

RECENT GST REFORMS AND PROPOSALS IN NEW ZEALAND

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Since its introduction in 1985, GST has become an important component of New Zealand's tax system, accounting for roughly 25% of total tax revenue. In March 1999 the New Zealand Government published a discussion document containing proposals for reform of the GST Act arising from a review of GST. This article outlines changes to the GST Act which have arisen from this review.

INTRODUCTION

GST came into effect in New Zealand in 1986 as part of a package of reforms aimed at establishing a tax system with a broad base and relatively low rates of tax. Consistent with the then Government's objective of a broad-based tax system, GST applies to most goods and services supplied in New Zealand.

The GST legislation provides few concessions. However, a limited number of supplies, primarily exports, are zero-rated (GST free), as GST is intended to be limited to consumption in New Zealand. Financial services are exempt (input taxed) because of the impracticalities, primarily valuation difficulties, involved in subjecting them to a full GST. The other main exemption is in relation to residential property.

With the exception of the zero rate for exports, New Zealand has a single rate of GST. The rate was originally 10% but was increased to 12.5% in 1989 and has remained unchanged since. GST currently represents approximately 25% of the total tax revenue collected by the Government.¹

¹ For 1996 the comparative figures were: New Zealand 23.6%, Canada 14.3%, United Kingdom 19.4%, OECD average 17.8%, EU (15) average 17.8%. OECD, *Consumption Tax Trends* (1999).

New Zealand's GST is generally regarded as an efficient tax with a high rate of compliance and low compliance and administrative costs. This is the result of its broad base and single rate.

Nevertheless any tax has its compliance and administrative costs. And a simple GST has some inherent problems, particularly the inability of a simple framework to easily accommodate commercial and technological advancements, notably in relation to transactions across different jurisdictions.

From an economic perspective, the broad base of New Zealand's GST reduces the extent to which GST deters consumption of goods and services, and alters patterns of consumption by changing the relative prices that consumers must pay for their goods and services. From a practical perspective, the existence of fewer boundaries in the GST system helps to lower its complexity and potential areas for avoidance.

To illustrate the point, the supply of a going concern is one of the few supplies (other than exports) that is zero-rated. This exception has created a need for detailed rules in the legislation and has been the cause of substantial numbers of cases undertaken in respect of the GST Act.

On the whole, however, the reliance upon general principles in the GST Act means that in many areas the scheme and purpose of the Act is clearer than it might have been if a schedular approach had been adopted.

A notable exception is the definition of "financial services", which is a schedular list of services with no generic principles set out. This approach has not provided the flexibility necessary to deal with innovations in products in the financial sector - if a product is not on the list it is not a "financial service". The lack of a generic description has also caused difficulties in interpretation.

In March 1999 the then Government released a discussion document, *GST: A Review*.² The discussion document made numerous proposals designed to reduce compliance costs or protect the revenue base. The document also contained some discussion of longer-term issues relating to the treatment of imported services and financial services. The remainder of this article outlines some of the key issues raised in the discussion document as they relate to the overall framework of New Zealand's GST.

² At the time of writing many of the proposals in the discussion document had been legislated for in the Taxation (GST and Miscellaneous Provisions) Act 2000 passed into legislation on 10 October 2000.

BASE MAINTENANCE MEASURES

Notwithstanding the broad base of New Zealand's GST, such boundaries as there are have, in the 14 years since GST was introduced, given rise to a number of different types of arrangement under which taxpayers have been able to obtain unintended GST advantages.

“Exported” services

The broad aim of GST is to tax at a single rate all final consumption that takes place in New Zealand. This is known as the “destination principle” and means that all supplies of goods and services in New Zealand, regardless of whether they are supplied to New Zealand residents or to tourists, are taxed at the standard rate of 12.5%. For services, this is achieved by taxing supplies that are physically performed in New Zealand. It has been possible, however, to zero-rate a supply of services physically performed in New Zealand but contracted for with a non-resident who is outside New Zealand, allowing the zero-rating of services that are consumed in New Zealand.

This was the result of the New Zealand Court of Appeal judgment in *Wilson & Horton v Commissioner of Inland Revenue*.³ This case concerned the zero-rating of advertising in a New Zealand newspaper that was supplied to a non-resident. The New Zealand Court of Appeal held that the zero-rating provisions in the GST Act were directed to the contractual arrangements between the supplier and the recipient. Any benefits that accrued in New Zealand arising from the advertising were disregarded because of the indirect relationship that the benefits had with the contract between Wilson & Horton and the non-resident.

