

Regulatory Impact Statement

GST: change in use adjustments, supply of accommodation, transactions involving nominations, and application of section 19D to non-profit bodies

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options relating to the goods and services tax (GST) treatment of change in use adjustments, supply of accommodation, transactions involving nominees, and application of section 19D of the Goods and Services Tax Act 1985 (GST Act) to non-profit bodies. These areas have been identified as problematic to both taxpayers and the Government, and as affecting the integrity of the GST system.

The analysis of different options was subject to extensive consultation under the Generic Tax Policy Process. Different options for dealing with the GST concerns have been considered in the light of submissions on the 2008 issues paper *Options for strengthening GST neutrality in business-to-business transactions* and 2009 discussion document *GST: Accounting for land and other high-value assets*, and are discussed in greater detail in the main body of the regulatory impact statement. The submissions on those consultation documents agreed that there is a need to address the issues discussed in this regulatory impact statement. We have also consulted with the Treasury who agree with our analysis of the options considered in this regulatory impact statement.

Inland Revenue is of the view that there are no significant constraints, caveats and uncertainties concerning this regulatory analysis. We consider that the options will not impose significant additional costs on businesses, impair private property rights or market competition, reduce the incentives for businesses to innovate and invest, or override fundamental common law principles. The proposals are not expected to have any significant revenue impact, although the revenue impact of the proposed amendments to the change in use adjustment rules is difficult to estimate with any degree of certainty.



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STATUS QUO AND PROBLEM DEFINITION

1. A number of areas of GST have been identified as not sufficiently clear or comprehensive. These areas of GST cause difficulties for both taxpayers and the Government, and affect the integrity of the GST system.
2. The issues are:
 - A. It is difficult to account for change in use of goods and services.
 - B. The boundary of the definitions of “dwelling” and “commercial dwelling” is not clear.
 - C. The treatment of transactions involving nominees is not clear.
 - D. Non-profit bodies’ operation may be affected by the requirement to change their accounting basis.
3. The Government indicated its intention to deal with the first three areas as part of the 2009 discussion document *GST: Accounting for land and other high-value assets*. The final area was raised by a submission to the discussion document.

A. Accounting for changes in the use of goods and services

4. The amount of an input tax deduction that can be claimed by a GST-registered purchaser in respect of acquired goods and services should relate to the taxable use of the goods and services. This is currently achieved by a set of complex adjustment rules.
5. Under the current regime, GST-registered persons may claim a full input tax deduction for GST paid on goods and services acquired for the principal purpose of making taxable supplies.
6. If the goods and services acquired for the principal purpose of making taxable supplies are used partly or entirely for another purpose, such as for private and exempt purposes (non-taxable purposes), the GST Act treats the non-taxable use of goods and services as a taxable supply by the registered person, and output tax is charged accordingly. In this way, goods and services that are “self-supplied” are treated in the same manner as other supplies.
7. Conversely, goods and services acquired principally for a non-taxable purpose (for which the GST-registered person is not entitled to an input tax deduction) may be partly or entirely used to make taxable supplies. In these circumstances, the GST Act allows a deduction to reflect that taxable use.
8. This approach of taxing the “self supply” of goods and services has often been criticised by commentators and tax practitioners as conceptually complex and confusing. It ignores the original input tax deduction claimed by the GST-registered person as the change in use adjustments do not relate to the amount of the deduction claimed on acquisitions. This is because the use of goods and services for a non-principal purpose is deemed to be a supply which is separate from the purchase transaction.

9. Another problem is that the GST Act does not provide a statutory limit to the maximum number of adjustments that have to be made. Therefore, since change in use adjustments do not relate to the amount of the initial input tax deduction, the value of adjustments that a person is required to make may potentially amount to more than the original GST paid on the purchase. It also means that in some cases, the value of the deduction received by means of change in use adjustments could exceed the amount of GST originally paid.

10. Other issues concerning this approach have been raised by the Court of Appeal decision in the *Lundy* (2005) 22 NZTC 19 at 637 case, which involved land being used concurrently for taxable (advertised for sale) and non-taxable (generating rental income) purposes.

11. Overall, because of the current detachment between the initial input tax claimed on acquisition and the subsequent change in use adjustments, the concepts behind imposing GST on mixed use assets are not sufficiently clear for many taxpayers. Coupled with the absence of any limits as to the maximum number of adjustments, the current regime may result in over or under taxation.

