# Impact Summary: GST refunds using credit notes

## Section 1: General information

| Purpose |
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| Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment (RIA), except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by or on behalf of Cabinet. |

**Key Limitations or Constraints on Analysis**

***Number of affected parties and potential future fiscal risks are unknown***

The potential future fiscal risk that the time bar may be ineffective for GST refunds made using credit notes is unknown as it depends on the scale of the particular issue that gave rise to the refund (e.g. changing interpretations or errors by the affected businesses that have not yet been identified) and number of past years affected. Therefore, it is not possible to estimate these amounts – although in some potential cases they could be in the tens of millions of GST revenue.

***Limited consultation with affected parties***

**Issue one: *Correct amount of GST adjustment***

A draft interpretation of the current law on the first issue is currently being consulted on and the initial feedback that has been received supports the proposed policy change as it would align the law with common business practices.

Some submissions were received on a similar proposal in 2012 (see section 5.1 below for more detail) which have been used to inform this RIA.

However, there has been no specific consultation on the proposed changes.

**Issue two: *Application of the time bar to credit notes***

The second issue has not been consulted on with external parties as informing external parties that the time bar may be ineffective could expose the Government to a significant fiscal risk. A GST registered person may be able to use credit notes to claim large GST refunds if they discovered they had been applying an incorrect GST treatment for a long time (e.g. more than 8 years).

Consultation will occur once the bill is introduced and during the Select Committee stage of the bill.

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| **Quality Assurance Reviewing Agency:** |
| Inland Revenue |
| **Quality Assurance Assessment:** |
| The Quality Assurance reviewer at Inland Revenue has reviewed the *GST refunds using credit notes* RIA and considers that the information and analysis summarised in it **partially meets** the quality criteria of the Regulatory Impact Analysis framework.<br><br>The Key Limitations or Constraints on Analysis section of the RIA notes that no consultation has been undertaken on the specific proposals and the amount of fiscal risk from not changing issue two is unable to be quantified. The first proposal is taxpayer favourable and maintains current operational practice. The second proposal is a base maintenance change consistent with the policy intent and the fiscal impact, although not quantifiable poses a significant risk if not addressed. The reviewer considers that the information in the RIA is as complete as could be expected and identifies the main risks and uncertainties. |
| **Reviewer Comments and Recommendations:** |
| Comments from the review of earlier versions of this RIA have been incorporated into this version. |
| **Responsible Manager (signature and date):** |
| <br><br><br>Graeme Morrison<br>Policy Lead<br>Policy and Strategy<br>Inland Revenue<br><br>23 October 2019 |

# Section 2: Problem definition and objectives

## 2.1 What is the policy problem or opportunity?

GST credit notes are issued by a supplier when the price for a supply is reduced after a tax invoice was issued, for example when faulty goods are returned. When a credit note is issued:

- the supplier must make an adjustment in their GST return in the period they issued the credit note; and
- the recipient (if GST registered), must make an adjustment in their GST return in the period they received the credit note.

Through these adjustments, the supplier will effectively be refunded for the GST accounted for on the portion of the supply that was refunded, and the recipient (if GST registered) will be required to repay the GST claimed on the refunded portion of the supply.

Inland Revenue has recently considered how the GST credit note provisions apply in cases where the GST registered business standard-rated (applied 15% GST) to a supply of goods and services which should in fact have been exempt (e.g. a financial service) or zero-rated (e.g. an export).

This has raised two policy issues:

**Issue one: *Correct amount of GST adjustment***

Firstly, from a policy perspective the current law may provide an incorrect amount of GST adjustment in situations where a supply was standard-rated but should have been exempt or zero-rated. This is because, the GST adjustment may be limited to the tax fraction (3/23rds) of the adjusted price.

For example, consider a supply of $100 plus $15 of GST which was incorrectly charged. The supply should have been exempt or zero-rated (no GST). In this situation, the correct policy outcome would be for the supplier to issue a credit note and make an adjustment for the incorrectly returned $15. The recipient (if GST registered) would then make an adjustment for $15 incorrectly claimed.

However, according to a draft interpretation that Inland Revenue is currently consulting on, the GST adjustment is limited to the tax fraction (3/23rds) of the price adjustment. Since the price adjustment is $15, the GST adjustment is limited to $1.96 (3/23 x $15) rather than $15.