In 1999, following on from a proposal in the discussion document, the legislation was amended to exclude from zero-rating the supply of services that are consumed in New Zealand but are contracted for by a non-resident who is outside New Zealand. The amendment provides that zero-rating does not apply to services supplied to a non-resident if another person (including an employee or company director of the non-resident) receives the performance of those services in New Zealand. The provision does not apply if it is reasonably foreseeable that the supply of the services is related to the making of taxable or exempt supplies by registered persons. This is because the services are in effect imported (having first in a technical sense been exported) and imported services are not subject to GST in New Zealand.

This issue is symptomatic of the difficulties that arise in setting a boundary around the concept of consumption, especially as regards arguments that tuition for non-residents at New Zealand schools or universities, for example,

³ (1995) 17 NZTC 12,325.

should be treated as an export for GST purposes. Excluding all non-residents from the GST base would remove this problem, but would create major avoidance and administrative issues and lead to a sizeable contraction in the GST base.

The basis of accounting for GST

Liability for GST under the GST Act arises at the earlier of the issue of an invoice or receipt of a payment. GST registered persons are required to account for GST on the invoice basis, under which GST is recognised on a transaction at the earlier of the time that payment is received or an invoice is issued, although in prescribed circumstances the payments or cash basis of accounting may be adopted. The use of the invoice basis of accounting ensures that GST is recognised at the time a supply liable for GST is made, consistent with the fundamental principle that GST is a tax on supplies, not receipts.⁴

Access to a payments basis of accounting is allowed for registered persons with turnover under \$1.3 million⁵ on the basis that this group may have an undue compliance burden complying with the invoice basis.

This exception to the general rule has created a boundary, which has provided substantial GST timing advantages. By deferring the date of settlement, it was possible to gain a significant advantage in relation to transactions involving two registered persons using different bases of accounting for GST. Specifically, a purchaser on the invoice basis was able to claim an immediate input tax credit but a vendor on the payments basis was able to defer the payment of output tax until payment is received.

To address this issue an amendment was made requiring GST to be returned on an invoice basis for any supply for which the consideration exceeds \$225,000 (including GST). The target of the amendment to require output tax to be returned on an invoice basis for supplies exceeding \$225,000 is longer-term deferred settlements. To limit cash flow and compliance concerns for shorter-term deferred settlements, agreements where settlement must be made within 365 days are excluded.

This issue is a further illustration of the difficulties that exceptions to general rules in the GST Act cause, and an example of the equity and efficiency trade off that must sometimes be made to create a workable GST framework.

⁴ *Commissioner of Inland Revenue v New Zealand Refining Company Limited* (1997) 18 NZTC 13,187.

⁵ Increased from \$1 million under the Taxation (GST and Miscellaneous Provisions) Act 2000.

The second-hand goods input tax credit

If a registered person acquires new or second-hand goods from a GST registered person, the GST component is shown on the tax invoice⁶ and can be claimed as an input tax credit. If a registered person purchases second-hand goods from an unregistered person, the supply is not subject to GST. However, the registered person may claim one-ninth of the purchase price as an input tax credit, provided sufficient records of the supply are kept.

Allowing a credit is intended to recognise the GST paid when the non-registered supplier acquired the goods and so ensure that only the final consumer incurs the GST cost on the amount of value added by registered persons – avoiding “tax cascades”.

The input tax credit for second-hand goods has, in the past, been used by registered purchasers to claim large GST refunds in relation to goods (particularly land) on which GST has not been paid by the seller. In some cases, second-hand goods appear to be sold to an associated person primarily to claim the input tax credit, with no real change in ownership occurring. It is likely that the goods would not have been sold if a credit were not available. In these cases the credits are windfall gains to the registered purchaser rather than refunds of tax previously paid. This is particularly problematic when assets are held for many years before they are on-sold.

To address this issue, an amendment has been made to limit the input tax credit available in relation to supplies of second-hand goods between associated parties to the lesser of:

- the GST component (if any) of the original cost of the goods to the supplier; or
- one-ninth of the purchase price; or
- one-ninth of the open market value.

This approach is preferred to the implementation of a “margin scheme”, such as that in Australia for land sales, which defers the input tax credit until the sale of assets. One of a number of difficulties with margin schemes is that, to remove the potential for associated persons to claim windfall input tax credits early by merely interposing another transaction, it would be necessary for a margin scheme to require all goods acquired and sold under the scheme to continue to be sold under the scheme.

