

Regulatory Impact Statement: GST apportionment and adjustment rules

Coversheet

Purpose of Document	
Decision sought:	<i>Analysis produced for the purpose of informing final Cabinet decisions on reforms to simplify the GST apportionment and adjustment rules</i>
Advising agencies:	<i>Inland Revenue</i>
Proposing Ministers:	<i>Revenue</i>
Date finalised:	<i>26 May 2022</i>
Problem Definition	
<p>The current GST apportionment and adjustment rules are complex and have high compliance costs, including unexpected liabilities for private assets such as vehicles and houses which have a small amount of business use.</p>	
Executive Summary	
<p>There are two main issues with how GST applies to assets that are used in a GST-registered business and also for non-taxable use (private use or to make exempt supplies):</p> <ul style="list-style-type: none"> • The rules are complex and have high compliance costs; and • Unexpected tax liabilities and compliance costs can arise because GST applies to private assets that have some business use and are owned by a GST-registered person. <p>Seven options were considered including the status quo and a non-regulatory option of Inland Revenue providing increased education and guidance about the current rules.</p> <p>Inland Revenue's preference which is also recommended in the Cabinet paper is a reform package of options 3, 4, 6 and 7. These options were consulted on in a public consultation document and through meetings with GST advisors and are supported by submitters.</p> <p>A package of measures is recommended because each separate option has some gaps and weaknesses. Using a package of options allows the other options to fill in such gaps. It reduces the number of businesses who are required to apportion GST on their business or private assets and reduces compliance costs in those cases where apportionment is still required.</p>	
Limitations and Constraints on Analysis	
<p>A key assumption is that for most of the affected businesses the proposed options will align with their current practices. This assumption leads to the non-monetised impacts being low as only a small number of businesses would have to consider or change their current practices. This assumption was checked as part of the consultation and is considered reasonable by Inland Revenue and other stakeholders.</p>	

There is limited information about the affected population of GST-registered persons who use assets for both business and private (or exempt) use, so assumptions were required to estimate monetised impacts and the non-monetised impacts of the options were informed by consultation.

The scope of the options is limited to measures Inland Revenue could implement and administer. The options were consulted on in a public consultation paper which also asked for submissions on any alternative options.

Responsible Manager

Graeme Morrison

Policy Lead

Indirect tax

Inland Revenue

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26 May 2022

Quality Assurance

Reviewing Agency:	Inland Revenue
Panel Assessment & Comment:	The reviewer considers that the information and analysis summarised in the regulatory impact statement meets the quality assurance criteria.

Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

1. Goods and Services Tax (GST) is a 15% tax on goods and services that are supplied to consumers in New Zealand by GST-registered persons (such as businesses).
2. A GST-registered person can deduct GST paid on purchases of assets (such as buildings and vehicles) that they use in their business.
3. Two issues arise where an asset is used both for business use and for private use.
4. The first issue arises where an asset has mostly business use, such as a van delivering packages during the week, with some minor private use, such as recreational use of the van in the weekend (or making exempt supplies). In such cases, complex apportionments and adjustments are required. The taxpayer must apportion (by way of a percentage) the total deduction, based on their estimate of the percentage of business use. This is to ensure GST is collected on the portion of the asset's private use. They are then required to monitor their actual business use of the asset over time. If the actual use differs from the estimated use, the taxpayer must account for this difference annually in their GST return. This is known as an adjustment.

5. The second issue arises when a GST-registered person acquires an asset mostly for private use but later makes some business use of the asset. For example, a GST-registered person acquires a dwelling to live in but uses one room of the dwelling as a home office, or they acquire a dwelling to be used as a holiday home, but also hire it out occasionally as guest accommodation. The GST system does not tax most private sales of assets, such as dwellings. This is because they are not part of a registered person's taxable activity (that is, their business). However, where a GST-registered person makes some business use of a mostly private asset, the use, and disposal, of that asset may be subject to GST. This can lead to a GST liability or adjustment if the asset is sold. The GST liability arises even if the person did not claim an input tax credit when they acquired the asset. The GST liability on a dwelling or land can also be significant as land is a high value, appreciating asset that is often held for long periods before disposal.

What is the policy problem or opportunity?

