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GST – Current Issues
c/- Deputy Commissioner, Policy & Strategy
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GST – Current Issues: an Officials' Issues Paper

Introduction

1. The New Zealand Law Society welcomes the opportunity to comment on *GST – Current Issues: An Officials' Issues Paper* released on 17 September 2015 (Issues Paper). The Law Society considers that the proposals to address the policy and administrative issues identified in the Goods & Services Tax Act 1985 (the Act) are largely positive. New Zealand's GST regime is notable for its general adherence to policy principles and therefore the Law Society supports proposals for change which ensure the Act operates as intended.

2. While the Law Society supports Inland Revenue's ongoing process to identify and remedy perceived concerns with the GST regime, it submits that some of the proposed changes are either too cumbersome or impose unnecessary compliance costs on both taxpayers and Inland Revenue, and may benefit from further consideration.

Summary of Recommendations

3. For the reasons explained below, the Law Society recommends that:

   (a) The proposal to allow input tax deductions for the cost of raising capital be adopted, but that proposal should:

      (i) be extended to cover the "financial services" under sub-paragraphs (g) and (h) in addition to (c) and (d); and

      (ii) not require taxpayers to calculate that apportionment using the turn-over method but instead should permit a choice of determination method that produces a "*fair and reasonable result*", as presently required under section 20(3G).

   (b) The proposal to allow taxpayers to aggregate their inputs and apply a single method of apportionment across all those supplies should be adopted as a welcome measure to reduce compliance costs, but that proposal should:

(i) not require taxpayers to obtain the prior agreement of the Commissioner; and

(ii) allow for agreements to be entered by industry bodies, rather than only by individual taxpayers, similar to that permitted for zero-rating of financial services under section 20F(1); and

(iii) not be restricted only to taxpayers with a turnover of $24 million per year but be available to all taxpayers.

(c) The proposal to clarify the extent to which services are supplied "directly in connection with" land in New Zealand be delayed until a consistent policy response can be reached to ensure that clarification is appropriate for all similar provisions that adopt that same phrase.

Cost of financial services in raising capital

4. The Law Society welcomes Inland Revenue's acknowledgment that the cost of raising capital by a GST registered taxpayer relates to the conduct of its taxable activity and furthers its ability to make taxable supplies.[1] This approach accords both with:

- the general policy of the Act to prevent tax cascades arising from financial services provided to GST registered taxpayers for the purpose of the taxable activity, under sections 11A(1)(q) and (r), Goods & Services Tax Act 1985; and
- the wider interpretation of what expenses give rise to input tax under section 3A and section 20(3C) on the basis they were incurred in making taxable supplies.[2]

5. The enhanced ability for registered persons to claim input tax on the costs associated with raising capital is welcomed. However, the Law Society submits that restricting this proposal to a narrow range of financial services is unwarranted and will therefore remedy only part of the GST cascade problem identified by officials.[3] The two specific concerns with the proposal are detailed below.

Nature of financial supplies included in proposal

6. At present the proposal extends only to two types of financial services defined under section 3(1):

(c) the issue, allotment, drawing, acceptance, endorsement, or transfer of ownership of a debt security; and

(d) the issue, allotment, or transfer of ownership of an equity security or participatory security.

7. Taxpayers would therefore be able to claim input tax on the costs associated with these financial services. The costs identified by officials in the Issues Paper include "*NZX fees, legal costs and advisory costs for preparing financial statements*". However, the Law Society questions why other commonly-related financial services obtained by registered persons when raising capital in the course of their taxable activity (which also give rise to a similar cascade of GST) are excluded from the proposal. For example, there appears to be no policy justification for excluding either sub-paragraphs (g) and/or (h) of section 3(1) from the proposal:

[1] At 2.5

[2] See *CIR v Trustees in the Mangaheia Trust and Trustees in the Te Mata Property* (2009) 24 NZTC 23,711.

[3] At 2.11

(g) *the renewal or variation of a debt security, equity security, participatory security, or credit contract:*

(h) *the provision, taking, variation, or release of a guarantee, indemnity, security, or bond in respect of the performance of obligations under a cheque, credit contract, equity security, debt security, or participatory security, or in respect of the activities specified in paragraphs (b) to (g).*

8. First, if the "*issue, allotment or transfer*" of a debt or equity security warrants the recovery of GST costs for the reasons set out by officials, it is difficult to understand why costs associated with the "*renewal or variation*" of those same securities should be excluded.