B. Supplies of accommodation

12. In October 2006, Inland Revenue released a draft interpretation statement about the exemption from GST for accommodation provided in a dwelling. Inland Revenue received a number of comprehensive submissions on the exposure draft, many of which requested that the policy underlying the GST treatment of accommodation be reviewed. Most submissions were concerned that the current legislative framework did not give taxpayers enough certainty about when the supply of accommodation should be treated as a taxable or exempt supply.

13. Accommodation provided by GST-registered persons in a “commercial dwelling” is a taxable supply, whereas the supply of accommodation in a “dwelling” is exempt. Supplies of “dwelling” were not included in the GST base because of concerns that if GST applied to rents, it would give owner-occupiers of residential accommodation a tax preference over tenants who reside in rental properties. Arguably, this goal is not currently achieved due to the wide interpretation of the definition of “dwelling”.

14. The current uncertainty around the boundary between the definitions of “dwelling” and “commercial dwelling” may create difficulties for suppliers of accommodation in identifying whether they are making taxable or exempt supplies. The current situation may cause different suppliers of essentially the same type of accommodation to treat their supplies differently for GST purposes owing to the suppliers’ differing interpretations of what constitutes a “dwelling” and “commercial dwelling”. This uncertainty may result in compliance costs to taxpayers and revenue loss to the Government (as a result of some commercially provided accommodation being treated as exempt from GST).

C. Transactions involving nominees

15. GST is often described as a tax on transactions. Most transactions involve only two parties – that is a contractual vendor and a purchaser – and much of the GST Act operates on that assumption. The GST Act is not generally designed to cater for tripartite arrangements –

that is arrangements where three parties are involved. A tripartite arrangement would ordinarily involve a purchaser nominating another person (a nominee) to receive the goods and/or settle the transaction.

16. In the absence of appropriate guidance, taxpayers have been experiencing uncertainty as to the GST treatment of nominee transactions, especially in relation to claiming input tax deductions. Such confusion and uncertainty undermines the design of GST.

D. Application of section 19D to non-profit bodies

17. Owing to differences in the accounting practices of different businesses, the GST Act allows differing accounting bases. Since parties to a transaction may not be using the same accounting basis, a GST-registered person accounting for GST using the payments basis may make a supply to a GST-registered person who accounts for GST using the invoice basis. In these situations, the payments-basis supplier accounts for GST when payment is received, while the purchaser may claim an input tax deduction following receipt of the tax invoice. These differences in accounting basis may be deliberately used in a small number of cases to obtain a tax benefit by deferring the payment of output tax for a significant period of time or even indefinitely.

18. The aim of section 19D of the GST Act is to limit taxpayers' choices of accounting bases when the application of GST accounting principles could give rise to such tax-base risks. Specifically, section 19D requires GST-registered suppliers accounting for GST using the payments basis to use the invoice basis when the consideration payable for a supply of goods and services is \$225,000 or more (including GST) and payment by the customer is deferred.

19. Section 19D applies to all taxpayers. The universal application of section 19D may have an unintended detrimental effect on some non-profit bodies. For example, a non-profit body may agree to supply an asset, such as a house, to an individual in need. Often the agreement will stipulate that the recipient of the asset will make a number of payments over a period of time and will receive the title in the asset when the asset has been paid for in full. These types of arrangements may trigger section 19D, and require the non-profit body to account for GST on an invoice basis. This would result in the non-profit body having to account for the GST on the entire purchase price at the outset, therefore creating a significant cost to the non-profit body. Consequently, the operation of the rule may discourage non-profit bodies from providing goods and services over a certain value.

OBJECTIVES

20. Since 1995 tax policy has been developed in accordance with the Generic Tax Policy Process, a process designed to produce better, more effective tax policy. Among other things, the process involves the post-implementation review of legislation, and the identification of remedial issues.

21. The review of the areas of GST described above and contained in the 2008 issues paper *Options for strengthening GST neutrality in business-to-business transactions* and the 2009 discussion document *GST: Accounting for land and other high-value assets* indicated that in

certain areas there is a lack of simplicity or certainty regarding the underlying rules. The objective of the proposals outlined in this regulatory impact statement is to correct those deficiencies and therefore improve the GST system as a whole.

