GST in New Zealand

2016 Edition

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Foreword

Foreword – John Shewan

My introduction to the political, policy and practical challenges of acceding to demands to exempt certain goods and services from GST on social good grounds came as a submitter in 1985 to Parliament's Finance and Expenditure Select Committee, the Committee responsible for the Bill to introduce the controversial new tax into law. The submitter ahead of me argued with considerable passion that imposing tax on books was abhorrent. The Chair of the Committee, Hon Trevor de Cleene, asked if the exemption requested would apply to all forms of literature. The answer was "of course". In response Mr de Cleene held up a glossy magazine featuring photographs of fit young men and women in various degrees of undress. With a wide grin he explained the tone of the accompanying narrative, and asked how, as a politician, he might explain to the public why GST should not be payable on this literature but should be payable on food and medicines. The embarrassed and red-faced submitter replied that food and medicine must be exempted as well, but that the nasty magazine should either be banned or taxed at a rate much higher than the 10 per cent proposed.

To the credit of successive governments, almost 30 years from its introduction New Zealand's GST system continues to be held up as the international benchmark for a value added tax. Its comprehensive base and single rate render it the envy of other nations with consumption taxes. Politicians in Australia and beyond shake their heads in disbelief at how in 2010 the New Zealand Government succeeded in selling to the public the merits of an increase in the rate of GST from 12.5 per cent to 15 per cent in return for reductions in personal tax rates and increases in benefits.

The policy and design attributes that underpin the success of New Zealand's GST feature throughout this book. The GST regime is very well designed. Conceptually, it starts from a very simple premise: its purpose is to raise a substantial portion of the revenue required to fund Government spending by imposing tax on goods or services consumed in New Zealand. The tax should be borne by the end consumer only, not by businesses and other intermediaries, and to be efficient and fair there should be no exceptions. Exceptions create winners and losers, complexity and confusion, anomalies and distortions. The public ends up paying for the resulting revenue loss.

While simplicity lies at the heart of the success of GST, the system is in fact very complex. The same is true of the internet, smart phones and motorcars. Top sports teams like the All Blacks make classy manoeuvres on the field look easy, but most try-scoring thrillers come off the back of months of complex design and training. So it is with GST.

The challenge in writing on any complex subject is how to pitch the text in a way that answers the core question "what does the reader need to know, and in how much detail?" *GST in New Zealand* cleverly addresses the issue by producing a text that should prove to

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be just as helpful to a person considering a one-off commercial property transaction as it will be to an accountant, lawyer, expert adviser, litigator, CFO or business operator who is dealing with GST on a regular basis. This is achieved through the use of a tiered approach that reminds me of circling an area of scenic beauty in a helicopter. To see and understand more you simply elect to descend closer to ground level. If you need to know a lot more you land and explore the area.

Readers wanting a general understanding of the theory and practice of GST, including a feeling for the compliance obligations and pros and cons of registering, will find all they need in the overview contained in Part 1 of the book. Students will benefit from this section as a launch pad for their broader studies. Management and company directors will find it a good appetiser. This group may not wish to take the helicopter any lower, although I expect that in casting their eye over the contents page many will spot a particular area of interest in the later parts of the book which they will consider worthy of a fly past or on the spot landing.

Part 2 of the book contains a detailed and extremely well referenced technical commentary. This will be an invaluable resource for advisers and others looking for in-depth guidance on a particular aspect of GST. The general editors and authors are seasoned operators with a wealth of experience in the law and practice (and, in one case, judicial interpretation) of GST, and it is therefore not surprising that the end result of their collective efforts is an exceptionally comprehensive and insightful coverage of the subject.

As a former practitioner in tax I often pondered why a particular provision was expressed as it was, or why a change had been made (or not made) in a certain area. Knowing what Parliament was trying to achieve, the perspective the courts have brought or what Inland Revenue's current views are, is typically a helpful starting point in interpreting a tax provision. *GST in New Zealand* provides a comprehensive road map, often starting with an historical overview of a provision, then citing relevant Inland Revenue publications and cases, then pulling the threads together with commentary topped off with pragmatic and insightful commercial guidance.

