



Tax policy report: GST: Accounting for land and other high-value assets

Date:	1 April 2010	Priority:	Medium
Security Level:		Report No:	T2010/486 PAD2010/57

Action sought

	Action Sought	Deadline
Minister of Finance	Agree to recommendations	7 April 2010
Minister of Revenue	Agree to recommendations	7 April 2010

Contact for telephone discussion (if required)

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1 April 2010

Minister of Finance
Minister of Revenue

GST: Accounting for land and other high-value assets

Executive summary

Following the recent report *Additional base broadening measures – Budget 2010* (PAD 2010/51; T2010/422) you have agreed to the work on GST base maintenance measures being finalised. These measures were included in the government discussion document *GST: Accounting for land and other high-value assets* released in November 2009 on which submissions have been received and considered. This report provides a brief overview of the main issues and the submissions received. It recommends that officials consult further on the main measures.

The main tax base risk concern identified in the discussion document is “phoenix” fraud schemes that involve Inland Revenue refunding GST with no corresponding output tax payments being made by suppliers. The discussion document proposed introducing a domestic reverse charge mechanism, which would require a registered recipient to account for both the payment and credit/refund aspects of the GST.

Nineteen submissions were received on the discussion document. A number of submitters supported the proposed domestic reverse charge mechanism. However, some submitters expressed a preference for an alternative approach of zero-rating the transactions in question.

Officials are satisfied that there is indeed a need for a mechanism to prevent “phoenix” fraud. Officials also consider that either a domestic reverse charge or a zero-rating regime would be able to achieve that goal, each with the same resulting increase in revenue. We recommend undertaking final consultation on the two options to ensure that the chosen measure is the most suited for the intended purpose. Consultation would also extend to the other key GST issues in the discussion document, including tax base risk concerns in relation to mortgagee (or equivalent) sales.

It is currently estimated that the revenue losses resulting these types of activities is approximately \$60m per annum when adjusted for a possible GST rate increase. Expedient consultation is necessary in order to meet the timeframes for a July 2010 tax Bill. Officials seek permission to do this over the coming weeks.

Recommended action

We recommend that you:

- (a) **Note** the content of the report.

Noted

- (b) **Agree** that officials consult further on the main issues raised in submissions.

Noted

Andrew McLoughlin
for Secretary to the Treasury

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Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. In November 2009, the Government released the discussion document *GST: Accounting for land and other high-value assets*, which proposed a number of changes to the GST Act that address certain tax base risks and improve the operation of the GST system in general. Specifically, the discussion document addressed the following:

- domestic reverse charge;
- strengthening the application of section 19D of the GST Act (which addresses transactions to defer GST payments);
- timing of refunds;
- transactions involving nominations;
- sales in satisfaction of debt (such as mortgagee sales);
- input tax and adjustments for change-in-use;
- accommodation.

2. Officials consider that there are good reasons to change certain aspects of the way GST operates when high-value assets, particularly land, are transferred. Submissions on the discussion document confirmed this. However, we consider that further immediate consultation with submitters is desirable in order to determine the most suitable mechanism to address these risks and achieve the required timeframes for a July 2010 tax Bill.

“Phoenix” fraud and preventive measures

3. Because GST is designed to tax consumption rather than production, one of the basic principles of the tax is that businesses should not be subject to GST when producing goods and services. This is achieved through the credit-invoice mechanism, which allows businesses to claim input tax deductions in relation to goods and services that are acquired for the purpose of making taxable supplies. Transactions between businesses should, therefore, be GST-neutral unless exemptions apply. The ability for businesses to claim input tax deductions does, however, result in a revenue loss when there is no matching GST payment made by the vendor. This can happen for a range of reasons, including both genuine business failures and through transactions that are deliberately structured to achieve this mismatch.

4. The main tax base risk concern identified in the discussion document is “phoenix” fraud schemes that often occur between associated entities and involve Inland Revenue refunding GST to one party with no corresponding payments being made by the supplier because, for example, the supplying company winds up before making payment. In considering this concern, the discussion document proposed to introduce a domestic reverse charge for transactions involving land, “going concerns” and assets with a value of \$50 million or more. The domestic reverse charge would require the recipient to account for the GST on both the input and output side, thereby ensuring that the transaction was revenue-neutral.

Submissions

5. Most submitters supported a mechanism that would ensure that a transaction is neutral from a GST perspective. The domestic reverse charge mechanism was viewed by a number of submitters as generally well-equipped to deal with “phoenix” fraud. Many submitters raised concerns in relation to some aspects of the proposal (for example, in relation to the scope of the application, whether it should apply to all transactions where land was a component; the need for the special time of supply rule; and the need to move from well-understood concepts such as the “GST-inclusive” terminology).

6. Some submitters preferred a zero-rating mechanism. These submitters considered that a domestic reverse charge would impose additional compliance costs and disrupt existing practices. Zero-rating, on the other hand, was viewed by those submitters as generally simpler and more familiar to businesses.

Officials’ preliminary views

7. Having reviewed the submissions, officials consider that there are indeed some advantages and disadvantages in both a domestic reverse charge mechanism and a zero-rating regime. Since overall submissions have not showed a clear preference towards either of those measures, further consultation is viewed as desirable to ensure that the chosen mechanism provides the best balance of simplicity and revenue robustness.

8. Officials agree that zero-rating may reduce some of the compliance costs of a domestic reverse charge. Officials have, to date, recommended the domestic reverse charge in preference to zero-rating because it addresses situations when:

- The supply is to a non-registered person who has purported to be a registered person. However, by the time the error (deliberate or otherwise) is discovered, the supplier has wound up and is no longer able to pay the tax.
- There is a misunderstanding in the characterisation of the transaction. If parties mistakenly enter into a transaction on the understanding that it is zero-rated, the recipient may later be able to claim deductions by arguing that the regime does not apply.

