

Impact Summary: GST apportionment

Section 1: General information

Purpose

Inland Revenue is solely responsible for the analysis and advice set out in this Impact Summary, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing policy decisions to be made by Cabinet.

Key Limitations or Constraints on Analysis

The options considered in this Impact Summary are limited to those which would be suitable for inclusion in the next omnibus tax bill. Accordingly, the analysis is limited to options which have already been identified and discussed during consultation with stakeholders, would represent minor improvements to the existing rules, and would not require substantial changes to current taxpayer practices.

A further round of consultation will be used to develop some major reform options to replace the current apportionment rules with much simpler rules. As this consultation is being used to develop the problem definition and identify major reform options, we are not seeking Cabinet decisions on these options currently, and a subsequent RIA will be prepared to analyse the major reform options at a later date.

Responsible Manager (signature and date):

Graeme Morrison
Policy Lead
Policy & Regulatory Stewardship
Inland Revenue

31 May 2021

To be completed by quality assurers:

Quality Assurance Reviewing Agency:

Inland Revenue

Quality Assurance Assessment:

The Quality Assurance reviewer at Inland Revenue has reviewed the *GST apportionment* Regulatory Impact Assessment prepared by Inland Revenue, and considers that the information and analysis summarised in the Regulatory Impact Assessment **meets** the quality assurance criteria.

Reviewer Comments and Recommendations:

The reviewer's comments on earlier versions of this Regulatory Impact Assessment have been incorporated into this version.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Background

The GST Act includes a set of apportionment and adjustment rules for determining GST input tax deductions when an asset such as a vehicle, farmhouse or home office is used partly to conduct a GST registered business and partly for a private or exempt use.

Officials do not hold data on how many of GST registered persons would be required to apply the GST apportionment rules, although it would be a small percentage of all registered persons (as most assets are solely used for business purposes).

In 2020, there were 660,000 GST registered persons (mostly businesses). Most GST registered persons are small businesses - 70% have less than \$250,000 of annual sales.

Current law

The current GST apportionment rules are complex and prescriptive. This can impose two types of problems on the affected GST registered suppliers, high compliance costs and unfair outcomes for some taxpayers.

Anecdotal information from tax advisors suggests that understanding of the GST apportionment rules, and therefore compliance with these rules, is very low among smaller businesses and the self-employed.

Inland Revenue consulted on some discrete, technical issues with the GST current apportionment rules in 2020. These issues were:

The GST apportionment rules overtax sales of appreciating assets which are partly used for business and partly used privately, such as farmhouses and home offices. For example, if a GST registered person purchased a house, used 20% of the property to run their consulting business and some years later sold the house at a higher price, they would be required to pay GST output tax based on the full gain in value of the house, rather than just 20% of the gain which relates to the 20% of the property used in their business.

The current rules are prescriptive and complex to apply. They do not generally accommodate reasonable calculation methods which may have lower compliance costs. However, large GST registered suppliers with more than \$24m of annual turnover (about 3,700 businesses or 0.56% of all registered persons) can apply to Inland Revenue to approve an alternative apportionment method (this is currently used by large financial institutions and retirement villages). The rationale for this limitation is that larger suppliers generally have more complex arrangements so were more likely to face high compliance costs under the ordinary rules. Consequently, smaller suppliers do not have an opportunity to reduce their compliance costs by applying to use a method which would have lower compliance costs than applying the main rules.

Officials recommend addressing these discrete issues as part of a first phase of a wider apportionment project.

However, the submissions and subsequent discussions with tax advisors have raised more fundamental concerns with the complexity of the current apportionment rules and the fact that understanding of the GST apportionment rules, and therefore compliance with these rules, is very low among smaller businesses and the self-employed – particularly in relation to houses which are partly used to conduct a registered person's business activity.

To address these concerns, a further round of consultation will be used to develop some major reform options to replace the current apportionment rules with much simpler rules. As this consultation is being used to develop the problem definition and identify major reform options, we are not seeking Cabinet decisions on these options currently, and a subsequent Regulatory Impact Statement will be prepared at a later date on the major reform options which will be progressed as a second phase of reforms.

