DavidCo Limited
CHARTERED ACCOUNTANTS

Level 2, Shortland Chambers
70 Shortland Street, Auckland
PO Box 2380, Shortland Street
Auckland 1140
T +64 9 921 6885
F +64 9 921 6889
M +64 21 639 710
E arun.david@davidco.co.nz
W www.davidco.co.nz

WEEKLY COMMENT: FRIDAY 6 MARCH 2015

1. For the next three weeks I am continuing with GST, due to there having been some very recent developments worth commenting on:

   (a) On 13 February Inland Revenue released Exposure Draft ED0164 of Operational Statement: *GST and the costs of sale associated with mortgagee sales*, which updates and will replace OS 005 *GST and the costs of sale associated with mortgagee sales* published in *Tax Information Bulletin* Vol. 16, No. 3 (April 2004);

   (b) On 25 February Inland Revenue released draft Interpretation Statement INS0109: *Goods and services tax – GST and retirement villages* which updates and will replace IS 10/08 *Retirement villages – GST treatment* published in *Tax Information Bulletin* Vol. 22, No. 11 (December 2010);

   (c) On 26 February the *Taxation (Annual Rates for 2015-16, Research and Development, and Remedial Matters) Bill* ("the R&D Tax Bill") was introduced containing measures to clarify the GST position of bodies corporate; and

   (d) On 2 March the TRA decision in *Disputant v Commissioner of Inland Revenue* [2015] NZTRA 1, *TRA 02/10* [2015] NZTRA 01 was released concerning the association between a vendor and a purchaser of land.

2. This week I will look at ED 0164 and the proposed law changes affecting body corporates. Next week I will look at INS0109 on GST and retirement villages and I will look at the TRA decision in TRA 02/10 week-after-next.

ED0164: OS on costs of mortgagee sales

3. Mortgagee sales are a special type of supply dealt with in sections 5(2) and 17 of the *Goods and Services Tax Act 1985* (the "GST Act"):

   (a) Section 5(2) states that the sale by the mortgagee is a supply by the mortgagor in the course or furtherance of the mortgagor's taxable activity (unless the mortgagor provides written confirmation to the mortgagee that the sale is not a taxable supply or the mortgagee determines based on information available that the sale by the mortgagor would not be a taxable supply);

   (b) Section 17 requires the mortgagee to make a special GST return (in Form IR373) by the 28th of the month following the month of sale, and pay the GST on the supply, and the mortgagor and the mortgagee are to exclude the supply from any other GST return they make.

GST is to be calculated on the whole price

4. The first issue discussed is the price on which the GST is to be calculated. The particular question addressed is whether the mortgagee's costs of sale can be deducted before calculating the output GST on the sale. This question is answered in the negative because:

   (a) In the Court of Appeal decision in *Commissioner of Inland Revenue v Edgewater Motel Ltd* [2002] NZCA 293, (2002) 20 NZTC 17,984 the use by Blanchard J of phrases like "by imposing a tax on the sale transaction" and "by way of deduction from the purchase price" clearly indicate that the full sale price is the relevant consideration for GST purposes (the discussion in OS 005); and

   (b) The Privy Council stated, in *Edgewater Motel Limited v Commissioner of Inland Revenue* [2004] UKPC 44, 21 NZTC 18,664, that the GST claim is directly against the mortgagee and is not dependent on any priority to the sale proceeds (the discussion in ED 0164).

5. The *Edgewater Motel* case was not specifically concerned with the purchase price on which GST is to be calculated. Rather, the issue was the order in which the GST was to be paid and the ranking of the GST payable relative to the debt owed to the mortgagee. Following the order of priorities listed in s. 104(1) of the *Land Transfer Act 1952* (and its successor s. 185 of the *Property Law Act 2007*), both the Court of Appeal and the Privy Council held that GST is "an expense occasioned by the sale" which the mortgagee is entitled to deduct from the sale proceeds before payment of his own debt (in other words, the GST had priority over the debt).