REGULATORY IMPACT ANALYSIS

A. Input tax and change in use adjustments

22. We propose to replace the existing complex and confusing adjustment approach with an approach that would apportion input tax deductions in line with the actual use of the goods and services. It is proposed that the current framework be replaced with the following rules:

- On acquisition, unless an exclusion applies, the portion of a deduction that a registered person can claim must correspond with the portion of the asset that is intended to be used for taxable purposes.
- In subsequent years, a person may be required to adjust the deduction claimed if the extent to which the asset is used for taxable purposes is different from the intended taxable use of the asset. A number of exemptions will be introduced to relieve a person from the requirement to make adjustments if the amount of revenue from the adjustments is low.
- A maximum number of adjustments that a person may be required to make will vary according to the asset's value or estimated useful life of the asset.
- Special "wash-up" rules will be introduced to deal with situations when goods are sold or a person deregisters.
- Legislative clarification of the treatment of assets used concurrently for taxable and non-taxable purposes will also be provided.

23. Transitional rules will be provided to allow taxpayers to use the new apportionment rules in respect of assets that have already been subject to the current change in use adjustment rules.

24. Submitters on the 2009 discussion document *GST: Accounting for land and other high-value assets* supported the proposed changes. It is considered that the proposed rules will be easier to use and understand than the current rules. Moreover, the proposals should reduce compliance costs for some taxpayers as, unlike the current rules, the requirement to make change in use adjustments in relation to assets other than land will be limited to a maximum of ten adjustments.

25. As Inland Revenue does not collect complete information about change in use adjustments, it is not possible to identify how much of the output tax paid or input tax received relates to change in use adjustments. Therefore, it is not possible calculate with certainty the revenue impact of the proposed changes.

26. The proposed changes will not have any social or environment impacts.

B. Supplies of accommodation

27. Supplies of accommodation in a “dwelling” are not included in the GST base because if GST applied to rents, it would give owner-occupiers of residential dwellings a tax preference over tenants who reside in rental properties. Thus, the definition of “dwelling” is intended to apply to situations where there is a reasonable level of substitutability between renting and owning a home. This goal is not currently achieved owing to the potentially wide interpretation of the term “dwelling”. Moreover, the boundary between what constitutes a “dwelling” and a “commercial dwelling” is not always clear and may not recognise more current types of accommodation.

28. It is proposed that the definitions of “dwelling” and “commercial dwelling” be amended to clarify the boundaries of those definitions and to ensure the GST treatment of equivalent types of accommodation are better aligned. The amendment will provide a narrower definition of what constitutes a “dwelling”, therefore, ensuring that the exemption from GST applies only in situations where there is a reasonable level of substitutability between renting and owning a house.

29. The amendments will also include a revised list of “commercial dwellings”, such as homestays, farmstays, and serviced apartments.

30. The proposed changes should give suppliers more certainty as to whether they supply accommodation in a “dwelling” or a “commercial dwelling”, by reducing their compliance costs. Since the changes involve narrowing the definition of “dwelling”, some supplies that are currently treated as supplies of a “dwelling” may be treated as supplies of a “commercial dwelling” under the proposed rules. This may result in more persons being required to register for GST – thereby having to account for the output tax and claim input tax deductions.

31. Again, officials have not been able to estimate the revenue impact of the changes. Owing to the narrower definition of “dwelling”, the changes are not expected to result in a revenue loss.

32. The proposed changes will not have any social or environment impacts.

Other options considered

33. In addition to the option proposed above, the 2008 issues paper *Options for strengthening GST neutrality in business-to-business transactions* considered another option for dealing with the issues.

34. This option would involve replacing the current legislative framework with terms that are more descriptive of the normal use of the premises. For example, the term “commercial dwelling” would be replaced with the term “guest accommodation”. Accommodation provided in a hospice, rest home or similar – but not including a hospital or a dwelling in a retirement village – would be defined as “care accommodation”. Both supply of “guest accommodation” and “care accommodation” would be taxable.

35. The majority of submissions on the issues paper supported the former option for resolving the concerns regarding supplies of accommodation. It was considered that the alternative option did not have enough advantages over the current approach to justify such a drastic change to the GST Act.

