

Tax Talk

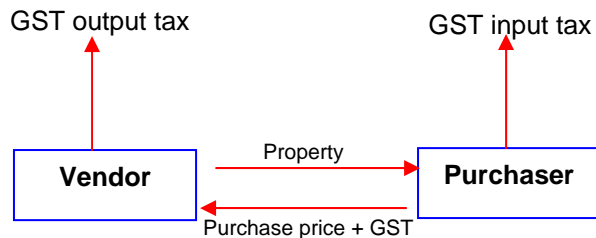
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The most significant change to GST in 20 years: the Domestic Reverse Charge

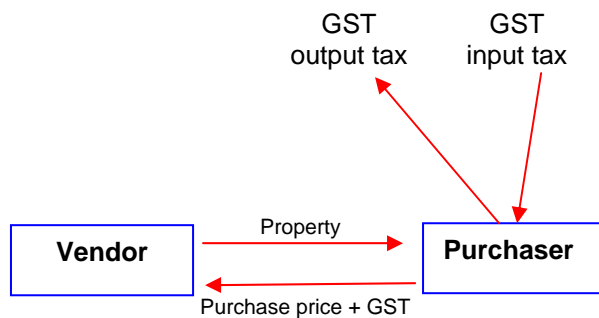
The Domestic Reverse Charge mechanism (DRC) proposed by the IRD has been hailed by some as being the most significant change to New Zealand's GST regime since the July 1989 increase in the rate of GST from 10% to 12.5%.

If adopted, the DRC will apply to large transactions that involve the sale and purchase of property between GST registered persons. Its effect is to make the purchaser (and not the vendor) liable to account for the GST on the transaction. The diagram below illustrates the difference between the existing GST regime and the regime that will apply if the DRC proposal is adopted.

Existing regime



Proposed regime: DRC



As the diagram shows, under the DRC regime the purchaser is no longer required to pay the

GST component to the vendor along with the purchase price. Instead, the purchaser pays the vendor a GST exclusive purchase price. The purchaser claims an input tax credit at the same time as accounting for the output tax liability. No cash will change hands on account of GST between the vendor and the purchaser. Similarly, no cash should change hands between the purchaser and the IRD because the purchaser's output tax and input tax on the transaction will match. This change gives the DRC regime a key advantage over the existing regime.

Often in commercial transactions the GST amount payable can be a significant amount, and therefore a major consideration. The purchaser must finance the GST component to pay along with the purchase price and remains out of pocket until the corresponding credit is received from the IRD. The IRD runs a significant risk, especially in circumstances where the vendor and the purchaser account for GST on different accounting bases. For example, under the existing regime the IRD incurs a credit risk on the vendor, but is still obliged to refund a purchaser's input tax regardless of whether the corresponding output tax is paid. In contrast, under the DRC regime, the purchaser accounts for GST and claims the credit simultaneously, no cashflow issues arise for any party, and the IRD credit risk is removed.

Under the DRC regime the vendor does not have a compliance burden. However, they are negatively affected as they would no longer have use of the GST component received from the purchaser, which they would have had until it was paid over to the IRD under the existing regime. Aside from the change in creditor priorities that disadvantage secured creditors (discussed below), the inability of vendors to have use of the GST component appears to be the only significant downside to the DRC regime.

The introduction of the DRC regime would also render the need to apply for a GST offset unnecessary. This reduction in compliance is a great result for taxpayers and the IRD alike as GST offsets are not legislatively provided for, and therefore not guaranteed to be approved. Furthermore, timeframes relating to the approval of a GST offset are not prescribed, and therefore there is no certainty that the offset will be approved prior to settlement date. This aspect currently presents a significant issue for the vendor, as they have to account for the output tax liability whether or not the purchaser pays the GST component along with the purchase price.

An additional issue relating to GST offsets is that the IRD will not usually approve an offset outright prior to the transaction taking place, but will approve it in principle only. This restriction exists because the purchaser may have an outstanding liability in relation to another tax type. In this case the credit would be applied to the purchaser's outstanding tax liability before it would be used to meet the vendor's output tax liability, again leaving the vendor in the precarious position of potentially having to account for a portion of the GST out of their own pocket.

There are a number of types of transactions to which the DRC is proposed to apply. These include:

- transactions involving significant assets
- high risk GST transactions
- the sale and purchase of going concerns
- the sale and purchase of land
- high value transactions (i.e. those transactions exceeding \$50 million).

A major side effect of the DRC mechanism not addressed in the discussion document relates to the changing of priorities of creditors. Under the existing mechanism if the vendor goes into liquidation prior to accounting for their output tax liability, the IRD will only be able to recover the tax in the event of funds remaining after the liabilities owed to secured creditors have been met. This change in priority is because the GST paid by the purchaser to the vendor forms part of the vendor's general assets until the point at which it is paid over to the IRD.

In contrast, under the DRC mechanism, the GST component never forms part of the vendor's assets, and therefore the IRD increases its priority above secured creditors.

The other key advantage of the DRC mechanism is that it eliminates the need to zero-rate going concern transactions as a very similar result would be achieved by applying this mechanism. However, the DRC does still rely on the definition of going concern to decide whether or not a transaction would be subject to the DRC mechanism (assuming it does not fall into one of the other types of transactions to which the DRC mechanism applies) and therefore does not render the definition completely obsolete.

For a transaction to be subject to the DRC mechanism, both parties must be GST registered, and agree in the contract that the transaction is subject to the DRC, and therefore that the purchaser will account for the output tax liability.

The DRC mechanism has just passed the discussion document/public consultation phase. As a result there is no guarantee that the regime will be introduced and what form it

would take if introduced. Our view is that the DRC regime is a positive change but should be less restrictive in terms of who can use it.

Want to know more?

If you would like more information on the proposed DRC mechanism and how it could affect your business, contact one of our experts.

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