The inclusion of Part 3 of the book was a brainwave. It must have been tempting to sign off at the conclusion of the two hundred of pages of technical commentary. Modestly, Part 3 is titled "Practical Guides". The 16 or more major topics covered in fact provide much more than a guide on several key problem areas frequently encountered in the GST world. This section of the book could be a stand-alone text for readers who are in need of informed practical guidance on a thorny issue or issues relevant to a transaction they have entered into or are contemplating. Most importantly, every one of these guidance notes provides a sign-post to potential fish-hooks for the unwary. The commentary is clearly deeply rooted in hands-on experience and reflects, I expect, the odd battle scar. Some readers will want to purchase the book to access just one of these chapters.

By way of example, the coverage in Part 3 of the GST implications of property transactions is outstanding. In my experience this area is fraught with difficulty, poorly understood and provides fertile ground for disputes. The myriad of GST issues associated with farms, dwellings, curtilage, leases, deceased estates, changes in use, assignments, nominations, novations, out-of-court settlements, mixed-use and property relationship settlements have kept many a commercial party awake at night. It is rare to come across a text that provides

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sound practical guidance on complex transactional issues, with appropriate doses of commercial caution, having first traversed the content and history of the law, underlying policy and Inland Revenue perspective, overlaid with the odd war story and ideas about how the contractual arrangements might be changed to avoid an unpleasant result.

In 2014, former Reserve Bank Governor and Politician Don Brash and I were invited to assist the Government of The Bahamas in the roll out of their proposed VAT by explaining to the public and the business community how VAT had benefited New Zealand. At that time the draft Bahamas regime was riddled with exemptions and zero-rating and the proposed rates (there were several) were high. Both the public and businesses were vigorous in their criticism, alarming given the proposed start date was only four months away. Specially designed orange coloured anti-VAT t-shirts were significantly more popular than the two curious advocates from New Zealand. During our visit we strongly recommended that the New Zealand model be followed. The New Zealand experience was used to demonstrate that with a substantial broadening of the base the rate could be halved and the system simplified significantly, making the tax much more saleable and efficient.

Our task in The Bahamas would have been immeasurably easier had we had access to a resource such as *GST in New Zealand*. Although the Government largely accepted our recommendations, in formulating them it was necessary to spend significant time digging over old ground to explain the economic considerations, design features and practical issues that legislators, administrators and businesses need to confront before and after a value added tax system is introduced. We spent hours pulling together material on specific topics such as how GST can apply to tourism, major property transactions, general insurance, financial services, bad debts and gambling. *GST in New Zealand* does that, and for that reason should be a useful resource for overseas jurisdictions looking to reform their tax system to introduce or increase reliance on VAT or GST.

This text is effectively three books in one: Part 1–an introduction to GST; Part 2–a detailed commentary on the regime's inner workings; Part 3–a practical guide to GST and common commercial transactions, the returns from which risk being severely undermined by inadequate attention to GST. *GST in New Zealand* is a welcome, user friendly and comprehensive guide which I am pleased to recommend.

John Shewan

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Chapter 26

Land Transactions: Zero-Rating, Dwelling and Curtilage

26.1 Overview

Prior to 2011, the Act treated the supply of land the same as any other supply of goods for GST purposes. Accordingly, a registered person selling land generally paid output tax under s 8(1) (unless supplied as part of a going concern, under s 11(1)(m)) and a registered person purchasing the land claimed an equal amount of input tax credit. A registered person purchasing land from an unregistered person could potentially claim input tax based on the land being secondhand goods under the Act. This treatment created fiscal risk to the revenue. If the seller of the land could not pay their output tax, Inland Revenue was likely, regardless, to have to pay the purchaser their input tax.

Inland Revenue highlighted the issues in Inland Revenue discussion document, *GST: Accounting for land and other high-value assets*, released in November 2009. The discussion document explained that reform was required for the GST treatment of land as a base maintenance measure to prevent the mismatch of compliance obligations. The paper reviewed a number of options for reform, including:

- a domestic reverse charge ("DRC") where the purchaser first pays GST on the supply and then claims input tax on the purchase;
- exempt land (but not improvements) from GST;
- allowing Inland Revenue to caveat land to put all parties on notice that the supply of that land is subject to GST. GST is then satisfied before the vendor can transfer the title to the purchaser. This effectively grants Inland Revenue a priority secured creditor status;
- providing purchasers of land with an input tax credit that can be set off against future output tax, but not refunded in cash; and
- permitting Inland Revenue to recover output tax from any member of the insolvent vendor's corporate group, using a wider definition of "associated persons" in s 2A of the GST Act.