9. It seems arbitrary to permit GST recovery on entering into a replacement (and therefore new) debt security but not a renewal of the existing facility. This would create a distortion and a difficult boundary issue between renewing an existing debt security and replacing it with a similar but new security. The costs of renewing or varying such securities are often significant and, if not included in the proposal, thereby create the same cascade of GST as their original issue or allotment.

10. Second, it is common for shareholders, other members of a corporate group or parties associated with the issuer to provide a guarantee of, or security for, the security issuer's obligations. Again the costs of providing such collateral security (including legal fees, accounting fees and valuation costs) are generally borne by the issuer and may be significant.

11. The Law Society sees no justification for restricting the range of financial services that give rise to input tax under the proposal to only the original capital raising and not to either its renewal or the provision of collateral under that security. Accordingly, it is recommended the proposal be extended to encompass both these additional categories of financial services in order to remove both distortions and potential boundary issues, so that registered taxpayers are able to recover input tax on the actual costs of raising capital and not merely on part of those costs.

Apportionment based on turnover

12. Officials recommend that input tax claimable by the registered person on fund raising costs be limited to the extent of their taxable supplies.[4] This is described as "*a pragmatic way*" of determining the correct amount of input tax that may be claimed.[5] In effect, this appears to impose on taxpayers the turn-over method of apportionment with respect to capital raising costs.

13. The Law Society submits that the mandating of a particular statutory method of apportionment is both contrary to the present approach applied under the input tax rules and is unnecessarily arbitrary. The input tax rules adopted in 2011 already provide for taxpayers who make mixed supplies to establish and apply an appropriate method of apportionment for input tax.[6] In particular, section 20(3G) obliges taxpayers to apply an apportionment "*choosing a determination method that provides a fair and reasonable result*". With respect to that obligation, Inland Revenue policy recognises that different methods of apportionment may be appropriate to different taxpayers in various circumstances, with no bias against, or preference for, a particular method: see *Tax Information Bulletin* Vol 23, No 1, February 2011, at p 34.

[4] At 2.12
[5] At 2.14
[6] Under section 20(3C) – (3J)

14. Officials are rightly concerned that capital raising costs with respect to exempt activities do not give rise to input tax.[7] But paradoxically the Issues Paper proposes that "*business would not be able to attribute the cost of raising capital to a particular activity … as money is fungible between activities*".[8]

15. Officials also appear to presume that other methods of apportionment of fund raising costs will be too imprecise or difficult to establish.[9] The Law Society submits that this presumption is misplaced as such apportionment is required by taxpayers in all other instances, and the method(s) used to determine that apportionment is not mandated in other circumstances.

16. The Issues Paper concedes that "*in some cases, the direct attribution of costs may be more appropriate*" but subsequently recommends against permitting such an approach. It is helpful that the Paper welcomes submissions on this point[10] because in many instances a "fair and reasonable" apportionment of capital raising costs may actually be more easily established by reference to the use to which the funds are used. Many taxpayers raise funds specifically for a new venture or purchase of new assets. Where this occurs, the apportionment of the costs of that capital raising should be determined by reference to that new activity or use of that new asset, and not according to the taxpayer's overall turnover. In those common circumstances the "pragmatic" imposition of the turn-over method is both less precise and more arbitrary than other methods of apportionment based on the actual use of the funds (which better fits with the approach to apportionment under the Act generally).

17. Where capital raising is for multiple purposes, apportionment based on the taxpayer's turnover may be appropriate where that gives rise to "*a fair and reasonable result*"; but such an outcome is already provided for under the existing statutory rules.[11] Accordingly, the Law Society recommends Inland Revenue not mandate that the turnover method of apportionment be adopted with respect to capital raising costs. In fact, there appears to be no necessity for any special apportionment rules to apply solely for these types of costs. Rather, the existing statutory rules regarding apportionment are already sufficient to determine accurately the appropriate level of input tax entitlement.