6. There are two key issues with how GST applies to assets that are used in a GST-registered business and also for non-taxable use (private use or to make exempt supplies).
7. First, the current GST apportionment and adjustment rules are complex and have high compliance costs. They require the registered person to monitor whether they use any of their business assets for non-taxable use and to make annual adjustments if there has been a change of use. Due to the compliance costs and complexity of the current rules, Inland Revenue and other stakeholders consider the level of compliance by affected GST-registered businesses with the current rules is likely to be very low.
8. Second, in the mostly private use case, the tax liabilities and compliance costs that can arise will usually be unexpected. We understand that many GST-registered persons are unaware that GST consequences can arise if their dwelling is partly used to make taxable supplies. Consequently, we expect that non-compliance is high and that many people are not accounting for GST on their dwelling on its disposal.
9. The issue with dwellings only arises if the dwelling is owned by a GST-registered person who uses the dwelling for both a taxable and a non-taxable use. Under slightly different fact scenarios, such as when the GST-registered person does not own the dwelling (for example, the GST-registered business is a company or partnership, or the house is owned by a company or trust that is not registered for GST), there is no need to apportion or account for GST on disposal. The current rules may therefore impose higher liabilities and compliance costs on some taxpayers when compared to those imposed on other taxpayers in similar situations.
10. There is limited information about the affected population of GST-registered persons who use assets for both business and private (or exempt) use. Some of the main groups potentially affected are farmers who sell their farmhouse, self-employed persons who sell a home office or vehicle with a mix of private and business use, holiday home accommodation providers and property developers who rent out residential houses prior to selling them.
11. 1,781 farms were sold in the 12 months to March 2022, but we do not know how many farms include a farmhouse (as opposed to just land). 1,006 GST-registered persons are registered with the business industry code "holiday homes and flat accommodation", and 7,881 GST-registered persons have registered with the code for "residential property development". The number of houses sold by these GST-registered persons (and whether there was private or exempt use of such houses) is unknown.

12. There is no data on self-employed persons who sell a home office or vehicle with a mix of private and business use. Based on discussions and submissions from GST advisors we have assumed that such persons are typically taking GST positions that their house is a non-taxable private asset, and their vehicle is a fully taxable business asset for GST purposes, consistent with the GST rules that operated prior to 2011.

What objectives are sought in relation to the policy problem?

13. The objective is to mitigate the problems described above. This could be achieved by targeting the application of the apportionment and adjustment rules, so they apply to fewer assets. This would remove compliance costs and reduce the risk of unexpected liabilities. Other options consider how to simplify the rules, so they impose lower compliance costs in those cases where apportionment and adjustment is still required.

Section 2: Deciding upon an option to address the policy problem

What criteria will be used to compare options?

14. The following criteria was used to assess the options:

- Fairness. The option does not significantly over-tax or under-tax the non-business use of the relevant asset. It also provides similar GST outcomes for the affected taxpayers compared to other taxpayers who have similar circumstances.
- Compliance costs. Compliance costs should be minimised as much as reasonably possible. The option should be easy for the affected parties to understand and apply.
- Tax collection and compliance. The option should reduce the fiscal risks associated with incorrect GST practices. The option should be practical for the affected businesses to comply with, so that they are more likely to apply consistent and correct GST practices.

What options are being considered?

15. One constraint is that the reform options should not undermine the overall purpose of the GST system, which is a simple, broad-based tax on the private consumption of goods and services by New Zealand consumers. This suggests some rules would still be required for high-value business assets that are clearly used to make taxable supplies while also having a significant amount of non-taxable use.

16. Therefore, the option of repealing (rather than reforming) the apportionment and adjustment rules has not been further analysed. The scope of the options is also limited to measures Inland Revenue could implement and administer. The options were consulted on in a public consultation paper which also asked for submissions on any alternative options.

Option One – Status Quo

17. The current GST apportionment and adjustment rules may create uncertainty, complexity, unintended consequences, and undue compliance costs. These issues are further described in the problem definition section.
18. The status quo can result in unfair outcomes where some taxpayers will face higher and unexpected GST costs compared to other taxpayers in similar situations. It imposes high compliance costs from complex and unclear rules requiring annual adjustments. It is unlikely to be fair in practice as the current rules are often not applied by the affected taxpayers. The small number of compliant taxpayers may be disadvantaged by facing higher compliance costs and liabilities than taxpayers that do not comply.

