GST: Business-to-business neutrality across borders

A government discussion document about GST on cross-border supplies between businesses

Hon Peter Dunne
Minister of Revenue

First published in August 2011 by the Policy Advice Division of Inland Revenue, PO Box 2198, Wellington 6140.

GST: Business-to-business neutrality across borders – A government discussion document about GST on cross-border supplies between businesses.
ISBN 978-0-478-27194-2

CONTENTS

CHAPTER 1 Introduction 1

The problem 2
Aims of this discussion document 2
How to make a submission 3

CHAPTER 2 GST and business-to-business supplies 5

Problems with current system 6
Conclusion 8

CHAPTER 3 B2B options for New Zealand 9

Zero-rating 10
Enhanced registration system 11
Direct refund system 13
Conclusion 14

CHAPTER 4 Enhanced registration system – design features 15

Outline of the proposed system 16
Other key changes 18
Other measures considered 22

CHAPTER 5 Tooling costs 24

Options 25
Conclusion 27

CHAPTER 1

Introduction

1.1 The primary objective of goods and services tax (GST) in New Zealand is to raise tax revenue in a manner that imposes the lowest possible cost on businesses, individuals and the Government. To achieve this, GST applies to a broad range of goods and services at a uniform rate of 15%.

1.2 The intention of this broad-based approach is to:

- reduce the extent to which GST alters consumption decisions in New Zealand by lowering the impact on the relative prices that consumers pay for their goods and services;
- reduce the extent to which GST distorts production and resource-use decisions in New Zealand. The approach lessens the extent to which GST alters the competitive position of a New Zealand business in both the market for the goods and services it produces, and the market for the inputs it uses to produce those goods and services, by minimising the impact on relative prices in those markets; and
- reduce the compliance and administrative costs associated with raising GST revenue.

1.3 Key to achieving these objectives is the taxation of the final consumer only − not the inputs and products in between. GST in effect applies only once, through offsetting input credits against taxable outputs. Business-to-business (B2B) supplies are, therefore, in effect, GST-neutral. This avoids taxation cascades, which can result when sales taxes are applied at various stages in the production process.

1.4 Because GST applies to consumption in New Zealand, it taxes both consumption by New Zealanders and non-residents who are consuming goods or services in New Zealand. GST is not, however, intended to apply to non-residents consuming goods and services outside New Zealand.

1.5 The GST system prevents the double taxation of goods and services that are traded between New Zealand and other countries through the "destination principle", which assigns the rights to tax the consumption of traded goods and services to the country in which those goods and services are destined to be consumed. This means that exports are zero-rated and imports are subject to GST, in the same way as domestically produced goods and services that are consumed in New Zealand.

The problem

1.6 An exception to the zero-rating of exports applies in practice to goods purchased in New Zealand by tourists. While there are schemes in place that enable removal of the tax impost in limited circumstances, tourists who take goods outside of New Zealand do not receive GST refunds as a matter of course. This is because the economic costs of doing so (mainly compliance and administration costs) outweigh the economic benefits. Tourists' purchasing behaviour has been assessed as unlikely to be altered by whether there is a general refund scheme or not.

1.7 While this may be so for tourists, there may be behavioural effects for non-resident businesses that operate in New Zealand. The destination model generally works well in relation to goods, because they physically pass through customs control and are relatively easy to identify. However, cross-border supplies of services are difficult to monitor because of their intangible nature. Countries generally aim to ensure that B2B transactions are untaxed in these circumstances, in line with the destination principle.

1.8 New Zealand zero-rates some cross-border services and has a registration mechanism which refunds GST incurred by non-resident businesses in many instances. Nevertheless, it is essential that our domestic GST laws relating to services received by non-residents are fair and efficient, and do not impose undue economic costs on New Zealand. We refer to this objective as B2B neutrality.

1.9 Such economic costs could arise if non-resident businesses are deterred from undertaking business with New Zealand because of the lack of GST neutrality in certain areas. Alternatively, New Zealand businesses could face additional constraints when undertaking business overseas because overseas jurisdictions perceive our rules in this area to be unfair.

Aims of this discussion document

1.10 This discussion document focuses on the desirability of cross-border B2B neutrality in our GST system and related matters. It discusses the current registration process for providing refunds of GST incurred by non-resident businesses and considers various options for enhancing or replacing the current approach – while being mindful of the need to balance neutrality and protect the tax base.

1.11 The current prohibition on refunds of GST input tax in relation to exempt supplies (such as financial services provided to non-businesses) would continue. This prohibition is a general feature of the GST rules and therefore applies to non-resident businesses too.

1.12 The following chapters are focussed solely on B2B supplies because of the behavioural effect that excessive taxation may have in that sector. This document does not seek to address issues that have been raised in the public domain regarding cross-border supplies between businesses and consumers, specifically:

- the desirability or otherwise of a refund scheme for tourists on goods they take with them when they leave the country; and
- the $60 minimum duty threshold on goods imported into New Zealand (meaning that a consignment of goods of up to NZ$400 value can generally be imported without GST being imposed). A review of this minimum level was recently conducted by New Zealand Customs Service.[1]

1.13 All legislative provisions in this document and references to "the Act" are to the Goods and Services Tax Act 1985, unless otherwise stated.

Summary of proposals

- That an enhanced registration system be introduced. This would retain the existing broad ability for non-resident businesses to register for GST, but would couple this with rules allowing non-resident businesses to claim input tax in a broader range of circumstances by removing the requirement for the business to be making taxable supplies. This system is considered preferable to either an expanded zero-rating system or a direct refund model. Both of these alternative approaches are discussed in chapter 3.
- That other measures be considered to provide certainty for taxpayers and to protect the revenue base under the enhanced registration system. Some key features include that the non-resident be registered for GST or VAT (or, if not, be a registered business taxpayer) in their home jurisdiction, that there be a minimum refund threshold and that accounting for GST be on a payments or hybrid basis (chapter 4).
- That supplies to non-residents of tools used solely in relation to exported products be either subject to GST (which would be deductible under the enhanced registration system) or zero-rated (chapter 5).

How to make a submission

1.14 Submissions on this discussion document should be made by 7 October 2011 and can be addressed to:

[1] See the New Zealand Customs Service December 2010 Issues paper: *Review of the de minimis*, and subsequent press release by the Minister of Customs at http://www.beehive.govt.nz/release/no-change-de-minimis.

