

# GST & imported services

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*A Challenge in an Electronic Commerce Environment*

*A Government discussion document*

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## PREFACE

Things have changed in the nearly fifteen years since GST was first introduced. Some of the assumptions and realities which underpinned the design of GST no longer hold true.

Removal of regulations from the telecommunications and financial services industries have opened them up to competition. Legal and technological constraints which had acted to stifle international trade in goods and services have faded away.

New Zealanders have become part of the global economy. As a result we are importing more services than when GST was designed. The development of electronic commerce will further increase the extent to which New Zealanders are able to purchase both goods and services from offshore.

Today, if you were to buy services from a New Zealand company, GST is charged. If instead you purchase services from a foreign company supplying services from offshore, GST is not charged. This document examines this tax treatment in the light of changes in the economy and in technology.

This document contains proposals that aim to ensure that the GST system adjusts to the electronic commerce environment and does not unfairly disadvantage New Zealand service industries. It is part of a continuing review of GST and a part of the Government's electronic commerce strategy, as set out in the Government strategy paper *E-Commerce: Building the Strategy for New Zealand*.

We look forward to receiving your submissions on this document.

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## TABLE OF CONTENTS

Chapter 1	INTRODUCTION	1
	Overview	1
	Objectives	1
	Key issues	3
	Application date	3
	Submissions	4
	Summary of proposals	4
Chapter 2	THE ELECTRONIC COMMERCE CHALLENGE	6
	Introduction	6
	The impact of electronic commerce on taxation	6
Chapter 3	GST AND IMPORTED SERVICES	12
	Current treatment of imported services	12
	Problems with the current treatment	12
Chapter 4	OPTIONS FOR TAXING IMPORTED SERVICES	17
	Introduction	17
	OECD consumption tax framework	17
	A change in the GST framework: the origin principle	18
	Register offshore non-resident suppliers	20
	Reverse charge	21
	Preferred option	22
Chapter 5	THE REVERSE CHARGE MECHANISM	24
	Introduction	24
	General application	24
	Limited to acquisitions for purposes other than of making taxable supplies	25
	Time of supply	26
	Valuation	26
	Mixed use acquisitions and apportionment	27
	Documentation requirements	28
Chapter 6	“SERVICES”	29
	Introduction	29
	Broad definition of “services”	29
	Generic description versus list	30
	Proposed policy	30
	The nature of digitised products	31
	Physical imports of software	32

Chapter 7	BRANCH AND INTRA-GROUP TRANSACTIONS AND COST ALLOCATIONS	35
	Introduction	35
	What is a “supply” in the context of cross-border, related party transactions	35
	Cost allocations and related party transactions	37
	Summary of proposed approach	40
Chapter 8	TELECOMMUNICATIONS SERVICES	42
	Introduction	42
	Telecommunications services – the issues	42
	Overseas approaches	44
	Proposed application in New Zealand	47
	The section 11A(2) amendments and telecommunications	49
Chapter 9	BUSINESS-TO-CONSUMER TRANSACTIONS	51
	Introduction	51
	Business-to-consumer transactions: the problem	51
	Possible solutions	51
	The future	55



# Chapter 1

## INTRODUCTION

### Overview

- 1.1 This discussion document considers the application of goods and services tax (GST) to imported services. This was raised as an issue for further development in the Government discussion document *GST: A Review* in March 1999 and in the Government strategy paper *E-Commerce: Building the Strategy for New Zealand* in November 2000. It proposes that GST be imposed on imports of services by registered persons making non-taxable supplies, adopting the “reverse charge” mechanism. It also sets out the proposed scope and general features of the mechanism, and signals further areas for development of GST in the future.

### Objectives

#### *General objectives*

- 1.2 The proposals contained in this discussion document are intended to improve the efficiency and equity of GST, reduce future erosion of the tax base resulting from the growth in electronic commerce and bring New Zealand into line with the internationally accepted GST framework. The proposals are also intended to clarify the international boundary in relation to GST.
- 1.3 This discussion document examines the current GST treatment of imported services in the light of:
- the increase in the volume of imported services since the introduction of GST in 1986;
  - the potential for future increases in the volume of imported services, including digitised products, arising from the rapid growth in electronic commerce;
  - the associated potential for future revenue loss from the GST base as a larger volume of services consumed in New Zealand is potentially supplied from offshore;
  - the competitive distortions created by treating identical supplies of services differently depending on the source of the supply; and
  - the ramifications of treating imported services in a manner inconsistent with New Zealand’s major trading partners and most OECD countries.
- 1.4 The review has been carried out, and the proposals resulting from it have been formulated, in the context of the Ottawa Taxation Framework and the Government’s electronic commerce strategy.

## *The Ottawa framework*

1.5 In October 1998, representatives of several governments (including the New Zealand Government) and businesses met at the OECD ministerial conference “A Borderless World: Realising the Potential of Electronic Commerce” in Ottawa, Canada. The conference discussed how to adapt to the challenges posed by electronic commerce. In relation to taxation, it was agreed at this conference that the same principles that governments apply to the taxation of “conventional” commerce should apply to electronic commerce. The five fundamental principles are:<sup>1</sup>

- **Neutrality:** Tax should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic commerce, thus avoiding double taxation or unintentional non-taxation.
- **Efficiency:** Compliance costs for business and administration costs for governments should be minimised as far as possible.
- **Certainty and simplicity:** Tax rules should be clear and simple to understand, so that taxpayers know where they stand.
- **Effectiveness and fairness:** Taxation should produce the right amount of tax at the right times and the potential for evasion and avoidance should be minimised.
- **Flexibility:** Taxation systems should be flexible and dynamic to ensure they keep pace with technological and commercial developments.

1.6 These core principles have been developed in the field of consumption taxes to give the following framework for cross-border trade:<sup>2</sup>

- Taxation rules should result in the taxation of cross-border trade in the jurisdiction where consumption takes place.
- The supply of digitised products should not be treated as the supply of goods.
- Countries should consider the introduction of the reverse charge, self-assessment, or other equivalent mechanisms to tax imports of services.
- Appropriate systems to collect tax on imports of physical goods should be developed.

1.7 The New Zealand Government endorses these principles, and any proposal in relation to imported services will be consistent with them as far as is possible.

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<sup>1</sup> *Electronic Commerce: Taxation Framework Conditions*, [www.oecd.org/daf/fa](http://www.oecd.org/daf/fa).

<sup>2</sup> *ibid.*

## *The Government's electronic commerce strategy*

- 1.8 The strategy paper *E-Commerce: Building the Strategy for New Zealand* set out the Government's commitment to ensuring New Zealand becomes "world class in embracing electronic commerce for competitive advantage".<sup>3</sup> A key principle is that there must be a predictable, simple and consistent legal environment for electronic commerce, with any Government intervention carried out in a transparent manner.<sup>4</sup> With respect to taxation, this requires that the tax system take into account the growth in electronic commerce, when possible, provide clear, simple and equivalent tax rules across jurisdictions and ensure an equivalent treatment of electronic and non-electronic transactions.
- 1.9 With these principles in mind, the review of the GST treatment of imported services, especially those provided electronically, was acknowledged in the strategy paper as a key part of ensuring that New Zealand's regulatory environment enables electronic commerce.<sup>5</sup>

### **Key issues**

- 1.10 Key issues in considering the GST treatment of imported services are:
- determining the appropriate jurisdiction in which a supply occurs and, when necessary, such as in the telecommunications sector, clarifying the rules that determine the place of supply;
  - distinguishing between supplies of goods and services, particularly with respect to digitised products;
  - the appropriate mechanism for taxing imported services; and
  - the extent to which efficiency is achieved without significant compliance and administrative costs.
- 1.11 This discussion document addresses these four areas.

### **Application date**

- 1.12 Legislation resulting from these policy proposals is expected to apply from mid to late 2002.

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<sup>3</sup> *E-Commerce: Building the Strategy for New Zealand*, November 2000, page 9.

<sup>4</sup> *ibid*, page 2.

<sup>5</sup> *ibid*, page 15.

## Submissions

1.13 The Government invites submissions on the proposals contained in this discussion document. Please note submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with the Act. If you feel there is any part of your submission which you consider could be properly withheld under the Act (for example, for reasons of privacy), please indicate this clearly in your submission.

1.14 Submissions may be made in electronic form to:

[policy.webmaster@ird.govt.nz](mailto:policy.webmaster@ird.govt.nz)

Please put "GST and Imported Services" in the subject line for electronic submissions.

1.15 Alternatively, submissions may be addressed to:

GST and Imported Services  
C/- General Manager  
Policy Advice Division  
Inland Revenue Department  
PO Box 2198  
WELLINGTON

1.16 Submissions should be made by 31 August 2001. They should contain a brief summary of their main points and recommendations. Submissions received by the due date will be acknowledged.

1.17 An electronic copy of this discussion document is available on-line at:

<http://www.taxpolicy.ird.govt.nz/publications/index.php?catid=2>

### SUMMARY OF PROPOSALS

- A reverse charge mechanism will be introduced to tax certain imports of services in business-to-business transactions. This will require GST registered recipients of supplies of imported services to self-assess GST on the value of the services if :
  - (1) the services are acquired for purposes other than of making taxable supplies; and
  - (2) the supply of those services, if made in New Zealand by a registered person, would be a taxable supply.

This means that if a registered person acquires services that would be subject to GST if supplied in New Zealand and for which the recipient would not have received a full, or any, input tax credit, the recipient will be required to add GST to the price of the services and return the GST to Inland Revenue.

- The recipient of a supply of imported services will be treated as if it had made that supply for the purpose of imposing and enforcing the reverse charge and for determining whether the GST registration threshold is exceeded. For all other purposes in the GST Act the recipient of a supply of imported services will be treated as the recipient, rather than the supplier, of the services.
- For the purposes of the reverse charge the normal time of supply and value of supply rules, in section 9 and 10(2) and (3) respectively, will be applied.
- Supplies of imported digitised products, such as software provided over the Internet, will be treated as supplies of services.
- A New Zealand branch or company will be treated as separate from its offshore head office or parent company in relation to supplies of services that would be subject to GST if supplied in New Zealand. This requires in these circumstances:
  - treating a New Zealand branch of a non-resident company as a separate entity; and
  - not disregarding supplies within a wholly-owned group of companies.
- The amount of a management fee or cost allocation charged to a New Zealand branch or subsidiary that is to be subject to the reverse charge will be calculated by taking the fee or allocation and excluding component supplies that are readily identifiable as not being for the acquisition of services that would be subject to GST if acquired in New Zealand.
- A supply of services in New Zealand will occur when a New Zealand customer initiates the supply of telecommunications services from a non-resident telecommunications supplier. Non-resident suppliers of telecommunications services will be required to register for GST if they make supplies of more than \$40,000 in a twelve-month period.
- Telecommunications services will be excluded from the reverse charge.
- The Commissioner of Inland Revenue will have a discretion not to require GST to be returned by telecommunications suppliers operating wholly offshore if it would not be cost effective to do so.

## Chapter 2

### THE ELECTRONIC COMMERCE CHALLENGE

#### Introduction

- 2.1 It is crucial that the New Zealand taxation framework is able to contend with, and respond to, changes in the commercial environment if it is to gather revenue in a stable, efficient and minimally distortionary manner.
- 2.2 The development of electronic commerce is one of the most significant changes in the business environment in the last decade. It greatly increases the ability of consumers to obtain goods and services worldwide and improves the ability of businesses to provide them.
- 2.3 This chapter looks at the ways in which electronic commerce is affecting, and will continue to affect, New Zealand's taxation system and outlines areas where change may be needed.

#### The impact of electronic commerce on taxation

- 2.4 Electronic commerce gives rise to issues in the three main areas of taxation:
  - income tax;
  - tax administration; and
  - goods and services tax (GST).
- 2.5 It provides opportunities to improve the efficiency and effectiveness of the tax system, and at the same time creates challenges which must be overcome if increased efficiencies and stable levels of revenue are to be achieved.