2.2 Who is affected and how?

The apportionment and adjustment rules apply to GST registered persons who use an input (usually a capital asset) for a business purpose and also for a non-taxable (such as private use or a residential rental) purpose.

The issue of appreciating assets being overtaxed mainly affects residential or rural land and houses that are partly used for a business use. It generally affects GST-registered sole traders who use part of their own house to conduct their business, or who intend to use part of their own house to conduct their business. It is less likely to affect other taxpayers, because under other common ownership structures such as where the business is a company or partnership, or the house is owned by a company or trust, the house is not owned by the GST registered person, and the sale of the house is not subject to GST.

The ability to apply to Inland Revenue to approve an apportionment method is currently limited to GST registered persons who have more than \$24m of annual turnover. The proposal would benefit GST registered persons who have less than \$24m of annual turnover as it would allow them to apply to use a calculation method which has lower compliance costs than the default rules. We do not know how many smaller suppliers would apply to use an alternative calculation method but we expect the overall uptake will be low, as most suppliers do not need to apportion their inputs and there has been low uptake for alternative methods by larger suppliers.

2.3 What are the objectives sought in relation to the identified problem?

The objective is to improve the fairness of GST outcomes and reduce the compliance costs imposed under GST apportionment and adjustment rules.

Section 3: Options identification

3.1 What options have been considered?

The following criteria was used to assess the options:

- Fairness. The option does not over tax or under tax the non-business use of the relevant asset. It also provides reasonable GST outcomes for the affected taxpayers compared to other taxpayers who have similar circumstances.
- Compliance costs. Compliance costs should be minimised as much as possible.
- Ease of implementation. The option is discrete, simple and can be implemented quickly through the next available tax bill or a non-regulatory mechanism.
- Sustainability. The option is less likely to need to be amended or replaced in response to developments over time, particularly in relation to second phase which will consider major reforms to simplify the apportionment rules.

Overtaxing the sale of appreciating assets

Option 1: Status quo

Pros:

Not rushing to solve this issue would allow a fuller range of options to be considered as part of the consultation process to develop major reforms to the apportionment rules. Some of these major reform options could be more effective.

Cons:

Affected taxpayers who comply with the GST rules are overtaxed relative to taxpayers who own their assets through an entity. This is unfair and could discourage compliance with GST and their other tax obligations.

Unlikely to be sustainable as some tax advisors are raising concerns about the unfair outcomes that can arise under the current rules and how they conflict with current practices.

Option 2: Allow a deduction which correctly reflects the non-taxable use of the asset

Pros:

Improves fairness by ensuring the GST rules do not overtax sales of appreciating assets which are partly used for business and partly used privately, such as farmhouses and home offices, by allowing a deduction which correctly reflects the non-taxable use.

Option 2 involves a simple amendment which can easily be implemented in the next taxation bill. The proposal has been consulted on and was supported by tax advisors which submitted on the GST policy issues paper.

Option 2 ensures that compliant taxpayers would not be overtaxed in respect of their non-taxable use of the asset which may encourage better compliance. We have

assumed that any of the affected taxpayers that do return GST on the sale of their house are only returning GST in respect of the percentage of the house used for business use. This assumption is supported by the fact that some tax advisors have told us they consider another existing rule in the GST Act may apply which provides for the same outcome as option 2, although the application of this rule is uncertain so a regulatory solution is preferred to provide certainty that a deduction can be taken to correctly reflect the non-taxable use.

Cons:

This option does not align with current behaviour of the affected taxpayers, which is not to account for GST on their own home, even if it is used partly for business. Based on discussions with tax advisors, officials understand that very few of the affected taxpayers are currently returning GST on the disposal of their homes.

The affected sole traders are likely to consider that the GST outcomes under this option are still unfair as they would face GST liabilities on their homes which would not arise for similar taxpayers which use other common ownership structures. For this reason, option 2 is unlikely to sufficiently address stakeholder's concerns and a second phase of consultation on wider reform options will be developed and consulted on.

Option 3: Treat houses (and potentially other assets) which have a small amount of taxable use as being fully non-taxable.

Pros:

This option would be consistent with the behaviour of the affected taxpayers, which is not to account for GST on their own home, even if it is used partly for business. This reduces compliance costs as the GST rules would align with current practices.