GST: Business-to-business neutrality across borders
C/- Deputy Commissioner
Policy Advice Division
Inland Revenue Department
P O Box 2198
Wellington 6140

1.15 Or email: **policy.webmaster@ird.govt.nz** with "GST: Business-to-business neutrality across borders" in the subject line.

1.16 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for officials from Inland Revenue to contact those making submissions and to discuss their submission, if required.

1.17 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider there is any part of it that should properly be withheld under the Official Information Act should clearly indicate this.

CHAPTER 2

GST and business-to-business supplies

This chapter looks at the desirability of GST neutrality in cross-border B2B transactions and discusses how this is dealt with currently.

2.1 New Zealand recognises the importance of avoiding double taxation in international trade. However, the method for ensuring that double taxation is avoided differs for income tax and GST purposes.

2.2 Income tax operates on the basis that countries will cast a wide net – taxing on the basis of both source and residence – and then surrendering taxing rights or providing a credit for foreign tax paid through the double tax agreement (DTA) network.

2.3 If GST operated on a similar basis, it would in theory require output tax to be collected on both imports and exports, with the surrender of some export taxing rights and provision for foreign output tax to be claimed as input tax through treaty agreements. However, other than for exchange-of-information purposes in some cases, DTAs do not generally cover GST. The OECD's guidance on consumption tax thus far has instead focussed on an internationally recognised system for allocating taxing rights across jurisdictions.[2]

2.4 As discussed in Chapter 1, GST works on the destination principle of taxation. If this principle were to be applied strictly, it would only look at the location of the relevant contractual parties. This means that goods and services provided by a New Zealand business to an Australian customer would always be zero-rated, irrespective of where the service was actually received. Under such a strict approach, GST would never be a burden on business and B2B neutrality would be achieved. Businesses would only pay GST (or its equivalent) in their own jurisdiction, irrespective of where the goods and services were received or where the supplier was physically located.

2.5 The destination principle works well for imported and exported goods, because items physically pass through Customs' control and are relatively easy to identify. However, cross-border supplies of services are more difficult to monitor because of their intangible nature; it is often difficult to pinpoint exactly when and where a service is consumed or even when it crosses a border and, therefore, which country has the taxing right.

[2] See OECD Committee on Fiscal Affairs, Working Party N°9 on Consumption Taxes: *OECD International VAT/GST Guidelines, Draft Guidelines on Neutrality*, December 2010.

2.6 GST laws for both goods and services received by non-residents must ensure that non-residents are treated on an equivalent basis to resident businesses or consumers, taking into account any significant risks to the tax base. For the reasons given, this document assumes that the supplies that cause the most difficulties from a B2B neutrality perspective will be supplies of services.

Problems with current system

2.7 A traditionally problematic area in applying GST to cross-border transactions has been when the contractual recipient is a non-resident, but the physical receipt of the services takes place in New Zealand.

2.8 Under the destination principle, the standard method for ensuring that no tax is collected in the originating jurisdiction is to zero-rate the supply. Zero-rating does not impose output tax on the supply, while ensuring that the domestic supplier can claim back the input tax they incurred in making the supply. To do otherwise would be to effectively penalise exporters by either increasing the cost of their exported products or forcing them to absorb a tax cost not imposed on domestic suppliers.

2.9 In determining the location of the recipient, New Zealand has, since the *Wilson & Horton* decision, looked to the location of the contractual recipient.[3] The *Wilson & Horton* decision created problems for the New Zealand tax base because in some cases, contractual relationships may not reflect the fact that consumption takes place in New Zealand. In areas such as the tourism and education sectors in particular, the potential arose to create contractual relationships with non-residents before they arrived in New Zealand, so that goods and services consumed in New Zealand could be zero-rated.

2.10 To deal with this situation, section 11A(2) of the GST Act was enacted to ensure that services received in New Zealand attract GST at the standard rate. Section 11A(2) is seen as an essential base maintenance provision. However, it is recognised that its role needs to be further considered in the context of supplies received by non-resident businesses in New Zealand.

2.11 Section 11A(2) results in a broad range of services (other than exempt services) received in New Zealand being standard-rated. If the non-resident business is not making "taxable supplies" in New Zealand, this GST cannot be claimed as input tax.

[3] *Wilson & Horton v Commissioner of Inland Revenue* [1996] 1 NZLR 26; (1995) 17 NZTC 12,325; (1995) 20 TRNZ 111.

2.12 The result is that New Zealand GST forms an irrecoverable cost to the non-resident business. Although an irrecoverable tax cost is not a problem if it is applied universally, it can create distortionary effects when it represents a real economic cost to a non-resident business and a resident business incurring the same cost would be able to claim the amount as an input tax deduction. In these circumstances, the cost of consuming services in New Zealand is higher for a non-resident solely on the basis of the GST treatment. All things being equal, this may have the effect of deterring a non-resident from consuming services in New Zealand altogether or limiting the market share that New Zealand businesses can realistically compete for.

2.13 An example of how section 11A(2) might apply is in the aviation training industry. A non-resident airline may contract with a New Zealand-resident training institute to instruct trainee pilots in certain skills. The pilot is, upon graduation, bonded to the relevant airline for a number of years. The trainee receives the services in New Zealand, so output tax is charged, even though the beneficiary of the training may be the non-resident airline – which acquires a fully qualified pilot for a considerable length of time. If the airline was carrying out a taxable activity in New Zealand, the GST incurred is likely to be available as an input tax credit.

2.14 The disparity between resident and non-resident businesses can to some extent be resolved if the non-resident business registers for New Zealand GST purposes. Currently, New Zealand allows any person that carries on a taxable activity to register for GST. As a “taxable activity” is not geographically confined, this means that any non-resident business can theoretically register for GST.

2.15 However, a person can only claim input tax as a deduction if they use the goods or services acquired for making “taxable supplies”. The concept of “taxable supplies” is geographically limited to supplies of goods or services in New Zealand. In order to claim a deduction for input tax, a non-resident business must therefore use the goods and services acquired for the purpose of making supplies in New Zealand. This limits somewhat the use of registration as a means for non-residents to obtain neutrality.

