Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: GST: Zero-rating land transactions

Date:	30 April 2010	**Priority:**	**High**
Security Level:		**Report No:**	T2010/732 PAD2010/83

Action sought

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

Contact for telephone discussion (if required)

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30 April 2010

Minister of Finance
Minister of Revenue

GST: Zero-rating land transactions

Executive summary

On 12 April 2010 Cabinet agreed that risks to the GST tax base arising from phoenix scheme fraud would be removed with effect from 1 April 2011 (Cab Min(10) 12/10 refers). Cabinet also directed officials to report back to you on the precise legal mechanisms for achieving the desired outcome, and for addressing other GST base maintenance risks. This report seeks your agreement to adopt as the preferred option the zero-rating of the supply of land between two registered persons.

"Phoenix" fraud schemes involve Inland Revenue refunding GST to a registered purchaser in circumstances where there is no corresponding output tax payment made by the registered supplier in the transaction because they have been deliberately wound up to avoid paying the GST. The occurrence of phoenix fraud is of particular concern in the property sector and is creating significant GST base erosion.

The 2009 discussion document *GST: Accounting for land and other high-value assets* identified two potential mechanisms for preventing phoenix fraud in property transactions – a domestic reverse charge and zero-rating. Although, at the time, officials preferred the domestic reverse charge mechanism, submissions, which were generally supportive of addressing the fraud issue, indicated a preference for zero-rating.

To ensure that the chosen measure would be the most suited for the intended purpose, you agreed that officials undertake final consultation on the two options (T2010/486; PAD2010/57 refers). The consultation was conducted by means of a short consultation note summarising more clearly the main advantages and disadvantages of the two approaches which was sent to submitters.

Following the additional feedback received, officials now agree that zero-rating is a more suitable mechanism for addressing the base risk concerns in question.

We therefore recommend that you direct officials to proceed on the basis that the GST rules be amended to require GST-registered vendors to charge GST at the rate of 0% on any transaction involving land or in which land is a component if the purchaser is also a GST registered person. The rules would be able to be introduced as part of the next tax bill, currently scheduled for July 2010, with application from 1 April 2011. We note that the revenue from addressing GST phoenix fraud (estimated to be $60 million per annum in out-years) has been included as part of the 2010 Budget Tax Package.

We note that the 2009 discussion document contained other measures aimed predominantly to reduce uncertainty in the area of GST and land transactions, such as the approach to apportionment and the boundary between residential and commercial accommodation. We will report on these further matters (which would also be able to be included in the July 2010 Bill) after the Budget.

Recommended action

We recommend that you:

(a) **Agree** that the GST legislation be amended to require GST-registered vendors to charge GST at the rate of 0% on any supply to a registered person involving land or in which land is a component.

Agreed/Not Agreed Agreed/Not Agreed

(b) **Agree** to include the amendments in the July 2010 Bill for the purposes of becoming effective from 1 April 2011.

Agreed/Not Agreed Agreed/ Not Agreed

(c) **Note** that officials will report on the remaining GST measures outlined in the 2009 discussion document entitled *GST: Accounting for land and other high-value assets* after the Budget, and that these measures would also be able to be included in the July 2010 Bill.

Noted Noted

Andrew McLoughlin
for Secretary to the Treasury

Marie Pallot
Policy Manager
Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

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 would address certain GST base risks and that would improve the operation of the GST system more generally. 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 the supplier deliberately winds up before making payment.

In considering this concern, the discussion document proposed to introduce a domestic reverse charge to transactions involving land, "going concerns" and assets with a value of $50 million or more. Another potential mechanism for preventing phoenix fraud – zero-rating – was mentioned in the discussion document, but was considered as less preferable.

Many submissions on the discussion document supported the need to address phoenix fraud in property transactions. Most of these submissions, however, expressed preference for the zero-rating rather than the domestic reverse charge mechanism. To ensure that the most suitable mechanism to address the tax base risks is adopted, officials undertook to conduct further consultation with key submitters (T2010/486; PAD2010/57 refers).

Further consultation

The consultation was conducted by means of a consultation note summarising the advantages and disadvantages of the two approaches. Submitters were asked to comment on the comparative merits of the respective options. Officials also suggested that either zero-rating or the domestic reverse charge would apply to transactions where land is a component, and not specifically or separately to "going concerns" or assets of value over $50m.

All responses supported the zero-rating approach over the domestic reverse charge mechanism. Submitters also made a number of comments in relation to some aspects of the proposed operation of the zero-rating rules:

- The definition of "land" to which the zero-rating rules would apply must be sufficiently clear.
- Removal of the high-value threshold was agreed to provided the administrative practices for offsetting GST in business to business transactions are maintained.
- Consideration must be given to how the rules would apply in transactions involving nominees.

Analysis and recommendation

Having reviewed the issue, officials now consider that zero-rating is a more suitable mechanism for reducing the GST risks from phoenix fraud.

While both mechanisms would be just as effective in reducing fraud (estimated at $60m per annum in out-years), the domestic reverse charge would introduce a totally new method of accounting for GST, under which the obligations of parties to a transactions would significantly differ from those under the normal GST rules. Under the zero-rating mechanism, however, the accounting obligations of the parties would remain virtually unchanged. Accordingly, using the existing zero-rating rules to address the GST base risk is likely to be an easier mechanism for businesses to deal with as it is a ‘known quantity’.

Previously, officials were concerned that zero-rating would not deal well with situations where an unregistered recipient purports to be registered or where parties mistakenly zero-rate a transaction. Officials now consider that these concerns can be addressed by introducing a comprehensive anti-avoidance provision and by ensuring that the scope of the application of the zero-rating rules is sufficiently clear. This can be achieved by applying the rules to any transaction in which land is a component rather than applying a test of land being the predominant feature of the transaction as suggested in the discussion document.

It should be noted that the domestic reverse charge, rather than the zero-rating, is a mechanism that is adopted in many European countries. Having discussed the issue with a European tax expert, we note that this preference can be partly explained by a European Union law that requires that the standard VAT rate to be at least 15% and any reduced rate at least 5% (which means that a Member State may be unable to zero-rate a supply of a specific good or service).

For these reasons, we recommend zero-rating as a more suitable mechanism for tackling the GST fraud concerns.

Officials note that the revenue from addressing GST phoenix fraud (estimated to be $60 million per annum in out-years) has been included as part of the 2010 Budget Tax Package.

Next steps

We recommend that you direct officials to amend the GST rules to require GST-registered vendors to charge GST at the rate of 0% on any transaction involving land, or in which land is a component, if the purchaser is also a GST registered person. The rules would be able to be introduced as part of the next tax bill, currently scheduled for July 2010, with application from 1 April 2011, consistent with Cabinet Minute (10) 12/10.

We note that the 2009 discussion document contained other measures aimed predominantly to reduce uncertainty in the area of GST and land transactions, such as the approach to apportionment and the boundary between residential and commercial accommodation. We will report on these further matters (which would also be able to be included in the July 2010 Bill) after the Budget.