Option two – Improved education and guidance on current law / rules

19. This option involves continuing with the current GST rules but with Inland Revenue providing additional education and guidance to improve the affected taxpayers' understanding of the rules.
20. This option is unlikely to reduce compliance costs. There is a large population of potentially affected small businesses who will be difficult to reach with guidance or education, especially as they will often not have tax advisors. As the current rules are compulsory and inflexible, there is a limited ability for published guidance to provide alternatives to apportionment or simpler methods for the affected taxpayers to use.
21. Raising awareness of the current issues is likely to create more pressure for policy reforms. Some of the issues with the current rules were identified because of Inland Revenue developing guidance on how these rules apply to particular situations such as business use of dwellings.
22. Submissions noted the importance of providing guidance materials and training if policy reforms were implemented.

Option Three – Election method

23. Option three would allow businesses, at the time of purchase, to elect to treat certain assets which are mainly used privately (or to make exempt supplies), such as a house with a home office, or a vehicle, as though they only had private or exempt use. If so, no GST deduction is claimed on purchase and GST will not apply if the asset is later sold.
24. This could ensure GST-registered sole traders are not disadvantaged compared to other types of ownership structures where private assets are usually held by a different person to the entity which is GST-registered. In both cases, the owner of the private asset would have a choice as to whether or not it was considered as part of the businesses' assets for GST purposes.
25. The option is expected to be effective at reducing compliance costs for the second issue involving appreciating and mostly private assets such as dwellings and land. However, it will not solve the first issue involving mostly business assets. Moreover, for cashflow reasons, GST-registered businesses may still choose to claim GST deductions for depreciating assets such as vehicles, even if they have only a small amount of business use. This option would therefore be less likely to reduce compliance costs from applying apportionment rules to those assets.
26. Submissions agreed that the election option would be an effective way to reduce compliance costs for dwellings and would align the GST rules with current taxpayer practices for dwellings.

Option Four – *Principal purpose test*

27. Option four would introduce a principal purpose test where an asset's dominant use at the time of purchase will determine the GST treatment. A similar rule previously applied prior to 2011 and Inland Revenue and other stakeholders consider that a lot of the affected taxpayers are continuing to take GST positions on this basis.
28. A principal purpose test would reduce compliance costs for taxpayers by eliminating the need for the apportionment and adjustment rules. However, a principal purpose test would be much less accurate than the current apportionment rules. Some private use of relevant business assets could be undertaxed, and some business use of private assets could be overtaxed.
29. For this reason, Inland Revenue consulted on a proposal that the principal purpose test would only apply to assets purchased for \$5,000 or less (GST exclusive).
30. Submissions supported this option but argued that a higher threshold should be used such as \$10,000 or \$50,000, or alternatively that the apportionment rules be replaced with a principal purpose test for all assets (as was the case prior to 2011). The pre-2011 rules required complex adjustments for private use of the asset which would greatly reduce the compliance cost benefits of this proposed option. However, applying a principal purpose test to high value assets (such as land) in the absence of any adjustment rules would undermine fairness and tax collection.
31. In response to submissions, Inland Revenue recommends applying a principal purpose test to assets purchased for \$10,000 or less (GST exclusive). While a higher threshold could reduce compliance costs for more assets, it would reduce fairness and tax collection. In particular, a higher threshold could create an unintended incentive for businesses to prefer to buy vehicles valued below the threshold as, unlike higher cost vehicles or vehicles provided to employees, GST would not be imposed on the private use of lower-value vehicles principally used for work, if the proposed simple principal purpose test could be applied to them.

Option Five – *Rounding based rules*

32. This option involves simplifying the GST apportionment rules with two components:
 - a rounding rule where assets with high (80% or more) or low (20% or less) business use will be deemed to have sole business or private use (rounding-based rules).
 - a percentage-based threshold (such as 20%), that would allow a modest change in the business or private use without requiring a GST adjustment to be made.
33. These proposals are expected to remove most partly business and partly private assets from the apportionment rules and reduce the need to make annual adjustments, which will reduce compliance costs. Some assets (with less than 80% business or private use) would continue to incur compliance costs, but these costs would be lower than the current rules as adjustments would only be required if there was a significant (more than 20 percent) change in use, which would usually be a planned, deliberate change.
34. Some submissions considered this option would be an effective way to reduce GST compliance costs for assets such as certain work vehicles which would generally have 80-99% business use. Such assets would be treated as having 100% business use, removing the need to apportion the vehicle cost or make annual adjustments.