2.16 Section 20(3C) of the GST Act also ensures that input tax is only available “to the extent” that the relevant goods and services are used for making taxable supplies. This rule restricts the ability of a non-resident to make token supplies in New Zealand and claim all input tax incurred as a deduction, because it is difficult to argue that all goods and services acquired in New Zealand are done so for the purpose of generating a very limited amount of taxable supplies.

2.17 In addition, under sections 52(5), (5A) and (7), the Commissioner has reasonably broad powers to (retrospectively in some instances) deregister a person that is not carrying on a taxable activity in New Zealand. These sections may act as a disincentive for non-resident businesses to register in the first place.

2.18 In determining what supplies are to final consumers and what supplies are to businesses, there are fine margins at play, even in our aviation training example. Pilot training is broadly "education", and most international students that come to New Zealand do so for their personal betterment. There is no sound policy reason for services consumed in New Zealand that have a private benefit to be outside the scope of GST, even when the recipient is a non-resident.

2.19 If a change is to be made, the challenge is to strike the right balance between addressing some lack of neutrality between resident and non-resident businesses and ensuring that GST is not easily avoided in New Zealand. This would be achieved by setting an appropriate business and consumer boundary.

2.20 There is a counter argument which says that the cost of GST is not always fully borne by a non-resident business. This would arise when the tax is not recoverable but is nevertheless incurred as a business expense. In these circumstances, the non-resident is likely to receive an income tax deduction for the New Zealand tax cost in their own country. The remainder of the tax burden may also be recovered by the non-resident business through the pricing of its products to its own consumers. We have therefore considered how important an issue GST is for a non-resident business, when these issues and other pricing factors such as exchange rate fluctuations are taken into account.

2.21 While difficult to measure, it is reasonable to assume that businesses would perceive the GST cost to be a significant factor when comparing New Zealand's GST treatment with that of other jurisdictions in which they may alternatively consume services. The following chapters therefore proceed on this assumption.

Conclusion

2.22 We consider that, if a solution that is workable for both government and taxpayers can be found, it may increase the attractiveness of New Zealand for non-resident businesses that consume services away from their main place of operation. This may result in a greater number of non-residents choosing to consume services in New Zealand, to the benefit of the New Zealand economy more generally.

CHAPTER 3

B2B options for New Zealand

This chapter looks at three possible methods for achieving greater neutrality in the cross-border supply of goods and services between businesses:

- zero-rating certain supplies;
- relaxing the restrictions on non-resident businesses when claiming input tax; and
- a refund system for non-resident businesses.

The chapter concludes that the second option – relaxing the restrictions on non-resident businesses when claiming input tax deductions – may best achieve the twin aims of promoting B2B neutrality and providing adequate protection for the revenue base.

3.1 Chapters 1 and 2 established that GST is not designed to impose a real fiscal cost on businesses – be they resident or non-resident – other than in certain defined instances when businesses are treated as if they were final consumers. This chapter considers how B2B neutrality might best be achieved in practice.

3.2 Different countries adopt different models to create a neutral outcome for non-resident businesses, each with its own strengths and weaknesses.

3.3 While there are other approaches, the three most common ways of achieving B2B neutrality appear to be:

- Zero-rating certain supplies;
- extending a non-resident business's ability to claim input tax credits, while retaining a broad ability to register for GST; and
- allowing non-resident businesses to claim refunds for input tax incurred without the need to actively register for GST.

3.4 There is already some flexibility in our GST system to cater for non-resident businesses. For example, if a non-resident business were to incorporate a New Zealand subsidiary and register that subsidiary for GST, it is often possible for the subsidiary to acquire New Zealand goods and services and then export "finished" goods and services to its non-resident parent. This structure allows the subsidiary to claim input tax for the supplies received and to zero-rate the supply to the parent. The net position is that the subsidiary obtains a refund and neutrality across the group is achieved. The following options therefore need to be considered in light of the fact that an existing structure – albeit one that may come at a higher compliance cost – is available in many cases.

Zero-rating

3.5 Extending the current zero-rating rules could take two forms: either a broad-based system, under which all supplies to non-resident businesses can be zero-rated, or a more focussed system under which only those services of most concern from a neutrality perspective would be specifically zero-rated.

3.6 If more focussed rules were introduced, they would be likely to target specific industries – an approach that is largely unprecedented in the GST Act. The targeted industries would be those that appear to be "unfairly" required to charge GST on supplies to non-resident businesses. In this respect, the Government could, in zero-rating particular activities, be regarded as "picking winners".

3.7 A broader approach that minimises these distortions across industries is therefore preferable, even though it is likely to give rise to a greater fiscal cost.

3.8 ***Strengths of zero-rating***

- Zero-rating is consistent with the destination model and with how the Act currently deals with goods and services that are exported. Having a system that aligns the treatment of all exports is simpler and more transparent.
- Zero-rating is a mechanism that is familiar to New Zealand businesses. The familiarity of the system may arguably also reduce compliance costs to non-resident businesses.
- Zero-rating would result in minimal administrative costs for Inland Revenue. The reporting requirements would fall on existing registered persons, so there would be no increase in the number of taxpayers registered for GST or otherwise filing with Inland Revenue.

3.9 ***Weaknesses of zero-rating***

- Under a broad-based system, zero-rating rules could fail to create the level of certainty anticipated. Although the policy may be clear, there will always be areas of contention from "borderline" activities. The fact that the scope of section 11A(2) itself has been litigated shows that rules designed to prevent confusion can themselves end up being disputed.
- Any rules will also be vulnerable to shifts in behaviour in the types of supplies made. A definition of certain activities would be fixed in time and may not be adequately "future-proofed". Such rules are more likely to require future amendments than general, principles-based legislation.
- Irrespective of how the relevant rules are drafted, they may not alleviate the GST cost altogether. These "gaps" would result in GST being a cost to a non-resident business when the same GST charged to a resident business may be able to be deducted as input tax.