#### *Income tax issues*

- 2.6 Rapid advances in technology have made it easier for non-residents to conduct substantial business with, and derive substantial income from, New Zealand customers without having a fixed place of business in New Zealand. This has implications for many of the concepts of our international tax rules, which were developed at a time when operating a business commonly required a physical presence.
- 2.7 For example, under double taxation agreements, a resident of one state is normally required to have a "permanent establishment" in another state before that state is able to impose tax on the non-resident's business profits. A permanent establishment in a state commonly requires a physical presence. Technological advances mean that a physical presence is no longer needed to conduct business.

- 2.8 Even if a physical presence is established in New Zealand, however, modern technology has made it relatively straightforward to ensure that the bulk of the value-adding activities are retained outside New Zealand. In that case, New Zealand would not be able to attribute any significant share of the overall profits of a non-resident to that physical presence in New Zealand.
- 2.9 This poses two important questions in relation to the taxation of income:
- Is there a need to redefine existing concepts to accommodate the changes to business practices caused by electronic commerce?
  - Is a continuing reliance on source-based taxation appropriate?
- 2.10 New Zealand imposes tax on the worldwide income of its tax residents (the residence principle of taxation). However, New Zealand also imposes tax on all income sourced in New Zealand, whether it is derived by resident or non-resident taxpayers (the source principle). The double tax agreements to which New Zealand is a party can modify the application of these principles.
- 2.11 Both the residence and source principles have definitional difficulties that may be exacerbated by electronic commerce.
- 2.12 The main challenge from electronic commerce to income tax is to the source rules (the statutory provisions defining the income which is sourced in New Zealand), especially for the business income of non-residents. Residents of countries with which New Zealand has double tax agreements must have a permanent establishment to become liable for income tax in New Zealand on their business profits.
- 2.13 For example, a programmer living in Australia is contracted to design a database for a New Zealand bank, and conducts all of her development from a terminal in Australia. She makes one short visit to New Zealand to discuss her development work with the New Zealand bank. Under New Zealand's double tax agreement with Australia, the Australian programmer would need an actual place of business in New Zealand (a permanent establishment) before New Zealand could tax her business income. New Zealand could not, therefore, tax the business income of the programmer. Similar protection would apply to most non-residents engaging in electronic commerce with New Zealand customers from a country with which New Zealand has a double tax agreement.
- 2.14 If non-residents from countries with whom New Zealand does not have a double tax agreement engage in business with New Zealand customers, their business profits would not be protected by the definition of "permanent establishment". Thus if the programmer in the example used here were from a country with which New Zealand does not have a double tax agreement, she would be deriving New Zealand-sourced business income, by virtue of her business being partly carried on in New Zealand. Even then, however, little of the income is likely to be attributable to New Zealand, as the courts have tended to look to where services are performed in attributing income from services between jurisdictions.

- 2.15 The Government recognises that there are international issues to which the policy response needs to be developed in co-operation with other countries. For that reason it continuously monitors the work the OECD is undertaking to update the concept of a permanent establishment, for the purposes of the OECD's model double tax agreement (which is used as the basis for most negotiations between OECD member countries). New Zealand shares the OECD view that the current framework of international income tax rules is adequate to deal with these issues. In particular, the benefits of the growth of electronic commerce should not be inhibited by attempts to impose new taxes or impose tax on income not sourced in New Zealand and derived by non-residents.

### *Tax administration issues*

- 2.16 The growth in electronic commerce has raised difficult issues for tax administrations in maintaining the revenue base. On the other hand, it has provided the opportunity to make tax administrations more efficient, improving the timeliness and quality of service to taxpayers – for example, by allowing the electronic filing of tax returns and the electronic payment of tax and tax refunds.
- 2.17 Although many of the revenue base concerns raised by electronic commerce are not new, the rate of technological development has increased their significance and potential impact on the tax base and tax administration.
- 2.18 Some of these issues are:
- *Audit trails may be more difficult to identify:* The lack of any central control of the Internet and the ease with which cross-jurisdiction transactions take place may make tracing complex arrangements more difficult.
  - *Verification of identity and residence:* Taxpayers can establish, and operate from, an Internet address in any jurisdiction even though they effectively reside elsewhere.
  - *Obtaining documentation:* The growth in Internet commerce may make obtaining the information necessary for enforcement difficult, particularly when transactions involve countries with which New Zealand does not have a double tax agreement or the issues involved are not covered by the information exchange powers contained in New Zealand's double tax agreements.
  - *The removal of convenient "taxing points":* With fewer or, in some cases, no intermediaries in the distribution of goods and services as a result of producers selling directly to consumers, the number of available collection mechanisms is reduced.



- 2.19 The Electronic Transactions Bill, currently before Parliament, aims to facilitate the use of electronic technology, in part by allowing paper-based legal requirements to be met using “functionally equivalent”<sup>6</sup> electronic technology. The Government is considering how the bill interacts with the requirements for businesses to keep records for tax purposes (largely contained in the Tax Administration Act 1994).
- 2.20 Inland Revenue’s policy on record storage emphasises the ability to restore documents to paper as a test for whether electronic recording provides a functional equivalent to paper, and this is consistent with the stated purposes of the bill. The Government is considering in more detail whether the bill should, among other things, specifically support the continuation of this approach to ensure that the integrity of information is maintained.
- 2.21 The Government is always interested in the views of taxpayers, tax agents and other interested parties on how tax administration can be made more efficient, and welcomes any views on how electronic commerce can be harnessed for greater efficiency gains.<sup>7</sup>

### *GST issues*

- 2.22 New Zealand’s GST was designed and introduced before the prevalence of electronic commerce. Although the general framework of GST remains robust enough to deal with most electronic commerce transactions, at a detailed level electronic commerce raises some difficult issues.

### *Invoices and record-keeping*

- 2.23 Invoices are Inland Revenue’s primary information source for verifying a registered person’s GST calculations. Suppliers of goods and services are now able to operate from anywhere in the world, in many cases without a physical address, which could diminish the ability of businesses to obtain suitable invoices, and that of Inland Revenue to verify the necessary details of transactions. Similarly, the fact that many suppliers may now more easily be situated outside New Zealand provides challenges for ensuring compliance with record-keeping requirements and gaining access to documents.

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<sup>6</sup> Clause 3(b) Electronic Transactions Bill; and Electronic Transactions Bill, Explanatory Note, General Policy Statement, page 1; conditions for functional equivalence are set out in Part 3 of the Electronic Transactions Bill.

<sup>7</sup> The Government discussion document *More Time For Business*, released 3 May 2001, contains a discussion of areas where technology could be used to lower compliance costs on business.

### *Border enforcement*

- 2.24 Electronic commerce has made it easier to import goods and services. Some products which would once have been in a tangible form and described as goods can now be supplied in a digitised form, making them more easily transferable and more akin to services in their mode of delivery. This creates border control issues, with it being increasingly difficult for customs and revenue authorities to monitor the importation of both goods and services. This, therefore, affects the ability of these authorities to gather revenue from such importations, eroding the revenue base.

### *Imported services and GST*

- 2.25 The major issue in relation to GST is the treatment of imported services. Unlike imported goods, most services imported into New Zealand are not subject to GST, except for freight and insurance services associated with imported goods. This treatment came about because of the low volume of imported services in the mid-1980s, when GST was introduced, compared with the compliance and administrative costs involved in taxing imported services.
- 2.26 Changes in the New Zealand economy, the global economy, and the way that business is done now mean that it is time to reconsider this treatment. The distortions which arise from treating services in a different manner depending on the place from which they are supplied, and the fact that most other OECD countries impose GST or VAT on imported services, suggest that the current exclusion of imported services from the New Zealand GST base should be reconsidered.
- 2.27 New Zealand service providers are at a disadvantage, therefore, compared with non-resident service providers, since New Zealand service providers must charge GST, whereas non-resident service providers are not generally required to do so.
- 2.28 From an international perspective, it is important to limit the non-taxation of supplies between New Zealand and our trading partners. By not taxing imports of services, the New Zealand GST system allows those services to avoid any impost of consumption tax, since such supplies would not have been taxed when exported from the jurisdiction in which they originated. As well as creating consumption distortion effects in New Zealand, it may also distort decisions in the country from which services are exported.

- 2.29 Any move to impose GST on imported services is not primarily designed to be a revenue raising exercise but it would stem future revenue losses from this source. The increasing mobility of the supply of services means that purchasing services supplied offshore is becoming more common. Although there is no evidence to suggest the tax base is currently significantly threatened by not applying GST to imported services, this does not mean a significant future revenue loss is not possible.<sup>8</sup>
- 2.30 This discussion document considers the GST treatment of imported services and proposes that GST be imposed on certain imported services.

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<sup>8</sup> For example, globally, electronic commerce is predicted to reach approximately US\$ 600 billion in trade by 2004-05, or roughly eight percent of all global trade (OECD Presentation: Electronic Commerce - Answering the Taxation Challenges, Tokyo OECD / Pacific Island Forum Conference, February 2001).

## Chapter 3

### GST AND IMPORTED SERVICES

This chapter outlines the current treatment of imported services, explains the reasons for this treatment, and discusses the reasons for proposing change in this area.

#### Current treatment of imported services

- 3.1 Unlike imported goods, most imported services are not subject to GST, except for freight and insurance services associated with imported goods.<sup>9</sup> This treatment largely reflects the limited volume of imported services that existed when GST was introduced, and the practical difficulties associated at that time with levying and collecting GST on them.
- 3.2 When GST was introduced, in 1986, all but international transportation services were consumed in the jurisdictions in which they were produced because of the legal and technological constraints that either prevented international trade in services altogether or made it uneconomic. The volume of services imported into New Zealand at the time was relatively low, and their exclusion from the GST base was, therefore, perceived to be relatively non-distortionary.
- 3.3 The practical difficulties involved in identifying and monitoring the supply of services also militated against their inclusion in the GST base at that time. The decision not to impose GST on imported services resulted from concerns that the revenue derived from GST on imported services would not justify the costs incurred by business and the Government in collecting that tax.

#### Problems with the current treatment

##### *The efficiency of the GST system*

- 3.4 Ideally, the tax system raises and redistributes revenue in a manner that is consistent with the government's economic and social policies. It achieves this objective while minimising the costs to the economy as a whole. This is referred to as the "efficiency" of a tax system. An "efficient" tax system is one that does not affect individuals' investment decisions one way or the other.

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<sup>9</sup> Section 12(2) – valuation of imported goods.

- 3.5 The limited number of exemptions and the uniform rate at which it is applied generally make GST an efficient tax relative to a multi-rate tax with many exemptions. The non-taxation of imported services, however, reduces the efficiency of GST. Both imported and domestically produced services can be consumed as part of the production process or as final consumption, but only domestically supplied services are currently subject to GST. The absence of GST on imported services, therefore, causes distortions in:
- *The relative prices faced by consumers of tradable services.* The absence of GST on imported services encourages domestic consumers to substitute imported services that are not subject to GST for domestically produced services that are subject to GST. In other words, it encourages inefficient patterns of consumption by discouraging the consumption of domestically produced services in favour of imported services.
  - *The relative prices faced by producers of tradable services for their outputs and their factors of production to the extent that tradable services are used in the production process.* The absence of GST on imported services also tends to encourage inefficient patterns of production and resource use in New Zealand. In particular, it discourages the domestic production of services, since domestic producers may not be able to pass on the GST cost to consumers, who are able to switch to imported services that are not subject to GST. It also discourages the use of domestically produced services by some New Zealand businesses. Domestic producers who are either unable to claim input tax credits, or unwilling to incur the compliance costs associated with claiming input tax credits, will tend to substitute imported services for domestically produced services.
- 3.6 By distorting these relative prices, GST causes resources to be allocated in a less efficient manner than they would be if both domestic and imported services were subject to taxation. It is clear that imposing GST only on domestic supplies of services creates a distortion by re-allocating resources away from domestic to foreign production. The production inefficiency arises because New Zealand consumers acquire a reduced level of the domestically supplied services and more services supplied from offshore.
- 3.7 Since the introduction of GST, several developments have promoted a considerable growth in the volume of services being imported into New Zealand. Deregulation of the telecommunications and financial services markets in New Zealand, coupled with rapid advances in communication and computer technology, mean that it is now possible to consume a wide range of services in New Zealand that have been produced offshore. This growth in the volume of imported services exacerbates the distortions caused by the non-taxation of imported services.