This could cause unreasonably high compliance costs, including requiring a non-associated purchaser to know the “GST status” of an asset (whether margin scheme or non-margin scheme). There could also be significant record-keeping and apportionment issues.

⁶ Or can be calculated from the “GST inclusive” amount.

While the solution does give rise to a difference in the treatment of transactions between associates and non-associates (who will still be entitled to a credit based on the purchase price), the solution is consistent with the invoice/credit framework, which would recognise only GST that has actually been paid and therefore deny a credit for any greater amount. Also, the proposal is targeted at those who are likely to know how much GST was paid, rather than at non-associates, who are less likely to be privy to such information.

Thus the amendment provides a relatively simple solution to a difficult base maintenance and conceptual issue, and is consistent with the policy of taxing only the final consumer of a good or service.

Input tax credits for goods imported and subject to a change in use

The change in use provisions are intended to apply where a purchaser of an asset acquires the asset for private purposes (or other purposes outside the GST net) and pays GST on that acquisition. If the asset is later used for taxable purposes (making supplies on which output tax is payable) a “change in use” adjustment is allowed for the deemed supply of the asset to the taxable activity. The adjustment is by way of an input tax credit for the tax fraction of the lesser of the open market value of the deemed supply of the asset or the cost of the asset.

By this mechanism, the same GST result is achieved for a registered person, who applies an asset previously used for some other purpose in making taxable supplies, as for a registered person making taxable supplies, who acquires a new asset on which GST is paid.

The mechanism is intended to be limited to assets inside the New Zealand GST base, and (like the policy behind the second-hand goods credit) provides a credit for GST actually paid but which, at the time of payment, did not qualify for a credit. Because of an ambiguity in the legislation, it has been possible, however, for registered persons to import assets from outside New Zealand and claim a “change in use” adjustment for the asset in respect of GST which has not in fact been paid.

In the case of moveable high value assets, such as ships or oil rigs, the risk to the GST base is substantial.

To address this substantial revenue risk, the change in use adjustment has been limited to situations where an input tax credit would have been available to the registered person, but for the fact that the asset was not acquired for taxable purposes.

COMPLIANCE ISSUES

Changes in use of assets

Without a doubt the most practically and technically difficult area in any GST system is the treatment of assets that are used both for making taxable supplies and for other purposes. This area will provide on-going challenges in New Zealand (as undoubtedly in other jurisdictions) for the private sector, tax practitioners and policy makers.

The principal objective of change in use adjustments is to ensure that input tax credits reflect the extent of the taxable use of goods and services. In New Zealand this is achieved by making adjustments to output tax or input tax if the original intended use of the goods and services changes or if the goods and services are acquired for both taxable and non-taxable purposes.

This mechanism reflects the principle that a private or other non-taxable use of goods or services is, in essence, a supply to a private consumer. For example, the private use of goods or services acquired by a registered person for the principal purpose of making taxable supplies represents a supply of goods or services to the registered person in their private capacity and, as such, should be subject to GST.

Although these principles are generally well understood, the legislation does not clearly specify how the calculations are to be made, which creates high compliance costs. A number of minor legislative changes have been made to reduce these costs.

The current GST treatment of goods or services applied for dual purposes is to allow or deny an input tax credit depending on the principal purpose for which goods or services are acquired, and deem any application to the non-principal purpose to be a supply (the adjustment approach). In this manner an asset is in effect treated as either within, or outside, the GST base. An alternative approach (the apportionment approach), more commonly used in other jurisdictions, is to provide that any non-taxable use is reflected in an apportionment of the initial input tax credit at the time of supply, on the basis of the intended continuing use of the goods or services for each activity.

The adjustment approach used in New Zealand is difficult to apply in some circumstances and has resulted in considerable litigation. The apportionment approach may appear to be a simpler and more accurate approach to the calculation of input tax, but it has considerable complexities. First, it starts with the assumption that intended continuing use can be predicted and thus requires “wash-ups” over the period the asset is held. Second, the treatment on disposal may be complex, as it is unclear whether apportionment should

be calculated on the respective amounts of taxable and non-taxable use on acquisition, on disposal, or in the intervening period.

These issues are also present to some extent with the adjustment approach and, in this respect, it is unclear how marked the difference between the two approaches is in fact.

ELECTRONIC COMMERCE ISSUES

The growth in the use of electronic commerce for transactions poses a number of difficulties for an indirect tax system. One of these is the potential reduction in convenient “taxing points” with the removal of intermediaries in the sale and distribution of goods and services. This is especially a concern to New Zealand, because of the absence of any GST on imported services, even on GST registered importers.