- Importantly, an expanded zero-rating system may push potentially large compliance costs onto New Zealand suppliers. The New Zealand-resident supplier may be required to identify each customer and determine the appropriate GST treatment on a transaction-by-transaction basis. For suppliers that do not deal exclusively with non-resident businesses, this could be extremely difficult to administer. A New Zealand service provider would have to establish not only that their client was a non-resident, but also that they were consuming the services purely for business purposes.
- When a supply is zero-rated, the output tax that would have been chargeable on that supply is immediately "lost" from the GST system. This makes any mistakenly zero-rated supply difficult for Inland Revenue to identify and recover. The GST Act would make the supplier in such cases liable for output tax not charged on the relevant supply. This would increase costs for New Zealand suppliers, forcing them into rigorous checks to determine whether the supply should be zero-rated and being financially penalised if they get it wrong. Risk-averse suppliers may resort to standard-rating all supplies, thereby defeating the objective of any revised rules.

Enhanced registration system

3.10 A variation on the current system that could promote B2B neutrality would be to retain the broad ability to register, but couple it with more generous rules around claiming input tax ("an enhanced registration system").

3.11 This would be similar to the rules that operate in Australia where, generally speaking, a registered person is entitled to an input tax credit for GST incurred to the extent that the acquisition is made in the carrying on of an enterprise ("enterprise" being a broadly similar concept to "taxable activity").[4] There is no requirement for the acquisition to relate to supplies made in Australia. Therefore, non-residents that acquire goods or services that attract Australian GST, but make few or no supplies in Australia, may often end their tax period in a net refund position, with the result that the net GST cost of their Australian activities is not an economic burden on the business.

3.12 ***Strengths of registration***

- An enhanced registration system has the potential to provide comprehensive B2B neutrality. A non-resident business would be able to claim input tax for expenses incurred in New Zealand to the extent that the supply is used for its worldwide taxable activities.

[4] See A New Tax System (Goods and Services Tax) Act 1999, Division 11.

- Non-residents would be operating under a similar system to residents, thereby enhancing the neutrality objective. If a non-resident business made no taxable supplies in New Zealand, they would be entitled to a refund of the relevant input tax. However, if the non-resident were to make some supplies in New Zealand, as a registered person, they would be required to account for output tax on those supplies. This means that a non-resident would not be able to obtain a competitive advantage by making supplies in New Zealand under the registration threshold (thereby not paying output tax yet still receiving neutral treatment for their inputs).
- An enhanced registration system would be complementary to existing Inland Revenue systems, as a non-resident business would be required to complete and file GST returns in the same way as any other registered person.
- An enhanced registration system would be similar to the system used in Australia. Having broadly similar rules could make it easier for Australian businesses to expand into New Zealand and for third-country businesses to operate in both jurisdictions.
- The GST system already contains most of the registration and input tax deduction provisions necessary to make an enhanced registration system work. Even though introduction of such a system would result in more GST-registered persons, it would not require complex new legislation to be introduced.

3.13 ***Weaknesses of registration***

- In order to access input tax deductions, non-resident businesses would need to incur the compliance costs of registering for GST and filing periodic returns. These costs do not necessarily need to be large, particularly given developments in online registration and return filing. However, risk-averse non-residents may be unfamiliar with, and less trusting of the system and may consider it necessary to engage a New Zealand advisor to help with ongoing filing requirements.

  Asking non-residents to fully engage in the New Zealand GST system could be seen as a deterrent rather than just an administrative step towards eligibility for a refund. For example, businesses could be concerned that GST registration could give rise to New Zealand income tax issues.
- Although Inland Revenue has systems for allowing non-residents to register, administration costs would nevertheless increase in line with the increased number of registered persons.
- New Zealand's current legislation has the basic mechanisms in place for non-resident businesses to register for GST, claim input tax and receive refunds. However, additional legislative safeguards to protect the tax base are likely to be necessary.

Direct refund system

3.14 A direct refund system would be largely similar to the way refunds are dealt with under the value added tax (VAT) system of the European Union (EU). GST and VAT systems are fundamentally similar. However, VAT has additional complexities. Whereas New Zealand's GST system must differentiate between supplies made by and to non-residents and those by and to residents, VAT must deal with residents, EU member states and residents of other countries outside the EU.

3.15 An EU VAT directive requires member states to allow "third country" taxable persons a deduction for VAT incurred in connection with their taxable business activities.[5] This deduction generally takes the form of a direct refund if the person does not make taxable supplies within the relevant EU member state.

3.16 The refund system involves third-country taxable persons completing a separate application form seeking refunds for VAT incurred. The refund claim is usually made after the end of a defined period for expenditure incurred during that period.

3.17 ***Strengths of refund system***

- Like an enhanced registration system, a refund system has the potential to create full neutrality between resident and non-resident businesses.
- A refund system is relatively easy to understand and is likely to be familiar to multi-national businesses, particularly those that incur GST or VAT costs in Europe.
- A refund system can be accessed on the basis of the need of the individual business, thereby eliminating the requirement for upfront registration and ongoing compliance costs.
- Following a European approach to administering a refund system may allow Inland Revenue to be more rigorous in processing refunds. This could be achieved by taking the refund system outside the requirement that refunds to registered persons be released within 15 days. Having longer for the review of refund applications could help prevent abuse of the system by giving Inland Revenue sufficient time to determine the legitimacy of claims submitted.

3.18 ***Weaknesses of refunds***

- A refund system could be more likely to give rise to fraudulent refund claims than a system that requires non-resident businesses to register as a pre-requisite to obtaining a refund.

---

[5] Thirteenth Council Directive (86/560/EEC) of 17 November 1986 on the harmonization of the laws of the member states relating to turnover taxes − Arrangements for the refund of value-added tax to taxable persons not established in community territory.

- If a non-resident was making supplies under New Zealand's current $60,000 registration threshold, the tax base could be eroded by giving refunds without the corresponding collection of output tax. (We note, however, that under the UK system, payment of a refund is contingent on there being no supplies made within the UK other than those subject to reverse-charge rules. This effectively requires businesses that make domestic supplies to register in order to obtain a refund.)
- The administration costs of this option are likely to be high for Inland Revenue. New forms would be needed, and staff hired or retrained to ensure applications were processed and monitored appropriately and refunds issued in a timely manner. More significantly, a refund system may require new IT systems to be developed.
- Such developments could be seen as being counter to Inland Revenue's programme of streamlining customer interactions and IT systems.

Conclusion

3.19 We consider that an enhanced registration system would provide the best balance between achieving B2B neutrality and protecting the revenue base. Although the refund model appears to have the advantage of accessibility and simplicity, it is also the option that would be likely to impose the highest administration costs on New Zealand and may be the most susceptible to abuse. A full zero-rating approach could give rise to substantial compliance costs for suppliers and would also be prone to greater legislative uncertainty.