C. Transactions involving nominees

36. It is proposed to clarify the rules to provide that in transactions involving nominations the GST treatment should be determined on the basis of the transaction's economic substance. This is done by:

- In transactions involving a “bare” nomination, in which the transaction is settled by the purchaser, there will be only one supply which will be to the purchaser. The purchaser will be the only party entitled to an input tax deduction.
- Where a vendor agrees to sell goods or services to a purchaser, and the purchaser nominates a nominee to settle the transaction by paying the purchase price to the vendor, the rules would treat the arrangement as involving one transaction – from the vendor to the nominee. The contractual purchaser would essentially be treated as acting as an agent for the nominee and “ignored” for GST purposes.
- Where a purchaser pays a deposit or contributes to the purchase price on settlement (but does not pay the whole amount of the purchase price), the rules will treat the transaction as involving a single supply between the vendor and the purchaser, with the purchaser being entitled to the input tax deduction. However, the purchaser and the nominee would be able to override this default rule by explicitly agreeing that the supply of the property be treated as a supply by the vendor to the nominee.

37. The proposed rules will also affect the tax invoice requirements. In normal circumstances, a taxpayer must have a tax invoice in order to claim an input tax deduction. In transactions involving nominations, a nominee may not have the tax invoice as it may have been issued to the purchaser. The absence of a tax invoice will not prevent the nominee from being able to claim a deduction as long as there is sufficient other documentation to establish the nominee's claim, based on the agreement between the purchaser and the nominee.

38. It is considered that this codification of the effect of nominations will provide more certainty to taxpayers as to their respective status in a transaction. As a consequence of this greater certainty, there should be a reduction of compliance costs to taxpayers involved in nominee transactions.

Other options considered

39. An alternative approach is to treat each nomination as a separate transaction for GST purposes and apply the current GST rules on this basis. For example, if a vendor agrees to sell goods or services to a purchaser, and the purchaser nominates a nominee to settle the transaction, the rules would treat the goods and services as being supplied twice for GST purposes – from the vendor to the purchaser under the original contract, and from the purchaser to the nominee under the nomination agreement.

40. This approach would also achieve the objective of clarifying the respective positions of parties in a nominee transaction, and, therefore, would provide more certainty than there is currently.

41. This “transactional” approach is not, however, supported by officials as it does not reflect the economic reality that there is ultimately only one transaction in which the goods and services are supplied by the vendor. This approach would require the identification of each party’s registration status and the GST consequences of the transaction may bear no resemblance to the economic substance of the transaction.

42. Most submitters on the 2009 discussion document *GST: Accounting for land and other high-value assets* supported the first option for dealing with transactions involving nomination.

43. Neither option would have any revenue, social or environment impacts.

D. Application of section 19D to non-profit bodies

44. To ensure that section 19D does not adversely affect the provision of supplies by non-profit bodies, it is proposed to exclude non-profit bodies from the application of the section in circumstances where the avoidance risk is low. Thus, a non-profit body that accounts for GST on a payments basis will not be subject to section 19D if the non-profit body determines that the recipient is a non-registered person who does not intend to use the asset in a taxable activity at the relevant time.

45. The proposed change would relieve the burden of section 19D from non-profit bodies, therefore allowing them to operate without the additional cost of having to fund the full cost of GST upfront.

46. There should be no revenue impact from the proposal as the risk of non-profit bodies seeking timing mismatches in relation to private consumer transactions is minimal.

CONSULTATION

47. In June 2008, officials released an issues paper, *Options for strengthening GST neutrality in business-to-business transactions*, which suggested a number of options to help resolve GST neutrality concerns and improve the operation of GST in general. Submissions on the issues paper led to further refinement of the options. These proposals were subject to further consultation in November 2009, as part of the government discussion document *GST: Accounting for land and other high-value assets*.

48. Submissions on the discussion document confirmed that there are good reasons to change certain aspects of the way GST operates. Specifically and as already noted, submitters generally supported the proposed rules in relation to change in use adjustments, nominations and accommodation. These submissions have been taken into account when assessing the options to address the problem.

49. The Treasury has been consulted on the topics considered in this regulatory impact statement and agrees with the chosen options.

