TOPIC 2

AN INDIRECT TAX: GOODS AND SERVICES TAX (GST)

LEARNING OBJECTIVES

After studying the material for this week you should be able to:

- Discuss the rationale for introducing this tax;
- Define the meaning of the different terms: goods, services, registered person, taxable activity, consideration, person, taxable, exempt and zero-rated supplies, taxable period, accounting bases as used in relation to GST, output and input tax;
- Outline who must, and can, be a "registered person";
- Discuss the significance of "time of supply" rules;
- Explain GST treatment/application in special circumstances;
- Outline payment of GST;
- Demonstrate an ability to research and cross reference applicable sections of NZT.

Supplementary Readings

1. Supplementary Readings in this Study Guide:

		Page:
(a)	Commerce Clearing House (2006). *New Zealand MTG*, ¶ 32-087.	10
(b)	Inland Revenue Department (September 1995). Differences between a taxable activity (GST) and a business activity (income tax). *Tax Information Bulletin (TIB)*, Vol. 7, No. 3, pp. 8-10.	14
(c)	Stroombergen, A. (2008, September 27). GST works – making food exempt doesn't. *The Dominion Post* p C2.	17
(d)	The Times (2009, February 6). Triumph in the teacake tax tussle. The Dominion Post p C2.	18

Additional Readings

2. Additional Reading References:

Alley, Chan, et al. (2009). *New Zealand Taxation* (Chap 19). Wellington: Thomson Brookers.

Topic Ten Outline

Goods and Services Tax

1. Introduction

2. What is GST and how does it operate?

3. Basic definitions relating to GST

- goods;
- services;
- registered person;
- taxable activity;
- person;
- taxable period;
- accounting bases;
- consideration vs value;
- taxable, exempt and zero-rated supplies;
- input tax;
- output tax.

4. Who must, and can, be "registered persons".

5. Time and value of supply.

6. GST treatment/application in special circumstances.

7. Payment of GST.

Explanatory Notes

<u>Goods and Services Tax</u>

1. Introduction

GST is a tax imposed by the <u>Goods and Services Tax (GST) Act 1985</u> and subsequent <u>Amendment Acts</u>. Parts of the legislation, and its application in practice, are detailed and complex. However, in 110.289 we are only concerned with the rationale and the general principles of the tax, and the listed readings cover the topic adequately.

2. What is GST and how does it operate?

2.1 Goods and Services tax is a tax currently at 12.5% levied on the value of all goods and services supplied in New Zealand (other than *exempt* supplies) by a registered person pursuing a taxable activity.

The registered person is liable to the Inland Revenue Department for output tax collected, less input tax paid, during the relevant taxable period.

2.2 How does it operate? Refer to **NZT** 19.1.2.

3. Definitions

Knowledge of the following definitions is essential for gaining an understanding of GST. Section 2 of the GST Act 1985 (and other related sections) defines:

(a) **"Goods":** this term, as used for GST purposes, is much broader in scope than its normal meaning, and it includes all types of personal and real property. It excludes choses in action (such as copyrights and insurance policies) which are included within the definition of services, and also excludes money. (See **NZT** 19.4.1).

(b) "Services": means almost everything which is not "goods" (e.g. TV repairs, doctors' services, accountants' services). Together with goods, the term includes all things capable of being supplied for a consideration, except money itself. (See **NZT** 19.4.1).

(c) "Registered person": a person who is, or is liable to be, registered under the Goods and Services Act 1985, and who is required to charge and collect tax, make returns and account for tax to the IRD. (See **NZT** 19.2.1).
Note that from 1 April 2009 the registration threshold increased from $40,000 to $60,000 as per the amendments to the GST Act 1985. Businesses below $60,000 can now de-register.

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(d) **"Taxable activity":** an activity which is carried on continuously or regularly and which involves making or supplying goods for a "consideration" to another "person". The activity may be conducted as a business, trade, manufacture, profession, vocation or club, and it need not be conducted for the purpose of making a profit. Also refer to Supplementary Readings: TIB Vol.7, No. 3 and **NZT** 19.3.1.

Exclusions to "taxable activity" are:

- Any employment, occupation or engagement as an employee, or as a director of a company. (Wages, salaries and directors' fees are not subject to GST);

- A hobby or private recreational pursuit;

- The occasional sale of domestic or household articles, personal effects or private motor vehicles;

- The making of "exempt supplies".

(e) **"Person":** for GST purposes means:

- an individual;
- a company;
- an incorporated club or society;
- an unincorporated club, society or body of persons;
- a trustee of a trust or estate;
- a public or local authority;
- a partnership.

(f) **"Taxable period":** regular intervals when a registered person and is responsible for filing GST returns. (Refer to **NZT** 19.12.1).
Note that from 1 April 2009 the threshold for filing 6 monthly GST returns has increased from $250,000 to $500,000 as per the amendments to the GST Act 1985.