- 3.8 The efficiency of the GST system, therefore, will be improved by taxing imported services at the same rate as other goods and services.

***Impact of electronic commerce on the economic costs of taxation***

- 3.9 The size of the costs caused by taxation depends upon the responsiveness of patterns of consumption and production to changes in relative prices (the elasticities of demand and supply). As responsiveness increases so do the economic costs.
- 3.10 In general, the responsiveness of demand to price increases with:
- the degree to which the services demanded can be substituted for other services;
  - the amount of time that has elapsed since the relative price change; and
  - the proportion of income spent on the service.
- 3.11 The responsiveness of supply increases with the length of time available to suppliers to change the quantities of production and introduce the technology that enables them to alter those quantities.
- 3.12 Electronic commerce increases the responsiveness of both demand and supply of services, particularly in industries such as telecommunications, where the services produced are highly substitutable. Specifically, electronic commerce reduces the cost at which services can be traded across borders and the speed at which markets react to changes in relative prices. As the use of electronic commerce develops as a means of transacting, relative price movements caused by taxation could result in larger economic costs, exacerbating the existing problems caused by the non-taxation of imported services.
- 3.13 Advances in technology mean that it is now possible for New Zealand businesses to import services that in the past would have had to have been supplied by domestic producers. For example, a New Zealand financial institution wanting to update its software systems faces a choice between obtaining the necessary services from domestic providers or importing them.
- 3.14 If the financial institution decides to obtain those services from a New Zealand programmer who is a registered person, GST will be charged on the software development. However, if the services are being used to update the financial institution's treasury operations, it cannot claim an input tax credit for those services because treasury operations are exempt from GST. By contrast, if the financial institution contracts with a non-resident programmer, the services may not be subject to GST since the supply may be deemed to occur outside New Zealand.

- 3.15 The absence of GST on these imported programming services, therefore, has the potential to distort the resource use decisions of financial institutions that need to purchase programming services. In particular, it lowers the price of imported programming services in relation to domestically produced services for those financial institutions that are either unable to claim input tax credits, or are unwilling to incur the additional compliance costs associated with claiming them.
- 3.16 The absence of GST on imported programming services also distorts patterns of production and resource use in New Zealand. In particular, it means that domestic programmers may not be able to pass on the full burden of the GST to businesses that purchase their services. This places domestic programmers at a competitive disadvantage in the markets for both their outputs and their inputs.

### *Equity*

- 3.17 GST is intended to impose the burden of the tax on the consumer, and, with the exception of firms making exempt supplies, not on producers. The fact that the burden of GST falls on New Zealand programmers in the situation described earlier, as a result of the design of the GST Act, means the policy intention is not being achieved. Nor is “horizontal equity” being achieved, since people in the same position are being subjected to different effective rates of tax.

### *Tax base implications*

- 3.18 Not taxing imported services poses a potential risk to the tax base. When GST was introduced, the level of imported services was low. The increasing mobility of the supply of services, however, means that purchasing services supplied from offshore is more common. Although there is limited evidence to suggest the tax base is currently threatened by not applying GST to imported services, this does not mean a significant future revenue loss is not possible.
- 3.19 In considering tax base implications, the imposition of GST on imported services would not, therefore, be expected to raise substantial revenue in the short term. It would, however, limit the potential for future significant revenue losses.

### *International consistency*

- 3.20 Not imposing GST on imported services is contrary to the generally accepted international framework for consumption taxes. Most other jurisdictions, particularly members of the OECD, include imported services in their consumption tax base. Indeed, the OECD has stated that members should consider the introduction of mechanisms for taxing imports of services by businesses, as this is necessary to limit the non-taxation of cross-jurisdictional supplies. The vast majority of nations operate consumption tax systems which tax the supply of goods and services consumed within their country. This is brought about by taxing imports of goods and services and not taxing exports of goods and services. This is known as the destination principle.
- 3.21 New Zealand operates under the destination principle. Nevertheless, by not taxing imports of services, the New Zealand GST system allows services which have not been taxed in the jurisdiction from which they have “originated”, and are consumed in New Zealand, to avoid the impost of any consumption tax.
- 3.22 It is important, therefore, for New Zealand to address the non-taxation of imported services.



## Chapter 4

### OPTIONS FOR TAXING IMPORTED SERVICES

This chapter outlines methods by which the importation of services into New Zealand could be made subject to GST. It concludes that the “reverse charge” mechanism is the most appropriate method, and recommends its introduction.

#### Introduction

- 4.1 The distortions caused by the non-taxation of imported services can be addressed in three ways. Two of these options result in GST being charged on imports of services, and both fit within the current GST framework. The third option involves a fundamental change to the GST framework. All three must be considered in the context of determining the appropriate “place of supply” rules for internationally traded services.
- 4.2 This chapter analyses these issues and concludes that the reverse charge mechanism is the most appropriate.

#### OECD consumption tax framework

- 4.3 The OECD has developed the “Ottawa framework” to provide the following guidelines for consumption tax:
- Rules for the taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place, and an international consensus should be sought on the circumstances under which supplies are to be regarded as consumed in a jurisdiction.
  - The supply of digitised products should not be treated as a supply of goods.
  - In relation to imports of services and intangible property, countries should examine the use of reverse charge, self-assessment or other equivalent mechanisms if this would provide protection for the competitiveness of domestic suppliers and for the revenue base.
  - Countries should ensure that appropriate systems are developed in co-operation with the World Customs Organisation and in consultation with carriers and other interested parties to collect tax on the importation of physical goods, and that such systems do not unduly impede revenue collection and the efficient delivery of products to consumers.

- 4.4 The place of consumption has been defined for business-to-business transactions as the jurisdiction in which the recipient has located its business presence. For business-to-consumer transactions, it is the recipient's usual jurisdiction of residence.<sup>10</sup>
- 4.5 The Government intends to base any proposal in relation to services imported by businesses in New Zealand on these principles. Especially important is the principle that consumption tax rules should result in taxation in the jurisdiction in which consumption takes place. This ensures that the unintentional double or non-taxation of goods and services does not occur when they are traded across borders. It also ensures that New Zealand continues to tax in accordance with the more internationally accepted "destination principle", rather than the "origin principle". These concepts are discussed in the following paragraphs.

### **A change in the GST framework: the origin principle**

- 4.6 Most goods and services are consumed in the same jurisdiction in which they are produced. In these circumstances, GST can be imposed on the basis of the place of supply (the location of the supplier) or the place of consumption (the location of the recipient) and the incidence of the tax will be the same. For reasons of administrative and compliance costs, it is easier to tax at the place the supply is made. Adjustments must be made, however, when goods and services are traded across borders, because the place of supply and place of consumption are not the same. To make these adjustments, GST can either be based on the "destination principle" or the "origin principle".

### ***The destination principle***

- 4.7 Under the destination principle supplies of goods and services are taxed in the jurisdiction in which the goods and services are consumed. This means that exports are zero-rated, while imports are taxed. New Zealand's GST system, and the vast majority of other countries' systems, are based on the destination principle.<sup>11</sup>

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<sup>10</sup> A report by the Committee's Working Party No. 9 on Consumption Taxes: Consumption Tax Aspects of Electronic Commerce, ([www.oecd.org/daf/fa/e\\_com/ec\\_6\\_WP9\\_REPORT\\_Eng.pdf](http://www.oecd.org/daf/fa/e_com/ec_6_WP9_REPORT_Eng.pdf)).

<sup>11</sup> The Russian Federation taxes imports into the Federation, but zero-rates only exports out of the Commonwealth of Independent States (CIS), so exports from within the Federation to other members of the CIS are taxed. It is often perceived that the European Union (EU) operates under the origin principle. For supplies to non-registered consumers within the EU this is generally true. Supplies between businesses, however, are not taxed under this principle. Instead tax is applied by using a reverse charge mechanism that applies to both services and goods supplied within the EU. This is not an "origin" system in the strict sense of the word, but is more representative of an attempt to move toward a single internal market. Between the EU and the rest of the world the destination principle applies.

### *The origin principle*

- 4.8 Under the origin principle supplies are taxed according to their origin and at the GST rate of the originating jurisdiction. This means that exports are taxed but imports are not taxed. Moving to the origin principle would therefore remove the need to tax imported services. It would also remove the need to tax imported goods.

### *Comparing the origin and destination principles*

- 4.9 This document raises proposals for taxing imported services under the current GST framework, which is based on what is known as the destination principle. Under this method of applying GST, exports are zero-rated (and thus face no GST impost), while imports are subject to GST as they cross the border. As a result, consumption in New Zealand is taxed but consumption of New Zealand goods and services outside New Zealand is not subject to GST. This is in accordance with the “Ottawa framework” for consumption taxes.
- 4.10 Economic theory holds that the same effect as taxing imports and zero-rating exports can be achieved by moving from the destination principle to the origin principle. Under the origin principle, goods and services are taxed according to the place from which they originate. This means that exports would be subject to GST (by removing zero-rating) but imports would be zero-rated and thus free of GST.
- 4.11 This would seem to place exporters and import-substitutable businesses at a disadvantage, as they would compete against imported goods and services and overseas purchased goods that would not be subject to New Zealand GST. However, when combined with an appropriate exchange rate adjustment a move to the origin principle could be expected to leave all producer and consumer prices, and thus trade flows, unaffected.
- 4.12 A GST based on the origin principle seems to have advantages when looked at in the context of the issues dealt with in this document. It means, for example, that there is no need to tax imported services (or any other imports), removing the need to tax supplies (such as digitised products) that are not easily taxed as they cross the border.
- 4.13 Nevertheless, a GST system based on the origin principle has serious administrative problems. Imports would need to remain zero-rated through to final consumption. To achieve this, a deemed input tax credit would need to be provided to registered persons first acquiring imported supplies. This would create an unacceptably high risk to the tax base. In addition, since the essential equivalence of goods and services taxation based on the origin and destination principles is often misunderstood, the origin approach, which on its face appears to disadvantage New Zealand businesses, is unlikely to be widely accepted as trade neutral.

- 4.14 Moving to the origin principle does not seem, therefore, to be a viable option, and this document concentrates on options based on the destination principle. However, we welcome comments on this issue.

### **Register offshore non-resident suppliers**

- 4.15 One mechanism for taxing imported services would be to change the current rules that determine the place of supply so that an obligation to register for GST is imposed on offshore non-residents if they supply services to New Zealand to a value exceeding the registration threshold.
- 4.16 In New Zealand the place of supply is determined by reference to the residence of the supplier. In the case of non-resident suppliers, the test is whether the services are physically performed in New Zealand and, for transactions between registered persons, whether the parties agree to treat New Zealand as the place of supply. In other jurisdictions, such as the members of the European Union (EU), the place of supply is determined by reference to the “establishment” of the supplier. These rules are based on the principle that the majority of consumption will occur in the GST or VAT jurisdiction in which the supplier resides.
- 4.17 These rules do not, however, generally require offshore non-residents to charge GST or VAT when they supply services within the taxing jurisdiction. This could be addressed by introducing a place of supply rule that is based on the effective use of goods or services supplied within the taxing jurisdiction.
- 4.18 A major difficulty with an effective use test is in determining where the service is in fact used. This is generally feasible if the service that is supplied is not readily transferable from one jurisdiction to another. For example, services in relation to land are less easily transferred to another jurisdiction than are services in the nature of, say, insurance, which can be effectively used in a number of jurisdictions.
- 4.19 Some jurisdictions apply a targeted effective use test to certain types of imported services, such as telecommunications. Whether this would be appropriate in relation to the New Zealand telecommunications sector is discussed in chapter 8.
- 4.20 A general impost of GST in this manner could also raise significant enforcement concerns, since the legislation would need to be enforced offshore. It would also create compliance cost concerns for non-residents required to register in New Zealand and charge GST.