This interpretation would not accommodate common commercial practices whereby GST registered persons issue credit notes to provide a $15 GST adjustment (rather than amending the original return). Although GST registered persons can request approval from Inland Revenue to amend their original GST return to get the correct $15 GST adjustment, this approach is inferior to using a credit note as it involves additional compliance costs and administrative costs.

**Issue two: *Application of the time bar to credit notes***

The second issue concerns whether the "time bar" is effective at limiting GST refunds that arise due to credit note adjustments. The ability to adjust a GST return to claim a GST refund is "time-barred" which means a GST registered person can only claim a GST refund in respect of GST returns that were filed less than 4 (or in cases of a clear mistake or simple oversight less than 8) years prior to the current date.

In contrast, because the credit note is issued on the current date, the time bar may be ineffective in respect of a credit note adjustment. This poses a potentially large fiscal risk as it means a GST registered person may be able to use credit notes to claim large GST refunds if they discovered they had been applying an incorrect GST treatment for a long time (e.g. more than 8 years). This would be contrary to the policy intent of the time bar on GST refunds.

## 2.2 Who is affected and how?

The first issue affects some GST registered persons (businesses) which have incorrectly charged 15% GST on a sale of goods and services when that sale should in fact have been exempt or zero-rated (0%).

However, GST advisors have informed us it is a common commercial practice to use credit notes to provide the correct amount of GST adjustment in such cases, in which case the proposed law change would simply align with existing practice (and therefore have no impact on compliance costs).

The second issue could potentially provide additional GST refunds to some businesses on rare occasions where they made a mistake more than 4 or 8 years ago. However, it was not intended that GST registered persons could receive additional GST refunds from using a credit note instead of adjusting the original GST return.

## 2.3 Are there any constraints on the scope for decision making?

There are no constraints on the decisions.

# Section 3: Options identification

## 3.1 What options have been considered?

The following criteria was used to assess the options:

- Horizontal equity – the affected parties should be able to achieve the intended policy outcomes and similar outcomes as other groups in similar situations such as those who amend their original GST return.
- Certainty – the affected parties should understand how the tax rules operate.
- Compliance costs and administration costs should be minimised.
- Policy stability / sustainability – the option should be able to be maintained and cope with future developments.

**Issue one: *correct amount of GST adjustment issue***

***Option 1: No law change (status quo)***

GST registered persons will still be required to request approval from Inland Revenue to amend their original GST return to get the correct GST adjustment, or accept a lower GST adjustment through a credit note.

*Pros:*

- Requirement to amend original return may provide IRD with a greater ability to check / approve the refund.
- IRD can increase certainty by publishing guidance on how the current law operates.

*Cons:*

- Provides the wrong policy outcome as it results in a much lower amount of GST refund compared to amending the original GST return.
- Uncertain and would impose compliance and administration costs as IRD's draft interpretation does not align with current business practices.
- Inconsistent with self-assessment basis of GST.

***Option 2: Make it easier to make the adjustment through amending the GST return***

This option would allow the affected GST registered persons to amend their GST returns on a self-assessment basis using Inland Revenue's systems (MyIR). For example, by allowing the amendment to be made in their GST return for the next period, or by relaxing the requirement to apply to Inland Revenue to approve an amendment to an earlier GST return.

*Pros:*

- May provide IRD with a greater ability to check the refund.

*Cons:*

- Some additional complexity as to get the correct GST adjustment a different refund mechanism must be used depending on why the GST was incorrect.
- Would impose compliance and admin costs as does not align with current business practices.
- Requires IRD to make systems and process changes and may require a law change.

***Option 3: Law change to clarify the correct amount of GST adjustment*** *(preferred option)*

This option would involve adding a new provision that ensures that when the affected GST registered person issues a credit note for a particular supply, it provides the same amount of GST refund compared to amending the original GST return which included the relevant supply.

*Pros:*

- Provides the same GST refund amount as amending the original GST return.
- Aligns with current business practices.
- Provides certainty about the refund amounts when GST credit notes are used.
- Reduces compliance and admin costs.

*Cons:*

- Requires law change.

**Issue two: *Application of the time bar to credit notes issue***

***Option 1: No law change (status quo)***

Because the credit note is issued on the current date, the time bar may be ineffective in respect of a credit note adjustment, even though the relevant supply which is adjusted was included in a GST return more than 4 or 8 years ago.

*Pros:*

- Allows the business to go back and correct all past mistakes, and claim GST refunds for these, no matter how long ago the mistake occurred.