(g) **"Accounting Bases"** (Section 19): methods used by registered persons to account for GST, i.e. *when* output and input taxes are to be taken into account for *calculating tax payable.* There are three methods available: **invoice, payments** and **Hybrid** bases. (Refer to **NZT** 19.12.2).
Note that from 1 April 2009 the threshold for using the payments basis has increased from $1.3m to $2m as per the amendments to the GST Act 1985.

(h) **“Consideration”:** has a wider meaning in relation to GST, than normal:

- It includes any amount paid, or any act, or forbearance, in respect of supplies of goods or services;
- It need not be in money terms (e.g. barter);
- It may take the form of a promise to refrain from doing something;
- It can be paid by someone other than the person receiving the goods or services.

Also refer to **NZT** 19.3.5 and 19.9.1.

It does NOT include unconditional gifts made to non-profit bodies where the donor does not receive a direct identifiable valuable benefit (e.g. street appeals, church offerings).

(i) **“Taxable Supplies”:** Refer to **NZT** 19.4.

(j) **“Exempt Supplies”:** Refer to **NZT** 19.5.

(k) **“Zero-rated supplies”:** Refer to **NZT** 19.6.

(l) **“Output tax”**: The tax *charged* by a registered person for goods and services supplied by that person. (Refer to **NZT** 19.12.3).

(m) **“Input tax”**: Refer to **NZT** 19.12.3.

4. Registered Persons

4.1 Any person (as defined) who conducts a taxable activity and supplies goods and services in New Zealand in excess of $60,000 (excluding GST) in any 12- month period must register with the IRD.

Note that from 1 April 2009 the registration threshold increased from $40,000 to $60,000 as per the amendments to the GST Act 1985.

4.2 The requirements for registration: **NZT** 19.2.1 and 19.2.4.

4.3 When to register: **NZT** 19.2.2

4.4 Cancellation: **NZT** 19.2.5.

5. Time and Value of Supply

5.1 General Rule

The **time of supply rules** indicate to the registered person *when* GST (i.e. the output tax) is to be *charged* on a transaction. The general rule is GST is charged when an invoice is issued or payment is received, whichever is earlier. The other rule is known as a special rule and applies to supplies made under agreements such as hire purchase and supply of periodic payments. A provision of *fringe benefits* comes within the ambit of a "special" time of supply rule in terms of levying/claiming the GST component of a fringe benefit.

Do not confuse the general time of supply (i.e. earlier of invoice or payment) with the *invoice basis* of accounting (i.e. calculating the input and output tax) for the net GST to the IRD.

Also refer to **NZT** 19.7 and 19.9.1.

6. GST Treatment/Applications in Special Circumstances

6.1 GST and Fringe Benefits [**NZT** 18.1.1, pp 833]

With regards to fringe benefits supplied the GST Act 1985 deems the fringe benefit as a 'supply' of goods and services. Sec.21I establishes a special time of supply rule for fringe benefits and s 23A requires that the GST is accounted for on the FBT return and paid at the same time as the FBT.

6.2 GST and Long Term Assets

6.2.1 Acquired for taxable supplies

Refer to Supplementary Readings: **MTG ¶32-087.**

Also refer to TIB Vol. 12, No. 12 (Dec 2000), which can be retrieved from the IRD website. (www.ird.govt.nz/techincal-tax/ and type the specific TIB you want).

6.2.2 Acquired for exempt/private purposes.

Capital assets may be acquired initially for private/exempt purposes but is later being used for making taxable supplies. Under such circumstances an input tax adjustment is required.

Refer to **NZT** 19.9.3 & 19.12.5 and **MTG** (see Supplementary Readings).

The above changes are designed to assist in the reduction of compliance costs for taxpayers, when making adjustments for changes in use.

6.3 **GST and Income Tax Implications**

6.3.1 **NZT** 19.14.5

The following example shows the impact of GST upon the purchase and sale of an *asset* which is subject to depreciation, when the taxpayer is a GST registered person in the first instance, and not GST registered in the second instance.

Example:

	GST Registered Person	**Non-Registered Person**
Cost of Asset	42,750	42,750
Input Tax Credit Claimed	4,750	nil
Book Value	38,000	42,750
Depreciation Year 1, eg 20%	7,600	8,550
Adjusted Tax Value	30,400	34,200
Depreciation Year 2	6,080	6,840
Adjusted Tax Value	24,320	27,360
Depreciation Year 3	4,864	5,472
Adjusted Tax Value	19,456	21,888
Sold For	22,000	22,000
Less Output Tax (1/9)	2,444	nil
Net Proceeds	19,556	22,000
Less Adjusted Tax Value	19,456	21,888
Depreciation Recovered (loss on sale)	100	112

Source: Staples (1997/98), pp. 420

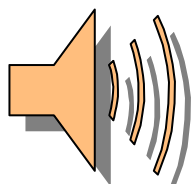
6.3.2 Other aspects of the preparation of income tax accounts.

