

²⁴¹ Ibid

²⁴² Ibid

would have ultimately passed these costs on to them through increases in the price of goods and services.

Taxpayers might also have needed extra advice in respect of transactions involving the proposed DRC from their tax agents (at least until such time they were familiar with such transactions). Those taxpayers that prepare their own GST returns and enter into transactions subject to DRC might also have required extra time to complete their GST returns to ensure it was correct.

Once again, perhaps more could have been done by the government to ease fears about the increase in compliance costs for businesses. In the UK, the tax authority worked with Oracle to help ease fears about compliance costs of the business community. Perhaps the New Zealand government could have been done something similar and worked with software developers to assist the business community.

The government could have offered incentives to businesses like interest-free loans and tax breaks to ease this burden on taxpayers. However, despite this assistance, the author is of the view that taxpayers who have been fully compliant would still be unhappy to be burdened with the extra cost of compliance as a result of a few non-compliant ones. As the majority of the taxpayers in general are fully compliant, burdening this majority at the expense of a handful of taxpayers is very difficult to justify unless evidence is available to verify the risk to the tax base.

It is the author's view that the government had not provided enough evidence to justify the introduction of the proposed DRC and to show the benefits of the proposed DRC outweighed the compliance cost.

The zero-rating provision on the other hand will also create compliance cost issues; however, taxpayers would not have to dig as deep into their pockets to make the changes required to be fully compliant when compared to the proposed DRC. The zero-rating provisions will require the supplier to obtain and retain information about the recipient to ensure that the transaction was correctly zero-rated. This would ensure that the supplier was not disadvantaged if it was later found that the transaction should not have been zero-rated. This would no doubt add to the compliance costs, however, as

systems would already be in place to capture other zero-rated transactions, this would in the author's view be relatively small.

Therefore in conclusion, it is the author's view that the decision not to introduce the proposed DRC can also be justified because of its impact on compliance costs.

D. Audit trail – unintended consequences

The author is also of the view that the proposed DRC would have created an unintended consequence, the lack of an audit trail for both the taxpayer and IR auditor. As discussed earlier, the introduction of the DRC had potential to cause confusion amongst taxpayers largely from the fact that transactions subject to DRC would be exclusive of GST. However, input tax credit in respect of these supplies would still be available to taxpayers.

It is the author's view that transactions that are "inclusive of GST" provides both the taxpayer and IR with what the author calls a "visible audit trail". In other words, one is able to identify at a glance from the cover of the S & P that somewhere along the chain of supply, if the property was to exit the GST net, there would be an output tax obligation placed on a taxpayer as the supply had been made inclusive of GST (zero or standard rated). This visible audit trail is lost if the supply is made "exclusive of GST" as proposed by the DRC and one would have to delve a little deeper before it becomes obvious that there will be an output tax obligation when the land in questions exits the GST net.

This becomes a major risk to the tax base and could potentially result in a loss of government revenue.

The following example will explain how this unintended consequence can occur:

- A commercial building is sold by taxpayer A to taxpayer B. As both taxpayers are GST registered and other requirements are met, the sale is subject to the DRC and the recipient self assesses for GST on the supply.

- 2 years later, taxpayer B sells the same property to taxpayer C who is also registered for GST. This supply is also subject to the DRC.
- Due to a change in council zoning rules, the property in question can now be developed into a residential property and this has made the property even more valuable due to its location.
- 4 years after purchasing the property, taxpayer C sells the property to taxpayer D who is not registered for GST. The S & P signed between taxpayers C & D is exclusive of GST.
- This decision was made by taxpayer C because the S & P he had signed when purchasing the property from taxpayer B was exclusive of GST. Unfortunately for taxpayer C, he overlooked the clause about the transaction being subject to the DRC.
- Taxpayer C also did not seek any professional advice on how the transaction should have been treated for GST purposes when he sold the property to taxpayer D. Consequently, as the sale by taxpayer C to taxpayer D had been exclusive of GST, taxpayer C assumes that he has no obligation to return output tax in respect of the supply.
- Taxpayer D builds a family home within a year of the sale and has moved into the residence with the family.
- A year later, taxpayer C is selected for an audit by IR.
- The IR auditor obtains all the required details from the taxpayer and notices that the S & P is exclusive of GST. The page with the clause in respect of the sale being subject to DRC is missing.
- As part of the investigations, the IR auditor also acquires information that indicates that the property is residential and taxpayer D resides there.