- 4.21 Last year the European Commission (EC) circulated a proposal<sup>12</sup> which would impose VAT on supplies of electronically delivered services based on the location of the consumer of those services (as opposed to the supplier's location, as at present). Suppliers selling electronic services<sup>13</sup> from outside the EU to customers inside the EU would be required to account for VAT in the same way as an EU resident supplier: they would register for, and charge, VAT.<sup>14</sup> The non-EU supplier would only be required to register only if it made sales of more than Euro 100,000 to private consumers in the EU, and would be required to register in only one jurisdiction within the EU.
- 4.22 The proposal was adopted by the EC on 7 June 2000.<sup>15</sup> It will operate alongside the reverse charge already in operation for business-to-business transactions.
- 4.23 Once in place, the proposal will rely partially upon international co-operation for enforcement. It will also rely upon the willingness of multinational firms to protect their goodwill and image in the EU and maintain a favourable environment in the EU for non-EU suppliers to do business. A favourable environment might provide, for example, protection of intellectual property and free access to markets.
- 4.24 While it is feasible for an economic bloc to implement such a system of taxation, it is questionable whether a country the size of New Zealand could unilaterally impose and enforce such a system.

### **Reverse charge**

- 4.25 The most commonly used mechanism for taxing imported services is the reverse charge. The members of the EU introduced a reverse charge in the late 1970s in response to the growing level of services traded within the common market. Canada's GST system incorporates the reverse charge and, more recently, Australia introduced a reverse charge as part of its GST system. There is a general acceptance among OECD member countries of the appropriateness of the "reverse charge" mechanism to tax imported services provided in business-to-business transactions.
- 4.26 The reverse charge mechanism results in the taxation of services in the jurisdiction in which the services are consumed, that is, in the jurisdiction to which they are imported. The adoption of a reverse charge mechanism is, therefore, consistent with the accepted OECD framework for consumption taxes and the OECD's more recent guidelines on the appropriate place of taxation for internationally traded services. These OECD guidelines, which are endorsed by the Business and Industry Advisory Committee (BIAC), a

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<sup>12</sup> *A Strategy to Improve the Operation of the VAT System within the context of the Internal Market* COM(2000) 349.

<sup>13</sup> For example, pay-per-view television.

<sup>14</sup> Conversely, EU suppliers that provide such services to non-EU customers do not have to charge VAT.

<sup>15</sup> It is unclear, however, whether it will be implemented, as it has been reported that the UK has recently expressed opposition to the proposal.

committee of the OECD, also recommend the adoption of the reverse charge mechanism as the most viable tax collection method for cross-border business-to-business transactions.

- 4.27 The specific design of the reverse charge can vary between jurisdictions but the principle is the same. Registered persons self-assess GST and claim an input tax credit to the extent that services were acquired for the principal purpose of making taxable supplies.
- 4.28 A similar obligation is imposed on registered suppliers of exempt goods and services and in some countries, such as Canada and Switzerland, on private individuals. In these circumstances an input tax credit for the self-assessed GST would not generally be available. For enforcement reasons, however, it is clear that the reverse charge is difficult to apply effectively to supplies of imported services to private individuals.
- 4.29 A reverse charge mechanism would, however, have one advantage. In relation to business-to-business transactions, it would be a suitable mechanism for correcting the production distortions created by the preference that registered suppliers acquiring services for purposes other than of making taxable supplies might have for internationally provided services over domestically provided services.

### **Preferred option**

- 4.30 Ideally, to remove all of the distortions created by the non-taxation of imported services, GST would be levied on all imports of services, both to consumers and businesses. The option of registering offshore non-resident suppliers would achieve this. However, a general requirement for offshore non-resident suppliers to register for GST would pose several problems, particularly with enforcement.
- 4.31 Requiring self-assessment of GST under the reverse charge would also remove all of the distortions. However, a general requirement for final consumers to self-assess GST under the reverse charge mechanism would also have enforcement problems. This, therefore, leaves the taxation of services imported by businesses.
- 4.32 The Government's preferred option is to implement a reverse charge on business-to-business transactions. The reverse charge has been adopted by the majority of countries with a general consumption tax and is proven to work well in relation to business-to-business transactions. It also results in the taxation of services in the jurisdiction in which they are consumed, consistent with the OECD framework for consumption tax.
- 4.33 In this case, if the New Zealand importer is making taxable supplies, the business would receive an input tax credit for any GST paid. In the light of this, the benefits of imposing GST on registered persons making solely taxable supplies are unlikely to be large enough to justify the compliance costs of doing so.

4.34 A net benefit from taxing imported services is, therefore, likely to occur only when the importer is acquiring the services for purposes other than of making taxable supplies. Therefore the reverse charge proposed in this discussion document is targeted at imposing GST on businesses importing services for purposes other than of making taxable supplies, as discussed further in the following chapter.

## Chapter 5

### THE REVERSE CHARGE MECHANISM

#### Proposed policy

- A reverse charge mechanism will be introduced. It will require the self-assessment of GST on the value of services imported by registered persons for purposes other than of making taxable supplies if the supply of those services in New Zealand by a registered person would be a taxable supply.
- For the purpose of imposing and enforcing the reverse charge, and for determining whether the registration threshold is exceeded, the recipient of a supply of imported services will be treated as if it had made that supply. The recipient of a supply of imported services will be treated as the recipient, rather than the supplier, of the services for all other purposes in the GST Act.
- For the purposes of the reverse charge, the normal time of supply and value of supply rules, in section 9 and section 10(2) and (3) respectively, will be applied.

#### Introduction

- 5.1 This chapter outlines the main features of the proposed reverse charge mechanism. The two following chapters deal with issues concerning the scope and operation of the reverse charge in more detail.

#### General application

- 5.2 The reverse charge mechanism will generally require registered recipients of supplies of imported services to self-assess GST on the GST-inclusive value of those supplies. For the purposes of the reverse charge, the recipient of a supply will add GST to the value of the services and be required to return the GST as if it had made a supply of the services.
- 5.3 This means that when New Zealand residents receive a supply of services which is not supplied in New Zealand under section 8(2) (and therefore not subject to GST under section 8(1)) they will self-assess GST on that supply of services as if the supply were made in New Zealand.
- 5.4 This will ensure, in keeping with the Ottawa taxation framework, that supplies of services are taxed in New Zealand if they are consumed in New Zealand.



- 5.5 It is proposed that the reverse charge apply to supplies of services performed for New Zealand recipients that would be taxable supplies if made in New Zealand by New Zealand-resident suppliers. For example, a supply of imported financial services, say, re-insurance of a life insurance contract, which would be an exempt financial service, will not be subject to the reverse charge.
- 5.6 As explained in more detail in the next two chapters, the reverse charge will generally apply to supplies of imported services that would be taxable if made in New Zealand and that are acquired by a person other than in the course of making taxable supplies.
- 5.7 The value of imported services supplied to a person will be included in the total value of supplies made by that person for the purposes of determining liability to register for GST under section 51. Although businesses making exempt supplies in New Zealand will usually be registered for GST in any event, the reverse charge may require others to register – in particular, any person importing services exceeding \$40,000 in value in a twelve-month period as a private consumer.
- 5.8 Introducing a reverse charge will not preclude a non-resident company carrying on a taxable activity and making supplies in New Zealand from registering for GST in New Zealand if it wishes to do so. In this situation the company would charge GST on any supplies made in New Zealand, and the reverse charge would not apply to the recipient of the supplies.

### **Limited to acquisitions for purposes other than of making taxable supplies**

- 5.9 The application of the reverse charge will be limited to services to the extent that they are acquired by registered persons (or persons liable to be registered) for purposes other than of making taxable supplies. Therefore, to the extent that a registered person acquires a service for purposes other than of making taxable supplies, the supply will be taxed under the reverse charge mechanism.
- 5.10 In contrast, any services imported and for which the taxpayer is entitled to an input tax credit if the services are supplied onshore will not be subject to the reverse charge. This approach will remove the necessity for taxpayers to pay GST for which they are then fully reimbursed through input tax credits. It will also remove the corresponding administrative costs.
- 5.11 This proposed treatment will differ in its scope from that of imported goods. Most imported goods are charged with GST at the border by the New Zealand Customs Service, regardless of whether or not the recipient of the goods is entitled to an input tax credit.<sup>16</sup> This is done because the Customs Service will not know at the time of importation if the recipient of the goods is entitled to an input tax credit – the recipient may not be registered or, if registered, may not be acquiring the goods for a taxable purpose. It is,

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<sup>16</sup> Section 12, Goods and Services Tax Act 1985.

therefore, more efficient to charge GST on the importation of all goods than it is to require recipients to prove on importation that they have acquired the goods for the principal purpose of making taxable supplies and are, therefore, entitled to an input tax credit.

- 5.12 For this reason the reverse charge will mainly apply to providers of financial services, such as banks, but will also apply to other registered persons who import services for purposes other than of making taxable supplies.

### **Time of supply**

- 5.13 Under section 9(1) of the GST Act, a supply takes place at the earlier of the time an invoice is issued or a payment is received for the supply.

- 5.14 Section 9(2)(a)(iii) further provides that in supplies between associated persons the time of supply for services is the time they are performed, unless an invoice is issued, or a payment is received on or before the last day for furnishing a GST return for the taxable period in which the services were performed. In that case the rule in section 9(1) applies.

- 5.15 These rules ought to work equally for the purposes of the reverse charge. It is proposed, therefore, that the time of supply for the reverse charge be the earlier of:

- when an invoice is issued in respect of the supply; or
- when payment is made in respect of the supply; or
- when the services are performed if the supply is between associated persons and an invoice has not been issued, or payment received, on or before the last day for furnishing a GST return.

- 5.16 Any rule based on the performance of a service has inherent difficulties, particularly if the service is performed uniformly over a period. The Government is, therefore, interested in receiving submissions on any special considerations and problems that should be taken into account in the application of these rules to supplies of imported services.

### **Valuation**

#### *The issue*

- 5.17 The general rule under section 10(2) of the GST Act for determining the value of a supply is that a supply is valued by reference to the amount in money that has been paid for the supply, or if the supply is paid for using non-monetary consideration, at the open market value of that consideration. Under section 10(3), the value of a supply between associated persons is the open market value of the supply, unless, in terms of section 10(3A), the recipient is entitled to an input tax credit for the supply. The Australian, Canadian and United Kingdom GST or VAT legislation use their general

valuation rules for their reverse charge mechanisms, which are equivalent to the rule in section 10(2) of the GST Act. Furthermore, under Canadian GST legislation, the value of a supply between branches is the “fair market value” at the time the supply is made.<sup>17</sup>

- 5.18 A requirement to adopt market valuation for transactions between associated persons ensures that objective considerations are applied and that supplies of goods and services are not under-taxed by GST. This would seem to apply equally for cross-border transactions as for domestic transactions. The Government is, however, interested in receiving submissions on any special considerations that should be taken into account in the application of the valuation rules to supplies of imported services.
- 5.19 Transfer pricing may be an issue to consider in the context of the proposed reverse charge. However, most countries, particularly New Zealand’s main trading and commercial partners, already have GST or VAT systems with reverse charges. The relatively low rate of GST in New Zealand as compared to other OECD countries with a GST or VAT system may, therefore, reduce the incentives to transfer price for GST purposes.<sup>18</sup>

### ***Proposed policy***

- 5.20 Supplies subject to the reverse charge will be valued in the same way as normal supplies under the GST Act, which means section 10(2) and (3)<sup>19</sup> will treat the value of the supply as:
- the total of the amount of money paid for the supply and the open market value of any non-monetary consideration; or
  - the open market value of the supply if it is between associated persons (branches, members of a group) and the monetary and non-monetary consideration is less than the open market value of the supply.
- 5.21 This proposed treatment is consistent with the treatment of intra-group supplies and the arm’s length principle expressed in New Zealand’s *Transfer Pricing Guidelines*.

### **Mixed use acquisitions and apportionment**

- 5.22 The recipient of a supply of imported services will be treated as if it had made that supply of services itself for the purpose of imposing and enforcing the reverse charge and for the purpose of determining whether the registration threshold is exceeded. For all other purposes in the GST Act, the recipient will continue to be treated as the recipient, rather than the supplier, of the services.

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<sup>17</sup> Section 220(c), Excise Tax Act.