New Zealand continues to monitor and contribute to OECD initiatives in this area, particularly as regards the taxation of services imported by non-registered purchasers.

IMPORTED SERVICES AND FINANCIAL SERVICES

The two final chapters in the discussion document raised issues for possible future reform of the GST Act – the treatment of imported services and the treatment of financial services. Government is reviewing both of these issues.

Imported services

Unlike most OECD countries, New Zealand does not subject most imported services to GST. This treatment reflects the limited volume of imported services when GST was introduced and the practical difficulties associated with levying and collecting GST on them. At the time GST was introduced (1985/1986), most services, except for transportation services, were consumed in the jurisdictions in which they were produced, because of the legal and technological constraints that either prevented international trade in services or made it uneconomic.

Since the introduction of GST there has been considerable growth in the volume of services being imported into New Zealand. Deregulation of the telecommunications and financial services market in New Zealand, coupled with the rapid advances in communication and computer technology which

are driving electronic commerce, means that it is now possible to consume a wide range of services in New Zealand that have been produced offshore.

Ideally, the GST system should not affect the decisions of domestic consumers and producers. In practice the absence of GST on imported services distorts consumption and production decisions. This absence encourages domestic consumers to substitute imported services that are not subject to GST for domestically produced goods and services that are subject to GST. This encourages inefficient patterns of consumption by discouraging the consumption of domestically produced services in favour of imported services.

The absence of GST on imported services also tends to encourage inefficient patterns of production and resource use in New Zealand. In particular, it discourages the domestic production of services, since domestic producers may not be able to pass on the GST cost to consumers, who are able to switch to imported services that are not subject to GST. It also discourages the use of domestically produced services by New Zealand businesses. Domestic producers who are either unable to claim input tax credits, or are unwilling to incur the compliance costs associated with claiming those credits, will tend to substitute imported services for domestically supplied services.

The discussion document examined the problems created by those developments and some of the possible solutions to the problems that have been used in other jurisdictions.

The main focus of the review of imported services will undoubtedly be on the economic distortions that failing to tax such services can create and the impact of the growth in services that are provided electronically, especially in the light of the continuing growth of electronic commerce. The work of the OECD in this area is of particular relevance to New Zealand, starting with the general acceptance by member countries of the “reverse charge” mechanism for taxing imported services provided from business-to-business. A solution for business-to-customer imported services is a much more difficult proposition, but New Zealand, along with other countries, will continue to monitor the work of the OECD in this area.

Financial services

Financial services provided in New Zealand are exempt from GST, that is, input tax credits cannot be claimed for the costs of producing such services, and output tax cannot be charged on the sale price. Exported financial services may be zero-rated, meaning input tax credits can be claimed for the costs of producing such services, but tax is charged on the sale price at a zero rate.

Supplies of financial services are exempt (input taxed) because of the complexities involved in identifying and measuring the value that is added by the supply. This is because the added value is often not separately identifiable in the charges made by financial intermediaries (including banks, finance houses, life insurers and fund managers) for the services they supply.

The inability of financial intermediaries to claim a large proportion of their input tax credits means that they are likely to prefer to purchase imported services and other supplies that do not attract GST. They may also seek to minimise their GST exposure by vertically integrating necessary production functions.

This behaviour affects the price of financial services. Financial intermediaries that find it difficult to purchase GST free supplies will attempt to pass on the GST to their customers. However, this exposes them to the risk that the price charged for financial services is higher than that charged by a competitor, not only domestically sourced but also from international fund providers that may not face the effects of GST on their purchases.

The boundary between exempt and taxable supplies also creates substantial compliance costs in the form of allocating operating and direct costs between the two forms of supply.

These issues will be considered as part of the Government's forthcoming review of GST and financial services.

CONCLUSION

Over the nearly 14 years since its introduction, GST has proven to be an efficient and relatively problem-free tax to administer, and a key contributor to Government revenue. The review of GST has raised important issues, which must be addressed to ensure that it remains so.

The proposed changes attempt to strengthen the principled, broad-based GST framework, which has been an important factor in the success of GST as a revenue gathering mechanism.

They also acknowledge that some trade-offs must be made, so that the tax is easy to comply with and administer.

The vexed problems raised by electronic commerce, the non-taxation of imported services and the exemption of financial services have been broached, and await the resolution necessary to ensure the continuing effectiveness of GST.