Refer to TIB Vol 7:1 (July 1995) pp 8-9 [www.ird.govt.nz/technical-tax/ and type the specific TIB you want].

7. Payment of GST

7.1 **NZT** 19.12.7.

Work Preparation



Read and study the material required for this week.

Review the following questions.

1. Identify and explain the legal requirements which must be met before GST can be imposed by a person on the sale of its goods and services.

2. Explain the following:

(a) The term "taxable activity" for the purposes of GST?
(b) How the time of supply rules determine when a supply takes place and therefore when GST must be paid or deducted.
(c) If GST is claimable on a fixed asset, used by the taxable activity, should the income tax treatment on the asset be at the GST-inclusive or GST-exclusive cost price?
(d) A going concern in relation to sale of a business.

3. Are the following subject to FBT and/or GST?

(a) International travel provided to an employee of an airline.
(b) A staff member of a firm is authorised to use a business vehicle for private running.
(c) A bank supplies low interest loan to an employee. The bank is liable for FBT. How would this supply be treated for GST?
(d) A landlord of commercial property and a new tenant agree to a rental of $400 per week.

4. Should some or all foods be exempt from GST? Discuss. (See readings by Stroombergen and The Times)

5. Refer to **NZT** 2009 Chapter 19, Review Question 4.

Commerce Clearing House (2006), *New Zealand Master Tax Guide*, para. 32-087.
(this article is the same as the 2009 version)

¶32-087 Change-of-use and mixed-use adjustments [GST ss 21–21H]

An adjustment to output tax or input tax must be made when a GST-registered person changes his or her use of goods or services from taxable to non-taxable supplies (or vice versa) or when goods and services are applied for mixed taxable/non-taxable use.

Taxable commodities applied for non-taxable purposes

An output tax adjustment is required under s 21 of the *Goods and Services Tax Act* 1985 when goods and services which have been applied for the principal purpose of making taxable supplies are subsequently applied for a private or exempt use, or are used for mixed taxable/non-taxable purposes. Goods or services acquired before 1986 principally for business purposes that are applied for a non-taxable use after 1986 are also subject to an output tax adjustment. The adjustment is based on the lesser of cost or market value.

> **Example 1:** Fred, who is GST-registered, buys a car for his business. He uses the car for private purposes on the weekend. Fred must make an output tax adjustment to reflect the mixed taxable/private use.

Example 2: Pauline buys a computer for her business in 1985. Two years later she brings the computer home for her daughter to use in school projects. Pauline must make an output tax adjustment to reflect the change in use.

The method for determining the extent to which goods and services are applied for private and exempt supplies is set out in s 21A. The allocation can be made on actual use or, in the case of exempt supplies, an alternative method of allocation is to divide the total value of all supplies for the taxable period by the total value of exempt supplies for the taxable period.

When allocating between taxable and non-taxable supplies, if the actual use method is not appropriate a pragmatic approach can be taken so long as it meets with the Commissioner's approval.

Registered persons may account for the adjustment on a one-off, annual or return-by-return basis. If a registered person chooses to make a one-off adjustment, he or she must make additional output tax adjustments to reflect any further changes in use that change the proportions by 20% or more. Special rules apply for one-off adjustments for replacement goods or services. See ss 21B and 21C.

The adjustment need not be made if a commodity is applied for exempt purposes and the total value of the exempt supplies over the next 12 months does not exceed $90,000 or 5% of the total consideration for all taxable and exempt supplies to be made in the 12-month period. See s 21(4).

It is not possible to use the one-off adjustment method and then to arrange for the sale of goods and services at market value. See s 21D.

Developers/builders letting out property pending sale

The Department considers that a full input tax credit is available to GST-registered developers at the time of purchase or construction if the property has been acquired for the principal purpose of resale. If the principal purpose remains that of resale but the property is rented out in the interim, the change in use to the non-taxable supply of residential renting requires an output tax adjustment under s 21. The adjustment is usually calculated on a return-by-return basis, being one-ninth of the lesser of:

- the market rental of the property; or
- the cost of applying the goods involved in the rental supplying (eg, maintenance costs, depreciation, rent-collection costs and interest).

Support for the Department's approach can be found in *C of IR v Morris* (1997) 18 NZTC 13,385 and more particularly in *Case* U13 (1999) 19 NZTC 9,147.

Example: A GST-registered builder built two apartments with the purpose of selling them, claiming input tax credits on the construction costs. As a result of the downturn in the property market, he decided to rent out the apartments pending their sale. The apartments were let for a number of years but remained for sale throughout that time. The builder had to account to the Department for one-ninth of the rental he received during each return period. See *Case* U13.