<sup>18</sup> Standard rate: New Zealand: 12.5%, Australia: 10%, Canada: 7%, United Kingdom: 17.5%, France: 20.6%, Germany: 16%, Ireland: 21%, Italy: 20%, EU(15) average: 19.4%.

<sup>19</sup> Section 10(3A) will not be applicable, as the supplies the reverse charge applies to will be outside the scope of that provision.

- 5.23 For example, a non-resident supplier provides software to a New Zealand life insurance company for \$1 million. Using a turnover approach, the software is used 70 percent for making exempt supplies of life insurance, and 30 percent for making taxable supplies of general insurance. Under the reverse charge, the life insurance company would, therefore, add GST to the \$1 million, giving a figure of \$1.125 million, and include the GST of \$125,000 imposed under the reverse charge in its GST return.
- 5.24 Because the company uses the software 30 percent for taxable purposes, it is entitled to an input tax credit adjustment, and will be able to make a deduction of \$37,500 from its output tax liability.
- 5.25 The company would not, however, include the \$1.125 million as a supply it has made for the purposes of making the adjustment based on turnover. This is because the amount assessed under the reverse charge will be treated as a supply received by the life insurance company, not a supply made by the life insurance company.
- 5.26 Conversely, if the life insurance company acquires the software for 70 percent use in making taxable supplies and 30 percent in making exempt supplies, the reverse charge will still apply, as the software is not solely acquired for making taxable supplies. The company will, however, be entitled to a full input tax credit on the importation of the services, as they are acquired for the principal purpose of making taxable supplies. It would then be required to make an adjustment for exempt supplies made using the software.

### **Documentation requirements**

- 5.27 The GST on supplies of imported services subject to the reverse charge will be included in a registered person's GST return in the same way as other supplies. As invoices will not always be provided for such supplies, alternative supporting documentation, such as a supply contract or record of payments made, will be required to substantiate the valuations adopted for the purposes of the reverse charge.

## Chapter 6

### “SERVICES”

This chapter addresses the application of the proposed reverse charge in relation to:

- what constitutes a “service” for the purposes of the reverse charge;
- the treatment of “digitised products”; and
- the treatment of physically imported software.

#### **Introduction**

- 6.1 The services to which the reverse charge is to apply must be clearly defined. So-called “digitised products”, and software more generally, raise a number of issues in this regard that require clarification.
- 6.2 This chapter deals with what constitutes a “service” for the purposes of the reverse charge.

#### **Broad definition of “services”**

- 6.3 The GST Act defines a service as anything other than goods or money.<sup>20</sup> Thus if the reverse charge applies to a registered person, it should apply to all supplies of services that, if acquired offshore, would give rise to a lower GST impost than if the services were acquired in New Zealand. This treatment corrects the production distortions created by the preference that registered suppliers acquiring services for the purpose other than of making taxable supplies may have for internationally provided services over domestically provided services.
- 6.4 As stated earlier (chapter 5), the reverse charge will not apply to supplies of services which would be exempt if supplied by domestic suppliers. For example, the reverse charge will not apply to supplies of imported financial services, as defined in section 3(1).

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<sup>20</sup> Section 2(1); choses in action are services, as they are specifically excluded from the definition of “goods”.

## Generic description versus list

- 6.5 Some jurisdictions apply the reverse charge to a specific list of services, and in other jurisdictions it is applied to all services, with specified exclusions. Both approaches raise questions over which services, if any, should be excluded and, indeed, what constitutes a “service” for the purposes of the reverse charge.
- 6.6 The Australian reverse charge applies to all imported services, apart from the supply by an overseas entity to an Australian branch of the services of an expatriate employee.<sup>21</sup> The EU, on the other hand, lists the specific services to which the reverse charge applies.
- 6.7 A clear disadvantage of listing the services to which the reverse charge applies is that problems are created with respect to defining each type of service in the list. This has been the case, to a degree, with the definition of “financial services”, for example, in section 3 of the GST Act. The list also runs the risk of rapidly becoming outdated, especially with the advent of new technologies, services, and methods of service delivery. The use of a specific list creates a boundary around which avoidance and tax planning activity can occur, with a resulting increase in compliance and administrative costs.
- 6.8 Indeed, the European Commission has suggested that the EU rule could be reshaped to become a general rule for services, stating that “[t]here are sound reasons ... for saying that the ‘list’ approach is fundamentally flawed and should be replaced by some more general measure.”<sup>22</sup>
- 6.9 Using a more generic definition instead of a list approach would remove the need to define each type of service subject to the reverse charge. It would also avoid the need to update the list as new types of services emerge and technology enables more of the existing services to be traded across borders.

## Proposed policy

- 6.10 It is proposed, therefore, that the reverse charge apply generally to all supplies of services, unless specific services are excluded from its scope. Chapter 7 discusses specific services that will be included in or excluded from the reverse charge.

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<sup>21</sup> Section 84 – 15(2), A New Tax System (Goods and Services Tax) Act 1999.

<sup>22</sup> *Harmonisation of Turnover Taxes* European Commission, Working Party 1, Brussels, June 1999, page 14.

## The nature of digitised products

### *The issue*

- 6.11 Digitised products are goods and services that are delivered by electronic means in digital form. These products can be delivered to a computer through the Internet, by way of telephone or cable network, or by satellite. Music in the form of compressed music files, film and software are examples of digitised products.
- 6.12 These products are usually received by customers directly from the supplier and are not subject to border control by Customs or handling by intermediaries. They are not tangible property when sent to the customer, but are easily converted to a tangible form by, for example, saving music files on to a compact disc.
- 6.13 The categorisation of digitised products as either goods or services is an issue for consumption tax purposes when digitised products are traded across borders. If they are treated as goods<sup>23</sup> the New Zealand Customs Service would be required to charge GST on the importation of a digitised product. If they are treated as services, they would, under the proposals in this discussion document, be subject to GST under the reverse charge only when imported by a registered person other than in making taxable supplies.
- 6.14 In October 1998 the OECD, as a part of the ministerial conference “A Borderless World: Realising the Potential of Electronic Commerce”, released a policy paper outlining taxation framework elements that required consideration as a result of electronic commerce.<sup>24</sup> The paper concluded that digitised products should not be treated as “goods” for cross-border consumption tax purposes. New Zealand has agreed to this treatment in principle.
- 6.15 Further, the EC, on behalf of the EU, has stated that sales of digitised products downloaded over the Internet should be taxed as services.
- 6.16 Administratively it is easier to levy GST on digitised products using a reverse charge (thereby treating them as services) rather than treating them as goods and the customs service levying the tax at the border under section 12 of the GST Act. This is because digitised products can enter a country in a number of ways – by cable, telephone wire, cellular network, or satellite, all of which pose enforcement and tracing difficulties.

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<sup>23</sup> Defined as “all kinds of movable personal property, including animals” in section 2 of the Customs and Excise Act 1996.

<sup>24</sup> *Electronic Commerce: Development of a Taxation Framework*.

- 6.17 A reverse charge avoids this problem by placing the onus of levying tax on the recipient of the import. The OECD framework is based, therefore, on the pragmatic problems associated with the taxation of digital goods rather than a purely principle-based approach to defining the nature of digitised products. It is also based on the assumption that there is a reverse charge mechanism on imported services, which is the case in most OECD countries.<sup>25</sup>

### ***Proposed policy***

- 6.18 In line with the OECD taxation framework, digitised products will be treated as services for the purposes of the reverse charge.

### **Physical imports of software**

#### ***The issue***

- 6.19 Software physically imported into New Zealand (contained on a disc or CD-ROM) is considered to be “goods” and liable to duty (in this case GST) collected by the New Zealand Customs Service under section 12 of the GST Act. GST is levied on the price paid or payable for the imported software package.
- 6.20 For valuation purposes, however, if the value of the contents (the message or data) is declared or invoiced in a manner which distinguishes it from the value of the carrier medium, the legislation allows the customs service to deduct the value of the contents from the price paid or payable. Customs will then levy GST only on the value of the carrier medium, plus the cost of freight and insurance incurred in bringing the goods to New Zealand.<sup>26</sup>
- 6.21 This method of valuation results from New Zealand’s commitment to the World Trade Organisation General Agreement on Tariffs and Trade (GATT). The agreement allows jurisdictions to impose customs duties on only the carrier media (CD-ROMs) physically imported into a country, excluding the software (data or instructions) content.<sup>27</sup> Although this valuation method is not mandatory, it is a convention which member countries will ideally follow. The distinction between content and media does not apply to imported sound, cinematic or video recordings, or embedded software.<sup>28</sup>

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<sup>25</sup> This is why this approach differs from that proposed for income tax purposes in the Exposure Draft of *Interpretation Guideline IG0007: Non-resident Software Suppliers’ Payments Derived from New Zealand – Income Tax Treatment*, whereby the means of delivery is not considered determinative of the income tax treatment.

<sup>26</sup> Second schedule cl 3(1)(c) of the Customs and Excise Act 1996.

<sup>27</sup> WTO Valuation Committee Decision VAL/8/Add, reaffirmed in WTO Valuation Committee Decision 4.1/1.

<sup>28</sup> Second schedule cl 3(3) of the Customs and Excise Act 1996.



- 6.22 The distinction is also restricted to pure customs duties – taxes such as GST which apply to both imported and domestically produced goods are excluded, even if the tax is collected or enforced by a customs authority at the border.<sup>29</sup> The GATT distinction between content and media is, therefore, not determinative of the appropriate GST treatment of physical importations of software.
- 6.23 For GST purposes it may be argued that a supply of software can be regarded as comprising both a supply of a goods component (the carrier medium) and the supply of a services component (the message or data). The GST Act provides little guidance on the treatment of composite supplies and it is, therefore, unclear whether, under a reverse charge system, a cross-border supply of software could give rise to GST both at the border on the “goods component” and under the reverse charge on the “services component”. The issue needs to be considered.

### *Options for removing the distortion*

- 6.24 The current treatment of physically imported software may give rise to the potential for the software component of imported software to avoid a GST impost. More generally, the current treatment could distort a registered person’s choice of the method of importation of software.
- 6.25 There are two approaches which would remove this distortion and avoidance opportunity. However, they both potentially involve introducing new distortions and increasing compliance or administrative costs.
- 6.26 The valuation rule could be removed for GST purposes, meaning that Customs would charge GST on the full value of physically imported software at the border. This would remove the distortion and avoidance opportunity, since registered persons would be subject to the reverse charge on electronically imported software. It would also, however, mean that non-registered persons (final consumers) and registered persons not otherwise subject to GST under the reverse charge will be charged GST on physical importations of software but not on electronic importations of software.
- 6.27 Although registered persons not subject to the reverse charge will generally be entitled to an input tax credit for the physical importation, taxing the full value of the import would give rise to a distortionary treatment between physically and electronically imported software for non-registered persons. This distortion occurs because services imported by final consumers (business-to-consumer transactions) are not subject to GST and, because of the impracticalities of doing so, are not likely to be subject to GST in the near future (see chapter 9). The extent of this distortion will increase with improvements in telecommunications and Internet technology and the associated ease with which software can be downloaded or electronically delivered.

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<sup>29</sup> GATT Article 3, Ad Article 3.

- 6.28 Alternatively, the valuation rule could be retained, with Customs charging GST on the value of the media, and registered persons importing for non-taxable purposes applying the reverse charge to the remaining value of the product. This treatment would remove the distortion and avoidance opportunity for registered persons subject to the reverse charge, while not affecting final consumers and registered persons not subject to it. This approach could, however, significantly increase compliance costs on registered persons subject to the reverse charge and administrative costs for Inland Revenue and the New Zealand Customs Service.
- 6.29 Despite their disadvantages, both approaches would clarify the GST treatment of physically imported software. The Government seeks submissions on which approach is preferred.
- 6.30 Neither of these options will affect New Zealand's commitment to the World Trade Organisation's moratorium on imposing specific tariffs or specific taxes on electronic transmissions and the Internet.<sup>30</sup>

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<sup>30</sup> Declaration on Global Electronic Commerce, May 1998, WTO Ministerial Conference.