35. However, other submissions considered that this option would not result in a significant reduction in compliance costs as they thought it may only reduce the need to make annual adjustments. They considered other compliance costs would remain such as the need to formulate a method for apportioning business and non-business use of the asset (such as value of the supplies, time or space allocated) and then monitor this to check the relevant threshold is not exceeded. In addition, the business use of a mainly private asset such as a dwelling may exceed 20 percent, so this option would not be effective at removing GST compliance costs or unexpected liabilities on such assets. It would also create cliff face issues where large costly adjustments would become required if the business use of the asset changed so as to exceed the relevant allowable threshold (e.g. if land went from 80% business use, to less than 80%, GST would need to be paid on 20% of the purchase price of the land).

Option Six – Integrity measures

36. The issues paper consulted on a package of integrity measures that will improve Inland Revenue's ability to collect GST owing on the sale of assets by a GST-registered business that claimed business use of the asset when they originally acquired the asset.
37. This could include a new requirement for certain GST-registered businesses to provide basic information to Inland Revenue about high-value land, pleasure craft (yachts or launches) or aircraft that they have purchased and intend to use in their business activity.
38. This information would help Inland Revenue identify and improve tax compliance in situations where a large GST refund (or cost saving from acquiring zero-rated land) was originally claimed on acquisition of the asset, but there has been a failure to continue to use the asset in a business activity or properly account for GST if the asset is later sold (e.g., because the business never commences trading or has closed down).
39. A new deeming rule is also proposed to clarify that in these situations (business use claimed on acquisition), GST is properly accounted for if the asset is sold, even though the person's business activity may have since ceased.
40. Other proposed measures ensure that a wash-up calculation that applies when there has been a permanent change to the percentage of business or private use, cannot be unintentionally exploited to avoid tax.
41. The integrity measures would improve fairness by removing opportunities for non-compliant taxpayers to exploit unintended GST subsidies which are not available to compliant taxpayers or to private consumers. However, it would increase compliance costs by requiring the businesses to provide certain information to Inland Revenue when they purchase land, high-value land, pleasure craft (yachts or launches) or aircraft.

Option Seven – Simplifying existing apportionment rules

42. This option involves several minor improvements to the existing apportionment rules that would slightly reduce compliance costs for GST-registered businesses. The improvements were strongly supported by submitters and include:
- Reducing the number of years GST-registered businesses need to monitor their actual business use of assets and make annual GST adjustments (this ranges from no subsequent adjustments for low-value assets, to 10 years of adjustments for high-value assets and land);
 - Expanding the ability to use a wash-up rule which provides a final adjustment (rather than ongoing adjustments) when there has been permanent change of use. The proposal will allow this rule to be used for any permanent change in

- use (rather than just a change to fully business, or fully non-taxable use) and to be applied 12 months earlier; and
 - Allowing Inland Revenue to approve a wider range of apportionment methods that are more practical for taxpayers to apply and consequentially repealing some complex formula in the legislation which apply to specific and uncommon scenarios.
43. Compared to the status quo, these improvements would reduce the number of annual adjustments and allow a wider range of methods. However, compared to options 3, 4 or 5 above which would remove certain assets from needing to be apportioned when purchased, this option would be less effective at reducing compliance costs for these assets.

How do the options compare to the status quo?

	Option One – Status Quo	Option Two – improved education / guidance on current law	Option Three – Election method	Option Four – Principal purpose test	Option Five – Rounding based rules	Option Six – Integrity measures	Option Seven – simplifying existing apportionment rules
Fairness	0	0	+	-	-	+	0
Compliance costs	0	0	+	++	0	-	+
Tax collection and compliance	0	+	-	- (if limited to low value assets) -- (if all assets)	--	+	-
Overall assessment	0	+	+	+	-	+	+

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

- 44. The proposal is a reform package consisting of options 3, 4, 6 and 7.
- 45. This is because each separate option has some gaps and weaknesses. For example, the principal purpose test would be too inaccurate leading to unfair outcomes for high-value assets so is proposed to be limited to assets acquired for \$10,000 or less (GST exclusive).
- 46. Using a package of options allows the other options to address gaps and weaknesses. For example, the election option (option 3) is likely to be most relevant for land and dwellings and not applied by the affected taxpayers to other types of assets, so options 4 and 7 are recommended in order to reduce compliance costs for other assets.
- 47. In this way, implementing a reform package reduces the number of businesses who are required to apportion GST on their business or private assets and reduces compliance costs in those cases where apportionment is still required.