See also *Tax Information Bulletin* Vol 6, No 11, April 1995, p 1.

The correct valuation of the deemed supply under former s 21(1) of the *Goods and Services Tax Act* was also considered by the Taxation Review Authority (the TRA) in *Case* W28 (2003) 21 NZTC 11,289. Briefly, the taxpayers in this case purchased a number of properties for the purpose of property development. Input tax credits were obtained by the taxpayers. The properties were subsequently let as residential dwellings. The taxpayers made adjustments for deemed supplies, but treated the "cost of the supply" as the depreciation of the respective properties. The taxpayers submitted that

this was the correct value of the deemed supply, as depreciation was the only cost that was unique to residential letting. The taxpayers considered that the costs incurred for interest, rates, insurance and maintenance were incurred for its other principal purpose of development and on-sale. Further, the taxpayers submitted that they were entitled to recover the output tax adjustments made on the deemed supply when the properties were sold. The TRA held that it was possible for the taxpayers to have two concurrent principal purposes. The value of each purpose was the amount of the holding costs directly referable to each purpose. With respect to the purpose of residential letting, depreciation was the only unique holding cost applicable. The TRA agreed with the taxpayers' submission that the output tax adjustments on the deemed supply (ie, the s 21(1) adjustments) could be recovered when the property was sold. The TRA decision was affirmed on appeal to the High Court — see *C of IR v Lundy Family Trust & Behemoth Corporation Ltd* (2004) 21 NZTC 18,595. The Commissioner appealed to the Court of Appeal on the basis that there should have been an adjustment based on depreciation of the buildings as well as one based on an allowance for the cost of the land. The Commissioner also argued for adjustments relating to other service costs and considered that there should be no reversal of these adjustments when the properties were sold.

The Court of Appeal noted that both parties had accepted that any adjustments should be on a periodic rather than on a one-off basis. It was considered, however, that s 21(1) was capable of being read in a manner that allowed for both one-off and periodic adjustments. In this case, because the properties remained on the market at all times but at the same time were let for residential purposes on a temporary basis, periodic adjustments were appropriate. Because at the relevant time no legislative guidance was given, any reasonable allocation appeared to be available. The Court of Appeal accepted the Commissioner's submission that depreciation was a suitable method of apportioning the cost of the buildings and considered that the cost of the land should be similarly apportioned. It was agreed that applying the depreciation rate to the land was a suitable methodology. An apportionment between taxable and non-taxable uses was also required in the particular period. The court considered that the taxpayers had used a reasonable allocation method within the scope of the legislation. In relation to the periodic service costs such as rates and insurance, the Court of Appeal said that a 75/25 apportionment would recognise that the principal purpose remained the sale of the properties and that these costs would have been incurred whether or not the properties were let. The court invited the Commissioner to make further submissions on whether this change of stance should be accepted.

The Court of Appeal concluded that where s 21(1) adjustments had been made, s 21(5) acted to restore the input tax deduction where the goods or services were again applied to a taxable purpose. The court agreed with the Taxation Review Authority and the High Court that there was nothing in s 21(5) that made any distinction in this regard between periodic and one-off adjustments. See *C of IR v Lundy Family Trust and Behemoth Corporation Ltd* (2005) 22 NZTC 19,637.

Change of use from non-taxable to taxable

An input tax adjustment can be claimed under s 21E when goods or services which have been acquired after 1 October 1986 principally for non-taxable purposes are subsequently applied for taxable purposes or are used for mixed taxable/non-taxable purposes.

> **Example:** A partnership bought a farm in 1973. In 1987 it subdivided the farm into sections with the aim of selling them. The partnership was not entitled to claim a change-of-use input deduction because the land was purchased before the introduction of GST (1 October 1986). See *Case* R19 (1994) 16 NZTC 6,099.

A taxpayer is not entitled to an input tax adjustment under s 21E if the taxpayer has already claimed an input tax credit in respect of the same goods and services.

Example: A family partnership was denied an input tax adjustment in respect of a subdivision it carried out because one of the partners had claimed an input tax credit when he purchased the land some years earlier. See *Case* U15 (1999) 19 NZTC 9,162.

The adjustment is calculated on the GST-inclusive cost of the commodity or its open market value, whichever is the lesser.

Example 1: A self-employed lawyer buys a computer for $5,000 for her family to use at home. She later decides that she needs a computer at work, and takes the home computer into the office. She is GST-registered, so she is entitled to claim a one-off input tax adjustment on the open market value of the computer at the time she applies it for making taxable supplies.

Example 2: A taxpayer inherited land from her deceased husband. Initially she did not use the land for any taxable activity, but subsequently she applied it for the purpose of making taxable supplies. The taxpayer was not entitled to a change-of-use adjustment in this case because she had acquired the land at no cost. See *Wilke v C of IR* (1998) 18 NZTC 13,923.