3.20 An enhanced registration system is more neutral, in that it would bring non-residents into the New Zealand GST system to file returns and be subject to the same rules as a resident business. Inland Revenue would also have periodic returns from the non-resident, which would provide some assurance that any New Zealand GST obligations were being met on an ongoing basis. We do, however, recognise the importance of minimising business compliance costs under this approach.

CHAPTER 4

Enhanced registration system – design features

This chapter discusses the mechanics of an enhanced registration system and outlines measures that could help to administer the system while protecting the tax base.

Submissions are welcome on whether the measures proposed in this chapter would strike the right balance between keeping compliance costs for businesses at a reasonable level while providing adequate revenue protection.

4.1 Under section 51 of the GST Act, a person is liable to be registered for GST when their supplies in New Zealand from their taxable activity either exceed $60,000 over the last 11 months (plus the month in question), or are anticipated to exceed $60,000 in the following 11 months (plus the month in question). Once liable to be registered, a person must charge output tax on their taxable supplies and will be entitled to deduct input tax to the extent that the goods or services received are used for making taxable supplies.

4.2 A person whose supplies are lower than the $60,000 threshold may voluntarily register if they are carrying on a taxable activity.[6] This voluntary registration provision, in the first instance, allows non-resident businesses to register for GST on the basis that they carry on a taxable activity, although not necessarily in New Zealand.

4.3 However, as mentioned previously, there is little benefit to a non-resident from registering in New Zealand because the ability to claim input tax is linked to supplies the person makes in New Zealand. If a non-resident makes very few or no New Zealand supplies, their ability to claim input tax is either proportionately very low or non-existent.

4.4 A further disincentive for a non-resident to register is the cancellation of registration provisions.[7] If the Commissioner is satisfied that a registered person is not carrying on a taxable activity, the Commissioner may cancel that person's registration. Crucially, for non-residents only, "taxable activity" for this purpose means a taxable activity carried on in New Zealand.[8] This means that, even if a non-resident registers in New Zealand, they operate under the possibility of their registration being cancelled if they cannot satisfy the Commissioner that they carry on their taxable activity here.

[6] Section 51(3).
[7] The deregistration provisions are contained in section 52.
[8] Sections 52(5) and 52(7).

Outline of the proposed system

Summary of the proposed system

An enhanced registration system would:

- retain the existing rights for a non-resident business to register; and
- allow input tax to be linked to the person's total taxable supplies, as if all the person's supplies were made in New Zealand.

Suggested legislative safeguards could include:

- requiring the non-resident to be registered for the comparable tax in their "home" jurisdiction (or registered as a business taxpayer when no comparison exists);
- the non-resident business falling within the requirements to be registered in New Zealand were its offshore activities conducted in New Zealand (that is, being of sufficient size to be over the registration threshold);
- a minimum refund threshold of $500 in the first year of registration to cover administration costs;
- the Commissioner having longer to process refunds for non-residents than for residents;
- access to refunds and continuing registration being contingent on meeting filing requirements;
- non-residents being required to account for GST on a payments or hybrid accounting basis; and
- non-resident businesses that on-supply New Zealand services to non-registered persons not being eligible to register in New Zealand.

4.5 The fundamental changes necessary to design an enhanced registration system relate to the ability to claim input tax, the rules around deregistration and the need to reduce the potential for other tax consequences to arise from registration.

Input tax

4.6 An enhanced registration system would link a non-resident's ability to claim input tax to their worldwide supplies. This should result in GST incurred on any genuine business expense incurred in New Zealand being able to be deducted, and refunds being made available when deductions exceed GST payable on taxable supplies.

4.7 There are two options for doing this. Either the ability to claim input tax could be linked to a registered person's "taxable activity", or a special rule could be created for non-residents to deem "taxable supplies" in the deduction provisions to include all supplies that would be taxable if made in New Zealand.[9] We prefer the second option because it would make it clearer that input tax could not be claimed in respect of exempt supplies, either within New Zealand or offshore.

Deregistration

4.8 There would be little point in expanding the ability to claim input tax without also amending the deregistration provisions. To do so would effectively invite non-residents to register, but still allow for their deregistration if they did not conduct their taxable activity in New Zealand. We consider that section 52(7) of the GST Act that allows for the deregistration of non-residents who do not carry on a taxable activity in New Zealand would need to be at least amended in order to provide non-resident businesses with some certainty over the long-term viability of their registration. Whether some form of deregistration power specific to non-residents should still exist is discussed later in this chapter.

Unintended consequences

4.9 One of the concerns a non-resident business could have in registering for New Zealand GST is that the GST law may have unforeseen consequences for other parts of its business. Experience in Australia suggests that non-residents may be reluctant to register for fear of GST attaching to supplies that would not logically form part of the business's involvement with Australia. The difficulties in the Australian context appear to stem from the breadth of the "connected with Australia" test (in Australia, supplies are "connected with Australia" if a supply is done in Australia, including supplies performed by a subcontractor).[10] Although New Zealand does not have a comparable test, it is nevertheless important to ensure that similar problems do not arise.

4.10 The intention is that any rules expanding a non-resident's ability to claim input tax would not further extend New Zealand's taxing right or give rise to possible double taxation.

4.11 Concerns in this area are most likely to centre on supplies that are deemed to be made on the cessation of registration.[11] Some clarification of the effect of these deemed supply rules would be useful if an enhanced registration system were to be implemented. In particular, we consider that output tax should only apply to supplies made when goods are physically located in New Zealand at the relevant time. In other words, if there are goods in New Zealand, as with any other registered person, there should be an assumption that they are being used for making taxable supplies. If a non-resident is only the recipient of services in New Zealand, it is not anticipated they would have any New Zealand-based goods to which GST could attach.

---

[9] The relevant deduction provision being section 20(3C).

[10] See Australian Government: *Implementation of the recommendations of the Board of Taxation's review of the GST cross-border transactions,* 15 February 2011. (http://www.treasury.gov.au/documents/1959/PDF/BOT_cross_border_transactions.pdf).

[11] See section 5(3).