Key for qualitative judgements:

- ++ much better than the status quo
- + better than the status quo
- 0 about the same as the status quo
- worse than the status quo
- much worse than the status quo

What are the marginal costs and benefits of the option?

Affected groups	Comment	Impact	Evidence Certainty
Additional costs of the preferred option compared to taking no action			
Regulated group <i>(GST-registered businesses with assets with a mix of business and private or exempt use and their tax advisors)</i>	One-off costs of understanding and responding to changes, although for most affected businesses, the proposals should align with their current practices.	Low	Medium
Regulators <i>(Inland Revenue)</i>	One-off costs of implementing and providing education and guidance on changes.	Low	High
Others <i>(Crown Revenue)</i>	Fiscal cost of less GST being collected on some affected assets, but as we do not have relevant data, we had to use assumptions to estimate this cost	Estimated \$4m per annum reduction in GST collected each year	Low
Total monetised costs	n/a	Estimated \$4m per annum reduction in GST collected each year	Low
Non-monetised costs		Low	Medium
Additional benefits of the preferred option compared to taking no action			
Regulated group <i>(GST-registered businesses with assets with a mix of business and private or exempt use and their tax advisors)</i>	Ongoing reduction in compliance costs as majority of partly business and partly private assets will no longer need to apply the apportionment rules or make annual adjustments. However, for most affected businesses, the proposals should align with their current practices. Some options may lead to a small reduction in overall GST returned but as we do not have relevant data, we had to use assumptions to estimate this cost	Low Estimated \$4m per annum reduction in GST paid each year	Medium Low
Regulators <i>(Inland Revenue)</i>	Reduced need to amend GST positions of affected businesses as new rules should be easier to apply correctly. Integrity measures will improve Inland Revenue's ability to collect GST	Low	Medium
Others	No identified benefits	n/a	Low

Total monetised benefits	n/a	Estimated \$4m per annum reduction in GST collected each year	Low
Non-monetised benefits		Low	Medium

48. The impacts of the non-monetised costs and benefits have been determined through public consultation and discussions with tax advisors who work with the affected group.
49. A key assumption is that for most of the affected businesses the proposed options will align with their current practices. This assumption leads to the non-monetised impacts being low as only a small number of businesses would have to consider or change their current GST practices in response to the reforms being implemented. This assumption also means that the monetised impact of the proposed reform options is considered to be nil for nearly all the affected assets (by value) as the GST outcomes provided by the reform options would align with these businesses' existing GST practices so would not result in any less GST being collected. This assumption was checked as part of the consultation and is considered reasonable by Inland Revenue and other stakeholders.
50. As Inland Revenue does not have relevant GST data on assets acquired by businesses and their private or exempt use, the estimated reductions in GST collected from the affected group of GST-registered businesses are very uncertain and based entirely on assumptions. This included the key assumption about current GST practices (noted above), and assumptions about the number and value of affected assets which may be complying with the current rules and which would potentially apply different GST positions as a result of the proposed reforms.

Section 3: Delivering an option

How will the new arrangements be implemented?

51. Inland Revenue will be responsible for the implementation and ongoing administration of the new rules. Inland Revenue will provide information to increase awareness and support taxpayers to comply with the new rules. This will include producing a relevant Tax Information Bulletin item and updating guidance on Inland Revenue's website.
52. One of the proposed integrity measures would require Inland Revenue to implement a new information disclosure for GST-registered persons who claim a large GST deduction (or cost saving from zero-rating) for business use, at the time they acquire land, aircraft, or high-value boats. Similar information disclosures already apply to persons with interests in foreign companies for income tax purposes.
53. The implementation risks are considered low as the preferred option is expected to make the GST rules easier to apply for the affected businesses and is also anticipated to align with the tax positions already taken by most of the affected businesses in respect of these assets.

How will the new arrangements be monitored, evaluated, and reviewed?

54. The proposed reform package potentially includes a new information disclosure by GST-registered persons who are claiming GST deductions in respect of land, aircraft and high-value boats. This information will assist Inland Revenue to monitor some of the affected assets which involve the highest level of tax compliance and collection risk.

55. Inland Revenue regularly reviews tax settings on an ongoing basis and provides advice and updates to the Government accordingly. Policy officials maintain strong communication channels with stakeholders in the tax advisory community and these stakeholders will be able to correspond with officials about the operation of the new rules at any time. If problems emerge, they will be dealt with either operationally, or by way of legislative amendment if agreed by Parliament.