## Chapter 7

### BRANCH AND INTRA-GROUP TRANSACTIONS AND COST ALLOCATIONS

#### Proposed policy

- A New Zealand branch or company will be treated as separate from its offshore head office or parent company in relation to supplies of services that would be subject to GST if supplied in New Zealand. This requires in these circumstances:
  - Treating a New Zealand branch of a non-resident company as a separate entity; and
  - Not disregarding supplies within a wholly-owned group of companies.
- The amount of a management fee or cost allocation charged to a New Zealand branch or subsidiary that is to be subject to the reverse charge will be calculated by taking the fee or allocation and excluding component supplies that are readily identifiable as not being for the acquisition of services that would be subject to GST if acquired in New Zealand.

#### Introduction

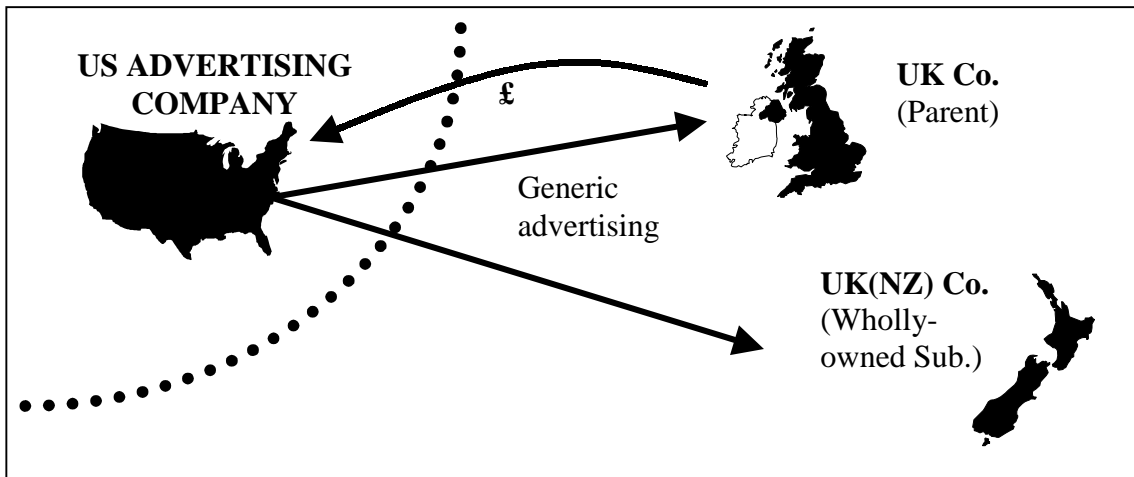
- 7.1 This chapter discusses the treatment of inter-branch and intra-group transactions, and the treatment of management fees and cost allocations, in the context of the proposed reverse charge.

#### What is a “supply” in the context of cross-border, related party transactions

- 7.2 Section 5(1) of the GST Act defines a supply as including “all forms of supply”, and the courts have interpreted the term according to its ordinary meaning: “to furnish with or provide”.<sup>31</sup>
- 7.3 It may be necessary in some instances to specify for the purposes of the reverse charge whether a supply of services has been made, particularly when intra-group or inter-branch transactions are involved. An overriding consideration is whether a member of a group or a branch is treated as an independent party receiving supplies from its parent or head office or as, in effect, part of a single entity. The following example is illustrative of where such clarification may be needed.

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<sup>31</sup> Per Davidson CJ, *Databank Systems Ltd v Commissioner of Inland Revenue* (1987) 9 NZTC 6,213 at 6,223.



- 7.4 A financial services group with a United Kingdom-based parent and a wholly-owned subsidiary in New Zealand decides to embark upon an international advertising campaign. To facilitate the campaign, the UK parent contracts with a United States based advertising firm for a series of generic advertisements for screening in all of the countries in which the group operates.
- 7.5 In this situation there would, in effect, be a supply of advertising services to the New Zealand subsidiary. However, because the contract is with the UK parent only, it is unclear whether the New Zealand subsidiary itself receives a supply of services.
- 7.6 In principle, the reverse charge should apply to all services that, if acquired offshore, would give rise to a lower GST impost than if acquired in New Zealand. However, in many instances the charge for the services will be incorporated into a larger sum. In the example used here the advertising cost to the New Zealand subsidiary may be incorporated into a general head office charge from the UK parent. Requiring the value of the service and every other component of the charge to be separately identified for the purposes of the reverse charge could create substantial administrative and compliance costs.
- 7.7 An important consideration in introducing a reverse charge, therefore, is to balance the objective of imposing the tax on services that, if not taxed, would give rise to distortions and the objective of minimising compliance and administration costs.

## **Cost allocations and related party transactions**

### ***Identifying entities to which the reverse charge will apply***

- 7.8 In some circumstances individual services supplied to a business will not be charged for or identified separately. This may be the case within a group of companies or single multi-national company, where the parent company or head office may, for example, allocate a proportion of its costs to the various parts of the enterprise. The existence of a supply of services may not be easily ascertainable in this situation. The charging of a global sum, or allocation of global costs does not, however, change the fact that a supply may have been made to which at least part of the costs relate. Thus, in principle, the nature of the charge, be it a global sum or specific charges for specific services, should not affect the GST treatment of any supplies made.
- 7.9 The more difficult issue is whether the New Zealand entity should be treated as distinct from its offshore parent or head office. The general approach proposed in this discussion document is to treat the New Zealand entity or presence as a separate person, but only in relation to supplies (including components of cost allocations) to which the reverse charge should apply because of the economic distortions that non-taxation would create. That is, the reverse charge will generally apply only to supplies of services that would be taxable supplies if made in New Zealand by a registered person.
- 7.10 Treating the New Zealand entity or presence as a separate person for the purposes of the reverse charge will require changes to the treatment of cross-border transactions between head offices and branches and cross-border transactions within groups of companies under the GST Act. Currently the GST Act, in the majority of situations, does not recognise transactions between head offices and branches and transactions within groups of companies as supplies. It is necessary, therefore, to treat parents and branches, and members of groups, as separate persons before identifying the supplies to which the reverse charge should apply.

### ***Inter-branch transactions***

- 7.11 GST applies only to supplies made between separate legal entities. A registered person may apply under section 56 of the GST Act for separate registration of any branch, and the branch will be deemed to be a separate registered person carrying on a separate taxable activity for the purposes of the GST Act. However, an offshore parent company not carrying on a taxable activity in New Zealand might not be a registered person, so section 56 would be inapplicable to the branch in New Zealand. (Although under the current legislation an offshore parent company not carrying on a taxable activity in New Zealand is arguably able to register for GST purposes, this position needs to be reviewed, as discussed later in this chapter.)

- 7.12 Therefore, based on the current law, the reverse charge would not apply to supplies from an offshore parent to a New Zealand branch (unless section 56 has been applied). If a New Zealand supplier makes exempt supplies in New Zealand and it is a branch of a non-resident company, any supplies of services from the non-resident company to its New Zealand branch will not be subject to GST, because a single legal entity cannot make supplies to itself.
- 7.13 Many of the entities to which the reverse charge will apply, such as financial institutions, are branches of foreign entities. If supplies between offshore parent companies and New Zealand branches were not within the scope of the reverse charge the distortions which the reverse charge was intended to remove would be perpetuated.
- 7.14 Therefore for the purposes of taxing imported services, a New Zealand branch of a non-resident company should be treated as a separate entity from the offshore part of the company (unless section 56 has been applied).

### ***Intra-group transactions***

- 7.15 Under section 55 of the GST Act, companies that are in a group of companies for income tax purposes<sup>32</sup> may apply for group GST registration if all of the members are registered for GST. Any person may voluntarily register for GST under section 51(3) if they can show that they are carrying on a taxable activity. A taxable activity, as defined in section 6(1), is any activity carried on continuously or regularly which involves or is intended to involve the supply of goods or services for consideration. The taxable activity definition is not restricted to activities carried on in New Zealand. Therefore it is arguable that a non-resident business which is not carrying on any business in New Zealand may register for GST if it so wishes, although it will only pay output tax on taxable supplies made in New Zealand and claim input tax credits directly related to those supplies.
- 7.16 This position needs to be reviewed as there seems to be little justification for a non-resident company not carrying on a taxable activity in New Zealand to be able to register for GST. At a minimum, there needs to be a restriction for the purposes of the reverse charge on the ability of such a company to register.
- 7.17 Based on the current legislation, therefore, a non-resident company which is a member of a group could apply, together with New Zealand members of the group, for group GST registration. Once registered as a GST group, all taxable supplies between members of the group would be disregarded.<sup>33</sup>

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<sup>32</sup> Section IG 1 of the Income Tax Act 1994.

<sup>33</sup> Section 55(7)(c) – although adjustments must be made under sections 55(7)(db) and (dc) in conjunction with sections 21(1) and 21E to reflect any changes in use of goods and services by the group.

- 7.18 A supply of services by a foreign subsidiary or parent of a New Zealand GST group to the New Zealand arm of the group would be disregarded, and the reverse charge would not, therefore, apply.
- 7.19 As with inter-branch transactions, if supplies between members of groups of companies were not within the scope of the reverse charge the distortions which the reverse charge was intended to remove would be perpetuated.
- 7.20 Therefore intra-group transactions should not be disregarded if, but for the existence of the GST registered group, that transaction would have been charged with GST under the reverse charge mechanism.

### ***Calculating the amount subject to the reverse charge***

- 7.21 The next issue, once the New Zealand entity or presence is separated from its offshore entity or presence, is how best to calculate the amount to which the reverse charge should apply. This requires a balance between removing the distortions which necessitate the reverse charge and minimising compliance and administrative costs.
- 7.22 The calculation could be made in two ways. The first would be to take the global sum or cost allocation and identify component supplies that should be excluded from the ambit of the reverse charge. This would target supplies that, in the main, have originated from a third party external to the parent company or head office, such as the advertising services of the US company in the example used earlier. An alternative would be to include in the calculation only those components of the global sum or cost allocation that would be subject to GST if supplied in New Zealand: again, supplies that have originated from an external third party.
- 7.23 Both approaches will give rise to the need for access to information from the offshore parent company or head office on which to base any apportionment or identification of a sum on which to apply the reverse charge. Inland Revenue would have difficulty obtaining access to such information, particularly given its limited ability under the current law to enforce requests for information made offshore in relation to GST. Taxpayers in these circumstances, who are associated with the suppliers, are in a better position to obtain this information. The Government therefore prefers the first option, which is to take the global sum and subtract the amounts that relate to specified supplies that should be excluded from the reverse charge.
- 7.24 Under either approach New Zealand businesses incurring cost allocations will need to be able to break down the allocations so as to identify the “taxable supply” components to enable the appropriate targeting of the reverse charge.

- 7.25 Charges that may be excluded would include exempt supplies such as interest on loans. Salaries might also be excluded. Although GST will apply in some circumstances, such as when fees are charged for seconded staff, in most cases it will not apply. The reason is that GST is not charged on the supply by an employee of services under a contract of service, and supplies within groups and between branches are disregarded for GST purposes. Excluded charges would be listed in the legislation.
- 7.26 The need to limit the scope for avoidance by placing higher values on the non-taxable components would also need to be considered.
- 7.27 If the New Zealand entity is a branch, there is no separate entity in law, and breaking down cost allocations in the manner proposed, subject to the need to minimise compliance and administration costs, would be appropriate. The issue is more difficult in the case of New Zealand subsidiaries, although, when wholly-owned,<sup>34</sup> there is no reason why, in principle, the same approach should not apply.
- 7.28 This approach can be contrasted with that in Canada. Under the Canadian Excise Tax Act<sup>35</sup> the true nature of any “management fee” is considered in determining whether there are multiple supplies of services to be separately characterised for the purposes of the reverse charge or one supply of management services. If the head office has a “hands on” management role (that is, control and decision making) any cost allocation or charge is generally characterised as a global “management fee” and, therefore, fully reverse charged. If not, the individual supplies are analysed and subject to the reverse charge if they come within the Canadian law.
- 7.29 This approach, while having some merit, also involves difficult judgments as to what constitutes “hands on management”.