Could improve fairness by ensuring sole traders do not pay more GST than other common ownership structures such as where the business is a company or partnership, or the house is owned by or a company or trust.

Cons:

Difficult to implement quickly as this option has not been designed yet or developed through consultation, which increases the risk the option is ineffective (e.g. if it is too difficult to use) or creates other unintended consequences (such as under taxing private consumption). Furthermore, the planned consultation process is necessary as there is a range of ways to design this option – for example Australia's GST rules exempt all sales of existing residential properties and zero-rate all farm sales (including the farmhouse), whereas the UK and Singapore allow GST registered suppliers to elect to not claim input tax deductions on purchasing assets in which case the sale of that asset is non-taxable. Until consultation occurs, it is not obvious which option, or combination of options would best achieve the policy goals. Consultation is also needed to develop appropriate transitional rules for registered suppliers and assets which are applying the current apportionment rules to retrospectively apply or transition to the new rules.

Prescriptive rules do not accommodate simpler methods

Option 4: Status quo

Pros:

Not rushing to solve this issue would allow a fuller range of options to be considered as part of the consultation process to develop major reforms to the apportionment rules. Some of these major reform options could be more effective

Cons:

High compliance costs would persist until the major reforms are developed and implemented.

Option 5: Allow smaller GST registered suppliers to apply to Inland Revenue to approve a different apportionment method.

Pros:

Improves fairness as all suppliers would have an opportunity to reduce their compliance costs by applying to use a method which would have lower compliance costs than applying the main rules.

Quick and simple to implement as involves removing a turnover threshold and the increased demand on Inland Revenue resources is not expected to be too high.

Cons:

Would only be effective at reducing compliance costs to the extent that suppliers apply to use a different method. We do not know how many smaller suppliers would apply to use an alternative calculation method but we expect the overall uptake will be low, as most suppliers do not need to apportion their inputs and there has been low uptake for alternative methods by larger suppliers. If uptake is a lot higher than expected there is a risk that Inland Revenue may need to allocate additional resources to processing applications..

Option 6: Replace the current prescriptive apportionment rules with a self-assessed rule that allows any fair and reasonable apportionment approach to be used.

Pros:

Because the apportionment method is not prescribed in legislation, this option provides the most flexibility for methods with lower compliance costs to be developed over time and tailored to the specific circumstances and commercial information held by the supplier.

Cons:

Creates uncertainty and inconsistent practices as there is no main rule as a guide for what GST outcomes the method should be aiming to achieve. Inconsistency will lead to unfairness such as one supplier using a much more generous method than comparable suppliers (who may be their competitors). It could also increase disputes with Inland Revenue. There would be pressure for Inland Revenue to produce guidance on what

methods are acceptable to use, which may mean a prescriptive approach eventually returns in the guidance. For these reasons this option is not considered sustainable.

3.2 Which of these options is the proposed approach?

Options 2 and 5 are the preferred options as they can easily be implemented in the next taxation bill and have been consulted on and supported by stakeholders / submitters.

Option 2 would improve fairness by ensuring the GST rules do not overtax sales of appreciating assets which are partly used for business and partly used privately, such as farmhouses and home offices, by allowing a deduction which correctly reflects the non-taxable use.

Option 5 option would allow smaller GST registered suppliers to apply to Inland Revenue to approve a different apportionment method which has lower compliance costs than the main rules.

While the proposed options are a clear improvement from the status quo, they are unlikely to be considered by the affected parties as a complete solution to their concerns with the current apportionment rules. To address this, officials will further develop and consult on option 3 along with a range of other major reform options as part of a second phase of reforms aimed at simplifying the GST apportionment rules.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties	Comment:	Impact
Additional costs of proposed approach, compared to taking no action		
Regulated parties (<i>GST registered persons with business and non-taxable use of an asset</i>)	<p>Unlikely to change the current practices for the vast majority of affected parties.</p> <p>A few regulated parties may face higher costs from seeking tax advice or assistance in respect of the proposals.</p>	Low
Regulators (<i>Inland Revenue</i>)	More contacts with regulated parties seeking an alternative apportionment method, but demand for this process is expected to be low so can be met with existing resources.	Low
Wider government	No expected costs as the proposed approach is unlikely to change current practices and therefore the GST positions taken by the affected parties.	Unable to estimate
Other parties	No expected costs	N/A
Total Monetised Cost		Unable to estimate
Non-monetised costs		Low
Expected benefits of proposed approach, compared to taking no action		
Regulated parties (<i>GST registered persons with business and non-taxable use of an asset</i>)	Reduced compliance costs for smaller businesses which choose to use a simplified apportionment method.	Low
Regulators (<i>Inland Revenue</i>)	Because compliant taxpayers will no longer be overtaxed in respect of their non-taxable use of the asset this may encourage a small increase in compliance.	Low
Wider government	No expected benefits	N/A
Other parties	No expected benefits	N/A
Total Monetised Benefit		Unable to estimate
Non-monetised benefits	Benefits depend on the uptake / compliance with the proposals which is expected to be low based on the current practices of the affected parties.	Low