An input tax adjustment can be made:

- as a one-off adjustment in the taxable period in which the goods and services are applied for the purpose of making taxable supplies;
- as an annual adjustment (ie, in each year in which the goods and services are applied for the purpose of making taxable supplies); or
- as a return-by-return adjustment (ie, in each taxable period in which goods or services are applied for the purposes of making taxable supplies).

The one-off adjustment is limited to goods that are capital assets with a cost of less than $18,000. See s 21G(1A). A one-off adjustment for a 100% change in use *may* be allowed in relation to goods and services that cost $18,000 or more. Application for such an adjustment must be made to the Commissioner under s 21H.

If a person adopts the annual adjustment method, that person must ensure that an allowance is made for any previous adjustments made in earlier taxable periods. See s 21G. See, also, "Questions we've been asked" item, "Deductions from GST output tax for subsequent changes to taxable use". This item is published in *Tax Information Bulletin* Vol 17, No 3, April 2005, p 20.

Inland Revenue Department (September 1995). Differences between a taxable activity (GST) and a business activity (income tax). *Tax Information Bulletin (TIB)* Vol. 7, No. 3, pp. 8-10.

Difference between a taxable activity (GST) and a business activity (income tax)

Summary

This item states the Commissioner's current policy on when a "taxable activity" for GST purposes may constitute a "business" for income tax purposes. It sets out the differences between a taxable activity for GST purposes and a business for income tax purposes.

Background

We have been asked to clarify whether a taxable activity for GST purposes is a business for income tax purposes in every case. There is some uncertainty as to the differences between a taxable activity and a business. Some people have assumed that once the Commissioner accepts an activity as a taxable activity, it will also be accepted as a business.

All legislative references in this item are to Income Tax Act 1994 unless otherwise stated.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
OB 1	2

Section 6(1) of the Goods and Services Tax Act 1985 (GST Act) defines the term "taxable activity" for GST purposes:

For the purposes of this Act, the term "taxable activity" means

(a) Any activity which is carried on continuously or regularly by any person, whether or not for pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club:

(b) Without limiting the generality of paragraph (a) of this subsection, the activities of any public authority or any local authority.

Certain activities are excluded from the term "taxable activity" under section 6(3) of the GST Act. These include activities that are essentially in the nature of a private recreational pursuit or hobby. Section 6(3) states:

Notwithstanding anything in subsections (1) and (2) of this section, for the purposes of this Act the term "taxable activity" shall not include, in relation to any person, -

(a) Being a natural person, any activity carried on essentially as a private recreational pursuit or hobby; or

(aa) Not being a natural person, any activity which, if it were carried on by a natural person, would be carried on essentially as a private recreational pursuit or hobby...

Section OB 1 defines the term "business" for income tax purposes:

"Business"-

(a) Includes any profession, trade, manufacture, or undertaking carried on for pecuniary profit:

(b) Is further defined in Schedule 6A for the purposes of that Schedule.

Case law

A person conducts a taxable activity for GST purposes when all of the following characteristics are present:

- There is some form of *activity*.
- The activity is carried on *continuously or regularly*.
- The activity involves, or is intended to involve, the supply of goods and services to another person for *consideration*.

The definition of "taxable activity" specifically includes an activity carried on in the form of a business. This means that a business activity for income tax purposes will also constitute a taxable activity for GST purposes, unless it is an activity specifically excluded by section 6(3) of the GST Act.

"Activity" has a wide meaning, and does *not* necessarily have to be an economic or commercial activity. It is defined in the Concise Oxford Dictionary as being, amongst other things, "a particular occupation or pursuit". It is essentially a series of acts that a person chooses to do. In the High Court case of *Newman v CIR* (1994) 16 NZTC 11,229, Justice Fraser stated at page 11,233:

[Activity] is a word of considerable breadth. The New Shorter Oxford English Dictionary 1993 ascribes a number of varying meanings or shades of meaning, none of which is exactly apposite to the word in its context in s 6. The nearest, I think,

is 'an occupation, a pursuit' and (in the plural) 'things that a person, animal or group chooses to do'. In its context here I think the word means a course of conduct or series of acts which a person has chosen to undertake or become engaged in.

In the Court of Appeal case of *Newman v CIR* (1995) 17 NZTC 12,097, Justice Richardson added at page 12,100:

The legislation is directed at a course of conduct which can fairly be described as being carried on continuously or regularly. As I see it, it is not a matter of importing any overlay of commercial dealing or of trying to draw a distinction between the divestment of commercial assets and private assets. Rather it is whether the process engaged in, whatever the asset or its location or the occupation of the taxpayer, comes within the statutory language. The application of the test to the particular circumstances will necessarily involve questions of fact and degree.