Mortgagee cannot claim input tax deduction for costs associated with the sale

6. The second issue discussed is the ability of the mortgagee to claim input tax deductions on the costs associated with the sale. There are three reasons advanced to support the Commissioner's view that the mortgagee cannot claim input tax deductions:

   (a) The right to be paid money is a "debt security" as defined in s. 3(2) and the collection of any amount relating to a debt security is the provision of a financial service, which is an exempt supply in terms of s. 14 of the GST Act, and even if there is an indirect connection with some other taxable activity of the mortgagee any such indirect connection is incidental to the activity of providing financial services;

   (b) The mortgagee acts on their own behalf by exercising rights conferred by the mortgage agreement, and is not acting as the agent of the mortgagor, so s. 5(2) cannot be used to support an argument that input tax deductions are available as agent of the mortgagor;

   (c) *GST - Disputant not entitled to input tax deductions regarding sale of property as mortgagee* [2006] NZTRA 12, *Case Y2* NZTC (2007) 13,017 confirms that the express language of s. 17 provides that in the special return required under that section the mortgagee must pay the full amount of the output tax without any deduction for input tax.

Business-to-business financial services rules will not support an input tax deduction

7. The business-to-business rules ("b-to-b rules") in sections 11A(1)(q) and 11A(1)(r), which allow a financial services business to deduct input tax when supplies are made to a business that makes at least 75% taxable supplies, had been newly legislated when OS 005 was issued and there was merely a statement that the conclusion that the mortgagee was carrying on an

exempt activity was "subject to the newly enacted section". Therefore, the question of whether the b-to-b rules allowed an input tax deduction was left open in OS 005.

8. The discussion in ED0164 negates an input tax deduction because s. 5(2) states the supplies are made in the course or furtherance of a taxable activity by the mortgagee. Therefore the b-to-b rules have no application.

Mortgagor cannot claim input tax deductions

9. The last point discussed in ED0164 (which was not discussed in OS 005) is whether the mortgagor is able to claim input tax deductions on costs incurred by the mortgagee. The answer is in the negative, because the mortgagee is the recipient of the supply, and the mortgagor is not the person who acquired the services. The mortgagee incurs the costs in the course of exercising their own rights.

Body corporate law changes

10. The Government has announced the removal of the requirement for bodies corporate to compulsorily register for GST by the introduction of proposed law changes in the R&D Tax Bill. The history behind the amendments was covered in:

    (a) *Weekly Comment* 5 July 2013 in which I discussed the issues paper released in May 2013: *IRRUIP7: Bodies Corporate – GST registration* ("the bodies corporate issues paper"), the conclusion being that a body corporate must register for GST if it makes taxable supplies exceeding the $60,000 threshold because the better view is that it carries on a taxable activity and makes supplies to its owners in the form of a number of services required by the *Unit Titles Act 2010*.

    (b) *Weekly Comment* 27 June 2014 in which I discussed *GST treatment of bodies corporate – A government discussion document* and the *Commissioner's interim operational position for GST and Bodies Corporate* released immediately after the discussion document.

The June 2014 proposals

11. The proposal in the June 2014 discussion document was to prohibit bodies corporate from registering for GST by introducing a new exemption in s. 14 under which supplies by a body corporate would be exempt from GST, effective from 6 June 2014 (the date of the release of the discussion document).

12. A proposed "look-through" rule, which would also have applied from 6 June 2014, would have allowed an owner to claim GST input tax deductions on goods and services supplied through the body corporate which the owner uses to make taxable supplies.

13. Under the proposals in the discussion document:

    (a) Previously GST-registered bodies corporate would have been required to deregister from 6 June 2014 with consequent output GST liabilities. Inland Revenue warned in the interim operational position that deregistration could result in common property and other goods that the body corporate acquired and still held being deemed to be provided to the body corporate and subject to output GST. This would not include individual units or flats, as they are property owned by the members of the body corporate and not by the body corporate itself.

    (b) Bodies corporate GST-registered before 6 June 2014 did not need to deregister pre-6 June 2014, but were required to backdate GST registration to the time supplies exceeded

$60,000 and they initially became liable to be registered, so that they were consistently GST-registered pre-6 June 2014, subject to a concession that limited backdating to the first taxable period after 1 April 2010.