The paper identified problems with each of those proposals. Inland Revenue instead promoted treating all sales of land between registered persons as zero-rated for GST purposes. The commentary to the Taxation (GST and Remedial Measures) Bill explained the rationale for the proposed change:[1]

> "The bill contains provisions that would require GST-registered vendors to charge GST [subject to certain conditions] at the rate of zero percent on any transaction with a registered person involving land or in which land is a component. … These changes are intended to prevent 'phoenix' fraud schemes where GST is refunded to a registered purchaser with no corresponding GST payment made by the vendor."

However, the issues were wider than fraudulent schemes, and the solution affects all business-to-business land transactions. The risk of potentially insolvent vendors not paying output tax, and Inland Revenue having to pay input tax, has been an enduring structural imperfection in the GST regime since it began. Fraud was simply one of the consequences of the design. The land zero-rating provisions are compulsory, meaning taxpayers cannot contract out of the rules to revert to the standard GST treatment. All GST-registered persons (regardless of their tax compliance history) must treat the supply of land to another registered person as zero-rated from 1 April 2011. The reforms deal effectively with the fiscal risks of the previous design of the legislation as far as supplies that wholly or partially involve land.

In some situations compulsory zero-rating will not apply. These are:

- when a registered person purchases land from an unregistered person (if used for making taxable supplies a secondhand goods input tax credit is available);
- when the land is supplied by a registered person to an unregistered person, such as a private consumer, then standard output tax is payable on the sale; and
- situations when the supply is exempt or not taxable, such as the supply of a principal place of residence per s 5(15).

1 Taxation (GST and Remedial Matters) Bill 2010 (182-2), p 2.

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These boundaries, and others, between standard GST treatment and compulsory zero-rating have continued to pose difficulties for taxpayers in practice. Areas of difficulty are:

- what is "land" in this context?;
- the treatment of commercial leases;
- when land transactions must be zero-rated;
- supply of land and related services;
- the consequences of classifying a transaction incorrectly;
- understanding what to look for in sale and purchase agreements; and
- acquiring land subject to Overseas Investment Office approval.

26.2 Zero-rating land — the three-limbed test

There are three limbs to the test governing the zero-rating of land. Under s 11(1)(mb) zero-rating is compulsory when:

- the supply wholly or partly consists of land;
- the supply is made by a registered person to another registered person who acquires the goods with the intention of using them for making taxable supplies; and
- it is not a supply of land intended to be used as a principal place of residence by the recipient of the supply or by a person associated with the recipient of the supply under s 2A(1)(c).

26.2.1 First limb: definition of land

Understanding the definition of "land" for the purposes of compulsory zero-rating is critical. The definition of "land" inserted for zero-rating purposes in s 2(1) of the GST Act includes:

- an estate or interest in land;
- a right that gives rise to an interest in land;
- an option to acquire land or an estate or interest in land; and
- a share in the share capital of a flat-owning or office-owning company, as defined in s 121A of the Land Transfer Act 1952.

The definition of land in s 2(1) of the GST Act for these purposes specifically excludes:

- a mortgage; and
- a lease of a dwelling.

"Land" includes ground within New Zealand, whether below or above water, and things of a permanent nature situated on the ground such as buildings, trees or any other structures that are permanently fixed to the ground.

Under New Zealand law, the Crown owns all land. Rights in respect of land held by others with title to land, usually called owners, derive their interest directly or indirectly from the Crown. Those bundles of rights held by owners are known as "an estate in land". The most comprehensive is a fee simple estate; an example of a lesser estate is a leasehold estate.

The definition of land excludes leases of "dwellings". Rental payments under commercial leases are standard rated, although a high advance rent payment may come within the zero-rating rules. This is discussed further below.

Chapter 40

Transactions with Particular Characteristics

40.1 Assignments, nominations and novations

40.1.1 Assignment

In contract law, an assignment involves an assignor transferring some or all of its rights under a contract to an assignee. Once contractual rights are assigned, the assignee is entitled to performance under the contract and can enforce the contract against the other party to the contract. However, an assignment of contractual rights does not create a contract between the assignee and the non-assigning party. Obligations under a contract cannot be assigned away, as that would allow a contracting party to evade contractual obligations by passing them to a non-creditworthy party. Novation, or a new contract, may effect that result.