An activity must be carried on continuously or regularly before it can be a taxable activity. The words "carried on continuously or regularly" refer to the activity which will culminate in the supply of goods and services, rather than to the actual supply of those goods and services.

In the *Newman* decision, the Court of Appeal considered whether the taxpayer's activity was carried on continuously or regularly by examining the activity as a whole, rather than the various sequential steps or components of which the activity was comprised. The Court's approach was to see whether the activity was carried on either continuously or regularly.

An activity is "continuous" if there is no significant cessation or interruption of the activity. In other words, it is carried on all the time. Temporary interruptions in the activity for holiday or health reasons, for example, will not generally mean that the activity is not "continuous". An activity is "regular" if it is repeated at reasonably fixed intervals.

It is important to note that to be a taxable activity, the activity need only be "continuous" ***or*** "regular".

Whether or not a taxable activity exists depends on the particular facts of each case. For example, a subdivision of land into two allotments, involving no development work, will not by itself amount to a taxable activity. However, the greater the number of allotments created and sold, the more extensive the development work, the more time and effort involved and the higher the financial commitment to the project, the more likely that the activity is carried on continuously. Therefore, it is more likely that there is a taxable activity.

The Commissioner's interpretation of the meaning of "taxable activity" in the context of subdivisions following the Court of Appeal's decision in *Newman* is set out in TIB Volume Seven, No.2 (August 1995).

A taxable activity does not include an activity which is clearly carried on as a private recreational pursuit or hobby for personal enjoyment and recreation. Factors which are taken into account when determining whether an activity is a taxable activity or a hobby include:

- the reasons for conducting the activity
- the business-like nature of the operations
- the time available to devote to the activity
- the level of financial investment
- the structure and organisation of the activity.

The factors that the Commissioner considers when deciding whether an activity is a taxable activity or a hobby are set out and discussed on page 5 of TIB Volume Six, No.14 (June 1995).

These principles are established and supported by the judgments in *Case N27* (1991) 13 NZTC 3,229 and *Case P83* (1992) 14 NZTC 4,553.

An activity is a business for income tax purposes if the nature of the activities is business-like, and the actions of the taxpayer indicate an intention to make a profit. The fundamental basis of a business is that it is an activity conducted in an organised and coherent way towards an end result. It is not necessary to show that the activity has a reasonable prospect of making a profit. However, a genuine intention to make a profit must be present. These principles are established and supported by the judgment in *Grieve v CIR* (1984) 6 NZTC 61,682.

Policy

A taxable activity for GST purposes will constitute a business for income tax purposes if the nature of the activity amounts to a business, and the actions of the taxpayer indicate an intention to make a profit. An activity's income tax status is determined independently from its GST status.

Although an intention to make a profit must be present before an activity can constitute a business for income tax purposes, it is not relevant when determining whether it is a taxable activity for GST purposes. The key element of a taxable activity is the supply of goods and services for a consideration. There can be a consideration for a supply even though no profit arises. Many supplies of goods and services are made without the intention of making a profit, for example, supplies by certain public sector agencies and some charities.

Example

Mrs Wilson operates a community newspaper designed to keep the community's residents informed of important local developments. A small number of advertising spots are also sold to local businesses, etc. The sale price and advertising revenue are only sufficient to cover costs. The activity does not have to be registered for GST purposes as its turnover does not exceed $30,000.

There is no intention to make a profit from the newspaper. Mrs Wilson receives no salary or other income from the venture, and, while she admits to

continued on page 10

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deriving enjoyment from her labours, the operation is clearly not essentially a hobby or recreational pursuit for these reasons:

- The main aim of the newspaper is to benefit the community.
- The newspaper has planned continuity.
- The newspaper's operation is regular and it is published frequently.
- Mrs Wilson runs the newspaper in a business-like manner.
- Mrs Wilson devotes considerable time to the newspaper's activities.

On the basis of the facts presented above, Mrs Wilson could register her newspaper activity voluntarily with Inland Revenue as a taxable activity for GST purposes. However, without an intention to make a profit in the venture the newspaper activity does not constitute a business for income tax purposes.

Mrs Wilson should consider the implications of a voluntary GST registration carefully before registering. Even though the activity is not returning a profit, there may still be GST payable, as input tax is not a component of certain expenses, for example wages paid to employees.

Stroombergen, A. (2008, September 27). GST works – making food exempt doesn't. *The Dominion Post* p C2.

Gst works – making food exempt doesn't

Adolf Stroombergen

THE ISSUE of gst on food is once more gaining traction among various political parties and social groups.

New Zealand's gst system is one of the best in the world because it has only one tax rate that applies to almost everything. We do not have the absurd situation that exists in some countries where, for example, bread has no gst, chicken has no gst, but a chicken sandwich does. Or the situation where the chicken sandwich attracts gst if it is served warm, but not if it is served cold.