4.12 Goods and services that are due to be supplied to New Zealand customers but (in the case of goods) are located outside New Zealand should logically not be subject to GST at the time because, if they were actually delivered to the customer, they should in any event be subject to GST under section 12. Services should not attract GST unless the non-resident has made a taxable supply to a New Zealand customer. Equally, goods and services that are located offshore for non-resident customers also should have no bearing on a non-resident's output tax liability on deregistration.

Other key changes

4.13 An enhanced registration system fits well within the existing legislative and administrative systems in place for GST. However, given the inherent difficulty in recovering tax from non-resident defaulters, some legislative protection is inevitable.

4.14 This section discusses possible measures to provide more certainty to non-resident businesses, ensure administrative efficiency and protect the revenue base. We consider that all of these options should apply in any enhanced registration system.

Home registration

4.15 A non-resident would be able to register in New Zealand if they are registered under a comparable transaction tax to GST, or for sales tax purposes, in the jurisdiction where their main taxable activity is based. Providing a tax registration number from the taxpayer's home jurisdiction is generally a pre-requisite to obtaining a VAT refund from EU member states. Evidence that the business is carrying on an "enterprise" is required for a non-resident to register for GST in Australia.

4.16 As most of New Zealand's major trading partners and over 120 countries operate VAT or GST, and others have at least a sales tax system, we consider that requiring a non-resident business to provide certification from their home tax authority that they are registered for the relevant tax is reasonable. The global incidence of taxes of this sort would mean that residents of New Zealand's major trading partners should not be prejudiced by the requirement. However, to cater for circumstances when there is no direct comparison, the rules should be suitably flexible to allow non-residents from such a jurisdiction to register by providing certification of their tax registration number as a business for income tax.

4.17 In addition, as part of the registration process, the non-resident business should be required to separately certify:

- that they are currently carrying on a taxable activity. This would provide confirmation of their status as a business in addition to the certification provided by the relevant tax authority;

- that the supplies made in the course of furtherance of that activity are of such a scale that they would, if made in New Zealand, require them to be registered. This requirement would ensure that only businesses that were relatively well-established could register;
- that the taxable activity is expected to continue for the course of the relevant tax period. This may allow the Commissioner to refuse registration in the event that a special purpose vehicle was set up temporarily solely for the purpose of obtaining a refund in New Zealand; and
- to advise Inland Revenue if the non-resident business ceases to carry on a taxable activity at any time or if their worldwide taxable activity falls below the registration threshold.

Minimum refund threshold

4.18 As the name suggests, a minimum refund threshold would only allow refunds to non-residents when the amount of the refund was over a certain amount. This would allow for recovery of the administration costs of providing refunds and the amount would therefore be relatively small.

4.19 Most EU member states have a minimum threshold for refunds. In the UK, a claim for VAT must be made in respect of supplies made during a period of not less than three months and not more than 12 months. However, a claim can be made in respect of a period shorter than three months if that period represents the final part of the prescribed year. If the period to which the claim relates is less than 12 months, the VAT claimed must not be less than £130. When the claim relates to a full 12-month period, the minimum refund drops to £16.[12] Germany operates thresholds of €500 and €250 respectively.[13] A refund threshold in New Zealand could be set somewhere between these – at, say, $500 of GST.

4.20 From an administrative perspective, a refund threshold might be difficult to monitor because the nature of an enhanced registration system means that each return would have to be scrutinised not only in its own right, but also for refund threshold implications. However, there may be a need to ensure that businesses that only have a limited time during which expenses are incurred in New Zealand do not stay in the system indefinitely.

4.21 We consider that a refund threshold should apply for the first year of registration. From that point on, a non-resident should be entitled to remain registered for as long as they are not filing nil, or very low returns. If there is a consistent period of, for example, five years of returns showing no or very little activity in New Zealand, the Commissioner should have the discretion to deregister the business at that time.

[12] European Commission, Taxation and Customs Union website: http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/traders/vat_refunds/uk_en.pdf.
[13] See above: http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/traders/vat_refunds/de_en.pdf.

4.22 Having a threshold on the amount of expenditure potentially creates a distortion between resident and non-resident businesses and, therefore impacts on B2B neutrality. However, this is a recognised trade-off for the additional administration costs that would necessarily be incurred in processing returns.

Time for refund processing

4.23 Under section 46, the Commissioner is required to refund an amount owing to a registered person no later than 15 working days after receipt of the relevant return. There are exceptions to this if the Commissioner requests further information or intends to investigate the circumstances of the return.

4.24 Despite the Supreme Court's recent clarification of the scope of this provision,[14] 15 working days would be a relatively short time to process significant refund returns by non-resident businesses. Although Inland Revenue can extend this period by investigating such returns, business confidence could be undermined if non-residents' returns were investigated as a matter of course in order to verify the contents. Any amendment in this area therefore becomes a balancing act between providing Inland Revenue reasonable time to verify returns − in circumstances where information may be more difficult to acquire − against the need for businesses to have some certainty around when a refund will be confirmed.

4.25 We note that EU member states tend to allow themselves a longer period for processing refund claims from "third country" taxable persons, compared with refund claims from taxable persons in that member state or from within other member states.[15]

4.26 Although we do not consider New Zealand would need a six-month window, as operates in some EU member states, a three-month period should allow sufficient time for any preliminary enquiries to be conducted, and a decision made on whether a broader investigation is warranted. A three-month timeframe would reflect the inherent difficulties associated with obtaining information from offshore, where issues such as language barriers may present themselves.

Non-compliance with filing requirements

4.27 The effective operation of an enhanced registration system will be dependent on the non-resident business complying with its filing requirements. Generally, if a greater level of compliance is needed, this is generated through the statutory penalty and use-of-money interest provisions. However, a non-resident business that is registered for GST may not be in a "tax payable" position, meaning that penalties and interest are unlikely to apply. Even if they did apply, enforcement against non-residents can be difficult.

---

[14] *Contract Pacific Limited v Commissioner of Inland Revenue* [2010] NZSC 136.

[15] Council Directive 2008/9/EC (applying to refunds with other EC jurisdictions), at Article 19, provides that a member state must accept or refuse a refund application within four months. By contrast the 13th VAT Directive (86/560/EEC), Article 3(1), leaves the time period for processing refunds up to the individual member. Article 3(2) supplements this by providing that "refunds may not be granted under conditions more favourable than those applied to community taxable persons."

