



16 February 2010

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Dear Ms Pallot

**GST: Accounting for land and other high-value assets**

The Society is grateful for the opportunity to comment on the discussion document above.

1. The discussion document proposes the introduction of a domestic reverse charge and advances business neutrality and neutrality to Government as its reason for these proposals.
2. Where the discussion document talks in terms of neutrality to Government, it should more correctly state that Inland Revenue considers that the credit-invoice mechanism that has been in place for the past 25 years in New Zealand's GST system has a flaw that is sufficiently significant to warrant the major change proposed. The discussion document proposes the introduction of a domestic reverse charge and changes to the rules around mortgagee sales as its solution.
3. There is no flaw that warrants the major changes proposed but, for completeness, we comment on the merits of the particular proposals and suggest preferred alternatives.
4. The effects of the recent global financial crisis on business have been well documented. Many commentators drew parallels with the great depression of the 1930s. Whether they are right or wrong there is no doubt that the crisis affected New Zealand businesses more significantly than had been experienced for some considerable time. There will no doubt be financial crises in the future, too.
5. In considering whether what the discussion document identifies as problems are so significant as to warrant the measures proposed to counteract them, care needs to be taken to ensure that the extent of the problem and the likelihood of it recurring in the near future have been quantified and that the measures proposed are not an overreaction. The discussion document provides no empirical assessment of what it considers is GST "lost" to Government.

6. The Society expects that such empirical data should not be difficult for Inland Revenue to collate and once the figure is accurately quantified, it will not warrant the changes proposed.
7. Care would need to be taken to ensure that the figures exclude GST on transactions which would in any event not be dealt with by the proposed changes such as, for example, sales by failed developers to end users who are not GST registered. Sales of apartments to the (not GST registered) public are an example of 'neutrality' that would not be achieved by the proposals and which may make up a reasonable proportion of the perceived problem.
8. The fundamental question underlying the discussion document is whether Inland Revenue should have priority for GST in relation to the types of transactions contemplated.
9. The ranking of GST would have been a matter given careful consideration when GST was introduced into New Zealand 25 years ago. The decision to afford Inland Revenue the priorities it already has and no more was not an oversight that now needs to be corrected.
10. Inland Revenue already has the privilege of enhanced priority for GST for secured creditors in respect of accounts receivable and inventory of insolvent taxpayers. Inland Revenue is also structurally preferred where a receiver or liquidator is appointed or a mortgagee sale occurs. There is no justification for further extending Inland Revenue's priority; either as a priority or by the mechanisms proposed by the discussion document.
11. Businesses, including lenders, have entered into transactions and taken positions having regard to the security offered by borrowers and other business counterparties and it is inappropriate to make changes of the types proposed.
12. Businesses face severe borrowing constraints and the proposed changes would further constrain their ability to borrow, with the proposal effectively to subordinate secured creditor's rights in favour of Inland Revenue.

## **Chapter 2 – Domestic reverse charge**

13. The Society is of the view that Inland Revenue's ranking in relation to GST should not be altered, and it makes the following observations in relation to the proposed domestic reverse charge.
14. New Zealand's GST system is widely recognised as successful, largely because of its broad base with limited exceptions. Creating exceptions adds to complexity and imposing an obligation on potentially unsophisticated registered people to account for GST on a reverse charge significantly detracts from this simplicity. All GST taxpayers will need to have systems that can identify and then account for those transactions subject to the domestic reverse charge. This will impose significant costs in terms of system changes, administration and training, and add a risk of interest and penalties should they fail to correctly recognise and account for the reverse charge.