In a GST context, an assignment of contractual rights is a supply. Thus, for example, the assignment of a lease of property used by a lessee (tenant) in the lessee's taxable activity will be a taxable supply — in many cases now zero-rated. Under the assignment, the lessee has contractual obligations to the landlord and remains liable under the contract unless the lessee's liability is expressly released by the landlord.

40.1.2 Novation

At its core, the novation of contractual rights and obligations is a process of substitution. That is, it is a transaction where, with the consent of all the parties, a new contract is substituted for one that already exists. In some cases a course of conduct may establish that the parties have substituted their original contract in this way.

Under a novation, an existing contract between two or more parties is discharged, and a new contract between the same or different parties substituted for the old contract. The new contract will be the only continuing set of legal obligations.

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40.1.3 Novation vs assignment

Novation is the most effective means of transferring rights under a contract if the transferor's objective is to avoid liability for future performance of obligations. Novation is often confused with assignment. The distinctions are (where the novation involves a different party):

- Novation abandons the rights and obligations of the outgoing party and instead the new rights and obligations of the incoming party replace them. Assignment is a transfer of rights only, and the original party remains liable.
- Novation requires the consent of all parties in order for it to be valid (that is, by way of tripartite agreement). A contract may be assigned without consent (unless there is a contractual provision to the contrary).
- Novation gives rise to a new agreement on the same terms or different terms to the original agreement, and the original agreement is discharged. An assignment does not discharge or extinguish the original contract. Consequentially, the assignor will remain bound by any prospective obligations and liabilities under it.

40.1.4 Nomination

Purchasers of goods or services may want to nominate someone else to take title of the goods or services. To achieve this, the purchaser of goods or services under a contract may have their name as the purchaser on the contract, but also include a reference to "or nominee" if the purchaser intends someone else is to take title to the goods or services.

A common example of a nomination in this context occurs when a person is entering a contract to purchase land, but desires to have the land acquired by another entity yet to be incorporated. By using the words "or nominee" the purchaser is reserving the right to nominate someone else who is to take title.

The GST Act contains a set of rules in s 60B to govern how nominations will apply in a GST context. Section 60B applies when:

- person A enters into a contract to supply goods or services to another person, person B; and
- person B directs person A to provide the goods and services to a nominated person, person C.

The approach taken in s 60B is to divide supplies into supplies of land and other goods and services:

- For supplies that consist wholly or partly of land, s 60B(6) treats the supply as a supply from person A to person C, the nominated party.
- Other supplies follow the consideration to determine who the contracting parties are for GST purposes. This is clear from the wording of s 60B(2) and (3).

The effect of s 60B(2) and (3) is:

- If person B pays the consideration for the supply, the supply is treated as a supply to person B and person C's existence is ignored.[1]

1 Goods and Services Tax Act 1985, s 60B(2).

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- If person C pays the consideration for the supply, the supply is treated as a supply from person A to person C and person B's existence is ignored.[2]
- When both person B and person C pay part of the consideration, the supply is treated as a supply from person A to person B. However, s 60B(4) allows person B and person C to agree in writing that the supply is to be treated as a supply to person C provided person B has not claimed an input tax credit in relation to the supply.

The words "or nominee" do not mean that the title is or must be conveyed to the nominee, they give the purchaser the right, not an obligation, to have the title conveyed to a nominated party. Care is necessary when the GST status of the nominee under the contract is relevant to the tax status of the supply. For example, under a contract for the sale of land intended to be zero-rated as the purchaser will incorporate a company and register the company for GST purposes. If the contract is expressed as GST inclusive, the purchaser may not carry out the nomination. The vendor will bear the unreimbursed cost of the GST on sale, unless the contract has appropriate provisions.[3]

40.2 Bad debts

A taxpayer may claim an input tax deduction for a bad debt that is written off during the applicable GST period under s 20(3)(i). The rules pertaining to the writing off and claiming of bad debts is set out in s 26.

An invoice-basis taxpayer will have presumably returned the value of the debt at the time it issued the relevant invoice for the supply.[4] Therefore, it will have already returned and paid output tax in respect of that supply. Accordingly, if that trade debt goes bad and payment will not be received, an invoice-basis taxpayer may claim an input tax deduction to reverse out the previous output tax paid in respect of that supply. By contrast, a payments-basis taxpayer will not have returned output tax on most types of supplies until full payment is received (hire purchase sales and door-to-door sales being exceptions), so generally there is no requirement to claim an input tax adjustment if that debt ultimately proves to be bad.