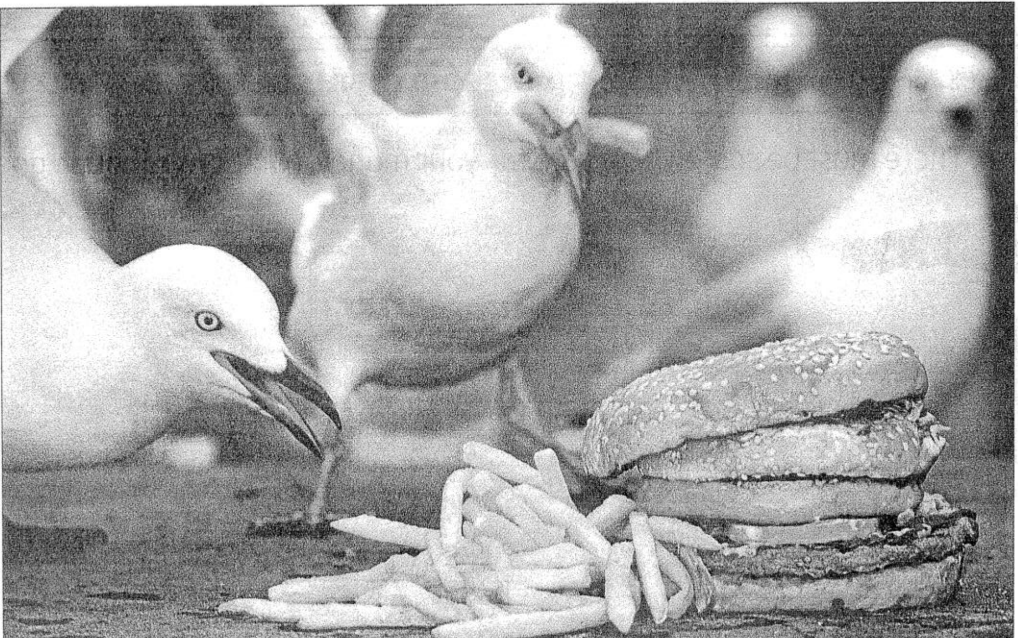
Policy-makers in New Zealand wisely decided that the administrative and compliance costs of having selected goods and services exempt from gst would be too high.

While the current focus is on food, when it was being designed there was as much opposition to gst on other basic goods and services such as energy and medical care.

Educators said that gst on books would inhibit learning and sporting goods producers suggested that gst would discourage exercise.

You can be sure that if gst on food is ever removed, other calls for exemptions will soon follow.

Another reason for levying gst on as wide a range of goods and services as possible is that the wider the tax base, the lower rate of tax required for any given amount of tax revenue.



Great scrap: We all need to eat, and prices are rising for consumers, but abolishing gst on food would be a bad move. Picture: FAIRFAX

Removing gst on all food would imply that gst on other goods and services would need to rise to realise the same amount of revenue.

This would strengthen calls for its removal on other basic goods and services.

The gst system would become progressively more complicated and more open to cheating and avoidance.

So why not get rid of gst completely?

If there was no gst, income tax rates would have to be higher. The higher a tax, the greater the incentive to avoid it and the more distortions it creates in the economy.

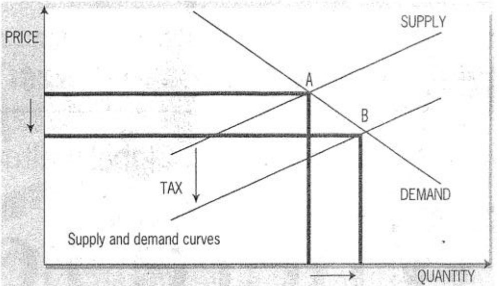
The main reason for gst being introduced in the first place was to enable governments to obtain tax revenue in a more efficient manner — more efficient in terms of lower compliance costs, and in terms of fewer economic decisions (such as what to buy or invest in) being determined largely by their tax implications. Gst is harder to avoid than income tax.

Many people believe that by removing gst on food, food prices will drop by the full extent of the tax.

However, there are three reasons why this would not happen.

■ The diagram shows the standard demand and supply curves familiar to any secondary school economics student. As prices fall demand rises, so the demand curve slopes down.

The supply curve slopes upward because higher prices make it more profitable to produce.



Removing a commodity tax such as gst is akin to a shift in the supply curve.

As far as consumers can tell, prices fall for any given quantity supplied. The market moves from A to B. Note though, that while the price paid by consumers falls, it does not fall by the full amount of the tax. The extent of the fall depends on the slopes of the curves.

■ Gst could be removed from the price paid by the consumer, but it would still exist on the prices of goods and services bought by food producers.