4.28 It is therefore proposed that the Commissioner should have one or both of the following powers to help ensure ongoing compliance:

- the power to withhold refunds until filing requirements have been met, and any necessary payments made, for all previous periods. A similar measure operates in Canada;[16] and/or
- a deregistration power for persistent non-compliance.

Payments or hybrid basis

4.29 Ensuring that non-resident businesses must account for GST on a payments basis could be an effective means for further protecting the tax base. This would limit refunds to GST that had actually been paid by the non-resident, rather than GST that had merely been invoiced.

4.30 An invoice system provides greater scope for a non-resident business to access substantial refunds without actually parting with any money. In the event of non-payment, the supplier could reverse the transaction through the bad debt provisions in section 25, but there would be limited means for ensuring that a non-resident repaid any refund provided.

4.31 As with other persons that account for GST on a payments-basis, eligibility for input tax would need to be documented by providing invoices and receipts from the New Zealand supplier.

Private consumption in New Zealand

4.32 It is important that in making any changes to the GST rules, the policy outcome of ensuring that private consumption in New Zealand is taxed here is not undermined.

4.33 The UK has a specific exclusion for "VAT charged on a supply to a travel agent [or tour operator that purchases and resupplies services of the kind enjoyed by travellers] which is for the direct benefit of a traveller other than the travel agent or his employee".[17] This rule appears designed to prevent non-residents from gaining refunds on supplies that are ultimately enjoyed by tourists. A similar provision could also be useful in the New Zealand context. However, given that one of the positive aspects of an enhanced registration system is that genuine business expenses such as hotel costs should be able to be claimed, any rule would ideally focus on the nature of the final consumer rather than the nature of the supply itself.

4.34 One approach may be to deny the registration if the taxable activity of the non-resident is predominantly the supply of goods and services that are received in New Zealand by non-residents who would not be eligible to register. In this context, such rules could treat all supplies by the non-resident as if they were made in New Zealand, so the non-resident would not be able to circumvent the rules and register on the basis that New Zealand only accounts for a small proportion of an international operation.

---

[16] OECD Forum on Tax Administration Compliance Sub-Group, *Developments in VAT Compliance Management in Selected Countries,* August 2009, page 25.
[17] The Value Added Tax Regulations 1995, Part XXI, Regulation 190(1)(b).

4.35 This would mean that, for example, a non-resident whose business is to on-sell tourism products would not be eligible to register if those tourism products are ultimately enjoyed by non-resident (and non-registered) individuals. The change would ensure the policy intent of section 11A(2), which denies zero-rating for services when the receipt of the performance of those services is in New Zealand, remains effective.

Other measures considered

4.36 In looking at possible additional features of an enhanced registration system, the following ideas were also considered. They are not being progressed at the current time, as discussed below.

Exchange-of-information agreements

4.37 Another option would be to restrict registration to businesses that are primarily based in jurisdictions with which New Zealand has an exchange-of-information agreement. This would allow Inland Revenue the opportunity to confirm that the registration application was genuine and also periodically to check the continuing registration status in the other jurisdiction. Without an exchange-of-information agreement with the home jurisdiction, these checks are unlikely to be possible.

4.38 Although New Zealand has a wide network of double tax agreements (DTAs) that contain exchange-of-information articles, and numerous independent exchange-of-information agreements, not all cover GST. Historically, these articles in treaties are limited to the taxes covered by the treaty itself – in New Zealand's case, this is often only income tax. Despite more recently negotiated treaties tending to include GST, the coverage is still not comprehensive.

4.39 Although GST coverage in our DTA and independent exchange-of-information agreement network incorporates some of New Zealand's major trading partners, it excludes other important trading partners. Having an exchange-of-information agreement in place as a pre-requisite to registration may therefore be too restrictive to be a genuine aid to B2B neutrality on a large scale.

4.40 The OECD has other initiatives that may, in the future, provide fuller coverage in exchange-of-information agreements, including multi-lateral agreements. However, even if New Zealand were to adopt these initiatives, it may not be of immediate assistance if they are not universally accepted. If significant developments in this area are made, they could be considered at a later stage to buttress an enhanced registration system.

Reciprocity

4.41 The ability for non-resident businesses to register could be made contingent on the business's home jurisdiction allowing registration of New Zealand businesses, or providing them with a refund for GST or VAT incurred in that jurisdiction. European VAT officially has a reciprocity requirement for traders from outside the EU although practices among member jurisdictions appear to vary.[18]

4.42 If all jurisdictions operating a GST/VAT were to recognise the need for full B2B neutrality, there would be no need to legislate for reciprocity because that recognition would incorporate the removal of any double tax impost in cross-border trade. New Zealand's GST system should apply best practice principles wherever possible. As a result, we do not consider that reciprocity should be a prerequisite to New Zealand registration.

Conditions on registration

4.43 In the UK, if there is insufficient evidence to refuse an application for registration, Her Majesty's Revenue & Customs can impose conditions on registration.[19] In practice, these restrictions could include a financial guarantee being provided or a shortened first filing period to enable a relatively quick assessment of the person's compliance. There may be merit to the "bond"-type arrangement, in that non-residents would need to provide money upfront as a sign of good faith. However, we consider that requiring non-residents to register on a payments or hybrid basis would have a similar economic outcome, without the need to pay initial GST twice in order to access a refund.

Only paying refunds to New Zealand bank accounts

4.44 Limiting the payment of refunds to New Zealand dollar-denominated accounts in New Zealand banks would mean that any refund would be held in New Zealand (temporarily at least) in the event that the non-resident was not actually entitled to the refund processed. It would also provide an additional information source for Inland Revenue for audit purposes.

4.45 However, in our view, a wider consideration of the benefits of such a measure is needed as, if implemented, its effect would not be confined to an enhanced registration system for non-residents.

---

[18] Article 2(2) of the 13th Council Directive 86/560/EEC.

[19] See, for example: Value Added Tax Act 1994, Schedule 1; Value Added Tax Act 1994, Schedule 2, section 4; and The Value Added Tax Regulations 1995, Regulation 25(1)(c).

CHAPTER 5

Tooling costs

This chapter considers another situation when GST may be a genuine impediment to business neutrality. The difference here is that the issue concerns goods – in particular, GST charged by New Zealand manufacturers on "tooling" costs for non-resident clients.