Given the above scenario, there is a possibility that the IR auditor could reach the same conclusion as taxpayer C and agree with the taxpayer that the sale was an exempt supply. While the possibility of this happening is very remote, it nevertheless exists. An IR officer under duress and pressure could potentially make the same error. This would result in lost revenue to the government.

However, if the transaction was inclusive of GST (zero or standard rated), it is unlikely that taxpayer C would make such an error. The front page of the S&P which would show that the transaction was inclusive of GST would be a “trigger” that would alert taxpayer C of their GST obligation. Even if for some reason taxpayer C made the same error as shown in the example, it would be expected of the IR auditor to identify this regardless of the stress or duress they were under.

The zero-rating provision in the author’s view provides IR with a valuable tool that from the outset allows it to visualise the outcome of the audit, that is, somewhere along the supply chain there would be an obligation for a certain taxpayer to pay output tax.

E. Audit intervention resources

The above scenario also presents another dilemma, that is, if the DRC was the answer to stopping GST fraud in transactions involving land, would IR’s increased scrutiny of this risk area continue given that new legislation had been introduced to deal with this very issue? The use of “phoenix type” entities was considered to be prevalent in property transactions. If the proposed DRC was the answer to such risks, then one has to assume that the IR would have to reduce its audit focus in this sector and divert its resources to other risks areas.

The author is of the view that the introduction of the DRC would still have required a substantial audit focus, especially in the initial settling in period while the legislation was new. The new legislation would in the author’s view still present taxpayers with opportunities to exploit the GST system. To ensure that taxpayers got the message that IR would still scrutinise such transactions, audit intervention would have been required. Audit intervention would also be required to give government confidence that the change in legislation has resulted in a decline in the use of fraudulent means to obtain a GST advantage.

Given the confusing and complex nature of the DRC, audit intervention might have been required for a substantial period of time until the government was confident that the legislation was working as it was meant to. The author is of the view that serious questions would have been asked of the government and IR of the need to scrutinise this area of the risk given that new legislation had been introduced. As overseas experience has shown, the introduction of DRC also has the potential of shifting the fraud to other sectors. There would have made matters worse for the government as serious questions about the allocation of IR's audit resources would have been posed.

The introduction of the zero-rating provision would also require the investment of resources by IR for audit purposes. However, given that the legislation has been used for over 20 years, the government would take some comfort in knowing the zero-rating provisions works as it is intended to in reducing the risk to the government tax base. It has been through its period of settling in and several issues have been addressed in Court. The author is of the view that audit intervention would be minor in comparison to what would have been required if the DRC was introduced. This would allow IR to apply its limited resources in other areas of risk ensuring that government tax base is well protected.

F. The scope of the DRC

The DRC in the UK applies to computer chips, mobile phones and only recently has been increased to include carbon trading as part of HMRC's plan to combat Missing Trader Intra-Community (MTIC). The proposed DRC in Australia on the other hand would only apply to supplies of going concern and farmland.

The DRC proposed in New Zealand was comprehensive in comparison to Australia and the UK. All land transactions, supply of going concern and high value assets in excess of \$50 million would have been subject to the DRC. Such a comprehensive application remains untested and as seen by the UK experience, there is already concern that those that participate in such fraudulent activities move into other sectors as a result of the introduction of the DRC.

A similar trend in New Zealand after the introduction of the proposed DRC could potentially have been disastrous to the New Zealand economy. As discussed in the earlier chapters, there is an increased reliance on tax revenue from GST by the government. The recent increase in the GST rate and the decrease in company and personal tax rates mean that going forward, the tax take from GST will become even more important to the government. The potential for the DRC to expose other sectors to fraudulent activities could result in a decrease in GST tax take from these other sectors.