### **Summary of proposed approach**

- 7.30 The treatment of related party transactions, management fees and cost allocations proposed in this chapter can be summarised as involving:
- (a) Starting from the principle that the reverse charge should apply to services which would be subject to GST if supplied in New Zealand.
  - (b) Treating a New Zealand entity or presence as separate from its offshore presence in relation to the services described in (a). This requires:
    - (i) Treating a New Zealand branch of a non-resident company as a separate entity; and
    - (ii) Not disregarding supplies within a wholly-owned group of companies.

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<sup>34</sup> For GST purposes defined in section IG 1(3) of the Income Tax Act 1994.

<sup>35</sup> Refer Policy Statement P 126.



- (c) Calculating the amount of a management fee or cost allocation that is to be subject to the reverse charge by taking the global sum or cost allocation and identifying component supplies that should be excluded from the ambit of the reverse charge. Such charges would include exempt supplies and potentially salaries.

7.31 Ultimately, the need to achieve a balance between the appropriate targeting of the reverse charge and the minimisation of compliance and administrative costs will be dependent on practical considerations, particularly the extent to which New Zealand entities are, in fact, able to identify the separate components of cost allocations. It will also depend on the ability of the reverse charge mechanism to counteract the development of a practice of placing higher values on the non-taxable components of a cost allocation. The Government therefore welcomes submissions on these issues.

## Chapter 8

### TELECOMMUNICATIONS SERVICES

#### Proposed policy

- A supply of services will occur in New Zealand when a New Zealand customer initiates the supply of telecommunications services from a non-resident telecommunications supplier. Non-resident suppliers of telecommunications services will be required to register for GST if they make supplies of more than \$40,000 in a twelve-month period.
- Telecommunications services will be excluded from the reverse charge.
- The Commissioner of Inland Revenue will have a discretion not to require GST to be returned by telecommunications suppliers operating wholly offshore if it would not be cost effective to do so.

#### Introduction

- 8.1 The provision of telecommunications services involves the sending or receiving of material or information by electronic or similar communications systems. As well as telephone calls, this includes Internet access and satellite transmission services.
- 8.2 These services are highly mobile and homogeneous, which makes it difficult to establish where they are supplied or consumed and hence where they should be appropriately taxed. Many jurisdictions have, therefore, included specific provisions in their GST legislation to deal with the taxation of telecommunications services.
- 8.3 This chapter examines whether similar provisions are justified in the GST Act.

#### Telecommunications services – the issues

- 8.4 Technological advances and the deregulation of the telecommunications market in New Zealand have made it possible for consumers in New Zealand to purchase telecommunications supplies from international service providers as easily as they can from New Zealand service providers.

- 8.5 For example, a New Zealand resident can choose to subscribe to either a New Zealand or an American Internet service provider (ISP) for Internet connection services. The New Zealand ISP would charge GST on the connection services it provides to the New Zealand resident, whereas the American ISP would not charge GST, even though the New Zealand resident is consuming the services in New Zealand.
- 8.6 Therefore the absence of GST on imported telecommunications services encourages consumers to substitute domestically produced services with imported telecommunications services. The extent of this distortion in patterns of consumption depends upon how substitutable New Zealanders consider imported services to be for domestically produced services.
- 8.7 The absence of GST on imported services may also distort patterns of production and resource use in New Zealand. In order to stay competitive with suppliers of imported telecommunications services, New Zealand telecommunications companies would be forced to lower their prices, thereby eroding their ability to pass on the full burden of the GST levied on the telecommunications services they supply to New Zealanders.
- 8.8 This means that the GST system would impose a relatively higher rate of tax on the value added by domestic telecommunications companies. This would reduce their ability to compete not only in the market for their products, but also their ability to purchase resources.
- 8.9 Therefore the absence of a GST impost on these services encourages inefficient patterns of consumption by discouraging the consumption of domestically produced services in favour of imported services. It also discourages the domestic production of services, since domestic producers may not be able to pass on the GST cost to consumers.
- 8.10 The introduction of a reverse charge on imported services would remove these distortions with respect to GST-registered suppliers acquiring services for a purpose other than of making taxable supplies. Entities making taxable supplies would not be affected, as they would be entitled to input tax credits for purchases of imported services if GST was imposed. The economic distortion problem would still exist in relation to final consumers of telecommunications services – “business-to-consumer” transactions. For these transactions there is, as yet, no solution to the general problem of imposing GST on supplies of services across international borders. (See the next chapter for a discussion of this issue.)
- 8.11 Although these distortions and problems exist for all business-to-consumer supplies, supplies of telecommunications services are being specifically addressed as there is a smaller and more identifiable group of suppliers involved and a more immediate threat to the GST base.

- 8.12 Equally significantly, the general application of the reverse charge would not provide the much needed certainty as to the place of supply of telecommunications services. The way in which other jurisdictions have provided this certainty, and hence clarified which supplies of telecommunications services are subject to GST or VAT in the jurisdiction, is discussed in the following paragraphs.

## **Overseas approaches**

### *European Union treatment*

- 8.13 In 1997 telecommunications services were added to those in article 9 of the EU 6<sup>th</sup> Directive<sup>36</sup> that are subject to taxation where the recipient of the service is established. Their inclusion was initially an interim measure but has now become permanent.
- 8.14 The rules are aimed at ensuring that telecommunications services used by customers resident in the EU are subject to EU VAT. There are two sets of rules for telecommunications services. The normal reverse charge mechanism applies to business-to-business transactions, whereas place of supply rules for business-to-consumer transactions treat certain supplies as made in the EU. Therefore, they may require a non-resident supplier to register for VAT purposes.

### *Business-to-business supplies*

- 8.15 Under article 9(2)(e) of the 6<sup>th</sup> Directive, the place of supply of telecommunications services provided to customers outside the EU or provided to taxable persons (equivalent to registered persons) in the EU but not in the same country as the supplier is:
- (i) where the customer has its business establishment; or
  - (ii) where the customer's fixed establishment to which the supplies are made is located.
- 8.16 In this case the taxable person would return VAT under a reverse charge if the supply was from a non-resident telecommunications supplier.

### *Business-to-consumer supplies*

- 8.17 Under articles 9(3)(b) and 9(4) of the 6<sup>th</sup> Directive, telecommunications services supplied by an operator established outside the EU to a private individual established inside the EU are supplied where the effective use and enjoyment of the services takes place. This also ensures that supplies made to customers who are not resident in the EU are not subject to EU VAT. In this case the supplier is required to register for and return VAT. For example, under the UK Value Added Tax Act 1994, when a UK resident

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<sup>36</sup> Which sets the framework and general rules for the VAT systems in all EU jurisdictions.

receives telecommunications services supplied by a non-resident and consumes them in the UK the supplier will be subject to UK VAT on those services.

- 8.18 If neither requirements (i) and (ii) of Article 9(2)(e) nor Article 9(4) apply, Article 9(1) treats the supply as made where the supplier is established.
- 8.19 Telecommunications services are defined as services relating to the transmission, emission or reception of signals, writing, images and sounds or information of any nature by wire, radio, optical or other electromagnetic systems, the provision of access to global information networks (the Internet), and the related transfer or assignment of the right to use capacity for such transmission, emission or reception.

### *Canadian treatment*

- 8.20 Under the Excise Tax Act non-resident suppliers of telecommunication services are liable to register for GST in Canada when they provide the services in the course of carrying on business in Canada<sup>37</sup> and:
- a telecommunication facility is located in Canada; or
  - the signal is emitted and received in Canada; or
  - the signal is either emitted or received in Canada and the billing location for the service is in Canada.<sup>38</sup>
- 8.21 The billing location is in Canada if either:
- the person responsible for payment of the bill has an account with a telecommunication supplier and the account relates to a telecommunication facility that is usually located in Canada; or
  - the telecommunication facility used to initiate the telecommunication service is located in Canada.
- 8.22 If the specific rules do not apply the general reverse charge provisions can still apply when the supply is made outside of Canada.
- 8.23 A telecommunication service is defined as the emitting, transmitting, or receiving signs, signals, writing, images or sounds or intelligence of any nature by wire, cable, radio, optical or other electromagnetic system, or by any similar technical system, or making available telecommunications facilities to provide such emissions, transmissions or reception.

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<sup>37</sup> Section 143(1) of the Excise Tax Act.

<sup>38</sup> Section 142(1) and Schedule IX Part VIII of the Excise Tax Act.

### *Australian treatment*

- 8.24 Division 85 of the A New Tax System (Goods and Services Tax) Act 1999 deals with telecommunication services. When final consumers receive telecommunication services from offshore the provision requires overseas suppliers to register for and return GST in Australia.
- 8.25 Division 85 provides that telecommunication supplies are connected with Australia, and hence subject to GST, if they are effectively used and enjoyed in Australia, regardless of where the supplier has a physical presence.
- 8.26 Section 85-5 provides that:
- “(1) A telecommunication supply is connected with Australia if the recipient of the supply will effectively use or enjoy the supply in Australia.
- (2) [The section] does not apply to a telecommunication supply, or a telecommunication supply included in a class of telecommunication supplies, if:
- (a) the supplier makes the supply through an enterprise that is not carried on in Australia; and
  - (b) the Commissioner determines that collection of GST on that supply or class of supplies would not be administratively feasible.”
- 8.27 Thus if the supplies are made from an enterprise offshore that has no permanent establishment in Australia and the collection of tax is deemed by the Commissioner not to be feasible, there is a discretion to treat the telecommunication supply as not being a taxable supply.
- 8.28 Section 85-10 defines a telecommunication supply to be a supply relating to the transmission, emission or reception of signals, writing, images, sounds or information of any kind by wire, radio, optical or other electromagnetic systems. It includes:
- the related transfer or assignment of the right to use capacity for such transmission, emission or reception; and
  - the provision of access to global information networks (the Internet).
- 8.29 If Division 85 applies to tax a supply the reverse charge in Division 84 does not apply.

## Proposed application in New Zealand

- 8.30 The approach adopted by the EU, and latterly Australia, has shown that it may be possible to address the problems posed by imported supplies of telecommunications services, and provide the necessary definition of the tax base, by enacting specific provisions determining the place of supply for these services. The approach in these jurisdictions is to treat telecommunications supplies as being made where the customer (the person “using” the call services) resides and, therefore, to require suppliers of those services to register for GST or VAT.
- 8.31 It is proposed to introduce similar, but not identical, rules for taxing telecommunications supplies to operate alongside and complement the proposed reverse charge mechanism.
- 8.32 Telecommunications services should be defined as clearly as possible, and in a way that ensures the definition will not be made obsolete by changes in communication technology. The Telecommunications Act 1987 defines telecommunication as the conveyance from one device to another of any sign, signal, impulse, writing, image, sound, instruction, information, or intelligence of any nature, whether for the information of any person using the device or not.<sup>39</sup>
- 8.33 This definition, and the definitions used in the EU and in Australia, are based on the definition of telecommunication adopted by the International Telecommunications Union (of which the New Zealand Government is a member) in the Final Acts of the World Administrative Telegraph and Telephone Conference<sup>40</sup> – known as the Melbourne Accord. The Melbourne Accord regulates international supplies of telecommunications. Telecommunication is defined as “any transmission, emission or reception of signs, signals, writing, images and sounds or intelligence of any nature by wire, radio, optical or other electromagnetic systems”.
- 8.34 A supply of telecommunications services could, therefore, be defined as the transmission, emission or reception of signals, writing, images, sounds or information of any kind by wire, radio, optical or other electromagnetic system, or by any similar technical system. It would include:
- the related transfer or assignment of the right to use capacity for such transmission, emission or reception; and
  - the provision of access to global information networks (the Internet).

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<sup>39</sup> Note that the recently introduced Telecommunications Bill is likely to change this definition.

<sup>40</sup> Final Acts of the World Administrative Telegraph and Telephone Conference (WATTC – 88), Melbourne, 1988.