Even the last link in the product chain — the supermarket or greengrocer — would still be paying gst on their inputs.

So they would still have to recover the cost of the gst that they paid on their inputs. Thus, the price reduction to the consumer would be very small.

The government could reimburse all gst paid by sellers (making them zero-rated rather than gst-exempt), but this would be more expensive, with more opportunities to cheat.

■ Even if there is some reduction in food prices, there would be nothing to stop food retailers from rebalancing prices, in effect taking some of the potential price reduction in food prices and applying it to other products instead.

This becomes more likely when "food" actually has to be defined. Does wine count?

So a broad-based gst is a good idea for reasons of economic efficiency, compliance costs and avoidance potential. Further, removing gst on food is unlikely to generate much of a price reduction.

That leaves the anti-gst on food lobbies with only one argument — that gst on food makes people less likely to have a healthy diet as they cannot afford good food.

There are two issues here — poverty and choice. When gst was introduced, taxes and benefits were adjusted to ensure that consumers were not made worse off.

If high food prices are of concern, the best way to help is to lower income taxes.

Removing gst on food may look like assistance to cash-strapped consumers, but in the long term we will all feel the effects of a less efficient tax system.

■ Dr Adolf Stroombergen is chief economist at Infometrics.

The Times (2009, February 6). Triumph in the teacake tax tussle. The Dominion Post p C2.

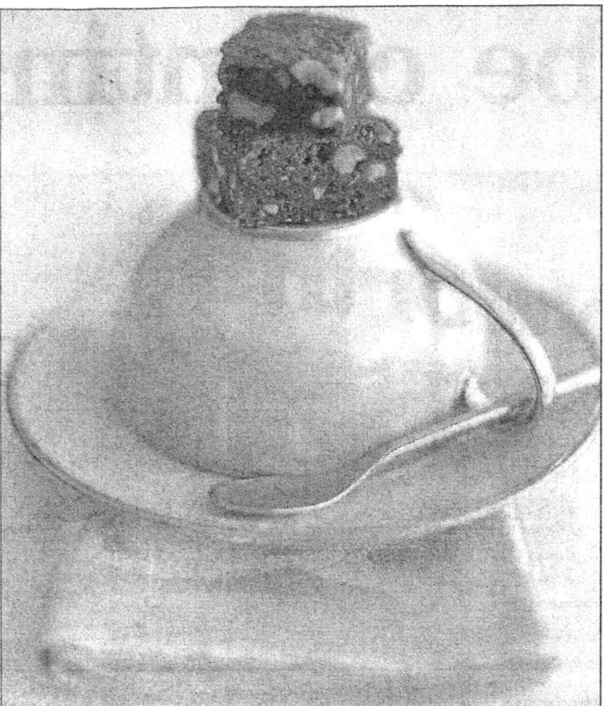
Triumph in teacake tax tussle

A STORM over a teacake is finally over after Marks & Spencer won a 13-year legal battle about whether its popular chocolate-covered treats should be deemed a cake or a biscuit.

The retailer said that it had overpaid tax for more than 20 years because its teacakes were mistakenly classified as chocolate biscuits, which bear valued-added tax (VAT) at a standard rate of 15 per cent.

The firm finally tasted victory after the House of Lords, Britain's highest court, said that Her Majesty's Revenue and Customs (HMRC) had abandoned its defence. The company is now entitled to a £3.5 million (NZ$9.9 million) rebate, and the taxman could face more than £100 million in similar claims.

The teacake tussle is the latest in a series of seemingly arcane legal disputes about whether various foods should be liable for VAT. In the past few years, the courts have been called on to decide whether Pringles are potato chips or biscuits (the verdict was biscuits), whether smoothies are a food or a beverage (beverage) and whether jaffa cakes are a cake or a chocolate-covered biscuit (cake).



Tea time: Tax men have been arguing over what goes with your tea. Photo: REUTERS

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Under British tax laws, food does not bear VAT except for food served in restaurants, hot takeaways and confectionery. Cakes are not charged VAT and neither are biscuits unless the biscuit is coated in chocolate.

In 2004, authorities admitted that for decades they had mistakenly classified teacakes as a chocolate-covered biscuit. M&S claimed £3.5 million in overpaid tax but was offered only £350,000 on the ground that 90 per cent of the VAT had been passed on to the retailer's customers.

HMRC argued that paying a rebate when the retailer had already recouped most of the overpaid tax would constitute unjust enrichment.

Last year the European Court of Justice sided with M&S. However, HMRC indicated that it wanted to argue legal technicalities and the case was referred back to the House of Lords. This week the Lords said the case had been abandoned.

Anthony Hindle, of the accounting firm KPMG, said that the taxman's withdrawal meant that a chance for the Lords to clarify the law on unjust enrichment had been lost. The issue arises frequently in tax refund cases.

The Times