In short, a deduction for a bad debt may be claimed if the taxpayer has:

- made a taxable supply;
- furnished a GST return properly accounting for output tax on the supply; and
- realising the debt is unlikely to be paid, has written off as bad all or part of that debt.

The debt need not be wholly bad before it can be written off as the input tax adjustment is calculated in proportion to the amount of the debt written off. So if part payment is received, then only the unpaid portion may be written off as a bad debt.

To qualify as a bad debt under s 26, the following criteria must be met:

- The debt must objectively be "bad" before it can be written off. If a reasonable and prudent commercial person would consider that it is unlikely the debt will be paid, then the debt is bad. This means the taxpayer must genuinely conclude the debt is irrecoverable.[5]

2 Goods and Services Tax Act 1985, s 60B(3).
3 *Commissioner of Inland Revenue v Capital Enterprises Ltd* (2002) 20 NZTC 17,511 (HC).
4 Goods and Services Tax Act 1985, s 9(1).

- The debt must actually be "written off".[6] Obviously taxpayers will adopt different accounting systems and therefore the actual steps required to write the debt off may differ, but some overt action to record or write off that debt as irrecoverable is required. What is required is for the taxpayer's accounts to cease treating the debt as a collectable asset. Simply considering the debt to be bad in the taxpayer's mind is insufficient.

Both criteria must be met before the bad debt deduction may be claimed under s 26 of the Act.[7]

The requirements for a debt to be written off and an input tax adjustment for GST to be claimed was considered in *Case W3*.[8] There the TRA compared s 26 with its equivalent provision now in s DB 31 of the Income Tax Act 2007 and noted that (apart from minor differences in emphasis) the two provisions had the same requirements. The TRA concluded:

- whether the debt is bad must be determined objectively on the facts. A debt becomes a bad debt when a reasonably prudent commercial person would conclude that there is no reasonable likelihood the debt will be paid; and
- the mere provision of a debt as bad is insufficient to satisfy that the debt has been written off, either for income tax or GST. There must be a genuine assessment that recovery is unlikely to be fruitful. This requires some practical steps to identify that particular debt as irrecoverable within the taxpayer's accounts. There must be evidence to verify this treatment as it is the act of writing off the debt that converts it into a bad debt and gives rise to the input tax adjustment.

Importantly, the bad debt rules in s 26 apply only to trade debts. They do not apply to the loss of capital or an unpaid loan. This type of debt falls within the definition of financial service in s 3(1) and therefore is exempt under s 14(1). In most instances, this distinction is obvious (for example, did the debt arise from the unpaid purchase price for taxable supply of goods or services, or did it arise following the advance of funds or other finance?). However, in some instances unpaid creditors are tempted to seek surety or other forms of payment to recover unpaid trade debts. In those circumstances, the nature of the debt may transform from a trade debt into a financial service. For instance, in *Case Q10* the taxpayer was an invoice-basis registered person who acted as intermediary for the sale of land owned by a third party in return for a commission.[9] The third party could not pay the full commission at the time of sale so the parties agreed that the taxpayer would be paid part of the commission immediately and take a mortgage over other land owned by the third party to secure the remaining balance. When the outstanding balance proved irrecoverable, the taxpayer wrote off the debt and claimed a bad debt for GST (to reverse the output tax paid on the full commission returned at the time the land was sold). The TRA rejected the

5 *Case N69* (1991) 13 NZTC 3,541 (TRA); and *Budget Rent A Car Ltd v Commissioner of Inland Revenue* (1995) 17 NZTC 12,263 (HC).

6 *Budget Rent A Car Ltd v Commissioner of Inland Revenue* (1995) 17 NZTC 12,263 (HC); and *Case Q10* (1993) 15 NZTC 5,061 (TRA).

7 Inland Revenue "Public Ruling BR Pub 05/01: Bad debts – writing of debts as bad for GST and income tax purposes" *Tax Information Bulletin: Volume 17, Issue 2* (March 2005) <www.ird.govt.nz>.

8 *Case W3* (2003) 21 NZTC 11,014 (TRA).