4.2 What other impacts is this approach likely to have?

No other impacts are identified.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

This issue was consulted on in 2020 as part of *GST policy issues – an officials' issues paper*. Inland Revenue received 12 submissions from GST advisors and accountancy firms on the GST apportionment issues.

The apportionment and adjustment chapter of the issues paper proposed a number of specific changes to the apportionment and adjustment rules. These changes were primarily aimed at addressing instances of the apportionment rules causing over and under taxation. The chapter also acknowledged the complexity of the rules and sought feedback on the ways in which the apportionment rules could be simplified and improved

Submissions mainly focussed on the complexity of the apportionment rules, with a number of submitters recommending a comprehensive review of the rules with a view to reducing complexity. Officials intend to further consult submitters and other interested parties on major reforms to simplify the apportionment rules as part of a second phase of changes.

Submissions supported the proposal to allow a deduction which correctly reflects the non-taxable use of the asset (option 2 above).

They suggested that it should not be limited to land and the proposal has been modified accordingly.

The option of allowing all taxpayers (not just those with more than \$24m of annual turnover) to apply to Inland Revenue to agree a different apportionment was proposed by one submitter, and supported by all five of the other submitters that officials discussed this proposal with.

While the proposed options are clear improvement from the status quo, they unlikely to be considered by the affected parties as a complete solution to their concerns with the current apportionment rules. To address this, officials will develop and consult on a range of major reform options as part of a second phase of reforms.

In terms of additional context, a regulatory stewardship review of GST raised the GST apportionment rules as a key issue for consideration.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

The proposals will require amendments to the Goods and Services Tax Act 1985 and could be included in the next available omnibus tax bill expected to be introduced in August 2021 and enacted during March 2022.

Option 2 prevents over-taxation of appreciating assets which are partly used for a business and a private or exempt use, will apply from 24 February 2020, which is the date the issue and the proposed amendment was consulted on in the GST policy issues paper. This will ensure compliant taxpayers are not disadvantaged if they sell an affected property before the proposed amendment is enacted.

Option 5 would apply from the date of enactment in March 2022.

Guidance materials to explain how the amendments would operate will be published when the bill is introduced, in response to submissions raised with Select Committee and after the bill is enacted by way of Tax Information Bulletin.

The proposals have been subject to consultation via a GST issues paper and would later be subject to the standard legislative process including submissions to a select committee. This means there will be sufficient time for the affected suppliers to react to and understand the changes.

In respect of option 5, Inland Revenue may experience more contacts from regulated parties seeking an alternative apportionment method. However, based on the existing experience of this process for large suppliers, demand for this process is expected to be low so can be met with existing resources.

The monitoring processes discussed on section 7.1 will be used to identify and mitigate any other implementation risks.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

The impact of the proposed options will be monitored by meeting with the Inland Revenue staff who deal with customer issues and enquiries on the GST rules and by meeting with tax advisors and industry groups who represent the affected parties to ask them about their experiences with the rules. Any issues could be addressed through remedial amendments, improved guidance or future reform options.

7.2 When and how will the new arrangements be reviewed?

As the proposed options are minor technical improvements, no formal review is planned. Instead, the options would be reviewed using the monitoring processes mentioned in 7.1 above.

Public consultation is planned on a package of major reform options for simplifying the apportionment rules as part of a second phase of reforms. This will allow stakeholders to raise additional issues and policy options.