14. The interim operational position sought to address the confusion resulting from a proposed law change with a past effective date, although the law changes had not even been introduced into Parliament:

    (a) GST-registered bodies corporate had to continue filing GST returns and unregistered bodies corporate could apply to be GST-registered;

    (b) GST refunds could be claimed, but once the law changed refunds relating to post-6 June 2014 had to be repaid and would be subject to use-of-money interest, and any output GST paid would be refunded;

    (c) Bodies corporate registered before 6 June 2014 could apply to have their registration backdated consistent with the proposed backdating rule;

    (d) The proposed "look-through" rule would not be applied until it was actually enacted.

The new proposed amendments in the R&D Tax Bill

15. The June 2014 proposals were very confusing. The Government has now decided to clarify that services provided by bodies corporate are supplies for consideration for goods and services tax (GST) purposes and give bodies corporate the option to register for GST. According to draft legislation in the R&D Tax Bill, this is to be done as follows:

    (a) First, under proposed s. 5(8A), the value of levies and other amounts received by a body corporate from its members is treated as consideration for services supplied. This rule applies from when GST commenced on 1 October 1986.

    (b) Second, such consideration is excluded for the purpose of determining whether the mandatory registration threshold of $60,000 is exceeded, under proposed s. 51(1B). However, a body corporate will be required to register if it receives consideration exceeding the threshold for making supplies to third parties (i.e. supplies to non-members).

    (c) Third, a body corporate that applies after 26 February 2015 (the date of introduction of the Tax Bill) to voluntarily register for GST, will, under proposed s. 51(5B), be GST-registered effective from the date of the application (i.e. backdating registration will not be allowed), and it must stay GST-registered for at least 4 years, under proposed s. 52(9).

    (d) Fourth, if a body corporate applies to be voluntarily registered, the value of its funds on the date it becomes registered is treated as consideration for supplies made on the date it becomes registered, under s. 5(8AB) and output GST must be paid. This rule applies from 26 February 2015 (the date of introduction of the R&D Tax Bill).

    (e) Fifth, if a body corporate is GST-registered – either because it is liable to be registered because it makes supplies to non-members in excess of the registration threshold or it decides to voluntarily register – all supplies become subject to GST, including supplies to members, because proposed s. 5(8A) treats funds received from members as consideration for supplies.

    (f) Sixth, a body corporate that is GST-registered on 26 February 2015 (the date of introduction of the R&D Tax Bill) that applies to be deregistered following the introduction of the new voluntary registration rules will be deregistered with effect on or after the date of the deregistration application, under proposed s. 52(8).

(g) Seventh, the deemed supply of "common property" (which has the same meaning as in the *Unit Titles Act 2010*) by a body corporate upon deregistration has a zero value, under a proposed amendment to s. 10(7A). This rule applies from 26 February 2015 (the date of introduction of the R&D Tax Bill).

(h) Finally, retirement villages are not subject to these rules because their supplies are different from those made by a typical body corporate. The proposed definition of a "body corporate" in s. 2 excludes "a body corporate of a retirement village registered under the *Retirement Villages Act 2003*".

16. In relation to the proposed new rule in s. 5(8AB) imposing a GST output tax liability on funds held at the time of registration, it is noted in the *Commentary* to the Bill that:

"A body corporate's "funds" include all cash and non-cash investments held by the body corporate. The new rule is intended to ensure a body corporate cannot restructure its cash reserves to avoid the application of output tax upon registration. "Funds" will include a body corporate's operating account, long-term maintenance fund, contingency fund and any capital improvement fund (see definition of "fund" under the Unit Titles Act 2010). Any financial investments held by the body corporate are also included (see section 130 of the Unit Titles Act 2010)."

17. In relation to funds held at the time of deregistration it is noted in the *Commentary* that:

"A body corporate seeking to deregister will not be refunded any GST paid on its funds held at the time of deregistration. This is consistent with the treatment of other registered taxpayers leaving the GST system. There is also likely to be a point on the "save and spend" cycle of a body corporate's activities when its accumulated funds are very low and it can exit the GST base with limited financial impact."

18. There is no "look-through" rule, as proposed in the June 2014 discussion document which would allow an owner to claim GST input tax deductions on goods and services supplied through the body corporate which the owner uses to make taxable supplies, if the body corporate does not register for GST.

Arun David, Director,
DavidCo Limited