9. Officials are now of the view that the first concern can be addressed under either the domestic reverse charge or zero-rating through a suitable anti-avoidance mechanism. The second concern can be addressed through applying the new rule to any transaction in which land is a component – this should remove most of the uncertainty about the boundary of the provision.

10. On the other hand, the domestic reverse charge is a mechanism that is adopted in many European countries and officials will undertake further work on its effectiveness there. Also, zero-rating may not operate effectively without specific legislation when the recipient entity makes exempt supplies and should therefore, in effect, be treated as a final consumer.

11. In relation to transactions over \$50m which the discussion document recommended be included in the domestic reverse charge, a number of submissions noted that the current offset process within Inland Revenue works effectively and that this provision is not, therefore, necessary. Officials agree, particularly given that phoenix fraud has to date largely been limited to the property sector. We also consider that going concerns would not need to be specifically included in the domestic reverse charge or zero-rating regime if the scope of the rule was broadened to include all transactions featuring land.

Domestic reverse charge/zero-rating and mortgagee sales

12. The GST Act requires a mortgagee to account for GST on the sale of the mortgagor's property when the property has been sold by the mortgagee in satisfaction of the mortgagor's debt (a mortgagee sale). Recently, however, there has been an increase in sales in satisfaction of debt (termed "de facto mortgagee sales") that are being presented as "ordinary" sales by mortgagors in the course of their taxable activities.

13. To overcome this problem, the discussion document proposed to supplement the current rules on sales in satisfaction of debt by treating a sale as a mortgagee sale if certain criteria are satisfied which demonstrate a degree of influence by the mortgagee in the sale. Submitters considered that some of the proposed criteria are too wide and push boundaries between a "de facto" mortgagee sale and a genuine sale by a mortgagor. Submitters expressed the view that if the proposal is introduced in its current form, many genuine sales by mortgagors would be covered by the rules.

14. The purpose of rules governing sales in satisfaction of debt is to ensure that goods owned by registered persons cannot exit the GST base without GST being accounted for. Without the rules, the GST component could be passed on to the mortgagee by an insolvent borrower, thus reducing the chance of the borrower ever accounting for output tax to Inland Revenue.

15. Both the domestic reverse charge and zero-rating mechanisms could achieve the same desired outcome without the need for an express anti-avoidance measure. Therefore, officials consider that the chosen mechanism should apply to all supplies of land between registered persons, including the supplies that are currently covered by the sale in satisfaction of debt rules. This approach is certainly the preference of submitters.

Implementation date

16. The purpose of a domestic reverse charge or zero-rating rules will be to reduce instances of "phoenix" fraud. For this reason, it is important to ensure that the measure is comprehensive enough to achieve that goal, and yet sufficiently simple not to create an unbearable burden to businesses. Since submitters differed on their views regarding which measure is preferable, officials consider that further consultation with some of the submitters is desirable.

17. Allowing time for further consultation on this and other issues in the discussion document, the measures can be introduced as part of the next tax bill, which is currently scheduled for July 2010. In order to achieve the required timeframes for a July 2010 tax Bill, Ministers are asked to allow officials to commence immediate further consultation on these matters.

18. A change in the way registered persons charge GST on supplies of certain goods and services will require both Inland Revenue and businesses to change their forms and systems. Therefore, we suggest that the measures, if adopted, should apply from 1 April 2011.

Other issues

19. Officials received submissions on all topics covered by the discussion document.

20. Submitters broadly agreed with the proposals in relation to the GST treatment of accommodation, change-in-use adjustments, and transactions involving nominations. Officials will continue work on finalising the details of these proposals.

21. Having reviewed the submissions, we now consider that the proposal to strengthen section 19D (which aims to prevent timing mismatches) should not proceed as the existing section is workable.

Revenue implications

22. A domestic reverse charge or zero-rating rule will address certain GST base risks. As was noted in the discussion document, conservative estimates from 2008 indicate that \$50 million of GST revenue is lost per annum due to GST evasion and aggressive planning in the property development sector. Recently, this estimate has been confirmed by Inland Revenue through the results of the property compliance project

23. The extent of the problem will increase if the GST rate is increased to 15%. Adjusted for the higher rate, officials estimate that the government may be losing about \$60 million per annum due to phoenix activities in the property sector.

24. We also note that there may be some savings from extending the application of either the domestic reverse charge or zero-rating rule to sales made in satisfaction of debt. Owing to the difficulty in quantifying the extent of the problem, it is not possible to provide any estimate of these potential savings.

25. Officials have, to date, identified phoenix fraud as a risk primarily within the property sector. Officials will consider the extension of either the domestic reverse charge or zero-rating rules to other sectors should the necessity arise.

Annex - List of submitters on the discussion document

1. New Zealand Institute of Chartered Accountants;
2. New Zealand Law Society;
3. Corporate Taxpayers Group;
4. PricewaterhouseCoopers;
5. Ernst & Young;
6. KPMG;
7. Russell McVeagh;
8. Minter Ellison Rudd Watts;
9. Minter Ellison Rudd Watts (on behalf of Southern Crossings Ltd);
10. Property Council New Zealand;
11. Federated Farmers of New Zealand;
12. Kensington Swan;
13. Salvation Army;
14. Bruce Lay;
15. Toovey Eaton & Macdonald Limited (on behalf of Campus Living Villages NZ Limited);
16. Toovey Eaton & Macdonald Limited (on behalf of the Institutes of Technology and Polytechnics Finance Managers Forum);
17. Toovey Eaton & Macdonald Limited (on behalf of New Zealand Vice-Chancellors' Committee);
18. Tomlinson Paull.