A decrease in the tax take could potentially mean that the government is unable to fund its economic and social policies. The flow on effect from this can result in the increase in unemployment and possibly crime as well

With the current situation (DRC not introduced), the government is aware of the sectors in which the fraudulent activity is the greatest (supplies involving land transactions) and can target their audit activities in these sectors (via IR). The increase in the funding to IR in recent budgets to target the property market and the hidden economy is an example of how the government can focus its resources.

There have never been such fears identified about the zero-rating provision. Given that the zero-rating provisions has been around over 20 years and issues in respect of it have been settled in the Courts, the zero-rating rules are less likely to be open to manipulation and fraud. The author is of the view that the extended zero-rating provision allows the government to reduce risks associated with land transactions going forward and still focus its limited compliance resources on land transactions, a sector which provides the greatest revenue risk for the government.

G. Timing of DRC - “The ship has sailed”

It was considered that transactions involving the land sector provided the most opportunities for the use of “phoenix type entities” and timing mismatches to exploit the GST system. Given that the property market was at its peak when the risks were first identified, perhaps the introduction of the DRC could have been justified.

These risks were first identified in the discussion document released in 2008 and one can therefore assume that the government was aware of these risks well before the

discussion documents were released. It has taken the government approximately four years from when the first discussion document was released to implement the new legislation (zero-rating provision which came into effect from 1 April 2011).

The business world that we operate in has changed remarkably in this time due to events like the financial market collapse. This has had a major impact on the world economy and has had consequences for the property market in New Zealand as well. It has been noted that there has been a considerable downturn in business in the real estate sector.

As the proposed DRC could not be applied retrospectively, the introduction of the DRC in the author's view from a timing perspective could not be justified. Some of the reasons for taking this view are:

- The downturn in the property market over the years would have meant fewer opportunities available for taxpayers to use such tax evasive schemes. With the level of activities in the property sector dropping, there would have also been greater risk of taxpayers being exposed to IR scrutiny thus it was less likely that taxpayers would engage in such fraudulent activities.
- In earlier discussions, it was mentioned that the introduction of DRC could result in the fraudulent activities spreading to other sectors. There is also a possibility that this has already happened even before any new legislation would have been introduced so again this could have been a waste of government resources.

The extension of the zero-rating provision also reduces the risk to government revenue in respect of land transactions going forward. Potentially, this again is too little too late due to the decline in the property market. However, as the zero-rating concept is not new and has been part of the New Zealand legislation for over 20 years, it is less likely to create any debate about the timing of its introduction as opposed to the DRC which was a very new concept.

Perhaps in the future, what the government needs is the ability to deal with threats to its tax base in real time. This would mean once an issue has been identified, the government can make changes to legislation immediately to deal with such issues. This

may seem draconian and somewhat undemocratic, however, if the government is able to present to those affected by its decisions some verifiable evidence of such threats, then opposition to such measures might not be a major issue.

Taking such drastic measures will ensure that threats to the tax base are dealt with as quickly as possible and the revenue loss is restricted unlike what is currently happening. It will also enable the government to move quickly to protect other sectors if there is any suggestion that other sectors have been affected as a result of any legislative changes. Currently, by the time measures are brought in to deal with risks to the tax base, it is often too late and taxpayers have moved on to other sectors where opportunities to exploit the GSTA exists.

H. Political Viewpoint

The author considers that from a political viewpoint, it would not have been in the government's best interest to introduce a concept like the DRC which in the view of many would have increased the complexity of the GSTA. The government could potentially have alienated itself from taxpayers affected by its decision and given the tough economic conditions the world is currently faced with, this might not have been the wisest move.

As discussed earlier, the ordinary citizens of the country could potentially also have been affected by the proposed DRC as a result of businesses passing on the increase in compliance costs via increases in the price of goods and services. The government has ensured that the ordinary citizens of the country are not affected by its decision. Given that the GST rate has recently increased, the last thing the government would want is to answer further questions about the increase in the cost of living due to businesses passing on the increased cost of compliance to its customers. With the general elections around the corner, the government has made a sound policy decision by not introducing the DRC.