*Cons:*

- Potentially large fiscal risk to the Government and could effectively allow GST refunds for time-barred returns contrary to the policy intent of the time bar.
- High compliance and admin costs due to the potentially large refund amounts and the historic nature of the relevant supplies.

***Option 2: Align with the time bars which apply for GST refunds made through amending the original GST return*** *(preferred option)*

This would involve applying a time limit from the date of a supply in which a credit note may be issued. The time limit would match the existing 4 year (or 8 year in the case of a clear mistake or simple oversight) time limits for GST refunds which apply when an amendment is made to the original GST return which included the relevant supply.

*Pros:*

- Provides the same GST refund amount as amending the original GST return.
- Provides certainty that the time bar applies to credit notes.
- Reduces compliance and admin costs (consistent set of GST refund rules and likely to align with current practices).

*Cons:*

- Limits the ability to claim GST refunds for past mistakes (but still allows a generous 4 or 8 years for this).

***Option 3: Expand an existing provision which provides a 7 year limit for using credit notes when a supply of land has been incorrectly standard-rated***

Credit notes cannot be issued in relation to supplies of land which were incorrectly standard-rated more than 7 years ago. This 7 year limit could be expanded to prevent a credit note from being issued in respect of other supplies that occurred more than 7 years ago.

*Pros:*

- Aligns with an existing 7 year time limit for credit notes and 7 year record-keeping requirements.
- Provides certainty for the time limit that applies to credit notes.

*Cons:*

- Can allow a different amount of refund to amending the original GST return (as this has a 4 or 8 year time limit) which could change which refund mechanism is used (and increase administration and compliance costs).
- Limits ability to claim GST refunds for past mistakes to 7 years.

## 3.2 Which of these options is the proposed approach?

**Issue one: *Correct amount of GST adjustment***

The preferred option is option 3 – a law change to clarify the correct amount of GST adjustment as it:

- Provides the same GST refund amount as amending the original GST return.
- Reduces compliance and administration costs by aligning the law with some common current practices of the affected businesses.

**Issue two: *Application of the time bar to credit notes***

The preferred option is option 2 - align with the time bars which apply for GST refunds made through amending the original GST return because it:

- Provides the same GST refund amount as amending the original GST return.
- Reduces compliance and admin costs (consistent set of GST refund rules and likely to align with current practices).
- Should be a sustainable policy as it means credit notes cannot be used to undermine the policy intent of the existing time bars for GST refunds and also removes the risk of a potentially large, unintended fiscal cost to the Government.

The proposed options are compatible with the Government's '*Expectations for the design of regulatory systems'*.

# Section 4: Impact Analysis (Proposed approach)

## 4.1 Summary table of costs and benefits

| Affected parties | Comment: | Impact |
|---|---|---|
| **Additional costs of proposed approach, compared to taking no action** | | |
| Regulated parties<br>*(Some GST registered businesses which have incorrectly charged 15% GST)* | ***Issue two:***<br>Lose the potential ability to access an unintended windfall of GST refunds in respect of transactions that took place more than 4 or 8 years ago in "time-barred" periods.<br><br>***Both issues:***<br>Minimal ongoing compliance costs as should be no change compared to current practices for most of the affected businesses. | Unknown, potentially high depending on the scale of the issue that creates the GST refund and number of years affected.<br><br>Low |
| Regulators<br>*(Inland Revenue)* | ***Both issues:***<br>Minimal ongoing administration costs as should be no change compared to IRD's current operational practices.<br><br>One-off cost of law change and associated guidance materials / monitoring and responding to any issues queries with the change. | Low<br><br>Low |
| Wider government | No expected costs. | |
| Other parties | No expected costs. | |
| **Total Monetised Cost** | ***Both issues:***<br>Not possible to quantify. It depends on future issues that give rise to this type of GST refund which are unknown. | Potentially high but unable to quantify |
| **Non-monetised costs** | | *Low* |

| Affected parties | Comment: | Impact |
|---|---|---|
| **Expected benefits of proposed approach, compared to taking no action** | | |
| Regulated parties<br>*(Some GST registered businesses which have incorrectly charged 15% GST)* | ***Issue one:***<br>Certainty and minimising compliance costs by aligning the law with current practices for most of the affected businesses. | Low |
| Regulators<br>*(Inland Revenue)* | ***Issue two:***<br>Removes the risk of a potentially large, unintended fiscal cost to the Government. | Unknown, potentially high depending on the scale of the issue that creates the GST refund and number of years affected. |

| | | |
|---|---|---|
| | ***Both issues:*** Certainty and minimising compliance costs and systems changes by aligning the law with current operational practices. | Low |
| Wider government | No expected benefits. | |
| Other parties | No expected benefits. | |
| **Total Monetised Benefit** | ***Both issues:*** Not possible to quantify. It depends on future issues that give rise to this type of GST refund which are unknown. | Potentially high but unable to quantify |
| **Non-monetised benefits** | | *Low* |

| 4.2 What other impacts is this approach likely to have? |
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| No other impacts have been identified from the proposed options. |