15. The proposed changes will require special rules for the domestic reverse charge which serve to illustrate the added complexity that a reverse charge mechanism will introduce.
16. It also leaves smaller businesses susceptible to unscrupulous vendors who may encourage purchasers to pay prices that do not recognise the GST liability that the purchaser will effectively inherit.
17. The proposed domestic reverse charge has a similarity to elements of the unsuccessful wholesale sales tax systems where one of the biggest problems was that registered traders presented registration certificates to avoid having to pay sales tax on purchases. Significant difficulties arose when those purchasers were required to make a payment to Inland Revenue when it was determined that those certificates did not support the exemption claimed. Every GST registered person in New Zealand would be susceptible to similar difficulties. The problem identified by the discussion document does not justify this, particularly as the domestic reverse charge is only a partial solution that does not apply where land is sold to non-registered people.
18. Part of the success of New Zealand's GST system is that it is designed so that a registered person needs to claim a credit and, in doing so, must consider entitlement to that credit. Further, Inland Revenue is, by design, interposed between the supplier and the recipient and has the opportunity to take an active role in each transaction soon after it occurs. The proposed domestic reverse charge removes Inland Revenue from the transaction until the purchasing taxpayer reports a domestic reverse charge or is subject to an audit. This significantly increases the likelihood that GST may be lost to the tax base and that, when unpaid tax is identified, it may be irrecoverable or may generate penalties for the purchaser.
19. The Society agrees with the problem identified by the discussion document, especially in relation to supplies involving significant assets such as land, where notwithstanding a purchaser's entitlement to an input tax credit, difficulties arise in funding the GST, the difficulty being paying it to the vendor and then awaiting a GST refund from Inland Revenue. This difficulty is one that businesses have had to deal with for the past 25 years and is a natural consequence of the structure of New Zealand's GST system.
20. Inland Revenue will be familiar with the practical solution that has grown to become an easily understood and well accepted method of dealing with this difficulty – the GST offset. Solutions developed by businesses have the appeal of being well understood and of being refined over time to become increasingly workable. To the extent that the offset mechanism needs further refinement, this should be investigated. The offset mechanism has the advantage of working within the existing system (rather than creating a new set of rules); it is well understood. As long as this is not mandatory it would not alter priorities and Inland Revenue would remain on the centre line between supplier and recipient, monitoring the transaction and documentation provided by the purchaser to support its entitlement to the credit which is to be offset.
21. A second existing mechanism (which again does not require significant structural changes to the GST system) that perhaps is most easily introduced would be to allow suppliers and recipients to elect to treat land and high value transactions as zero-rated. This would also not alter priorities. However, as with all zero-rated transactions, Inland Revenue is not interposed between the parties and issues as to the purchaser's

entitlement to the credit that would otherwise arise and any other vetting of the transaction is left to subsequent audits. These issues would need to be investigated in the course of developing further zero-rating rules if that were to proceed.

### **Chapter 6 - Sales in satisfaction of debt under s 5(2)**

22. Under s5(2) of the Goods and Services Act 1985 (the GST Act), a secured party exercising a power of sale is required to account for GST, and to furnish a special GST return to Inland Revenue, unless either:
  - 22.1 the relevant mortgagor has provided a statement in writing that no GST would be payable on a sale of those goods by that mortgagor (with supporting reasons); or
  - 22.2 the secured party can determine, on the basis of reasonable information held, that no GST would be payable on a sale by the mortgagor.
  
- 23 Chapter 6 is not actually directed at s5(2) situations. It considers perceived inadequacies of the GST regime in situations where, in Inland Revenue's view, s5(2) principles should apply. There is an apparent perceived misuse of the GST regime, whereby it is asserted sales are in legal form conducted by the mortgagor, but are in substance conducted by the mortgagee. Inland Revenue officials accept that increased sales in satisfaction of debt occur during difficult economic times. However, clause 6.5 of the discussion document states that "differential tax treatment based on whether there is an open or a covert sale by a mortgagee is distortionary and inconsistent with the policy intent of section 5(2)".
  
- 24 Chapter 6, and the proposed substance over form remedy generally, suffers from a number of defects:
  - 24.1 The overriding issue throughout the discussion document is the perceived threat to the tax base created by the current GST rules as they apply to high value transactions, and instances of GST asymmetry where the Inland Revenue considers the tax base is materially threatened. The priority of Inland Revenue in circumstances where there are insufficient funds to satisfy both the secured creditor and the Inland Revenue is of particular concern. The discussion in chapter 6, and the proposed remedy, is not well integrated with the discussion on the possible domestic reverse charge, or such viable (and in the Society's view preferred) alternatives, such as zero-rating or an offset mechanism. It is not clear why the domestic reverse charge, zero-rating or an offset mechanism would not apply to s5(2) situations.
  - 24.2 The proposal is not necessary if any of the domestic reverse charge, zero-rating or offset mechanisms are introduced.
  - 24.3 Section 5(2) is an unusual provision, in that it has the effect of elevating the Inland Revenue's priority in limited circumstances. The proposal would effectively further improve the priority positions of the Inland Revenue in certain circumstances. If Inland Revenue considers that GST should now receive a preferred status, it should put that proposal up for consultation.

- 24.4 The indicators are vague and the proposal is likely to be unworkable in practice. It would require the subjective use of various indicators, which is likely to lead to alternative behaviour and increased disputes. The ambit of s5(2) is currently well understood. The proposal would result in unnecessary complexity for taxpayers.
- 24.5 Inland Revenue appears not to have tested the anti-avoidance provision in relation to the perceived abuse.
- 24.6 No numbers are given to substantiate the assertions made. In the experience of tax lawyers secured parties do not engage in “de facto mortgagee sales”.

The Society trusts these comments are helpful. If you require further assistance please do not hesitate to contact Diana Brown, the secretary of the Society’s Taxation Committee, by phone (04) 463-2967 or email [diana.brown@lawsociety.org.nz](mailto:diana.brown@lawsociety.org.nz).

Yours sincerely

A handwritten signature in black ink, appearing to read "John Marshall". The signature is written in a cursive style with a large initial 'J'.

John Marshall QC  
**President**