- 8.35 The services supplied would, therefore, be the action of sending or receiving material or information provided by the telecommunications supplier to the New Zealand customer.
- 8.36 Under the proposed rule, a supply of services in New Zealand would occur when a New Zealand customer initiates the provision of telecommunications services from a non-resident telecommunications supplier – for example, when a New Zealand customer connects to the Internet using an overseas ISP. Conversely, if a non-resident customer initiates the provision of telecommunications services from a New Zealand-resident telecommunications supplier the supply would not be subject to GST in New Zealand.
- 8.37 There are two possible approaches to determining whether there is a New Zealand customer (and conversely, if there is a non-resident customer) and, therefore, whether the consumption and the supply of telecommunications services has occurred in New Zealand and is subject to GST.
- 8.38 The first is to treat a supply of telecommunications services as occurring in New Zealand when a person who is usually resident in New Zealand initiates a supply of telecommunications services. This approach avoids potential problems associated with identifying the jurisdiction in which the customer is actually physically located when they initiate the supply.
- 8.39 This approach does not, however, provide the most accurate identification of the jurisdiction in which the customer is actually present and consuming the services – it sacrifices this accuracy to provide a simple and certain result.
- 8.40 The second approach would be to treat a supply of telecommunications services as occurring in New Zealand when the customer who initiates the supply is actually physically present in New Zealand. This approach would require the telecommunications supplier to identify the place from which the customer is initiating the supply of telecommunications services. If the telecommunications supplier were not able to identify the jurisdiction from which the customer was initiating the supply of telecommunications services, the services could be treated as supplied either in the jurisdiction in which the customer is usually resident or the jurisdiction of the telecommunications supplier.
- 8.41 Although it is potentially capable of more accurately identifying the jurisdiction in which consumption actually occurs, a test which looks at where the customer is actually physically present may be more difficult to apply. Difficulties in identifying where the customer is physically located will increase with advances in technology, such as the increased use of wireless communications and Internet telephone services.
- 8.42 The Government welcomes submissions on the advantages and disadvantages of these approaches.



- 8.43 Under the proposed rule, a non-resident telecommunications supplier making over \$40,000 of such supplies in a twelve month period will become liable to be registered for GST, and incur all the associated GST obligations.
- 8.44 In this situation the reverse charge will not be applied to telecommunications services. Although the reverse charge would tax such supplies to exempt suppliers, it may not be possible for telecommunications suppliers to distinguish between customers who would be liable to the reverse charge and those who should be charged GST on supplies.
- 8.45 It is also proposed to include a discretion for the Commissioner of Inland Revenue not to enforce the rule in relation to telecommunications suppliers operating wholly offshore if it would not be cost-effective to do so. Under such circumstances the reverse charge would also be deemed not to apply to such a supply.

### **The section 11A(2) amendments and telecommunications**

- 8.46 In 1999 section 11(2A), now section 11A(2), was inserted into the GST Act to ensure that section 11(2)(e), now section 11A(1)(k), did not apply to zero-rate services that were consumed in New Zealand but contracted for by a non-resident who was outside New Zealand.
- 8.47 Section 11A(2) provides that section 11A(1)(k) does not zero-rate services supplied to a non-resident if another person (including an employee or company director of the non-resident) receives the performance of those services in New Zealand. The provision does not apply if it is reasonably foreseeable that the supply of the services is related to the making of taxable or exempt supplies by registered persons.
- 8.48 At the time the amendment was made concerns were raised that it might, contrary to the policy intent, incorrectly exclude "inbound" telecommunications services from the GST zero rating provisions.
- 8.49 An example of an "inbound" telecommunications service is an overseas caller making a telephone call to a person in New Zealand. This service is provided to the overseas caller by an overseas telecommunication supplier who contracts with a New Zealand telecommunication supplier to connect the call in New Zealand. In this situation the New Zealand telecommunication supplier serves as a link between the overseas telecommunication supplier and the New Zealand resident receiving the phone call. Such services are intended to be zero-rated under the GST Act.
- 8.50 The Government does not consider that section 11A(2) applies to "inbound" telecommunications supplies, as the connection service supplied by the New Zealand telecommunications company is received by the overseas telecommunications company, not by the person in New Zealand receiving the call. This was made clear in the report of the Finance and Expenditure Committee on the Taxation (Annual Rates and Remedial Matters) Bill and in

the Inland Revenue's *Tax Information Bulletin* article on the legislation after it was enacted.

- 8.51 Enacting specific rules for telecommunications services will further clarify the place of supply of telecommunications services, and hence clarify what supplies are subject to GST in New Zealand. This will ensure that connection services in relation to “inbound” telecommunications services provided by a New Zealand telecommunications supplier are not subject to GST in New Zealand.

## Chapter 9

### BUSINESS-TO-CONSUMER TRANSACTIONS

#### Introduction

- 9.1 At present, most imports of services occur through business-to-business transactions. The volume of business-to-consumer transactions is still relatively small, but is expected to increase. This discussion document only proposes a solution to the problems caused by the non-taxation of business-to-business imports of services, as there is not, as yet, a viable tax collection mechanism for business-to-consumer imports of services.
- 9.2 This chapter outlines the problems and possible future tax collection mechanisms with regard to business-to-consumer transactions.

#### Business-to-consumer transactions: the problem

- 9.3 The collection of GST from transactions involving supplies between non-resident businesses and New Zealand private consumers poses a difficult problem to which, internationally, there is yet to be a workable resolution.
- 9.4 The problem arises because the non-resident business will not in the usual course of events be registered for GST and, therefore, will not return GST to Inland Revenue on any sales to New Zealand consumers.
- 9.5 Electronic commerce has increased the extent to which services can be traded across borders. As electronic commerce further develops as a means of transacting, the extent to which it is possible and affordable to purchase services from offshore providers will increase.
- 9.6 Difficulties also arise when determining the residence of the consumers, principally when digitised products are being supplied, since these may be sent to an Internet address which may not have any obvious connection to the actual residence of the consumer. (For example, the address may not be identifiable as a New Zealand domain name.)
- 9.7 As discussed in the previous chapter, business-to-consumer transactions are a particular issue for telecommunications suppliers, as it is difficult to determine if these services are physically performed or occur at a particular location, and the services are highly mobile.

#### Possible solutions

- 9.8 Four possible methods have been identified to collect GST from business-to-consumer transactions.

### *Self-assessment*

- 9.9 Under a system of self-assessment, consumers who receive services from offshore suppliers self-assess and return GST on the value of those supplies. This means that a mechanism such as the reverse charge would apply to private consumers. This method appears at this stage to be the least effective way to subject supplies of imported services to private consumers to GST. There are significant compliance and enforcement issues, with there being no or very few incentives for consumers to comply with a requirement to self-assess. There are also difficulties in identifying those who have imported services, and difficulties relying upon consumers knowing that they must comply with the self-assessment requirement.
- 9.10 Placing the burden of complying with tax rules on the consumers of imported services would tend to discourage the consumption of such services, and distort consumption patterns towards domestically produced services.
- 9.11 Such a system is also contrary to recent simplification initiatives which aim to shift the burden of compliance from individual taxpayers, and contrary to the GST framework which avoids placing any administrative requirements on private consumers.

### *Registration of non-resident businesses*

- 9.12 This option would require non-resident businesses making supplies of services to a country to register for GST in that country and charge and return GST on the supplies they make, according to the GST rules of that country. Non-resident suppliers would, therefore, be treated in the same manner as New Zealand suppliers for GST purposes.
- 9.13 This approach is used with some success in the EU with respect to supplies of telecommunications services, apparently owing to:
- the relatively limited and identifiable number of companies involved in the supply of telecommunications services, and the ability to trace those companies, since to provide their services they must interconnect with resident telecommunications suppliers;
  - compliance costs being limited by the need to register in only one EU nation for the purposes of all EU VAT;
  - the size and economic power of the EU; and
  - the incentives that telecommunications service providers have to comply with EU law.

- 9.14 The EC also has a broader proposal which would impose VAT on supplies of electronically delivered services based on the location of the consumer of those services (as opposed to the supplier's location, as is currently the case).<sup>41</sup> Suppliers selling electronic services<sup>42</sup> from outside the EU to consumers inside the EU would be required to account for VAT in the same way as an EU-resident supplier. The non-resident supplier would register for, and charge, VAT in the EU.<sup>43</sup> The non-EU supplier would be required to register only if it made sales of more than Euro 100,000 to private consumers in the EU, and would be required to register only in one jurisdiction within the EU.
- 9.15 The proposal will operate alongside the reverse charge already in operation for business-to-business transactions. The proposal was adopted by the EC on 7 June 2000, but is not yet legislated for in member countries.<sup>44</sup>
- 9.16 The proposal will rely partially upon international co-operation for enforcement. It will also rely upon the willingness of multinational firms to protect their goodwill and image in the EU and retain a favourable climate in the EU for non-EU suppliers to do business.
- 9.17 The OECD has recently published for public consultation a draft report from its working party on consumption taxes.<sup>45</sup> The report states that, in the short term (pending adoption of technology-facilitated options), the most viable collection mechanism to support the practical application of the Ottawa Taxation Framework Guidelines<sup>46</sup> to business-to-consumer transactions lies with a mechanism based on the registration of non-resident suppliers. The working party acknowledges that the registration of non-resident suppliers has its shortcomings and that simplified approaches to the registration of non-resident suppliers should be developed.
- 9.18 Although this approach appears to have been successfully applied to telecommunications services in the EU, there are a number of difficulties with its general application to imported services:
- It would impose significant compliance burdens on the non-resident supplier, which would need to have technical knowledge of the GST or VAT systems of the jurisdictions to which it makes supplies.
  - It will be more difficult to enforce the registration requirement generally, as other service industries may not be as identifiable or as traceable as the telecommunications industry.

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<sup>41</sup> *A Strategy to Improve the Operation of the VAT System within the context of the Internal Market* COM(2000) 349.

<sup>42</sup> For example pay-per-view television.

<sup>43</sup> Conversely, if an EU supplier provides such services to a non-EU customer they do not have to charge VAT.

<sup>44</sup> It is unclear, however, whether it will be implemented, as it has been reported that the UK has recently expressed opposition to the proposal.

<sup>45</sup> *A report by the Committee's Working Party No. 9 on Consumption Taxes: Consumption Tax Aspects of Electronic Commerce*, ([www.oecd.org/daf/fa/e\\_com/ec\\_6\\_WP9\\_REPORT\\_Eng.pdf](http://www.oecd.org/daf/fa/e_com/ec_6_WP9_REPORT_Eng.pdf)).

<sup>46</sup> See discussion in Chapter 1.

### ***Technology-based solutions***

- 9.19 As the identification of suppliers and recipients becomes increasingly difficult in the electronic commerce environment, owing to the growing employment of electronic cash payment systems and software protecting customer privacy, technology-based withholding systems using financial intermediaries could be used to collect GST.
- 9.20 Financial intermediaries would withhold the GST or VAT portion of any payment for a supply of goods or services acquired electronically, and remit the money to the relevant revenue authority.
- 9.21 Assuming withholding by financial intermediaries were technically feasible, the following problems might arise:
- The financial intermediary would need to know the jurisdiction in which the supply was taking place. Identification of the residence of the consumer may be possible if a credit or debit card were used, but not necessarily if electronic cash were used.
  - The financial intermediary would need to know the GST or VAT rules of that jurisdiction.
  - The financial intermediary would need to know the nature of the supply, to determine the correct GST or VAT treatment.
- 9.22 This approach might require compensating financial institutions for the high compliance burdens placed upon them, and measures to ensure that financial institutions in jurisdictions which did not comply with the withholding framework were not used to avoid the withholding regime.

### ***Taxation at source and transfer***

- 9.23 A further option is to enter into consumption tax agreements with countries under which a business making an export would charge and collect GST or VAT on that supply, and return that amount to their revenue authority. The revenue authority would then pass the tax on to the revenue authority of the country in which the services are acquired.
- 9.24 This approach would require a network of agreements between nations, and a system of incentives to encourage the revenue authority in the exporter's jurisdiction to ensure compliance by the exporter. It would impose a compliance burden upon exporters, who would be required to have an understanding of the GST or VAT rules of the countries to which it was exporting.

## **The future**

- 9.25 A general impost of GST on supplies of imported services from businesses to private consumers is not proposed at this stage. The New Zealand Government is continuing to participate at the OECD and discuss these issues with member countries, and will monitor the EU proposal to register non-resident suppliers of electronically delivered services.