9 *Case Q10* (1993) 15 NZTC 5,061 (TRA).

taxpayer's claim for the bad debt. The TRA ruled that the trade debt for the commission was not bad because it had been satisfied in full at the time the debt was capitalised. In effect, the taxpayer had swapped the trade debt (a taxable supply) for a mortgage (a financial service). The subsequent write-off of the mortgage debt therefore did not give rise to an input tax deduction because it merely represented a loss of capital and was therefore an exempt financial service and not a bad trade debt. Accordingly, taxpayers should be cognisant of the risk of capitalising or taking other forms of security with respect to trade debts as the relief under s 26 may not be available.

Note: When the taxpayer who has previously written off a debt as bad and claimed the corresponding input tax adjustment under s 26 subsequently recovers all or part of the bad debt, the amount of that recovery is again subject to output tax under s 26(2).

Note also, the sale or assignment of a debt to a third party at a discount (known as "debt factoring") does not generally entitle the taxpayer assigning the debt to write off the debt as bad.[10] For a full discussion of the rules relating to debt factoring see 17.8.

40.3 Brokerage and multiple parties providing elements of a supply

Brokerage is the fee charged by an intermediary for bringing together suppliers and consumers of goods or services. The intermediary may be the agent of either party or entirely independent. Sometimes the fee is calculated by reference to the service provided by the intermediary (for instance, the time and costs incurred by the broker) or it may be calculated by reference to the goods or services exchanged between the principal parties (for instance, a commission based on volume or quantum of sales).

The status of the intermediary and its legal relationship with the other parties is crucial to determining the correct GST treatment of brokerage fees.[11]

First, the principle laid down by the Pricy Council in *Commissioner of Inland Revenue v Databank Systems Ltd* provides that each stage in the supply of goods or services must be separately determined.[12] Refer to Chapter 9. In that case, Databank performed a number of accounting and financial clearing services under contract with a number of different banks. The banks relied upon those services from Databank to allow them to process cheques and other payments directed by their customers. The banking services provided to customers by the banks were on any view exempt financial services. However, that did not necessarily mean the services Databank provided to the banks were also exempt financial services.

Databank had no contractual relationship with banks' customers, but claimed its services were so integral to the banks' performance of its exempt financial services to those customers that its own services must also be exempt. The Privy Council applied a separate analysis of each step in the supply chain, normally based upon the contractual relationship/s (if any) between the various parties. In a principled way, the Privy Council looked at what

10 *Case T27* (1997) 18 NZTC 8,188 (TRA); and Inland Revenue "Public Ruling BR Pub 05/01: Bad debts – writing of debts as bad for GST and income tax purposes" *Tax Information Bulletin: Volume 17, Issue 2* (March 2005) <www.ird.govt.nz>.

11 Some agents have obligations created under the Goods and Services Tax Act 1985: see also 4.2, 6.5 and 7.6.

12 *Commissioner of Inland Revenue v Databank Systems Ltd* [1990] 3 NZLR 385 (PC).

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Databank supplied to the banks and then looked at what the banks supplied to their customers. Doing so provided clarity.

The two supplies were made by different parties and were separate for GST purposes. As a result, the inevitable answer was that:

- Databank supplied accounting and clearance services. They do not fall within the definition of "financial services" in s 3 of the GST Act. This was a taxable supply, the same as other companies providing IT and accounting services; while
- the banks supplied loans, deposit accounts and the like, which are "financial services", to its customers, and are exempt from GST.

Parties must determine the true nature of their legal relationships to determine whether any fee paid for the supply made by an intermediary:

- is in respect of a separate supply of brokerage services made by that intermediary; or
- is part of the total supply of goods and services between the parties.

Case U26 illustrates the issue.[13] The owners of a massage facility provided premises to independent masseuses, often for the performance of sexual services. Customers paid a single fee direct to the masseuse who then paid an agreed amount of approximately 30 per cent as a fee to the owner of the facility.

The owners of the facility were GST registered, and returned GST on their receipts. The masseuses were not registered and paid no GST on the remaining 70 per cent. Inland Revenue considered the masseuses were subcontractors performing the parlour owner's business, and therefore the owner should pay GST on the total the masseuses received. The owners said their only contractual relationship was with the masseuses, and they were only entitled to the 30 per cent fee paid for the use of the premises.