## Section 5: Stakeholder views

**5.1 What do stakeholders think about the problem and the proposed solution?**

**Issue one: *Correct amount of GST adjustment***

A draft interpretation of the current law on the first issue is currently being consulted on (*PUB 00352, Changing GST treatment after reducing the previously agreed consideration*) and the initial feedback that has been received supports the proposed policy change as it would align the law with common business practices.

A similar set of proposed changes to the credit note rules was consulted on as part of 2012 issues paper *GST remedial issues*. However, a decision was made not to proceed with any changes to the credit note rules in 2012. This was because one part of the 2012 proposals suggested that when a credit note was issued in such circumstances it should be necessary to pass on the GST refund to the purchaser. Submissions from private sector GST advisors disagreed with this aspect of the proposal and noted that whether or not a refund should be paid through to the purchaser was a contractual matter and should not be dictated by the GST Act. The new proposal does not include the aspect which these submitters opposed in 2012.

**Issue two: *Application of the time bar to credit notes***

The issue of how the time bar applies to credit notes has not been directly consulted on with external parties. Informing external parties that the time bar may be ineffective in such cases could expose the Government to a significant fiscal risk. To manage this risk the proposed option could apply from the date that the bill containing the proposed amendment is introduced.

Despite this, a proposed option which would have addressed the second issue was referenced in the 2012 consultation document *GST remedial issues* (which asked whether that adjustment should be treated as taking place in the same period as the original supply), but no submissions were received on this option. A decision was made not to proceed with any of the proposed changes to the credit note rules in 2012 due to submitter's disagreeing with one aspect of the 2012 credit note proposals that suggested that the refund should be passed onto the purchaser (described above).

**Further consultation**

Further consultation on both issues / proposals will occur during the Select Committee stage of any bill containing the proposed amendments.

It is expected that some stakeholders will submit against the proposal to apply a time bar to credit notes as the proposed law change could potentially limit businesses ability to claim a GST refund for errors they made in their GST returns more than 4 or 8 years ago.

However, it was not intended that GST registered persons could receive additional GST refunds from using a credit note instead of adjusting the original GST return as this would be contrary to the policy intent of the time bar on GST refunds. Most of the affected businesses have been applying the time bar on GST refunds to credit notes (and this has also been Inland Revenue's operational practice). This means the proposed law change to apply a time bar would align with these current practices.

In contrast, if the existing law is unchanged it could potentially provide an unintended windfall of large GST refunds in respect of transactions that occurred more than 4 or 8 years ago in "time-barred" periods.

## Section 6: Implementation and operation

| 6.1 How will the new arrangements be given effect? |
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| The proposals will require amendments to the Goods and Services Act 1985 which could be included in the next available tax omnibus bill expected to be introduced in early 2020.<br><br>Guidance materials to explain how the amendments would operate will be published when the bill is introduced, in response to submissions raised with the Select Committee and after the bill is enacted.<br><br>There is a risk that the proposed amendments could have unintended consequences or may not adequately accommodate existing business practices. These risks will be mitigated by aligning the provisions with similar existing rules, consulting GST advisors once the relevant provisions are introduced in a bill and through the monitoring described in section 7.1 below. |

# Section 7: Monitoring, evaluation and review

| 7.1 How will the impact of the new arrangements be monitored? |
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| As both proposed law changes are expected to align the law with the current practices of most of the affected businesses and Inland Revenue's operational practice, they should have minor impacts on compliance and administrative costs.<br><br>Inland Revenue will monitor if any unintended consequences arise through its usual processes of monitoring GST refunds, and through contacts and feedback from the affected businesses and their GST advisors. Inland Revenue would then consider how best to address specific issues that arise. This could include answering queries, publishing guidance materials, adjusting operational practices, making remedial law changes or reviewing the policy. |

| 7.2 When and how will the new arrangements be reviewed? |
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| The review will be the monitoring described in section 7.1. above, on an ongoing basis. |