The extension of the zero-rating provision was perceived to be the better option according to the submissions made by stakeholders. By agreeing with the submissions, the author is of the view that the government has shown that it is open to dialogue with

stakeholders and this creates a bond of understanding between the government and all the stakeholders concerned, especially during these difficult times.

IX. CONCLUSION

The focus of this paper was to consider whether the proposed DRC was the “nirvana” that would have solved the business-to-business neutrality issues or if the correct decision has been made by the government in legislating for the zero-rating provision. On balance, while there were many advantages in legislating for the proposed DRC, it is the author’s view that the proposed DRC was not the solution to the business-to-business neutrality issues identified by the government.

As discussed in the earlier chapters, the introduction of any new legislation should not disadvantage one stakeholder at the expense of another. While the proposed DRC would have been of benefit to all stakeholders, there is no question in the author’s mind that the government would have had the most to benefit if the proposed DRC had been legislated for. The proposed DRC would certainly have reduced the risk of revenue loss to the government.

There was also the possible opportunity for the New Zealand Government to once again lead the world in introducing new innovative tax policies on a scale not seen before; however, once the novelty of the legislation would have worn off, the negatives of the proposed DRC would have outweighed the positives. It is the author’s view that the same tax base protection can be achieved by the extended zero-rating provision.

In summary, the proposed DRC in the author’s view would have:

- added to confusion and created uncertainties by the introduction of a new concept. This could have resulted in some genuine errors being made by taxpayers while also opening up opportunities for those trying to exploit the GST system.
- moved the New Zealand GST model further away from what is considered to be the best practice model due to the confusion and complexities created by the proposed DRC. The NZ GST model is revered around the world and according to the best practice VAT model, is one of the best in the world.

- added to compliance costs. Businesses in New Zealand are generally small to medium in size and given the state of the world economy, the added costs as a result of the proposed DRC would have impacted on businesses productivity and their competitiveness.
- created unintended consequence. The proposed DRC would have resulted in the loss of what the author considers to be a “visual audit trail” for the taxpayer and IR alike.
- resulted in questions been asked of the government’s allocation of resources to IR as substantial audit intervention would still be required by IR of transactions subject to DRC.
- potentially increased the scope of the DRC. As experience of the UK domestic reverse charge has shown, the fraud would have eventually moved to another sector. These other sectors could also have been burdened with an increase in compliance costs , something New Zealand’s business sector could ill-afford in the current business climate.
- been “too little too late”. According to the government, the risks associated with the use of phoenix type entities was considered to be greatest in transactions involving land. The property market has slowed down considerably due to the downturn in the world economy. One has to question the timing of such comprehensive legislation and why it was not considered when the property market was at its peak.
- from a political viewpoint, been a bad decision. Legislating for the proposed DRC that most submissions including NZICA were not in favour of could have alienated the government from the business sector. The ordinary citizens of New Zealand could potentially have been affected as well if compliance costs were passed on to them.

It is the author's view that the extended zero-rating provision can achieve the same results for the government in respect of the business-to-business neutrality issue without creating too much of a burden on the taxpayers.

While the zero rating provision has the potential to create some issues as well, on balance, it is considered to be the better option in this instance because:

- it provides a similar tax base protection as the DRC.
- it is a well understood concept and has been part of New Zealand's GST legislation for the last 20 years.
- while there will be an increase in compliance costs, it would not be as substantial as the compliance costs created by the proposed DRC.
- the zero-rating provision provides both the taxpayers and IR with an audit trail.
- it is politically a wise decision by the government. The government has given the message it is willing to listen to its citizens.

Therefore, in conclusion it is the author's view that the government has made the correct decision in extending the zero-rating provision as the proposed DRC was not the answer to solving the GST business-to-business neutrality issues. However, as with any changes or introduction of new legislation, this question can only be answered for certain over time as the use of the new zero-rating rules by taxpayers' increases and it comes under the scrutiny by IR. It is once this position is reviewed by the government in the future that a clear answer will emerge.

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