Under Inland Revenue's analysis the owner paid GST on 100 per cent of the fees paid by the customer, but could not claim a GST input tax credit for the 70 per cent retained by the unregistered masseuses. Under the owner's analysis, 70 per cent of the fees retained by the masseuses were GST-free as a supply by an unregistered person.

The TRA summarised the issue as follows:[14]

> "The respondent submits that there are two separate supplies made, namely, the overall supply by the partnership to its clients and the incidental supply of services to the partnership by its ladies as its sub-contractors.
>
> "… the issue as far as GST is concerned involves what services are supplied, and by whom, and this involves an analysis of the contractual arrangements made by the individual working ladies. Inter alia, he dealt with the intentions of the parties and the perception of clients to which I have already referred, and also to the general understanding within the industry."

After reviewing the nature of those legal relationships the TRA explained:[15]

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13 *Case U26* (1999) 19 NZTC 9,243 (TRA).
14 *Case U26* (1999) 19 NZTC 9,243 (TRA) at [60]–[61].
15 *Case U26* (1999) 19 NZTC 9,243 (TRA) at [71].

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> "Here the issue is whether the ladies are part of the business enterprise of the disputant partnership as subcontractors to it or whether they are independently operating their own services business as some type of licence holder from the disputant partnership. From an overall perspective I do not find the ladies to be under the control of the disputant any more than is necessary for the efficient and profitable conduct of the disputants' business of making premises available to the ladies. In other words, it seems to me from the evidence overall that the ladies are not integrated into the disputants' business but have their own quite separate respective activities …"

Finally, referring to the principle established in *Commissioner of Inland Revenue v Databank Systems Ltd*[16] the TRA concluded that:[17]

> "… as in *Databank*, there are two separate contracts. In *Databank* there was the contract between a bank and its customers and the contract by a bank with *Databank*. The activities of the banks and *Databank* were separate, notwithstanding they may be simultaneous and interdependent. Here, there is a contract between the disputant partnership and each lady, and between each lady and the customer. On the evidence, the customer never contracts with the disputant partnership. To quite a degree those contracts are simultaneous and interdependent."

As a result, the parlour owner was liable for GST only on the fees it received from the masseuses and not for all fees paid by the customers. This case shows the importance of correctly categorising the relationship between the parties to determine if the fee paid by the intermediary should be treated as a separate supply for GST purposes.

40.3.1 Brokerage of financial services

A common form of brokerage arises with respect to financial services, as defined in s 3 of the Act. This includes financial services providers who supply financial intermediation services. Financial intermediation services bring together suppliers and consumers of financial services. Examples include deposit-taking intermediation, which involves bringing together suppliers and users of financial capital, and brokerage services involving the buying and selling of financial instruments, debt and equity securities, life insurance and currencies.

Those financial services are generally treated as exempt supplies by virtue of s 14(1) of the Act. However, in some instances those financial intermediation services may be treated as zero-rated financial services if provided to GST-registered customers.[18] The rules dealing with the regime for zero-rating of financial services is at 15.9.

It is, however, important to address situations where financial service providers also provide standard rated taxable supplies, such as financial advice. Refer to 14.3.

16 *Commissioner of Inland Revenue v Databank Systems Ltd* [1990] 3 NZLR 385 (PC).

17 *Case U26* (1999) 19 NZTC 9,243 (TRA) at [73].

18 Inland Revenue "GST guidelines for working with the new zero-rating rules for financial services" (October 2004) <www.ird.govt.nz>.

40.4 Business-to-business financial services

From the enactment of the GST regime the policy decision was taken to exempt financial services from GST.[19] This exemption had the dual effect of both ensuring the providers of financial services were not obliged to impose GST on supplies made to customers but also that those providers could not recover the GST paid on the cost of goods and services acquired to make those exempt financial services. Unfortunately, this exempt treatment meant financial service providers had to pay GST on all goods and services acquired to make their exempt supply of financial services, which they could not recover as input tax. This resulted in the over-taxation of financial service providers.

The supplier, therefore, either had to absorb that extra GST expense as part of its cost structure or pass that GST cost on to customers, both private consumers and registered taxpayers who utilised the financial services as part of their own taxable activity (but also could not claim input tax on the cost of acquiring those exempt financial services). Those registered taxpayers then also had to either absorb that extra GST expense or again pass that GST cost to its own customers. This passing on of the additional GST cost caused an undesirable cascade of GST.