The chapter highlights two possible ways of addressing the issue:

- relying on the enhanced registration system; or
- introducing a special zero-rating rule.

Submissions are welcome on which of these options is preferred.

5.1 In the manufacturing sector, we understand that there is a specific pricing model that is used to quote for, and undertake, work of a tailor-made nature. This system involves quoting for the production of a certain quantity of goods (either in bulk or on a per unit basis) and quoting separately for the "tooling costs" associated with completing the order to the specific requirements of the customer. As the name suggests, these tooling costs are designed to cover expenses associated with creating or adapting tools that can only be used in fulfilling the particular order.

5.2 We understand the major reason for this separation of costs is driven by the customer's desire to be the "owner" of the specific tools, even though they have no intention of ever taking delivery of them. This is important for the customer because it prevents the manufacturer from using the tools in a future product, thereby reducing the possibility of copy products appearing on the market.

5.3 However, this pricing structure creates a problem from a GST perspective when the manufacturer is resident in New Zealand and the customer is non-resident. The actual goods being produced will be exported and therefore generally able to be zero-rated under section 11. By contrast, the tools will be used exclusively in New Zealand and will not be physically exported. Because the tools are not exported, none of the existing zero-rating rules apply and the tooling costs will be subject to GST at the standard rate.

5.4 The imposition of GST would not occur if the tooling costs were bundled into the cost of the completed product. For example, instead of charging $100 for the products and $10 for the tooling costs, the New Zealand manufacturer could charge $110 for the products. Because the products would ultimately be exported, the full amount could be zero-rated. However, this alternative, as we understand it, would not be acceptable to international consumers, who operate in a set quoting/invoicing environment and insist on this model being followed to assert their proprietary rights over the tools used.

5.5 This is not a problem unique to New Zealand. Australia recognises this problem specifically in legislation. Section 38−188 of the A New Tax System (Goods and Services Tax) Act 1999, provides:

> A supply of goods is ***GST-free*** [zero-rated] if:
>
> (a) the recipient of the supply is a non-resident, and is not registered or required to be registered; and
>
> (b) the goods are jigs, patterns, templates, dies, punches and similar machine tools to be used in Australia solely to manufacture goods that will be for export from Australia.

5.6 The UK has a provision in its Value Added Tax Act 1994 that is very similar in its application.[20]

5.7 New Zealand manufacturers are of the view that the lack of a corresponding provision in our GST legislation forces them to charge any tooling costs on a "plus GST" basis. As the non-resident customer is usually unable to reclaim this GST as input tax, New Zealand manufacturers are arguably at a competitive disadvantage to other potential suppliers.

Options

5.8 It is arguable that imposing GST on tooling costs is justifiable because the tools are used and consumed entirely within New Zealand. There will always be occasions when businesses are forced to absorb costs in order to win substantial contracts. These costs include the price of premises, plant, labour and raw materials – all of which naturally fluctuate between various jurisdictions. Tax, it can be argued, is a similar variable. For a New Zealand business, absorbing the GST on a small fraction of the overall income derived from a contract (i.e., the tooling costs) could be a price worth paying for the overall revenue stream that a contract would generate.

5.9 Despite this, we consider this issue should be considered further. There are two main options for addressing the concerns of manufacturers in these circumstances:

- relying on the enhanced registration system; or
- introducing a special zero-rating rule.

[20] See Value Added Tax Act 1994, Schedule 8, group 13, section 3.

Registration system for tooling

5.10 Under the enhanced registration system we have outlined, a non-resident business incurring GST as a real cost would effectively become optional. If a non-resident business was engaging a New Zealand manufacturer, it would, in most cases, be able to register for GST and claim input tax for any GST imposed on the tooling costs. Assuming it had no other connection with New Zealand, the non-resident business would be eligible to have this input tax refunded. The same economic result as zero-rating would be achieved without the need for a special legislative provision.

Special zero-rating rule

5.11 For GST purposes, it is important to focus on who the consumer actually is and where the benefit from the consumption of the goods and services is enjoyed.

5.12 In the case of tooling costs, the customer is the non-resident business and the enjoyment of that contract is also wholly offshore. Unlike, for example, tourists that consume goods and services in New Zealand, the manufacturing customer may not visit New Zealand. The ultimate product of the manufacturing process is exported and the tools, although not physically exported, are owned by the non-resident for the purpose of their offshore business. The fact that the tools remain here can be said to be of little consequence, because they are no longer owned by the New Zealand resident and the value of them is never realised in the domestic market. The customer could, as owner, insist on their exportation at any time.

5.13 If the tooling costs are in effect an export, it is arguable that their supply should be zero-rated in the same manner as other exports. Of relevance to this view is the treatment of services that are performed for a non-resident directly in connection with goods that are then exported. Section 11A(1)(m) allows such services to be zero-rated. It is difficult to argue that the tooling costs are conceptually different to services provided in relation to exported goods.

5.14 Given the similarities between tooling costs and services provided directly in connection with exported goods – both are provided to a non-resident as an inherent part of goods that are ultimately exported – we consider that this could be a situation where a specific zero-rating rule may be justified.

5.15 However, if a zero-rating rule was introduced, it would only apply to tools that are exclusively used on exported goods and where title of those tools passes to a non-resident. If these tools or resulting goods were later on-supplied by the non-resident owner back into the New Zealand domestic market (or allowed by the non-resident to be used for manufacturing for the domestic market), supporting rules may be needed to ensure that the tools would then be treated as imports and GST paid at an appropriate level at that time.

5.16 This exclusivity requirement would add some complexity to a zero-rating system, in that it would still require an enhanced registration system to provide the right result in certain instances. For example, if the goods were used both for domestic and foreign markets, or the tools or goods were on-supplied into New Zealand, GST would be payable. The non-resident would have to use the enhanced registration system to claim any available input tax.

5.17 A further disadvantage of zero-rating (as mentioned previously in relation to zero-rating more generally) is the definitional concern. Although both Australia and the UK use very similar wording for their zero-rating provision, it seems likely that there could be some debate around what constitutes a "similar machine tool", for example.

Conclusion

5.18 We can see merit in both options and welcome submissions on which is preferable. We are particularly interested in the definitional issues surrounding a zero-rating rule and the extent to which a zero-rating rule for tooling costs would be necessary if an enhanced registration system were introduced.