Compliance costs of apportionment for large businesses

18. The Law Society welcomes Inland Revenue's acknowledgment that some large businesses suffer disproportionate compliance costs in determining the correct apportionment for all individual supplies used in making mixed supplies.[12] It is agreed that this difficulty is presently experienced widely by the retirement village sector but also a number of other taxpayers that make mixed supplies. As a result, the Law Society supports the proposal[13] to permit such taxpayers to aggregate supplies generally in order to establish a single agreed method of apportionment.

19. However, the Law Society has some concerns regarding the compliance costs arising from the proposed method of implementation. In particular we question the need for each taxpayer to obtain the agreement of the Commissioner before the apportionment method under this proposal can be adopted.

20. Officials recognise that the compliance costs imposed on industries habitually making mixed taxable and exempt supplies are onerous. The Issues Paper correctly identifies that taxpayers

7 At 2.12
8 At 2.14
9 At 2.14
10 At 2.16
11 Under s 20(3C)
12 At 3.4
13 At 3.20

in the financial services sector have benefited by obtaining general agreement with the Commissioner over the appropriate level of apportionment to be applied.[14] In particular, the Law Society is aware that certain industry groups have been able to reach industry-wide agreements with Inland Revenue that are applicable to all their members.[15] The Law Society recommends that any legislation giving effect to this proposal should enable the adoption of a similar industry-wide agreement applicable to the retirement village sector, as found in section 20E.

21. By contrast, the Issues Paper appears to propose that individual retirement villages must enter into agreements with the Commissioner before they can aggregate their supplies and establish a global apportionment of input tax.[16] In particular, the proposal specifies that each agreement "*would need to be fair and reasonable after taking into account the specific business circumstances of a taxpayer*."[17]

22. The Law Society is concerned that implementation of this proposal may require each retirement village operator to negotiate a separate agreement with Inland Revenue in order to achieve the compliance savings. This agreement process will however impose its own compliance costs on both the taxpayers and Inland Revenue. It is noteworthy that agreements for financial service providers such as banks and life insurers were negotiated collectively by their industry representatives under section 20E and applied across all members of that sector (thus alleviating the need to negotiate individual agreements that reflect "*the specific business circumstances of a taxpayer*").

23. Accordingly, the Law Society recommends that the proposal be amended to provide that agreement/s may be reached with industry representatives, such as the Retirement Villages Association, that reflect a fair and reasonable apportionment of its members' entitlement generally, in order to harmonise industry behaviour, reduce the potential for disagreement with the Commissioner, and to reduce the compliance costs for individual taxpayers.

24. Alternatively, the proposal could be amended to permit all taxpayers unilaterally to elect into a simplified apportionment regime. It appears that the chief benefit of the proposal is to allow taxpayers to determine an appropriate rate of apportionment across all their aggregated supplies, rather than on a supply-by-supply basis, with the resulting reduction in compliance costs. Presumably that agreement merely establishes that the apportionment methodology used by the taxpayer with respect to those aggregated supplies is fair and reasonable. As such, the Law Society submits that agreement requires nothing additional to the existing statutory tests under section 20(3G) and questions why there is any need for an advance agreement with Inland Revenue. Any proposal that relies upon reaching agreement with the Commissioner has the potential to impose both delays and significant compliance costs on all parties, and is a potential source of additional dispute activity.

25. The Law Society submits that all taxpayers should be able to aggregate their supplies and apply a single method of apportionment without needing to have first reached an agreement with the Commissioner. Instead, taxpayers should only be required to give Inland Revenue notice of

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[14] These agreements are provided for under section 20E as an alternative for calculating the correct apportionment "*on the basis of the statistics of the supplies made*".

[15] For example, the Bankers Association for its members and the Financial Services Council on behalf of Life Insurance companies.