Inland Revenue's solution to solve this problem from a policy perspective, announced in a discussion document released in 2002, was to zero-rate most business-to-business supplies of financial services.[20] This proposal provided relief from the over-taxation of financial services by ensuring that:

- financial service providers could recover GST input tax on many of the goods and services they acquired to make financial services. This had the additional benefit of encouraging financial services providers to outsource essential activities, thereby improving efficiency overall; and
- no GST was passed on by those providers to GST-registered customers, thereby reducing the cascade effect (which remained for the supply of financial services to private customers).

The new regime for the zero-rating of business-to-business ("B2B") financial services came into effect on 1 January 2005.[21] The operation of this regime is technically complex and particular advice on its application to individual taxpayers or in specific circumstances is strongly recommended. However, generally the rules provide for some financial service providers to impose GST (at the rate of 0 per cent) on financial services provided to other GST-registered customers, and accordingly to reclaim GST input tax on (a proportion of) the cost of goods and services acquired in making those zero-rated supplies. As a result, the traditional model (whereby GST is not charged on exempt financial services and financial service providers cannot deduct input tax for GST paid on goods and services used in supplying financial services) ceased to apply in many instances.

From 1 January 2005, an additional deduction may be made from output tax for supplies of financial services made to another financial service provider, which, in turn, makes supplies to businesses that qualify to receive zero-rated financial services. The amount of

19 Goods and Services Tax Act 1985, ss 3(1) and 14(1).
20 Inland Revenue "GST and financial services" (October 2002) <www.ird.govt.nz>.
21 Goods and Services Tax Act 1985, s 11A(1)(q) and (r).

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input tax that can be deducted will be determined by the ratio of taxable to non-taxable supplies made by the financial service provider.[22]

Financial services providers can only elect to zero-rate supplies of financial services to a customer that is both GST registered and at least 75 per cent of its total supplies are taxable supplies (or is part of a group that meets this threshold). The 75 per cent taxable supply threshold excludes any business-to-business zero-rated supplies. Applying this 75 per cent threshold ensures that the zero-rating of financial services cannot be applied to supplies made to customers that are unregistered consumers or who are GST registered but make more than 25 per cent exempt supplies.

These requirements impose an obligation on financial service providers to ascertain whether or not the customer is registered for GST and what proportion of taxable supplies it makes. When determining the level of business-to-business zero-rated supplies made by the recipient of the financial service, the supplier must either use actual figures obtained from customers or a proxy method approved by the Commissioner.

As an administrative concession, Inland Revenue has published guidelines to assist financial service providers with determining whether customers meet the 75 per cent threshold.[23] These guidelines permit providers to use the Australian and New Zealand Standard Industrial Classification ("ANZSIC") codes, which identify businesses that have similar economic activities and can be found on the Statistics New Zealand website.[24] If a customer's business activity has been allocated an ANZSIC code a provider may treat it as making taxable supplies that exceed the 75 per cent threshold. Accordingly, in most instances financial service providers need only obtain information from customers as to their GST registration status and the nature of their taxable activities, and then refer to the ANZSIC codes in order to satisfy the statutory requirements for zero-rating.

Having applied the statutory criteria to its customer base, the provider of financial services must then calculate the proportion of its zero-rated financial services compared to its total supplies. This calculation determines the ratio of taxable to non-taxable supplies made by the financial supplier, and therefore the proportion to which the goods and services it acquires in making its total supplies may give rise to a corresponding input tax claim under s 20(3C) of the Act.

Note that a special value of supply rule applies to the supply of a financial service between associated persons that are either zero-rated or are provided to another financial services provider (discussed below). In these cases, the value of the supply must generally be at open market value to prevent any over-valuation of supplies of financial services made between associates.[25]

40.4.1 Supplies made between financial services providers

Given the nature of the financial services industry, many providers make supplies of financial services to each other. Obviously, the recipient of those services would not satisfy

22 Goods and Services Tax Act 1985, s 20(3)(h).
23 Inland Revenue "GST guidelines for working with the new zero-rating rules for financial services" (October 2004) <www.ird.govt.nz>.
24 Statistics New Zealand <www.stats.govt.nz>.
25 Goods and Services Tax Act 1985, s 10(3B).