CONCLUSIONS AND RECOMMENDATIONS

50. The changes proposed in this regulatory impact statement have been subject to extensive analysis and consultation. It is considered that each proposed option is well-suited for achieving the objective of clarifying the GST treatment of the transactions concerned.

A. Input tax and change in use adjustments

51. The amount of an input tax deduction a GST registered purchaser may claim in respect of an acquired asset should relate to the taxable use of the asset.

52. The current approach does not achieve this objective owing to the lack of connection between the initial input tax deductions and the adjustments for change in use. Coupled with the absence of any limits as to the maximum number of adjustments, the current regime may result in over or under taxation.

53. The proposed regime deals with these concerns by establishing a clear link between the taxable use of the asset, the initial input tax claimed on acquisition and the subsequent change in use adjustments. The proposed regime will also establish a maximum limit on the number of adjustments that have to be made in respect of assets other than land, thereby, providing more certainty to taxpayers regarding the extent of their obligations and reducing compliance costs for some taxpayers.

54. The changes are not expected to have social or environment impacts. It is not possible calculate with certainty the revenue impact of the proposed changes.

B. Supplies of accommodation

55. The current definitions of “dwelling” and “commercial dwelling” do not provide sufficient certainty about when the supply of accommodation should be treated as a taxable or exempt supply. Therefore, it is proposed that a number of changes to the current terms “dwelling” and “commercial dwelling” be made to provide a clearer indication of the boundary between exempt and taxable accommodation.

56. This option is preferred over the other option considered in the 2008 issues paper that would involve replacing the current legislative terms with terms that are more descriptive of the normal use of the premises. Most submitters considered that the alternative option did not have enough advantages over the current approach to justify such a drastic change to the GST Act.

57. The proposed changes are not expected to have social or environment impacts. The revenue impact of the changes is not possible to calculate with certainty.

C. Transactions involving nominees

58. Since the GST Act does not specify the GST treatment of transactions that involve nominations, to avoid uncertainty a codification of this area of law is considered desirable.

59. Officials recommend that, in transactions involving nominations, the GST treatment should be determined on the basis of the economic substance of the transaction. It is considered that this approach is best-suited to ensuring that the GST consequences follow the economic substance of the transaction.

60. Although an alternative approach that would treat each nomination as a separate transaction for GST purposes would achieve the objective of clarifying the respective positions of parties, it would not reflect the economic reality that there is ultimately only one transaction in which the goods and services are supplied by the vendor to the nominee.

61. The codification of this area of law should give taxpayers more certainty about the GST consequences of transactions involving nominees, thereby reducing taxpayers' compliance costs. The changes are not expected to have revenue, social or environment impacts.

D. Application of section 19D to non-profit bodies

62. Section 19D is an anti-avoidance provision aimed to prevent the deliberate manipulation of accounting bases rules with the view to obtaining a timing advantage. The provision may, however, apply to certain supplies made by non-profit bodies, thereby increasing their costs and discouraging them to make those supplies.

63. It is proposed that non-profit bodies be excluded from the application of section 19D when they can determine that the supply is to a non-registered person who is not using asset in a taxable activity at the relevant time.

64. The changes are not expected to have revenue, social or environment impacts.

IMPLEMENTATION

65. The proposed changes will require legislative changes to the Goods and Services Tax Act 1985. The changes are intended to be made as part of the next available tax bill.

66. The amendments in relation to input tax deductions and change in use adjustments, the definitions of "dwelling" and "commercial dwelling", and transactions involving nominees will apply from 1 April 2011 to give taxpayers more time to familiarise themselves with the new rules and, if necessary, change their systems. The proposed rules will apply prospectively. The current change in use adjustment rules would remain in force for goods and services that have been subject to adjustments prior to 1 April 2011, but transitional rules will allow taxpayers to transition those assets to the new rules.

67. The amendment in relation to the application of section 19D to non-profit bodies will apply from the date of enactment.

68. We cannot identify any significant implementation risks associated with the proposals. It is, however, important to ensure that taxpayers are aware of and are able to understand the proposed changes. Inland Revenue will prepare a Tax Information Bulletin item and update the GST Guide to communicate the effect of the proposed changes to taxpayers.

MONITORING, EVALUATION AND REVIEW

69. The proposed amendments will be monitored, evaluated and reviewed as part of the normal post-implementation phase of the generic tax policy process.