[16] At 3.21

[17] At 3.22

their election to adopt that apportionment method; similar to the requirement on financial service providers to elect into the zero-rating regime for financial services.[18]

26. This unilateral option would both recognise the self-assessment nature of the GST regime and be consistent with the general reduction in the number of matters requiring the exercise of the Commissioner's discretion.[19] It would also reduce the immediate compliance costs on Inland Revenue and the taxpayer of implementing this proposal, yet maintain the present statutory obligation on taxpayers to ensure their apportionment methodology is "*fair and reasonable*". Once so notified, Inland Revenue is able to audit individual taxpayers to verify they are adopting an appropriate method of apportionment,[20] with the potential imposition of shortfall penalties if an unreasonable apportionment is adopted.[21]

27. The Law Society submits that either of these recommendations would also eliminate the need to restrict the proposal to only larger taxpayers with a turnover of $24 million per annum who file monthly GST returns.[22] Accordingly, the Law Society recommends this aspect of the proposal not be adopted. The potential compliance cost savings resulting from the ability to aggregate supplies in order to achieve a fair and reasonable apportionment should be available to all taxpayers – subject always to the continued obligation on all taxpayers to make annual adjustments to the level of that apportionment.[23]

Services supplied directly in connection with land

28. The Law Society appreciates the policy concern identified by the Commissioner about whether services are supplied "*directly in connection with land*", under section 11A(1)(k)(i)(A).[24] Clarification of the scope of the zero-rating rules as to whether a service is performed "*directly in connection*" with other goods or services would be helpful.[25]

29. The Law Society is concerned that the problems identified with the scope of the rule regarding services supplied "*directly in connection with*" land arise equally with respect to many of the other potentially zero-rated services under section 11A(1). That is a common phrase determining the correct GST treatment of many such supplies, including:

- (1)(e) services regarding land situated outside New Zealand;
- (1)(f) services regarding personal property situated outside New Zealand;
- (1)(h) services regarding stores for ships or aircraft while in New Zealand;
- (1)(i) services regarding specific goods under the Customs & Excise Act 1996;
- (1)(k)(i)(B) services regarding personal property situated outside New Zealand;
- (1)(l) services regarding the supply of information to non-residents;
- (1)(m)/(maa) services regarding zero-rated goods.

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18 Under section 20F(1)

19 Including the proposal at 8.13 replacing the Commissioner's discretion regarding temporary breaches of the $500,000 threshold for filing 6-monthly returns under section 15C(2).

20 Presumably by reference to the non-codified factors listed at 3.22 and 3.24, including the possibility of regular reviews of that methodology by the Commissioner as noted at 3.23.

21 Under Part IX Tax Administration Act 1994

22 At 3.26

23 Under sections 21-21G

24 For instance, see *Malololailai Interval Holdings NZ Ltd v CIR* (1997) 18 NZTC 13,137 (HC).

25 See the numerous cases determined under the various statutory provisions in which those words appear, including: *Auckland Regional Authority* v *C of IR* (1994) 16 NZTC 11,080; *Wilson & Horton Ltd* v *C of IR* (1995) 17 NZTC 12,325 (CA); and *Suzuki New Zealand Ltd* v *C of IR* (2001) 20 NZTC 17,096 (CA).

30. The proposal recommends "*an amendment be made to clarify or alter the scope of the services supplied 'directly in connection with land' …*".[26] However, all of the provisions listed above raise the same difficulty of interpretation yet are omitted from the proposed clarification.

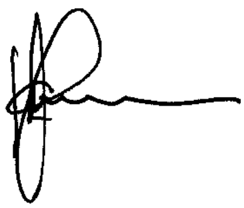
31. The Law Society questions whether it is appropriate to isolate the concern over the single matter of services regarding land in order to clarify that issue only, while not addressing the presumably identical concerns with the interpretation of that phrase in the numerous other instances in which it appears. The Law Society recommends that any amendment or clarification of that widely-used phrase be applied consistently in order to give effect to the underlying policy considerations.

32. The scope of the zero-rating regime is a central plank of the "*destination principle*" underlying the entire GST regime.[27] Good tax policy therefore dictates a consistency of treatment across all different types of zero-rated services using that phrase – not a unilateral change to only one type of those services. Accordingly, the Law Society submits that this proposal should be delayed while additional consideration is given to the uniform clarification of the scope of that phrase across the entire zero-rating regime.

Conclusion

33. This submission has been prepared with the assistance of the Law Society's Tax Law Committee. If you wish to discuss it further, please do not hesitate to contact the convenor of the committee, Neil Russ, via the committee secretary, Jo Holland (jo.holland@lawsociety.org.nz / 04 463 2967).

Yours faithfully



Chris Moore
President

[26] At 5.27
[27] As acknowledged at 5.1